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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

AND INTERNATIONAL FINANCE CORPORATION

COUNTRY PARTNERSHIP STRATEGY

FOR

THE ORIENTAL REPUBLIC OF URUGUAY

FOR THE PERIOD 2010-2015

August 18, 2010

Argentina, Paraguay and Uruguay
Country Management Unit
Latin America and the Caribbean Region

The last Country Assistance Strategy for Uruguay was discussed by the Executive Directors on June 9, 2005, (Report No. 31804-UY), and a Progress Report on the implementation of that Country Strategy was noted by the Executive Directors on April 1, 2008, (Report No. 42789-UY).

CURRENCY AND EQUIVALENT UNITS
(As of June 30, 2010)

Currency Unit = Uruguay Peso
US$1 = 21.12 Uruguay Pesos

WEIGHTS AND MEASURES
Metric System

FISCAL YEAR:

January 1 – December 31

IBRD		IFC	
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ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities
APL	Adaptable Program Loan
CAF	Andean Development Corporation (*Corporación Andina de Fomento*)
CAS	Country Assistance Strategy
CASCR	Country Assistance Strategy Completion Report
CBU	Central Bank of Uruguay (*Banco Central de Uruguay*)
CC	Climate Change
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
CPI	Consumer Price Index
CPS	Country Partnership Strategy
DINAMA	Dirección Nacional de Medio Ambiente
DPL	Development Policy Loan
EMBI	Emerging Markets Bond Index
ESW	Economic and Sector Work
FBS	Fee-Based Service
FDI	Foreign Direct Investment
FA	*Frente Amplio*
FMD	Foot & Mouth Disease
FX	Foreign Exchange
GAC	Government and Anticorruption
GCR	Global Competitiveness Report
GDP	Gross Domestic Product
GEF	Global Environmental Facility
GHG	Greenhouse Gas
GoU	Government of Uruguay
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IBTAL	Institutions Building Technical Assistance Loan
ICR	Implementation Completion and Results Report
IDF	Institutional Development Fund
IFC	International Finance Corporation
IFIs	International Financial Institutions
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LCR	Latin America and the Caribbean Region
MDGs	Millennium Development Goals
MEF	Ministry of Economy and Finance
MERCOSUR	*Mercado Común del Sur*
MGAP	Ministry of Livestock, Agriculture and Fisheries
MIC	Middle-Income Countries
MSP	Ministry of Public Health
M&E	Monitoring and Evaluation
NCD	Non-Communicable Diseases
NGOs	Non-Governmental Organizations
NLTA	Non-Lending Technical Assistance
OECD	Organization for Economic Co-operation and Development
OPP	Office of Planning and Budget
OSE	*Obras Sanitarias del Estado*
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PIU	Project Implementation Unit

ABBREVIATIONS AND ACRONYMS

PPIAF	Public-Private Infrastructure Advisory Facility
PPP	Public-Private Partnership
PRIDPL	Programmatic Reform Implementation Development Policy Loan
R&D	Research and Development
SINARE	National System for Registering Companies
SMEs	Small and Medium Enterprises
SWAp	Sector-Wide Approach
UNDAF	United Nations Development Assistance Framework
UNDP	United Nations Development Program
UNICEF	United Nations Children's Fund
UTE	National Administration of Power Plants and Electric Transmissions
WBG	World Bank Group
WHO	World Health Organization

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THE ORIENTAL REPUBLIC OF URUGUAY

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EXECUTIVE SUMMARY

Uruguay has a strong history of broad-based social welfare and solid democratic institutions building on a deeply ingrained preference for equality and political consensus. The country enjoyed the highest human development standards in the region during the last century, and Uruguay's society is still among the most equitable in the region in terms of income distribution and social indicators. Like many of its neighbors, recent decades were marked by successive domestic economic crises, the most recent accompanying the Argentina crisis of 2001-2002. In 2004, in the aftermath of the crisis, the Uruguayan electorate brought forth an important shift in the political landscape by voting into power a center left coalition (the *Frente Amplio* -FA).

Efforts to decrease the economy's vulnerability after the 2001-2002 crisis resulted in it proving more resilient to the recent global recession than many other emerging market economies. This was due to a generally solid macroeconomic framework, greater exchange rate flexibility, rising international reserves, and improvements in the banking system.

The first FA administration led by former President Vázquez successfully consolidated the restoration of macroeconomic stability, increased integration into international markets, and improved the investment climate. These efforts paid off with an unprecedented economic growth rate (6.6 percent on average from 2004 to 2008). The focus on promoting economic growth was accompanied by a desire to ensure that all Uruguayans shared in the country's success. Thus, expanding social protection programs, as well as health and education services, was central to the policies of the Vasquez Administration. These combined efforts resulted in poverty declining by nearly 35 percent; and extreme poverty by 50 percent, between 2003 and 2008, with unemployment falling from 16.9 to 7.9 percent.

The second FA Government took power in March 2010, and the new President, José Mujica, declared that he would consolidate the positive economic and social outcomes achieved by his predecessor. The new Government recognizes the importance for Uruguay to look beyond the region when setting its reform agenda for the next years. The country indeed has a unique opportunity to reach, in the medium term, living standards and quality of institutions that are comparable to those enjoyed by advanced economies.

The implementation of the 2005-2010 Country Assistance Strategy (CAS) was largely successful, and Bank-financed activities contributed significantly to the Government's development objectives, with Bank support structured in three pillars: (i) reducing vulnerability; (ii) sustaining growth; and (iii) improving living standards. This period witnessed a marked strengthening of the Bank's partnership with the Government of Uruguay (GoU). The Bank opened an office in Montevideo in 2005, which strengthened relations with the Government and facilitated successful CAS implementation. Further, the Bank was able to customize its financing innovatively in order to disburse a Development Policy Loan (DPL) in local currency. Finally, the Bank demonstrated an ability to shift the focus of its collaboration to areas in which the Government was prioritizing critical reforms and initiatives which required important knowledge transfer to move forward with innovative approaches.

This Country Partnership Strategy (CPS) aims to help Uruguay take the next steps in consolidating economic reforms, and enhancing social outcomes. It will build on the positive experience of the previous CAS period, when the Bank's financial assistance was significantly increased and the policy dialogue extended to a wide array of critical components of the country's development strategy. This positive experience entailed a flexible and responsive stance by the Bank characterized by nimble and effective responses to evolving needs. This enabled the Bank to expand its support to the Government into new areas – like promotion of innovation, public sector reform and health reform – and thus support emerging key government priorities.

The proposed CPS includes a Bank lending program of approximately US$700 million, together with an active International Finance Corporation (IFC) program and a strategic joint Government-Bank program of Analytical and Advisory Services (AAA), structured around the following four pillars: (i) Reducing Macroeconomic Vulnerability & Strengthening Public Sector Administration; (ii) Competitiveness & Infrastructure; (iii) Agriculture, Climate Change, and Environment; and (iv) Increasing Social Inclusion & Equity. Reflecting the lessons of the CAS Completion Report, the strategy will be flexible to accommodate the Government's potential need to adjust course in the event of unforeseen domestic or external developments, and it will buttress the administration's efforts to achieve consensus on its ambitious reform agenda. Indicative support for this strategy is proposed to include a series of two DPLs totaling US$200 million (late 2010 and late 2011), investment lending totaling approximately US$500 million, and a well-focused and demand-driven AAA program. The proposed strategy places a heightened emphasis on supporting Uruguay in accessing international expertise and best practices, as well as sharing its own experiences with other countries through South-South exchanges.

The proposed IFC activities in Uruguay for the CPS period complement the Bank's strategy by focusing on the following four main areas: (i) financial services, (ii) agribusiness, (iii) competiveness, and (iv) education. In the financial sector, IFC aims to support banks and non-banks that focus on the mid-market corporate and low-income retail banking segments. In agribusiness, the focus is likely to remain on export-oriented enterprises with deep linkages to small- and medium-sized farms. All three of IFC's active investment projects in Uruguay are in export-oriented agribusiness companies. The Corporation also aims to reinforce the country's competitiveness by financing infrastructure projects, especially those in the renewable energy, logistics, and water sectors once appropriate regulations are in place. Finally, IFC hopes to support private sector education institutions, particularly those that offer technical and vocational courses for low income students.

While Uruguay's resilience in the face of the recent global economic crisis demonstrates that it is much more strongly positioned than it was 10 years ago, significant risks remain. Despite declining as a source of risk since 2005, debt sustainability remains the main economic risk, followed dollarization and exposure to global and regional shocks. Political risk is low, though significant social risk arises from the tensions between pressure to expand government programs and the need for a prudent fiscal stance in order to further reduce macroeconomic vulnerabilities. Finally, natural disasters and climate change have already had a major impact on rural income, as well as important fiscal implications, in recent years.

I. INTRODUCTION

1. **Uruguay has a strong history of broad-based social welfare and solid democratic institutions building on a deeply ingrained preference for equality and political consensus, which is still very present today.** The country enjoyed the highest human development standards in the region during the last century. While the country has faced adverse developments in recent decades, these standards remain high, and Uruguay's society is still among the most equitable in the region in terms of income distribution and social indicators.

2. **This country of 3.3 million people has set its own distinct development path in a context of a deep economic inter-connection with its large neighbors, Brazil and Argentina.** In Uruguay, the state is widely recognized as trustworthy and effective in the delivery of public goods, and the society has explicitly voiced its preference for having the state play an active and expanded role in most public service sectors. This trust is a reflection of the country's tradition for consensus-based policies and of the strong performance of the public sector in ensuring nearly universal coverage and adequate quality and transparency in the provision of services.

3. **Uruguay's traditional development model combines a dynamic primary export base and a welfare state responsible for the distribution of economic benefits**. This model came under serious pressure in the latter part of the twentieth century, due to unfavorable commodity price developments and a weaker performance in public sector management. This triggered a gradual social and economic decline, leading to high unemployment rates and chronic fiscal and balance of payments imbalances, and compromised opportunities for economic expansion.

4. **In the early nineties, the country embarked on an economic turnaround based on economic opportunities offered by expanding links with regional partners, facilitated by economic integration through the *Mercado Común del Sur* (Mercosur) – and with all the benefits and vulnerabilities thus implied**. This strategy produced encouraging early results, with high growth rates, progress on economic diversification, and substantial poverty reduction. However, the increased reliance on regional economic relations made Uruguay's economy highly vulnerable to the performance of its neighbors, as was dramatically demonstrated when Argentina's severe political and economic crisis broke out in 2001. This had a devastating effect on all dimensions of Uruguay's economy and society. Unemployment and poverty rates rapidly increased to 20 percent and over 30 percent, respectively. Real wages plummeted as the Peso was devalued and the economy went into a deep recession. The Government faced a mounting fiscal deficit and an exploding external debt, placing the country on the verge of insolvency.

5. **Uruguay managed the crisis very well**, **without defaulting on its debt**. The Government rapidly put together a comprehensive recovery program based on respecting contracts and commitments, while mitigating the adverse social consequences of the crisis. In particular, the authorities refused to default on the debt, and worked hard to reach agreement with creditors on a debt restructuring plan consistent both with the repayment capability of the country and with the rules of the game. This recovery program enjoyed broad political and social consensus, and the authorities managed to mobilize the international community to help safeguard fiscal solvency and address structural issues that were critical for return to high growth levels. Eventually, as the economy recovered much faster than expected, Uruguay was able to repay the multilaterals' emergency loans well ahead of schedule.

6. **In 2004, in the aftermath of the crisis, the Uruguayan electorate brought forth an important shift in the political landscape by voting into power a center-left coalition (the *Frente Amplio* -FA)**. In a reflection of the stability of Uruguay's consensus-oriented democracy, the loss of the executive branch by the two parties that had dominated the political scene for 170 years did not generate significant disruptions in the post-crisis recovery agenda. The FA ensured remarkable institutional continuity while gradually consolidating a reform agenda around which it shaped an unprecedented political consensus.

7. **The first FA administration, led by former President Vázquez, successfully consolidated the restoration of macroeconomic stability and undertook determined efforts to increase Uruguay's integration into international markets and improve the investment climate**. These efforts paid off with unprecedented economic growth (6.6 percent on average from 2004 to 2008). Based on its conviction that sustained and broad-based economic growth require policies that go beyond stable macroeconomic conditions, the Vázquez administration took a proactive stance on promoting innovation, infrastructure development and institutional reforms for increased competition and conducive conditions for private sector development.

8. **Pairing these efforts in promoting economic growth with expanding social protection programs, as well as health and education services was central to the policies of the Vázquez Administration**. The Government focused on promoting universal access to key benefits and services by vulnerable groups. This included the expansion of the family allowance program, the introduction of a pioneering program to provide every primary school student a personal computer (*Plan Ceibal*), and the launch of a major health reform aimed at gradually increasing coverage to ultimately reach the totality of the population. These combined efforts in the economic and social fronts generated positive outcomes that went beyond recovering ground lost in the 2002 crisis. Between 2003 and 2008, poverty declined by nearly 35 percent; and extreme poverty, by 50 percent. Unemployment fell from 16.9 to 7.9 percent.

9. **The second FA Government took office in March 2010, with President José Mujica promising to continue the sound policies implemented in recent years, with a view toward consolidating the positive economic and social outcomes**. He committed his administration to further increase the effectiveness of public policies – such as further expanding social sector programs with an increased emphasis on enhancing their impact. The new Government has committed itself to studying global best practices in setting its reform agenda for the coming years. In the medium-term, the country has a unique opportunity to achieve living standards and quality of institutions comparable to those enjoyed by advanced economies.

10. **This proposed Country Partnership Strategy (CPS) covers the years 2010-15 and is aligned with the country's development vision**. It proposes a Bank lending program of approximately US$700 million, together with an active International Finance Corporation (IFC) program and a strategic joint Government-Bank program of Analytical and Advisory Services (AAA). The CPS will provide for flexibility to enable the program to respond to emerging needs. Rather than providing a detailed blueprint of the terms and scope of the partnership between the Government and Bank, the CPS aims at laying out the guiding principles for shaping this partnership. While it specifies the programs identified for the initial years of the partnership, sufficient flexibility is built into the CPS to allow for responding to evolving government priorities and needs.

II. COUNTRY CONTEXT

A. Political Developments

11. **With the election of Mr. José Mujica by an ample margin and the FA's concurrent achievement of a majority in both houses of Parliament, the Uruguayan electorate has endorsed the policy framework inaugurated in 2005**. There seems to be a growing consensus in the country that, after overcoming the challenges resulting from the 2002-03 crisis, the country now needs to develop a broad national consensus on a development agenda that will put the country on a path of sustained growth and high standards of human development.

12. **President Mujica has consistently expressed the need to articulate "state policies" that will stand above the day-to-day political debate**. From his first days in office he has reached out to opposition parties in seeking consensus in critical areas such as education, infrastructure, environment, security and public sector reform. In successful intra-party negotiations, Mr. Mujica approved having non-members of the ruling coalition invited to the board of directors of some of the government-controlled institutions and corporations, a strong departure from past political practices. He is currently benefitting from strong approval ratings, leaving him well-positioned to pursue his political initiatives and legislative agenda. Maintaining this support will depend on his capacity to translate the populace's strong expectations into a concrete development agenda that will effectively improve living conditions.

13. **In its first months, the Government announced a number of important new reform initiatives**, most notably a renewed commitment to customs reform, the introduction of a *public-private partnership framework for investment in the infrastructure sector* and, further consolidation of social protection transfer programs. It also managed to complete some reform efforts initiated under its predecessor government, such as the May 2010, launch of the *Empresa en el Día* initiative, a one-stop-shop for firm creation which constitutes a significant improvement in Uruguay's business environment. The Government also changed the presentation of its budget from an administrative to a program-based format, which will enable preparing the new 5-year budget in way that better reflects policy objectives.

B. Economic Performance

14. **Efforts to decrease the Uruguayan economy's vulnerability after its 2001-2002 crisis resulted in it proving more resilient to the recent global recession than most other emerging market economies.** This reflects a generally solid macroeconomic framework, greater exchange rate flexibility, rising international reserves, improvements in the banking system, and an improved investment climate that lessened the impact of the crisis and positioned the country well to benefit from a recovery.

15. **Prior to the global recession, Uruguay had enjoyed several years of impressive economic performance.** Real GDP growth averaged 6.6 percent from 2004 through 2008 and largely resulted from a rebound in both domestic demand and exports. Growth reached 8.5 percent in 2008, the highest level in the last 20 years, despite a slowdown in the last quarter of the year due to the crisis. International trade expanded significantly, though Uruguay's trade structure remains highly concentrated, both by product and geography. Export growth averaged

13 percent per year in 2004-2008. Unemployment declined to its lowest level in over a decade, falling from 13.1 percent in 2004 to 7.3 percent in 2009. Although economic activity slowed with the crisis and the economy contracted in the first quarter of 2009 (-2.9 percent), growth resumed in the second quarter and reached 2.9 percent for the year. Current projections anticipate an increase to 5.5 percent in 2010, and -- in subsequent years -- revert back to long-run growth of 4 percent. Annexes C and D contain more detail on the economic context and debt sustainability, respectively.

16. **Public debt management has achieved considerable success in terms of reducing debt and improving its composition.** Gross public debt declined from 79.3 percent of GDP in 2005 to 60 percent in 2009. With the increase in foreign reserves, net public debt declined about 20 percentage points of GDP over the same period.[1] In terms of debt composition, 78.9 percent of total public debt is held by private creditors, compared to 55.7 percent by end-2004, reflecting restored access to market financing. The foreign currency share of total public non-financial sector debt fell from 76.6 percent in 2004 to 56.7 percent by December 31, 2009. Debt sustainability continues to pose a risk, albeit one that has been greatly reduced. Medium-term government borrowing requirements are manageable, despite a concentration of maturities in 2011[2]. A conservative estimate of the gross borrowing requirements for 2011 amounts to US$2.9 billion or 6.5 percent of GDP. With less than a third of this amount expected from International Financial Institutions (IFIs) (see Section IV), Uruguay will likely need to seek substantial additional funding from capital markets.

17. **The banking system consolidation process that occurred in the aftermath of the 2002 crisis and proactive Central Bank intervention and supervision have contributed to greater financial system stability**. Since the outbreak of the international financial crisis, the financial system has managed to navigate the storm without major difficulties. Prudential requirements have been improved and banking regulation and supervision has been strengthened. The accumulation of foreign reserves by the central bank contributed further to the confidence in Uruguay's currency, which has been floating since mid-2002.

18. **Despite a significant decrease over recent years, the degree of dollarization remains high.** Since the 2002 crisis the level of dollarization in the financial system has fallen from 83 percent to 55 percent for credits, and from 92 percent to 77 percent for deposits. However, it remains high, implying a substantial exposure of the banking sector to foreign currency risk from corporate balance sheet mismatches.

C. Poverty

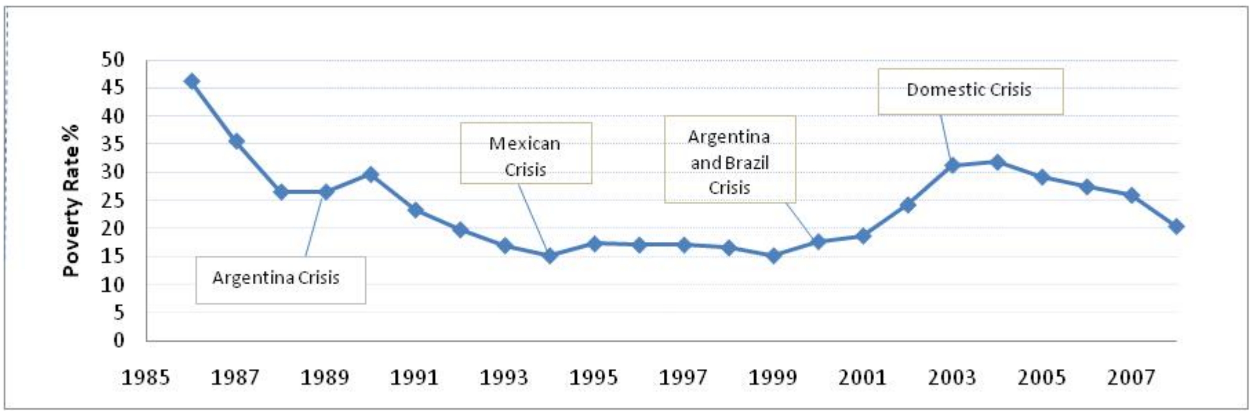
19. **Uruguay's long-standing focus on social equity makes advances in the reduction of poverty and inequality a central policy priority**. However, successive economic crises at the end of the last century weakened the social model, and today poverty, extreme poverty and inequality levels remain relatively high despite recent improvements. Exacerbated by the 2001-2002 crisis, both poverty and extreme poverty began a downward trend in 2004, and in 2008 both neared the lows of the previous decade (20.9 percent for poverty, 1.5 percent for extreme

[1] Public debt-to-GPD ratio is calculated using end-of-the-period exchange rate
[2] A large share of the maturities are owed to local markets and are denominated in indexed local currency units

poverty). Uruguay has not suffered the degree of impact experienced by some of its neighbors – that of having a longer-term trend of increasing poverty as a result of successive crises.

20. **Improvements in equality were more modest.** The Gini coefficient declined from its highest level of 0.44 in 2004 to 0.42 in 2008, a slight improvement from its pre-crisis level (0.43 in 2000). Uruguay ranks high among Latin American and Caribbean Region (LCR) countries in the provision of basic opportunities for children according to an equality of opportunity principle across five very basic goods and services for which there were comparable data across countries circa 1998 and 2008 (access to water, sanitation, electricity, completing sixth grade on time, and school attendance for children 10-14). As detailed later, implementation of the National Plan for Social Equity, as well as health and education reforms, is hoped to further improve equity in these areas.

Figure 1: Long Term Poverty Trends in Uruguay



III. DEVELOPMENT CHALLENGES & GOVERNMENT'S VISION

21. **In its first months in office, the Government has conducted intensive internal and external consultations for defining its longer-term government program.** This consultative process centered on the preparation of a new five-year budget, which will cover the period up to the end of the Government's mandate (2010-2015), and is expected to be presented to parliament at the end of August 2010. In parallel, the authorities are preparing partnership programs with their main development partners, most of which coincide with the five-year budget period.

22. **While no formal Government program has been issued, the authorities have laid out at different occasions their policy priorities.** These priorities, which are still in process of being fine tuned and translated into concrete legal and policy initiatives, are as follows:

- The authorities have committed to adhere to the prudent fiscal and economic policies of the last administration and continue expanding coverage of social program and basic services.
- They have identified the following key priorities to deepen reform achievements: (i) strengthening competitiveness through increased coverage and better quality of infrastructure and a more conducive business environment; (ii) expanding and improving the impact of social service delivery, with an emphasis on education; iii) enhancing productivity and

income and job generation in the agriculture and food sector; (iv) protecting the environment and mitigating and adapting to the effects of climate change; and v) improving security of citizens.

- They expressed a keen interest in getting more value for money in public programs; and the Government has launched a number of important cross-cutting reform initiatives. Most notable in this regard are the introduction of a policy framework for public-private partnerships in infrastructure investments, and a renewed effort on public sector reform.

23. **The proposed CPS has been designed to support implementation of this agenda**. In intensive consultations with authorities, strong expectations emerged towards Bank support in facilitating transfer of knowledge and experience in specific reform areas. As the country enters this new development phase, there will be a need for flexibility and innovation in the definition of the specific lending and non-lending support from the Bank.

A. Strengthening the Business Climate and Competitiveness

24. **As Uruguay's macroeconomic growth recovered, the authorities recognized the importance of improving the environment for private sector development for embarking on a sustained path of high growth**. In particular, they have stressed the need to upgrade infrastructure services -- critical for both enhancing economic productivity and meeting social policy objectives. The authorities have also stated their intent to improve other aspects of the business environment and investment climate, such as regulation, tax policy, licensing and other procedures.[3] The Government hopes to build on substantial progress already made, including the effective implementation of a new Bankruptcy Law in 2008 which eases the process and reduces the costs of closing a business, and the introduction of a one-stop-shop for firm creation in May 2010 that simplified procedures for starting a business. In this context, the new Administration has made enhancing the facilitation of logistics one of the top priorities of its reform agenda. Finally, there is a strong emphasis on supporting the deepening and extension of capital markets, so as to enhance access to finance by private sector firms.

25. **Coverage and quality of infrastructure services in Uruguay is high compared to the region and other middle income countries (MICs); however, to maintain these standards, further improve efficiency and quality, and extend coverage, there is a need for more investment, better regulation and enhanced corporate governance**. Uruguay has achieved an impressive degree of access to basic infrastructure (Table 1), and good overall quality and coverage of its infrastructure. However, one weak link is the railway system, with nearly half of the 3,000 km national rail network abandoned and cargo volumes on the remainder that are a fraction of regional standards. The railway system, as in many other countries, has suffered over the last thirty years due to competition from road freight transport and lack of investment, as well as several flawed reform attempts which further delayed key investments. The non-functioning rail system threatens to lead to rapid degradation of the road network (especially given increasing transport of heavy forestry products) and hence high maintenance and rehabilitation costs.

[3] According to the *Global Competitiveness Report 2009-2010*, the five most problematic factors for doing business are 1) restrictive labor regulations, 2) inefficient government bureaucracy, 3) tax rates, 4) access to financing, and 5) inadequate supply of infrastructure.

26. **Growing energy challenges are also unfolding as domestic demand is expanding rapidly**. The Government's energy sector strategy includes: (i) diversifying energy sources to reduce costs and emissions, as well as increase energy security; (ii) increasing private participation in new renewable power generation; (iii) increasing regional energy trade; and (vi) facilitating availability and acquisition of energy efficient goods and services, including efforts to raise public awareness regarding demand side management interventions. Despite efforts to increase energy efficiency, demand has increased by over 4 percent per year since 2002. In addition, there have been repeated instances of drought (2006 and 2008 in particular), insufficient thermal back-up capacity, and difficulties in importing electricity from neighboring countries. This has led to high supply costs and fiscal pressure as the Government sought to avoid passing on cost increases to end users. Supply challenges are compounded by weaknesses in several sections of the transmission and distribution network. The Government recognizes these challenges and has reaffirmed its commitment to (i) establishing a new 500 MW interconnection with Brazil and upgrading the existing transmission and distribution systems; (ii) increasing energy efficiency; and (iii) creating a larger role for non-traditional renewable energies (wind, biomass and small-scale hydro in particular) in Uruguay's energy matrix.

Table 1: Access to Public Services[4]

Country	Percent of population with sewerage service (2006)	Percent of population with in-house access to potable water (2006)	Electricity (percent of population with access in 2009)	Fixed telephone lines per 100 people (2008)	Mobile telephone subscribers per 100 people (2008)	Internet users per 100 people (2008)	Road density (km per 100 km2 in 2009)	GDP per capita, PPP, in 2008
Argentina	44	79	95	24	117	28	15	14,333
Brazil	45	79	97	21	78	35	21	10,296
Chile	78	91	99	21	88	33	11	14,465
Colombia	74	86	87	15	89	37	n/a	8,885
Mexico	64	90	97	19	70	22	18	14,495
Uruguay	53	98	100	29	105	40	34	12,734

27. **The Government of Uruguay (GoU) has set a target of combined public and private investment of 3-5 percent of GDP for the infrastructure sector**, up from less than 2 percent for public investment over the past years. It was thereby clearly stated that given the limited fiscal space available, this would require mobilizing significant levels of additional resources for infrastructure investments outside the budget. In particular, there is a need to promote private sector investment in infrastructure, which is currently very low in regional comparison. The Global Competitiveness Report (GCR) 2009-2010 for Latin America and the Caribbean identified Uruguay as the most dynamic country during 2009, with significant progress achieved in infrastructure, macroeconomic stability, higher education and training and technological readiness.

28. **Given the need for increased private investment, the Government is exploring new forms of public-private partnerships (PPP) and is preparing a new PPP framework law.** PPP opportunities are being explored in areas such as freight rail transport, additional port terminals and access channel dredging, as well as in social sector infrastructure provision.

29. **The new Government has shown a strong commitment to complete the business environment reform agenda initiated by its predecessor**. This far-reaching reform program

[4] Data from *World Development Report (2009), WHO/UNICEF Joint Monitoring Program 2006* and International Telecommunication Union data, 2008.

(National System for Registering Companies, *SINARE*) was initiated several months ago to streamline and centralize all public procedures related to the life cycle of a private company and create a single registry for businesses. The official launch in May 2010 of the initiative, *Empresa en el Día*, a key dimension of this reform program, was one of the first reform breakthroughs accomplished by the new Government. It established a web-based, one-stop-shop for firm creation that significantly reduces the number of steps, time and costs to start a business.[5]

30. **The Government has recognized the logistics sector as a promising source of growth in itself as well as an important dimension of the country's competitiveness**. Over the last two decades, due to its central location, efficient port services and modern financial system, Uruguay has emerged as a regional hub for services and logistics. In 2008, exports of services in this sector have reached US$1 billion. To further exploit this potential, the new Government has highlighted the importance of reviving the comprehensive customs reform, which has made only limited progress during the last administration, and indicated a shift in emphasis of the reform to enhancing the trade facilitation function of customs and moving to a risk-based control system.

31. **Access to financing by Uruguayan firms is also a key constraint to private sector development**, and increasing the sophistication, transparency and stability of the Uruguayan financial market is a key Government objective.[6] Pension funds have accumulated sizeable assets, yet these are largely channeled to investments in government securities. The authorities have taken important steps in recent years to strengthen local financial and capital markets, such as the adoption of a new capital market legal and regulatory framework in 2009, the 2008 bankruptcy law, the 2009 law on payments system and securities settlement, and the 2008 establishment of a deposit insurance institution. The challenge ahead now is to build capacity and promote market development to facilitate access to financing for the private sector.

B. Improving Social Inclusion & Equity

32. **The Government is committed to consolidating the progress achieved on social protection and to further improving public health care and education outcomes, with a special emphasis on providing for the basic needs those living in extreme poverty and further enhancing social inclusion.** In 2000, the Government introduced family allowances for poor families and has modified the program in the years since to expand coverage, increase benefits and provide an incentive structure for secondary school students. By 2009, over 500,000 children were receiving benefits from the expanded program. These efforts effectively included the poorest households into the social protection system—the percentage of households in the poorest quintile not receiving any income transfer declined from 50 percent in 2003 to about 20 percent three years later, and more than 85 percent of children living in poverty reside in households that received family transfers in 2008.

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[5] Uruguay ranks 114 of 183 countries in the 2010 *Doing Business* Report, and 132 in the "starting a business" category.

[6] The World Bank *Investment Climate Survey* (2008) indicates that, on average, enterprises' retained earnings account for 82% of fixed assets and 73% of working capital financing, respectively. The report highlights the low use of bank credit by Uruguayan firms -- it accounts for only 6% of working capital and even less of asset financing.

33. **The GoU has committed to continue social protection initiatives while seeking to increase their impact,** placing special emphasis on non-contributive schemes. The authorities have declared their intention to reach the remaining non-covered families and enhancing the effectiveness of the family allowances system. They consider the following to be the principal challenges in this regard: (i) to better identify and incorporate potential beneficiaries not yet covered; (ii) to more effectively use the transfer programs to advance social policy objectives, such as by identifying adolescents at risk and providing incentives for them to complete secondary education; and (iii) to improving the capacity for monitoring and evaluation of transfer programs, such as by institutionalizing and broadening the scope the centralized beneficiaries registry (*Sistema de Informacion Integrada para el Area Social*).

34. **President Mujica has also highlighted the limited decent housing opportunities for low-income families as a critical social challenge**. In response the Government has launched a housing initiative (*Plan Juntos*) to expand such opportunities by facilitating access to housing finance and promoting self-help initiatives for housing construction and rehabilitation.

35. **Education is a strategic priority as part of the GoU's objectives of raising living standards and better integrating into the world economy.** Uruguay has been implementing reforms in recent years to improve the equity and quality of the education system. Uruguay has achieved universal access to early education for 5-year olds, universal primary education (grades 1-6) and early secondary. However, these enrollment rates hide important differences in the quality of education among students of different socio-economic backgrounds. At the secondary level, there remain challenges in terms of coverage --net enrollment rates for the lowest quintile of the student population is 37 percentage points below that for the highest quintile. In addition to the gaps in coverage at the secondary level, a key challenge for Uruguay is to address the learning deficits of its students, particularly in terms of cognitive abilities.[7] Bank support to the sector has been focused on the expansion of the full-time school program, the main initiative of the Government for improving the quality of education for lower-income primary students. Thus, they propose to continue expanding early childhood education and full time schools, and enhancing the educational impact of *Plan Ceibal* (Box 1) at the pre-school and primary school levels. With regard to education quality at the secondary level, the Government will focus on strengthening technical education and its linkage to labor market demands, and expanding the *Plan Ceibal* to secondary school students.

36. **A comprehensive health sector reform program was approved by Parliament in 2007 – the completion and implementation of these reforms is an important legacy of the previous administration**. While it remains among the top-ranked LCR countries on health indicators, Uruguay's relative position has slipped in recent years.[8] Fifty-two percent of urban Uruguayans report having contributory health insurance, and 97 percent report having either some type of insurance or a regular source of care. The prevalence of infectious diseases is low; importantly, Uruguay has experienced a transition in its demographic structure over the last decades, and its epidemiological profile has changed to one of a high prevalence of Non-Communicable Diseases (NCD). The ambitious reform program aims to provide universal

[7] In the 2006 Program for International Student Assessment (PISA) in language, mathematics and science for 15 year-old students, Uruguay outperformed other LCR countries (excl. Chile), but was below the OECD countries

[8] In Uruguay today, life expectancy at birth is 75 years, the infant mortality rate is 10.5 per 1,000 live births, and 99 percent of births are delivered in a hospital or clinic.

health insurance coverage and to shift the prevailing heath care model from high cost treatment of acute illnesses to preventive care for NCDs. As nine percent of GDP is devoted to the health sector, a key concern for the new administration is to contain the increasing cost of the health system while putting available resources to more efficient use.

37. **These reforms enjoy a high level of positive social acceptance, and to date insurance coverage has been expanded to reach an additional 300,000 inhabitants, mainly children of poor households.** The reforms range from regulation and policy stewardship to health promotion and the improvement of health care, and from effective prevention policies to epidemiological surveillance and monitoring.

Box 1: Uruguay's *PLAN CEIBAL* – One Laptop per Child

Created by Presidential decree in April 2007, *Plan Ceibal* provides all students and teachers in public primary schools with a laptop computer and internet connectivity through the schools free of charge. The main objective was to reduce the digital gap, not only with respect to other countries but also within the Uruguayan society to foster equitable access to education, information and culture. The Plan is based in three pillars: (i) equity of access to computers, (ii) learning, and (iii) connectivity. The combination of these elements is intended to promote equal opportunities; enhance the development of new tools for learning and teaching; and encourage new relationships in an interconnected society. Policies and strategy for the program are decided, in close collaboration with the Education Committee, by a dedicated committee comprised of representatives of relevant government agencies. The Technological Laboratory of Uruguay (LATU) is in charge of the implementation of the program.

This Plan was accompanied with connectivity infrastructure to primary schools (80 percent of schools now have at least one access point, covering 95 percent of public primary school students). Equally impressive is the focus on the non-equipment aspects of the program. These are covered in detail on the Plan's webpage (www.ceibal.edu.uy), which includes educational materials for teachers and students and the Ceibal Channel, which connects classrooms to a TV studio that showcases student-teacher interaction across the country to facilitate peer learning for teachers. There is also a virtual Campus Ceibal where teachers can access training on didactic topics and take virtual classes. Finally, the Plan includes an online formative evaluation mechanism that enables simultaneous evaluations with immediate feedback on student results.

By 2009 all 380,000 students and teachers in public primary schools had received their computers. The Plan initially faced resistance from teachers. However, there are recent indicators that this resistance has been reduced and that the Plan is now widely accepted. The teachers received training and machines before the deployment to students. Students bring the laptops to class and use the machine during classes; parents are requesting to be e-trained; and in many localities the schools have become the center of the community activities. The Plan generated an interesting interaction between teachers, children and parents with plenty of potential for student learning; however, there has not yet been an evaluation of the Plan's impact on student learning or household welfare. Such studies are now underway, and the Bank has been asked to support the development of an evaluation of the preliminary educational and other social welfare impacts.

GoU aims to expand the Plan as follows: (i) complement connectivity with digital training for education personnel; (ii) gradual expansion to public secondary schools; and (iii) using connectivity to increase the scope and quality of other social services (e.g. remote medical consultations and nutrition checks).

38. **Uruguay's societal orientation toward inclusion and equity is reflected in a largely positive picture on gender issues**. Education standards are among the highest in the region.

Female participation in labor markets is high: the ratio of female to male labor force participation (0.75) is higher than the average for upper middle income countries (0.69) and the LCR countries (0.66) for year 2008. In Uruguay 82.5 percent of women are employed by the services sector, exceeding the norm for upper MICs (71.7 percent) and for the LCR region (74.6 percent). Women occupy 12.1 percent of seats in the parliament (2008), below the average for both upper middle income countries (19 percent) and the region (22 percent). In the context of an otherwise positive reproductive health context – with 99.3 percent of all births being attended by skilled health staff and a contraceptive rate above the norm for upper MICs – Uruguay's adolescent fertility rate is an outlier. While it has shown a steady decline from 66.9 births per 1,000 women ages 15-19 in 1998, it is still higher (at 60.9 in 2008) than the average for upper middle income countries (51.5), but lower than the average for LCR countries (72.2).

39. **The Government has recently focused even more attention on gender equity**. In its economic dimension, this would mean to increase female labor force participation in non-traditional sectors, reduce the high concentration of women in informal and domestic jobs, and decrease gender wage gaps. In its social dimension, key challenges are recognized as the reduction of gender-based violence and prevention of adolescent pregnancies.

C. Consolidating Agricultural Sector Growth and Bringing its Benefits to Family Farms

40. **The new Administration has stressed the important potential of the agricultural and food sector**, as a source for growth, in general, and for increasing income and job opportunities in rural areas. This sector continues to be an important and dynamic part of the national economy, having grown at almost twice the rate of the overall national economy since 2001 and now representing almost 10 percent of total GDP[9].

41. **The Government has recognized as a particular challenge the fact that family farms are lagging behind the productivity and prosperity gains associated with large-scale farming**. These family farms are much more limited in exploiting opportunities offered by markets and remain strongly exposed to external price or climate shocks[10]. For President Mujica, reversing this trend is critical to retaining more of Uruguay's younger population in rural areas, as there has been a trend of young people moving away from family farming.

42. **There is a keen interest in developing a modern and well targeted agricultural and rural development policy**. President Mujica used the term *agro-inteligencia* to describe his vision on this. Such a policy aims at consolidating the integrated approach practiced in recent years, which promoted sustainable use of natural resources while fostering comparative advantages of the agricultural and food sector. For example, Uruguay distinguished itself as a reliable exporter of beef to standard-sensitive markets and as the only country in the region to achieve 100% traceability of cattle. Such policies are critical for remaining highly responsive to increasingly rigorous international food safety and quality standards and thereby maintaining

[9] Agriculture and forestry account for 12% of national employment, given the prevalence of labor-intensive SMEs.
[10] There are about 19,400 larger and medium-sized farmers (~715 ha in size on average) that farm about 85 percent of Uruguay's land. Production in these farms is strong linked to export markets and has proven relatively resilient to shocks (i.e. drought, input prices, market fluctuations). The about 32,700 family farms (~77 ha in size on average) have been less capable of seizing market opportunities and have been more strongly exposed to these shocks.

competitiveness. In this context, the Government is interested in expanding the innovative tracking system, which now enables tracking all cattle in the country, to other livestock.

D. Protecting the Environment and Mitigating the Effects of Climate Change

43. **The new Administration has expressed its commitment to further strengthening natural resource management and sustainable use of soil and water at the farm level, as well as mainstreaming biodiversity conservation in production**. This is in response to rising concerns on environmental degradation caused by expansion of agriculture and intensification of livestock production. More sustainable production is also necessary to protect the country's reputation as a "green" producer *(Uruguay Natural*), a feature valued highly by trading partners.

44. **In addition, Uruguay has recently set clear targets on Climate Change and Pollution Management issues.** Uruguay has been seriously affected by climate change, most notably through a higher climate variability observed in recent years.[11] Repeated and severe inundations and droughts have had a strong negative impact on rural livelihoods and production. Thus, in 2010, GoU prepared and launched a *National Response to Climate Change Plan* that includes strategic guidelines on climate change adaptation and mitigation. Regarding cleaner production in the industry sector, the GoU has also presented a *National Action Plan on Production and Sustainable Consumption*. This plan seeks to identify, coordinate, integrate and potentiate a set of actions, programs and projects targeted to prevent and minimize environmental impacts from production and consumption. Both plans offer partnership opportunities to identify and prepare projects not only with IBRD resources but also with trust funds.

45. **The Government is keen to reduce Uruguay's net emissions of green house gases (GHGs), which to a large extent is the result of emissions caused by agriculture and livestock production.** Through the new strategy, the Government intends to put in place an integrated approach to mitigation and adaptation.

46. **There is also a great need to improve environmental compliance in Uruguay's industrial sector.** The GoU recently launched a Sustainable Industrial Development program to help small and medium enterprises improve compliance with environmental regulations through investments in cleaner production processes. As in many other countries, Small and Micro Enterprises (SMEs) in Uruguay are typically more polluting than larger companies as they lack resources, knowledge or incentives to adopt newer, cleaner technologies.

47. **Water resources management in the context of a changing climate is a clear challenge in Uruguay.** This is a key issue in that this resource is affected by climate variability and change, and it relates to hydropower generation (hence impact on energy for industrial and other activities). The country has a new water law which promotes the creation of a water council (in the *Dirección Nacional de Medio Ambiente* - DINAMA) and promotes integrated water resources management and basin planning. Since the end of the last century, rainfall in Uruguay has shown an increase, together with temperature and sea level. Current projections confirm this increasing tendency. Finally, the occurrence and severity of floods has been increasing, with large events occurring annually.

[11] Climate change models for Uruguay point to a moderate increase in temperatures combined with greater volumes, intensity and variability of rainfall over the next several decades.

E. Reforming the Public Sector

48. **In his inauguration speech, President Mujica announced that his Government would undertake a far-reaching public sector reform** (*Reforma del Estado*). Compared to other LAC countries, Uruguay ranks reasonably well in governance and transparency indicators. [12] However, there are several aspects in which its public sector management system still lags behind standards of practice in countries in similar stages of development. The new Government has advanced swiftly on several ongoing reform processes in the public sector, such as deepening the e-government agenda, strengthening tax administration, and improving targeting and effectiveness of social protection programs. At the same time, consultations are beginning on how best to tackle those reform aspects that have not yet progressed, such as enhancing customs administration, modernizing public procurement to improve quality and reduce costs while strengthening transparency and competition[13]; and improving the national statistical system.

49. **The exact scope, content, focus and sequence of public sector reform under the new administration is yet to be laid out in detail.** There was an initial announcement that this reform will contain four pillars: human resource management, administrative restructuring, improved management of public resources and enhanced use of technology in public sector management. Two key objectives have clearly emerged:

- As improving quality and impact of public spending is at the heart of the Government's priorities, there is a strong emphasis on enhancing capacity on budget formulation and evaluation of results of public programs and budgetary spending. For the new 5-year budget, the Government has moved from an administrative to a program-based budget presentation, which sets the basis for linking output indicators to budgetary allocations. This should facilitate evaluation of public programs and allow for better informed budget decisions.
- The Government recently tabled for discussion sweeping changes to the civil service legislation designed to professionalize and streamline the civil service by harmonizing civil service careers across different government units, simplifying and unifying the process of attaining positions, clarifying labor relations between civil servants and the State, and modifying the legal status of public servants and political appointees.[14] Preliminary reactions indicate that the political opposition is in favor of the announced changes, but the public sector unions are strongly opposed.

IV. URUGUAY – WORLD BANK PARTNERSHIP

A. Performance under the 2005-2010 Country Assistance Strategy (CAS, Report No. 31804-UY) and Evolution of the Partnership

[12] Chile and Uruguay tied as top-ranking Latin-American countries in Transparency International's *2009 Corruption Perceptions Index* (25th out of 180 countries).

[13] Uruguay is unique in the Latin American and Caribbean region for its absence of an agency responsible for public sector procurement that can issue executive norms, promote automation, monitor efficiency, train public officials in charge of procurement, oversee compliance, handle disputes and, in general, act as the lead government agency.

[14] Proposals are detailed in *Los Ejes e Instrumentos de Fortalecimiento Institucional del Estado* discussed and approved at the *Consejo de Ministros* on July 16, 2010.

50. **The Vázquez Administration ended up forming a close and productive partnership with the Bank in a number of key areas.** The preparation of 2005-2010 CAS through extensive consultations and in response to demands from the authorities laid the ground for this partnership. There were several other key factors that helped strengthen relations between the Bank and the Government and facilitated successful CAS implementation. First, the opening of a Bank office in Montevideo in 2005 enabled a more swift and effective response to local needs and a more effective engagement with the main segments of Uruguay's society. Second, the Bank was able to customize its financing to specific needs of the Government—the disbursement of a Development Policy Loan (DPL) in local currency stood out in this regard, as described below. Third, the Bank showed flexibility in adapting its lending and non-lending program to align it with the Government's emerging prioritization of critical reforms and initiatives, and provided timely and effective knowledge transfer in this regard.

51. **This positive evolution of the relationship in recent years provides a great opportunity for the World Bank Group (WBG) to contribute to Uruguay's ambition to take the country to the next level of development.** It will thereby be critical to continue to respond timely and effectively to the country's needs. The new Government's keen interest in further enhancing its partnership with the Bank has emerged consistently during CPS consultation process (Box 2).

Box 2: Country Partnership Strategy Consultations

The consultations on the CPS (as summarized in Annex I) commenced in February 2010, before the inauguration of the new administration, when discussions were held on a set of Policy Notes between the Bank and the newly elected authorities. These discussions were followed by presentations to the main opposition parties. These discussions were attended throughout by the President-elect, Mr. José Mujica, the elected Vice-president, Mr. Danilo Astori, and future cabinet members. These interactions were appreciated both by the Government and the opposition, and enabled the Bank to gauge the relatively high degree of consensus that exists today in Uruguay on the policy agenda and development challenges. A consultation on the CPS with broad stakeholder participation was held in August, and the Government is leveraging the opportunity provided by CPS preparation to plan an extended series of stakeholder consultations that will not end with the finalization of the CPS but rather continue into implementation.

In April 2010, the dialog on the main priorities for the collaboration between the Bank and Uruguay over the next five years was deepened. The Bank Vice President met with President Mujica, Vice-president Astori, the economic and social cabinet, as well as with representatives from the legislative branches, private sector and civil society. These discussions generally confirmed as valid the proposed orientations of the DPL and, more generally, the forthcoming Country Partnership Strategy. In May 2010, consultations on the DPL, specifically, and the framework of the strategy, more generally, were held. Another round of more detailed discussions on the results matrix and the program under the CPS was held July 1, 2010.

Finally, systematic stakeholder consultations were kicked off in early August, 2010, and will continue through the first year of CPS implementation. Given the multi-sectoral objectives of both the CPS and the Government's own development strategy, this series of consultations is generally organized around the following themes rather than individual ministries or sectors: (i) Modernization of the Public Sector; (ii) Strengthening Competitiveness and the Business Climate; (iii) Strengthening the Infrastructure Sector; (iv) Environmental Protection and Climate Change Adaptation; and (v) Social Protection and Equity. The outcome of the consultations is summarized in Annex I.

52. **The 2005-2010 CAS was structured around the following pillars: (i) reducing vulnerability; (ii) sustaining growth; and (iii) improving living standards.** The March 2007 CAS Progress Report (Report No. 42789-UY) confirmed the general thrust of the 2005 CAS and concluded that the Bank program had achieved substantial success over the previous two years. A central focus of the assistance was provided through a programmatic series of DPLs supporting the consolidation of macroeconomic reforms and the advancement of critical structural reforms. This was complemented by a comprehensive renovation of the investment project portfolio from 2005-2007. This resulted in gradual yet marked shift in the investment lending portfolio towards the support of more complex and reform-oriented operations, in areas like tax reform, financial sector and capital market development, health and education, innovation, infrastructure and public services, natural resources management and state modernization.

53. **The attached CAS Completion Report (CASCR) concludes that the 2005 CAS was broadly successful in meeting its targets.** For example, the following achievements illustrate how the Bank was able to respond in timely fashion to specific demands from the country:

- The First Programmatic Reform Implementation Development Policy Loan, approved in May 2007 and disbursed in local currency, marked the first time the World Bank issued a local currency bond for the purpose of a back-to-back disbursement of a specific loan. It was also innovative in that the Bank became the first foreign issuer to launch a public bond in Uruguayan pesos, lowering the cost of financing and increasing diversification of public debt and pension funds' portfolios.

- In agriculture, the Bank was instrumental in supporting GoU efforts to eradicate foot-and-mouth disease and to introduce individual traceability of cattle. This led to a major breakthrough in the prevention of animal diseases, and significantly enhanced Uruguay's image as a regional leader and reliable exporter of beef products to standard-sensitive markets. Uruguay is the only country in the region to achieve 100% traceability of cattle.

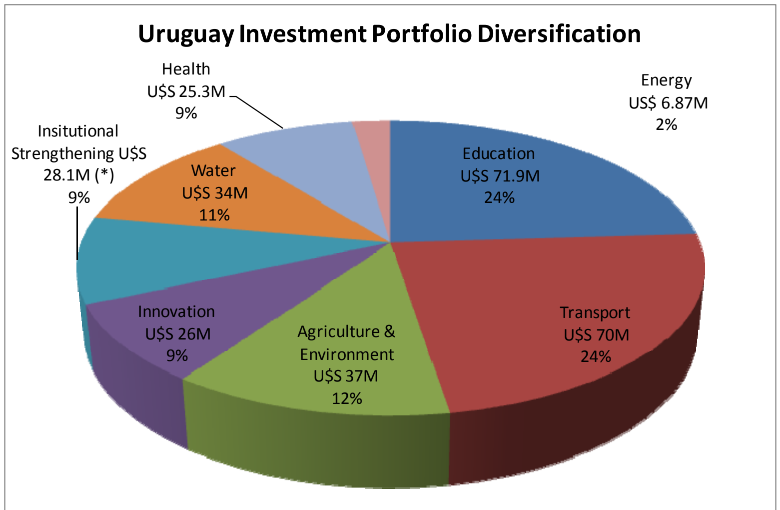
54. **The CASCR finds that the flexible design of the CAS and the programmatic nature of development policy lending allowed the Bank to react quickly during the global financial crisis and to adjust its support to provide Uruguay the needed contingent financing**. Moreover, the 2008 CAS Progress Report envisaged a plan for dealing with global financial turbulence. By contrast, the 2000 CAS proposed a more rigid program, strictly linked to country performance and, when the Argentine crisis arose in 2002, the Bank had to resort to Special SALs to provide short-term relief, at the expense of creating medium-term payment problems.

55. **Another important lesson learned was that the consensual nature of Uruguay's policy making environment affects the pace of implementation of key reforms**. In Uruguay reforms can take a long time to mature, but they tend to be sustained once implemented. The programmatic structure of the program under the 2005 CAS, providing support for key reforms through the DPL series, was in retrospect the right one, allowing time for reforms to come to fruition, while focusing largely on implementation of measures for which the Government had already obtained approval. The CASCR also highlights the need for the Bank to mobilize staff with the requisite skills. In the Institutions Building Technical Assistance Loan (IBTAL)

customs component, which was not implemented for broader political reasons, the Bank's lack of in-house expertise slowed implementation.

B. The Ongoing Portfolio

Figure 2



(*) Includes stated modernization under the Institutional Strengthening TAL (USD12.1M) and modernization of the water company under the OSE System Modernization and Rehabilitation Project (US$16 M)

56. **The Bank is supporting a diversified portfolio of nine investment projects in Uruguay, including two Global Environmental Facility (GEF) grants totaling US$257.2 million.** Institutional strengthening is a cross cutting dimension of the investment portfolio, accounting for an average of 30 percent of each loan. The portfolio is supports a number of critical government reform initiatives, such as the following:

- Strengthening the national innovation system (Promoting Innovation to Enhance Competitiveness Project),
- Expanding the full time school model to increase equity in the provision of preschool and primary education (Third Basic Education Quality Improvement Project),
- Strengthening health delivery services and health policy framework for non communicable diseases (NCD), including implementation of a pilot program (*Previniendo*) to enhance NCDs control and risk factor prevention, (Non Communicable Diseases Prevention Project),
- Promoting the adoption of economically and environmentally viable, integrated agriculture and livestock production systems (Integrated Natural Resource and Biodiversity Management Project),
- Facilitating investments in improving energy use by creating an enabling policy and regulatory environment (Energy Efficiency Project),

57. **In general, portfolio performance remains positive, both in terms of achievement of development objectives as well as implementation progress**. There are currently no projects at risk in the portfolio. The disbursement ratio for Uruguay in FY10 was a solid 30.2 percent. However, the most recent portfolio review reveals that there is some lag in disbursements which can be attributed to the type of operations that the portfolio is supporting (institutional strengthening, technical assistance) and the fact that Uruguay has not yet explored faster disbursement instruments and modalities in support of these types of projects such as Sector-Wide Approaches (SWAPs), results-based disbursements components. It is expected that under the Government and the Bank will explore using such instruments under the new CPS.

C. The WBG's Indicative Program (2010-2015)

Strategic Approach & CPS Pillars

58. **The overall objective of the WBG's lending and non-lending program for the new CPS period is to help Uruguay consolidate economic reforms, and enhance social outcomes.** First of all, this means to build on the positive experience of collaboration between the country and the Bank during the previous CAS period. But the new CPS will be even more tailored to the specific needs of this advanced middle-income country, in order to contribute effectively to implementing Uruguay's reform agenda.

59. **In this sense, the new Government has shown a keen interest in using the Bank's support in a strategic way, shifting to a partnership that adds important value to the Government's own program and that stresses the role of knowledge and know-how transfers.** In line with this, the government counterparts expressed a desire to engage in a new programmatic DPL series and move to investment operations that have expanded institutional reform content and focus increasingly on results. It has also sought a more demand-based system for identifying and delivering of analytical and technical assistance.

60. **The main strategic orientation of the CPS is aligned with the Government's priorities, as presented in the previous chapter.** The 2010-2015 CPS focuses on the following four pillars: (i) Reducing Macroeconomic Vulnerability & Strengthening Public Sector Administration; (ii) Competitiveness & Infrastructure; (iii) Agriculture, Climate Change, and Environment; and (iv) Increasing Social Inclusion & Equity.

61. **Reflecting the lessons of the CASCR, the strategy will be flexible to accommodate the Government's need to adjust course in the event of unforeseen domestic or external developments**. Indicative support for this strategy is proposed to include a series of two DPLs totaling US$200 million (late 2010 and late 2011), investment lending totaling approximately US$500 million subject to IBRD's overall lending capacity, and a well-focused and demand-driven AAA program. This lending mix might be adjusted to prepare for or respond to domestic or external shocks. This being said, in the likely event of a further strengthening of Uruguay's economy and position in international financial markets, and if the Government maintains its keen interest in a more strategic and systematic orientation on knowledge services, there might be a gradually declining emphasis on lending in the medium-term.

62. **Beyond the need for continuity in existing areas of support to maintain momentum of reforms, the Government's guiding principles for selecting new lending activities is "innovation" and focus on results**. The Government intends to use Bank resources for adding important value to interventions with strong expected development impact, contributing best practice technical know-how in the respective areas and helping build strong institutional capacity, in particular in reform program design and managing for results. As a consequence, the Government is interested in introducing results-based and sector-wide lending instruments for new operations like the planned transport loan and possibly for a new loan in the social sectors. This is expected to consolidate the Bank's role in most areas where it is already active, such as education, health or innovation, and at the same to lead to a more in-depth involvement in new areas like public-private partnerships in infrastructure development, public sector reforms and

climate change mitigation and adaption. Another important criterion for selecting new lending operations is to realize synergies and avoid duplication with other externally-supported interventions by closely coordinating with other partners, most notably the Inter-American Development Bank (IADB). Table 2 provides the agreed lending program for the first two years of the CPS, while providing indicative allocations for the reminder of the CPS period.

Table 2: Indicative lending program for 2010-2015

	Lending (US$ millions) by Calendar Year		
Loans	**2010**	**2011**	**2012-2015 Loan amts TBD**
Development Policy Lending (DPL)	100	100	
Investment Lending		120	380
Improvement of Primary Education		40	
Integrated Agricultural Devt. & Natural Resources Management		40	
Transport Infrastructure Modernization			
Innovation and Competitiveness			
Drinking Water Systems (OSE)		40	
Health Sector Support			
IBTAL (additional financing)			
Output-based Loan for Social Sectors and Human Opportunities			
Sustainable Industrial Development			
Energy Sector Strengthening			
Energy Efficiency			
TOTAL	**100**	**220**	**380**

63. **The proposed strategy places a heightened emphasis on supporting Uruguay in accessing international expertise and best practices, as well as sharing its own experiences with other countries through South-South exchanges.** Toward this end, the Government and the Bank agreed to introduce an innovative modality for analytical services, knowledge transfers and technical assistance based on the successful approach implemented as part of the Bank's partnership strategy with Chile. This modality – a joint analytical and technical assistance program – aims at enabling the Bank to tailor its non-lending program to the needs expressed by the Government and to respond swiftly and flexibly to demands. This joint program will be based on a framework agreement that clarifies the objectives, governance structure, and shared financing of the program. Rooted fully in demand from the Government, an annual work program would be agreed between the Government and the Bank and define the main knowledge products and services to be elaborated in the following year, including a detailed timetable and cost estimates. An indicative menu of AAA for the first two years of the CPS is included in Table 3.

Pillar 1: Reducing Macroeconomic Vulnerability & Strengthening Public Sector Administration

64. **While Uruguay's resilience in the face of the global financial crisis demonstrates the progress made in mitigating macroeconomic vulnerabilities, this remains a key priority for the Government and an area in which continued Bank collaboration is desired**. The Government and Bank concur that collaboration under the first two pillars of the previous CAS – reducing vulnerability and sustaining growth – provide a successful basis on which to build. The CPS would have a particular focus on supporting Government efforts to return to the positive trend on improving fiscal results from before to the 2009 crisis, and to reduce the weight of external debt as well as their share denominated in foreign currency.

Table 3: AAA program for FY11 and FY12

Activity	**Description**
Reform of housing policies	Consider policy options to increase the supply of social housing (focused on creating incentives for self-initiative)
Strengthening of Plan Ceibal by means of international best practices	Support exchange of experiences with similar programs in other countries, and study pending challenges.
Social Policy Assessment	Analyze the impact of social policies, in particular family transfer programs on social indicators.
Review of public expenditures on the social sectors	Evaluate the effectiveness and efficiency of public expenditure, particularly in the social sectors and key social programs.
Monitoring social policy results with the Human Opportunity Index	Develop an internal mechanism to monitor and evaluate the impact of social policies on human opportunities (NLTA)
Health reform	Complete analytic work and technical assistance (NLTA)
Mitigation and adaptation to climate change effects in the rural sector	Diagnosis of challenges and identification of adaptation and mitigation of climate change effects in the rural sector
Further strengthening business and investment climate	Assessment of reform priorities for further strengthening the legal, regulatory and administrative framework for business and investment activities.
South-South exchanges	Exchange of experiences and knowledge with other developing countries, with initial focus on strengthening institutional capacity on economic, debt and public finance management.

Note: The exact content of the AAA and details like method of cooperation—study, knowledge transfer or technical assistance—will be defined jointly in a formal agreement to be signed on this new joint AAA program modality.

65. **These outcomes are reflected in a series of two DPLs, the first of which will be presented to the Board at the same time as the CPS.** (Box 3) The World Bank remains committed to providing the GoU with competitive and flexible local currency financing, subject to market conditions and consistent with the GoU's own financial objectives. In addition, as part of its dialogue with Bank's authorities, the Ministry of Economy and Finance has expressed demand for Bank support to enhance international cooperation and knowledge transfer with other countries' Ministries of Finance, including those from the region.

66. **Uruguay has been a leading country in LCR in utilizing the IBRD Treasury Department's banking products and services in order to manage some of its balance sheet risks, particularly interest rate and currency risks**. This partnership will likely strengthen over the next CPS period as further financing in Uruguayan Pesos is expected to be executed and as ongoing discussions on broader hedging strategies and instruments (energy, weather, etc) are completed.

67. **Reform of the public sector with a view toward better value for public expenditures is a strong theme of President Mujica's agenda and an area of key Bank support**. The Bank has been helping the Uruguay Government with its state modernization agenda through the IBTAL including by financing technical exchanges between the New Zealand and Uruguay authorities in various aspects of public sector management. Through the ongoing IBTAL loan and a potential Additional Financing for the same, the Bank will continue to provide support for the adoption and implementation of a program-based budget, as well as for the monitoring and evaluation efforts to continually strengthen the budget process. In addition, the Bank program will likely support the adoption of a new computerized system of budget management and improvements in the statistical system. Since the public sector reform agenda is still to be defined in detail and the IADB is also involved in several reforms, other areas for Bank support will be defined later, but these may include: strengthening of controls in tax collection agencies, support for an agency responsible for regulating public sector procurement and the reforms to the civil service.

Box 3: The First Programmatic Public Sector Competitiveness and Social Inclusion Development Policy Loan (DPL)

The proposed DPL supports the implementation of reforms which have been identified by the new Government as priorities for obtaining Bank support. The DPL series supports implementation of the Government's agenda in three main areas: (i) public sector management, (ii) competitiveness, and (iii) social inclusion. In particular, the main development objectives of the new loan are to strengthen the efficiency of the public administration while promoting macroeconomic stability, improve competitiveness through measures such as, facilitating trade, strengthening the business environment and development of financial markets. It also seeks to improve social inclusion through measures targeted at enhancing the equity and efficiency of health, education and social protection systems.

The program is expected to consist of a series of two loans, each amounting to US$100 million. The approach taken by this loan series reflects the flexibility requested by the Government to best address evolving challenges. The proposed loan also targets the consolidation of reforms supported by the Programmatic Reform Implementation Development Policy Loan (PRIDPL) series (approved May 2007), and bolsters Government efforts in other areas were not supported by the PRIDPL series. Specifically, the loan recognizes recent achievements in public sector management, business climate and social service delivery (prior actions for DPL-I). The indicative triggers for DPL-II reflect broad policy areas of support, anchoring the new Government's reform agenda through 2011.

Pillar 2: Improving Competitiveness & Infrastructure

68. **The Government seeks to strengthen competitiveness through increased coverage and better quality of infrastructure and establishment of a more conducive business environment.** Beyond the strong demand for Bank expertise in the area of public-private partnerships, with PPIAF-financed activities already launched, sector dialogue has shaped a

proposed infrastructure program under the CPS to achieve: (i) improvement of the condition of key land transport infrastructure; (ii) efficiency improvements in *Obras Sanitarias del Estado* (OSE) to free up resources for additional investment; (iii) improvements in the quality of the electricity supply by expanding, upgrading and rehabilitating the transmission and distribution networks; (iv) energy efficiency improvements to slow the growth of electricity demand; and (v) improved international trade logistics support. Among the means of support are an ongoing Energy Efficiency GEF Grant, an ongoing OSE Modernization and Systems Rehabilitation project, a proposed Transport Infrastructure Modernization Loan, and possibly an Energy Sector Strengthening Project (see Table 2). Infrastructure and SME financing are prime candidates not only for local currency financing, but also for customized financial solutions conducive to reducing financial vulnerabilities and providing access to competitively priced, flexible products with long maturities. IBRD and IFC have a lengthy track record in such types of operations globally, which could be applied to the specific case and needs of Uruguay.

69. **The WBG's considerable experience in providing assistance on financial markets and business climate-related challenges throughout the region could prove very helpful in further strengthening the business climate in Uruguay.** The Bank has already deployed a series of lending and non-lending instruments in Uruguay to tackle these fronts and preliminary feedback from these activities is promising. Thus, a range of WBG support is proposed to further strengthen the business climate in the following ways: (i) promotion of the new one-stop shop for firm creation; (ii) support GoU actions to facilitate increased availability of credit to the private sector; (iii) support GoU efforts to increase market capitalization, and (iv) strengthen GoU actions to improve infrastructure. In addition to the DPLs, the achievement of these outcomes will be supported through AAA on competitiveness and capital markets, an investment climate assessment, and support from the IFC. Dialogue with the Government includes the potential for IFC to provide longer-term dollar financing to the private sector through onlending facilities channeled through local commercial bank partners.

Pillar 3: Protecting the Environment, Mitigating the Effects of Climate Change, and Strengthening Family Agriculture

70. **The WBG is well positioned -- in terms of the financing options, knowledge and expertise at its disposal – to support the implementation of the *National Response to Climate Change Plan* and the *National Action Plan on Production and Sustainable Consumption*.** Uruguay's profile of carbon emissions is unique as a net greenhouse gas emitter where 80 percent of emissions come from the agriculture sector. The *National Response,* which frames climate change adaptation and mitigation as an integrated agenda, seeks to integrate rural producers into integrated water management as an adaptation measure, and improved management of water resources at the farm level would be achieved as part of the proposed Integrated Agricultural Development and Natural Resources Management Project. Trust fund resources, such as the WBI Carbon Finance Assist program, could also address potential future demand in the sector. In this context, a *Low-Carbon Growth Study* for Uruguay could also target other key sectors determined in partnership with the Government and in consultation with other stakeholders.

71. **In addition, the recently-completed fifth GEF replenishment offers a platform to identify and prepare new GEF blended operations with IBRD projects** in the focal area of

climate change as well as in others (biodiversity, international waters, land degradation and persistent organic pollutants). Finally, IFC is well suited to support the Government's commitment to renewably energies, given its experience in developing renewable energy sources in the region, especially in wind, hydro, and bio-fuels. IFC is also actively promoting energy efficiency financing packages to current and existing clients.

72. **Bank assistance (complemented by GEF and Climate Change (CC)-related financial instruments) would also support a comprehensive strategy to address climate change adaptation and mitigation in the agricultural sector**. In addition to broadly supporting efforts to achieve growth in the agriculture sector, the planned integrated and inclusive agricultural development project – informed by the Family Agricultural Development AAA (Report No. 55550-UY) prepared in FY10 –is expected to support the adoption of new technologies and sustainable agro-environmental production practices. With regard to agricultural risk insurance, the GoU has expressed interest in a risk financing instrument to reduce the vulnerability of farmers to shocks. In this sense, the "Insurance to the Poor" would allow the country to transfer the risk of natural disasters affecting agriculture production to the insurance markets. This would contribute greatly to the efforts to achieve stable growth and improved competitiveness in the Uruguayan agricultural sector.

73. **The Bank is also prepared to support Uruguay in addressing its water resource management challenges.** Through the DPL, Water resources management is supported at the farm level in rural areas. In addition, there is an opportunity of partnership with the Government in the development of a *National Water Resources Management Plan* that would provide a strategic context to address some of the key issues in the sector – perhaps through a Non-Lending Technical Assistance (NLTA). This plan would address the institutional set up and strengthening for water resources management, and Bank expertise could provide substantial support to the implementation of the new Water Law given that the law incorporates concepts new to the country. The resources management plan could also address impact mitigation from flooding and disaster exposure.

74. **Forestry is a primary subsector for development in Uruguay, thus presenting the challenge of ensuring sustainability biodiversity-friendly practices**. The development of a "landscape approach" to the management of expanding plantation forests could offer multiple benefits, including encouragement to mainstream biodiversity-friendly practices. In line with this option, the GEF offers grant resources to finance projects focused on the conservation of biodiversity and environmental services in productive landscapes. In addition to this, Trust Fund resources could be mobilized to finance a "Strategic Environmental Assessments" at departmental and national level to support the landscape approach.

75. **The Bank will help finance the conversion of firms (especially SMEs) in different industrial sectors to cleaner production processes**. This support will be provided through an IBRD Sustainable Industrial Development Project. This operation would also strengthen the institutional capacity to enforce existing regulations both at national and sector levels. In terms of the current institutional capacity to enforce compliance, the GoU has implemented some measures, including the control of regulations compliance. However, these efforts have been isolated. In this context, DINAMA, together with other ministries in relevant sectors, has agreed to coordinate efforts and to work together in the design of new and comprehensive instruments to

facilitate supervision and control of cleaner production processes which would be part of the new IBRD operation.

Pillar 4: Increasing Inclusion & Social Equity

76. **The experience of the World Bank in Uruguay and other countries in the region positions it well to respond to the Government's demand for technical assistance in the implementation of the National Plan for Social Equity.** Several interventions are proposed to support the aforementioned government objectives in the social sectors. The proposed CPS will support government efforts to increase access and impact of social protection policies by expanding coverage of social protection programs to provide income protection for all vulnerable populations and linking income protection with human capital promotion effectively. Instruments for influencing these outcomes will include the DPL I, the proposed Social Sector investment loan, the additional financing for IBTAL, a public expenditure review for the social sectors, and a social policy assessment.

77. **The Bank will support the Government's efforts to increase equity, quality and efficiency in the provision of preschool and primary education, as well as activities under the Family Allowances program to increase secondary school enrollment among that program's beneficiaries.** Support will be provided through the Third Basic Education Quality Improvement project, the Promoting Innovation to Enhance Competitiveness Project, a proposed new Social Sector operation, and AAA on the One-Laptop-Per-Child initiative. In addition, IFC hopes to finance private sector not-for-profit and for-profit tertiary education institutions in Uruguay that offer technical training and vocational courses aimed at low-income groups.

78. **The Bank is already strongly engaged in supporting the Government's health sector reforms and will continue to support these efforts to extend health insurance universally to the population and strengthen preventive treatment for NCDs.** Instruments of support include the Non-Communicable Diseases Prevention Project, the proposed new Social Sector operation, and the ongoing NLTA on supporting reform implementation.

79. **The Bank recently approved an Institutional Development Fund (IDF) grant to Promote Equitable Access of Society to the Legal System, the first Bank grant to be executed by the Uruguayan Parliament,** to raise awareness among vulnerable groups of the benefits and rights established in select social legislation. It will allow Parliamentarians to monitor the social impacts of selected laws, develop tools to incorporate a social analysis when reviewing draft legislation, and, in cooperation with agencies of the Executive, develop institutional capacity to better implement such laws.

80. **The Bank embraces the Government's increased emphasis on further enhancing gender equity in the country.** The Government has recently given more attention to the issue of gender based violence, supported by an IDF grant by the Bank, and the newly approved IDF grant to Promote Equitable Access to the Legal System includes vulnerable women as significant target beneficiaries. Efforts to reduce the adolescent fertility rate will be strengthened by support through the Bank's portfolio of health activities, including a newly-launched regional study. .

Table 4: CPS Program Objectives and Select Activities

Pillar I: Reducing Macroeconomic Vulnerability & Strengthening Public Sector Administration	**Pillar II:** Competitiveness & Infrastructure	**Pillar III:** Agriculture, Climate Change & Environment	**Pillar IV**: Social Inclusion & Equity
Outcomes the Bank Program expects to influence			
Control expenditure growth to ensure no further deterioration of fiscal balances. *Bring public debt ratios down to more sustainable levels.* *Further reduce the share of foreign currency-denominated debt.* *Strengthened institutional capacity in evaluating budgetary results.* *Enhanced Integrated Financial Information System (SIIF) in place.* *Public procurement is made more efficient and transparent.*	*One-stop shop for most business related-procedures in operation.* *Substantial increase in credit to the private sector* *Higher market capitalization* *Depositario Central de Valores operational* *Improvement of the condition of key land transport infrastructure,* *Efficiency improvements in OSE.*	*Continued improvements in veterinary and food safety standards, sustainable production practices, adoption of new technologies and capacity building* *Implementation of the National Plan for Response to Climate Change in the agricultural sector* *Reduced loss of productivity due to droughts* *Conversion of industrial firms to cleaner production processes.*	*Increased access and impact of social protection policies* *Expanded access to quality health protection.* *Increased share of NCDs diagnosed and under follow-up primary care* *Improved access, equity, and quality in education attainment* *Conditionality of Family Allowances on continued secondary education successful re-integrates significant number of youth into secondary education system*
Selected Activities in support of these objectives			
DPL I (2010) and DPL II (2011) IBTAL Project (ongoing) IBTAL (AF) (LEN) CFAA/PEFA (AAA)	DPL I (2010) and DPL II (2011) AAA: Study on Competitiveness; Capital Markets Policy Note; IFC - Financial Support Transport Infrastructure Modernization Loan (LEN) OSE Modernization and Systems Rehabilitation project (LEN) Energy Sector Strengthening project (LEN) Energy Efficiency GEF (on-going)	Integrated Agricultural Development and Natural Resources Management Proj. GEF Biodiversity Conservation Integrated Agr, Devt. (LEN) AAA on Climate Change and Agriculture Sustainable Industrial Devt (LEN) OSE project (LEN) Carbon Finance, Carbon Partnership Facility (potential)	DPL I (2010) and DPL II (2011) HOI Index Monitoring AAA on Social Housing Policy Social Sectors PER (AAA) Health Reform Assessment (AAA) Non Communicable Diseases Prevention Project (ongoing) IDF grant to Promote Equitable Access of Society to the Legal System IFC Support

Fiduciary Products

81. **Uruguay's strong capacity and positive track record on governance provides a sound fiduciary environment for implementing the proposed Bank program.** As part of the continuing dialogue with the authorities and to update our own knowledge as a basis for technical assistance, the Bank proposes to include core fiduciary work in the CPS**During the first half of the CPS period, an update of the Country Financial Accountability Assessment (CFAA) could be carried out using the Public Expenditure and Financial Accountability (PEFA) methodology.** The last CFAA was published in June 2005 (Report No.32851-UY). Given the priority the administration places on its public sector reform program, this exercise presents an opportunity for the Bank to provide technical advice and support on Public Financial Management (PFM) reforms that are part of the government agenda. The PEFA study will assess the status of country's Public Financial Management systems/ reforms against 28 high-level of PFM indicators. This study could serve as an objective baseline for the impact of the PFM reforms that the Government is initiating and also serve to measure their progress.

82. **It is also proposed to launch a new Country Procurement Assessment Report (CPAR) within the first year of the CPS period.** The last CPAR was conducted by the Bank in 1999 and the report delivered to the Government in 2000. At that time, IADB, UNDP and relevant government agencies provided valuable input on the local procurement environment, and the Bank will actively seek collaboration with other partners in the execution of the updated CPAR as well. A primary objective of the dialogue will focus on the attainment of consensus for the conducting of an assessment of the public procurement system using the indicators-based OECD/DAC tool.

IFC Activities

83. **Summarizing the initiatives mentioned above, IFC expects to focus on four main areas during the CAS period: (i) financial services, (ii) agribusiness, (iii) competiveness, and (iv) education.** In the financial sector, IFC aims to support banks and non-banks that focus on the mid-market corporate and low-income retail banking segments. IFC is looking at opportunities to support local banks with onlending facilities for agribusiness SMEs and with trade finance lines for exporters. IFC has financed microfinance ventures elsewhere in Latin America and thereby managed to reach groups that had previously been unable to obtain credit on acceptable terms. IFC is in talks with a potential client in this sector. It intends to help develop Uruguay's small microfinance sector through investments with microfinance institutions, on a selective basis. The Corporation also aims to support housing finance projects that can help expand this incipient market. IFC has also gathered considerable experience in supporting the development of capital markets in other Latin American economies.

84. **Agribusiness is an important market for the IFC given its significance to the Uruguayan economy**. Here the focus is likely to remain on export-oriented enterprises with deep linkages to farms. IFC will continue supporting projects that integrate SMEs into corporate supply chains. IFC may also finance more projects in Uruguay's expanding forestry industry, especially where they provide for participation of small businesses in their supply chains. All three of IFC's active investment projects in Uruguay are in export-oriented agribusiness

companies. These include a citrus producer (Milagro), a dairy cooperative (Conaprole), and a large paper pulp producer (UPM, formerly Botnia[15]).

85. **IFC also aims to reinforce the county's competitiveness by financing infrastructure projects, especially those in the renewable energy, logistics, and water sectors once appropriate regulations are in place**. The ongoing legal and regulatory reforms related to promotion of public-private partnerships and expanded scope of investments by institutional investors in the local capital market could open further opportunities for IFC involvement in this area. The IFC also hopes to support private sector education institutions, particularly those that offer technical and vocational courses for low income students to improve their employability, raise incomes, and improve productivity.

D. Development Partners

86. **As during the 2005-2010 CAS period, the Bank will collaborate closely with the Government and other development partners to ensure a synergistic complementarity with their programs.** Contributions of key development partners are detailed below.

87. **The IADB played an important role helping Uruguay to solidify its recovery after the 2002 crisis.** The IADB's *Country Paper* (2005-2009) defined a target scenario of US$ 1.2 billion in approvals over the five-year period, with actual credits for the period exceeding US$ 1.6 billion to support a portfolio concentrated on Reform/Modernization of the State (38.4%), Sanitation (22.6%) and Transportation (19.4%). The new Country Strategy with Uruguay (2010-2014) is currently under preparation and will be presented to the Board of Directors by October 2010. Lending under the new program is expected to approximate US$ 1.8 billion, of which US$ 1.4 billion would be allocated for investment loans. The program may also include additional financing for knowledge products. A reorientation in terms of sectors is not anticipated, and there will be a continued emphasis on infrastructure, particularly transportation. Under the new strategy, the IADB will continue providing support to secondary education and social programs such as *Infamilia*, a program aimed at improving living conditions for and social inclusion of disadvantaged children, adolescents and their families.

88. **The Andean Development Corporation's (CAF) engagement in Uruguay has deepened over the past five years,** with total approvals increasing from US$ 70 million in 2005 to U$S 590 million in 2009. The majority of 2009 approvals (67.8%) corresponded to a non-committed contingent credit line to be granted in case Uruguay were to lose access to international capital markets. During 2009 CAF also approved US$ 150 million for development of road and electricity infrastructure. CAF also approved a US$ 40 million loan to improve the environmental and sanitary conditions of the department of Maldonado. Cooperation funds of USD 300,000 were also provided through the different programs developed by CAF.

[15] This project was the subject of an international waterways dispute with Argentina. In April 2010, the International Court of Justice delivered its judgment finding that Uruguay had breached its procedural obligations under the *Estatuto del Río Uruguay*, but not its substantive obligations under Articles 35, 36 and 41 thereunder, namely: (i) to ensure that the management of the soil and woodland does not impair the regime or quality of the river; (ii) to coordinate measures to avoid changes in the ecological balance; and (iii) to prevent pollution and preserve the aquatic environment.

89. **In 2006, the country team of the United Nations in Uruguay developed the United Nations Development Assistance Framework (UNDAF) for the period 2007-2010.** The main assistance areas defined in the UNDAF were: (i) achieve sustained and sustainable growth, (ii) eradicate indigence and reduce poverty and (iii) promote the exercise of all Human Rights and strengthen the quality of democracy. Financing for these activities totaled approximately US$32.8 million. After Uruguay became one of the eight pilot countries for the "Delivering as One" initiative in 2007, the UN System and the Government signed the "One Programme" which defines more specific results to achieve the outcomes set in the UNDAF 2007-2010 and promotes joint initiatives to strengthen the coherence and added value of the UN system's cooperation in the country. The UNDAF for the period 2011-2015 is currently under preparation.

90. **As of April, 2010, 412 non-refundable cooperation projects financed by bilateral and other partners active in Uruguay**, amounting to over US$ 215 million. The main areas of cooperation were Environment (US$ 90 million), Decentralization and Local Development (US$ 45.7 million) and Industry, SMEs and Microcredit (US$ 31 million). The European Union and Spain were among the main contributors, with US$ 39.2 million and US$ 39 million in active projects, respectively. During the period 2004-2008, support from Spain was mainly oriented to Infrastructure and Social Services (65%). The strategy for joint cooperation between Uruguay and Spain for the next four years will be defined in 2010. The European Commission, in its 2007-2013 Country Strategy Paper for Uruguay, establishes grant aid of EUR 31 million (US$ 44.5 million) for that period, of which almost 60% would be spent in Social and Territorial Cohesion projects and the remaining 40% in Research and Development and Innovation projects.

V. RISKS

91. ***Economic Risk***. Despite declining as a source of risk since 2005, debt sustainability remains the main economic risk, followed by dollarization and exposure to global and regional shocks. Public debt is still sizeable and largely denominated in foreign currency (57 percent). The financing requirements for debt service are significant, with a concentration of maturities in 2011. The highly dollarized economy implies substantial exposure to foreign currency risks for the banking sector due to corporate balance sheet mismatches. Uruguay is vulnerable to a severe deterioration in global and regional economic conditions. While there has been diversification in the destination of Uruguay's exports, they are still highly concentrated in agricultural primaries. Regional conditions remain important and a crisis in neighboring countries would still have a strong impact on Uruguay, although less severe than in 2002. The Bank aims to help mitigate this risk through its DPL financing, and ongoing dialog on macroeconomic and fiscal policies, as well as technical assistance on various aspects of economic management.

92. ***Political and Social Risk***. Political risk was assessed as low throughout the 2005-2010 CAS period and continues to be so. The 2009 Presidential and Parliamentary elections proceeded smoothly with no indication of increased political risk. As has already featured prominently in statements from the President, a significant risk arises from the tensions between pressure to expand government programs and the need for a prudent fiscal stance in order to further reduce macroeconomic vulnerabilities. The consensus orientation of Uruguayan society and President Mujica's inclusive approach to reforms suggests minimal risk that political changes would adversely affect prospects for the implementation of reforms. The CPS, in

particular the proposed joint AAA program, which aims at providing a menu of viable reform options well founded in joint analytical work, is expected to contribute positively to this consensus-based political processes.

93. ***Risk related to Civil Service Reform***. The sweeping changes to the civil service legislation proposed by the administration, while apparently favored by the political opposition, are strongly opposed by the public sector unions. This is a highly contentious and difficult issue that is central to public sector reform, and the outcome could have implications for the Government's ability to achieve its broader public sector reform agenda. While the Bank has not been involved to date, it has considerable experience with such reforms in other Latin American countries and is prepared to provide technical assistance and/or facilitate some south-south knowledge exchange on the topic.

94. ***Climate Change and Natural Disasters Risk***: Droughts have had a major impact on rural income, as well as important fiscal implications, in recent years, and there is evidence that climate change is worsening the magnitude and intensity of droughts. Two significant consequences include decreased hydro-power – and thus increased energy costs – and a loss of agricultural output due to a lack of drinking water for livestock. Therefore, support under the Natural Resources management pillar is expected to include adaptation measures currently under discussion with Government.

Annex A: Uruguay CPS Results Framework 2010-2015

PILLAR 1 - REDUCING MACROECONOMIC VULNERABILITY & STRENGTHENING PUBLIC SECTOR ADMINISTRATION				
Country Strategic Goals and Indicators	**Issues and Obstacles**	**Outcomes the Bank Program Expects to Influence**	**Milestones**	**Bank Program Instruments**
1 Reduce Macroeconomic Vulnerabilities				
Consolidating gains on macroeconomic stability by reducing remaining vulnerabilities	Scope for countercyclical policies remains limited as: • Fiscal policy is subject to debt sustainability considerations, with high debt exposed to exchange rate fluctuations. • Monetary policy is limited by inflationary pressures • Limited role of the exchange rate as shock-absorber due to high levels of dollarization.	Control expenditure growth to ensure no further deterioration of fiscal balances. Bring public debt ratios down to more sustainable levels. Further reduce the share of foreign currency-denominated debt.	The fiscal balance of the consolidated public sector remains above the 2009 baseline of -1.7% of GDP.[16] The gross public debt ratio decreases from its 2009 baseline of 60% of GDP.[16] The foreign currency-denominated public debt share decline to less than its 2009 baseline of 56.7 % of the total outstanding debt.[16]	DPL I (FY11) and DPL II (FY12) Periodic Macro-Monitoring and Financial Notes. Fiscal and/or Social Expenditure Reviews. IBTAL (and IBTAL AF) (ongoing)
2 Public Sector Modernization				
Efficient and equitable management of public resources	Current budget presentation not conducive to strategic, programmatic planning and evaluation of results of public programs Computerized System of Budget Management needs to be modernized Lack of public agency responsible for regulating public sector procurement and promoting modernization and cost-saving improvements in public sector procurement.	Strengthened institutional capacity in evaluating the results of budgetary spending program and using the results of these evaluations in the preparation of annual budgets. Enhanced Integrated Financial Information System (SIIF) (or entirely new system) in place that conforms to programmatic budget classification and allows accrual accounting. Public procurement is made more efficient and transparent through a properly functioning regulatory agency and the introduction of e-procurement.	5-year budget for 2010-2015 is prepared with a programmatic classification (early 2011). Increase in the number of expenditure programs for which output and outcome indicators have been identified (2009 baseline: zero). Contract for software upgrading is underway (2011) and user training has begun (2012). Rise in number of GoU processes started and completed electronically to 25 (2009 baseline: 20)	IBTAL (including AF) (ongoing) CFAA/PEFA

[16] These milestones are set in reference to a baseline which does not take into account the scenario of a substantial deterioration of the external environment.

PILLAR 2 –COMPETITIVENESS & INFRASTRUCTURE				
Country Strategic Goals and Indicators	**Issues and Obstacles**	**Outcomes the Bank Program Expects to Influence**	**Milestones**	**Bank Program Instruments**
1. Fostering Competitiveness				
Improve the country's business climate and create opportunities for investments	Need to overcome major remaining obstacles to doing business and investing in Uruguay: • Competition from the informal economy, • Tax rates, • Labor regulations and • Access to finance • Regulations for opening a business • Customs	All firms are centrally registered, and one-stop shop for most business related-procedures in operation. Substantial increase in credit to the private sector.	Reduction in the number of days to create a firm (Baseline: 65 days according to 2010 Doing Business).[17] The ratio of Credit to GDP increases (2009 baseline: 22.9% of GDP). Increase in the number of irregularities detected by the risk management system relative to the number of inspections (2009 baseline: 0)	DPL I (FY11) and DPL II (FY12) Study on Competitiveness (ongoing) Investment/Business Climate Assessment (planned) IFC - Financial and Advisory Services support
2. Enhancing the Regulatory Environment				
Promote financial market development **Increase depth and efficiency of the financial sector through implementation of the regulatory reform program**	After approving a new capital markets law in 2009, the challenge now is to implement the new legislation in a way that promotes higher market participation.	Increased market capitalization *The Depositario Central de Valores* is in operation and handles an electronic management of securities Issuance by BCU of secondary legislation for the surveillance of the system, the functioning of clearing houses, and the use of guarantees	There is a positive trend towards higher market capitalization from its (2009 baseline of US$139 million. The *Registro del Mercado de Valores* is computerized and about 70 percent of all public securities are in electronic format The total number of new private sector issuances (stocks, corporate bonds, financial trusts, etc) increases from its 2009 baseline of 8. Stock exchange activity rises for both the primary and secondary markets from their baseline 2009 level of US$6,200 millions.	DPL I (Fy11) and DPL II (Fy12) Capital Markets Policy Note (2009 - 2010) IFC Support

[17] The Doing Business might not be the best measure for actual number of days (risk of over-estimation) as it is built following the official procedure for firm registration; thus the measure does not reflect the fact that as a common practice new Uruguayan firms usually rely on the purchase of existing licenses for registration. Such a practice avoids the standard procedure which is otherwise lengthy.

PILLAR 2 –COMPETITIVENESS & INFRASTRUCTURE				
Country Strategic Goals and Indicators	**Issues and Obstacles**	**Outcomes the Bank Program Expects to Influence**	**Milestones**	**Bank Program Instruments**
3. Infrastructure Strengthening				
Improve quality and coverage of Uruguay's infrastructure to strengthen the country's emerging role as a logistics center, and underpin medium-term growth and poverty alleviation objectives	Large increases in investments in infrastructure needed to maintain current quality and coverage; more to close coverage gaps Poor rail infrastructure limits Uruguay's ability to transport increasing volumes of forestry products, risking a rapid dilapidation of road network. High levels of dependence on domestic hydropower and weak transmission capacity lead to high generation costs in dry years and vulnerability to system failures.	Improvement of the condition of key land transport infrastructure, Efficiency improvements in OSE free-up resources for additional investment from retained earnings. Energy efficiency improvements reduce "natural" growth of electricity demand.	Implementation of railway sector reform Improvement of institutional capacity in the MTOP to carry-out multi-modal transport planning Access to sewerage services increased; water losses reduced; and baseline of the impact study on public health of access to sewerage services completed. Key sections of UTE's transmission lines and highly loaded transformer sub-stations are rehabilitated.	Transport Infrastructure Modernization Loan (FY12) OSE Modernization and Systems Rehabilitation project (FY12) Integration of Public Policies on Risk Mgmt. for threats of water origin Trust Fund Sewerage Access in Uruguay Study (TF) Energy Sector Strengthening project (Timing TBD) Energy Efficiency GEF (on-going) Road Safety Trust Fund IFC financing for PPP projects pending approval of appropriate regulations IFC financing for potential renewable energy and energy efficiency projects

PILLAR 3 – AGRICULTURE, CLIMATE CHANGE, AND ENVIRONMENT				
Country Strategic Goals and Indicators	**Issues and Obstacles**	**Outcomes the Bank Program Expects to Influence**	**Milestones**	**Bank Program Instruments**
1. Agriculture and Climate Change				
Widen successful agricultural export model to an increasing number of farmers in support of environmentally sustainable, integrated and inclusive rural development	The agricultural sector, in particular family farmers remain vulnerable to internal and external shocks, and have limited ability to access standard-sensitive export markets The agricultural sector is both a major contributor to Greenhouse Gas Emissions, and highly vulnerable to climatic variability which pose significant adaptation and mitigation challenges for a natural resource based economy	Continued improvements in veterinary and food safety standards, sustainable production practices, adoption of new technologies and capacity building Implementation of the National Plan for Response to Climate Change in the agricultural sector Reduced loss of productivity due to droughts	Expanded information and tracking systems, covering other livestock species as well as value chain integration Consolidation of different rural development programs Reduced GHG emissions and water contamination in the agricultural sector, mainly livestock, dairy, and rice (baseline: TBD) Development of renewable energy (biogas and cogeneration) facilities at the farm and agro-industrial level	Natural Resources Mgmt. Project (ongoing) AAA on Family Agriculture (ongoing) GEF Biodiversity Conservation (ongoing) Integrated agricultural development loan (FY12) AAA on Climate Change and Agriculture (Planned) Montevideo Landfill Gas Recovery Trust Fund (ongoing) Grid-Connected Wind Farm at Caracoles Hill Trust Fund (ongoing) IFC financing for export-oriented agribusiness projects, and support for small- and medium-sized farms.
2. Other Environmental Issues				
Develop cleaner and more sustainable production models for industry in order to improve environmental compliance, and improve access to standard sensitive export markets	Many tanneries, slaughterhouses and other industrial enterprises operate using inefficient and polluting technology because of poor technical and financial capacity, and low awareness.	Conversion of groups of firms (especially small and medium-size enterprises) in different industrial sectors to cleaner production processes.	Increased technical and financial capacity among SMEs to undertake cleaner production investments and improve environmental compliance.	Sustainable Industrial Development project (FY12) Promoting Cleaner Production & Improving Environmental Compliance in the Industrial Sector (TF) OSE project (sanitation aspect) (FY12) Carbon Finance, Carbon Partnership Facility (potential)

PILLAR 4 – Inclusion & Equity				
Country Strategic Goals and Indicators	**Issues and Obstacles**	**Outcomes the Bank Program Expects to Influence**	**Milestones**	**Bank Program Instruments**
1. Support National Plan for Social Equity				
Implement ongoing reforms in the social protection system, with a view to addressing the still high poverty levels (above 20 percent) and in particular to reach Uruguayans that still live in extreme poverty	Existing targeting and conditionality of existing programs fails to reach certain groups of society. Data on beneficiaries of social programs is dispersed across different administrative units	Expand effective coverage of SP programs to all targeted beneficiaries, lifting a large number of remaining people out of extreme poverty. Link income protection policies with human capital promotion effectively Establishment of a single database of beneficiaries of all major social protection and programs (SIIAS)	Reduction in extreme poverty rate. (2008 baseline: 1.5 percent) Family allowances cover increased share of targeted beneficiaries. (2009 baseline: 80% of households in poorest quintile The Integrated System of Information of the Social Areas (SIIAS) is fully operational	DPL I (FY11) and DPL II (FY12) Social Sector Results-based Investment Loan (Timing TBD) Social Policy Assessment (Planned) AAA on Social Housing Policy (Planned) Human Opportunity Index Monitoring (Planned) IBTAL (ongoing) Public Expenditure Review on Social Spending (Planned) IDF grant to Promote Equitable Access of Society to the Legal System (ongoing) IFC support for projects enhancing access to finance for low-income groups
2. Support Health Sector Reforms				
Implement health insurance reform to achieve universal coverage Adapt health system to changing epidemiological profile of country	55% of the population remains without insurance coverage.	Expand access to quality health care by expanding health insurance coverage to population not covered directly through labor markets (spouses, retired workers). Increased share of cases diagnosed and under follow up by primary care teams for Hypertension, Diabetes and Obesity/overweight	Substantially increased share of women between 50 and 69 years of age have had a mammogram by 2012. (Baseline 2006: 25%) Significant increase in the proportion of newborns with disabilities being monitored by early detection and treatment units. (Baseline 2006: 0%) Significant increase in the proportion of population at NCDs risk being screened in at least three departments (Baseline 2006: 0%)	Health Reform Assessment (AAA) (Ongoing) Social Sector Results-based Investment Loan (Timing TBD) Non Communicable Diseases Prevention Project (ongoing)

PILLAR 4 – Inclusion & Equity				
Country Strategic Goals and Indicators	**Issues and Obstacles**	**Outcomes the Bank Program Expects to Influence**	**Milestones**	**Bank Program Instruments**
3. Education				
Enhance access to and quality of education, especially for disadvantaged groups **Reduce the high drop-out rates in secondary education among poorer groups of society**	High drop-out rates and important differences in enrolment amongst students from different socioeconomic backgrounds in secondary education, leading to the serious problem of 24 percent of Uruguayan adolescents being out of school and work in 2008. Difficulties in transforming available resources in the education system into satisfactory results in student learning, which has fallen behind compared to countries at similar levels of development and presents a high inequity in results.	Increases in equity, quality and efficiency in the provision of preschool and primary education by: • Fully implementing pre-school education for four year-olds and expand it to three year-olds. • Continued expansion of FTS for students from disadvantaged backgrounds Conditionality of the Family Allowances program on continued secondary education is successfully used to identify youth who could qualify for the benefit and thereby has lead to re-entering of a significant number of such youth into the education system.	Reaching an enrolment of 47,000 student places in Full Time Schools (FTS) (2009 Baseline: 37,600) Decrease in repetition rate in 1st grade of primary from 22 percent in 2006 and decrease in repetition rate in 2nd grade from 15 percent in 2006. Improved academic achievement in language and mathematics in 6th grade from 52 percent and 32 percent of questions answered correctly in language and math respectively in 2006.	Third Basic Education Quality Improvement Project+ Additional Financing (ongoing) Social Sector SWAP (Timing TBD) UY/AR One Laptop per Child AAA (Planned) Promoting Innovation to Enhance Competitiveness Project (ongoing) Potential IFC financing for technical and vocational education institutions with a focus on low-income students

June 25, 2010

URUGUAY: CAS COMPLETION REPORT

Date of CAS:	**May 10, 2005**	**Report No. 31804-UY**
Date of Progress Report:	**March 3, 2008**	**Report No. 42789-UY**

Summary

This document evaluates country developments in Uruguay and the respective contributions of the Government and the Bank during the period of the FY05-FY10 CAS, approved on June 1, 2005.

When the 2005 CAS was prepared, Uruguay was in the midst of a dual transition. On the one hand, Uruguay was still recovering from the economic and social consequences of the 2002 crisis and the Government had shifted its priorities from crisis response towards equitable and sustainable development. On the other hand, Uruguay was facing a political transition, as the victory of the *Frente Amplio* coalition in October 2004 ended 170 years of dominance by the two traditional parties - the *Partido Colorado* and the *Partido Nacional*- in Uruguayan politics.

The CAS was aimed at supporting the Government in addressing its main challenges of:

- Reducing Vulnerability
- Sustaining Growth
- Improving Living Standards.

The Bank program was broadly organized around these main challenges and anchored around a series of programmatic development policy loans (DPLs) supporting reforms in the key areas of public sector management, financial sector reform and reform of social programs.

Over the two years following the approval of the 2005 CAS, there were important and positive economic developments. Not only had Uruguay recovered from the 2002 crisis, but economic growth and fiscal outcomes had largely outperformed those projected in the 2005 CAS. In addition, the policies pursued by the new administration had a positive impact on social indicators, and, as of mid-2006, unemployment and poverty exhibited a declining trend. On the political front, the *Frente Amplio* coalition had largely delivered on its economic program and enjoyed a relatively high level of support.

Against this positive background, the CAS Progress Report prepared in March 2007, more than half-way through the CAS period, confirmed the general thrust of the 2005 CAS and concluded that the Bank program had achieved substantial success over the past two years. During the period from 2005-2007, the Bank portfolio had also undergone a comprehensive renovation, with projects approved in the mid-1990s gradually exiting the portfolio and being replaced by more diversified operations. The Bank had also increased its presence on the ground with the opening of an office in Montevideo, which facilitated CAS implementation.

About half of the original CAS envelope of $800 million (or $395 million), had been committed at the time of the CAS Progress Report, which included the possibility of increasing the CAS envelope by an additional $60 million to enable the Bank to incorporate into the program a possible DPL with a DDO feature of $300 million (to replace the PRI DPL II and PRIDPL III envisaged in the 2005 CAS). This amount was later increased to $400 million at the request of the Government and the PRI DPLII was approved (in January 2009) as precautionary financing in the midst of the global financial crisis that started in early 2008. Despite the increase, lending remained within the CAS envelope, as planned investment lending for an equivalent amount was postponed to accommodate the increase in the PRI DPLII amount.

This CAS Completion Report concludes that the Bank strategy as outlined in the 2005 CAS was appropriate and successful in assisting the Government achieve a strong recovery from the 2002 crisis and in making important strides in the implementation of key reforms. The Bank decision in the 2007 CAS Progress Report to slightly increase the CAS envelope and postpone selected investment lending in order to provide contingent financing was also timely and appropriate, and the PRIDPL II provided Uruguay with a risk management tool in the event of a public sector financing shortfall and interrupted market borrowing. This bolstered the Government’s confidence in times of crisis. Finally, the substantial renovation of the portfolio and increased Bank presence on the ground during the CAS period resulted in greater relevance and enhanced impact of the Bank’s work, including both lending and analytical services. In turn, the renewed and increased Bank engagement helped the Government to keep sight of its long-term development goals despite its preoccupation with mitigating the impact of the global financial crisis.

I. INTRODUCTION

1. The 2005 CAS was prepared at a time when Uruguay was undergoing a political and economic transition. On the political front, the victory of the *Frente Amplio* (FA) Coalition in the October 2004 presidential election ended 170 years of dominance by the two traditional parties – the *Partido Colorado* and the *Partido Nacional*- in Uruguayan politics. Moreover, the sharp recession that hit Uruguay in 1998-1999 and the crisis that followed in 2001-2002, coupled with rising poverty levels and limited scope for renewal within the ruling party, were determining factors behind the FA victory in the 2004 elections.

2. On the economic front, Uruguay was undergoing a transition, away from the crisis management practices that characterized the period FY03-FY04, when the economic situation deteriorated rapidly following Argentina's default on its public debt and the Bank deemed appropriate, through the 2002 CAS Progress Report, to propose adjustment lending as the preferred instrument to support Uruguay during the crisis period. At the time the 2005 CAS was prepared, Uruguay had already bounced back from the crisis and, starting in mid-2003, was enjoying a strong recovery, which resulted in GDP growth rates of 12.3 percent in 2004 and in a primary surplus to the public sector of 3.8 percent of GDP in 2004 (a major turnaround, given a primary fiscal deficit of 1.5 percent of GDP in 2001). The 2005 CAS was therefore developed with the objective of assisting the Government in sustaining the economic recovery process and placing the new authorities on a path of equitable and sustainable development while implementing an agenda of post-crisis structural reforms.

II. LONG-TERM STRATEGIC GOALS

The Government's Program

3. President Vázquez began his presidency on March 1, 2005 enjoying broad support both domestically and internationally. The economic environment was benign, Uruguay's recovery from the crisis had been robust and the outlook for the future was favorable, despite the existence of important risks. The political transition was smooth, given the consensual nature of Uruguay's political system and the openness of its society. Upon assuming office, the *FA* administration reached agreement with the two traditional parties and the independents on an overall framework for the conduct of economic and foreign policy. An "Inter-Party Agreement" was signed shortly before the new administration took office, committing all political parties to honor the outcome of the 2003 debt renegotiations, which successfully brought the country's debt servicing obligations in line with its post-crisis payment capacity through a sovereign debt exchange. The fact that a multi-party agreement could be reached so early in the new administration was a good omen for future stability and political continuity.

4. While the *FA* embraced an agenda for change, Tabaré Vázquez's electoral document "*El Gobierno de Cambio- La Transición Responsable*", which enunciated the new Government's program, suggested broad continuity in the economic policies of the past. It also confirmed the central role of the state in certain strategic economic sectors (i.e. water, petroleum and telecommunications) and aimed to improve the climate for private sector investment. The document proposed a new national strategy articulated along six key complementary themes: enhancing productivity *(Uruguay Productivo),* fostering social development *(Uruguay Social),*

promoting innovation *(Uruguay Innovador),* strengthening democracy *(Uruguay Democrático),* enhancing regional and global integration *(Uruguay Integrado),* and promoting policies which consolidate and promote Uruguayan culture *(Uruguay Cultural).*

5. Attaining high, equitable and sustainable economic growth was a top priority of the Government's agenda. Under *Uruguay Productivo,* growth was to be attained trough the implementation of both structural changes and short-term economic policies. Structural changes included transforming the financial sector, developing the capital markets and de-dollarizing the economy. Reforms also called for improving professionalism in the civil service, enhancing transparency in the conduct of state functions, and decentralizing management.

6. Fostering social participation and increasing inclusion was the most distinct and overarching goal of the new Government's program. As such, one of the first actions of the new administration was the creation of a new social emergency program called PANES *(Plan de Asistencia Nacional a la Emergencia Social),* which aimed at attending to the needs of those below the extreme poverty line, or at high risk of falling below it, through a set of eight coordinated programs in the following areas: basic food, health emergency, minimum income, education for critical areas, workfare, two housing programs, and homelessness. While several of these programs had been tried before without much success, the PANES attempted to overcome obstacles in the effective delivery of these programs using the structure of existing institutions and volunteers. The new administration also placed education high on its agenda, including a promise to increase funding to improve system equity and relevance to the needs of the labor market. In health, the objective of the new administration was to create a more harmonized system through the introduction of a national health insurance providing a more equitable access to services and improved quality of care.

7. In the innovation area *(Uruguay Innovador),* the new administration sought to promote scientific and technological progress to overcome what was perceived to be a period of creative stagnation. This was to be achieved, among others, through the creation of a National System of Innovation, the drafting of a strategic innovation plan and by reorienting the education system towards scientific and technological applied research with strong links to the productive sector. *Uruguay Democrático* emphasized the need to introduce greater transparency and efficiency in Government, while *Uruguay Integrado* called for strengthening relations with Mercosur and for a better integration of Uruguay with the rest of the world economy. Finally, *Uruguay Cultural* emphasized the need to instill a culture promoting diversity as the basis for social inclusion and the creation of a cultural identity.

8. When the new administration took office, there appeared to be a broad consensus within the *Frente Amplio* on the above strategy and the economic team enjoyed a high degree of respect and broad support. The new administration had also proactively sought dialogue with the International Financial Institutions (IFIs) and elicited their active support in implementing its development agenda.

The Bank's Program of Support

9. The Bank's program for FY05-FY10 proposed a menu of lending and non-lending services in support of the Government's program "*El Gobierno de Cambio- La Transición*

Responsable". In particular, the Bank aimed at assisting the Government in achieving the underlying objective of its program, namely the attainment of equitable and sustainable economic development. The Bank's assessment was that, in order to meet this overarching objective, the Government needed to face important challenges in three areas: i) reducing vulnerabilities; ii) sustaining growth and iii) improving living standards. The Bank's program was therefore organized around these three key challenges. Moreover, an overarching goal of the Bank's program was to support the Government's objective of reducing inequality and increasing social inclusion.

10. The program included a number of interventions in areas were support was requested by the authorities. These areas included tax reform, financial sector and capital market development, health and education, innovation, infrastructure and public services, natural resources management and state modernization. The proposed areas of support were carefully selected on the basis of the outcome of an extensive CAS consultation process, the findings of core analytical work undertaken in the previous years and a review of past successes and failures, as identified by the Completion Report of the FY00-FY05 CAS. The Bank program included support in each of these areas through a combination of investment lending, technical assistance and development policy lending.

11. The Program was anchored around several development policy loans (DPLs) supporting reforms in the key areas of public sector management, financial sector reforms, and reform of social programs. These included a first DPL in the social sectors that was presented to the Board together with the CAS, and three additional programmatic development policy loans in FY06-08. These new DPLs replaced the policy lending operations prepared during the 2002 crisis, when the Bank had to resort to emergency lending instruments to satisfy Uruguay's urgent financial needs. Indeed, a combination of SALs and Special SALs (SSALs) were approved during the crisis to enable the Bank to contribute its share of a US$3.8 billion package of support from the IADB, the IMF and the Bank. However, the compressed repayment schedule of the SSALs contributed to a hump in debt service repayments in 2006 and 2007. Hence, at the time of the FY05-FY10 CAS, and in order to correct and smooth the debt service profile, the Government agreed with the Bank to disburse the second and third tranche of SAL II after modification of two outstanding conditions and to cancel the outstanding second and third tranche of SSAL II, which paved the way to the new DPL series.

III. COUNTRY AND CAS OUTCOMES

12. The 2005 CAS was results based. The CAS Program Matrix specified country development objectives and outcomes as well as specific CAS outcomes and milestones. The 2007 CAS Progress Report also included a CAS Results Matrix which evaluated progress in relation to specific CAS Outcomes. The CAS Results Matrix provided in Attachment 1 to this Completion Report reproduces the country and CAS specific goals identified in the CAS and CAS Progress Report with additional data on outcomes. A conclusion emerges that the 2005 CAS was generally successful in meeting its targets.

PILLAR 1: REDUCING VULNERABILITY

13. There has been good progress over the CAS period in reducing vulnerabilities thanks to considerable progress in macroeconomic stability, the success of the Government's debt and

fiscal management policies, greater exchange rate flexibility, rising international reserves, and improvements in the banking system. All of the above has contributed to making Uruguay less vulnerable to shocks than in 2002. Despite this progress, vulnerabilities remain, particularly linked to the high dollarization of the economy, a high concentration of exports in agricultural primary products, and the impact that regional conditions have on Uruguay's small and open economy.

Country Outcomes

14. Country development goals identified in the 2006 CAS were largely attained. The Government's debt management policies have achieved considerable success, as the Government has managed to re-profile its debt and refinance expensive emergency financing. The public debt burden, one of the major economic vulnerabilities, has fallen as a share of GDP since the crisis in 2002. Total gross public debt fell from 101.0 percent of GDP in 2003 to 57.0 percent by mid-2009. The net public sector debt also declined from US$9,662 million (40.3 percent of GDP) to US$8,254 million in 2008 (26.5 percent of GDP), a level similar to the one prior to the 2001-2002 financial crisis. As a consequence of the large multilateral disbursements that occurred in the context of the international crisis, total gross public debt grew to 69 percent of GDP and net public sector debt went up to 35.3 percent of GDP in 2009.

15. The Government has also gradually increased the peso share of debt by issuing US dollar and inflation indexed peso-denominated debt in domestic and international markets. Nevertheless, dollarization remains as a source of vulnerability as the share of foreign currency-denominated debt is still substantially high (65.1 percent in 2009).

16. In January 2009, Moody's increased the rating of Uruguayan government bonds from B1 to Ba3, to reflect the improvements made by the country in terms of its debt profile. Sovereign debt is now rated three steps below investment grade (Uruguay lost investment grade rating in 2002, largely because of the high level of indebtedness resulting from the crisis).

17. The primary fiscal balance improved from a position of a large deficit of -2.2 percent of GDP in 2004 to a peak primary fiscal surplus of 1.4 percent of GDP in 2008. The exchange rate is not misaligned and remains close to its real equilibrium value. A flexible exchange rate regime was adopted in mid-2002. Initially, the peso depreciated substantially, but then followed an appreciating trend through 2008. In late 2008, the peso depreciated by over 25 percent vis-à-vis the U.S. dollar, but after the economy started to recover, it appreciated by roughly the same amount. Interestingly, those fluctuations of the exchange rate had almost no impact on the economy, showing that it performed its shock-absorber function as expected.

18. The position of international reserves has also strengthened. International reserves increased sharply during 2007-2008 with booming commodity prices and favorable international conditions. Reserves, which by end-2009 were US$8.1 billion, are expected to keep growing in the future, albeit at a declining pace due to the slowdown in international capital flows.

19. The banking sector has also recovered from the severe crisis of 2002, and noticeable improvements have been made from the prudential and profitability standpoints. The financial sector law adopted in 2008 includes a substantially improved bank resolution framework. The

new deposit insurance agency foreseen in the law was formally established recently and a law on capital market reform aimed at improving the legal framework in the areas of security registration was passed by the Lower House. Further, the restructuring of the BHU has progressed and its recapitalization is about to be completed.

CAS Outcomes

20. CAS outcomes outlined both in the 2005 CAS and in the 2008 CAS Progress Report were also broadly achieved. Dialogue between the Bank and the authorities on debt policy was intense and of high quality. The Bank assisted the Government in meeting its debt service obligations, particularly in 2006-2007, when amortizations were heavy, through development policy lending supporting the Government in key policy areas. The first DPL (SPDPL) for US$75 million was approved by the Board together with the CAS on June 9, 2005. It supported reforms in social policies as well as important measures taken by the Government with respect to health, education and social protection. A subsequent DPL, the First Programmatic Reform Implementation Development Policy Loan (PRIDPL 1) in the amount of US$100 million, was approved in May 2007. This operation supported the Government's reform program in taxation, business environment, and capital markets development, and aimed at improving the social protection system. The loan was disbursed in local currency in May 2008, as the World Bank became the first foreign issuer to launch a public bond in (inflation indexed) Uruguayan pesos. This was the first time ever that the World Bank issued a local currency bond for the purpose of a back-to-back disbursement of a specific loan. A second PRIDPL in the amount of $400 million was approved on 3 February 2009 and was fully disbursed. This operation continued the support provided under PRIDPL1 for the implementation of key reforms and built on the achievements of the SPDPL. The tax reform supported by PRIDPLI and II became the cornerstone of the Government's tax administration and tax policy reform. Moreover, the measures identified in these two operations to improve the business climate and promote the capital market were aligned with the financial sector and capital market reform goals set out in the CAS. In the financial sector, the Bank also provided support to the authorities through PRIDPLII in modernizing the legal framework for bankruptcy to provide for efficient and timely resolution of problem enterprises, thereby contributing to the CAS outcome in this area.

PILLAR 2: SUSTAINING GROWTH

21. During the CAS period, the Government focused on improving the business climate, promoting competitiveness, improving infrastructure and developing the capital markets as a means to spur and sustain economic growth. The Vázquez administration also focused on achieving greater integration of Uruguay into the world economy through trade expansion beyond Mercosur and trade diversification. Enhancing competitiveness was another important aspect of the Government's strategy to sustain growth.

Country Outcomes

22. Country goals in terms of trade policies were successfully achieved. Supported by a sound macroeconomic framework, one of Uruguay's most notable achievements has been the increase in investment levels, which have continued to recover since the 2002 crisis. Total gross capital formation increased by almost 10 percentage points, from 13.1 percent of GDP in 2002 to 22.1 percent of GDP in 2008. During 2009, faced with a contraction in global demand due to the

global financial crisis, Uruguay' s new fiscal policy included raising public investment from 3.2 percent in 2008 to 3.4 percent of GDP in 2009. Besides the increase in investment, and to cope with the negative impact of the international crisis, the government also implemented a series of measures to help exporters and facilitate access to credit, particularly for those industries hit by the global slowdown, such as textiles and dairy. The country's strong export performance has contributed substantially to economic growth during the CAS period. Annual export growth was on average 13.5 percent over 2004-2008. Export markets also became more diversified, as the share of exports going to Argentina and Brazil, the two traditional and largest partners, have halved, giving way to substantial growth in exports to non-traditional markets, such as the European Union, Russia and China. The trade and investment framework agreement signed in 2007 with the United States provides the setting for discussion of trade issues of mutual interest. Further, FDI increased considerably over the period, with FDI inflows reaching 5.7 percent of GDP in 2008, up from 2.4 percent of GDP in 2004. Pulp mills comprised a major source of FDI in recent years and the completion of the Botnia plant gave a further boost to exports in 2008.

23. In the infrastructure sector, results were mixed in terms of meeting country goals. In the water sector, good results were achieved in terms of improving the efficiency and effectiveness of OSE and increasing treated water pumping capacity in Montevideo. Further, the creation of DINASA (a policy setting directorate with the Ministry of Housing) in 2006 strengthened capacity to define policy in the water sector. On the negative side, progress in terms of reducing unaccounted for water was slower than expected. In the electricity sector, conditions in the regional electricity markets and supply security concerns have made it less urgent to unbundle UTE (the public electricity monopoly) and introduce greater private investment in generation. Similarly, efforts to open the water sector to greater competition suffered a reverse following a 2004 constitutional referendum which banned private participation in the sector. In transport, Bank support has contributed to improvements in road maintenance to the point where Uruguay today has a far higher percentage of national paved roads in good condition than other countries of comparable income in Latin America. In agriculture and natural resource management, Uruguay has played a key role in enhancing regional collaboration to address food safety and quality. Implementation of the state modernization agenda has proceeded satisfactorily, with the exception of reforms in the customs area, where progress has stalled. Country goals in the innovation area were largely achieved, with the newly created (2007) National Innovation Agency already playing a key role in stimulating innovation for competitiveness and employment creation.

CAS Outcomes

24. The Bank has long had an active involvement in the infrastructure sector, particularly in the water supply and sanitation area. A major CAS outcome in this area was institutional improvements in OSE (the public water monopoly), where progress initially lagged behind expectations, mainly because of lack of support by OSE leadership for sector modernization. However, substantial progress has been made on the institutional side under the *Frente Amplio* administration, in the context of the implementation of APL2. Improvements in corporate governance of OSE were also particularly noteworthy, with the appointment of a new and capable OSE director and a substantial de-politicization of OSE's Board. Another key milestone in the water and electricity sectors was the introduction of yardstick competition. This milestone has been achieved as a program to monitor and reduce losses for unaccounted water is underway,

with the creation of a well functioning UFW (Unaccounted – for – Water) unit within OSE. The Bank continues to assist OSE in improving UFW under APL2.

25. In agriculture, the Bank has been instrumental in assisting the Government in its fight against foot-and-mouth disease (FMD) (Bank assistance was provided in the form of a loan and a complementary grant for regional animal health issues) and overall, major strides were made in the prevention of animal disease, thereby enhancing Uruguay's image as an exporter of beef products to standard-sensitive markets. The signing of a regional agreement on FMD, a key CAS outcome in the agriculture area, has been achieved. Another important milestone, the introduction of a structured rural extension service for small farmers, however, has not been met, as most support for small farmers is being provided under individual projects (including the Bank's Natural Resource Management Project, which aims at supporting the adoption of sound environmental practices in the rural areas). The Bank is providing support to the authorities in meeting this CAS outcome and is currently providing support to the Ministry of Agriculture (in the form of a AAA) to develop a strategy to improve provision of services, including extension services for family farmers.

26. In the innovation area, the main CAS outcome of establishing a national innovation policy has been achieved. Similarly, other important milestones such as an increase in the number of researchers in industry and an increase in the number of patents have been met. However, available data related to other milestones points to a deterioration of indicators in recent years. In the case of the milestone measuring increases in private sector R&D investments, available data shows that while in 2000 39% of total investments came from the private sector, the private sector's share of investments in R&D shrank to 24.6% in 2008. Similarly, available data for the milestone related to the establishment of new business lines indicates that, while in 2000-2003 36% of firms in the manufacturing sector carried out innovative activities, in 2004-2006 this percentage had dropped to 28%. Despite these preliminary findings, available data is insufficient to determine with certainty the lack of achievement of the CAS outcomes.

PILLAR 3: IMPROVING LIVING STANDARDS

27. Improving living standards was the third pillar of the CAS and an area where the Government is likely to face challenges over the coming years. Further, reducing inequality and social inclusion was an overarching goal in the Government's program. While social indicators have recovered considerably since the 2002 crisis, progress has been slow and much more needs to be done in the future.

Country Outcomes

28. The Government has been partially successful in meeting country goals in poverty alleviation and social protection. Uruguay managed to reverse the increasing trend in poverty observed up to 2004. Since 2005, the poverty figures began to decrease mainly due to two factors: high GDP growth and public policies oriented to poverty alleviation (*Plan de Atención Nacional a la Emergencia Social -PANES; Ingreso Ciudadano; Plan de Equidad*). The share of people living in moderate poverty decreased by 10 percentage points (using the 2002 methodology) between 2005 and 2008 (from 30% to 20%), accounting for about 400,000

Uruguayans moving out of poverty. It must be emphasized that child poverty fell substantially in the period, especially in the group 0-5 years, from 56% in 2005 to 38% in 2008.

29. In regard to health, the only specific country development goal identified in the 2005 CAS results matrix is the creation of an integrated and fiscally sustainable health system that would safeguard the health outcomes already achieved. Given that the goal was very broadly defined and has a long-term horizon, reasonable progress towards this long-term goal would indicate a positive outcome where data is available. In education, progress in being made towards the overarching goals of improving quality and equity in primary schools, improving quality at the secondary level and improving equity at the tertiary level. While the Government has been partially successful in meeting country goals in education as identified in the 2005 CAS, improving students' learning and reducing inequity in results still are challenges for the country, especially in comparison to OECD countries. The educational system still faces difficulties in transforming available resources at the school, teacher, students and educational system levels into student learning. Country goals in terms of social inclusion, gender and civil society were equally broad and far-reaching, which makes it difficult to evaluate progress over the short time span of CAS implementation, especially in the absence of quantifiable outcomes.

CAS Outcomes

30. The successful implementation of the PANES Social Emergency Program and its phasing out and replacement by the newer Family Allowance scheme suggest that this CAS milestone has been overachieved. However, there is a lack of available data in other social protection targets, such as the increased financial sustainability of the pension system for which only BPS (*Banco de Previsión Social*) data is available. In education, overall, students' achievement has improved over the CAS period and the achievement gap between students in the lowest and highest income levels has been reduced (these overall trends continue even though the results for the 2005 assessment - and the 2009 not yet released results - cannot be compared with the earlier results because of important methodological changes to the assessment). Even though in PISA 2006 Uruguay outperformed most of the other Latin American countries, Uruguayan students' performance was below that of students from OECD countries (with the exception of Mexico) and presented one of the highest variances in the results (even above what could be expected given the country's income inequality). National repetition rates remain high in grade 1 and, despite some improvements, have not been reduced to the target 10 percent. The Bank has had a long-standing involvement in the education sector, and supported the Government in its goal of improving educational quality through the introduction of the full-time school model. Overall, Bank performance in the sector has been satisfactory, as indicated in a 2006 Project Performance Assessment Report PPAR for three education projects (Vocational Training and Technological Development, MECAEP I and II).

31. While reforms in the health sector are complex and have important fiscal impacts, the CAS milestone of completing and implementing the national health insurance regulation has been met. In addition, fiscal transfers to BPS have been reduced. Progress against the additional CAS milestone of reducing the share of health sector expenditure directed at primary and large fiscal subsidies cannot be estimated due to lack of data. The ongoing Non-Communicable Disease Prevention Project continues to support the Government's efforts to strengthen its health delivery services and the current health policy framework for non- communicable diseases. CAS

Milestones for social inclusion, gender and civil society were broadly defined. In some cases, the Bank has made a limited but concrete contribution to the achievement of the CAS Milestone. For example, the Bank provided technical assistance on PANES evaluation and helped establish participatory M&E systems. This contributed to the achievement of the broad CAS Milestone of strengthening social impact evaluation frameworks across all Bank supported reforms. In other cases, CAS Milestones were not linked to Bank support (i.e. maintaining consensus on the economic program) or the CAS Milestone was so broadly defined that the extent of progress made towards the given milestone could not be assessed or was not quantifiable.

IV. OVERALL BANK PERFORMANCE AND LESSONS LEARNED

32. **Bank performance over the CAS period has been strong**. The planned lending program was largely delivered. A stronger partnership with the Government was formed and the quality of the dialogue improved substantially over the CAS period. The opening of the country office and a constant Bank presence on the ground facilitated these achievements.

33. **The quality of Bank lending has been high.** The renovation of the portfolio which occurred over the CAS period was driven by a frank and open dialogue with the authorities at both the central and sectoral level. Moreover, project identification was completely demand driven, resulting in a portfolio which is more diversified than in the past. The generally high quality of Bank lending during the period is evidenced by a generally good progress in portfolio implementation and by the achievement of the projects' development objectives.

34. **The additional financing instrument was used selectively.** In the case of the education project, it was used to cover financing gaps which arose because of price escalations in civil works which could have otherwise negatively impacted the achievement of the project's physical objectives. Other planned additional financing operations (transport project and natural resources management project) did not materialize as funds were still available under the respective operations.

35. **The Bank was proactive in restructuring operations with components where implementation was lagging**. In the case of the Institution Building Technical Assistance Project (IBTAL), the Bank took a proactive stance in amending the operation by deleting the customs component, which was plagued by issues that could not be foreseen by either the authorities or the Bank at the time the operation was designed (i.e. corruption scandals in a highly politicized setting).

36. **Experiences indicate that AAA was generally well prepared and relevant.** It was also well received and extensively debated, which is partly due to Uruguay's participative culture and to the institutional setting. In some cases, as for the work on PANES and on capital markets, policy advice under the Bank AAA translated into legislation and actual policy. In other cases, it is still too early to determine whether the Bank's advice will materialize into policy actions. As the challenge for the Bank in the future is that of adding value in an increasingly sophisticated setting, a formal evaluation of the impact and relevance of AAA completed during the CAS period (see Annex 3 for a complete list) would be very useful in terms of taking stock of the Bank's analytical work to date and guide its future direction.

Lessons Learned

37. A number of important lessons can be derived from the Bank's experience in Uruguay.

38. **The consensual nature of Uruguay's policy making environment affects the pace of implementation of reforms. Hence, in Uruguay reforms take a long time to mature, but they tend to be sustained once implemented.** A case in point is the approval of the bankruptcy law, and, more generally, reforms in the financial sector. Although at a slow pace, not only were reforms successfully implemented, but Uruguay is now up to international best practice in areas such as prudential regulation for banks. As country ownership of reforms is critical, the programmatic structure of the program under the 2005 CAS, providing support for key reforms through the DPL series, was in retrospect the right one, allowing time for reforms to come to fruition, while focusing largely on implementation of measures for which the GoU had already obtained approval or for which legislation had been submitted to Parliament.

39. **The flexible design of the 2005 CAS and the programmatic nature of development policy lending allowed the Bank to react quickly during the global financial crisis and to adjust its support so as to provide Uruguay with the needed contingent financing**. Further, the 2008 CAS Progress Report envisaged a plan for dealing with the global financial turbulence, including the possibility of an increase in the CAS envelope. By contrast, the 2000 CAS proposed a more rigid program, strictly linked to country performance and, when the Argentine crisis arose in 2002, the Bank had to resort to Special SALs to provide short-term relief, at the expense of creating medium-term payment problems.

40. **Long-term Bank engagement in a sector is essential as it builds trust and enables a more fluid policy dialogue.** In the water sector, considerable advances were made, particularly in terms of improving efficiency, transparency and effectiveness. In retrospect, the Bank's long-term engagement through a series of APLs was the right instrument as it enabled the Bank and the authorities to not only design a road map for reforms, but also to periodically revise the objectives and priorities that were originally set out for the sector. In addition, the experience with APL1 and ALP2 underscores the importance of continuity in Bank involvement in the sector without gaps.

41. **Bank presence in a sector needs to continue despite setbacks, as persistency will eventually pay off.** Again, the experience in the water sector in Uruguay is illustrative, as the Bank decided to remain engaged despite the 2003 reversal in policy on private sector participation in the sector. The Bank was able to differentiate between the overall objective of its involvement in the sector, which was to create a modern and efficient water sector, and the tools to achieve this objective. Private sector participation was simply a tool, and in the post-referendum period the Bank focused on achieving the same results with different tools, such as benchmarking and improvements in corporate governance of OSE, which in turn greatly improved transparency. In this regard, the Bank's experience in an advanced MIC such as Uruguay would provide a useful example to other developing countries.

42. **Uruguay is an increasingly sophisticated borrower, which is fully aware of its needs, and the Bank should respect its priorities.** As the economic situation continues to recover, the relationship between the Bank and the Government is likely to evolve towards the kind of

relationship the Bank has with advanced MICs such as Chile and Mexico. Uruguay has a fairly well developed procurement system, and the level of corruption is relatively low, which should be taken into account by the Bank in the preparation of future operations. In this sophisticated setting, the Bank should mobilize staff with state of the art expertise. In the case of the IBTAL customs component, which failed to implement for broader political issues, the Bank's lack of in-house expertise in the customs area slowed down implementation.

43. **The design of operations entailing a high degree of coordination with other donors should be carefully evaluated.** Again, in the case of the IBTAL, the Bank decided to support only one component (human resources) in a broad customs reform program of fourteen components, with the IDB supporting the remaining thirteen. While coordination with the IADB was largely successful, in the future greater care should be exercised at the time of project design in selecting areas to be supported out of a larger program, and in ensuring that the areas selected are closely interrelated.

44. **In the sophisticated environment described above, the Bank will have to sharpen its focus and concentrate on areas where it can add value.** While it is becoming increasingly difficult for the Bank to effectively contribute to the policy debate, the Bank should explore new areas where its international experience could add value. One possible area of future Bank involvement is the impact evaluation agenda, where the Bank could add value by providing its view as an independent evaluator. In addition, a closer collaboration with local institutions and think tanks leading to joint analytical work would add value through knowledge sharing and capacity building.

CAS RESULTS MATRIX

PART I – REDUCING VULNERABILITY		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
1. Debt Sustainability		
Reduce debt burden to a level commensurate with sustained macroeconomic stability.	Quality dialogue on debt sustainability supports government decision making on debt policy.	Debt Management Unit in the MEF has made great progress in improving the debt profile. Dialogue with Debt Office established under PRIDPL1. Public debt declined from 101.0 percent of GDP at the end of 2003 to an estimated 57.0 percent of GDP by mid 2009. The share of foreign-currency denominated debt has fallen from 90.2 percent of total debt in 2004 to 65.1 percent in 2009.
Achieve improved sovereign credit ratings.		Sovereign credit ratings have improved (for government bonds Moody's rating increased from B1 in 2006 to Ba3 in January 2009). The outlook of rating agencies was revised to positive from stable given Uruguay's resilience to external shocks and its prudent macroeconomic management. Spreads increased slowly throughout 2008, from a minimum of 141 in May 2007, but the situation worsened in October, rising to a maximum of 834 basis points. Since then, the spreads have fallen to 263 basis points in November 2009.
2. Fiscal Management		
Achieve a sustained primary surplus commensurate with the targeted reduction in debt/GDP ratio.	Primary surplus is sustained at the level of 2004 or somewhat higher.	The primary fiscal balance moved from a position of large deficits during 1998-2001 to surpluses of 3-4 percent of GDP in 2004-2007. The surplus was reduced to 1.3 percent of GDP in 2008, falling short of the Government's target of 3 percent of GDP; this was mainly due to the sharp decline in the surplus of the state-owned electricity company (UTE) as a consequence of the severe draught in 2008. The fiscal position deteriorated further in 2009 (1.1 percent of GDP), due to the effect of both the draught and the financial crisis.
	Tax revenues as a share of GDP are maintained at levels required to meet primary surplus target while protecting essential social expenditure.	In 2005 and 2006, tax revenues were 17.9 and 18.8 percent of GDP, respectively. A comprehensive tax reform was enacted on July 1, 2007, that was expected to be at least revenue neutral. Due to the negative effect of the financial crisis as well as of the draught, revenues as a share of GDP dropped to 18.0 percent of GDP in 2007 and to 17.7 percent of GDP in 2008. This trend reverted in 2009, with revenues slightly increasing to 18.0 percent of GDP, and the recovery is expected to continue in subsequent years.
	Personal income tax is introduced.	The tax reform of 2007 introduced a Dual Personal Income tax on all domestic sources of income (IRPF).

CAS RESULTS MATRIX

PART I – REDUCING VULNERABILITY		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
	Number of taxes is reduced. Social expenditure reforms are introduced	The tax reform eliminated 10 low-yield taxes that in 2006 represented 6.4 percent of total tax collection of the tax administration. (see Improving Living Standards below).
3. Financial Sector		
Reduce financial sector vulnerability and improve the efficiency of financial intermediation.	Restructuring program for BHU is completed.	The state housing bank , BHU, has undergone an in-depth restructuring process that has precluded it from offering new loans or taking new deposits until very recently. Nevertheless, on December 8, 2008, the central bank (BCU) announced its authorization to BHU to begin lending again. Mortgage lending has started on a small scale, limited to the Montevideo areas and to clients with two years worth of savings.
Develop capital markets and de-dollarize the economy	Framework for bank regulation and supervision is strengthened.	The financial sector recovered markedly from the general run on deposits during the 2002 crisis and the system currently benefits from the reforms introduced over the last years in of regulation and supervision. Currently, Uruguayan banks are characterized by a liquid balance sheet, primarily funded with deposits and liquid assets. Risk management and internal control systems have been strengthened across financial institutions. There is increasing disclosure of financial information to the market by the Superintendency of Financial Institutions. Authorities have taken various measures to internalize credit risks from dollarization and cross border activities. The largest state bank, BROU, has made improvements in information availability, risk management and internal controls. Finally, after several years on hiatus, the proposed reform of the BCU charter was approved by Parliament in October 2008 and has been implemented during 2009. The reorganization plan is aimed at enhancing BCU´s independence, and at strengthening its supervisory functions as well as the banking resolution framework. In particular, the law created the Financial Services Superintendency within the BCU, which unifies the three divisions responsible for bank, insurance, and securities supervision. Also, the reform includes the creation of an independent entity named Corporación de Protección del Ahorro Bancario in charge of managing deposits insurance.
	Deposit insurance program is funded.	The Deposits Insurance fund has been constituted and is fully operational. The law to reform the BCU charter included the creation of a unit independent from the BCU called Corporación de Protección del Ahorro Bancario that would perform the tasks of the Superintendencia de Protección del Ahorro Bancario. The newly-created institution has

CAS RESULTS MATRIX

PART I – REDUCING VULNERABILITY		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
		responsibility for the resolution process for troubled banks as it can immediately dispose of a troubled bank's assets and make timely payments to the depositors. The COPAB is in charge of running the deposit insurance scheme. At this point, the Superintendency is still operational until the Senate approves the board of the new entity.
	Measures introduced to promote capital markets and development of peso-based financial services	The new capital markets bill was approved by Parliament on November 24, 2009 and promulgated by the President on December 2, 2009. The drafting process has included consultations with private sector participants and the request of experts´ opinion. More important, the new law has been built on the shortcomings of the 1996 Law and contains several provisions designed to enhance investors' confidence in capital markets such as, corporate governance requirements, wider scope of supervision, controls on market abuse, and stronger disciplinary sanctions. The BCU is currently reorganizing in order to address capital market issues and facilitate the implementation of the new Law. Regarding improvements in corporate governance, BCU developed regulations for the presentation of consolidated audited financial statements and information to be included in the annual reports of issuers, pension funds administrators, and trust administrators. The BCU is also working on the implementation of risk-based supervision of securities markets' participants. Additional measures include the certification and professionalization of key market players. Finally, progress is being made on securities clearance and settlement systems. The Financial Services Superintendency within the BCU has designed a plan for the oversight of the settlement activities of the two stock exchanges. In addition, the BCU has decided to implement a new large value payments system that will include a securities depository for both public and private securities. In terms of information transparency and disclosure, a draft law establishing a new entity in charge of accounting standards, Ente Emisor de Normas Contables Adecuadas, was submitted to Parliament and is under review. A recently-signed decree puts in place a sustainable and effective process for the adoption of the most recent IFRS standards.

CAS RESULTS MATRIX

PART II-SUSTAINING GROWTH		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
1. Trade Policies		
Promote exports and diversify export markets.	Exports expand in line with the medium-term macro framework and the structure of exports continues to diversify.	Real export growth was on average 13.5 percent over 2004-2008. Despite the recent financial turmoil and a worsening of the terms of trade, exports also performed well in 2008, with a real growth of 10.1 percent. The negative effect of the crisis on exports was felt in 2009, when exports only grew by 2.5 percent. Exports are expected to slowly recover in 2010, though well below previous years' rates. Uruguay has diversified its trade away from its Mercosur partners: in 1999, 45 percent of exports were destined to Mercosur; by 2008 the share of Mercosur exports had fallen to 27 percent, giving way to a substantial growth in exports to non-traditional markets, particularly to the European Union, Russia and China. Noteworthy is the fall in the share of its exports to Argentina from 18 percent in 1999 down to 9 percent in 2008.
	Government seeks new trade opportunities both within Mercosur and bilaterally.	In January 2007, a Trade and Investment Framework Agreement (TIFA) with the USA was signed.
2. Agriculture, Natural Resources and Environmental Management		
Increase production, value added and exports of agricultural products. Promote regional coordination to address food safety and quality.	Regional agreement signed on Foot & Mouth disease control.	Regional collaboration has improved substantially, with Uruguay playing a key role. As a result, Agriculture Ministers and Veterinary Departments of the "expanded " Mercosur (including Chile and Bolivia) have made progress towards a common approach. Bank assistance was provided in the form of a TA and a complementary grant (ongoing) for regional animal health issues. Overall, major strides have been made in the prevention of animal disease, improved food safety and the enhancement of Uruguay's image as an exporter of beef products.
Ensure sustainable and efficient use of natural resources including ecosystems and native species.	Reformed extension services for small farmers.	Presently, Uruguay does not have a structured rural extension service, and most support for small farmers is provided through specific projects. It is therefore difficult to report any significant change in the country's public extension system. On ongoing Bank AAA is assisting the Ministry of Agriculture to develop a strategy to improve provision of services, including extension, for family farmers. The Bank's Natural Resources Management project is supporting the adoption of sound agro-environmental practices in the rural areas including biodiversity conservation.

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PART II-SUSTAINING GROWTH		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
	Implementation of an integrated water resources management framework.	A Drought Prevention Program in rural areas of the northern and eastern departments co-finances the construction of small reservoirs and water distribution equipment for livestock. Efforts are underway to develop a Rural Water Strategy (with assistance provided by the Bank under the Natural Resources Project) No information available on targets.
	Attainment of national targets on carbon finance.	Carbon Finance operations: Preparation of a 10MW Wind- Farm Power Project has been completed (UTE). The project seeks to reduce greenhouse gas emissions by grid-connected electricity generation from wind power. The emissions reduction will arise from the displacement of fossil-fuel-based electricity generation on the national grid. The project activity should generate 178,878 CERs during the first crediting period. Total estimated reductions (tons of CO2e) are 178,878. World Bank Institute Carbon Finance Assist Program: Uruguay has improved its capacity to fully participate in the flexible mechanisms of the Kyoto Protocol to the United Nation's Framework Convention on Climate Change. The portfolio of CDM projects comprises 33 activities, By May 2009, the DNA had approved 7 projects, reducing almost 300,000 tons of CO2e per year. There were 3 registered activities and 2 of them had issued CERs. Furthermore, there were 6 projects under validation and/or requesting national approval, with estimated reductions of almost 200,000 ton CO2e per year.
3. Infrastructure		
Ensure universal access to infrastructure and public services at sustainable cost. Reduce by half the poor without access to basic water services. Better alignment of water, energy and telecom performance indicators and prices with international benchmarks.	Improved mobility of the poor in urban centers and lower cost of transport. Introduce yardstick competition in water and energy.	No data available on mobility of the poor in urban centers. Due to improvements in the quality of the overall road network and despite increases in gasoline prices, operating costs for cars and light vehicles have remained steady while operating costs for large vehicles have decreased very slightly. Regulatory accounting implemented in the WSS and electricity sectors with both state owned utilities following specific procedures; performance indicators for the WSS, electricity and telecommunication sectors disclosed and published periodically; and service quality regulations for WSS, postal

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PART II-SUSTAINING GROWTH		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
		and electricity distribution in place and operational. OSE continues collecting and reporting to the public performance indicators from its benchmarking system. .
Policy definition, regulation and operation functions better delimited and policy making capacity within ministries and regulators strengthened.	Programs implemented for reducing losses and unaccounted-for water.	Underway. Well functioning UFW unit created in OSE which is tackling UFW more holistically by testing and rolling out new initiatives, including new financial incentive systems. In 2008, OSE met target UFW indicators for the year for country as a whole, Artigas and Metro; however, it did not meet target indicators in four departments. OSE continues to work on improving UFW under the APL2 project.
	Construction of sewage treatment plants in Salto and Pasyandu.	Paysandu: Engineering design completed. Process to obtain environmental license by DINAMA for the construction of the plant in being finalized. Salto: OSE began the engineering design and obtained the environmental viability for the location of the plant.
	Separate functions for policy definition, regulation and operations.	In the power sector, progress has been made in the separation of policy making (MIEM), regulation (URSEA) and operation (ADME, UTE and private generators). So far, four private generators have been authorized to be part of the National Interconnected System. In the WSS sector the creation of a regulator URSEA (2003) and policy-maker DINASA (2006) has provided the separation of functions. However, further consolidation is required, including a better definition of roles and responsibilities.
	Strengthened policy-making capacity within line ministries and autonomy of regulators.	In June 2007, the GOU created a National Commission for Energy Policy, including all political parties represented in Congress. In 2006, the GOU approved and URSEA started to enforce service quality standards for electricity distribution and commercialization services. A recent WB report found URSEA with a good degree of autonomy compared with other regional regulatory agencies. In the WSS sector, the creation of DINASA (2006) has strengthened capacity to define policy in the water sector. A Water Law driven by DINASA was approved by Parliament in September 2009. DINASA has strengthened its water resources and urban drainage technical and policy capacities.
	Vertical disintegration of public monopolies.	Current conditions of the regional electricity markets and security supply concerns have made it less urgent to disintegrate UTE (power company) in

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PART II-SUSTAINING GROWTH		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
		the short term. Current strategy of the GOU is to diversify power generation sources allowing UTE to become the main buyer in the wholesale market to provide incentives for private participation, particularly on renewable energy investment. . Efforts to break up public monopolies in the WSS sector (including the successful Maldonado concession) were reversed following the 2004 Constitutional Amendment. OSE and IMM (Intendencia Municipal de Montevideo) retain the monopoly in the sector.
	Strengthened competition authority of URSEA and URSEC.	URSEA is becoming a key player in the power market as regulator, enforcer of service quality regulations and approver of safety standards for electric equipment.
	Introduction of regulatory accounting.	Regulatory accounting implemented in the WSS and electricity sectors with both state owned utilities following specific procedures. URSEA completed the technical work in the natural gas sector. URSEC has completed the technical work needed for the implementation of regulatory accounting in the telecommunication sector.
	URSEA performs efficiently its regulatory tasks (as per monitoring methodology and targets to be established).	Performance indicators for the WSS, electricity and telecommunications sectors disclosed and published periodically by URSEA and URSEC. Parliament has approved and the Executive has promulgated laws authorizing URSEA and URSEC to request information from the public and private operators of electricity, natural gas, WSS and telecommunications services
	Further de-politicization of Board of Directors.	Little quantifiable progress at this time.
	Petroleum prices are maintained at import parity levels and electricity prices are maintained to reflect cost of service.	No progress to report at this time.
	UTE distribution losses decrease from 22% in 2004 to 15% in 2009.	UTE has made progress towards reducing electricity distribution losses, which reached 17.1% in 2006. Unfortunately, they increased again after 2006 and currently stand at around 17,9 %.

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PART II-SUSTAINING GROWTH		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
	At least 200 MW of additional interconnection capacity is under construction by 2009 and long-term contracts are passed with Argentina and Brazil for supply of electricity and gas.	UTE has already called for bids for the supply of a converter station that will be part of a 500 MW interconnection with Brazil.
	Further deepening of wholesale market by 2009.	GPU is advancing plans for ADME to contract UTE to provide dispatching services under ADME rules. Eleven private firms have already been authorized to generate electricity and connect their facilities to the National Interconnected System. Most of them generate from renewable sources.
	Natural gas law is enacted.	Study on the regulation of the natural gas sector is concluded. Audit on performance of natural gas operators concluded. URSEA continues to regulate by contracts.
4. Enabling Environment for the Private Sector		
Improve framework for participation in public services and infrastructure.	Approval by ADME of a first set of PPAs (Power Purchase Agreements) and request proposals for three ongoing energy contracts to be replaced by PPAs.	The GOU has approved seven private firms to become generators and be connected to the National Interconnected System. In the short run, additional firms producing renewable energy will also become generators. These generators sell their production to the spot market or to UTE through short and medium term Power Purchase Contracts.
Increase protection for contract and property rights.	15% reduction in administrative and judicial appeals of contract cases.	No progress reported at this time.
	Enactment of new bankruptcy legislation and 50% of cases resolved under new law.	The bankruptcy law (Law18.387) and its regulations were approved in October 2008 and became effective in April 2009. Judges have been trained and courts assigned to bankruptcy cases have been equipped.. The IBTAL project provided support for these activities. Information on number of cases resolved under the new law is not available.
Stimulating innovation for competitiveness and employment creation.	National Innovation Policy established.	The National Innovation Agency has been established, a. Board was appointed in mid-2007 and the General Manager was appointed in October 2007. A number of innovation related programs that were previously dispersed under other ministries or public agencies are in the process of being transferred to the Agency. In the first two years of operation, ANII established 30 funding modalities, or instruments, in order to promote innovation in Uruguay. 78 innovation projects have already been selected for funding.

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PART II-SUSTAINING GROWTH		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
	Increased private sector R&D investments.	Available data indicates that in 2000 39% of total investment in R&D came from the private sector. In 2008, the Government's share of investment in R&D increased to 60.2% (from 20.3% in 2000) and the private sector's share shrank to 24.6%. In absolute terms, public investment in science and technology almost tripled between 2005 and 2008, from US$36.6 million to US$102.8.
	More researchers in industry and agribusiness.	28% of researchers employed in industry in 2006, as compared to 15% of researchers employed in industry in 2004. Later data is not yet available.
	Increased number of patents.	The total number of patents awarded increased from 27 in 2005 to 72 in 2008.
	New business lines established.	In 2001-2003 only 36% of firms in the manufacturing sector carried out innovative activities. In 2003, total investment in innovative activities for the sector was equal to 6.2% of the aggregate manufacturing value. In 2004-2006 only 28% of firms in the manufacturing sector carried out innovative activities. In 2006, total investment in innovative activities for the sector was equal to 9.3% of the aggregate manufacturing value. (The fall in the percentage of innovative firms in 2004-2006 with respect to the 2001-2003 period is inversely proportional to the increase in the size of the industrial sector, which was due to the favorable macroeconomic context).
5. Modernization of the State		
Reorganize public sector functions to enhance efficiency, transparency and accountability.	100% use by executive units in the central administration of SICE (Sistema Integrado de Compras Estatales) within the public administration.	SICE used by all executive units in the central administration, except for ASSE (health services) and the Presidency.
Foster citizen participation in collaboration with civil society. Enhance de-centralization and improve local service delivery.	Adoption of TOCAF (Texto Ordenado de Contabilidad y Administración Financiera).	TOCAF was first adopted in 1991, and there were several amendments to the law, including a last amendment in 2001. However, the TOCAF has been adopted in a general way, and lacks harmonized procedures and documentation. No progress has been made in this regard during the 2005-2010 CAS period. The Bank-funded Institution Building TA Loan (IBTAL) does not include support for the implementation of either SICE or TOCAF.

CAS RESULTS MATRIX

PART II-SUSTAINING GROWTH		
Development Objectives and Outcomes	**CAS Outcomes1 and Milestones**	**Progress to date**
	Expanded and more effective use of results-based budgeting and performance audits.	Expanded use of results-based budgeting has been achieved. The next five-year budget is being prepared under a programmatic format, which will further strengthen the link between budget allocations and results. Performance audits are not supported by the Bank and no information is available.
	25% cost reduction for central administration from purchase of goods as a result of competitive bids.	Costs of medicines purchased by UCA are 35% lower than costs in retail market. No information for food purchases.
	Increased percentage of users satisfied by government performance and public service delivery as evidenced by the regular survey data.	No progress reported at this time. Percentage of user satisfied by government performance not an IBTAL-measured result.

PART III-IMPROVING LIVING STANDARDS		
Development Objectives and Outcomes	**CAS Outcomes and Milestones**	**Progress to date**
1. Social Protection and Poverty Alleviation		
Reduce urban poverty from 31% (2003/04) to 20 % (2009). Albeit baseline missing, reduce rural poverty in tandem with urban poverty reduction till 2009.	Social emergency program (PANES) implemented, reaches 200,000 beneficiaries by 2006, and is largely phased out by 2009. Family allowance program has at least 60 percent of take-up among the poor by 2009.	PANES reached a maximum of 85,000 households (nearly 350,000 people) before being closed and replaced by the new Family Allowances scheme. As of August 2009, 375,000 children were receiving the new benefit. 87% of the first quintile children and 76% of second quintile children were receiving family allowances in 2008.
Increase pension coverage of people in old age from 87% to al least 90% by 2009 while spending on pensions declines from 18.3% of GDP (avg. 2000-2003) to below 17% by 2009.	Pension system becomes more sustainable financially with more flexibility to include workers. Pension spending not to exceed 17% of GDP by 2009. Pension coverage of people in old age increases to at least 90%. More regular poverty monitoring in place.	Pension expenditures reached around 15% of GDP in 2006, and have been declining as a percentage of GDP since 2006. Although data for 2007 and 2008 is unavailable, data from a BPS survey indicates a decline in expenditures by 0.8% of GDP between 2006 and 2008. Since BPS is the largest public pension scheme, we can reasonably conclude that overall pension expenditure as a percentage of GDP have been declining since 2006. Proportion of the elderly covered by social security remained unchanged since 2006 (it was 85.3 % in 2006 and 85% in 2008). In 2008, the poorest quintile coverage was over 70%. A participatory M&E system of social policy was established in MIDES and it is up and running.
2. Health		
Create integrated and fiscally sustainable health system that safeguards the health outcomes already achieved.	National Health insurance regulation completed and implemented.	The health reform process prescribed by law has been implemented. Now, the insurance premium is the same for all citizens and it is collected through the BPS (Banco de Previsión Social- Previsional Social Bank) by the FONASA (-Fondo Nacional de Salud- National Health Fund). The JUNASA (Junta Nacional de Salud -National Health Board) buys health services from private and public Integrated Health Insurances enterprises, and pays the services by capitation adjusted by risk (sex and age) and according to sanitary goals (6% of the total capitation payment is adjusted according to sanitary goals). As a consequence of the ongoing process, the coverage rate for the population between 0 and 18 years has increased.

PART III-IMPROVING LIVING STANDARDS		
Development Objectives and Outcomes	**CAS Outcomes and Milestones**	**Progress to date**
		ASSE (Administración de los Servicios de Salud del Estado- -State Health Services Administration)) decentralization had been completed, but the internal reform processes to adapt its organization to the regulation are slowly ongoing.
	Share of health sector expenditure directed towards primary and large fiscal subsidies for BPS health preventative care increases from 0.4 % in 2003 to 4% in 2009.	No data available for comparison. The allocation of the Ministry of Health's Budget in "Planning, surveillance and control of quality of healthcare and health promotion activities" was 0.18% in 2006 and 3.6% in 2009.
	Fiscal transfers to BPS reduced in line with medium-term macro framework.	The Government budget law established a gradual reduction in the credit assigned to transfers to the Banco de Previsión Social (BPS) for the period 2005-2009, from 2.2 % of GDP in 2005 to 1.2% of GDP in 2009.. Actual transfers to BPS decreased from 1.8% of GDP in 2005 to less than 1% of GDP in 2009.
3. Education		
Improved quality and equity in primary school: full-time primary school model reaches 20% of all primary students, representing 40% of all poor students by 2009. Improved quality in secondary school: dropout rates decrease to 35-40% by 2009.	Full time primary school model reaches 20% of all students, representing 40% of poor students.	10% of students in public primary schools are attending full time schools in 2009. These schools are targeted to poor students. and 75% of them come from disadvantaged or very disadvantaged backgrounds.
	School enrollment rate of 4 year olds reaches at least 95% by June 2010.	By 2008 school enrollment of 5 years old is almost universal, and school enrollment rate of 4 years old is 75% in 2008.
	First grade repetition rates fall to less than 10% by June 2010.	Repetition rate in urban schools have gone down from 20.2% in 2002 to 13.7% in 2008. Repetition rate in Full Time Schools was 14.4% in Full Time Schools and it was 10.1% in 2008.
	Percentage of students achieving proficiency levels in math and language increases by 15 percentage points by June 2010.	The 2005 national assessment methodology is different from that employed in the previous national assessments (1996, 1999 and 2002), and thus this comparison cannot be made.
	Achievement gap between students from low and high income backgrounds is reduced.	The achievement gap between students from the lowest and highest income background in national assessments of primary education quality steadily declined in the 1996-2005 period. The 2009 is undergoing and results will be available in April 2010.
	Performance of 15 year old students in PISA 2006 is higher than in PISA 2003.	Uruguayan students' average performance in PISA varied by subject.

PART III-IMPROVING LIVING STANDARDS		
Development Objectives and Outcomes	**CAS Outcomes and Milestones**	**Progress to date**
Improved equity in higher education: share of enrollment in higher education for students from bottom two income quintiles increased from 17% in 2003 to about 25% in 2009.	Secondary school dropout rates decrease to 25% by June 2010. Improved equity in higher education; share of enrollments in higher education for students from bottom two income quintiles has increased from 17% in 2003 to about 25% in 2009.	Students had lower average scores in 2006 than in 2003 in language and science, but had higher average scores in mathematics. Results from the 2009 PISA exam will be available in December 2010. By 2006, the secondary school dropout rate remain high (50%) and the majority of the drop-outs belong to the lowest income quintiles. By 2005, more than 60% of the higher education students come from the two riches quintiles, and less than 15% of the students come from the two lower income quintiles.
4. Social Inclusion, Gender and Civil Society		
Empower civil society-- including youth, women, and afro-descendants--to access increased social and economic opportunities. Implementation of the Equality of Opportunities and Rights Plan through strengthening IWA, and partnership with relevant sectors. Gender mainstreaming in Government policies and launching anti-discriminatory initiatives. Full implementation of national plan against domestic violence at central and regional levels.	Civil society outreach efforts increase. Framework for social impact evaluation is strengthened across all Bank-supported reforms. Social consensus on economic program is maintained. Decreased unemployment and poverty rates among socially excluded groups. Reduced levels of domestic violence.	In-country capacity to conduct social impact evaluation strengthened with MIDES. Technical assistance on PANES evaluation using a variety of approaches delivered. Participatory M&E system in MIDES established. Capacity of local civil society to monitor quality in service delivery strengthened. President Vázquez ended his presidency with an approval rating of over 60% (in November 2009) , a credit to his steady handling of the economy. Moreover, President Vázquez's personal popularity reached 64%' at the end of the administration period (with only 22% disapproving of his performance). Unemployment (annual average) continues decreasing from 13.1percent in 2004 to 9.1percent in 2007 and 7.5 percent in 2008. Notwithstanding the economic slowdown, unemployment kept decreasing in 2009 to 7.3 percent. Moderate poverty and extreme poverty have also decreased significantly from 31.9 and 3.9 in 2004 to 20.5 and 1.5 respectively in 2008. As per national plan, first-ever cadre of multidisciplinary teams to handle violence cases created country-wide and specialized research regarding causes of domestic violence conducted. National unified violence against women registry designed in order to provide accurate number of incidents. Dissemination of information brochures with PANES package provided greater awareness of this issue and increased number of cases reported. As an additional result on gender mainstreaming, the capacity of the capacity of the Women's Institute within MIDES has been strengthened.

Attachment 2
Comparison of Programmed and Actual Lending FY05-FY10

Loan Amounts (US$ Millions)			
Operations Proposed and/or Approved	2005 CAS Base Case Program	2007 Progress Report Base Case Program	Actual Lending
FY05			
Transport Infrastructure Maintenance and Rural Access	70.00	…	70.00
Int. Nat. Resources and Biodiversity Management	30.00	…	30.00
DPL I[18]	75.00	…	75.38
FY06			
Nat. Health Insurance and Soc. Sec. Support	20.00	…	Not Done
DPLII	75.00	…	Not Done
Infrastructure (Energy)	70.00	…	Not Done
FY07			
Innovation/Science & Technology[19]	35.00	…	26.00
DPLIII[20]	75.00	…	100.00
Water Sector APL II	30.00	…	50.00
Institutions Bldg.	15.00	…	12.10
Suppl. Financing for Foot & Mouth Disease[21]	…	…	6.50
FY08			
Education	25.00	…	Not Done
Coastal and Marine Resources	30.00	…	Not Done
DPLIV	50.00		Not Done
Non -Communicable Disease Prevention[22]	…	25.30	25.30
FY09			
Social, Institutional & Infrastr. Investments	100.00	…	Not Done
PRIIDPL II[23]	…	300.00	400.00
FY10			
Social, Institutional & Infrastr. Investments	100.00	…	Not Done
Third Basic Education Additional Financing		15.00	29.90
Transport Infrastr. Maintenance and Rural Access - Additional Financing		50.00	Not Done
Natural Resources Mgmt. – Additional Fin.		30.00	Not Done
Railways Rehabilitation		50.00	Not Done
IBTAL Additional Financing		10.00	Not Done
Environmental Project		10.00	Not Done

[18] **Social Program Support Loan DPL**
[19] **Promoting Innovation to Enhance Technology**
[20] **PRI DPL I**
[21] **Not in the original CAS, but approved prior to the CAS Progress Report**
[22] **Instead of National Health Insurance Project originally planned for FY06.**
[23] **The CAS PR indicates that PRIDPLII and PRIDPLIII could be replaced by a $300 DDO. This operation, called PRIDPLII, was later on increased to $400 million.**

Attachment 3
Comparison of Programmed and Actual AAA
FY05-FY10

Fiscal Year	2005 CAS	2007 Progress Report	Actual Delivered
FY05	-Policy Notes -Sources of Growth -Public Expenditure Review -Health Strategy		-January 2005 -March 2004 -June 2005 - December 2005
FY06	-CPAR -ROSC (Insolvency) -ROSC (Governance) -Investment Climate Assessment -Equity and Quality of Education -Country Gender Assessment ➢ Labor Opportunities Study ➢ IDF on Legal Status of Women - Financial Sector Assessment	-ROSC (Accounting and Auditing)	-December 2005 -August 2006 -June 2006 -November 2007 -February 2007 -November 2008 -December 2008 -May 2006 -May 2006
FY07	-DPR Infrastructure -Programmatic DPR Social Sectors	Income Transfer Policy Study -Strengthening Energy Security NLTA -Opportunities and Informality[24]	-December 2008 -June 2007 -June 2007 -June 2010 (planned)
FY08	-Programmatic DPR Agriculture & Environment	-Strengthening M&E of Social Policy NLTA -Programmatic DPR Infrastructure -Investment Climate Assessment (ICA) -Programmatic PSIA Tax Reform - Railways Efficiency Study -Payments System Fee for Services Study -CEM Trade and Competitiveness - -NLTA on Quality of Spending on Social Programs -Pro-Employment Strategy Family Farm Development Health Reforms Implementation NLTA	-July 2007 -May 2008 -January 2008 -May 2008 -December 2009 -June 2009 -December 2009 No Done Not Done -June 2010 (planned) -June 210 (planned)

[24] Not included in the 2008 CAS Progress Report, but requested by the authorities following the presentation of the regional study on inequalities and opportunities in 2009.

Annex C
Macroeconomic Framework

1. **Recovery from the 2002 Crisis.** Growth in 2004-2008 averaged 6.6 percent per year and largely resulted from a rebound in domestic demand. Investment, private consumption and exports were the main drivers of growth during that period. Investment was fueled by large FDI inflows during the 2006-2008 period and private consumption that expanded on the heels of declining unemployment, rising real wages and increased bank lending. Export growth averaged 13 percent per year in 2004-2008. By sector, manufacturing, transport and communication, wholesale and retail trade, and construction contributed the most to economic growth; manufacturing alone accounted for about 29 percent of growth.

2. Sound macroeconomic management instilled greater resilience to external shocks: the overall fiscal deficit declined from 3.7 percent of GDP in 2002 to zero in 2007, as expenditures growth was contained and the revenue tax base expanded. Monetary policy contained inflationary pressures from higher commodity prices and rising wages, and consumer price inflation converged to a preannounced target, which has been recently reduced to 4-6 percent. International reserves accumulation further supported confidence in Uruguay's currency, which has been floating since mid 2002.

3. Public debt as a share of GDP has fallen consistently and the Government's debt management policies have successfully reduced medium-term debt obligations. Due to strong growth, the appreciation of the Uruguayan peso (27 percent), and a better fiscal position (average primary balance of 3.3 percent in 2004-2008), gross public sector debt decreased by more than 40 percentage points of GDP from 105.0 in 2003 to 61.7 percent in end 2008.

4. Effective social policies further contributed to job creation and poverty reduction prior to the 2008 crisis. Social policies, particularly the *Plan de Asistencia Nacional a la Emergencia Social* (PANES) as well as the *Plan de Equidad* that started in 2008, were successful in fighting extreme poverty, which declined from 3.9 percent in 2004 to 1.5 percent in 2008. Unemployment reached its lowest level in over a decade in 2008, falling from 13.1 percent in 2004 to 7.9 percent in 2008.

5. **The Impact of the Recent Global Economic Crisis**. The global crisis impacted Uruguay initially through the financial sector. The Lehman Brothers bankruptcy in mid-September 2008 sharply raised risk aversion in global financial markets which quickly spread to Uruguay. Sovereign debt spreads widened substantially in 2008, by over 500 points, peaking at 907 basis points in October 2008 and remaining at high levels throughout the remainder of 2008[25]. From August through December 2008, the peso depreciated by 26.4 percent against the U.S. dollar and foreign-currency deposits increased from 76 percent of total deposits in August 2008 to 82 percent in May 2009. Inflation started to increase in September 2008 to a high of 9.2 percent in January 2009. Although capital inflows declined, they remained positive at about US$ 1.7 billion in 2009, and their composition changed in favor of multilaterals. While private capital

[25] The substantial rise in sovereign spreads through the global crisis was not explained by macro fundamentals, which remained broadly adequate. Rather, it reflected global investor risk aversion towards sovereign paper, especially from smaller countries such as Uruguay whose sovereign debt tends to be less liquid than other larger middle-income countries' debt.

inflows accounted for over 75 percent of total capital inflows in 2008, their share dropped to 25 percent in 2009, with large disbursements from multilaterals filling the gap. The overall fiscal deficit widened from 1.5 to 1.7 percent of GDP in 2009, while the primary surplus declined from 1.3 to 1.1 percent of GDP, as revenues slowed with the crisis and expenditures increased with fiscal stimulus. A severe drought further raised fiscal pressures as a shortfall in hydroelectric power generation needed to be covered by costly energy imports.

6. Although the impact of the global crisis has been moderate, economic activity slowed in 2009. GDP grew by 2.9 percent in 2009, one of the strongest growth performances in the region. The main factor behind the slowdown in GDP was the decline in investment (-10.7%). The contribution of public and private consumption was positive but small. The fall in domestic demand was partly offset by a recovery in foreign absorption, mainly due to a substantial decline in imports (-8.6 percent) and a moderate increase in exports (2.5 percent). The labor market experienced a downward adjustment in 2009 Q2, which was however strongly reversed in subsequent quarters. Unemployment peaked in April 2009 at 8.3 percent following the decline in output, but fell to 6.6 percent in the last quarter of 2009, the lowest level in over a decade. Overall, 32,400 new jobs were created during 2009.

7. **The Response to the Global Economic Crisis**. The Government responded to the crisis with a mix of monetary, fiscal and social policies. The Central Bank initially increased interest rates to contain persistent inflationary pressures, but policy rates started to come down from March 2009 onwards, as inflationary pressure subsided.[26] Fiscal policy responded with a moderate stimulus package that increased public investment, supported exporters, facilitated access to credit, and strengthened social protection. Although Uruguay's relatively high debt-to-GDP ratio and underlying inflationary pressures did not provide sufficient space to adopt more expansionary fiscal measures without threatening macroeconomic stability, the government successfully avoided a contractionary stance: the Government reallocated public spending towards objectives with a high growth impact and raised public investment by 0.3 percentage points of GDP. Furthermore, all public entities were required to reduce operational expenditures by at least 5 percent. At the same time, a moderate training subsidy was introduced.

8. **Growth**: The Uruguayan economy is expected to continue to recover over the short and medium-term, provided the currently sound macro policy framework is maintained. As international and regional prospects improve, GDP growth is projected to increase from 2.9 percent in 2009 to 5.5 percent in 2010. In addition, private investment is expected to accelerate after an upturn in the inventories cycle. Private consumption is also expected to hold up due to declining unemployment and a firm exchange rate. Space for further fiscal and monetary stimulus is restricted by a relatively high debt-to-GDP ratio and underlying inflationary pressures. In 2011, growth is expected to slow to 5.0 in line with expected weaker global growth, as policy stimulus packages around the world will be reduced and inventories have been replenished. In subsequent years, growth is expected to revert back to the long-run pre-global crisis average growth rate of 4.0 percent.

26 The Central Bank further implemented four additional measures: (i) development of a futures market for foreign currency, where prices are agreed as far as 1 year in advance, to reduce foreign exchange risk; (ii) gradual reduction in the reserve requirements for deposits in foreign currency from 30 percent to 25 percent; (iii) an agreement with the Central Bank of Brazil to use domestic currencies in bilateral trade, rather than in U.S. dollars; (iv) repayment of export pre-financing in Uruguayan pesos instead of U.S. dollars, for operations performed in November 2009.

9. **Inflation:** Inflationary pressures from increasing commodity prices and wage increases are likely to persist and are expected to keep consumer price increases at the upper limit of the 4-6 percent target range throughout the forecast period. CPI inflation is projected to reach 7.5 percent in 2010, which would be slightly beyond the target range for this year of 5-7 percent, and then to slowly converge to its target range in the subsequent years.

10. **Fiscal accounts:** Economic recovery and reduced fiscal stimulus are expected to contribute to gradual improvements on the fiscal side. The deficit is expected to narrow in 2010, posting a primary surplus of 2.1 and an overall deficit of 1.0 percent of GDP. In 2010, the primary fiscal balance is expected to improve as revenues increase faster than expenditures and public investment maintains a constant GDP share according to government projections. Interest payments increase by 0.3 percent of GDP in line with the payment schedule for public sector debt. Over the following years, the primary fiscal balance is expected to gradually improve due to lower projected expenditures. Following a high concentration of debt service payments in 2011 (see below), lower subsequent interest payments are expected to improve the overall fiscal balance thereafter.

11. **Financing gap:** Medium-term government borrowing requirements are manageable, but some risks arise in 2011. Including amortizations, interest payments and the recapitalization of *Banco Hipotecario del Uruguay* (BHU), gross financing needs of the overall government amount to US$2.7 in 2010. The Government has already secured US$500 million from bond markets last September and further holds more than US$1 billion in public sector deposits in the domestic banking system. Together with available multilateral financing, borrowing financing needs for 2010 appear therefore manageable, even though the Government faces a concentration of maturities in 2011, with payments worth US$2.3 billion or 5.6 percent of GDP. Based on a conservative estimate of the primary fiscal balance, the gross borrowing requirements for 2011 are likely to amount to US$2.9 billion or 6.5 percent of GDP. Uruguay will therefore likely seek additional financing from multilateral institutions and capital markets to cover financing needs.

12. **External accounts:** The current account is expected to decline from 0.7 in 2009 to -1.8 in 2010, reflecting a decline in the trade balance and of net factor incomes.[27] The current account is expected to improve over the medium-term, as the economy recovers and due to a persistent surplus in the services account, which is largely due to high tourism receipts that even held up during the crisis.

13. **Monetary accounts:** After depreciating substantially between August and December 2008, the Peso faced strong pressures to appreciate in 2009, with the UY$/US$ exchange declining by 19 percent during the year. At the same time, international reserves steadily increased as the Central Bank's purchased foreign currency to smooth volatility. With CPI inflation on the decline and moderate economic growth, the Central Bank has cut interest rates from 10 percent to 6.25 percent in 2009. With the Government taking a more active stance in exchange rate policy, the exchange rate has recently started to revert to levels considered more competitive.

[27] The 2009 GDP growth rate is based on World Bank staff estimations, 2009-2010 inflation rates are government projections, the exchange rate projections for 2010-11 are Consensus Economist.

14. **Financial system:** Since the outbreak of the international financial crisis, the Uruguayan financial system has managed to navigate through the storm without major difficulties. In particular, the banking system consolidation process that occurred in the aftermath of the 2002 crisis has apparently paid off as evidenced by the adequate performance of most financial system indicators. Even though, a scenario of more acute systemic deterioration cannot be disregarded at this stage, current fundamentals provide a high level of comfort. In 2009, total volume traded in the primary market (*Bolsa Electrónica de Valores*) decreased 17 percent relative to the previous year. Despite lower trading activity, the market evidenced an increase in the number of new issuances relative to 2008.

15. **Medium-Term Challenges.** Reducing macroeconomic vulnerability and sustaining equitable economic growth are expected to remain priorities of the new Government. Uruguay is still vulnerable to external shocks, through its dependence on neighboring Argentina and Brazil, and commodity prices. While dependence on its two large neighbors has decreased over the last few years, the correlation with economic activity in Argentina remains high and trade links with Brazil are strong. In addition, given the large share of agricultural commodities in total export, and its strong reliance on oil imports, the country's economic performance is directly affected by fluctuating commodity prices.[28] Despite significant progress in debt reduction, debt remains high and exposed to exchange rate fluctuations. During the current crisis, debt sustainability considerations limited scope for fiscal stimulus. Further debt reductions would create necessary space for effective countercyclical measures. A similar argument applies to monetary policy. Although inflation has been broadly kept within its range, it still remains relatively high and restricts monetary policy. At the beginning of the current crisis, monetary policy initially reacted pro-cyclically to counteract inflationary pressures on the wage bill. Lower levels of debt and inflation would ensure that monetary and fiscal policy can reinforce each other and act in a synchronized and countercyclical fashion; lower levels of dollarization would further strengthen the role of the exchange rate as a shock-absorber. Procedural and administrative obstacles for business activities have been also recognized as key structural challenges for economic development, and reform efforts have accelerated in this regard under the new administration. Over the longer term, an integral part of the reform effort plans to place heightened priority on expanding access to education, improving infrastructure and logistics, and reaching environmental objectives.

[28] This point is well illustrated in Box 4 of *Uruguay—Staff Report for the 2009 Article IV Consultation*, IMF, October 2009.

Table 1. Uruguay: Macroeconomic Framework

(Key economic indicators in percent, unless otherwise indicated)

Uruguay: Macroeconomic Indicators
(in percent, unless otherwise indicated)

	Actual						Projected					
	2004	2005	2006	2007	2008	2009	2010p	2011p	2012p	2013p	2014p	2015p
National accounts												
Real GDP growth (%)	5.0	7.5	4.3	7.5	8.5	2.9	5.5	5.0	4.0	4.0	4.0	4.0
GDP (US$ billion)	13.7	17.4	19.8	24.0	31.2	31.5	41.0	44.2	47.4	50.9	54.6	58.4
External sector												
Current account balance (% of GDP)	0.0	0.2	-2.0	-0.9	-4.8	0.7	-1.8	-1.5	-1.1	-0.6	-0.4	-0.2
excluding pulp mill projects 1/	0.0	0.2	-2.0	0.4	-4.8	0.7	-1.8	-1.5	-1.1	-0.6	-0.4	-0.2
Trade balance (% of GDP, incl. services)	3.5	2.3	-0.5	0.7	-2.9	2.4	-0.7	-0.4	-0.1	0.5	0.7	0.6
Exports of goods and services (% of GDP)	31.1	29.3	29.2	28.9	30.1	27.2	24.1	24.5	24.9	25.6	25.4	25.2
Imports of goods and services (% of GDP)	27.6	27.0	29.7	28.3	32.9	24.7	24.8	24.9	25.0	25.0	24.7	24.5
FDI (US$ billion)	0.31	0.81	1.49	1.24	1.79	1.23	1.26	1.30	1.33	1.37	1.40	1.44
Prices												
CPI (% change, end of period)	7.6	4.9	6.4	8.5	9.2	5.9	7.3	6.7	6.2	6.0	6.0	6.0
CPI (% change, period average)	9.2	4.7	6.4	8.1	7.9	7.1	7.5	7.0	6.4	6.0	6.0	6.0
Exchange rate (local currency/US$, end of period)	26.4	24.2	24.5	21.6	24.4	19.6	20.1	20.8	21.4	22.0	22.7	23.7
Real effective exchange rate (2005=100, + = appreciation)	89.1	100.0	101.9	103.9	116.1	121.5	—	—	—	—	—	—
Merchandise terms of trade (2000=100)	99.9	90.7	88.6	88.7	92.3	—	—	—	—	—	—	—
Labor market (%)												
Unemployment rate 2/	13.1	12.2	11.4	9.6	7.9	7.3	—	—	—	—	—	—
Fiscal (% of GDP)												
Revenues 3/	28.0	28.0	28.0	28.0	26.2	27.7	29.1	28.8	28.9	29.0	29.1	29.2
Current surplus of Public Sector Enterprises	2.7	2.1	1.4	2.4	0.8	1.3	2.5	2.1	2.1	2.1	2.1	2.1
Current expenditures 3/	21.5	21.9	22.0	21.9	21.8	23.7	23.8	23.5	23.3	23.0	22.8	22.6
Public investment	2.5	2.3	2.6	2.9	3.2	3.4	3.4	3.5	3.7	3.9	4.0	4.0
Primary balance (deficit (-)/surplus (+))	3.8	4.0	3.6	3.5	1.3	1.1	2.1	2.1	2.2	2.4	2.6	2.9
Central Government & Public Sector Enterprises	3.9	3.7	3.5	3.2	1.1	0.7	1.8	1.8	1.9	2.1	2.3	2.6
BSE 4/	0.0	0.2	0.0	0.2	0.2	0.1	0.3	0.3	0.3	0.3	0.3	0.3
Central Bank	-0.2	0.0	-0.2	-0.1	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1
Local Governments	0.1	0.2	0.4	0.2	0.1	0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Interest payments	5.6	4.4	4.2	3.5	2.9	2.8	3.1	3.2	2.8	2.7	2.4	2.0
Overall fiscal balance (deficit (-)/surplus (+))	-1.8	-0.4	-0.5	0.0	-1.5	-1.7	-1.0	-1.1	-0.6	-0.3	0.2	0.9
Savings and investment (% of GDP)												
Gross domestic investment	17.5	17.7	19.4	19.4	22.7	17.9	20.7	19.9	19.4	18.9	18.4	18.3
Gross national savings	17.5	17.9	17.4	18.4	17.9	18.6	18.9	18.5	18.3	18.2	18.0	18.1
Foreign savings	0.0	-0.2	2.0	0.9	4.8	-0.7	1.8	1.5	1.1	0.6	0.4	0.2
Indebtedness (% of GDP)												
Public sector gross debt 3/	89.6	79.3	70.4	62.6	61.7	60.0	53.2	49.2	45.9	43.2	40.8	38.8
of which FX-denominated	68.7	57.9	47.8	42.4	40.0	34.0	33.8	35.0	34.3	33.9	33.2	32.3

Sources: Central Bank of Uruguay, Ministry of Economy and Finance, National Bureau of Statistics (INE), ECLAC, IMF, and World Bank staff calculations.
Notes: 1/ Current account balance excluding imports related to the construction of pulp mill projects (Botnia and Ence)
2/ Covers urban population (cities and towns of more than 5000 inhabitants). Period Average
3/ Covers Central government and BPS. Public debt-to-GDP ratio is calculated using end-of-the-period exchange rate.
"—" refers to data that is not available.

Annex D
Debt Sustainability Analysis

1. **While limiting the fiscal space to engage into counter-cyclical measures, Uruguay's public debt position is generally resilient to a range of simulated negative shocks. However, further debt reductions would create necessary space for effective counter-cyclical measures, underscoring the importance of sustaining prudent macroeconomic policies.** Under conservative assumptions, total gross public debt is projected to decline from 60.0 percent of GDP in 2009 to 38.8 percent of GDP in 2015. A series of stochastic simulations indicate a 97.5 percent likelihood that gross public debt will be below 106.2 percent of GDP and a 50 percent probability that it will be below 44.7 percent of GDP by 2015. Even though stochastic simulations suggest that the public debt profile is unlikely to differ from the baseline scenario, stress tests show that adverse shocks could at least temporarily reverse the favorable debt trends observed since 2003. Furthermore, different scenarios in terms of the share of foreign-currency denominated debt in total government debt were considered to assess the impact of dollarization on debt sustainability. The results of these bound tests (see below) indicate that de-dollarization would be able to gradually reduce the country's vulnerability to exchange rate fluctuations.

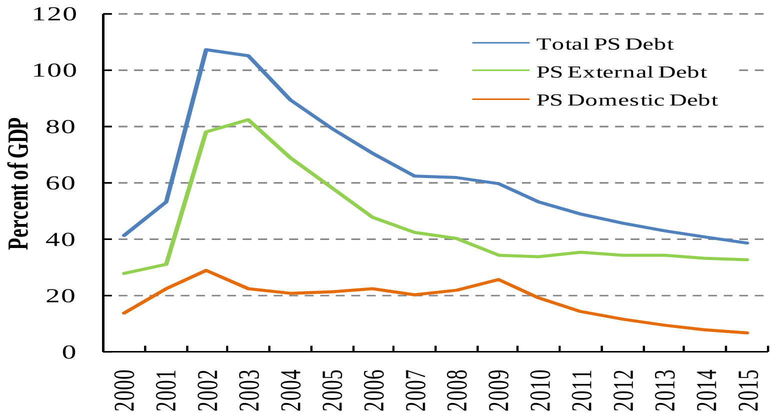
PUBLIC DEBT TRENDS AND STRUCTURE

2.1 **Over the last five years, a successful debt management strategy has resulted in lower debt stock.** As a result of the strong growth achieved in 2004-2008 (annual average of 6.6 percent), the appreciation of the Uruguayan peso (27 percent) and a better fiscal position (average primary balance of 3.6 percent in 2003-2007), the gross public sector debt-to-GDP decreased by more than 40 percentage points of GDP from 2003 to 2008. Total public debt declined from 105.0 percent of GDP in 2003 to 60.0 percent of GDP in 2009 (in net terms, from 71.2 percent of GDP in 2003 to 30.7 percent of GDP in 2009).

2.2 **Debt composition has improved, with lower exposure to exchange risk and longer maturity.** In terms of debt composition, by end-2009, 78.9 percent of total gross public debt was held by private creditors, compared to 55.7 percent by end-2004, reflecting restored access to market financing. The foreign currency share of total public sector debt fell from 76.6 percent in 2004 to 56.7 percent in December 2009. As of end-December 2009, short-term debt (less than 1 year) of the overall public sector was 3.3 percent of total debt, with long-term debt (over 5 years) representing 80.2 percent of all obligations, up from 58.6 percent in 2004.

2.3 **In spite of these efforts to reprofile debt, medium-term borrowing requirements are expected to peak in 2011.** Although the Government has succeeded in smoothing short-term obligations, attention should be paid to the medium-term debt calendar. Despite efforts made to repurchase debt due until 2012, there is still some concentration of payments around 2011 and 2017-2018.

Annual public debt as a share of GDP



Source: WB staff calculations.

DEBT SUSTAINABILITY ANALYSIS

2.4 **The debt sustainability analysis is performed on the basis of two methodological approaches.** The deterministic approach presents the evolution of main determinants of public debt over time. The stochastic approach shows how the main determinants of public debt are affected by stochastic shocks.

2.5 **A favorable medium-term macroeconomic framework would help preserve a stable path for Uruguay's public debt in 2010-2015.** The baseline for our debt sustainability analysis is conservative. It assumes an economic slowdown in 2009, followed by a recovery to 5.5 percent growth in 2010. Fiscal accounts are expected to deteriorate with the economic slowdown in 2009, but to recover in the subsequent years, although not to pre-crisis levels. Under these assumptions, total gross public debt is projected to decline from 60.0 percent of GDP in 2009 to 38.8 percent of GDP in 2015. The baseline scenario is based on the assumption of an average primary surplus of 2.4 percent during 2010-2015.

2.6 **Sustained fiscal adjustment, economic growth and exchange rate stability are critical for continued improvement in public debt indicators.** For the baseline scenario, we find that during 2004 and 2009 exchange rate stability accounted for 38 percent of debt reduction, while fiscal adjustment (primary surplus) and continuing healthy growth also played a significant role, with a contribution of 20 percent and 31 percent, respectively.

Table 1. 1. Cumulative Public Gross Debt Decomposition, 2001-2015

Public Gross Debt Decomposition	**2001-2015**	**2001-2003**	**2004-2009**	**2010-2015**
		Percent of GDP		
Change in public sector debt	-2.6	63.7	-45.0	-21.3
Primary deficit (- surplus)	-34.0	-2.4	-17.4	-14.2
-Seignorage	-7.9	-1.8	-9.3	3.2
Contribution from real interest rate	15.7	2.4	7.9	5.4
Contribution from real GDP growth	-33.3	5.3	-26.0	-12.6
Contribution from real exchange rate change	-11.3	24.3	-32.5	-3.1
Residual	68.3	35.9	32.4	0.0

Source: Central Bank of Uruguay, MEF, and World Bank staff projections. Note: gross debt of the overall public sector
(NFPS and Central Bank).

2.7 **Following a deterministic approach to the debt sustainability analysis, we find that adverse shocks could temporarily reverse the favorable debt trends observed under the baseline scenario.** We consider various stress tests to evaluate the behavior of the public debt ratio under different scenarios. First, a one-time 30 percent exchange rate depreciation in 2011. This shock would cause the debt-to-GDP ratio to deteriorate rapidly to 58.6 in 2011, going back to 53.8 in 2012 and declining gradually thereafter. Second, a combined shock (two-standard deviations shocks to primary surplus-to-GDP ratio, real growth rate and real interest rates) in 2010-2011. This combined shock would cause the projected gross debt to reach 62.4 percent of GDP and 65.0 percent of GDP in 2010 and 2011, respectively, decreasing in subsequent years.

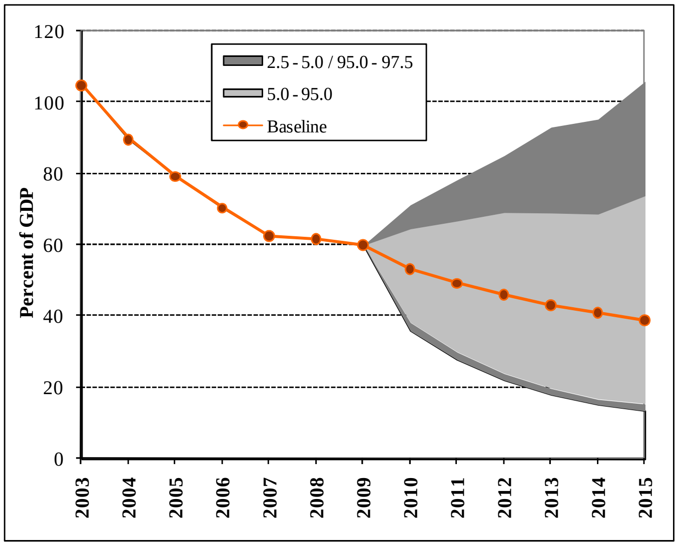
Table 1. 2. Gross Public Debt: Alternative Scenarios and Bound Tests, 2009-2014 (in percent of GDP)

	Actual	**Projected**					
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Baseline	60.0	53.2	49.2	45.9	43.2	40.8	38.8
Alternative scenarios							
A1. Key variables are at their historical averages in 2010-15	60.0	54.5	50.4	46.6	43.0	39.6	36.4
A2. No policy change (constant primary balance) in 2010-15	60.0	54.2	50.6	47.2	43.9	40.6	37.2
Bound tests							
B1. Real interest rate is at historical average plus two standard deviations in 2010 and 2011	60.0	55.9	53.5	48.9	44.3	39.4	34.3
B2. Real GDP growth is at historical average minus two standard deviations in 2010 and 2011	60.0	64.3	68.4	63.4	58.4	53.0	47.4
B3. Primary balance is at historical average minus two standard deviations in 2010 and 2011	60.0	56.7	55.4	50.7	46.0	41.0	35.8
B4. Combination of 1-3 using one standard deviation shocks	60.0	62.4	65.0	60.1	55.1	49.9	44.4
B5. One time 30 percent real depreciation in 2011	60.0	53.2	58.6	53.8	48.9	43.9	38.6
B6. 5 percent of GDP increase in other debt-creating flows in 2010 and 2011	60.0	58.2	58.3	53.5	48.7	43.6	38.3
Summary	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Baseline	60.0	53.2	49.2	45.9	43.2	40.8	38.8
Second most extreme stress test (B4)	60.0	62.4	65.0	60.1	55.1	49.9	44.4
Most extreme stress test (B2)	60.0	64.3	68.4	63.4	58.4	53.0	47.4

Source: World Bank staff projections. *Note:* gross debt of the overall public sector (NFPS and Central Bank).

2.8 **Stochastic simulations are then run to assess the impact of volatility and uncertainty on debt sustainability**. Based on the historical variances of four simulated variables (real GDP growth, change in real exchange rate, real interest rates of domestic and external debt), and abstracting from any feedback of rising debt levels on fiscal policy, Monte Carlo simulations were run to obtain confidence bands around the baseline projections of the gross-debt-to-GDP ratio. Our simulations indicate a 97.5 percent likelihood that gross public debt will be below 106.2 percent of GDP and a 50 percent probability that it will be below 44.7 percent of GDP by 2015.

Figure 1. 1. Gross Public Debt-to-GDP: Stochastic Simulations



Source: World Bank staff projections.
Note: gross debt of the overall public sector (NFPS and Central Bank).

Table 1. 3. Uruguay: Public Sector Debt Sustainability Framework, 2004-2014

(in percent of GDP, unless otherwise indicated)

	Actual					Projected					
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Public sector debt 1/	79.3	70.4	62.6	61.7	60.0	53.2	49.2	45.9	43.2	40.8	38.8
o/w foreign-currency denominated (gross)	57.9	47.8	42.4	40.0	34.0	33.8	35.0	34.3	33.9	33.2	32.3
Change in public sector debt	-10.3	-8.9	-7.9	-0.9	-1.7	-6.9	-4.0	-3.2	-2.8	-2.3	-2.1
Identified debt-creating flows	-14.9	-8.9	-17.1	-4.2	-11.6	-6.9	-4.0	-3.2	-2.8	-2.3	-2.1
Primary deficit	-4.0	-3.6	-3.5	-1.3	-1.1	-2.1	-2.1	-2.2	-2.4	-2.6	-2.9
Revenue and grants	28.3	28.2	28.2	26.4	28.1	29.4	29.1	29.2	29.3	29.4	29.5
Primary (noninterest) expenditure	24.2	24.6	24.7	25.1	27.0	27.2	27.0	27.0	26.9	26.8	26.7
-Seignorage	-2.8	-1.5	-1.2	-2.0	-0.9	-1.2	-0.4	0.2	0.8	1.5	2.1
+Automatic debt dynamics:	-8.1	-3.7	-12.4	-0.8	-9.7	-3.6	-1.5	-1.3	-1.2	-1.3	-1.4
Contribution from interest rate/growth differential	-4.1	-2.1	-4.3	-4.7	0.1	-1.9	-1.3	-1.0	-0.9	-1.0	-1.1
Of which contribution from real interest rate	2.1	1.1	0.6	0.2	1.9	1.2	1.3	0.9	0.9	0.7	0.4
Contribution from domestic real interest rate 2/	1.0	-0.6	-1.2	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contribution from real interest rate on foreign debt 3/	1.2	1.7	1.8	0.6	1.8	1.2	1.3	0.9	0.9	0.7	0.4
Of which (-) contribution from real GDP growth excl. OSF	-6.2	-3.3	-4.9	-4.9	-1.7	-3.1	-2.5	-1.9	-1.8	-1.7	-1.6
Contribution from real exchange rate depreciation 4/	-4.0	-1.6	-8.1	3.8	-9.8	-1.6	-0.3	-0.3	-0.3	-0.3	-0.3
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
-Privatization receipts	0.0	0.0	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	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	0.0	0.0
Residual, including asset changes	4.6	0.0	9.3	3.3	10.0	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	280.6	249.4	221.6	233.4	213.7	181.1	169.3	157.5	147.5	139.0	131.4
Gross financing need 5/	18.0	33.6	5.1	7.8	6.8	4.2	12.0	8.2	7.0	6.2	6.0
in billions of U.S. dollars	3.1	6.7	1.2	2.4	2.1	1.7	5.3	3.9	3.6	3.4	3.5
Key Macroeconomic and Fiscal Assumptions											
Nominal GDP (local currency)	425.0	476.7	562.2	653.2	711.1	806.5	906.1	1002.7	1105.4	1218.5	1343.3
Real GDP growth (in percent)	7.5	4.3	7.5	8.5	2.9	5.5	5.0	4.0	4.0	4.0	4.0
Average nominal interest rate on public debt (in percent) 6/	5.4	5.9	5.9	5.3	4.9	6.6	6.4	5.6	5.4	5.0	4.7
Average real interest rate (including exchange rate revaluation on foreign currency denominated debt) 7/	-2.2	-0.6	-11.4	7.1	-13.3	-0.8	1.8	1.1	1.0	0.6	0.3
Exchange rate, end of period (LC per US dollar)	24.2	24.5	21.6	24.4	19.6	19.7	20.5	21.1	21.7	22.3	23.0
Change in the real exchange rate (Local currency per US dollar) 8/	-6.1	-2.8	-17.5	9.7	-24.1	-4.9	-0.8	-0.9	-1.0	-0.9	-0.8
Nominal depreciation of local currency, end of period (LC per dollar)	-8.6	1.2	-11.9	13.0	-19.4	0.1	4.2	3.2	2.8	2.8	2.9
GDP deflator (in percent)	0.7	7.5	9.7	7.0	5.9	7.5	7.0	6.4	6.0	6.0	6.0
Growth of real primary spending (deflated by GDP deflator, in percent)	8.3	5.9	8.0	10.1	10.8	6.4	3.9	4.0	3.8	3.7	3.4
Primary deficit	-4.0	-3.6	-3.5	-1.3	-1.1	-2.1	-2.1	-2.2	-2.4	-2.6	-2.9

Notes: 1/ Gross external and domestic public sector debt.

2/ The domestic real interest rate contribution is derived as $(i_d-\pi)/[(1+\pi)(1+g)]$ times previous period gross domestic debt ratio as defined in footnote, with i_d=domestic interest rate, π=domestic inflation rate; g=real GDP growth rate.

3/ The foreign real interest rate contribution is derived as $(i_f-\pi^*)/[(1+\pi^*)(1+g)]$ times previous period gross external debt ratio, with i_f=foreign interest rate, π^*=US inflation rate; g=real GDP growth rate.

4/ The real exchange rate contribution is derived as $\hat{e}_t \cdot [(1+i^f_t)\cdot b^*_{t-1} - (1+i^l_t)\cdot nfa^*_{t-1})]/[(1+\pi^*_t)\cdot(1+g_t)]$, with the change in real exchange rate $\hat{e}_t$ defined as in footnote 8/ and all other variables defined as in footnote 3.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period gross public debt stock.

7/ The real interest rate on public debt is calculated as $\alpha_t \cdot \{[(1+i_t^f)\cdot(1+\hat{e}_t)/(1+\pi_t^*)]-1\} + (1-\alpha_t)\cdot\{[(1+i_t^d)/(1+\pi_t)]-1\}$, with α_t as the share of foreign currency denominated debt in total public debt and all the other variables defined as in footnotes 3/, 4/ and 6/.

8/ Change in the real exchange rate $\hat{e}_t$ is defined as $\Delta(e_t \cdot P_t^*/P_t)/(e_{t-1}\cdot P_{t-1}^*/P_{t-1}) = (1+s_t)\cdot(1+\pi_t^*)/(1+\pi_t)$, in percent.

Annex E
Banking Sector Update

The Uruguayan financial system has so far managed to weather the global economic downturn without major difficulties. Lessons learned and reforms introduced after the 2001-2002 crisis (with its epicenter in Argentina) have helped the system to be better prepared to resist turbulence from abroad. In addition, proactive Central Bank intervention and supervision have contributed to assuring financial system stability.

In recent years, the Banking System has consolidated its recovery and appears to have recovered from most of the effects of the 2001-2002 crisis. In particular, financial system deposits have recovered significantly and continued to grow at a strong pace while credit has also recovered, though at a milder rate. Asset quality has improved as well, with NPLs reaching record low levels in 2008. Improved regulation has facilitated reduced balance sheet mismatches and the creation of adequate capitalization and liquidity positions. However, certain weaknesses inherent in the Uruguayan system, though less harmful than in the past, still persist.

Uruguayan capital markets continue to be small and dominated by sovereign issues. In contrast, international debt issues are sizeable in proportion of GDP compared to other Latin American countries, but the bulk continues to be represented by the sovereign. For their part, equity markets are among the less developed of Latin America relative to the size of the economy. In Uruguay, market capitalization is approximately 0.5% of GDP (December 2009), versus 61% of GDP in Brazil, 46% of GDP in Colombia, 21% in Argentina and 51% in Peru.

AFTERMATH OF THE 2002 CRISIS: FINANCIAL SYSTEM RECOVERY

Capital Markets

Uruguay's capital markets still play a minor role in investment financing. Although pension funds continue to accumulate funds, resources are largely channeled to investments in government securities. Weaknesses in investor protection and corporate governance practices continue to limit enterprises' access to the capital markets. Leaving aside natural barriers such as the country's small size that may limit potential market activity, studies and interviews with market participants point to problems not only at the issuer level but also at investors' and exchanges' level, as well as to weaknesses in the regulatory framework.

In recent years, the Uruguayan Authorities have taken critical steps to facilitate the development of capital markets. In particular, efforts have included the drafting of a new Capital Markets Bill that was finally sanctioned in December 2009; and the reorganization of the Central Bank of Uruguay to address capital market issues and facilitate the implementation of the new Law. In addition, a new Bankruptcy Law has been recently sanctioned and is currently under implementation. The new regime seems to properly address the weaknesses of previous legislation. Finally, as part of the initiatives to enhance the reliability of information, a recently-signed decree puts in place a sustainable and effective process for the adoption of the most recent IFRS standards while a process is currently in place aimed to establish more homogenous working standards at the *Registro de Estados Contables* (REC).

Banking System

The Argentine crisis led to a significant contraction in terms of financial intermediation and number of entities. However, the regulatory and operating environments as well as the Uruguayan banking system fundamentals have improved substantially since then.

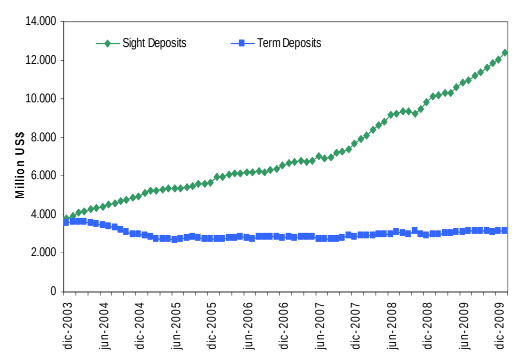
As result of the crisis, Uruguay has made significant efforts to improve financial system regulation. In particular, progress has been made in the regulation and supervision of state banks. The largest state bank, BROU, has made considerable improvements in information availability, risk management and internal controls. The state housing bank, BHU has undergone an in depth restructuring process that has precluded it from offering new loans or taking new deposits until very recently. Finally, after a pause of several years, the proposed reform of the BCU charter was approved by the Parliament in October 2008. The reform is aimed to improve Central Bank autonomy and its role in financial supervision. In addition, the reform includes the creation of a (now operational) independent entity named *Corporación de Protección del Ahorro Bancario*, responsible for managing deposits insurance.

In terms of structure, the banking system remains highly concentrated. The two existing public institutions, *Banco de la República Oriental del Uruguay* and *Banco Hipotecario del Uruguay*, account for approximately half of total banking system assets. In addition, if the five largest banks are to be considered, concentration reaches figures above 80% of total assets. The recent acquisition of ABN Amro Bank by Banco Santander has further increased financial system concentration.

Economic recovery consolidation and the gradual improvement in confidence have contributed to the normalization of total system liabilities. In particular, total deposits have recovered significantly both in domestic and foreign currency. Consequently, the system continues to be highly dollarized with dollar denominated deposits representing near 80% of total private sector deposits as of December 2009. However, the share of non-resident deposits, once a source of financial system volatility, has dropped markedly from levels above 50% of the depositary base in 2001 to approximately 19.5% as of December 2009.

Deposits remain mostly short term in the form of checking and savings accounts (see Figure 1). The poor stock of term deposits that account for only 21% of total private sector deposits as of December 2009 can be attributed to a series of factors. In the first place, excess liquidity currently available in the system as a result of a constant inflow of domestic and international funds discourages banks from increasing interest rates in order to raise additional funds. Secondly, the relatively high reserve requirements of 35% and 25% for foreign currency and domestic currency denominated deposits, respectively; and the fact that no interest is paid on them have substantially reduced the intermediation margin of banks leading to further reductions in interest rates paid on deposits.

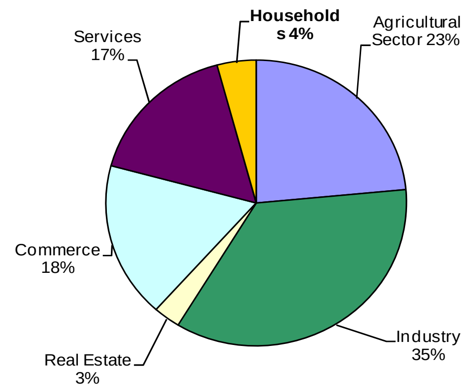
Fig. 1: Evolution of Deposits
(by Term, Million USD)



Source: BCU

Financial system assets have experienced a gradual revival. Currently, nearly 65% of assets are composed of cash and cash equivalents, deposits held in foreign banks and government bonds. The remainder consists mainly of credit to the non-financial private and public sectors. In particular, overall credit to the non-financial sector has improved in the last years ranging from 22% in 2003 to approximately 32% of banking system assets as of December 2009. However, origination volumes relative to GDP continue to lag behind pre-crisis levels.

Fig. 2: Breakout by Type of Borrower - Dollar denominated Credit, Dec 09-



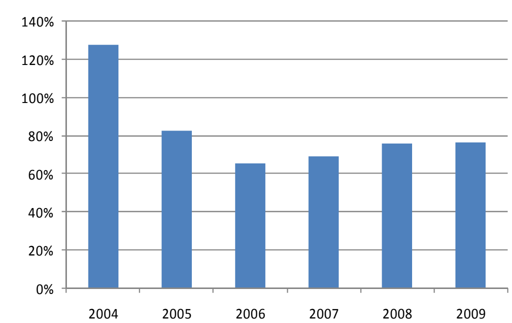
Source: BCU

A breakout by type of borrower shows that corporate lending represents the majority of the stock of outstanding credit with a share of 72% of total non-financial private sector credit as of December 09. The remainder corresponds to household related loans. A breakout by currency shows that most of dollar denominated credit corresponds to corporate lending reflecting the series of prudential regulations currently in place (see Figure 2).

Access to bank financing by Uruguayan firms continues to be limited. The 2008 World Bank Investment Climate Survey highlighted the low use of bank credit by Uruguayan firms as it accounts for as little as 6 percent of working capital and even less for asset financing. The problem is more acute in the case of SME financing. Uruguayan enterprises are required to pledge more collateral as a percentage of their loans than enterprises in many comparable countries.

Systemic liquidity has been enhanced in recent years with liquid assets to short term liabilities (with less than 91 days maturity) near 77% as of December 2009 (see Figure 3). On the funding side, Uruguayan financial institutions benefit from cheap retail deposits (mostly transactional) of domestic and international nature with limited reliance on market funding. In addition, tight BCU reserve requirements for domestic and foreign currency denominated deposits have helped increase the level of cash and cash equivalences available in the system. Finally, the modest growth in origination volumes has also contributed to further strengthen banks liquidity positions. Not surprisingly, the Uruguayan financial system exhibits a relatively low loan to deposit ratio of 47% as of December 2009.

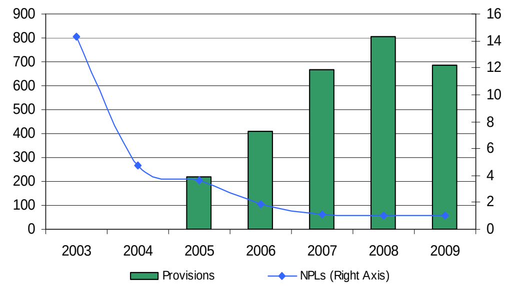
Fig. 3: Liquidity Ratio (*), 2004-2009



(*) Liquid Assets (Cash+short term investments) / Short Term Liabilities (includes credits below 91 days maturity)
Source: BCU

Asset quality has improved considerably in recent years (see Figure 4). A combination of sustained economic recovery, BCU support to troubled entities and the introduction of different refinancing facilities for delinquent borrowers has led to a sound recovery in asset quality. This improvement is evidenced by the ratio of NPLs to total loans that has ranged from figures near 25% in 2003 to new record lows of less than 1% in mid-2008. In addition, current systemic coverage rates remain robust as they represent more than five times the level of troubled loans.

Fig. 4: NPLs %, Coverage Rates %, 2003-2009

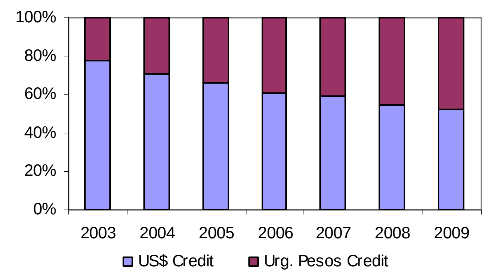


Source: IMF Global Financial Stability Report, 2010

Banks continued with the process of reducing their balance-sheet mismatches. In particular, the exposure to foreign currency mismatches has been reduced significantly thanks in part to enhanced prudential regulation. Currently, currency composition of loans is changing as the share of dollar denominated credit over total private sector credit has decreased from figures near 80% in 2003 to figures close to 50% in December 2009 (see Figure 5). Moreover, household related credit is currently originated almost entirely in Uruguayan pesos as borrowers income tends to be denominated in domestic currency as well.

Profitability has accompanied economic recovery. Uruguayan banking system benefits from a wide net interest rate margin resulting from low cost domestic retail deposits and relatively high returns bared by assets deposited abroad usually in highly rated foreign banks. Other sources of profits are Uruguayan government securities and to a lesser extent proceeds arising from loan origination. On the other hand, relatively high and inelastic labor costs reduce the maneuverability margin of financial institutions in cases of declining earnings.

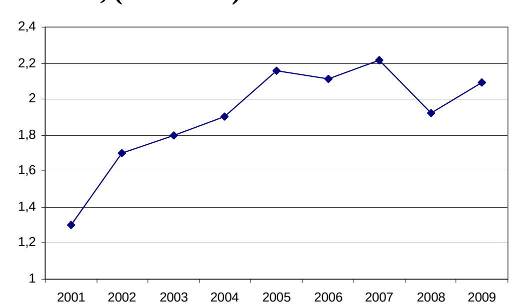
Fig. 5: Private Sector Credit
-Breakout by Currency-



Source: BCU

The capital adequacy ratio for the system remains robust with figures well above domestic and international requirements. The capitalization of the financial system has improved during the last years as a result of an increase in capitalized earnings and new capital contributions. A more favorable operating environment and a recovery of confidence have allowed the financial sector to increase financial intermediation and gradually stabilize its sources of recurrent earnings. In addition, prudential regulation and more conservative business strategies have led to a reduction in foreign currency risk. Improvements in asset quality have also contributed to the strengthening of capital levels. As a result, the systemic capital adequacy ratio relative to the minimum regulatory requirement has improved in the last years reaching a level of 2.09 times in December 2009 relative to approximately 1.3 times in 2001 (see Figure 6).

Fig. 6: Capital Adequacy vs. Regulatory Minima, (# of times)



Source: BCU

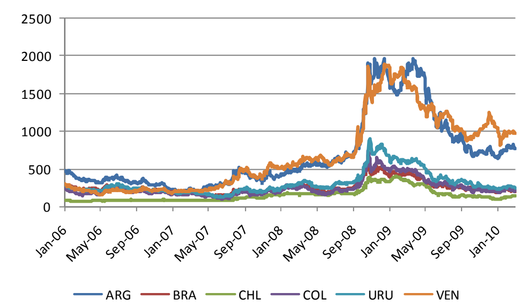
THE INTERNATIONAL FINANCIAL CRISIS AND ITS EFFECTS ON THE URUGUAYAN FINANCIAL SYSTEM

Uruguayan Risk Profile

Despite persistent volatility in the international front, the risk profile of Uruguay improved during 2009. As of December 2009, the average UBI (Uruguayan Bond Index) spread was at 226 bps and remained below its 3-month moving average, showing a reduction of almost 500 bps from a peak reached in December 2008. A gradual easing in international market conditions explains observed performance. In January 2009, Moody's upgraded Uruguay's sovereign debt rating to Ba3 from B1 reducing to 3 notches the gap to investment grade. According to Moody's press release, "the upgrade reflects reduced vulnerabilities associated with a somewhat lower degree of dollarization in government debt obligations and, at the margin, Uruguay's banking system". In this regard, Uruguay benefits from strong market access and relatively low spreads as a result of a series of measures undertaken in recent years aimed to improve the sovereign debt profile.

When compared to regional peers, Uruguay performed strongly with a risk profile similar to those of Chile, Brazil and Colombia (see Figure 7). Prospects on debt profile are encouraging – based on Uruguay's track record – but are linked to the preservation of a conservative fiscal policy and further reductions in dollar denominated debt.

Figure 7: EMBI Evolution, monthly, 3-month MA



Source: Bloomberg

Capital Markets

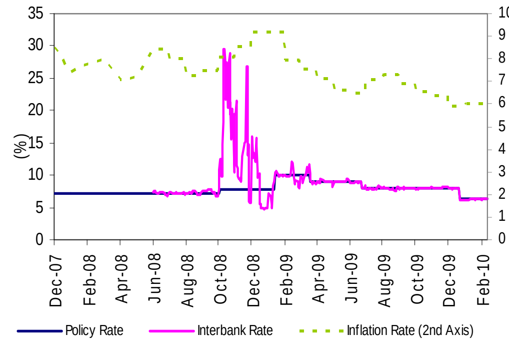
In 2009, total volume traded in the primary market decreased 17% relative to the previous year. This performance was explained by extremely weak activity during the first half of the year as in the second and third quarters volumes surpassed by far previous year levels. Also, trading activity around public and private sector related issuances remained at similar proportions throughout the year. Most of the volume traded in the primary market took place in the *Bolsa Electrónica de Valores* which accounted for 95% of total trades.

Despite lower trading activity, the market evidenced an increase in the number of new issuances relative to 2008. In particular, there were 5 corporate bond issuances for a total amount of USD 121 million relative to 2 issuances for USD 37.7 million during 2008. Similarly, financial trusts totaled 3 new issuances for USD 34.6 millions relative to 1 large issuance in 2008 for USD 55.4 millions. As observed in previous years, no equity issuances took place during 2009.

Banking System

Despite the negative economic effects of the current international financial crisis on most developed and developing countries, the Uruguayan economy continued to exhibit strong economic activity until early 2009. This explains why the Uruguayan monetary policy strategy has differed substantially relative to regional partners as it has been aimed to contain inflationary pressures rather than boost economic activity. However, in the second quarter of 2009 the monetary policy rate was adapted to reflect an incipient less favorable economic environment (see Figure 8). In this context, the financial system exhibited signs of slight deterioration but fundamentals remained adequate.

Figure 8: Monetary Policy Rate, Interbank Rate.

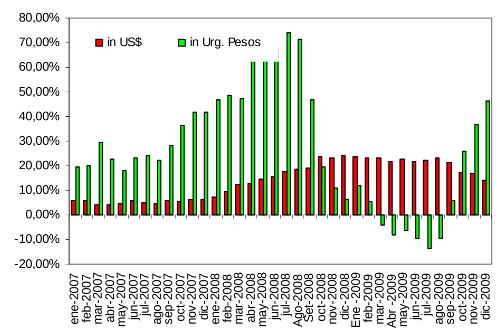


Source: BCU, Key Statistics, Daily

Non-resident deposits gained dynamism. Since the beginning of the international crisis back in mid-2007 and the series of political instabilities arose in Argentina during 2008, deposits far from losing dynamism, continued to exhibit strong growth rates thanks in part to increases in non-resident deposits. In particular, total private sector deposits have grown 21% in 2008 relative to 13% in 2007 while non-resident deposits have experienced a more vigorous behavior with annual growth rates of 41% in 2008 versus 8.2% in 2007. Thus, non-resident deposits could be a potential source of volatility in the future as they are susceptible to flight.

Dollar-denominated deposits maintained their leadership in terms of level and growth rates (see *Figure 9*). This dynamic has been further exacerbated during 2008 and the first quarter of 2009 due to a series of portfolio dollarization episodes triggered by foreign exchange instabilities and inflows of non-resident deposits.

Fig. 9: US$, Domestic currency Deposits (yoy growth)



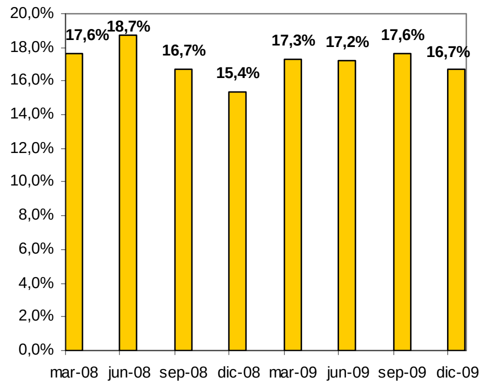
Source: BCU

A widespread slowdown in origination volumes of private sector credit began in the second half of 2008 and continued until recently. In the second half of 2009, a reversal seems to have begun. Performance prior to the second half of 2009 can be attributed to weakening international and domestic economic conditions. In particular, credit stagnation has been more acute in commercial lines as companies (main destiny of credit origination) have adopted a wait and see strategy due to deteriorating prospects in economic activity. However, the recent easing in international conditions coupled with a change in the monetary policy strategy (aimed to boost economic activity) have positively impacted on credit figures. It is still too early to confirm the observed improvement as a trend but if costs of funding remain adequate and domestic and international conditions do not deteriorate, demand for credit should improve further.

Systemic liquidity figures have not varied relative to a year ago and remained at adequate levels. Liquid assets to short term liabilities (less than 91 days maturity) reached 76.6% as of December 2009 relative to 76.3% a year ago. These figures are explained by a growing depositary base coupled with a decline in liquid assets due to a gradual revamp in origination volumes. In particular, credit stagnation observed in 2009 could be argued to be demand-driven as companies (main destiny of credit origination) adopted a wait and see strategy due to deteriorating prospects in economic activity. However, a more lax monetary policy coupled with a more benign operating environment has increased the appetite for credit.

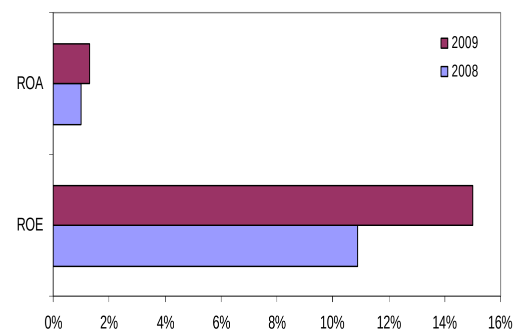
As of December 2009, systemic capital adequacy ratio and profitability indicators have improved slightly when compared to a year ago and remain at adequate levels (see *Figures 10 and 11*). In particular, profitability figures experienced a gradual deterioration during 2008 as international conditions worsened. The relatively low reliance of the system on loan origination activities has not allowed developing a stable source of recurrent earnings. In turn, the main source of profits in recent years has been the differential between returns on assets held abroad and interest paid by banks on their deposits. Then, the drastic worldwide reduction in interest rates eroded significantly Uruguayan banks' interest rate margin and thus their overall profitability.

Fig. 10: Capital Adequacy Ratio



Source: BCU

Fig. 11: ROE and ROA, 2008-2009



Source: IMF Global Financial Stability Report, 2010

Despite the current international financial crisis, asset quality continues to exhibit strong figures with NPLs to total loans at historically low levels of near 2% as of December 2009. Moreover, systemic coverage rates for public and private banks represent more than five times the level of troubled loans. In particular, the modest growth of credit in recent years has reduced the potential credit risk associated with unseasoned pools. Existing systemic coverage rates provide a high degree of comfort, though a domestic downturn scenario might add pressure to observed performance,.

TO SUM UP: IMPROVEMENTS & CURRENT WEAKNESSES

Structural Improvements

- Regulatory environment has improved as a result of the last crisis; the regulator (Central Bank of Uruguay) takes a more proactive role.
- Most weak banks have gone bankrupt or been absorbed; only strong entities remain.
- Exposure of Uruguayan banking system assets to Argentine risk is currently limited in contrast with the situation experienced during the 2001 crisis.
- Capital adequacy ratios are above domestic and international requirements, except for *Banco Hipotecario del Uruguay* (public bank) which underperforms.
- Systemic liquidity continues to be high when compared to regional standards. Liquid assets account for 60 percent of short term liabilities as of January 2010.
- Banks count with good collateral and in many cases external support.

- Asset quality remains strong despite the current international financial crisis. The modest growth of credit in recent years reduces the potential credit risk associated with unseasoned pools. Coverage rates exhibit robust levels. Still, a downturn domestic scenario might put pressure to observed performance.

Weaknesses

- Financial system remains highly concentrated. The two existing public institutions, *Banco de la República Oriental del Uruguay* and *Banco Hipotecario del Uruguay*, account for approximately half of total banking system assets. If the five largest banks are to be considered, concentration reaches more than 80% of total assets. The recent acquisition of ABN Amro Bank by Banco Santander has further increased financial system concentration.
- Non-resident deposits have decreased significantly over the years but their current high levels still pose a potential source of instability. Nevertheless, reserve requirements seem to be adequate to deal with such an event.
- Financial intermediation still has room for growth -- in particular, on the borrowers' side. SMEs' insufficient financing makes it a niche with enormous potential for growth.
- The lack of a significant source of recurrent earnings exposes systemic profitability to substantial volatility.
- Relatively high and inelastic labor costs reduce the maneuverability margin in cases of declining earnings.
- Uruguayan financial system's still high dollarization limits the power of BCU to act as a lender of last resort.

WHAT LIES AHEAD

In sum, the Uruguayan Banking System has become more resilient than in the past to situations of distress. Fundamentals have improved as evidenced by enhanced asset quality, high liquidity figures, lower non-resident deposits and adequate capital ratios. However, Uruguayan banks still face risks associated with balance sheet mismatches as financial system dollarization, although lower than in the past, remains high in absolute and relative terms. An increase in exchange rate volatility could exacerbate the risk of balance sheet mismatch, although its consequences to overall financial system stability should remain bounded.

Annex F: IBRD Program Summary

1. **In line with the priorities identified by the Government, the 2010-2015 CPS will focus on the following four pillars: (i) Sustainable Economic Growth and Reduction in Macroeconomic Vulnerability; (ii) Competitiveness & Infrastructure; (iii) Agriculture, Climate Change, and Environment; and (iv) Increasing Social Inclusion & Equity.** Indicative support for this strategy is proposed to include a series of two DPLs totaling US$200 million (FY11 and FY12), investment lending totaling approximately US$500 million subject to IBRD's overall lending capacity, and a well-focused and demand-driven AAA program.

2. **The proposed strategy places a heightened emphasis on supporting Uruguay in accessing international expertise and best practices, as well as sharing its own experiences with other countries through South-South exchanges.** Toward this end, the Government and the Bank agreed to introduce an innovative modality for analytical services, knowledge transfers and technical assistance based on the successful approach implemented as part of the Bank's partnership strategy with Chile. This modality–a joint analytical and technical assistance program–aims to enable the Bank to tailor its non-lending program to needs expressed by the Government and respond swiftly and flexibly to demands. This joint program will be based on a framework agreement that clarifies the objectives, governance structure, and shared financing of the program. Rooted fully in demand from the Borrower, an annual work program would be agreed between the Government and the Bank and define the main knowledge products and services to be elaborated in the following year, including a detailed timetable and cost estimates.

3. **Beyond from the need for continuity in existing areas of support to maintain momentum of reforms, the Government's guiding principle for selecting new lending activities is "innovation."** There is a focus on using Bank resources for adding important value to critical interventions, contributing world class technical know-how in the respective areas and helping build strong institutional capacity, in particular in reform program design and managing for results. Another important criterion for selecting new lending operations is to ensure that through close coordination with other donors, most notably the IADB, synergies are realized and duplications avoided. Table 4 provides the agreed lending program for the first two years of the CPS, while providing only very indicative allocations for the reminder of the CPS period.

Pillar 1: Reducing Macroeconomic Vulnerability & Strengthening Public Sector Administration

4. **While Uruguay's resilience in the face of the global financial crisis demonstrates the progress made in mitigating macroeconomic vulnerabilities, this remains a key priority for the Government and an area in which continued Bank collaboration is desired**. The Government and Bank concur that collaboration under the first two pillars of the previous CAS – reducing vulnerability and sustaining growth – provide a successful basis on which to build. The CPS would have a particular focus on supporting Government efforts to achieve the following outcomes: (i) contain expenditure growth to ensure no further deteriorate of fiscal balance in 2010, (ii) keep inflationary pressures under control, (iii) reduce dollarization levels. Bank efforts supporting these outcomes include the following:

5. **The Programmatic Public Sector Competitiveness and Social Inclusion Development Policy Loan Series (FY11 and FY12).** DPL I supports the implementation of reforms which have been identified by the new Government as priorities for obtaining Bank support. The program consists of a series of two loans, each amounting to US$100 million, which will support implementation of the Government's agenda in three main areas: (i) public sector management, (ii) competitiveness, and (iii) social inclusion. In particular, the main development objectives of the new loan are to strengthen the

efficiency of the public administration while promoting macroeconomic stability, improve competitiveness through measures such as, facilitating trade, strengthening the business environment and development of financial markets. It also seeks to improve social inclusion through measures targeted at enhancing the equity and efficiency of health, education and social protection systems. DPL I also targets the consolidation of reforms supported by the PRIDPL series (approved May 2007), and bolsters Government efforts in other areas were not supported by the PRIDPL series. Specifically, the loan recognizes recent achievements in public sector management, business climate and social service delivery (prior actions for DPL-I). The indicative triggers for DPL-II reflect broad policy areas of support, anchoring the new Government's reform agenda through 2011.

6. **Institutions Building Technical Assistance Project (IBTAL) and Additional Financing (ongoing).** The Bank has been helping the Uruguay Government with its state modernization agenda through the IBTAL including by financing technical exchanges between the New Zealand and Uruguay authorities in various aspects of public sector management. Through the ongoing IBTAL loan of US$12.1 million and a potential Additional Financing for the same, the Bank will continue to provide support for the adoption and implementation of a program-based budget, as well as for the monitoring and evaluation efforts to continually strengthen the budget process. The objective of the IBTAL is to improve the Borrower's public sector performance by: (i) supporting its public sector modernization program in the areas of customs administration, monitoring and evaluation, performance-based budgeting, and e-government; and (ii) strengthening its institutions involved with the design and implementation of public policy reforms in the areas of taxation, promotion of the business environment, and social protection.

7. **Treasury Department Services.** Uruguay has been a leading country in LCR in utilizing the IBRD Treasury Department's banking products and services in order to manage some of its balance sheet risks, particularly interest rate and currency risks. This partnership will likely strengthen over the next CPS period as further financing in Uruguayan Pesos is expected to be executed and as ongoing discussions on broader hedging strategies (energy, weather, etc) are completed.

8. **CFAA using the Public Expenditure and Financial Accountability (PEFA) methodology.** The last Country Financial Accountability Assessment (CFAA) was published in June 2005 (Report No.32851-UY). Given the priority the administration places on its public sector reform program, this exercise presents an opportunity for the Bank to provide technical advice and support on Public Financial Management (PFM) reforms that are part of the government agenda. It is proposed to conduct a PEFA study that would assess the status of country's Public Financial Management systems/ reforms against 28 high-level of PFM indicators. This study could serve as an objective baseline for the impact of the PFM reforms that the Government is initiating and also serve to measure their progress.

9. **CPAR.** As the last CPAR was conducted by the Bank in 1999 and the report delivered to the Government in 2000, the Bank proposes to update this analytical tool. At that time, IADB, UNDP and relevant government agencies provided valuable input on the local procurement environment, and the Bank would actively seek collaboration with other partners in the execution of the updated CPAR as well. A primary objective of the dialogue would focus on the attainment of consensus for the conducting of an assessment of the public procurement system using the indicators-based OECD/DAC tool.

Pillar 2: Improving Competitiveness & Infrastructure

10. **The Government seeks to strengthen competitiveness through increased coverage and better quality of infrastructure and establishment of a more conducive business environment.** Beyond the strong demand for Bank expertise in the area of public-private partnerships, with PPIAF-financed activities already launched, sector dialogue has shaped a proposed infrastructure program under the CPS to achieve: (i) improvement of the condition of key land transport infrastructure; (ii) efficiency

improvements in OSE to free up resources for additional investment; (iii) diversification of sources of energy to reduce dependence on specific resources and decrease costs; and (iv) energy efficiency improvements by industry, agriculture and residential consumers to slow the growth of electricity demand. Means of support under the 2010-2015 CPS include the following:

11. **Energy Efficiency GEF Grant (ongoing):** The Energy efficiency project is partially financed by a US$ 6.9 million grant. The development objective of this project is to increase the demand for and competitive supply of energy efficient goods and services, contributing to: (a) improved efficiency of energy use; (b) reduced reliance of the Uruguayan economy on imported electricity and fuels; and (c) reduced emissions from the energy sector. The Project's global environmental objective is to promote energy efficiency through (i) building capacity and know-how among stakeholders; (ii) stimulation of consumer demand; and (iii) promotion of project development and investment financing. The project consists of three main components: Energy Efficiency Market Development (implemented by MIEM); Utility Based Energy Efficiency Services (implemented by UTE); and. Project Management (implemented by MIEM and UTE). The project has supported the development of a string regulatory framework in energy efficiency in the country as well as its inclusion in the public agenda.

12. **Energy Sector Strengthening Project (Timing TBD):** The operation will strengthen energy security in Uruguay. Given the draughts and the regional scarcity of natural gas, in recent years Uruguay faced strong difficulties to satisfy its electricity demand. The operation would focus on enhancing transmission and distribution capacity, with a view to contributing to assure the adequate ease of use of electricity in all the country.

13. **Transport Infrastructure Maintenance and Rural Access (ongoing):** The project's development objective is to upgrade the country's road transport infrastructure to a condition that facilitates the transportation of freight and passengers at a cost-efficient level of service. This is being done by rehabilitating key transport links, removing existing bottlenecks, arresting any further deterioration of infrastructure due to budgetary constraints, and improving infrastructure management and safety. The project is helping to reduce transport costs and preserve the infrastructure stock in Uruguay in an efficient and sustainable manner at both the national and local levels. In general, the structure and composition of the transport industry in Uruguay is highly competitive. Thus, the net reduction in transport costs brought about by the project should translate into freight tariff reductions, ultimately reducing the price of the transported goods and stimulating higher levels o f productivity and economic activity.

14. **Transport Infrastructure Modernization Loan (FY12)**. This operation would consist of an output-based loan supporting the MTOP five-year work program that finances typical road works (mainly CREMAS), and possibly supports the implementation of reforms in other surface transport modes as well as the institutional improvement of the MTOP. The loan would disburse with indicators that link road condition and progress of the transport sector reform.

15. **OSE Modernization and Systems Rehabilitation project APL III/IV (FY12).** The project development objective (PDO) of the overall APL program is to increase the efficiency, coverage and sustainability of water supply and sanitation services through: (i) improved efficiency and effectiveness of OSE; (ii) increased capacity for pumping treated water in Montevideo and UFW reductions; and (iii) increased sewerage treatment and a new strategy for sewerage expansion. There is currently an ongoing project under this program (OSE APL II) and another under preparation (OSE APL IV). A study on the preparation for the OSE APL IV project called *Construction of Wastewater Treatment Plants* is being conducted to support this investment operation. It should be noted, however, that OSE is proposing to jointly prepare the APL III and APL IV projects (in a combined APL III).

16. **Integration of Public Policies on Risk Management for Threats of Water Origin (ongoing Technical Assistance)** aims to support DINASA's (*Direccion Nacional de Agua y Saneamiento*) institutional and technical strengthening throughout financial and technical assistance in a specific field. It would be a bridge between the financial assistance provided by the World Bank Technical Assistance Loan (closed) and DINASA's financial support throughout Uruguay's National Budget.

17. **The Sewerage Access Study Trust Fund (ongoing)** aims to support preparation of a study to evaluate impact on public health of connecting to a sewerage system. It's the most advanced study of its kind in the Bank (and maybe in the world) today.

18. **Road Safety Trust Fund (ongoing)**. The objective of this grant is to generate a sustainable cultural change trough information, education, training and awareness. This campaign is line with the GoU´s recently approved Road Safety National Strategy, the implementation of which is led by the National Road Safety Unit (UNASEV), road safety lead agency created by law in 2008. It finances the improvement of data collection on use of passive road safety elements for children, as well as a communication campaign to raise social awareness on the importance of using road safety elements for children. The activities financed under this grant are currently being disseminated at the regional level by the Global Road Safety Facility as best practice. As a result of this grant the beneficiary is preparing a manual describing the methodology used in Uruguay to develop this Road Safety campaign aimed at protecting children, to share the experience and exchange information with other countries in LCR.

19. **IBRD has developed considerable experience in providing assistance on financial markets and business climate-related challenges throughout the region, and the Bank has already deployed a series of lending and non-lending instruments in Uruguay to tackle these fronts**. Preliminary feedback from these activities is promising. Thus, a range of WBG support is proposed to further strengthen the business climate in the following ways: (i) promotion of the new one-stop shop for firm creation; (ii) substantially increase the credit available to the private sector; and (iii) the completion and operationalization of several Public-Private Partnerships as key elements of meeting targets for infrastructure investment. In addition to the DPLs, the achievement of these outcomes will be supported through the activities below.

20. **Promoting Innovation to Enhance Competitiveness Project (ongoing).** This project's development objective is to strengthen Uruguay's capacity to generate, transfer and adapt knowledge and technology by supporting: (i) the institutional framework for science, technology, and innovation (STI); (ii) investments in human capital and high-quality research teams; (iii) technology transfer and private sector innovation; and (iv) cross-sectoral and international research collaboration and mobility of researchers between public institutions and the productive sector. There are 3 components. Component one will support STI policies and institutional strengthening. Component two will build human capital and high-quality research teams and will strengthen the capacity to develop new knowledge. Component three will promote innovation and technology transfer to the productive sector.

21. **AAA on competitiveness (ongoing).** In response to the Government's request, this study assesses Uruguay's potential as a logistics hub and as a regional distribution center. The competitiveness of Uruguay's logistics system is assessed from an international perspective and policy recommendations towards further efficiency gains are provided. The study focuses on policies related to enhancing domestic and regional trade facilitation and assesses the wider economic impact of such reforms on logistics costs and trade.

22. **Investment Climate Assessment (FY12).** This activity would be a key ESW built on the previous Uruguayan Investment Climate Assessment carried out in 2007. The study would seek to: (i) measure prevailing investment climate conditions in Uruguay and their evolution relative to the last

assessment; (ii) provide international comparisons on key business climate indicators; (iii) identify the features of the investment climate that matter most for firm productivity and competitiveness; and (iv) make policy recommendations on key reform priorities. It will help identify priorities for policy reform and will provide the Government and the private sector evidence that can be used to advocate for further policy reforms.

Pillar 3: Protecting the Environment, Mitigating the Effects of Climate Change, and Strengthening Family Agriculture

23. **The WBG is well positioned -- in terms of the financing options, knowledge and expertise at its disposal – to support the implementation of the *National Response to Climate Change Plan* and the *National Action Plan on Production and Sustainable Consumption*.**

24. **Integrated Natural Resources and Biodiversity Management Project (ongoing).** The objective of this project is to conserve Uruguay's globally significant biodiversity particularly through financing the incremental costs associated with promoting integrated production systems in key biodiversity areas. In this context, this project fits perfectly with the Government strategy to expand the work initiated under the PRENADER Project, but with more emphasis on natural resources and biodiversity conservation and management. The mainstreaming of biodiversity in the rural sector and the value added to rural land production based on sound practices may be replicated elsewhere with a strong communications scheme. The academic sector and civil society organizations would be key elements to disseminate and bring into concrete actions the lessons derived from this initiative.

25. **GEF Biodiversity Conservation (ongoing).** The first component, Natural Resources and Biodiversity Management Component provides technical and financial assistance to demand-driven activities aimed at promoting sustainable management of natural pastures and rain-fed agriculture. The GEF contribution to the Fund would support mainstreamed demand for biodiversity initiatives in priority ecosystems. The second component, fully financed by GEF resources, establishes demonstration areas within the selected areas of GEF-interventions (grasslands and *serranías*), for a sustainable use of natural resources in key micro-catchments which are important for biodiversity, combining sound practices for natural resources management, and creating increased public awareness on the significance, and socioeconomic importance of biodiversity. The third component develops support services that contribute to the efficient implementation of sub-projects, financed under the previous two components. The fourth component supports the sound and efficient management of the Project.

26. **Montevideo Landfill Gas Recovery Carbon Trust Fund (ongoing).** The project aims to design, install, and operate a landfill gas flaring unit at Montevideo's controlled landfill, thereby avoiding 1,299,836 tons of carbon dioxide equivalent (tCOze) emissions from July 2007 to December 2012. In addition to achieving carbon Emission Reductions (ERs) through methane combustion, the project will contribute to a positive local environmental impact under objective one above by controlling flammable gas migration and non-methane volatile organic compound (NMVOC) emissions, which can cause other local and global environmental effects and are hazardous in high concentrations.

27. **UTE 10MW Grid-Connected Wind Power Farm at Caracoles Hill Trust Fund (ongoing).** This is a small-scale Clean Development Mechanism (CDM) activity aimed at reducing greenhouse gas emissions by displacing electricity generated from carbon intensive sources in the Uruguayan grid. Its main objective is to reduce greenhouse gas emissions by grid-connected electricity generation from wind power. The emissions reduction will arise from the displacement of fossil-fuel-based electricity generation on the national grid. The project will contribute to the sustainable development of Uruguay, most notably through energy security and the substitution of crude oil and derivatives imports. This

project being the first of its kind, it is designed as a small-scale pilot, aimed at being easily replicated in case of success.

28. **Carbon Finance Assistance (disbursing under TF054846).** The objective of this operation was to strengthen the national capacity at both institutional and technical level in order to enable the development of Clean Development Mechanism (CDM) projects and other mitigation activities. This technical assistance has achieved the following: (i) Capacity building within, and technical assistance to the DNA, (ii) Capacity building within other Government Agencies, (iii) Participation in Carbon Expo and preparation of promotional materials, (iv) Outreach to the private sector and the general public, (v) Analysis of the legal and regulatory framework for the approval of CDM projects and the sale of the corresponding CERs, and (vi) Technical assistance for development of programmatic CDM opportunities.

29. **Sustainable Industrial Development Project (FY12)**. This operation would also strengthen the institutional capacity to enforce existing regulations both at national and sector levels. In terms of the current institutional capacity to enforce compliance, the GoU has implemented some measures, including the control of regulations compliance. However, these efforts have been isolated. In this context, DINAMA, together with other ministries in relevant sectors, has agreed to coordinate efforts and to work together in the design of new and comprehensive instruments to facilitate supervision and control of cleaner production processes which would be part of the new IBRD operation.

30. **Promoting Cleaner Production & Improving Environmental Compliance in the Industrial Sector Trust Fund (RETF).** During 2010, the GoU has presented a National Action Plan on Production and Sustainable Consumption. This plan seeks to identify, coordinate, integrate and potentiate a set of actions, programs and projects targeted to prevent and minimize environmental impacts from production and consumption. This project is expected to become active September 31 2010. Its objectives are to support activities that will seek to promote cleaner production, improve environmental compliance and boost competitiveness in the industrial sector (particularly for SMEs) in Uruguay, through the provision of technical assistance to the *Dirección Nacional de Medio Ambiente* (DINAMA). These activities will be part of the project preparation activities relating to the Uruguay Sustainable Industrial Development Project.

31. **Integrated Agricultural Development and Natural Resources Management Project (FY12).** The proposed operation would represent an innovative results-oriented initiative that would replicate the successful experience of the ongoing Natural Resources and Biodiversity Management Project, while expanding the objective and scope to incorporate a strong focus on Climate Change adaptation and mitigation in the agricultural sector. The project would incorporate specific support to the development of innovative public instruments to improve information systems for planning and decision making, as well as supporting private sector investments to mitigate emissions, utilization of biomass for energy generation, and improve resilience to climate variability at the farm level. Project design would also benefit from the conclusions and recommendations of the recently completed AAA on Family Agriculture regarding the specific factors that increase the vulnerability of this important subsector of the farming community, and the analytical work conducted on Climate Change. The project, financed by a blend of a Bank loan and possibly GEF funds, would represent one element of an integrated results-oriented set of instruments that would also include Bank assistance to the Ministry of Livestock, Agriculture and Fisheries (MGAP) to access other possible sources of bilateral and multilateral financing for climate change (such as the Adaptation Fund), as well as analytical support, technical assistance, and collaboration with MGAP regarding dissemination of experiences, organization of conferences, and participation in international events related to climate change.

32. **AAA on Family Agriculture (ongoing).** The Development Objective (DO) of the this Economic Sector Work (ESW) is to contribute to more equitable agricultural sector development in Uruguay while

maintaining the country's natural resource base and guaranteeing the long term sustainability of the farming community. Towards this objective, the ESW, through its diagnostics and recommendations focusing on the family agriculture segment, would contribute to an improved knowledge base within DGDR and a capacity for coherent programming of policies and instruments to address the main constraints to agricultural development in general, and by family agriculture in particular.

33. **AAA on climate change and agriculture (FY12).** This analysis would assess international experiences and provide guidance to the development of the Government's integrated strategy for mitigating and adapting agriculture and livestock production practices to climate variability, including by exploring the use of risk management (insurance) instruments.

Pillar 4: Increasing Inclusion & Social Equity

34. **The experience of the World Bank in Uruguay and other countries in the region positions it well to respond to the Government's demand for technical assistance in the implementation of the National Plan for Social Equity, as well as to support the continuing reform in the health and education sectors.** Several interventions are proposed to support the aforementioned government objectives in the social sectors.

35. **Output-Based Social Sector Project (Timing TBD).** This lending operation would contribute to finance the policies discussed and identified as efficient and priority in the studies on Health Reform Assessment, One laptop per Child and Social Policy Analysis, to help the Government implement necessary reforms.

36. **Human Opportunity Index (NLTA) (FY12).** This is a possible follow-up work on "Monitoring social policy through the HOI". It would be an input towards the preparation of the Social Sector Results-based project.

37. **Social Policy Analysis (FY12).** This activity would comprise an evaluation of the Family Allowances and *Tarjeta Alimentaria* programs and discussion of further reform options on income transfer programs, including the use of FA and TA for the extreme poverty eradication plan, reforms in the FA program, and reforms in the old age non contributory pension program. This ESW will include an analysis of public expenditure efficiency and impacts of these policies on the Human Opportunity Index.

38. **Reform of Housing Policies (FY11).** The objective of this study would be to consider policy options to increase the supply of social housing, focused on creating incentives for self-initiatives.

39. **Social Sectors Public Expenditure Review (FY12)**. Upon taking office, the administration proposed a public sector reform agenda aimed at, among other things, developing result-oriented medium-term budgeting, reforming the civil service, enhancing governance and transparency, and implementing effective and well-targeted social policies and programs supported by more effective social service delivery. A Social Sector Expenditure Review would aim to achieve the following objectives: (a) develop an overview of the fiscal stance and a debt sustainability analysis, and their prospects in the medium term; (b) upgrade public expenditure management, supported by a PEFA evaluation; (c) assess recent social policies and their budgetary implications; (d) examine the incidence of social expenditure of the main social programs; and (e) complete an evaluation of key social programs (mainly family allowances and *Tarjeta Alimentaria*), while implementing impact evaluations wherever data make it possible.

40. **Third Basic Education Quality Improvement project (ongoing)**. The objective of this project is to increase equity, quality, and efficiency in the provision of preschool and primary education. These

objectives will be achieved by: (i) expanding the full-time school model, which focuses on students from socioeconomically disadvantaged backgrounds; (ii) improving the quality of preschool and primary education by enhancing the teacher training system and introducing new teaching and learning instruments in the classroom; and (iii) increasing the efficiency of education institutions. There is an ongoing additional financing for this project which addresses the financing gap arising from the increase in project costs associated with a change in the Government of Uruguay's (GoU) strategy on civil works, and the significant escalation of construction costs in the country.

41. **Education Project (FY12).** The proposed education operation (estimated $40 million) would include continued support for the expansion of the full time school (FTS) and related activities, aimed to increase the quality of education at the primary level. The envisioned activities expected to be financed under the project include; (i) the construction, rehabilitation and equipping of new FTS schools; (ii) the procurement of didactic materials for the schools (school equipment, learning materials, and school libraries); and (iii) teacher training for FTS.

42. **AAA on the One-Laptop-Per-Child initiative (FY11).** This activity would consist of an assessment of the CEIBAL program and implementation so far, and discussion of possible options regarding the use of laptops in the classroom and expansion to secondary education.

43. **The Non-Communicable Diseases Prevention Project (ongoing)**. The Non Communicable Diseases Prevention Project seeks to support the Government's efforts to further strengthen its health delivery services and the current health policy framework for NCDs. In this context, the specific development objectives of the operation are (i) to expand accessibility and quality of primary health care services related to selected NCDs early detection and medical care; and (ii) to avoid and reduce exposure to selected NCDs risk factors as well as their health effects. The operation consists of four components: Component 1 - Strengthening of the MSP's capacity to address the country's changing epidemiological profile; Component 2 -Improving access to quality care services for prevalent NCDs in public primary-care facilities; Component 3 - Implementation of the *Previniendo* Pilot Program; and Component 4 – Project Management. These components are implemented by the three main directorships within the MSP, with overall support and coordination from a Project Support and Coordination Unit (PSCU).

44. **IDF grant to Promote Equitable Access of Society to the Legal System (ongoing).** The first Bank grant to be executed by the Uruguayan Parliament, this is designed to raise awareness among vulnerable groups of the benefits and rights established in select social legislation. It will allow Parliamentarians to monitor the social impacts of selected laws, develop tools to incorporate a social analysis when reviewing draft legislation, and, in cooperation with agencies of the Executive, develop institutional capacity to better implement such laws.

Annex G: IFC Program Summary

1. IFC activities in Uruguay are focused on the country's rich natural resource endowment, while fostering a more competitive private sector environment. The Corporation expects to move forward with a balanced approach that aims to finance private sector players with the scale needed to compete in global markets, while encouraging the growth of SMEs and supporting low-income groups. It expects to attain these objectives by expanding the availability of financial services, supporting agribusiness and forestry, financing infrastructure projects, and encouraging the growth of Uruguay's tertiary and technical education system. These aims areas are in line with two of the four CPS pillars: improving competitiveness and infrastructure, and increasing inclusion and equity.

2. Uruguay's financial system has survived the global crisis, but lacks the depth achieved in other countries in the region such as Brazil and Chile. In 2008, domestic credit provided by the banking sector was equivalent to 33% of GDP, less than for regional upper middle income peers Chile or Brazil, but better than Argentina. Uruguay has an embryonic microfinance industry. Uruguay's microfinance sector ranks 50th out of the 55 countries surveyed in the 2009 Global Microscope on the Microfinance Business Environment, reflecting low scores for institutional development and regulatory framework.

3. This suggests that substantial opportunities exist for financial institutions to expand the range of services available to middle- and low-income households, as well as to second tier corporates and farms. Corporate lending in Uruguay tends to be concentrated at large companies.

4. IFC aims to support banks and non-banks that focus on the mid-market corporate and low-income retail banking segments. IFC is looking at opportunities to support local banks with onlending facilities for agribusiness SMEs and with trade finance lines for exporters. IFC currently has only one trade finance client in Uruguay with $160,000 in guarantees outstanding as of May 2010. IFC has financed microfinance ventures elsewhere in Latin America, particularly in Bolivia, Mexico and Peru and thereby managed to reach groups that had previously been unable to obtain credit on acceptable terms. IFC is in talks with a potential client in this sector. It intends to help develop Uruguay's small microfinance sector through investments with microfinance institutions, on a selective basis. The Corporation also aims to support housing finance projects that can help expand this incipient market. IFC has also gathered considerable experience in supporting the development of capital markets in other Latin American economies.

5. Agribusiness is an important market for the IFC given its significance to the Uruguayan economy. Although it is a relatively small part of the economy, accounting for 10%-15% of GDP, agribusiness products comprise the bulk of Uruguay's exports. The recent resolution of the legal conflict with Argentina over the construction of the Orion paper pulp project sponsored by UPM-Kymmene (formerly Botnia SA), and partly financed by IFC, may open the way for fresh investment in this sector. Uruguay's excellent soils and temperate climate are favorable for the fast growth of commercial plantations.

6. Orion and similar large-scale projects have the potential to reshape the structure of Uruguay's industrial base and generate large export revenues in future years. Orion is the largest foreign investment in Uruguay's history and is enabling the country to move up the value chain beyond the export of raw materials. It is generating some 2,500 local jobs and has created opportunities for small independent suppliers to enter the company's value chain. Orion has also deployed advanced environmental management techniques and technologies that allow it to sequester a net 500 kilos of CO_2 equivalent per year per ton of paper produced. The plant will produce one million tons of paper per year during its 30-year life.

7. Despite the attractiveness of Uruguay's fundamentals, its lack of scale often imposes higher financing and operating costs than direct competitors in neighboring countries. Competitors based in Brazil and Chile are able to attract substantial volumes of capital into their agro-industrial sector either through foreign direct investment or from their local financial system. Although FDI inflows have become significant as a proportion of Uruguay's economy, their absolute volume is relatively modest; inflows have never greater than $2 billion per year.

8. IFC's investment focus is likely to remain on export-oriented enterprises with deep linkages to farms. IFC expects to support projects that integrate SMEs into corporate supply chains. All three of IFC's currently active investment projects in Uruguay are in export-oriented agribusiness companies. These include a citrus producer (Milagro, with a $9.56 million loan outstanding as of May 2010), and a dairy cooperative (Conaprole $17.01 million loan and $3.33 million in quasi-equity financing outstanding in May 2010), as well as UPM-Kymmene ($66.11 million loan outstanding in May 2010).

9. IFC aims to reinforce the county's competitiveness by financing infrastructure projects, especially those in the renewable energy, logistics, and water sectors once Congress has approved the relevant legislation and appropriate new regulations are in place. The ongoing legal and regulatory reforms related to promotion of public-private partnerships and expanded scope of investments by institutional investors in the local capital market could open further opportunities for IFC involvement in this area.

10. Uruguay's education system has benefited from attention under the previous government and the Mujica administration has stated that it will remain focused on improving the country's education system. The IFC hopes to support this strategy should opportunities arise to finance private for- and not-for-profit education institutions, particularly those that offer technical and vocational courses for low income students to improve their employability, raise incomes, and improve productivity. This would support the Government's strategy by improving the range and quality of higher education and by improving equity within the system. IFC has built a portfolio of investments in successful technical and vocational colleges in Brazil, Chile, Colombia, and Mexico that are aimed at working adults and low-income students many of whom are the first in their families to enter college. IFC-financed colleges enrolled 802,000 students in calendar year 2008 throughout Latin America.

Annex H: Proposed Global Environmental Facility (GEF) Program

1. The GEF provides financing for activities that achieve global environmental benefits. It is the designated financial mechanism for the international conventions on biological diversity, climate change, persistent organic pollutants, and desertification. It also collaborates closely with the Montreal Protocol - the legal instrument to implement the objectives set out in the Vienna Convention on Ozone Depleting Substances - and regional and international waters agreements. The World Bank is one of the main GEF implementing agencies in Uruguay.

2. **Current GEF program**: The World Bank GEF program comprises two operations with total financing of US$ 13.8 million. The current operations span biodiversity and climate change (energy efficiency):

- Integrated Ecosystem and Natural Resources Management Project, (US$ 7 million)
- Energy Efficiency Project, (US$ 6.8 million)

3. The Bank's GEF strategy in Uruguay blends GEF-financed activities with Bank loans, not only to better leverage GEF resources but also to better mainstream global environmental concerns in country programs. The Bank's comparative advantage for implementing GEF projects is based on the following:

- Leveraging investments, particularly as part of co-financing with IBRD operations in the area. The GEF helps develop, catalyze, and complement investment operations.
- Leveraging dialogue based on areas of current engagement and technical expertise. The GEF is often a new entry point for dialogue in key sectors, including energy and transport.
- Fostering new ideas and innovation, often with NGOs, the private sector, and others.

4. **GEF potential in Uruguay**: Current Government priorities are in the areas of climate change, biodiversity, and water resources management. Whereas biodiversity and climate change (energy efficiency) have been the dominant areas of World Bank GEF programming over the past few years, there are additional opportunities in nearly all areas eligible for GEF support.

5. Currently the World Bank is implementing large-scale projects on biodiversity, and climate change and energy. These large projects are typically a blend between GEF-funds and WB loans while some only receive financing from the GEF. However, a key issue to consider is the System for Transparent Allocation of Resources (STAR) that the GEF has recently adopted, which implies a maximum allocation for Uruguay in the areas of Climate Change (US$ 3.9 million), Biodiversity (1.9 US$ million) and Land Degradation (US$ 0.6 million) over 4 years. Although the current administration has decided to take maximum advantage of GEF, the strategic use of available resources has not been determined, and there are not projects have thus far been endorsed by the GEF under the new STAR.

6. During the proposed CAS period, the Bank will continue its strategy of blending GEF activities with Bank loans, and will support stand-alone operations in those areas where there is a high potential of sector transformation while addressing global environmental issues. As an example of this approach, the Bank will continue working with Uruguay to finance the incremental costs of conservation in rural areas by means of a probable second phase for the Integrated Ecosystem and Natural Resources Management Project. The potential of renewable energies and energy efficiency are still opportunities to expand the future GEF cooperation. In addition, the Bank's financial support for infrastructure, environment and rural development under the proposed CPS could open additional opportunities for GEF co-financing.

Annex I: Consultations

1. The preparation of the CPS was highly participatory in terms of public sector stakeholders, and the new Government is leveraging the opportunity provided by the CPS preparation to plan an extended series of stakeholder consultations that will not end with the finalization of the CPS but rather continue into implementation.

2. The consultative process commenced before the inauguration of the new administration. Discussions on a set of Policy Notes were held between the Bank and the newly elected authorities in February, 2010, followed by presentations to the main opposition parties. These discussions were attended throughout by the President-elect, Mr. José Mujica, the elected Vice-president, Mr. Danilo Astori, and future cabinet members. These interactions were appreciated both by the Government and the opposition, and enabled the Bank to gauge the relatively high degree of consensus that exists today in Uruguay on the policy agenda and development challenges.

3. In April 2010, the dialog on the main priorities for the collaboration between the Bank and Uruguay over the next five years was deepened. The Bank Vice President met with President Mujica, Vice-president Astori, the economic and social cabinet, as well as with representatives from the legislative branches, private sector and civil society. These discussions generally confirmed as valid the proposed orientations of the DPL and, more generally, the forthcoming Country Partnership Strategy.

4. In early May, 2010, consultations on the DPL, specifically, and the framework of the strategy, more generally, were held. The main objective was two-fold: first, to seek feedback from Government, partners from academia, civil society organizations, Parliament, and the private sector on the various areas of reform covered by the new DPL series; and second, to explain the purpose and the design of the new DPL series in the context of the Government's own development strategy and the Bank's CPS to a wider stakeholder group, beyond the main partners in the Government.

5. Another round of more detailed discussions on the results matrix and the program under the CPS was held July 1, 2010, resulting in an agreed lending program and a general framework for a joint AAA program. From that point intensive dialogue on the finalization of the CPS was continuous.

6. Finally, the aforementioned systematic stakeholder consultations were kicked off in late July/early August, 2010, and will continue through the first year of CPS implementation. Given the multi-sectoral objectives of both the CPS and the Government's own development strategy, this series of consultations is generally organized around the following themes rather than individual ministries or sectors:

- Modernization of the Public Sector
- Strengthening Competitiveness and the Business Climate
- Strengthening the Infrastructure sector
- Environmental Protection and Climate Change Adaptation
- Social Protection and Equity

7. The first round of consultations, organized jointly with the Ministry of Economy and Finance, focused on the preparation of the CPS. While the broader CPS was presented, this group focused mostly on Competitiveness, Business Climate and Infrastructure. There were participants from the Parliament, research institutes, consultant firms, and the private sector.

8. There was a general consensus among participants that the main constraints to competitiveness of the Uruguay's economy related to the insufficient quality of education, in particular the inability of the educative system to generate skills demanded by the economy, as well as inadequate reach and quality of infrastructure. Limited access to finance, caused by factors found both at the supply and demand side of the financial sector were also highlighted as a key underlying problem.

Education

9. Insufficient quality of education was a critical general concern voiced by participants. The current problems at the secondary level (high dropout rates, teacher absentees, etc.) were mentioned as a threat for the society and the economy. There was a discussion on how to strengthen education policy, especially at the tertiary level, in order to better match educational program with demands for skills from the private sector. An important deficit on professional skills was identified. Companies situated in the interior of the country were particularly affected by this problem, as these areas suffered from a "brain drain" of professionals to the capital.

Infrastructure and logistics

10. The lack of well developed infrastructure, especially in areas beyond Montevideo, was mentioned as critical constraint to growth, with the view that very sizeable investments are needed to remedy this problem. It was recognized that these investments could not be financed without the participation of the private sector, given the severe fiscal limitations. Some participants felt however that public-private alliances were not possible without an initial injection of capital by the public sector (for instance for upgrading the railway infrastructure). The reform of state-owned enterprises was seen by several participants as a key element in this regard, as by opening up these companies to the private capital, significant amounts of private capital could be mobilized.

11. Logistics was highlighted by some participants as a key sector, both as source of growth itself as well as a key factor determining production costs of other sectors. There was a discussion on how to improve the regulatory and administrative environment of the logistics sector, and the streamlining and professionalization of customs was highlighted in this regard.

Access to finance

12. There was a sense among participants that improvements in strengthening the regulatory and legal framework of Uruguay's financial and capital markets have led to these markets now generally complying with international standards. In view of this, it was advocated that the Bank should shift the emphasis of its support from strengthening regulation to promotion of market participation.

13. Several participants stated that the emphasis should therefore now be put on promoting activities in the local financial and capital markets, in particular those that would help smaller economic agents improve their access to financing. It was felt by most participants that the priority thereby should be to strengthen the demand side, by enhancing awareness about financial instruments and promoting the availability of information. Increasing capacity in risk management was highlighted, through measures like promoting the use of derivatives by companies. At the supply side, there was still an important need for professionalization of key agents active in financial and capital markets.

14. Some participants stressed the importance of better adapting bank regulations to the particular reality of small and medium enterprises (in terms of economic resources, time and human resource capacity), as a key factor for facilitating their access to the finance. This was also mentioned as a valuable tool for bringing small companies from the informal to the formal sector.

Competitiveness

15. Since strengthening Uruguay's competitiveness is a national strategic priority, it was suggested by some participants that defining and implementing a reform agenda in this regard should be elevated above the political and economic cycles. The creation of an independent institution for this purpose was put forward. Participants also mentioned the lack of coordination among public institutions as hampering the effectiveness of the Government in promoting competitiveness. In this context, there were some references to a proliferation of institutions responsible for this reform agenda. Also, some participants expressed a need for enhancing capacity of the Foreign Service in promoting Uruguayan products and companies abroad.

Next Steps

16. Subsequent rounds of consultations will provide ongoing feedback from stakeholders to complement quantitative data on progress against the Government's development objectives and against the CPS objectives, as well as informing the continued evolution of Government strategy. Particular emphasis will be placed on those themes which were not fully addressed in the first round.