DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

U R U G U A Y

MULTISECTOR GLOBAL FINANCING PROGRAM III (MS-III)

Operation No. 1407/OC-UR
Approved on June 12, 2002

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

URUGUAY

MULTISECTOR GLOBAL FINANCING PROGRAM III (MS-III)

(UR-0136)

LOAN PROPOSAL

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CONTENTS

ABBREVIATIONS

AFAPs	pension fund management companies
BCU	Central Bank of Uruguay
BHU	Uruguayan Mortgage Bank
BROU	Banco de la República Oriental del Uruguay
CND	National Development Corporation
DINAMA	National Environment Directorate
GDP	gross domestic product
IDB	Inter-American Development Bank
IFIs	intermediary financial institutions
IMF	International Monetary Fund
MERCOSUR	Southern Common Market
MIF	Multilateral Investment Fund
MS-I	Multisector Global Financing Program I
MS-II	Multisector Global Financing Program II
MS-III	Multisector Global Financing Program III
SIIF	Superintendency of Intermediary Financial Institutions (Central Bank)
VAT	value-added tax
WTO	World Trade Organization

Inter-American Development Bank
Regional Operations Support Office
Operational Information Unit

Uruguay

TENTATIVE LENDING PROGRAM

2002

Project Number	Project Name	IDB Fin. US$ Millions	Status
UR0136	Multesectoral Finance Global Program	180.0	
*UR0142	Port of M'bopicua	13.6	
UR0139	RTC Improvement Municipal Management IMM	3.0	
UR0134	Infancy, Adolescent & Family At Risk	40.0	
UR0131	Municipal Development and Management	84.0	
UR0150	Financial Sector Loan	200.0	
	Total - A : 6 Projects	**520.6**	
*UR0148	Port of Montevideo	12.2	
	Total - B : 1 Projects	**12.2**	
	TOTAL 2002 : 7 Projects	**532.8**	

2003

Project Number	Project Name	IDB Fin. US$ Millions	Status
UR0147	Legislature Administrative Strengthening	3.9	
UR0135	Highway Infrastructure	160.0	
UR0141	Cattle Development Program	32.0	
	Total - A : 3 Projects	**195.9**	
	TOTAL - 2003 : 3 Projects	**195.9**	

Total Private Sector 2002 - 2003	**25.8**
Total Regular Program 2002 - 2003	**702.9**

*** Private Sector Project**

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URUGUAY

IDB LOANS

APPROVED AS OF APRIL 30, 2002

	US$Thousand	Percent
TOTAL APPROVED	**2,591,421**	
DISBURSED	2.108.994	81.4%
UNDISBURSED BALANCE	482.428	18.6%
CANCELLATIONS	250.026	9.6%
PRINCIPAL COLLECTED	624.198	24.1%
APPROVED BY FUND		
ORDINARY CAPITAL	2.445.506	94.4%
FUND FOR SPECIAL OPERATIONS	104.079	4.0%
OTHER FUNDS	41.836	1.6%
OUSTANDING DEBT BALANCE	**1,484,795**	
ORDINARY CAPITAL	1.452.037	97.8%
FUND FOR SPECIAL OPERATIONS	32.759	2.2%
OTHER FUNDS	0	0.0%
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	272.171	10.5%
INDUSTRY. TOURISM. SCIENCE -TECHNOLOGY	251.981	9.7%
ENERGY	115.350	4.5%
TRANSPORTATION AND COMMUNICATIONS	322.998	12.5%
EDUCATION	145.338	5.6%
HEALTH AND SANITATION	390.635	15.1%
ENVIRONMENT	0	0.0%
URBAN DEVELOPMENT	265.880	10.3%
SOCIAL INVESTMENT AND MICROENTERPRISE	82.765	3.2%
REFORM -PUBLIC SECTOR MODERNIZATION	630.958	24.3%
EXPORT FINANCING	8.940	0.3%
PREINVESTMENT AND OTHER	104.405	4.0%

***** Net of cancellations with monetary adjustments and export financing loan collections.**

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URUGUAY

STATUS OF LOANS IN EXECUTION AS OF APRIL 30, 2002

(Amounts in US$ thousands)

APPROVAL PERIOD	NUMBER OF PROJECTS	AMOUNT APPROVED	AMOUNT DISBURSED	% DISBURSED
Before 1996	2	99,000	91,301	92.22%
1996 - 1997	6	442,900	347,877	78.55%
1998 - 1999	5	309,900	185,600	59.89%
2000 - 2001	7	347,425	93,794	27.00%
TOTAL	20	$1,199,225	$718,571	59.92%

* Net of Cancellations . Excluding export financing loans.

MULTISECTOR GLOBAL FINANCING PROGRAM III (MS-III)

(UR-0136)

EXECUTIVE SUMMARY

Borrower:	Eastern Republic of Uruguay	
Executing agency:	Central Bank of Uruguay (BCU)	
Amount and source:	IDB (Ordinary Capital): Local: Total:	US$180 million US$ 45 million US$225 million
Financial terms and conditions:	Amortization period: Grace period: Commitment period: Disbursement period: Interest rate: Inspection and supervision: Credit fee: Currency:	20 years 5 years 2 years and 9 months 3 years variable 1.00% 0.75% U.S. dollars, dollar window

Objectives: The program's objective is to help supply the medium- and long-term financing needs of Uruguayan private enterprises, to help make up the shortfall on the domestic financial market which is not mobilizing sufficient medium- and long-term savings to fund private-sector productive investments.

Description: To pursue the above-mentioned objective the program proposes to: (i) expand and solidify the supply of medium- and long-term credit, on market terms, for private-sector investment projects intended to realign, improve and expand efficient operations of private businesses established in any economic sector in Uruguay; and (ii) provide the liquid resources needed to spur the use of financial products already available for medium- and long-term financing of private productive investment and to launch new products and financing facilities for those same purposes.

The proposed program will provide funding to enlarge the Central Bank (BCU) medium- and long-term loan discount window that was created under the first multisector credit program (MS-I, IDB loan 705/OC-UR) and enlarged under the second multisector program (MS-II, IDB loan 1155/OC-UR). Funding under the program described here will enable the BCU to provide intermediary financial institutions (IFIs) with lines of credit to discount subloans the IFIs approve to finance: (i) capital investments of companies of any size and operating in any sector of private enterprise in Uruguay except for activities on the Bank's negative list; (ii) term-mismatch insurance cover for IFI medium- and long-term lending portfolios; (iii) medium-term financial and operating leasing; (iv) securitization of bank loans to support private-sector productive investments that qualify for program funding; and (v) medium- and long-term export credit operations. The apportionment of the program funds among economic sectors, activities, and financial products will be determined by market demand.

The borrower for the operation will be the Eastern Republic of Uruguay. The BCU, as executing agency, will administer the discount window, channeling funds to authorized IFIs that submit eligible projects according to the program's operating rules. Funds will be lent to IFIs in dollars. On the funds it supplies to IFIs the BCU will charge a variable interest rate not lower than the financial cost of domestic 90-day dollar deposits (see paragraph 3.14 of the proposal that follows). The IFIs will lend to end-borrowers under competitive free-market conditions as regards both risk screening and subloan interest rates. Any IFI regulated by the Superintendency of Intermediary Financial Institutions (SIIF) and with SIIF authorization to operate will be able to tap the facility. The SIIF will set IFI eligibility criteria and the amounts of discount facilities and term-mismatch cover for which IFIs will qualify, within the program's authorized limits. These amounts will be reviewed annually by reference to each IFI's financial situation, institutional capacity, and portfolio performance.

The Bank's country and sector strategy: The Bank's program is in line with the current Uruguayan administration's development strategy and priorities, which center on preserving economic stability, making the economy more competitive and spurring private investment by making more medium- and long-term credit available.

Focuses of the Bank's support in its operations programming, consonant with the government's strategy and priorities, are: (i) initiatives to make Uruguayan production more competitive regionally and internationally and foster private investment; (ii) reform and modernization of the State and governance

improvements; and (iii) efforts to improve the well-being of Uruguayans and enhance equity. The proposed program directly pursues the first of these strategy focuses.

Environmental and social review: The environmental compliance procedures already in place will continue in the MS-III operation proposed here. The National Environment Directorate (DINAMA) will have primary responsibility for environmental classification and assessments of funded projects. However, to expedite procedures, the initial project classification and subsequent preventive monitoring will continue to be done by an environment unit in the National Development Corporation, hired for the purpose by the program's executing agency. DINAMA will be notified of the classification. In this program the IFIs will reaffirm the undertaking required of them in the previous multisector programs: to ensure that end-borrowers comply with environmental requirements and those relating to the conservation and use of natural resources. The regulations also will reassert the right of the BCU and IFIs to suspend subloan disbursements or declare a loan to be immediately due and payable if the end-borrower fails to perform the contract environmental covenants. The evaluation of MS-III outcomes will include an evaluation of the procedures followed to classify, assess and monitor environmental impacts of program-funded projects.[1] The Bank's Committee on Environment and Social Impact reviewed the proposed arrangements on 11 June 2001 and found them to be satisfactory.

Benefits: Uruguay needs to increase private investment, as an engine of GDP growth. The proposed program will promote an increase and diversification of medium- and long-term financing facilities and products, on market terms, for investment projects in any branch of private-sector economic activity.

Because the program financing will be driven by the demand for efficient private-sector activities in all sectors, it is impossible to gauge specific outcomes ex ante, in terms of subloan numbers or amounts. However, in light of the MS-I and MS-II results, there is every assurance that the proposed objectives will be achieved satisfactorily. (See paragraphs 1.32–1.40.)

Risks: In order for the program to operate successfully, the macroeconomic, financial and exchange-rate environment will have to be conducive to growth in private investment. The government has already made significant headway on reforms and inflation control, and further gains are planned in the framework of the April 2002-March 2004 IMF standby arrangement approved in March 2002. That program

1 The findings of the MS-I and MS-II environmental report are outlined in paragraph 3.43.

provides for measures to develop Uruguayan financial markets, especially capital markets, as well as IDB and World Bank financial support, and envisages the potential impact of that support on increases in monetary aggregates. This substantially reduces any risk on this front.

Another risk in programs of this kind is that of financial system dislocations. Such a risk was very much in evidence in Uruguay in the 1980s but it stands at acceptable levels today thanks to the restructuring of the system in the past decade, significant strengthening of supervision mechanisms, and the reorganization of government banks. However, mention should be made of the heightened risk in the agriculture sector in recent years, which hurt Banco de la República Oriental del Uruguay's (BROU) loan portfolio because its borrower base is concentrated in sectors that are vulnerable to economic downturns (agriculture, small business). The situation worsened following an outbreak of foot-and-mouth disease early in 2001. To address this situation the government took steps to alleviate the difficulties of farmers, enabling them to reschedule their bank debts of up to US$200,000 (see Box 3 in the proposal). To offset that measure's potential impact on BROU's financial position the government gave the bank a US$20 million capital injection in 2001. The subsidy to indebted producers thus was transparent, using budget funds. The current situation in Argentina's financial system has, for the moment, had only isolated repercussions in Uruguay (problems with Banco Comercial and Banco Galicia) that are being remedied with no major harm to the Uruguayan system. Any worsening of the regional macrofinancial environment could have a substantial impact on the pace of execution of the operation proposed here.

The program presents no currency risk since the transferred loan proceeds are onlent to IFIs in dollars (as received from the IDB). IFIs can decide in which currency to onlend these funds, but if they select a currency other than the dollar, they assume the entire exchange risk.

Special contractual conditions:

The following will be conditions precedent to the first disbursement: (i) the borrower and the BCU must have signed an agreement, satisfactory to the Bank, stipulating terms and conditions for transfer of the proceeds of the Bank's loan and the two parties' obligations (see paragraph 3.5); and (ii) the BCU must demonstrate that: (a) the program's Operating Regulations agreed upon with the Bank have been approved and put into effect, including program-specific directives on administrative, accounting, financial, and supervision procedures (paragraph 3.5); and (b) it has executed an agreement with the CND under the terms of which that agency will classify and monitor subloans for purposes of tracking compliance with

environmental requirements under the program (see paragraphs 3.12 and 3.13).

Eighteen months after the first disbursement of the Bank's loan or after 50% of the loan proceeds have been disbursed, whichever occurs first, the borrower and the Bank will review the program to assess the achievement of its objectives (paragraph 3.32). Subsequent reviews will be conducted at 18-month intervals thereafter until the loan is disbursed in full. The environmental assessment and compliance monitoring procedures will be reviewed at the same time (paragraphs 3.46, 3.47 and 3.48).

The borrower and the Bank have agreed that the disbursement period for the loan will be at least three years. They further agreed that the Bank will recognize up to US$15 million in subloans formalized between IFIs and end-borrowers as from 1 April 2002 as being eligible for reimbursement out of the loan proceeds. Table II-1 shows estimated program costs and the projected annual disbursement timetable.

Poverty-targeting and social sector classification: This operation does not qualify as a poverty targeted investment or as a social equity enhancing project, as described in the indicative targets for Bank activities in the Eighth Replenishment report (document AB-1704).

Exceptions to Bank policy: The program funds could be used to finance the purchase of real estate and housing. This would be a continuation of the exception the Board approved for the same purposes for the MS-I and MS-II programs.

Procurement: Not applicable.

I. FRAME OF REFERENCE

A. Macroeconomic setting

1. The Uruguayan economy in recent years and today

1.1 Since the mid-1970s Uruguay has steadfastly pursued a strategy to open up its economy and markets. By way of a series of structural reform programs the country has done away with severe distortions and constraints on growth of private enterprise. Throughout virtually the entire 1990s the Uruguayan economy grew at a satisfactory pace and inflation declined. Thanks to the combination of an anti-inflation policy using the exchange rate as a nominal price-system anchor and tight controls of the public finances, Uruguay was able to slash annual price increases from the triple digits in 1990 to single digits (3.6%) in 2001. Some highlights over that interval were the counterinflationary effects of the 1995 fiscal adjustment; a civil service downsizing starting that same year along with moves to modernize the central government and its tax and budget administration processes; social security reform, and a reorganization of public enterprises' operations and finances, which yielded substantial efficiency and productivity gains. Also since the mid-1970s, as part of its economic and market liberalization strategies, Uruguay has made resolute efforts to make its exports more competitive, despite the restrictions and subsidization policies its products have had to contend with on external markets. Those constraints have dampened the growth potential of a number of major commodities like meat, in which Uruguay has comparative advantages.

1.2 After posting real GDP growth rates averaging 3.9% from 1990 to 1998, the economy slipped into a recessionary phase, with GDP declines of 2.8% in 1999, 1.3% in 2000, and 3.1% in 2001. The slowdown can be attributed to several factors: (i) deteriorating terms of trade as Uruguayan export prices plummeted (for rice, wool, meat, and dairy products) while import prices rose sharply, particularly for oil; (ii) the depreciation of the Brazilian *real* against the U.S. dollar and Uruguayan peso since 1999, which is hurting Uruguay's trade with Brazil; (iii) an outbreak of foot-and-mouth disease in 2001 that temporarily halted Uruguayan meat exports; and (iv) the protracted recession in Argentina and the ensuing institutional and financial crisis in that country, particularly since it imposed restrictions on bank withdrawals (the *corralito*), all of which is impacting its external payment capabilities, the demand for goods, and Argentine tourism flows to Uruguay. As a result, Uruguay's unemployment rate climbed from 11.3% in 1999 to 13.6% in 2000 and 15.3% in 2001, and the balance-of-payments current-account deficit of the 1990s has worsened. As economic activity stalled, the public sector had to cut costs, including capital expenditures, to try to narrow its consolidated deficit which stood at 4.1% of GDP in 1999. Even with those efforts, the deficit held at 4% of GDP in 2000 and edged up to 4.2% in 2001. These pressures are continuing in 2002. To pare the fiscal deficit the government has had to bring in new tax and restraint measures. In February 2002, owing to the persistent consolidated public

sector deficit and a mounting external debt stock, Uruguay lost the investment-grade rating it had been receiving since 1997 from two of the leading international bond raters.

1.3 The centerpiece of the government's short- and medium-range growth strategy is to see increased exports—helped by a real exchange rate that will make exporters more competitive—carry the rest of the economy along with them and create employment. But the situation in the region is complicated owing to the protracted crisis in Argentina which is seriously impacting Uruguay's economy. Over the longer term the government is confident that the steadfast pursuit of economic policies that will propel private investment in a more competitive environment, with relatively stable prices, will make robust growth viable. Accordingly, the government's priorities have been to preserve stability and basic macroeconomic equilibria. In 2001, in addition to public sector spending restraint measures and the deregulation of a number of activities, the government reduced employers' social-security contributions in the production sectors, to make agriculture and industry more competitive. Concurrently, to keep the fiscal accounts in balance the government brought in a sales tax (COFIS) called the Contribution to Social Security Funding, approved in June 2001, which is expected to yield about US$150 million a year. A new fiscal adjustment equivalent to 2.8% of GDP was approved at the end of February 2002, featuring spending cuts and slight increases in several taxes.[2] However, given the current recession, these measures are likely to yield only modest returns, so new spending cuts are likely.

2. Insufficient investment

1.4 The government's pro-private enterprise policies achieved significant gains in the 1990s. In 1999 private fixed investment stood at 11.8% of real GDP, up appreciably from the low 1988-1990 average of 8.1%. However, in 2000 this percentage again began to trend down. Meanwhile, total fixed public investment equaled only 15.4% of GDP in 1999 and slipped to 13.9% in 2000. These levels are too low for the kind of long-range growth that can boost average worker productivity and keep unemployment down.[3]

1.5 If Uruguay is to increase production output and efficiency it will need to enrich the framework of economic policies and instruments that affect private enterprise, including taxation elements and, in particular, access to medium- and long-term credit. In the new approaches and support mechanisms that will be called for there would need to be special emphasis on those that can help expand and diversify

[2] The tax on public and private-sector earnings over UR$22,200 and UR$27,751, respectively; increases in the Financial System Tax rate from 0.18% to 0.36% and the tax on loans to entities subject to the industrial and commercial earnings tax, and new taxes on telecommunications, credit cards, and pension fund management company fees.

[3] Uruguay – Discussion Paper. Analysis of Investment and Saving. IDB/RE1/OD1, April 1998.

exports. This in turn will mean strengthening mechanisms for channeling domestic savings into productive investments. Programs like the operation proposed here are useful vehicles to that end, to help supply more medium- and long-term credit for private-sector capital projects.

3. IMF arrangement

1.6 As it pursued its pro-growth strategy with price stability the Uruguayan government has received support in the form of IMF standby credit.[4] The undisbursed balance under the most recent arrangement covering the period 1 March 2000 to 31 December 2001 is US$198 million. A new US$742 million standby credit approved at the end of March 2002 is posited on –1.75% GDP growth in 2002 and a fiscal deficit target of 2.5% of GDP in 2002 and 1.5% in 2003.

4. Status of structural reforms

1.7 In recent decades Uruguay has implemented a succession of sweeping structural reforms intended to unfetter its economy and open it up to market forces. The most noteworthy reforms have to do with exchange rate, foreign trade, fiscal, monetary, banking, and price policies. The rewritten exchange rate and financial sector policies freed up transactions of all kinds: they permitted deposits in foreign currency and the entry of new financial institutions; removed interest rate ceilings and other controls, effectively leaving the marketplace free to set rates; did away with selective credit allocation; launched a reorganization of the government banking sector, and set a sound new financial-system legal and regulatory framework in place to assure the system's solvency and efficiency. Trade policy reforms: (i) lowered the import tariff ceiling from 346% to 20% and reduced the number of tariff categories from 30 to 3, apart from Southern Common Market (MERCOSUR) tariff reductions and removals; (ii) exempted exports from the value-added tax, and (iii) virtually abolished export levies. The new taxation policy smoothed distortions in relative prices of capital and labor by way of: (a) the aforementioned reforms of foreign-trade levies; and (b) the lowering and realignment of private employer-employee contributions to social security and family benefits. The revamped wage policy left wage and salary negotiations entirely to the parties to work out through agreements and progressively reduced the frequency of inflation adjustments to annual reviews, provided that inflation the previous year had been below 10%. Policies to downsize the State have addressed (and continue to address) two fronts: (i) reductions in civil service rolls, particularly in State enterprises, which saw their staff complement fall by almost half between 1986 and 1998; and (ii) social security reform (1996), which

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[4] The IMF's standby programs are designed taking into account information furnished by the World Bank and IDB on their lending operations in Uruguay, including anticipated disbursements and their impact on monetary aggregates. The operation proposed here would represent barely 2% of total system-wide credit to the private sector.

introduced a mixed private/public pension system with benefit provisions more in line with Uruguay's present demographic structure. The price control policy has left only a handful of household staples under administrative control. On the regulatory side, the government has taken steps to liberalize, open up and deregulate the markets for fuel (gas and oil) and telecommunications, postal services, and ports.

B. The macrofinancial setting

1. The Uruguayan banking system

a. Background

1.8 Turmoil in Uruguay's financial system in the 1980s prompted sweeping adjustments in the second half of that decade and in the early 1990s. The crisis had been triggered in 1979 when the authorities brought in a system of preannounced monthly devaluation rates (the *tablita*), which favored investments in short-term financial assets with external funds. The production sectors ended up with heavy debt burdens after seeking speculative gains (spreads between real interest rates in pesos and dollars with a pre-fixed future exchange rate). The *tablita* system was abandoned in 1982, the result of external factors and policy inconsistency.

1.9 The robust growth in credit and the ensuing overestimation of the repayment capabilities of borrowers, who ended up defaulting on their contractual obligations, resulted in huge losses for private commercial banks. To protect the system the Central Bank had to buy nonperforming loan portfolios, sustaining sizable losses in the process. Banco de la República Oriental del Uruguay and the National Development Corporation took charge of two failed banks (Banco Comercial and Caja Obrera) and of the branches of two foreign banks (Banco Italia and Banco Pan de Azúcar), their parent companies having foundered as well. Deposit insurance and absorption of the failed banks cost the government over US$1 billion. The IDB, the World Bank, and the IMF[5] examined this process and the Financial Sector Adjustment Program (loan 626/OC-UR) supported the sector's restructuring taking the new approach described below.

1.10 Under this adjustment program the government bolstered prudential regulation and supervision; the Central Bank's charter was revised and the amendments implemented, strengthening that agency's oversight and sanctioning powers and its authority to regulate the entry and exit of institutions and deal with troubled banks; and a new Financial Institutions Act permitted commercial banks to engage in investment banking business. Complementing efforts on those fronts was the IDB-funded Investment Sector Program (loan 703/OC-UR), which promoted other

[5] See for instance World Bank, RPO 672-85, *Several Studies on Liberalization and Stabilization in the Southern Cone,* 1985, and IMF Working Papers, *Liberalization and Financial Crisis in Uruguay (1974-1987)*, 1991.

financial-system modernization and consolidation actions such as social security reform, authorizing the creation of private pension fund management companies; dismantling of the insurance industry monopoly; rewriting of bankruptcy and securities market laws, and new legislation governing securitization, leasing, and factoring. These reforms laid the legal and institutional foundations for a broadening of bank system operations, new financial products, and a fledgling capital market.

b. The current situation and prospects

1.11 Uruguay's banking system consists of the Central Bank (BCU), two official banks—Banco de la República Oriental del Uruguay (BROU) and the Uruguayan Mortgage Bank (BHU), and 21 private commercial banks. The country also has seven finance corporations, five credit unions and 11 offshore institutions. The Central Bank's Superintendency of Financial Institutions (SIIF) oversees the operation of all these institutions. BROU and BHU together supply about 44% of the local lending market (see Table I-1). The majority of the private commercial banks are subsidiaries of foreign banks and conduct credit operations separately with residents and nonresidents. The country's four pension fund management companies and five investment fund management companies are associated with banks. The banks also operate in the securities market via the Electronic Stock Exchange and, through subsidiaries, participate in the general and life insurance market.

Table I-1
Uruguay. Financial system lending to the private sector [1]
(in millions of current U.S. dollars)

	Private commercial banks and cooperatives	BROU	BHU	Government banks—Total	System total
Total outstanding at 31 August 2001	5,985	2,952	1,756	4,708	10,693
Nonresident balances	1,766	-	-	-	1,766
Resident balances	4,220	2,952	1,756	4,708	8,927
Share of total	55.9%	27.6%	16.4%	44.1%	100%

[1] Excludes domestic BCU credit.
Source: BCU Statistical Bulletin No. 248, September 2001.

1.12 Even though Uruguay's banking system grew and became more financially sound in the 1990s (see Table I-2) and inflation began to fall sharply as of 1997, intermediated credit was still heavily concentrated in dollar operations and there

was a dearth of medium- and long-term financing.[6] The bulk of funds administered by pension fund management companies are concentrated in short-term paper or government securities. Businesses thus have to come up with money from their own operations or borrow from banks, usually with short repayment terms and rollover options even for capital project finance. The only significant source of genuine (without mismatching) medium- and long-term credit other than Uruguay's official banks continues to be the Central Bank's discount window with financing from the multisector programs. The Bank proposes to continue furnishing such support by way of the operation described here.

Table I-2
Financial system growth
(in millions of current U.S. dollars)

Selected indicators	1990	1995	2000	2001 (Nov.)
Net international reserves	2,521	3,561	5,705	5,921
Net lending to the public sector	1,008	1,142	806	568
Lending to the private sector	2,203	4,304	7,683	8,836
Deposits—pesos	741	1,547	1,645	1,413
Deposits—foreign currency	4,701	6,744	11,831	12,726

Source: BCU Statistical Bulletin No. 252, January 2002. Includes BCU, BROU, BHU, private commercial banks and, as of 1994, credit unions.

1.13 The economic slowdown in Uruguay in 1999-2001 hurt the country's financial system as well, as did the spillover from Argentina's economic problems, exchange-rate difficulties in accessing other markets in the area, and the recession in the industrialized nations. Uruguayan banks' profit performance has suffered as a result of the sluggish economy: in 1999, for instance, returns on equity were 20.4% for private commercial banks and 2.8% for government banks; in 2000 these ratios plunged to 12% for the private banks and –10.3% for government-owned institutions.[7] Another telling indicator is nonperforming loans as a percentage of total loans outstanding system-wide, which rose from 9.8% in 1998 to 15.8% in 2000 to 17.3% in November 2001.

1.14 The foregoing figures notwithstanding, Uruguay's financial system is solidly capitalized and its liquidity position is healthy. Its financial soundness was spotlighted in February 2002 when problems arose with two institutions—Banco Galicia and Banco Comercial. The Central Bank took control of Banco Galicia for 90 days while the problems of its Argentine parent company were worked out. A

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6 Private commercial bank lenders concentrate on short-term financing of services, commerce, and consumer purchases. Medium-term revolving (three-year) credit is available only to selected large corporations, subsidiaries of foreign corporations, and commercial construction and housing ventures (terms up to five years).

7 BROU returns suffered heavily because of crisis conditions in the agriculture sector, which accounts for the bulk of BROU's borrower base. Declining BHU returns are attributable largely to exchange losses, stemming from that bank's significant currency mismatch.

plan has been unveiled for that institution's capitalization by a group of international and Argentine banks. The Banco Comercial problem is being resolved thanks to resolute action by the Uruguayan authorities, who quickly arranged for the bank's recapitalization by way of US$100 million from its shareholders (Credit Suisse, First Boston, Dresdner Bank and JP Morgan) and a temporary State injection of US$33 million.

1.15 Looking beyond the banking system, the solidity of the financial sector overall is expected to improve in future by dint of the Central Bank's current efforts to tighten regulation and oversight of the institutions it oversees and to bring under its formal supervision umbrella a series of financial activities now being performed by a patchwork of under-regulated quasi-financial institutions, to make certain that they do not indirectly damage the industry's reputation.

1.16 The above-mentioned measures are particularly significant today as growing competition from MERCOSUR and beyond the region make it crucial for Uruguay's financial system to broaden and solidify its footing in regional business. To that end it will be necessary to: (i) continue supporting the expansion and deepening of financial activities in various areas and market segments, with new approaches and financial products; (ii) increase the system's competitive efficiency; (iii) improve its facilities for exporters, in line with government policies; and (iv) foster modern management of nonfinancial enterprises, to enhance their prospects and give them greater access to formal financial markets.

2. Money laundering

1.17 Law 17,016 and Executive Orders 398/99 and 139/001 regulate the roles of the public prosecutor's office (judicial branch) and the Central Bank regarding requests for international law enforcement cooperation. Law 17,343 enacted in May 2001 extended the crime of money laundering to take in not just drug trafficking but other serious crimes as well. The Central Bank, for its part, has taken action to track the monetary proceeds of illicit activity (money laundering) and prevent operations that attempt to give legitimate cover to such illicit transactions. A Financial Information and Analysis Unit has been set up in the SIIF with a centralized database to record transactions of persons required to report them. This system is provided for in the above-mentioned legislation and in Central Bank circulars from 2000 and 2001. In March 2001 a Center for Training in Prevention of Money Laundering[8] was created under the aegis of the National Drug Control Commission. At the second meeting of the South American Financial Action Task Force on Money Laundering held in Montevideo that same year it was agreed that the new Center would coordinate training on a regional scale for all the member states.

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8 The Center's purpose is to train financial system officials, judges, public prosecutors and professionals in the law and regulations for the repression of asset laundering.

3. Demand for financial assets and bank lending trends

1.18 In recent years there has been a trend away from peso asset holdings in the Uruguayan economy (Table I-3). The monetary base (M_0), currency (pesos) in circulation (M_1), and peso near-money (M_2) have steadily diminished whereas resident and nonresident dollar holdings (M_4) have been on the rise. The Argentine crisis in 2001 sharpened this trend.

Table I-3
Monetary indicators
(% of GDP)

	1974	1979	1982	1988	1990	1994	1995	1998	1999	2000	2001 (Nov)
M_O	9.8	9.5	8.3	10.2	5.9	5.2	4.8	4.2	4.2	3.9	3.2
M_1	12.4	10.6	10.2	7.6	6.4	7.1	6.7	6.2	6.3	5.9	4.7
M_2	18.5	22.9	26.5	17.9	14.7	11.4	11.7	10.6	11.0	8.3	9.7
M_3	22.3	37.5	58.9	53.6	50.9	37.7	37.1	38.9	43.0	37.1	10.9
M_4	30.4	42.5	85.9	88.4	85.3	51.3	49.3	53.2	64.0	71.4	107.0

M_O = Monetary base.
M_1 = Money, pesos.
M_2 = Near-money, pesos.
M_3 = M_2 pesos plus residents' dollar deposits.
M_4 = Near-money pesos plus total dollar deposits.
Source: BCU Monthly Bulletin, various issues.

1.19 The contrast between the weakening demand for peso-denominated assets and the preference for dollar-denominated deposits and government securities is striking. Residents' dollar deposits equaled 29% of GDP in 2000; nonresident deposits were the equivalent of 34% of GDP.

1.20 In real terms, aggregate peso and dollar credit grew steadily until 1995 and then skyrocketed until 1998 in response to the economic upturn, the convergence of prices and the exchange rate, and a steady decline in interest rates. Overall private bank lending rose quickly in nominal terms, with 11% annual increases between 1996 and 1998. In 1999-2000, echoing conditions in the economy generally, this growth rate slipped to 7%. The 1996-1998 growth episode had been fueled in part by strong demand from the production and commercial sectors and an increase in consumer and mortgage credit—mortgage lending having being impelled by legislation abolishing the Uruguayan Mortgage Bank's monopoly on that business. To judge from the 5.7% real growth rate in 1999-2000, the demand for credit was still robust. The lower rate of growth is associated with the economic slowdown but also with the increase in bank minimal capital requirements, from 8% of risk-weighted assets to 10%. These new standards have been phased in since 1999, to be fully effective in mid-2001. In the first 11 months of 2001, total lending climbed 2.7% in current terms but fell back 1% in real terms.

1.21 From 1995 to 2000, peso credit as a share of the total declined steadily while the dollar-denominated lending share increased (see Table I-4).[9] In 1995, peso credit accounted for 41.4% of aggregate lending; by November 2001 it made up only 26.3% of the total. Private commercial banks handled most of this business: their share of total peso and dollar lending climbed from 41.6% in 1995 to 54.6% in December 2000 and 54% in August 2001. Total financial-system dollar credit (BROU and private commercial banks) increased significantly starting in 1991, the aggregate dollar portfolio having soared from US$1.963 billion in 1990 to US$8.485 billion in November 2001—US$2.348 billion of this being BROU operations. The hefty increase in private commercial bank lending to residents had much to do with this upswing (US$756 million total in 1990, US$3.529 billion in November 2001).

Table I-4
Financial system credit to the private sector[1]
(amounts in millions of current U.S. dollars at 31 December each year)

	Pesos	% of total	Foreign currency	% of total	Total	Private commercial banks (% of system total)	Foreign-currency lending to nonresidents (% of foreign-currency total)
			Residents and non-residents				
1990	1,388	41.4	1,963	58.6	3,351	38.3	20.3
1994	2,630	42.7	3,532	57.3	6,162	40.0	15.7
1995	3,042	41.3	4,315	58.7	7,357	41.6	12.5
1996	3,091	38.6	4,902	61.4	7,993	42.2	12.9
1998	3,567	34.2	6,860	65.8	10,427	44.7	13.7
1999	3,703	33.0	7,490	67.0	11,193	48.9	19.4
2000	3,178	29.3	7,649	70.7	10,827	54.6	17.1
2001[2]	2,857	25.2	8,485	74.8	11,342	54.0	26.8

[1] Includes BCU, BROU, private commercial banks and Uruguayan Mortgage Bank.
[2] November 2001.
Source: BCU Statistical Bulletin, November 2001.

1.22 Trends in lending to individual sectors from 1991 to 2000 mirrored the respective sector's reaction to the restructuring of the economy and production sector realignments (see Table I-5). In the course of the country's economic liberalization moves some manufacturing sectors suffered and others (such as the chemical and forestry industries) gained. That was the case also in the services and tourism sector, with major new hotel and shopping center construction. Meanwhile, agriculture was hurt by price declines as crises unfolded in Asia, Russia and other markets. The breakdown of lending totals reflected these developments. The percentage share for manufacturing (including processing of meat, wool, leather

[9] This is largely attributable to persistent inflation, a lack of peso financial assets to reflect the peso value trend, and legalization of the unrestricted issuance of foreign-currency contracts.

and other commodities), wholesale trade, and agriculture dropped while consumer credit and lending for services, the retail trade and construction gained.

Table I-5
Credit to the resident private sector (private commercial banks)
(amounts in millions of current U.S. dollars)

	1991	1995	2000	2000 % in foreign currency	2001 (June)
Agriculture	118	248	403	97	428
Manufacturing	443	718	932	87	846
Construction	26	68	205	90	191
Commerce	273	637	913	88	831
Wholesale	222	476	545	87	502
Retail	51	161	368	88	329
Services	95	313	746	81	670
Consumer credit	96	394	951	70	748
Total	**1,051**	**2,378**	**4,150**	**84**	**3,713**

Source: BCU Statistical Bulletin No. 248, September 2001.

1.23 The trend in manufacturing credit points up the problems with which this sector has had to contend to adapt to an environment of heightened external competition and industrial realignment and restructuring exercises in individual subsectors (see Table I-6). Though the traditional sectors—food products, beverages, leather goods—still predominate in absolute terms, the chemical industry and "other" (nonspecified) subsectors have gained a significant percentage share. At the end of 2000, dollar-denominated loans accounted for 84% of all private commercial bank credit to the resident private sector. For agriculture the share of dollar financing was 97%; for manufacturing it was 87% and for construction, 90%.

Table I-6 **Industry breakdown of manufacturing credit [1] (private commercial banks)** *(in millions of current U.S. dollars)*					
	1991	**1995**	**2000**		
			Total	**Pesos**	**Foreign currency**
Food products	106	138	255	21	234
Beverages	22	60	80	20	60
Textiles	65	93	46	2	44
Leather goods, footwear and apparel	75	94	114	6	108
Wood and cork	4	7	12	1	11
Paper and printed products	25	47	54	7	47
Rubber products	13	15	16	1	15
Chemicals	68	130	192	39	153
Metal products	23	32	26	3	23
Electrical equipment and appliances	9	24	13	1	12
Transportation machinery and equipment	7	17	13	3	10
Other	26	61	110	16	94
Total	**443**	**718**	**932**	**120**	**812**

[1] Resident private sector.
Source: BCU Statistical Bulletins.

C. Size and management of Uruguayan businesses

1.24 An important consideration in any analysis, from a regional and international perspective, of the problems facing Uruguay's business community and possible avenues of solution is the small size of most of the country's businesses.[10] There were 1,400 exporting enterprises in the country in 1999-2001. The 50 largest accounted for 67% of total export sales—and 10 of those firms represented 28% of the country's total export trade. Exports from the other 1,350 businesses made up the 33% balance.

1.25 Various studies of this issue[11] pinpoint some of the problems associated with company size and management quality that are affecting these businesses' competitiveness: inadequate, obsolete equipment; a lack of modern designs and products and, consequently, businesses' failure to keep up with shifting preferences in the marketplace; and difficulties in securing financing on suitable terms and conditions. Another explanation advanced repeatedly for these firms' low capital investment levels is that Uruguayan business owners are distinctly risk-averse. This

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[10] According to MERCOSUR definitions, small businesses are those reporting gross annual sales of US$3.5 million equivalent or less. Medium-sized enterprises are businesses with up to US$20 million in gross annual sales.

[11] Particularly noteworthy is the Business Development Strategy approved by the Bank and the Uruguayan government in late 1997.

has much to do with the question of business size, the modus operandi of microentrepreneurs and owners of small and mid-sized enterprises, and business ownership structures which typically are closed, largely owing to the modest size and limited scope of the business activity. This latter feature also is holding up capital market development because there are so few large private corporations.

> **Box 1**
> **Financial assistance to exporters**
>
> By introducing trade finance products the proposed program will help propel this segment of the business community—small and mid-sized exporters.
> The experience of the U.S. agency Ex-Im Bank, with its small-exporter assistance programs, could serve as a model for Uruguay. The Uruguayan Central Bank operates export credit facilities and, for intraregional exports, the Latin American Integration Association Reciprocal Payments Agreement. In that respect it functions as an export agency, which could be broadened following approaches consonant with World Trade Organization rules and other guidelines similar to Ex-Im Bank's.[1] Given Uruguay's size, creating a specialized government agency with the associated bureaucracy would not be warranted, nor would assigning this function to a government-owned bank (e.g. BROU) be a sound approach, since it would mean mixing first and second tier operations.
> The Central Bank's Operations Division is in charge of official export finance programs (pre- and post shipment). These are all second-tier dollar operations (minimum US$10,000) at terms of 180, 270, or 360 days. In practice, operations are for 180 days. The program proposed here would make possible the discounting of post-shipment financing at terms longer than 360 days.[1]
> [(1)] *Ex-Im Bank. M. Sullivan. Exports Wanted. North-east Exports. January-February 2001.*

1.26 In today's more open global economy with its free-market rules, rapid advances in technology, huge multinational conglomerates and sophisticated marketing techniques, the small average size of Uruguayan businesses dampens their competitiveness prospects in global markets unless they form production chains or have strong support, including access to credit, such as was provided in the past for forestry, the dairy industry, citrus growers, etc. According to mid-1990s studies that are still considered valid, 250 of Uruguay's largest companies accounted for close to 90% of its total export sales. In nine subsectors, the output of four major exporters constituted the entire export trade; in eight subsectors, between 75% and 97% of exports came from four exporting firms.

1.27 In order for the Uruguayan government's export growth strategy to succeed there will need to be sweeping structural changes in the production and business sectors to remedy the problems enumerated above. With that assessment in mind the Bank has been supporting these reform efforts by way of various operations that have achieved significant institutional improvements. These include major initiatives to modernize the State and actions to support business development, modernization of technology, and nonfinancial aspects of export development (see footnote 14 later in this proposal).

D. Strategy and rationale for the Bank's participation

1.28 The Bank's program is in line with the government's stated development strategy and priorities for the five-year period 2001-2005, which center on maintaining economic stability, making the economy more competitive, and spurring private investment. These mark a continuation of the previous administration's initiatives under the National Strategy for Competitiveness and Employment, which already envisaged policies and concrete actions to foster fixed and human capital accumulation in order to improve competitiveness in the long run. This included the enactment of laws to foster investment, regulate new capital market instruments and overhaul the pension system, and support for the development of medium- and long-term credit markets. In addition, in pursuit of the Business Development Strategy[12] put together by Uruguay and the Bank in 1997 to support private sector investment and activities, the Bank has provided funding for Uruguayan government initiatives to strengthen and expand the financial system, reform the State, strengthen legal and incentive frameworks for private investment, foster business and technology development, and improve infrastructure.

Box 2
Deepening of the Uruguayan financial market

The financial assistance the Bank would provide through the operation described here would continue to support the deepening of Uruguay's financial market, following the strategy approach adopted when operating practices in that market were overhauled so as not to repeat previous experiences with "financial repression". The Bank's new approach was to tackle obstacles to private investment with a trio of mutually complementary operations: (i) finance sector programs; (ii) investment sector programs, and (iii) multi-sector medium- and long-term credit programs (see paragraph 1.39). In keeping with that approach, IDB-funded financial sector programs in Uruguay (626/OC-UR and 664/OC-UR) promoted financial-sector restructuring to return private commercial banks to a solid footing in terms of solvency, returns, and liquidity, bolster the system's regulatory framework and oversight, revamp macrofinancial policy, and restructure government-owned banks.

The Investment Sector Program (703/OC-UR) supported important developments in laws and regulations governing capital market instruments as well as institution-strengthening to foster private investment under market conditions. Complementing this operation were Multilateral Investment Fund (MIF) resources and other Bank technical-cooperation operations to strengthen the superintendencies of insurance, securities and exchange, and pension fund management companies, and the SIIF, all falling within the Central Bank's purview.

Two successive multisector credit programs (MS-I and MS-II) have been spurring financial market development by instituting rules and standards needed for the operation of new facilities and injecting medium- and long-term resources for private enterprise to fund production realignment projects in any sector.

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[12] This strategy identified four serious constraints for business development: (i) inadequate regulatory frameworks; (ii) a lack of infrastructure; (iii) inadequate business and technology management; and (iv) limited access to financing.

1.29 Focuses of the Bank's current operations programming, consonant with the government's strategy and priorities, are: (i) initiatives to make Uruguayan producers more competitive regionally and internationally and foster private investment; (ii) reform and modernization of the State and governance improvements; and (iii) efforts to improve the well-being of Uruguayans and enhance equity. Increases in investment and in investment financing on suitable terms are crucial to this end. The proposed program directly pursues the first of those strategy focuses.

Box 3
Banco de la República Oriental del Uruguay loan arrears in 2000

At the end of 2000, BROU accounted for 92% of over-91-day loan arrears in the overall IFI-discounted portfolio in the MS-II program. This was attributable to the economic slowdown that year, which hit BROU's portfolio harder than private commercial bank portfolios because BROU's borrower base is concentrated in very vulnerable sectors (agriculture, small business). An outbreak of foot-and-mouth disease exacerbated the situation. A sizable percentage of BROU's nonperforming MS-II loans have approval dates between 1998 and 2000; this confirms the tie-in of its high arrears rate to worsening conditions in the agriculture sector. BROU reported US$2.8 million in loans more than two years in arrears (potential losses, 100% provisioned); this was 9% of total loans discounted under MS-II. To address this situation the government took steps to alleviate farmers' difficulties, enabling them to reschedule up to US$200,000 of their bank debt (principal and interest at 31 December 2000), excluding externally funded borrowings. The loss would not have significantly impaired BROU's capital but, in order to offset the impact on the bank's financial position, the government included a section in Law 17,345 of June 2001[1] earmarking US$20 million of the first-year proceeds of the tax provided for therein for BROU as a capital contribution to cover losses ensuing from the aforementioned reschedulings. The subsidy to these indebted producers thus was transparent, using budget funds.

[1] This law approved a new 3% COFIS tax on imports and sales of goods subject to VAT, to offset the reduction in employers' social security contributions in the production sectors.

1.30 The third multisector global credit program (MS-III) proposed here is part of the Bank's continuing comprehensive effort to develop Uruguayan financial markets, particularly a medium- and long-term credit market, to help boost private productive investment and remedy market failures. Among the causes of such failures are high inflation, the ownership structure and small size of Uruguayan businesses, legislation and legal instruments that are inadequate or obsolete in today's rapidly changing global market economy, etc.[13] The proposed program forms part of the Business Development Strategy and, as such, will address the needs for private investment finance arising out of other programs now in progress.[14]

[13] As noted elsewhere in this proposal, the Bank and Uruguay have been pursuing various measures to remedy the problems listed here.

[14] These operations, intended to boost the economy's production capacity, are: Dairy Farm Infrastructure Program II (914/OC-UR), Agricultural Modernization and Development (1063/OC-UR), Pilot Livestock Industry Development Program (UR-0137), Technology Development (646/OC-UR, 647/OC-UR, and UR-0110), and Agricultural Services (1131/OC-UR). Various technical assistance operations now under way are supporting business development and productivity improvements.

1.31 Multisector credit has been chosen as the vehicle to address medium- and long-term financing constraints for private investment for a number of reasons, in keeping with the Bank's financial-market development policies and its experience in Uruguay (see Box 2). First, by virtue of the program's design, channeling these resources will help deepen the financial system so it can provide more capital funding for the production and services sectors (see paragraph 1.33). Second, the operating approach employed in MS-I and MS-II, which will continue in the MS-III program described here, assures that funds will be allocated by reference to market criteria and anticipated project returns, with no subsidies or preallotments to selected entities or sectors, and with sound arrangements in place for administering and supervising the resources. Third, since the apportionment of funds among economic sectors and types of activity will be driven essentially by market conditions, notably the anticipated returns on investment and the cost of loanable funds (interest rate), the program will foster efficient resource allocation by the marketplace.

E. The Bank's experience in previous multisector credit operations

1. Impact at the subproject level

1.32 The Bank's loan for its first multisector credit program in Uruguay (705/OC-UR) (abbreviated here as MS-I) was fully disbursed by March 1998 with very satisfactory results, despite some initial difficulties owing to delays in fulfillment of conditions precedent, particularly regarding the effective coordination of the environmental agencies' investment project classification and monitoring work. The total value of investments funded by MS-I subloans surpassed expectations because the local counterpart exceeded the program's requirement: as of February 2002, loans and recoveries totaled US$246 million[15] (IDB share 46.4%, end-borrowers 41.4%, IFIs 12.2%). Two thirds of the initial loans had repayment terms longer than five years; the other third were at shorter terms. Over half (57%) of the loans were for capital purchases of plant and equipment.

1.33 The second multisector credit program (1155/OC-UR) (MS-II) has achieved its objectives satisfactorily, the final disbursement having been made in the first quarter of 2002. This operation's impact was measured by reference to: (i) capital investment leveraged; (ii) number and average size of loans approved; (iii) geographical coverage; and (iv) type of projects financed. Tables I-7 and I-8 below summarize the program's performance to 31 December 2001, when 99% of the loan proceeds had been disbursed. Investment leverage in MS-II was significantly higher than in MS-I, when the leverage figure was 2.3 times the financing amount. In MS-II (not counting term-mismatch facilities) the leverage factor was 2.8. Thanks to the IDB's US$148 million loan a total of US$479 million in investments was mobilized—US$245 million via the term-mismatch facility for

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[15] The IDB's loan (705/OC-UR) for MS-I was for US$90 million.

the Uruguayan Mortgage Bank and US$273 million for investment projects. The average loan amount for investment projects was US$52,000, substantially below the MS-I average of US$200,000. The breakdown of subproject cost totals was 26.3% for permanent working capital and 73.7% for plant, machinery and construction. Those capital outlays were for housing (33.3%), leasing (11.7%), plant and equipment (10.8%), and other investments (17.8%). As for the geographic distribution of lending, echoing the MS-I experience, MS-II operations in the country's interior accounted for a sizable share of the total. There were more operations there than in Montevideo though, as anticipated, the lending volume was somewhat higher in Montevideo (Table I-8). One facet of the planned monitoring work to gauge the effectiveness of the MS-III program is continued tracking of the aforementioned four indicators as well as the number of participating private-sector IFIs (Table I-9), taking the MS-II figures as baselines for the assessment (see paragraph 3.33).

Table I-7
Breakdown by purpose of credit at 31 December 2001
Multisector credit program II (1155/OC-UR)
(amounts in US$000)

Purpose of financing	Number of subloans	%	Amounts			TOTAL
			IDB	IFIs	End-borrowers	
Working capital	**3**	**0.2**	**5,074**	**0**	**56,425**	**61,499**
Permanent working capital	3	0.2	5,074	0	56,425	61,499
Capital investment	**1,527**	**99.0**	**79,368**	**20,579**	**72,015**	**171,963**
Plant and equipment	99	6.5	17,321	610	7,409	25,339
Leasing	835	54.6	17,869	1,197	8,266	27,332
Housing	457	29.9	20,124	18,360	39,070	77,555
Other	136	8.9	24,054	412	17,270	41,737
TOTAL	1,530	100.0	84,442	20,579	128,440	233,462
Term-mismatch cover						
Housing[1]	7,210	100.0	63,614	180,210	1,707	245,521
TOTAL	7,210	100.0	63,614	180,210	1,707	245,521
GRAND TOTAL	**8,740**	**100.0**	**148,056**	**200,789**	**130,147**	**478,983**

[1] All operations were with the Uruguayan Mortgage Bank. In MS-III the number of participating entities is expected to increase significantly.

Source: BCU, International Operations Area.

Table I-8 **Geographic breakdown of direct loan discounts** **Multisector credit program II (1155/OC-UR)** *(amounts in US$000)*						
Region	**Number of subloans**	**%**	**Amounts**			**TOTAL**
			IDB	**IFIs**	**End-borrowers**	
Montevideo	708	46.3	53,002	19,716	55,691	129,117
Interior	822	53.7	31,440	864	72,749	105,875
TOTAL	**1,530**	**100.0**	**84,442**	**20,580**	**128,440**	**235,092**
Source: BCU, International Operations Area						

2. IFI participation and portfolio performance

1.34 At present, eight of Uruguay's 21 private intermediary financial institutions (IFIs) and one government bank (BROU) are eligible to use the rediscount window and are versed in its operating procedures, applying them progressively to their entire medium- and long-term loan portfolios. For the participating IFIs it is very important that there be continuity in the timely availability of these medium- and long-term resources, since these institutions are expanding and strengthening their in-house capacity to handle this kind of funding and, given the adverse regional macroeconomic climate, it would be difficult for them to broaden their operations using internally generated funds. The evolution of the cost of these funds to IFIs shows it to be competitive relative to the London Interbank Offered Rate (LIBOR), the main market benchmark for dollar operations. Additional incentives for IFIs and end-borrowers are the matching of maturities and the long-range stability of this funding source.

Table I-9
Funding breakdown by IFI[1] at 31 December 2001
Multisector credit program II (1155/OC-UR)
Listed in order of IDB percentage share – Amounts in US$000

Bank	Number of subloans	%	Amounts			TOTAL	IDB %[2]
			IDB	IFIs	End-borrowers		
BROU	137	9.0	30,000	147	17,451	47,598	35.5
Comercial	749	49.0	19,230	1,097	12,379	32,706	22.8
Santander	5	0.3	9,587	17,813	83,936	111,336	11.4
COFAC	457	29.9	7,938	551	6,781	15,270	9.4
Montevideo	105	6.9	7,824	208	3,355	11,387	9.3
ACAC	39	2.5	4,648	229	1,629	6,506	5.5
Sudameris	10	0.7	2,401	225	700	3,326	2.8
FUCAC	17	1.1	1,582	280	1,726	3,588	1.9
Surinvest	11	0.7	1,231	29	485	1,745	1.5
TOTAL	1,530	100.0	84,441	20,579	128,440	233,462	100.0

[1] The Uruguayan Mortgage Bank (BHU) participated only in the term-mismatch facility. For details see Table I-7 above.
[2] IDB funding as a percentage of the total.

1.35 There has not been a single instance of IFI arrears to the Central Bank (BCU) in the MS-II portfolio. At the end-borrower level, at 31 December 2001, the over-91-day arrears rate for MS-II subloans discounted by IFIs and BROU stood at 19%.[16] Nonperforming BROU operations accounted for 92% of the over-91-day past-due total of loans discounted by IFIs at the BCU. At that same date the over-91-day arrears rate on BCU-discounted private commercial bank loans was quite low (4.7%). This performance compares favorably with the average arrears rate for the overall private IFI portfolio at terms longer than 30 days (BCU classification categories 2, 3, 4 and 5), which was 1.3% in 2001.

1.36 Difficulties in the agriculture sector from 1998 to 2001 left their mark on the BROU portfolio (see Box 3). However, according to BCU indications, BROU has made significant progress in recent months on improving its cost structure and operating results, and has adopted a loss provisioning policy identical to the one in place in private-sector IFIs. BROU also revamped its interest rate structure in line with its costs and operating risk and term considerations. It has succeeded in stabilizing and reversing its portfolio performance trend. By dint of these improvements BROU will be able to participate in the program proposed here, since it would be in compliance with the planned new portfolio arrears limits (see paragraph 3.6).

[16] The arrears rate is defined as the ratio of loans with one or more payments over 91 days in arrears to the total MS-II IFI discounted portfolio at 31 December 2001. (See also Box 5, page 22.)

3. Lessons learned

1.37 The first lesson drawn from experiences in the MS-I and MS-II programs is that the strategy the Bank adopted in the early 1990s to support the development of its member countries' financial systems has been successful in Uruguay (see Box 2 and paragraph 1.33), and that the strategy is replicable in countries with similar economic and political environments. As part of that new approach the Bank supported sweeping changes in then-prevailing financial sector practices commonly referred to as 'financial repression'. The Uruguayan experience validates the strategy which the Bank has pursued since the late 1980s to promote member country moves to abandon directed credit policies, lending rate ceilings and other instruments of financial repression and embrace instead free-market practices in order to develop their financial systems and financing for private productive investment more quickly and efficiently.

1.38 A second lesson is that, given the difficulties in reducing or eliminating market failures triggered by inflation, sharp devaluations and financial system deterioration, it is unrealistic to expect dramatic advances on financial sector reform and modernization or on securing and mobilizing long-term savings. It is no easy task to overcome years of negative experiences of savers and investors. Changing the expectations and practices of businesses, banks, and individuals is a gradual process that takes time.

1.39 The third lesson is that it is important to follow market rules and practices in setting interest rates and in lending to individuals and businesses, and to strictly apply international best practices in financial system regulation and oversight. It is largely because Uruguay took that road that it has been able to keep its macrofinancial environment stable even with the domestic difficulties mentioned above, and has weathered the spillover from neighboring countries' financial and exchange-rate dislocations.

1.40 The fourth lesson has to do with the effectiveness of the modus operandi of the previous two programs (MS-I and MS-II) to create an enabling environment for the development and gradual launch of new products. The first step in the product launch methodology is to ascertain the potential market demand for credit at specified terms. The next steps are to: (i) devise and implement a legal, institutional, and regulatory framework conducive to new product development; and (ii) make available to IFIs liquidity facilities that will encourage and equip them to bring out new products. Using this methodology it has been possible to enrich the IFI product mix with such medium- and long-term credit products as housing mortgage finance and financial leasing. The operation described here proposes to launch medium- and long-term post-shipment export financing and financial asset securitization.

II. THE PROGRAM

A. Objectives

2.1 The program's objective is to help supply the medium- and long-term financing needs of Uruguayan private enterprises, to help make up the shortfall in the domestic financial market which is not mobilizing sufficient medium- and long-term savings to fund private-sector productive investments.

B. Description

1. Medium- and long-term financing

2.2 To pursue the above-mentioned objective the program proposes to: (i) enlarge and solidify the supply of medium- and long-term credit, on market terms, for private-sector investment projects intended to realign, improve or expand efficient operations of private businesses established in any economic sector in Uruguay; and (ii) provide the liquid resources needed to promote greater use of the financial products already available for medium- and long-term financing of private productive investment and launch new products and financing facilities for the same purposes.

2.3 The proposed program will provide funding to enlarge the Central Bank (BCU) medium- and long-term loan discount window that was created under the first multisector credit program (MS-I, IDB loan 705/OC-UR) and expanded under the second multisector program (MS-II, IDB loan 1155/OC-UR). Funding under the program described here will enable the BCU to provide intermediary financial institutions (IFIs) with lines of credit to discount subloans the IFIs approve to finance: (i) capital investments by companies established in Uruguay, of any size and operating in any sector of private enterprise, except for activities on the Bank's negative list; (ii) term-mismatch insurance facilities for IFIs' medium- and long-term loan portfolios (see Box 4); (iii) medium-term financial and operating lease operations; (iv) securitization of bank loans to support eligible private-sector productive investments; and (v) medium- and long-term export credit. The apportionment of program funds among economic sectors, activities, and financial products will be determined by market demand.

Box 4
Term-mismatch insurance facility

The purpose of this facility is to enable IFIs to lengthen the repayment terms of loans they approve, using short-term deposits and other short-term funding sources, for private-sector productive investment projects that qualify for classification in portfolio risk categories 1 and 2 (standard risk), without the IFIs' having to run excessive maturity-mismatch risks. The aim is to insure against that risk in the event of a systemic crisis that impairs financial system liquidity. In exchange for annual premiums paid by IFIs to the Central Bank for liquidity insurance under the facility, the Central Bank undertakes to provide to IFIs which are current on their premiums medium- and long-term financing of up to 50% of the insured loans in the event of a sudden drop in M_3 (defined as money + near-money + residents' dollar deposits) of 7% from the average value the previous quarter. The cover will not be activated if deposits drop in any individual IFI. The insurance facility's technical reserves are separate from BCU reserves and will be held in separate accounts, being property of the Ministry of Finance.

2.4 The borrower for the program will be the Eastern Republic of Uruguay. The Central Bank of Uruguay (BCU), as executing agency, will administer the discount window, channeling the funds to authorized IFIs that submit eligible projects according to the program's operating rules. The IFIs will lend to end-borrowers under competitive free-market conditions as regards both risk screening and subloan interest rates, adhering to prudential regulations set by the BCU's Superintendency of Intermediary Financial Institutions (SIIF). Any SIIF-regulated banking institution that has SIIF authorization for regular operation will be eligible, in principle, for this facility. The SIIF will determine IFI eligibility criteria and the amounts of lines of credit and term-mismatch cover for which IFIs will qualify, within the program's authorized limits. These amounts will be reviewed annually by reference to each IFI's financial situation, institutional capacity, and portfolio performance.

2. New products

2.5 One of the central objectives of multisector credit programs in Uruguay has been to gradually develop the medium- and long-term credit market as well as new products to invigorate the country's long-term financial markets generally and the capital market in particular. The product menu has grown with each successive program, commensurate with the gains achieved in institutional capacity, changes in legislation, and market demand. Operations eligible for funding under MS-I were medium- and long-term loans for capital purchases and permanent working capital associated with capital project execution; working capital finance for micro-enterprises, and housing mortgage finance. Additional products introduced in MS-II were facilities to insure against term-mismatch risk for medium- and long-term lending using short-term funds; lease contract financing, and technical assistance for institutional development of the SIIF, Banco de la República Oriental del Uruguay (BROU), the Uruguayan Mortgage Bank (BHU), and IFIs. The MS-III program proposed here will continue to fund the aforementioned products and will foster liquidity conditions that, if duly regulated, should continue to expand and

solidify the medium- and long-term credit market. Accordingly, the spectrum of MS-III activities includes not just the new products described above (paragraph 2.3) but a progressive expansion into other facilities and products, as appropriate institutional market conditions are achieved in the course of the program.

2.6 To that end, the Bank and the BCU as executing agency will periodically discuss the strength of demand for new products and, if so decided, how and when the new products will be launched. Sections dealing specifically with each new product will be added to the Credit Regulations, covering requirements and operating features of each.

2.7 Based on the findings of the most recent evaluation of the MS-II program in March 2001, the Bank and the BCU as executing agency agreed to amend the Credit Regulations to allow remaining MS-II funds and the MS-III funds to be used to: (i) discount operations with partially capitalizable interest, such as forestry investments; and (ii) finance transferable loans ("chain" finance) for construction, sale or leasing of buildings and housing.

Box 5
Discounting of transferable loans

With this product, IFIs will be able to tap the program's discount facility for capital projects of construction firms that erect buildings or building units for sale. One construction finance vehicle in Uruguay is the sale of planned buildings with novation of the mortgage loan taken out by the builder. The builder obtains lump-sum financing when construction begins. When the project is finished, the builder transfers the loan in whole or in part to the building's purchasers under a novation agreement. The non-novated portion of the loan is paid when title is transferred to the purchasers. In MS-III, IFIs would be permitted to discount loans taken out by construction companies and their subsequent novations.

2.8 A further MS-III provision is that, from the operation's outset, its resources can be used for medium- and long-term export finance—this being one of the products that would be introduced in pursuit of the Bank's Eighth Replenishment mandate in this area (document AB-1704, paragraph 2.90).

2.9 The primary aims of the planned MS-III financing are to: (i) create conditions for Uruguayan exporters that are on a par with the export environment in the more advanced countries and other MERCOSUR member states; (ii) help lending institutions fully understand export costs and risks and, consequently, try to change their preference for lending for other activities with known risks; (iii) remedy problems of access or very high costs of the export credit facilities currently available; and (iv) reduce the disadvantages ensuing from segmented markets that favor large export firms. In the present system, the only assistance available to Uruguayan exporters is in the form of: (a) rebates of indirect taxes paid during the production process, in line with World Trade Organization (WTO) rules and the WTO code on official export assistance; (b) the VAT exemption for exports;

(c) duty-free imports of raw materials and intermediate goods used for export manufacturing, and of capital goods intended for priority activities; (d) the Central Bank export financing facility mentioned earlier; and (e) preferential bilateral export agreements (with Mexico, for instance) and regional agreements (e.g. MERCOSUR and the Latin American Integration Association).

3. Scaling of the program

2.10 Factors examined to decide on the size of the proposed program were: (i) estimates of private investment in the Uruguayan economy; (ii) prospective end-borrower demand; and (iii) capacity of IFIs and potential demand on their part.

2.11 According to the analysis of potential IFI demand, the need for new medium- and long-term credit would be in excess of US$70 million annually. This justifies the US$225 million in financing proposed for MS-III. Other elements taken into account to arrive at that figure were the expectations expressed by officials of private commercial banks that use the discount window, funds remaining in MS-II, and the repayment timetables of MS-I and MS-II subloans. According to the estimates, beginning in 2002 there would be around US$20 million a year, on average, available to lend from recoveries on subloans approved under the two previous programs. Given the current economic forecasts, the combination of those funds and the proposed MS-III resources could satisfy the banking system's annual demand for long-term private investment funding for the next three years.

2.12 The Bank's support for the proposed program would take the form of a US$180 million loan from the Ordinary Capital. The borrower will be responsible for the local counterpart of US$45 million, which would come from end-borrower contributions to the respective investment projects (US$25 million) and participating IFIs' credit resources (US$20 million).

4. Program costs and disbursements

2.13 The borrower and the Bank have agreed that the disbursement period for the loan will be at least three years. They further agreed that the Bank will recognize up to US$15 million in subloans formalized between IFIs and end-borrowers as from 1 April 2002 as being eligible for reimbursement out of the loan proceeds. It is also anticipated that up to US$50 million in term-mismatch insurance cover could be used. Table II-1 shows estimated program costs and the annual disbursement timetable.

Table II-1 **Program costs and disbursements**[1] *(US$000)*				
Funds	**Year 1**	**Year 2**	**Year 3**	**TOTAL**
IDB loan	**90,000**	**45,000**	**45,000**	**180,000**
Credits	89,100	44,550	44,550	178,200
Inspection and supervision	900	450	450	1,800
Local counterpart	**21,000**	**12,000**	**12,000**	**45,000**
IFIs	9,000	5,000	6,000	20,000
Business owners	12,000	7,000	6,000	25,000
ANNUAL TOTALS	**111,000**	**57,000**	**57,000**	**225,000**
[1]Disbursement projections are indicative figures only.				

5. Sustainability prospects of the facility

2.14 The market's inability to mobilize enough medium- and long-term savings to finance private investment, particularly for small and mid-sized businesses, is a problem that can only be resolved in a climate of lasting macroeconomic stability. It therefore requires sustained, substantial government involvement, especially in emerging markets. That being the case, the Uruguayan authorities view the Central Bank's medium- and long-term discount window, through which the program proposed here will operate, as a permanent fixture. Indeed, one of the facility's founding strategic objectives was to make sure there would be a stable mass of intermediated medium- and long-term credit in the system. This is the only way to assure sustained financing for a critical mass of private-sector investments even in the worst external financial market access scenarios. The authorities also have indicated that Uruguay hopes to continue counting on Bank support to maintain this facility, both because of the financing terms and the technical value-added that the authorities see in the Bank's participation in the operation's design and monitoring. Apart from the loan discussed here, then, Uruguay will foreseeably seek additional financing from the Bank in future for this purpose.

III. PROGRAM IMPLEMENTATION

A. Borrower and executing agency

3.1 The borrower for the operation will be the Eastern Republic of Uruguay. The Central Bank of Uruguay (BCU) will be its executing agency and financial agent. The funds will be channeled by the BCU, acting as a second-tier institution. Eligible IFIs will operate as first-tier institutions.

3.2 The BCU was created in 1967 with the following mandate: (i) assure the stability of the national currency and keep international reserves at adequate levels; and (ii) foster and preserve the solidity, solvency, and sound operation of the national financial system. The BCU charter and the Financial Intermediation Act were both amended in 1995, consolidating the BCU's bank regulation and oversight responsibilities and its authority to take charge of faltering IFIs as a preventive measure. The revised BCU charter created a Superintendency of Intermediary Financial Institutions (SIIF) headed by a superintendent, reporting directly to the BCU board but with technical and operational autonomy. Laws enacted by the Parliament between 1993 and 1998 dismantled insurance and mortgage market monopolies, created pension fund management companies (AFAPs) and investment funds, and regulated the securities market and corporate debt securities. The BCU's regulatory and supervisory mandate has been broadened accordingly. Various IDB operations[17] provided support for all these reforms and helped strengthen the BCU to equip it to discharge its new functions.

3.3 The BCU is headed by a three-member board that is responsible for policy and general administration. The agency's day-to-day management is in the hands of a General Manager and the SIIF, the General Manager having responsibility for currency-issue matters, monetary programming, reserve requirements, etc., and the SIFF, under its Superintendent, for IFI regulation and supervision.

B. Institutional features of the proposed program

1. Operating arrangements

3.4 Activities falling to the BCU as the program's executing agency will be performed by its regular staff. The Office of the BCU General Manager and the SIIF will be in charge of preparing and supervising the program's operations side. An Interdepartmental Technical Committee appointed by the BCU board will

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[17] Including a MIF operation (ATN/MT-6098-UR) to strengthen BCU insurance and securities market functions, the MS-II technical assistance component designed to help the SIIF implement Basle Committee recommendations and improve technical training of SIIF staff, and a component of the sector loan in support of social security reform (921/OC-UR) that provided technical support to the AFAP oversight unit.

coordinate and monitor the work of the aforementioned two bureaus. The International Operations Area in the Office of the General Manager will manage the operational elements and be directly responsible for the facility's operation. The SIIF will be in charge of IFI eligibility clearance, IFI performance tracking, and setting ceilings for credit lines for individual IFIs. The BCU General Manager will oversee the work of the Interdepartmental Technical Committee.

3.5 The Republic and the BCU will sign an agreement under the terms of which the former will transfer to the latter the proceeds of the Bank's loan,[18] stipulating the transfer terms and conditions and the executing agency's undertakings pursuant to the contract with the Bank, including those pertaining to program interest rates and costs (see paragraphs 3.14-3.16). As was noted above, signature of the BCU-Ministry of Finance agreement will be a condition precedent to the first disbursement of the loan. The use of program funds will be governed by the program's Operating Regulations, which will include IFI eligibility guidelines and a set of Credit Regulations. Approval and entry into force of the Operating Regulations agreed on with the Bank will be another condition precedent to disbursement of the loan proceeds. As required for the program's implementation and monitoring, the BCU will issue specific directives on administrative, accounting, and financial procedures for the program's operation, which will be added to the Operating Regulations.

2. IFI eligibility and credit allocation

3.6 Program-funded subloans will be discounted at the BCU window created for that purpose. Within the BCU, the SIIF will decide on the eligibility of IFIs that apply to join the program and will monitor participating IFIs' performance. The IFI eligibility requirements are spelled out in eligibility guidelines in the program's Operating Regulations. The following are some of the requirements participating IFIs must fulfill to the BCU's satisfaction: (i) comply with BCU requirements as to prudential technical ratios relating to liquidity, financial solidity and investment loan portfolio management, or be in the process of rigorously applying a BCU-approved adjustment plan, cleared by the Bank, that will bring the IFI into compliance in that regard within 24 months; (ii) demonstrate to the SIIF's satisfaction that they have the capacity to promote, evaluate, and administer subloans and comply with program-specific rules and with other pertinent bank standards in force for each kind of operation (product) the IFI proposes to intermediate using program funds; and (iii) adhere to the following provisions on portfolio arrears and quality: (a) loans with risk ratings of 4 or higher (see Box 6) will not be discountable; and (b) the average arrears rate of an IFI's portfolio, including its BCU-discounted loans, cannot be higher than 1.3 times the system-

[18] Signatories to the agreement will be the BCU and the Ministry of Economic Affairs and Finance.

wide IFI average (commercial IFIs and BROU) for the institution's overall loan portfolio.[19]

3.7 In principle, the pool of eligible IFIs will consist of regulated financial intermediaries, including one official bank (BROU),[20] private commercial banks, finance corporations and credit unions that satisfy BCU technical ratio requirements and demonstrate, to the SIIF's satisfaction, that they have the financial and institutional capacity to comply with the program's requirements set out in its Operating Regulations. The program has already secured the participation of 12 IFIs, including BROU, which have discounted subloans, 97% of them averaging less than US$50,000. After a thorough analysis the SIIF will determine each IFI's credit line ceiling, eligible product type and extent of participation, by reference to the above-listed eligibility criteria. The greater part of the private commercial IFIs and BROU are expected to continue participating.

3.8 The program's end-borrowers will be individuals or legal persons in the private sector, lawfully established in Uruguay, which in the IFIs' assessment have demonstrated technical, financial, administrative and legal capacity to execute the investment project for which funding is being sought.

3.9 The IFIs will provide end-borrowers with information furnished by the National Environment Directorate (DINAMA) and/or the Environment Unit of the National Development Corporation (CND) on environmental classification and compliance requirements.

3.10 Program funds will be channeled through eligible IFIs by way of individual participation agreements between the IFI and the BCU. For each IFI declared eligible for the program, the BCU will set a credit line limit on the basis of the institution's financial solidity, fulfillment of the eligibility requirements, and net worth. The credit ceiling will be the lesser of 75% of the IFI's adjusted net worth or US$60 million. Each BCU-IFI participation agreement will state the aggregate credit line available to the IFI (for investment loan discounting, term-mismatch insurance cover, discounts of export credit and lease financing, etc.). These contracts will be reviewed annually, including the IFI's credit allotment.

3.11 To make sure that IFIs put program funds to the agreed use, for every subloan they will sign a provision of funds contract with the BCU and will promptly provide the BCU with such documentation as that agency may request pertaining to subloan contracts (see paragraphs 3.22, 3.23 and 3.30). After reviewing the documentation the BCU will credit the funds to the IFI's account. At a minimum the subloan

[19] This ratio was selected because it is similar to the maximum deviation from the current system average for first-class IFIs.

[20] At this writing the BHU is not eligible to participate because of its arrears rate and lack of an acceptable adjustment plan.

contract must state the Credit Regulations requirements for program subloans (see paragraphs 3.28 and 3.29).

3. Agreement with the National Development Corporation

3.12 The CND, coordinating with DINAMA, will be in charge of environmental impact and compliance assessment for MS-III as it has done to date. The CND Environment Unit has two full-time specialists and will be able to hire additional consultants in different areas of expertise.

3.13 Another CND task will be to provide operational support for the program's promotion among the business community.[21] For both these purposes (environmental compliance and business promotion) the CND will sign an extension to its current agreement with the executing agency, stipulating *inter alia* the compensation the CND will receive for costs incurred in providing these services. These expenditures are to be incorporated into the program's costs for purposes of calculating the interest rate the BCU will charge IFIs on program funds (see paragraph 3.16). Signature of the CND contract extension will be a condition precedent to the first disbursement of program funds. The BCU will receive periodic reports on the CND's promotional and environmental compliance work, copies of which will be sent to the IDB.

C. Program interest rates and costs

1. Interest rates for IFIs

3.14 The discount window will operate in dollars, but IFIs can elect to lend to end-borrowers in dollars or Uruguayan pesos.[22] Annual interest rates for IFI discount operations will be variable, adjustable on the start date of each accrual period. The rates must be high enough to defray, at a minimum, the cost of funds furnished by the IDB plus BCU administrative costs; in no event may the rates be lower than the cost of 90-day interest-bearing deposits in the five banks with the largest deposit base, adjusted for requirements and returns on reserves and mandatory government security holdings.[23] The choice of the 90-day certificate of deposit rate as a basis for the discount rate has to do with the current term structure and volume of operations in Uruguay (see Table III-1) and the regulatory framework for commercial bank

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[21] The Finance Ministry and BCU themselves publicize and coordinate the program at the IFI level.

[22] They also may lend in Uruguayan pesos with dollar adjustment provisions, or in pesos with no exchange adjustment, but in the latter case they must comply with all BCU regulations and ceilings on currency-mismatch risk.

[23] 90-day certificates of deposit continue to be the predominant marginal funding vehicle in Uruguay's banking system.

interest-rate risk pursuant to Basle Committee principles (January 2001) on interest-rate mismatch risk.[24]

2. BCU intermediation costs

3.15 The BCU will calculate the costs of operating the facility, taking into account the outcomes of the first two multisector credit programs (MS-I and MS-II). The BCU will cover these costs out of its IFI fee revenues for administering the program portfolio and the spread to be charged according to market conditions.

3.16 On the basis of the above-mentioned costs, the BCU will periodically determine the spread and the fees it will charge participating IFIs, making the appropriate adjustments each time for cost or revenue overestimates or underestimates from the preceding period. The agreement between the borrower and the BCU will describe the workings of this arrangement.

3. Lending rates and other finance charges

3.17 IFIs will be free to set their spreads and the interest rates they will charge on individual subloans to end-borrowers. The credit and exchange risk for such operations will be entirely for the IFIs' account. The premise for this approach is that allowing IFIs to set subloan interest rates, with an eye on market conditions, is the most effective way of promoting efficient resource allocation, since it encourages private-sector investment decision-makers to be guided by economic efficiency criteria and assures additionality of the program funds.

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[24] Basle Committee, *Principles for the Management and Supervision of Interest Rate Risk*, January 2001.

Table III-1 Selected interest rates *(in percent)*[1]							
	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001 (Sept.)**
Financial system							
Foreign currency deposits (31-180 days)	4.6	4.8	4.8	4.9	5.0	5.2	3.5
Foreign currency loans (generally)	13.8	13.1	12.3	12.5	12.6	13.5	13.9
Foreign currency loans (prime rate)	9.0	8.5	8.5	8.5	8.3	8.3	7.2
Peso deposits (31-180 days)	38.2	28.1	19.6	15.1	14.2	12.1	16.7
Peso loans (prime rate)	61.7	48.2	39.2	30.6	26.2	20.7	27.6
Public sector							
Dollar treasury bills (182 days)	6.0	5.4	5.1	6.6 [2]	[3]	7.4 [2]	[4]
International rates							
LIBOR (182 days)	5.5	5.6	5.8	5.1	6.5	6.2	2.5
LIBOR (364 days)	5.4	5.8	5.9	5.1	6.9	6.0	2.6
BCU onlending rate to IFIs (MS-I and MS-II)	6.9	7.1	6.9	6.9	7.2	7.2	7.3

[1] Annual arithmetic average of interest rates of the five most representative institutions for each financial product.
[2] Second quarter. No operations for the rest of 2000.
[3] July to October.
[4] No transactions.
[5] Source: IMF, *Country Report No. 01/47*, March 2001, and BCU Monthly Bulletin.

4. Statistics on lending rates and other finance charges

3.18 IFIs charge different kinds of rates on their program-funded subloans to end-borrowers: fixed rates (including the IMABA tax on bank assets); six-month LIBOR + a variable spread + IMABA; and country risk + spread + IMABA. As Table III-2 shows, rates vary depending on the purpose of the loan (investment, housing, permanent working capital, leasing).

Table III-2 Lending rates and other charges				
Bank	**Investment loans**	**Housing loans**	**Permanent working capital**	**Leasing**
Comercial	13-15 % fixed	14.5-16% fixed	13-14% fixed	14.5% fixed
COFAC	13.5% fixed	13.5% fixed	-	13.5% fixed
FUCAC	11-14.6% fixed	Not funded	-	Not funded
SURINVEST	None funded	None funded	None funded	LIBOR + 4 6%
Santander	Country risk + 2-3%	LIBOR +6-7%	-	13.5% fixed
BROU	Varies quarterly with cost of funds, risk and term: 8.7-11.9%	Not funded	Varies quarterly with cost of funds, risk and term: 8.4-11.9%	Varies quarterly: 7.2-8.7%
Montevideo	LIBOR + 5-6%	LIBOR + 5.5-6%	LIBOR + 5-6%	7-11% fixed
SUDAMERIS	LIBOR + 5-9%	Not funded	-	Not funded

Source: BCU

D. Operational features

1. Operating Regulations

3.19 These are the set of requirements agreed on by the IDB, the borrower, and the BCU to govern the program's execution. They consist of the Credit Regulations, IFI eligibility guidelines, and model participation and provision of funds agreements. They also describe the program's operating and supervision arrangements.

2. Credit Regulations

3.20 For the most part the MS-III Credit Regulations are similar to the ones agreed on with the Bank for the previous multisector programs (MS-I and MS-II). A section will be added to these Regulations for every new product developed, listing requirements relating to that product and their concordance with rules and criteria that apply to the full spectrum of products eligible for financing, such as end-borrowers' obligations, security requirements, discountable amount, etc. The Credit Regulations, as amended, are consistent with the Bank's rules and policies and with current Uruguayan banking and financial legislation and practices, and address the main facets of the operation. The following paragraphs summarize key features of the Regulations, omitting the interest-rate information that was examined above in section C.

a. IFI obligations and responsibilities

3.21 Participation by IFIs in MS-III is voluntary. The BCU will assess an IFI's eligibility only if the IFI applies for the program. Once an IFI has been declared eligible it must sign a participation agreement with the BCU setting out the terms and conditions of the line of credit the IFI will receive.

b. End-borrower obligations

3.22 Each subloan contract executed by an IFI with an end-borrower must stipulate, *inter alia*: the right of the IFI, the BCU, the IDB, and the program's external auditors to examine and supervise goods, work sites and construction financed or to be financed through the subloan, and the end-borrower's pledge to satisfy all subloan requirements in the Credit Regulations and IFI participation agreements and any other program-related condition established by the BCU, including environmental assessment and compliance provisions.

c. Security

3.23 End-borrowers receiving IFI subloans must provide security satisfactory to the IFIs in accordance with Uruguayan banking laws and standards. The BCU may request the endorsement or assignment of such security and, at its discretion, the furnishing of such other guarantees as it deems necessary.

d. BCU discount and subloan ceilings and terms

3.24 The maximum that an IFI may discount under the program is the equivalent of 80% of eligible expenditures of its projects overall. The 20% balance is to be furnished by end-borrowers and IFIs, as prescribed in the Credit Regulations, and will form part of the program's local counterpart.

3.25 Save as expressly authorized by the BCU and the Bank, an IFI may not approve program-funded subloans to any single end-borrower which, when added to that borrower's outstanding MS-III debt, would exceed the equivalent of US$7 million.

e. Repayment terms

3.26 The BCU will determine maximum repayment terms, including grace periods, for subloans to be discounted by IFIs. The amortization term is not to exceed 15 years. Within those limits IFIs would be free to set the repayment terms for individual subloans, with due regard to the project's service life, nature of the investment and the end-borrower's ability to pay.

f. Restrictions on the use of MS-III funds

3.27 The following kinds of expenditures will not qualify for MS-III funding: (i) end-borrowers' overhead and administrative costs; (ii) debt restructurings, dividend payments or recoveries of previously invested capital; (iii) asset transfers, including purchases of equity shares or participations; (iv) severance payments; (v) recurring expenditures, including taxes; and (vi) working capital, except for microenterprises' working capital needs and permanent working capital associated with the execution of projects being funded. Permanent working capital is understood to mean working capital associated with investment projects executed using MS-III funds.

g. Subloan contract covenants

3.28 Subloan contracts will stipulate the following: (i) the right of the IFI, the BCU, the IDB, and the program's external auditors to examine and supervise goods, work sites and construction financed or to be financed through subloans and leasing operations; (ii) the end-borrower's pledge to use the program-funded goods and services exclusively to execute the respective project; (iii) the end-borrower's agreement to adhere to technical guidelines it receives for works execution and project operation, relating to conservation and use of natural resources, the environment, and completed investment projects; (iv) the right of the BCU and the IFI to suspend subloan disbursements or declare a subloan to be immediately due and payable if the end-borrower fails to perform its contractual obligations; (v) the end-borrower's obligation to keep and promptly make available accounting, financial, and technical records and information required according to the rules set by IFIs in concert with the BCU, and to provide all such information as the IFI,

BCU, or IDB may reasonably request;[25] and (vi) the end-borrower's agreement not to transfer, sell, or partially rent or in any other way assign rights or obligations acquired using program funds, save as expressly authorized by the respective IFI.

3.29 Requirements for subloans for lease financing are: (i) the lease agreement will accord to the IFI rights similar to those prescribed in the Regulations for subloans, such as the IFI's right to terminate the lease financing if the subborrower defaults on its contractual obligations; and (ii) the lease contract will contain the rental payment schedule, calculating the component as though the lease credit were a loan for the amount of the leased equipment and each rental payment a payment of interest and principal on such loan.

h. Subloan eligibility

3.30 The program will introduce new standards for IFI arrears scoring, applying objective and subjective portfolio quality rating criteria (see Box 6) to subloans to decide whether an IFI may access and continue using the facility for those loans. The aim of these standards is to clearly pinpoint impaired and unrecoverable loans (category 4, with provisions of 50% of outstandings, and category 5, loans more than 240 days in arrears, with 100% provisioning), which must be repaid to the facility immediately. Furthermore, an IFI will only be eligible if its overall loan arrears rate is at most 1.3 times the average system rate for all risk categories (1 through 5) or if an adjustment plan acceptable to the SIIF and the Bank is in place for the IFI (see paragraph 3.6).

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[25] Apart from the SIIF requirements set out in the circular on client records (No. 2001/179 of 13 November 2001), all files on multisector program-funded projects must contain at least the following information: (i) certificates and authorizations required by national or departmental legislation; (ii) an evaluation of the project's financial viability; and (iii) specific information required by the program, on which subject the BCU will issue a directive in due course.

Box 6
Portfolio quality: Risk categories

Category 1	**Standard (Pass).** Loans that are current or have payment(s) less than 30 days past-due. Provisioned at 0.5% of total outstanding.
Category 2	**Watch**. Borrowers up to 60 days in arrears; borrowers sporadically or temporarily in arrears. Provisioned at 5% of total outstanding.
Category 3	**Substandard**. Borrowers up to 150 days in arrears, or 60-180 days late in reporting to IFIs, or with cumulative losses that do not significantly impair equity. Provisioned at 20% of outstandings.
Category 4	**Doubtful**. Borrowers up to 240 days in arrears (loans in legal collection), or over 180 days late in reporting, or showing signs of capital impairment, or with legal problems. Provisioned at 50% of outstandings.
Category 5	**Loss**. Borrowers over 240 days in arrears (in default); borrowers who have fled or declared bankruptcy or initiated arrangements with creditors; legal proceedings instituted; borrowers whose creditworthiness is severely impaired or who are unable to generate funds to pay their debt. 100% provisioned.

3. Monitoring of IFIs and subprojects

a. Periodic program reviews

3.31 Throughout the program the borrower and executing agency, on the one hand, and the Bank, on the other hand, will periodically review the interest rates being charged on subloans. The borrower and executing agency will, if necessary, take appropriate measures consistent with the country's economic policies to harmonize subloan interest rates with the Bank's policy objective.

3.32 Eighteen months after the first disbursement of the Bank's loan or after 50% of the loan proceeds have been disbursed, whichever occurs first, the borrower and the Bank will review the program to assess the achievement of its objectives and outcomes (including environmental elements). Subsequent reviews will be conducted at 18-month intervals thereafter until the program funds are disbursed in full.

3.33 At each of these review meetings the parties will assess the program's development effectiveness by reference to the following performance indicators, using as baselines the MS-II levels for each at 31 December 2001: (i) materialization of investments with an aggregate cost of more than 125% of the Bank's loan; (ii) participation of at least one third of the financial system's private commercial IFIs; and (iii) diversified geographic coverage of investments, at least 33% of investment projects being outside the Montevideo area.

3.34 As one part of the operation's evaluation, a mechanism will be set in place for the continual monitoring and evaluation of the economic impact of the funded projects

in terms of investment and employment, using a representative sample of the benefiting businesses.

3.35 This work entails an annual review of a sample of completed projects that account for at least 5% of the subloans approved with program funds, the last disbursement of which had been released the year preceding the year of the review. The projects will be visited by a multidisciplinary team from the Bank's Uruguay Country Office and the Central Bank's International Operations Area. During the visit a lengthy questionnaire will be filled out, eliciting data on the business's main economic, institutional and financial characteristics before and after the project was funded. This work will continue throughout the life of the program, as an important task in tracking its impact.

3.36 On the matter of macroeconomic impact indicators, given the proposed program's small scale relative to annual private investment volumes and total banking system assets, it was decided to make an analysis of performance of the following macrofinancial indicators a feature of the periodic reviews: (i) changes in private investment as a percentage of gross domestic investment; (ii) changes in monetary aggregates as a percentage of GDP; and (iii) changes in total lending at repayment terms longer than one year as a percentage of financial system credit to the private sector.

b. Internal and external audits

3.37 The BCU's Internal Audit Service will audit that agency's administration of the program. This audit unit is to establish and maintain administrative, accounting, and internal control procedures to ensure that the program adheres to Bank requirements and generally accepted practices in this field. External audits of the program will be conducted by Uruguay's General Accounting Office, in accordance with terms of reference approved in advance by the Bank.

3.38 Audited financial information on the status of subloans approved by IFIs using funds from the BCU-operated multisector credit programs must be kept current and satisfy Bank requirements, to enable Bank staff and external auditors to readily ascertain the status of the program-funded portfolio.

E. Term-mismatch insurance facilities

3.39 These products will provide IFIs that apply for this form of protection with liquid funds equal to up to 50% of the insured portfolio to cover liquidity risks. The BCU will only release the funds if M_3 (see Table I-3) declines by more than 7% from the preceding quarter's monthly average. As a condition for release of the funds the insured loan portfolio must be pledged as security, maintained by the IFI in accordance with the Regulations and other operating rules of the discount facilities. The pledged portfolio will consist of IFI loans with Standard and Watch ratings

(categories 1 and 2) under the current guidelines; there must be over one year remaining on their repayment term, and they must be considered acceptable by the BCU, under the terms of the respective participation agreement.

F. Environmental impact assessment and monitoring

a. Responsibility

3.40 The Ministry of Housing, Land-Use Planning and the Environment created in 1990 by Law 16,112 has primary responsibility for environmental matters, which it exercises through the National Environment Directorate (DINAMA). Law 16,466 of 1994 made environmental impact assessments mandatory for certain kinds of ventures.

3.41 Since 1993 DINAMA has received support under a US$1.4 million IDB-funded institution-strengthening program (ATN/SF-4375-UR). A new operation with the same objectives is currently being evaluated. However, DINAMA still does not have the institutional and financial capacity to fully discharge its environmental compliance mandate for program-funded projects. Accordingly, in 1994 the BCU signed an agreement with the National Development Corporation (CND),[26] the agency that had successfully served as environmental compliance assessment agency for the IDB's Global Credit Program for Small Business and Microenterprise (614/OC-UR).

3.42 The BCU-CND agreement was renewed in 1999 when MS-II was launched, and its extension will be a condition precedent to the first MS-III disbursement. In the agreement the CND undertakes to: (i) provide IFIs with guidelines and information-system support to preclassify activities that may be eligible for financing according to their environmental impact; (ii) before funding is approved, assess the environmental impact of subloans preclassified in category III or IV and report their rating to DINAMA; and (iii) make recommendations to end-borrowers and IFIs on environmental impact mitigation measures and monitor their implementation.

3.43 In 1992 the Bank's Environment Committee classified MS-I as having potentially moderate environmental impacts. The Committee's recommendations were incorporated into the program's operating design. The environmental report on companies receiving MS-I financing revealed no problems; to the contrary, it outlined gains achieved by replacing machinery and adopting cleaner processes and technology. The environmental consultant's final report on MS-I confirmed those findings. Likewise, the May 2001 evaluation report on MS-II environmental assessment and monitoring mechanisms (produced when 75% of the funds had

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[26] The CND is a public agency attached to the Executive Branch, established under private law. A mixed-capital corporation (State 60%, private sector 40%), it was created by Law 15,785 of 4 December 1985 with a business development mandate.

been disbursed) confirmed that the procedures in place were adequate. A breakdown of 542 loans by category showed 534 for category II projects, 7 for category III, and 1 for category I.[27] There were no category IV operations. In other words, the majority of the disbursed projects have had little impact on the environment. Most were for construction and equipment leasing. All category III projects for which environmental management recommendations had been made at the time of classification were visited a posteriori to see if the recommendations had been implemented. If not, recommendations were made to address the problem and DINAMA was notified, suggesting annual follow-up to check on the recommendations' implementation.

3.44 The arrangements already in place for MS-II will continue in MS-III, incorporating pertinent recommendations from the MS-II environmental report as far as operating regulations are concerned, for the proposed program and for MS-I and MS-II recoveries. As was the case in the previous operations, DINAMA in the Ministry of Housing, Land-Use Planning and the Environment will have primary responsibility for environmental assessments. However, the initial classification and subsequent follow-up will be done by the CND Environment Unit, which will keep DINAMA apprised of its work. The Bank's Committee on Environment and Social Impact reviewed the proposed arrangements on 11 June 2001 and found them to be satisfactory.

b. Operation of the environmental assessment, classification and monitoring mechanism

3.45 According to the established environmental procedures, IFIs participating in the MS-III discount facility will have no formal responsibility for environmental classification of the activities they finance. However, the Credit Regulations explicitly reaffirm the requirement that end-borrowers agree to adhere to technical guidelines they are given regarding the conservation and use of natural resources and the environment in works execution and project operation. The regulations likewise reassert the right of the BCU and the IFI to suspend subloan disbursements or declare a subloan to be immediately due and payable if the end-borrower fails to perform its contractual obligations. Each IFI's participation agreement also will reaffirm the institution's pledge to make sure its end-borrowers satisfy, *inter alia*, the environmental requirements set forth in the contract or prescribed at any time by the pertinent environmental authorities.

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[27] Environmental impact categories: I–positive impact; II–environmentally neutral; III–moderate potential impact; IV–heavy potential impact.

c. Periodic reviews of the efficacy of the program's environmental compliance mechanisms

3.46 To make certain that environmental requirements are satisfied, the loan contract will contain the same covenant that appeared in the previous operations to the effect that, within 18 months after the date of signature of the loan contract the borrower, in concert with the institutions participating in the program, is to begin reviewing a representative sample of program-funded activities, to see to what extent they have implemented the recommended environmental impact mitigation measures.

3.47 Every 18 months throughout the program, at the time of the reviews referred to in paragraph 3.32, the borrower will provide the Bank with an evaluation of compliance with recommended measures for mitigating any adverse environmental impacts of program-funded activities, together with the progress report referred to in Article 7.03 of the General Conditions of Bank loan contracts. If, according to the environmental evaluations, the recommended action has not been taken, the activities in question will no longer be eligible for program funding, the respective loans will be considered to be due and payable, and the IFI's BCU account will be debited forthwith to repay them.

3.48 The final evaluation of MS-III outcomes will include an independent evaluation of the procedures used to classify the environmental impact of program-funded projects and assess their environmental compliance.

IV. VIABILITY, RISKS AND BENEFITS OF THE PROGRAM

A. Viability

1. Economic viability

4.1 The Uruguayan economy is in need of a considerable private-investment effort in order to: (i) propel GDP growth, (ii) realign production structures to operate effectively within MERCOSUR and the global marketplace; and (iii) increase private-sector output and employment so as to reduce the public sector's participation in the economy and workforce.

4.2 By dint of its macroeconomic and financial policies the Uruguayan government has created basic conditions for realigning and expanding the nation's productive capital stock. One crucial element to that end is an adequate, efficient, stable supply of credit, which can only be secured by deepening financial intermediation.

4.3 The program described here is one of the government's proposed instruments to continue expediting the above-mentioned changes, because multisector global credit programs, against a backdrop of economic efficiency and competitiveness, have proved to be an effective vehicle for financial deepening. They also help mobilize savings and improve their allocation under market conditions. In the process, they foster the private capital formation that is essential to raise the fixed private investment rate in the economy.

2. Financial viability

4.4 The proposed program is considered to be financially viable. The operating design envisages full recovery of Central Bank (BCU) and IFI costs. The interest rates and fees the BCU, as executing agency, would charge IFIs will be high enough to defray all its financial and administrative costs. The IFIs will be free to set subloan terms and conditions (interest rates, fees, etc.) and thus will be able to cover all their costs.

4.5 Taking into account the estimated executing agency costs and current IFI spreads, the cost of program funds to end-borrowers is in line with prevailing Uruguayan financial market interest rates. Actual demand for program funding thus is expected to match the estimates.

3. Institutional viability

4.6 The BCU has the organization and administrative resources needed to implement and manage the proposed program. The IFI eligibility criteria assure that commercial banks and other participating financial intermediaries will have the

operating capacity to act as MS-III intermediaries, that they are financially sound, and that they have the requisite accounting information and loan administration systems to ensure that subloans are properly executed. The institutional capacity of the BCU and IFIs has been amply demonstrated in MS-I and MS-II.

B. Benefits

4.7 Uruguay needs to increase private investment, as an engine of GDP growth. This will mean deepening financial activities and making them more efficient, to help boost the private sector's output and develop its export potential. The proposed operation is a reaffirmation of the Bank's ongoing support for government programs to promote: (i) more medium- and long-term credit for all economic activities on market terms; and (ii) the strengthening of the institutional base needed to create an enabling environment for the development of new long-term financing sources and products, this being an integral part of efforts to boost private investment.

4.8 The program's primary objective is to help develop Uruguay's medium- and long-term financial markets. Its aim is to instill the minimum lending liquidity conditions required for institutions to launch financial facilities and products for that purpose. This strategy is important for capital market development as well, since that process is very closely associated (particularly in the early stages) with the growth of medium- and long-term credit markets and, in particular, the appearance and increasing use of fixed-income (debt) securities.

4.9 Because the proposed program is a multisector operation, providing financing for any efficient private-sector activity in any sector and depending on the demand for funding in each, it is impossible to gauge specific outcomes ex ante, in terms of subloan numbers or amounts or anticipated investment leveraging. However, to judge from MS-I and MS-II results, there is every assurance that the proposed objectives will be achieved, the operating approach selected will work well, and the Uruguayan system and the BCU have the capacity to execute the operation.

C. Risks

1. Macroeconomic and financial environment

4.10 In order for the proposed program to operate successfully, the macroeconomic, financial and exchange-rate environment will have to be conducive to growth in private investment. As for macroeconomic risks, the government has already made significant headway on reforms and inflation control, and further gains are planned in the framework of the IMF standby arrangement which envisages capital market development as well as IDB and World Bank financial support. This substantially reduces any risk on this front.

2. Financial system dislocations

4.11 Another risk in programs of this kind is that of financial system dislocations. This was a threat in Uruguay in the 1980s but there is little likelihood of it today because of the restructuring of the system in recent years, the tightening of supervision mechanisms, and the reorganization of government banks, particularly BROU.[28]

4.12 The program presents no currency risk since the loan proceeds would be onlent to IFIs in dollars, as they were received from the IDB. IFIs can choose the currency in which they make subloans to end-borrowers, but if they select a currency other than the dollar they assume the entire exchange risk. Thus far, IFIs have onlent all MS-I and MS-II resources in dollars.

4.13 Lastly, difficulties in the Argentine financial system in 2002 have had isolated repercussions in Uruguay (problems with Banco Comercial and Banco Galicia), which are being remedied with no major harm to the Uruguayan system. Any worsening of the regional macrofinancial situation could have a considerable impact on the pace of execution of the proposed operation.

3. Legal certainty

4.14 Mention should be made of the decision taken by the Uruguayan authorities to contend with heightened risk in the agriculture sector in the wake of recent (1998-2000) outbreaks of foot-and-mouth disease. BROU’s loan portfolio has suffered because its borrower base is concentrated in the sectors most vulnerable to economic downturns (agriculture, small business). To address this situation the government has taken steps to alleviate farmers’ difficulties, enabling them to voluntarily reschedule their bank debts of up to US$200,000. To offset that measure’s potential impact on BROU’s financial position the government gave the bank a US$20 million capital injection in 2001. The subsidy to these indebted producers thus was transparent, using budget funds (see paragraph 1.36).

D. Social sector and poverty classification

4.15 The proposed operation is not poverty targeted, nor does it qualify as a social equity enhancing operation as described in the indicative targets for Bank activities in the Eighth Replenishment report (document AB-1704).

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[28] One significant achievement of this process was to ease the risk of contagion of unsound loan administration practices which ended up fostering a culture of nonpayment that was permeating the rest of the financial system.