1. Country and Sector Background

The Uruguayan economy has proven relatively resilient to the global recession: GDP grew by 2.9 percent in 2009, among the highest rates in the region. Such resilience resulted from structural adjustments made since the 2002 crisis. In particular, the financial system had been consolidated and was well capitalized while exports had grown strongly and to more diversified markets, which reduced vulnerability to external shocks. In addition, macroeconomic management was prudent, focusing on lowering inflation and achieving long term fiscal sustainability. Thus, the country was able to take advantage of the favorable external conditions prior to the crisis, and GDP grew, on average, by an unprecedented 6.8 percent per annum in 2004-2008. This strong growth performance allowed for employment creation and poverty reduction. Unemployment fell from 16.9 percent in 2003 to 7.6 percent in 2008. At the same time poverty could be reduced from 31.3 in 2003 to 20.5 percent in 2008, and extreme poverty from 3 percent to 1.5. These developments laid down a solid base that helped the economy weather well the recent international financial crisis.

The Uruguayan government has been committed to a comprehensive reform program including public sector management, competitiveness, and social inclusion. While engaging into a modest fiscal stimulus package to mitigate the negative impact of the crisis, the government progressed on its reform agenda throughout 2009 and 2010. The government of president Mujica took office on March 1, 2010 and is committed to continue with and to consolidate the achievements of the previous government. With the goal of intensifying his predecessor’s efforts on public sector reform, President Mujica has called for a redesign of the state to render it more efficient while improving the quality of services, working in collaboration with public employees and with a
focus on results and evaluation. Reforms in the competitiveness area are focused on trade facilitation, on improving the business climate, and on deepening financial markets. Within social inclusion, the government has cited education as a “priority of priorities” and critical for productivity and social stability. The President has pledged to reallocate resources from other sectors to support the expansion of full-day schools, technical/vocational education, and *Plan Ceibal* (Uruguay’s “One Laptop per Child” program).

2. **Operation Objectives**

This proposed DPL is the first in a programmatic series of two single-tranche operations. It supports the Uruguayan Government’s reform program to enhance economic growth and social inclusion. This program is focussed on improving the efficiency of public sector management while maintaining macroeconomic stability, improving competitiveness, and strengthening social inclusion. These priorities are also reflected in the new Country Partnership Strategy between Uruguay and the World Bank. They are considered critical to the government’s development goals, because Uruguay is a small open economy in an increasingly global environment, and despite progress in all three areas in recent years, is still lagging behind regional competitors.

The main development objectives are:

- **(i) Improving the efficiency of public sector management**, by supporting reforms that a) render public sector administration more transparent, flexible, and agile, and b) implement performance based budgeting.

- **(ii) Improving competitiveness**, by supporting reforms that a) expand and facilitate trade, b) improve the business climate, and c) promote financial market development.

- **(iii) Strengthening social inclusion**, by supporting reforms that a) strengthen social protection, b) improve the quality and efficiency of health services, c) improve the equity and quality of the education system.

The proposed set of prior actions for Board approval is listed below.

- **(i) Improving the efficiency of public sector management**
  - Advances the e-government function through i) approval of *ley 18,600, ley de documento electrónico y de firma electrónica* on September 21, 2009; ii) implementation of the electronic workflow tool in the Ministerio de Industria, Energía y Minería and in the Ministerio de Salud Pública.

  - Advances in the program-based budgeting, through the formulation of the new budget, spelling out objectives and goals at the level of programmatic areas, programs, and further sub-components (in previous budgets, the presentation followed institutional structures and not specific programs).
(ii) Improving competitiveness

- Promotion of logistics to facilitate trade through: i) the creation of CONALOG; ii) the presentation of the law to create INALOG to the Parliament in August 2009.


- Approval of the Ley de Mercado de Capitales on November 24, 2009.

(iii) Strengthening social inclusion

- The family allowance system is expanded reaching 80 percent of minors of low-income households.

- The government adopts a decree institutionalizing the SIIAS.

- Implementation of measures unifying insurance rates and expanding insurance coverage to reach nearly 300,000 people, mainly children of poor households.

- Implementation of measures seeking to improve the efficiency of the Ministry of Health. In particular: (i) the launch of the SNIIS (Sistema Nacional Integrado de Información en Salud); and (ii) launch of a pilot project to reduce red tape (Expediente Electrónico).

- Expansion of the Full Time School program, creating 35,670 student places in 130 full-time schools.

3. Rationale for Bank Involvement

The DPL series focuses on areas of reform that the new government has itself deemed as priority and supports the Uruguayan Government’s reform program aimed at enhancing economic growth and social inclusion. At the same time the DPL series incorporates the results of the Bank’s analytical work and the on-going consultation process with the government. Upon the government’s request, the proposed loan recognizes recent achievements in public sector management, business climate and social service delivery (prior actions for DPL-I). The policy matrix also anchors the new government’s reform agenda through 2011 (indicative triggers for DPL-II).

This new loan series builds and expands on the achievements of the previous DPL series (PRIDPL) and will be a cornerstone of the Uruguay CPS (2010-2015). The proposed loan supports the consolidation of reforms supported by the PRIDPL series whose implementation continued through 2009 and 2010. It also supports government’s efforts in other areas that were not supported by the PRIDPL series.
The design of the new DPL series incorporates lessons learnt from recent operations in Uruguay. First, the programmatic approach taken by this loan series reflects the flexibility requested by the government to best address evolving challenges. By incorporating flexibility into the loan series within a defined policy framework, the Bank is serving the needs of Uruguay, a middle-income country with strong macroeconomic fundamentals now facing second and third generation reform challenges. Additionally, the policy-making environment in Uruguay is consensual. The programmatic structure of the new DPL series allows for the time needed for reforms to come to fruition.

Consultations with key government partners and a wider stakeholder group accompany the DPL preparation, to further account for the consensual nature of policy-making in Uruguay. The consultations took place in Montevideo on May 6th. Their purpose was first, to seek feedback from government, partners from academia, civil society organizations, Parliament, and from the private sector on the different areas of reform covered by the new DPL series; and second to explain the purpose and the design of the new DPL series to a wider stakeholder group, beyond the main partners in the Government.

Fit into overall Bank assistance and coordination with other donors

The programmatic DPL series will be fully consistent with the reform agenda set out in the CPS. The objectives of the Uruguay CPS for 2010-2015 include: (i) reducing macro-economic vulnerability and supporting public sector management; (ii) strengthening the infrastructure base and the country’s competitiveness; (iii) supporting efforts to address challenges related to the environment and climate change and toward strengthening natural resource management; and (iv) fostering social inclusion and equity. In the area of macroeconomic management, the pillar of the CPS would have a particular focus on supporting government efforts to achieve results in the following areas: (i) a continued reduction of the debt burden and of the dollarization of the debt, (ii) continued achievement of fiscal targets. On competiveness, CPS pillar would also seek to increase the depth and efficiency of the country’s financial sector, promote innovation and efficiency of export supply chains and facilitate modernization of public institutions. On social inclusion and equity, the CPS will support key elements of the governments’ National Plan for Social Equity; the implementation of the health sector reform program, the continued work on education including, and efforts toward greater gender equity.

As of May 2010, a number of active loans in the Uruguay IBRD portfolio are complementary with the reform agenda supported by the current DPL. The Additional Financing loan for the Third Basic Education Quality Improvement Project (P111662) continues to finance the ongoing activities of the original project aiming at increasing equity, quality, and efficiency in the provision of preschool and primary education by: (i) expanding the full-time school model, and (ii) increasing the efficiency of primary education institutions. The loan on Promoting Innovation to Enhance Competitiveness Support (P095520) seeks to improve the economy’s competitiveness through the development of new export products and markets. The Second Health Sector Development Project (P050716) aims to support the government's efforts to (i) to expand accessibility and quality of primary health care services related to selected NCD's early detection and medical care; and (ii) to avoid and reduce exposure to selected NCD risk factors as well as their health effects. The IBTAL (P097604) is structured to support core elements of the government’s public administration modernization agenda, as well as institutional needs arising
from the reform program supported by the PRIDPL series. It assists with the design and implementation of reforms in the fiscal, financial and social areas.

A clear division of labor has been agreed between the Bank and the IADB in supporting the implementation of key reforms in the areas of macroeconomic and public sector reform, competitiveness and social inclusion. Since October 2006, the IADB has been financing a series of three programmatic policy lending operations to support tax reform in Uruguay. The first IADB operation included as a condition the submission of the tax reform package to Parliament. The second IADB operation in this series included parliamentary approval of the tax reform as one of its public sector reform triggers, while the third loan is tied to preparation of an implementation plan for the VAT component of the tax reform. Since January 2007, the IADB has also approved a programmatic lending series focused on competitiveness. The submission of the draft insolvency and enterprise reorganization (bankruptcy) law to Parliament was included as a prior action for the first operation in this series, as well as the establishment of the private sector support unit in the Ministry of Economy. A technical assistance loan, related to the social protection component of the PRIDPL II operation, was approved by the IADB in October 2008 with the objective of financing the execution of the first two rounds of the social protection survey. A conditional credit line was approved to finance multi-sector projects that were developed under Uruguay’s National Strategy for Children and Adolescents Support Program, part of a long-term government effort to increase safety nets for poor children and teenagers.

4. Financing

Source of Finance: IBRD
Loan Amount: US$100 MILLION
Number of tranches: Single

5. Institutional and Implementation Arrangements

The Bank will monitor actions and review progress of the implementation of the proposed operation using different sources including:

- Central and non-financial public sector budget monitoring from the Ministry of Economy and Finance;
- BCU reports and analysis;
- DGI and BPS information systems;
- Credit rating agencies reports-several sources;
- Doing Business indicators;
- Investment climate surveys;
- Reviews and analyses of laws and implementing regulations from the World Bank and other stakeholders;
- Financial audits and follow up of CFAA recommendations;
- World Bank supervision missions and reports; and
- IMF and IADB reports.

The Uruguayan government and the Bank have agreed to monitor progress in the DPL program regularly, including periodic reviews of CPS progress. The Ministry of Economy and Finance, is
the main counterpart agency for the loan, which is in charge of monitoring and evaluating the program and responsible for collecting the data necessary to assess implementation progress from the appropriate sources. Other important agencies are the Central Bank (for capital market issues), DGI and BPS. The maintenance of agreed triggers for continued policy-based lending will be reviewed in the CPS Interim Progress Report.

6. Benefits and Risks

Benefits
DPL-I will help Uruguay’s government in achieving its development goals of enhancing economic growth and social inclusion through (i) improving the efficiency of public sector management, (ii) improving competitiveness, and (iii) strengthening social inclusion.

Risks
The Uruguayan program, to be supported by the proposed DPL, faces three types of risks: Economic, political and social, institutional and natural disasters. Risks and mitigation measures are summarized below.

Economic (moderate): The key economic risk remains public debt sustainability. Public debt is sizeable and largely denominated in foreign currency. High debt levels limit the government’s room to implement effective countercyclical measures. During the global crisis, the overall gross public sector debt increased to 54.2 percent in September 2009 (from 51.4 percent in 2008). The main risk to debt sustainability is the potential impact of deterioration in the regional or global economic outlook on Uruguayan’s economic growth. A small, open and dollarized economy, the implications of such external shocks could be substantial for the real sector in Uruguay. The commodity-dependent export base is vulnerable to a downturn in agricultural commodity prices and external demand. While the country has diversified its export markets and reduce export concentration in Brazil and Argentina, a substantial and prolonged slowdown in external demand could deteriorate fiscal and growth prospects.

Mitigation: Four factors have contributed to mitigate the debt sustainability risks. First, growth outperformed expectations in 2003-2008. Second, the primary surplus over 2004-07 was also higher than expected. Third, prior to the global crisis there were additional gains in terms of declining public debt ratios and debt servicing needs due to the depreciation of the US dollar prior to 2008. Fourth, the government debt management strategy has contributed to reduce medium-term borrowing requirements. In response to the global crisis, the government opted for a moderate fiscal stimulus package. Debt sustainability risks are further mitigated by the signs of economic recovery since the last quarter of 2009. Even under conservative assumptions regarding the economic recovery, total public net debt is projected to decline from 25.7 percent of GDP in 2008 to 17.8 percent of GDP in 2013.

Financial sector vulnerability is another source of economic risk. The main risks posed by the financial sector in the 2002 crisis were the high levels of dollarization, the importance of State Banks, and a combination of inadequate supervision of foreign banks and high levels of non-resident deposits. While substantial progress has been made, some of these factors still pose risks. The government continues to face large contingent liabilities arising from explicit and implicit guarantees to the state banks and non-banking financial institutions. Public banks represent more than 50 percent of total banking system assets. Financial sector vulnerability has
diminished but the current international situation raises some uncertainties. There has been a steady improvement in financial sector indicators. Solvency and liquidity ratios for the banking sector are better, and profitability has increased. However, a deep and protracted deterioration in international economic conditions may increase NPLs. Also, the current level of unremunerated reserve requirements has negatively affected bank profitability. During the global crisis, financial sector volatility increased, triggered by a change in behavior of economic agents, who switched the currency denomination of their banking deposits from pesos to US dollars, forcing banks to buy US dollars. Since the last quarter of 2009, financial sector volatility subdued.

**Mitigation:** A strengthened prudential regulatory and supervisory framework for the financial system would help to better contain risks. NPLs remain low at below 1 percent and the level of provisioning seems adequate following the adoption of a conservative approach on prudential regulation after the 2002 crisis (e.g., anticyclical provisions, and the carrying out of stress tests on foreign exchange position of non-tradable sector). Currency mismatch has been better protected. Loans in foreign currency have been mainly targeted to the tradable sector. Exchange rate risks are mitigated due to the central bank’s prudential regulation policy. Provisioning requirements oblige banks to perform a stress test on loans for the non-tradable sector and take it into account for the credit category classification and, thus, provisioning. Also, the central bank applies capital requirements for net exposures on foreign currency. The central bank monitors closely this risk through the implicit foreign exchange risk indicator (non-tradable sector exposure). The new central bank Charter Law intends to enhance the institution’s operational autonomy and accountability. The amendments to the charter are intended to strengthen the institutional framework and supervision of financial institutions.

**Political and social (low):** The 2009 Presidential and Parliamentary elections proceeded smoothly with no indication of increased political risk. The new government has indicated its commitment to maintain prudent macroeconomic policies and consolidate the achievements by the previous administration in pursuing economic growth with equity. A risk might arise from the tensions between pressure to expand government programs and the need for a prudent fiscal stance to preserve debt sustainability.

**Mitigation:** This risk is mitigated by Uruguay’s track record of strong commitment to fiscal prudence following the 2002 crisis and the efforts by the government to build support for its policy reforms, in line with Uruguay’s tradition of consensus building.

**Implementation (low):** Managerial risks relate to potential difficulties in implementing the proposed reforms because of a potential shortage of trained human resources. Additionally, sustainability and program outcome risks exist related to the achievement of expected outcomes in some of the reforms supported by the loan. In particular, the outcomes expected from the implementation of the capital market law might not be achieved since they depend not only on the government but also on the private sector response.

**Mitigation:** The managerial risks are mitigated by government efforts to strengthen capacity in key implementing agencies. The IBTAL series that accompanied the previous PRIDPL series together with related TA from other donors is providing strong capacity-building support. The sustainability and program outcome risks are mitigated by the government’s commitment to consolidate achievements by the previous administration. In the area of capital markets, the reforms that were supported by the PRIDPL series took time, but they were completed in 2009, even after the PRIDPL-II was approved by the Board.
7. Poverty and Social Impacts and Environment Aspects

**Poverty and Social Impacts**
The policy reforms supported by the proposed loan are expected to have a positive social impact, including for the poorer groups in society. In particular, the reforms are expected to have (i) a direct positive impact on poverty reduction through the expansion of coverage of social services for low-income households, and (ii) an indirect positive impact, by encouraging private investment and promoting public sector efficiency. Public sector and competitiveness reforms are not expected to have an adverse poverty or social impact. Rather, they could indirectly have a positive social impact. Public sector reforms by seeking to improve efficiency in the delivery of key public services will contribute to better targeting and lower costs of government services. Competition reforms (be it trade facilitation, logistics, business climate or capital market development) can foster private investment and growth, and in turn, contribute to boost employment creation and poverty reduction. The simplification of firm start-up processes can facilitate the creation of small and medium sized companies that could also contribute significantly to employment creation.

The social inclusion reforms have an explicit focus on improving equity and reducing poverty. The strengthening of the social protection system is geared toward increasing the welfare of low income groups and so is expected to have a positive effect on poverty reduction. In particular the expansion of the family allowances system (sistema de asignaciones familiares) to 80 percent of Uruguayan minors from low-income households, the expansion of coverage to those citizens between 65 and 70 years of age in extreme poverty (with an over 80 percent increase of budget allocation to this program in 2009) and the unemployment insurance program launched in February 2009, are expected to reduce to have positive impact on poverty reduction. The education and health sector reforms are also expected to promote equity in the first years of schooling. For example, the expansion of pre-school for all children beginning at age four is expected to particularly benefit low-income households. Similarly, the program of community teachers that lowered the repetition rate from 50 to 20 percent in the 40 schools attended by disadvantaged students is directed towards the same aim. Improving the targeting of existing programs is expected for example with the help of the unification of the legal basis of the family allowances system. This action is also expected to increase the program’s efficiency (by reducing the risk of doubling benefits).

**Environment Aspects**
The proposed operation is not likely to have any significant effects on the environment, forests, and other natural resources. However, to the extent that actions supported by the loan program are successful, over time, in attracting new private investment, there will be a need to continue strengthening Uruguay’s institutional capacity to identify and address environmental policy and regulatory issues.

Environmental policies and regulations are in place, and implementation is improving. The Ministry of Housing, Planning and Environment (Ministerio de Vivienda, Ordenamiento Territorial y Medio Ambiente, MVOTMA), through the National Environment Directorate (Dirección Nacional de Medio Ambiente, DINAMA) is responsible for the formulation, execution, supervision, and evaluation of the national plan for environmental protection and for
proposing and implementing national policy, harmonizing the needs of environmental protection with sustainable development. Uruguay’s large new foreign-financed investments in the pulp industry have elevated the public awareness of, and government commitment to, monitoring and compliance with environmental regulations. Uruguay was one of the first countries in the region to complete its Second National Communication on Climate Change in 2004 and has subsequently moved quickly to benefit from innovative financing through the carbon market. Carbon and GEF strategies are being implemented since 2009 to improve solid waste management in its two largest cities, as well as initiate multiple investments in renewable energy.

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