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URUGUAY

January 2014

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV Consultation with Uruguay, the following documents have been released and are included in this package:

- The **Staff Report** for the 2013 Article IV Consultation, prepared by a staff team of the IMF for the Executive Board's consideration on November 13, 2013, following discussions that ended on October 4, 2013, with the officials on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 29, 2013.

- An **Informational Annex** prepared by the IMF.

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 13, 2013 board meeting on the Article IV Consultation Staff Report.

- A **Statement by the Executive Director** for Uruguay.

The document(s) listed below have been or will be separately released.

- **Selected Issues Papers**

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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URUGUAY

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

October 29, 2013

Background: Uruguay has experienced a decade of strong and inclusive expansion since its 2002 crisis, thanks to important institutional reforms, large-scale FDI projects attracted by Uruguay's stable macroeconomic environment and business-friendly investment climate, and favorable external conditions.

Current setting*:* Growth has moderated to a more sustainable pace since 2012, mostly owing to weaker external demand from regional trading partners with which Uruguay is highly interconnected. Unemployment remains near historical lows, fiscal policy has loosened, and inflation persists above the target. Monetary policy, on the other hand, has tightened considerably since August. The baseline scenario is for the output gap to close gradually. Near-term risks are mostly to the downside, but vulnerabilities are limited given the strong liquidity buffers of the public sector.

Focus*:* Discussions focused on policies to support a smooth convergence of output to potential in the near term; the optimal policy response in case of inward spillovers; and requirements to bolster the medium-term outlook.

Policies: Staff supported the authorities' objective of gradually reducing inflation. Additional efforts to communicate the targeted monetary policy stance would help smooth the volatility in short-term interest rates and enhance the central bank's control over inflation expectations. A tighter fiscal policy stance and a moderation in wage growth would support monetary policy in taming inflation. In case of adverse external shocks, the exchange rate should be the main shock absorber and the ample liquidity buffers could be used to smooth out excessive volatility. Staff recommended that the reserve requirements on non-residents' purchases of central bank and government securities be unwound once there is clear evidence that the capital inflow surge has subsided. Uruguay's medium-term growth would benefit from more flexible wage determination and deeper financial markets. It is critical to press on with efforts to boost infrastructure.

Past advice: There is broad agreement between the authorities and staff on the macroeconomic policy priorities. In recent consultations the Fund has placed greater emphasis on reducing inflation to the mid-point of the target range and called for fiscal restraint, in part to help monetary policy. In addition, staff has encouraged prudent wage growth to facilitate disinflation, safeguard competitiveness, and promote macroeconomic flexibility. Recently, the authorities tightened monetary policy and issued new wage setting guidelines aimed at restraining the growth of real wages and reducing the use of backward-indexation.

Approved By
Saul Lizondo and Vivek Arora

Discussions took place in Montevideo during September 23–October 4. The staff team comprised Oya Celasun (Head), Camilo E. Tovar, Garth Nicholls, (all WHD) and Samar Maziad (MCM). Yulia Ustyugova (WHD) took part in the second half of the mission. Viktor Kitange (FAD), Jesse Siminitz, Sumiko Ogawa, Juan Yepez, Xiomara Jordan (all WHD) provided support in Headquarters. Natalia Melgar and Sandra Shaw (Montevideo Office) also supported the mission.

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OVERVIEW

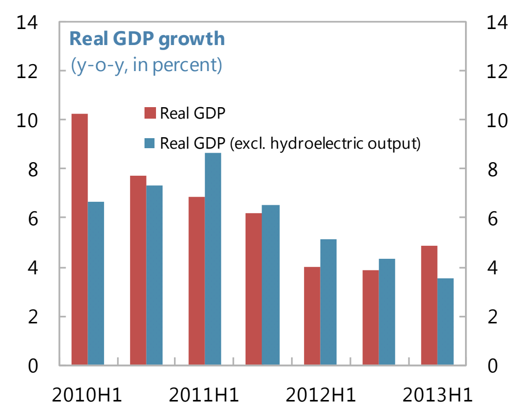
1. The year 2012 concluded the decade with the strongest average GDP growth on record in Uruguay and a remarkable improvement in living standards (Figure 1). Key drivers of Uruguay's strong rebound from its 2002 crisis included important institutional reforms, large FDI projects attracted by Uruguay's stable macroeconomic environment and business-friendly investment climate, and favorable external conditions.[1] The result has been a strong rise in employment, real wages, and consumption. Poverty rates have declined sharply thanks to strong growth and active social policies (Box 1), and income inequality has also declined further since 2004.

2. The main priority is to safeguard and enhance these gains by ensuring a smooth landing of the economy, and to bolster medium-term potential. 2012 saw slower growth and widening imbalances—a higher fiscal deficit and inflation, a strong real appreciation (boosted by portfolio inflows), and a wider current account deficit. The task ahead is to calibrate the policy mix so as to decisively tackle inflation, safeguard competitiveness, and facilitate a smooth landing in a less favorable global environment. The medium-term goals—to reinforce resilience to shocks and bolster potential output—are unchanged.

RECENT DEVELOPMENTS

A. Real Developments

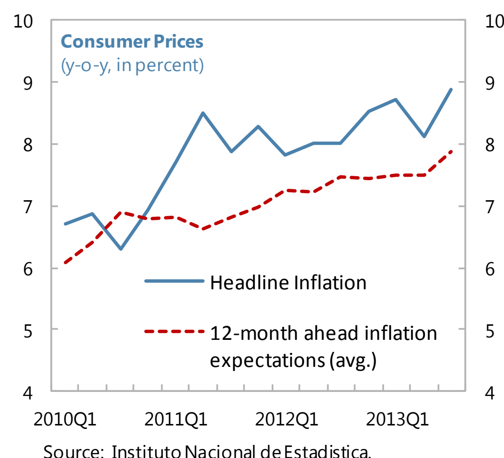
3. Growth has decelerated but remains solid. After averaging 7.7 percent in 2010–11, real GDP growth moderated to 3.9 percent in 2012, mostly owing to lower export and tourism revenues from Argentina and Brazil, and a drop in hydroelectric output due to a drought. Staff's growth projection of 4 percent for 2013 reflects a rebound in hydroelectric output in the first half of the year as well as renewed momentum in commodity exports and domestic demand, in particular private consumption. Private investment remains close to historic highs as a share of GDP although it has decelerated somewhat after a boom in 2012 (Figure 2). Unemployment, which averaged 6¾ percent in the six months through August, is near historic lows.



Source: Banco Central del Uruguay and Fund staff estimates.

[1] The Selected Issues Paper *Agricultural Land Prices–A Channel in the Transmission of Global Commodity Price Shocks on Economic Activity*, by Juan Yepez, examines the impact of food commodity prices on agricultural land prices in Uruguay and the region in the last decade, and the role played by agricultural land prices in transmitting commodity price shocks to the broader economy.

4. Inflation remains above the central bank's target range of 4–6 percent and has edged up recently (Figure 3). Nontradables inflation has averaged about 9 percent since mid-2011, compared to slightly less than 8 percent in the previous three years. Headline inflation, after rising in 2012Q3 owing mostly to a jump in food prices, temporarily dipped to 7.5 percent in December 2012 as the authorities lowered administered prices and took other temporary measures. The lower December inflation rate contributed to slower real wage growth in the first half of 2013 as many wage contracts are indexed to end-year inflation, helping to contain inflation pressures. However, inflation climbed back to 9 percent in September 2013 due to the recent rise in energy prices and the peso depreciation. Twelve-month-ahead inflation expectations have risen to about 8 percent from 7.5 percent half a year ago.



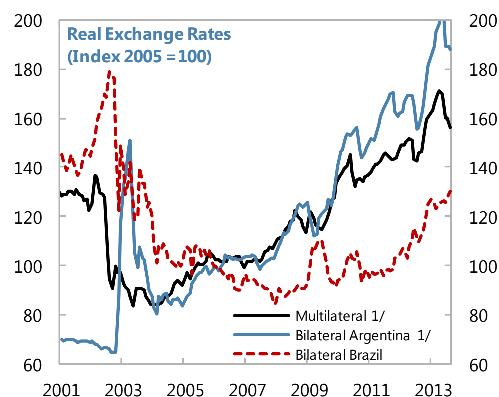
Source: Instituto Nacional de Estadistica.

5. The current account deficit has widened significantly (Figure 4). Of the total increase in the current account deficit—from 2.9 percent of GDP in 2011 to 5.4 percent of GDP in 2012—about two thirds reflected a widening of the trade deficit, mostly due to higher imports of capital goods associated with the construction of the Montes del Plata pulp mill and a surge in oil imports for electricity generation after the drought. In addition, net services revenues, mainly tourism, weakened in the second half of 2012, reflecting weak flows from Argentina and Brazil. Although the trade balance has been normalizing in 2013—with a sharp drop in oil imports and buoyant soy exports—the services balance has weakened further, reflecting a continued decline in tourism revenues from Argentina, increased travel by Uruguayans to Argentina, and higher services imports associated with hydrocarbon exploration.

6. The portfolio inflow surge that had started in early 2012 came to a stop in June 2013. The sharp increase in the foreign purchases of locally-issued, peso-denominated public securities in spring 2012 was spurred by Uruguay's new investment grade rating, wider interest rate differentials (in particular relative to Brazil), and an improvement in global risk appetite. At first, most of the inflows went into short-maturity central bank securities. After the central bank introduced a reserve requirement on nonresidents' purchases of central bank paper in September 2012, flows rotated into central government notes (Box 2). The inflows ground to a near halt in June, amid generalized financial volatility in emerging markets following the Fed's tapering announcement and after Uruguayan authorities announced in late May that they would extend the reserve requirements for nonresidents' purchases of central bank paper to purchases of central government paper. Total foreign holdings of locally-issued peso-denominated public securities were broadly flat between May and September.

7. The real effective exchange rate (REER) has depreciated moderately since May, after appreciating strongly in the previous year. The REER strengthened 13 percent in the twelve months through April 2013, with particularly pronounced appreciations against Uruguay's

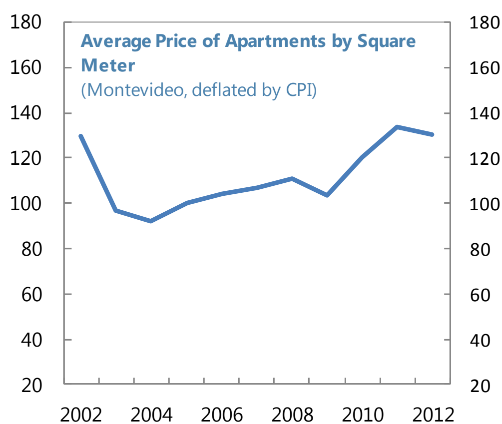
main trading partners, Argentina and Brazil (19 and 14 percent, respectively). The peso weakened by 16 percent against the U.S. dollar between late-May and end September, but the REER depreciation was smaller at about 8 percent between (from May to August), since the currencies of Argentina and Brazil also depreciated against the U.S. dollar over the same period. Staff estimates that the REER remains slightly on the strong side (0–10 percent, see Box 3).[2]



Source: Fund staff calculations based on Instituto Nacional de Estadistica data.
1/ The real exchange rate against Argentina is calculated using the unofficial CPI for Argentina and the average of the unofficial and official exchange rates for the Argentine peso.

8. Credit continues to expand at a solid pace, but remains modest relative to GDP (Figure 5). Credit to households—mostly denominated in local currency—has been growing by about 8 percent (y-o-y) in real terms in recent months, while credit to firms—mostly denominated in U.S. dollars—has been growing at about 18 percent (y-o-y). The stock of credit to the private sector stood at 24 percent of GDP in August 2013.

9. The growth of house prices moderated in 2012. Most of the expansion in the real estate market in recent years had been concentrated in the urban luxury segment, and according to anecdotal evidence, has received heavy foreign investment (mainly from Argentina). The vast majority of real estate transactions are done in cash (household mortgages stood at 4 percent of GDP in July 2013, broadly unchanged from levels in recent years). Tight foreign exchange restrictions in Argentina, and a new bilateral tax treaty on information exchange between Argentina and Uruguay, appear to have cooled the market, with the growth of house prices softening in 2012. Market participants pointed out that this trend continued in 2013.



Source: Fund staff calculations based on Instituto Nacional de Estadistica data.

[2] The Selected Issues Paper *Competitiveness Trends in Uruguay*, by Garth P. Nicholls, looks at the evolution of Uruguay's exports structure and its drivers in the past decade, and discusses the balance of payments stability assessment.

B. Policy Actions

10. The central bank gradually tightened the monetary policy stance through March 2013 and announced changes to the policy framework in May 2013 (Figure 6).

- *Between June 2012 and March 2013*, the central bank raised reserve requirements on bank deposits and notched up the policy rate by a cumulative 50 basis points. The rate, at 9.25 percent from end-December, remained 300–400 basis points below staff's estimates of the neutral short-term interest rate. The central bank stepped up its pace of reserve accumulation in early 2013 in order to limit the appreciation of the peso amidst heavy capital inflows. In the meanwhile, concerns grew on the fiscal cost of sterilizing the reserves, and the currency appreciation against Argentina and Brazil.

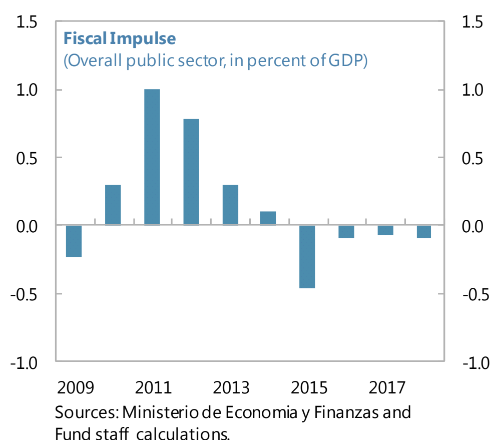
- *In June 2013*, the authorities announced a new reserve requirement of 50 percent for nonresidents' purchases of locally-issued Treasury notes to discourage further portfolio inflows and replaced the overnight interest rate target with targets for M1 plus saving deposits (M1+). They also announced a widening of the inflation-target-band to 3–7 percent starting in July 2014 from 4–6 percent.[3] The M1+ targets for 2013Q3 and 2013Q4 (12.5–13 percent and 15–17 percent, respectively) represent a broadly unchanged pace of monetary expansion relative to 2013H1 but a slower pace of growth than in the last two years. The authorities envisage a further reduction in the rate of M1+ growth over the next two years (to 8 percent by mid-2015—which would be lower than the sum of potential growth and the mid-point of the inflation-target).

- *Since July 2013*, monetary conditions fluctuated widely as the markets adjusted to the new framework and the authorities fine-tuned their operations. In July, the overnight interbank rate dipped sharply, averaging 4.5 percent. In August and September, the central bank tightened liquidity, which drove the overnight interest rate to an average of 17.5 percent. In early October, nominal peso yields for 1–60 months maturities were about 4 percentage points above their levels in May.

11. The fiscal deficit widened in 2012 and fiscal policy is projected to remain slightly expansionary in 2013 (Figure 7). The primary balance declined to -0.2 percent of GDP in 2012 from 2 percent in 2011. About half of the decline was due to one-off transfers and the higher cost of electricity generation (using imported oil) at the state energy enterprise. The other half largely reflected the greater-than-expected costs of the broadening of the pension and health care systems (under reforms initiated in 2008, with a sizable wave of new beneficiaries added in 2012 in a process that will go on until 2016). Although the primary balance is expected to improve to a 0.6 percent of GDP surplus in 2013, thanks largely to the recovery in the profits of the state energy enterprise, fiscal policy is poised to add another small positive impulse mainly

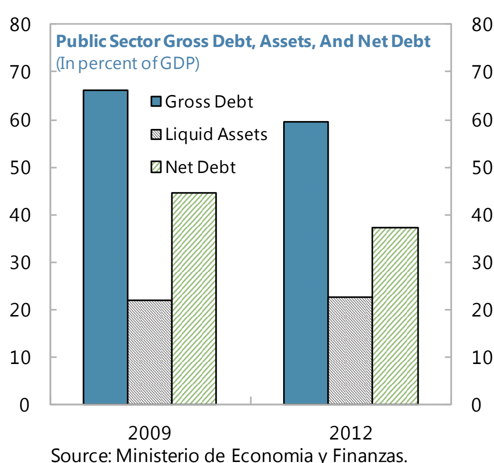
[3] The central bank had abandoned M1+ as its operational target in 2007Q3 and replaced it with a target for the overnight interest rate.

due to a rise in public investment spending. Under unchanged policies, the deficits of the overall public sector would settle around 2¼ percent of GDP in the medium term—about 1.0–1.5 percentage points of GDP higher than envisaged in last year's budget—and the gross public debt to GDP ratio would remain broadly unchanged at about 60 percent of GDP. Net debt (gross debt minus liquid assets) would remain around 36–37 percent of GDP between 2013 and 2015.



Sources: Ministerio de Economia y Finanzas and Fund staff calculations.

12. The authorities continued implementing a debt management strategy aimed at reducing vulnerabilities. As a result of active liability management, Uruguay's public debt profile has improved significantly in recent years—with a much reduced share of foreign currency debt and a high average maturity (Box 4). Moreover, the public sector has accumulated a considerable stock of liquid assets, which amounted to 22.4 percent of GDP at end-2012. The authorities have also secured contingent credit lines with multilateral agencies of some 4 percent of GDP. Since spring 2012, Uruguay has obtained investment grade sovereign ratings from four major rating agencies and has access to foreign funding at favorable costs (4.5 percent for a US$ denominated 10-year bond issued in August 2013).



Source: Ministerio de Economia y Finanzas.

13. The government's newly-issued guidelines for the ongoing wage negotiation round seek to restrain the growth of real wages. The ongoing negotiation round, which started in July and will end around November, will affect about one third of workers. The government has recommended that workers and enterprises set wages for three years with two options for setting annual wage increases. The first option would entail increases in line with the central bank's inflation target (with an ex-post correction based on actual inflation) plus a real adjustment between zero and 3 percent, dependent on GDP growth and the performance of the sector; there would be clauses that allow renegotiation in the event of large shocks. The second option—in a break with past guidelines—would entail contracts without backward indexation. Negotiations continue amid labor unrest; the authorities expect real wage growth to moderate from about 4 percent in the last two years to 2–2.5 percent in the new round. However, the take up of non-indexed contracts is likely to be limited.

OUTLOOK AND RISKS

14. The outlook is for growth to be somewhat below 4 percent in 2014–15, with gradual reductions in inflation and the current account deficit. Growth is projected to soften to 3.5 percent in 2014, with the phasing-out of the rebound in hydroelectric generation subtracting 1.5 percentage points, and the scheduled start of production and exports by the pulp mill adding 1 percentage point. A further slowdown in public spending in 2015 (with a roughly constant fiscal budget in the aftermath of the elections) along with a gradual tightening of monetary conditions should keep growth in 2015–18 somewhat below the potential growth rate of 4 percent. Inflation is projected to ease over time as monetary policy is tightened, but the recent depreciation of the peso against the U.S. dollar implies some upside risk for inflation in the year ahead. The current account is projected to improve gradually in line with a recovery in external demand.

15. Risks to the growth outlook are mostly to the downside in the near term. As a small open economy, Uruguay is exposed to risks of inward spillovers (See Annex I for an analysis of Uruguay's external linkages and the importance of global spillovers for Uruguay's growth). It also faces domestic overheating risks. In the medium term, iron-ore mining may provide a boost to growth.

- *Export commodity prices.* About two-thirds of Uruguay's exports are commodity based—mostly food related. Although likely to be less sensitive to growth than energy and metal prices, a sustained decline in food prices—e.g., in case of lower than anticipated emerging market growth potential or a sharp slowdown in China—would hurt growth in Uruguay. At the same time, a decline in energy prices that would likely accompany such a scenario would help buffer the adverse effects though a lower import bill.

- *Weaker growth in the region.* Uruguay has significant economic connections with Argentina and Brazil, through trade, tourism, and FDI flows. Prospects for these countries could imply downside risks for Uruguay through direct spillovers or confidence effects.

- *Oil prices.* There is a threat of higher oil prices in the short-term due to geo-political events.

- *Tighter global financial conditions.* Potential market volatility associated with the prospective exit from accommodative monetary conditions in advanced economies or a re-emergence of financial strains in Europe could lead to a tightening in global financial conditions and peso depreciation. The adverse impact on bank balance sheets (stemming from high credit dollarization) would be contained given broadly adequate capital and the strong level of foreign assets of the banks and the public sector. At the same time, the tightening of global financial conditions associated with the normalization of monetary policy in advanced economies could weaken FDI into Uruguay and weigh on growth.

- *Domestic overheating.* If monetary conditions were not to tighten sufficiently or if the ongoing wage negotiation round were to result in strong growth in real wages, inflationary pressures would rise further and competitiveness would weaken. Such an over-heating

scenario would make the economy more vulnerable to external shocks and reduce the scope for a soft landing and a gradual adjustment of policies in the period ahead.

- *Natural resource revenues*. On the upside, the start of large-scale iron mining would boost investment, and eventually export and fiscal revenues in the medium run. The current account could widen due to the FDI-financed imports of capital goods in the initial phase of the project.

Uruguay: Risk Assessment Matrix

	Sources of risk	Up/downside	Likelihood	Impact
External	Large decline in Uruguay's export prices (due to lower than anticipated emerging market growth potential, sharp slowdown in growth in China)	↓	M	H
External	Protracted economic and financial volatility in emerging markets triggered by prospective exit from unconventional monetary policy in advanced economies	↓	H	L
External	Re-emergence of financial stress in the euro area and tightening in global financial conditions	↓	M	L
External	Sharply lower growth in the region	↓	M	M
External	Global oil price shock triggered by geopolitical events	↓	L	L
Domestic	Domestic overheating followed by a hard landing	↑↓	L	M
Domestic	Increased mining revenues in the medium term	↑	H	H

Note: The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of the staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline. The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities.

16. The Uruguayan economy is generally well placed to manage these risks as liquidity buffers are strong, external stability risks are modest, and the financial system is unlikely to act as an important propagator of downside shocks (the policy responses to adverse inward spillovers are discussed in paragraph 34).

- *The public sector has strong liquidity buffers*. Fiscal financing risks are modest as the non-financial public sector has financial assets of 5.8 percent of GDP (the central government has liquid assets that would cover debt service needs through 2014) and has access to 4 percent of GDP in contingent credit lines. Central bank reserves are also strong—at end-2012, the

BCU had around 19 percent of GDP in free reserves (gross reserves minus reserve requirements against foreign currency denominated deposits). BCU's reserves amply exceed various prudential benchmarks.

- *External stability risks are limited*. Although the peso appears somehat on the strong side, external financing risks are limited in the near term as central bank reserves are high and FDI prospects remain solid (Box 3).

- *The financial system is small and appears resilient.* Bank credit to the private sector is low at 24 percent of GDP. Most banks are liquid, with low loan-to-deposit ratios. Non-resident deposits are more than matched by banks' liquid foreign assets and reserve requirements; the foreign assets of the commercial banks and the central bank exceed the sum of foreign-currency deposits and short term-external debt. The main point of vulnerability is that 27.5 percent of bank loans in foreign currency are to firms whose earnings are in local currency. That said, non-performing loans are less than 1.5 percent of total loans, and stress tests conducted during the recent FSAP suggest that banks can withstand significant shocks, despite some pockets of vulnerability.

Selected Financial Soundness Indicators

	2010	2011	2012	2013 1/	LA5 2/
Regulatory capital in percent of risk-weighted assets	16.1	13.7	12.8	12.4	16.0
Non-performing loans in percent of total loans	1.0	1.3	1.5	1.4	2.8
Non-performing loans in percent of total household loans	3.5	3.1	3.5	3.8	n.a
Specific loan-loss provisions in percent of non-performing loans	73.1	71.1	69.0	61.3	n.a
Operating costs in percent of gross income	91.3	83.4	81.0	80.9	n.a
Return on assets 3/	0.8	0.8	1.0	1.3	1.8
Return on equity 4/	8.1	7.9	12.6	15.3	17.5
Liquidity ratio 5/	47.4	47.8	52.6	52.6	30.6
Dollar loans in percent of total loans	59.4	58.5	57.9	61.9	22.2 6/
Dollar deposits in percent of total deposits	74.1	71.9	71.9	75.4	18.4 6/
Non-resident deposits in percent of total deposits	16.4	14.6	15.2	15.0	n.a
Private sector credit in percent of GDP	19.7	20.5	22.2	24.0	31.8
Household consumer credit in percent of GDP	8.4	8.5	8.8	8.9	n.a
Implicit exchange rate risk 7/	31.4	31.4	34.0	27.5	n.a

Sources: Banco Central del Uruguay, IMF Global Financial Stability Report, and Fund staff calculations.

1/ Latest available data (August 2013).

2/ Median of Brazil, Chile, Colombia, Mexico, Peru, for 2012. Definitions of soundness indicators vary by country.

3/ Annualized net income before extraordinary items and taxes from the beginning of the year until the reporting month, in percent of average value of total assets over the same period.

4/ Same as footnote 3 but in percent of average value of capital over the same period.

5/ Liquid assets with maturity up to 30 days in percent of total liabilities expiring within the same period.

6/ Excludes Brazil.

7/ Share of foreign currency bank credit to unhedged borrowers.

17. The authorities were in broad agreement with staff's outlook but saw more limited downside risks. They felt that the reduced trade and tourism linkages with Argentina would imply lower spillovers than in the past, and that the mostly commodity-based exports to Brazil could easily find markets elsewhere if Brazilian growth were to disappoint. They argued that an

eventual rebalancing of demand in China—from investment toward consumption—would likely improve Uruguay's terms of trade by boosting food prices and lowering energy prices. They also stressed that the strong liquidity buffers built by Uruguay's public sector eliminates the risk of debt-financing problems that Uruguay experienced in the past, and allow for a counter-cyclical policy response if adverse shocks were to occur.

POLICY DISCUSSIONS

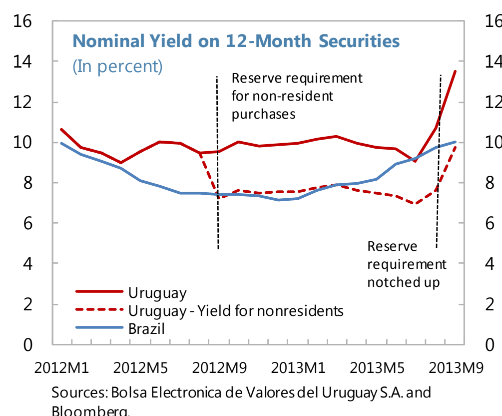
Taming Inflation in a Context of Volatile Capital Flows

18. There was agreement that inflation remains an important policy issue and staff supports the central bank's goal to gradually reduce inflation. Above target inflation and expectations reduce the scope to ease monetary policy in response to negative economic shocks, creates macroeconomic uncertainty, and adversely affects low income households. Lowering inflation would help foster the de-dollarization and de-indexation of the economy. In staff's view, the high level of inflation reflects a number of factors, but most importantly an inflation target that is not anchoring expectations within the range, and robust growth in domestic demand and unit labor costs in recent years.

19. Staff and the authorities discussed the rationale for the recent changes to the capital flow management measures (CFM) and the monetary policy framework. The authorities stressed that their objective in extending the CFM to locally-issued central government securities was to contain portfolio inflows; the differential between the policy rate in Uruguay versus other emerging markets—especially Brazil—had been seen as an important driver of portfolio inflows and peso appreciation in the year to May. On the decision to replace the overnight interest rate target with a monetary aggregate target, the authorities also argued that the transmission from the overnight interest rate target to deposit and lending rates had been modest in the context of excess liquidity and elevated dollarization in Uruguay's banking system. They felt that targets for monetary aggregates could have a more direct and stronger influence on domestic demand than short-term interest rates.

20. There was agreement that the broadening of the CFM announced in May was justified by macroeconomic considerations. At the time of the announcement, the peso was clearly on the strong side and there was no room to counteract the appreciation pressures by altering the macroeconomic policy settings—with a fiscal tightening not feasible in the short run and a monetary easing not desirable given above-target inflation and expectations. Staff noted that as a general principle CFMs should not substitute for warranted macroeconomic adjustment and be removed once the conclusion can be reached that the inflow surge has subsided. There was agreement that it was too early to reach such a conclusion, as the Fed's decision to delay its tapering of asset purchases had raised the possibility of renewed inflows.

21. Staff and the authorities agreed that the tightening of the monetary policy stance had been appropriate. A tighter stance was needed in view of above-target and rising inflation, and the CFM had raised the scope to tighten policy without provoking a further surge in portfolio inflows. At the same time, the authorities emphasized the need to monitor the stance carefully as the sharp increase in peso interest rates had largely offset the reduction in the yield differential achieved by the CFM (e.g. against other emerging markets, such as Brazil). Staff considered that although renewed portfolio inflows were possible in the near term, the underlying trend was for a gradual tightening in global financial conditions, and preserving the tighter stance—with some fine-tuning, as needed—would help avert a further rise in inflation expectations.



Sources: Bolsa Electronica de Valores del Uruguay S.A. and Bloomberg.

22. The change in the operational target for monetary policy has raised new practical challenges and put an extra premium on communication. The sizable fluctuations in the overnight interest rate since early July (in a range from 2.5 percent to almost 40 percent) to some extent reflect the market uncertainty regarding the targeted monetary policy stance as the central bank and the market were adjusting to the new framework. The authorities agreed with staff that additional efforts by the central bank to communicate its inflation goal and how it plans to achieve that goal with its instruments would be beneficial to assure a smooth transition. Staff noted that the communication on the central bank's envisaged monetary growth target for mid-2015 had been a useful step in that direction.

23. The effectiveness of the new operational framework in delivering the inflation targets needs to be closely monitored. It is important that the central bank stands ready to test the strength of the transmission between money growth and inflation and be nimble in revising the targets for M1+ if inflation does not display a clear downward trend over time. Staff also suggested that in the longer run, other operational frameworks may have to be considered if the link between M1+ growth and inflation does not prove to be sufficiently stable. The authorities also underscored the need to monitor the effectiveness of the monetary targets in controlling inflation—a test they saw necessary for any new framework. They did not share the concern that the potential instability of monetary demand could complicate the task of controlling inflation by targeting monetary growth; they did not see the relationship between their previous operational target—the overnight interest rate—and domestic demand to be more certain than the relationship between monetary growth and inflation.

24. Staff noted that the widening of the inflation target band also calls for further communication efforts. After two years in which inflation had exceeded the upper limit of the target by 2 percentage points, a widening of the band could be perceived as tolerance for higher

inflation and a lower commitment to tighten policy in response to upward pressures on inflation. However, policy credibility may actually be enhanced if inflation is brought into the target band under the new framework, especially if there were a narrowing of the band again over time to effectively anchor inflation expectations. Staff argued that further communication on the central bank's decision to widen the band and its strategy for bringing inflation into the band would be useful. The authorities took note of staff's position, but did not consider that the widening would be taken as a signal of a lower commitment to control inflation.

Prudent Wage-Setting

25. A moderation in real wage growth would be critical to safeguard competitiveness, curb overheating risks, and tame inflation. The cumulative growth in real wages has exceeded the growth of aggregate output per worker in recent years and the ensuing increase in real unit labor costs has contributed to inflation. Staff supported the authorities' recent wage-setting guidelines that would keep the growth of real wages in the range of 0–3 percent depending on the performance of GDP and the sector; the envisaged decline in the growth rate of real wages (from about 4 percent in the last few years) would help contain rises in real unit labor costs going forward. Staff also welcomes the proposed safeguard clauses that would allow a re-negotiation in the event of a substantial change in the performance of the sector; such renegotiations could help reduce the rigidity of real wages and buffer employment in the event of negative shocks.

26. Staff welcomed the authorities' initiative to offer guidelines for non-indexed wage adjustment. Reducing backward-indexation in wage contracts is crucial for raising the resilience of labor demand against potential adverse shocks; it would also lower inflation inertia and facilitate a reduction of inflation as the monetary policy stance is tightened. Staff argued that the authorities' recent guidelines for the possible design of non-indexed wages are an important step in this regard and should be promoted strongly.

Fiscal Policy—Supporting Monetary Policy and Sustaining the Decline in Net Public Debt

27. Staff emphasized that a tighter policy stance would help alleviate some of the burden on monetary policy. Staff estimates that despite a decline in the headline fiscal deficit, fiscal policy will be neutral or provide a small positive impulse this year following a positive impulse last year, with real expenditure growth slowing but remaining above the growth of real GDP. With still tight labor market conditions and output growth somewhat above potential recently, staff argued that a tighter fiscal stance would help alleviate some of the burden on monetary policy in fighting inflation and reduce real appreciation pressures.[4] The authorities did not see scope to alter the course of fiscal policies in the near term. They considered the impact of fiscal policy on inflation to be limited in Uruguay and felt that staff's empirical findings on this

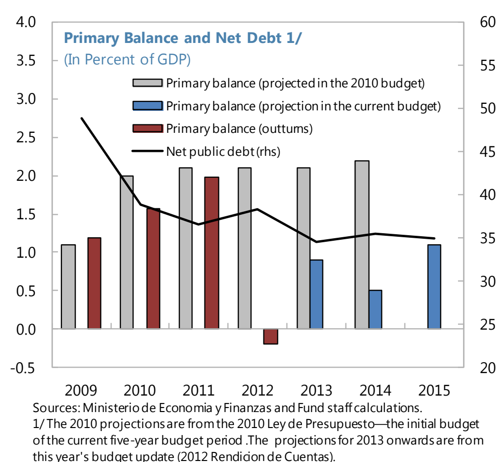
[4] See the Selected Issues Paper *Fiscal Policy and Inflation in Uruguay: Exploring the Nexus*, by Camilo E. Tovar. The paper estimates that a one percent of GDP reduction in the central government primary balance is associated with a 0.45 percentage point decline in inflation.

relationship was consistent with their conclusion. Staff reiterated that even if the impact of fiscal policy on inflation may be moderate, given the trade-offs facing monetary policy, any support from a tighter fiscal policy stance would be beneficial.

28. The authorities have shifted their focus from gross to net public debt over time. The initial public sector budget for the 2010–15 period and the budget updates (*Rendicion de Cuentas*) for 2011 and 2012 included an objective to reduce gross public debt to 40–45 percent of GDP by 2015 (from 66 percent of GDP in 2009). At end-2012, gross public debt stood at about 60 percent of GDP, with the deviation from earlier projections reflecting mostly the stronger accumulation of foreign assets.[5] In the meanwhile, debt net of liquid assets declined from 44 percent of GDP in 2009 to about 37 percent of GDP in 2012; staff projects it to remain broadly stable around that level under the current policies and outlook.

29. Staff noted that although Fund surveillance of fiscal sustainability is usually based on gross debt, in certain cases there may be merit in focusing on net debt as a complementary measure to reflect factors that could mitigate risks associated with gross debt. In the case of Uruguay, staff recognizes the relevance of net debt, since the sizable liquid financial assets of Uruguay's consolidated public sector (including the central bank and central government) do mitigate financing risks.

30. Staff recommended a gradual fiscal adjustment through the medium term to keep net public sector debt on a firmly downward-sloping path. Staff and the authorities agreed that public-debt vulnerabilities were contained in the near term given the comfortable level of liquid assets of the central bank and the central government, as well as the robust profile of the public debt. Since debt dynamics remain sensitive to growth and exchange rate shocks (see Annex II), and given the uncertain external outlook for the years ahead, staff recommended keeping net debt as a share of GDP on a firm downward-trend. Returning the overall deficit of the public sector to 1 percent of GDP in the medium term (as envisaged in last year's budget update–2011 *Rendicion de Cuentas*) from the 2.0-2.5 percent projected now would be consistent with that goal.



Sources: Ministerio de Economia y Finanzas and Fund staff calculations.
1/ The 2010 projections are from the 2010 Ley de Presupuesto—the initial budget of the current five-year budget period .The projections for 2013 onwards are from this year's budget update (2012 Rendicion de Cuentas).

31. The authorities saw their net debt objective as having been fulfilled. They noted that the net debt ratio had declined significantly and stood very close to the levels projected in the previous years of the current five-year budget period (that started in 2010) in part due to the greater-than-expected GDP growth and real exchange rate appreciation.

[5] In April 2013, Uruguay's historic public debt series were revised upwards due to a methodological change. The revision to end-2012 gross public debt was 2 percentage points of GDP.

32. Staff and the authorities also discussed options for reducing the fiscal deficit. Staff called for restraining the growth of expenditures while safeguarding infrastructure investments and the safety net for the poor. It also saw scope for raising contributions to the public pension and health care insurance plans since recent legislation to broaden coverage has proven more costly than initially envisaged. The authorities noted that the low share of discretionary spending excluding infrastructure investments implied little scope for lowering the deficit by slowing the growth of spending. They felt that the contributions by workers and firms to the pension and health care plans were already high by international standards and saw little room for raising them. They did see scope to increase tax revenues in the longer run, mainly from higher-income earners. They noted that Uruguay's marginal tax rates for higher income earners remained below international comparators. They saw it important to preserve an investment-friendly corporate tax structure, with competitive marginal tax rates and tax breaks for selected investments; they noted that the standards for qualifying for such breaks had been raised last year.

Policy Response to Inward Spillovers

33. In the event of a worsening of the outlook, staff argued that the policy response should depend on the nature of the shock:

- *In case of a significant worsening of the terms of trade*, due for example to a persistent growth slowdown in large emerging market economies, the exchange rate should be the main shock absorber. Reserves and liquidity buffers could be used to smooth out excess volatility and CFMs can be unwound if there are disruptive portfolio outflows. Since the terms of trade decline could be long-lasting, a counter-cyclical fiscal policy response is unlikely to be appropriate.

- *In case of sharply lower regional growth*, which would likely be temporary, automatic fiscal stabilizers could be used to buffer the shock, but within limits, given the adverse implications for public debt dynamics. International reserves, liquidity buffers, adjustments to reserve requirements could be used to curb excessive volatility.

The authorities agreed on the important role of exchange rate flexibility in buffering shocks. They also considered that Uruguay's strong liquidity buffers would afford a fiscal policy response, at least through automatic stabilizers.

Follow-up on the FSAP Recommendations

34. The authorities have taken several important steps to enhance financial stability over the past year, in line with the recommendations of the 2012 FSAP update (Box 5). Good progress has been made in several priority areas, including enhancing the resources of the central bank's Financial Services Superintendency (SSF), and bolstering crisis preparedness, stress testing, and the supervisory process.

35. Several measures to enhance supervision will be adopted in 2014, including:

- Creation of a new unit a dedicated to operational supervision and the addition of three new financial analysts to enhance SSF resources in this area.
- Creation of a new unit dedicated to capital market supervision.
- Creation of a new unit on authorizations to improve the due process and handling of requests made by financial institutions to the superintendency.
- An increase in the financial and human resources of the SSF by converting twenty temporary externally-funded staff to permanent positions, and adding an analyst dedicated to monitor BROU, the state-owned bank that accounts for about 40 percent of bank assets in Uruguay.
- A review of the internal structure of the SSF and its supervisory methodology to enhance risk-based supervision. The SSF is also initiating an international certification process (ISO9000) for its different activities and processes, including regulation, authorization, financial intelligence, and customer service. In 2014, the ISO certification process will cover the supervisory process, infrastructure, and sanctions.

36. In the areas of supervisory process and contingency planning, the SSF has taken a number of important steps. By end-2013, banks will submit the results of their first capital adequacy evaluation. The SSF is also considering a more stringent stress testing exercise, which will be used to establish capital surcharges for individual banks in 2014 in line with adopting Pillar II. The SSF is also coordinating closely with COPAB, the deposit insurance fund, to propose legal reforms to improve the exchange of information and coordinate action in the event of bank resolution. In 2014, the SSF will conduct a profound independent assessment of the private pension system, including a review of the strategy and business model of the BSE, the public insurance company that provides annuities. In addition, progress has been made in establishing international-standards of securities regulation, with new rules on corporate governance, insider reporting, and takeover bids having come into effect in February 2013.

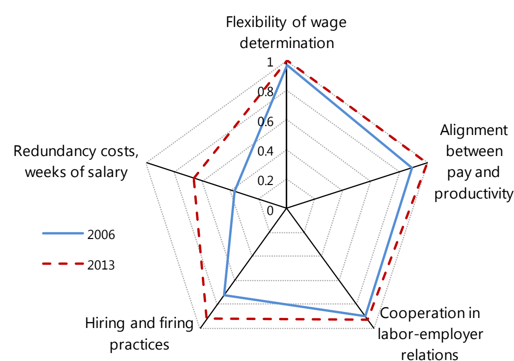
37. The authorities have also continued to strengthen their regulatory framework. Significant progress has been made with the implementation of Basel II and III. Additional capital requirements were introduced in 2013 to cover market and operational risks, and a capital surcharge (capped at 2 percent) is being applied for systemically important banks. Moreover, the central bank has updated its roadmap to implement remaining elements of Basel III, such as the net stable funding ratio and liquidity coverage ratio, which should be in place by 2018.

Bolstering the Medium-Term Prospects

38. A medium-term potential growth rate of four percent is feasible but will require policy actions in several areas. In particular, total factor productivity growth would need to stay high and human and physical capital accumulation would need to strengthen to offset the drag from lower labor force growth.

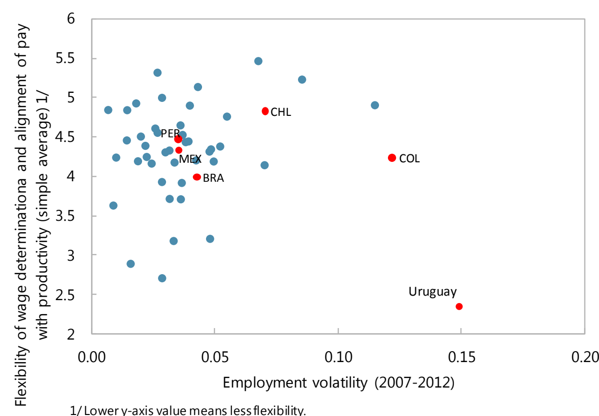
39. An efficient labor market would bolster Uruguay's growth potential and reinforce the resilience of employment to shocks. Certain aspects of labor market efficiency continue being reported as the most problematic aspects of doing business in Uruguay (e.g., in the 2013 Global Competitiveness Report of the World Economic Forum). There would be merit in reviewing the changes introduced to the labor market regulations in recent years, and consider changes to ensure a good balance between the requirements of a dynamic labor market and appropriate protection for workers.

Selected Indicators of Labor Market Efficiency 1/



Source: World Economic Outlook and 2013 Global Competitiveness Report of World Economic Forum.
1/ A value of 1 indicates the country is ranked last.

Flexibility of Wage Determination and Employment Volatility
(Emerging Markets in LAC, Asia, Africa and Europe)



1/ Lower y-axis value means less flexibility.

40. Infrastructure investments are also needed to sustain strong potential growth. Staff welcomes the advances in diversifying Uruguay's energy supply. Half of the energy supply will be based on renewable sources by 2015, with the diversification helping to reduce the impact of droughts on public balances—through UTE's finances. However, delays in tackling infrastructure gaps—ports and roads—through private-public partnerships remain to be addressed.

41. There is room to deepen financial markets and enhance the efficiency of the financial sector. Higher competition across banks and lower costs would help ensure a better and wider range of services to households and SMEs. The authorities highlighted that the financial inclusion law that is currently being discussed in Congress would improve access to finance by currently excluded segments (e.g. lower-income households and micro enterprises), expand the range of services available, reduce costs, promote youth savings, and encourage formalization and electronic payments. As regards the development of capital markets, staff reiterated the FSAP recommendation that easing the domestic investment mandate of pension funds could support the development of capital markets. Following up on another FSAP recommendation to offer more than one portfolio option for pension contributors (in order to achieve a more efficient trade-off between safety and return along the lifecycle), the authorities noted that a draft law being considered by Congress would allow private pension funds to offer their clients two portfolio options as opposed to a single one, thus helping them better align their portfolio choice with their investment objectives.

42. There has been continued progress on meeting international tax standards and in strengthening Uruguay's AML/CFT regime. To comply with international tax standards, the government has signed 12 double taxation treaties and 11 tax information exchange treaties (1 and 6 of each, respectively, are pending parliamentary approvals in Uruguay and/or the partner country). In addition, negotiations for 7 double taxation treaties and 6 tax information exchange treaties are either complete or under way. Importantly, an information exchange treaty with Argentina, which includes double taxation components, became effective in February 2013. To increase transparency, the Uruguayan authorities have also put in place a law requiring the registration with BCU of all holdings of stocks and shares. Finally, the authorities expect that their new financial inclusion law, which requires a number of commercial transactions to be done electronically, will strengthen the AML efforts.

43. The authorities have established a framework to appropriately manage the iron-ore resources that may come on stream in the next few years. Under current prices, proven reserves would generate exports of some US$1.5 billion per year (3 percent of 2012 GDP). A law regulating large scale mining projects has just been approved by Congress (Box 6).[6] The law sets out a taxation regime in line with contemporary international standards and would create an intergenerational sovereign wealth fund that would receive 70 percent of mining related government revenues. On potential Dutch disease risks, staff and the authorities agreed that the relatively moderate amount of spending out of export revenues limited the risks of a significant real appreciation. While recognizing that mining projects to be politically sustainable are expected to provide a source of financial support for local social and economic development, staff recommended any spending financed by mining revenues to be designed in a way that does not create budgetary risks from the finite and potentially volatile nature of the mining revenue.

STAFF APPRAISAL

44. The outlook for the Uruguayan economy is solid, but risks and challenges remain. After a decade of strong expansion, growth has moderated to a more sustainable pace. External demand has weakened, but domestic consumption and investment remain robust. Inflation persists above the target range. The current account deficit has widened but is expected to narrow as external demand gradually recovers. Foreign direct investment is poised to stay strong.

45. Risks to the outlook stem from global, regional and domestic factors. Global downside risk scenarios include a lasting drop in export commodity prices and tighter global financial conditions. The prospects for regional trading partners could also imply some downside risks for Uruguay, with potential spillovers through trade, tourism and FDI. On the domestic front,

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[6] The Selected Issues Paper *The Fiscal Regime for Large-Scale Mining in Uruguay*, by Victor Kitange, provides a review of the new fiscal regime applicable to large-scale mining in Uruguay and gives a preliminary forecast of potential government revenue from the Valentines iron-ore mining project.

continued strong increases in labor costs could stoke higher inflation and further real appreciation, hurting export competitiveness and eventually, growth.

46. Macro-financial vulnerabilities are contained. Uruguay's financial system is not likely to act as an amplifier of external shocks given its small size and muted links to the real sector; banks are well regulated and their balance sheets generally appear robust. The central bank and commercial banks have sizable net foreign asset positions. Public debt vulnerabilities are low: astute debt management in recent years has brought the share of domestic currency debt to above 50 percent and the average maturity of debt is high. The central government also has a comfortable level of liquid foreign assets and contingent credit lines.

47. The authorities have made good progress towards implementing the recommendations of the 2012 FSAP. Staff welcomes the steps taken to enhance the resources of the SSF, improve crisis preparedness and stress testing, and upgrade the supervisory process.

48. The extension of the CFM to locally-issued government securities was warranted by macroeconomic conditions. At the time of the broadening of the CFM there was little scope to counteract currency appreciation pressures from portfolio inflows with monetary easing or prompt fiscal tightening. Such capital flow management measures, however, should be temporary; it would be advisable to remove them once there is clear evidence that the capital inflow surge has abated.

49. Inflation persisting above the ceiling of the BCU's target band remains an important macroeconomic policy issue. High inflation and expectations reduce the scope for monetary policy easing in response to a negative shock, they also raise macroeconomic uncertainty and have an adverse impact on lower income groups. The mission welcomes the tightening of the monetary policy stance over the last two months that is evidenced by the rise in nominal peso yields.

50. The recent change in the operational target for monetary policy has raised new practical challenges and put an extra premium on communication. Additional efforts by the central bank to communicate its targeted monetary policy stance and inflation goal would help market participants adapt to a new operational framework and smooth market volatility. Going forward, the effectiveness of the new framework in delivering the inflation targets needs to be monitored.

51. A moderation in wage growth is a critical pillar in supporting the goal of lowering inflation and bolstering employment. Real wage growth has exceeded the growth of aggregate output per worker in recent years, and the ensuing growth in real unit labor costs has contributed to inflation. Prudent real wage growth would also curb the risk of overheating and safeguard competitiveness. Reducing backward-indexation in wage contracts and thereby the downward rigidity of real wages is also crucial for raising the resilience of labor demand against adverse shocks. The authorities' recent guidelines for the possible design of non-indexed wages are an important step in this regard and should be promoted strongly.

52. A tighter fiscal policy stance would be better aligned with the goal of reducing inflation. The deficit has decreased this year mostly due the phasing-out of one-off factors. But fiscal policy will be neutral or provide a small positive impulse this year following a positive impulse last year. With still tight labor market conditions and output growth around potential, a tighter fiscal stance would help alleviate some of the burden on monetary policy in the task of taming inflation.

53. A lower fiscal deficit would also help keep net debt on a firmly downward-sloping path. Keeping net public debt on a firm downward sloping path remains desirable given the uncertain external outlook for the years ahead. Returning the overall deficit of the public sector to 1 percent of GDP by the medium term—in line with last year's budget projections—would be consistent with that goal. To lower the deficit, slowing the growth of spending would be desirable (shielding much-needed infrastructure investments and spending that protects the poor), but since discretionary expenditures account for a relatively small share of the total, new revenues may also be needed.

54. In the event of a worsening of the outlook, the policy response should depend on the nature of the shock. In case of a significant worsening of the terms of trade, due for example to a persistent growth slowdown in large emerging market economies, the exchange rate should be the main shock absorber. Reserves and liquidity buffers could be used to smooth out any excess volatility and CFMs (if still in force) can be unwound if there are disruptive portfolio outflows. Since the terms of trade decline in such a scenario could be long-lasting, a counter-cyclical fiscal policy response is unlikely to be appropriate. In case of sharply lower regional growth, which would likely be temporary, automatic fiscal stabilizers could be used to buffer the shock, but within limits, given the desirability of maintaining prudent public debt dynamics. International reserves, liquidity buffers, and reserve requirements could be used to curb excessive volatility.

55. The medium-term outlook for Uruguay is generally favorable but will require various policy actions to maintain solid and stable growth. Specifically, boosting public infrastructure and raising the efficiency of labor markets would help sustain high productivity and investment growth, and enhance competitiveness. Improving access to finance and spurring capital market development would increase the financial sector's contribution to growth.

56. Staff proposes that Uruguay remains on the 12-month Article IV consultation cycle.

Box 1. Uruguay: Social Policies for Inclusive Growth

Uruguay continues to make steady progress in improving social conditions, supported by robust economic growth and progressive social policies. Recent social policy reforms have increased progressivity and coverage, and would help to consolidate the gains from Uruguay's long-standing inclusive growth policies. These reforms include:

- Expanding unemployment benefits and old-age pensions to people who had not fully contributed to the pension system (2010), by reducing the number of years of service required to quality for a pension from 35 years to 30.

- Other reforms that have likely increased the progressivity of the tax system include the refund of the 22 percent VAT on purchases made with Food and Family Allowance cards to 200,000 low-income households (2012).

- The incidence of social spending has also generally been progressive and the recently expanded coverage of the national health insurance system (2007), by harmonizing health care system and improving equity in access to health services, should reinforce this trend. Reforms have expanded coverage under public plans in 2010 to about 47 percent of the population under a universal benefit plan compared with coverage of 23.7 percent in 2007 under various plans with varying benefits. As a result of government efforts to include previously excluded segments of the population, health insurance has become near universal with about 95 percent of Uruguay's population covered.

Socio-Economic Indicators in Uruguay and Comparators

	Uruguay		LA-5 1/ 2/	OECD 2/
	2005	2012	2012	2012
GDP per capita (PPP, in U.S. dollars)	9,626	16,037	14,554	35,921
Income inequality (Gini index, lower value=less inequality) 3/	45.9	45.3	53.1	37.7
Human Development Index ranking (169 countries: lower value=better ranking)	58	51	70.8	22.2
Unemployment (average)	12.1	6.1	6.8	8.7
Population (in millions)	3.3	3.4	81.5	37.8
Poverty (percent of population below poverty line) 3/	36.6	13.1	25.4	23.6
Illiteracy (percent of population age 15 years and over) 3/	2.2	1.9	6.1	2.2
Life expectancy at birth (years, average) 3/	75.6	76.4	75.4	79.6
Share of Population 65+ (percent)	13.5	14.0	7.1	15.3

Sources: UNDP Human Development Report, World Bank Development Indicators, IMF World Economic Outlook, Instituto Nacional de Estadistica del Uruguay, and Reporte Social 2013, Ministerio de Desarollo Social.

1/ Brazil, Mexico, Chile, Colombia, and Peru.

2/ Simple averages.

3/ Latest survey.

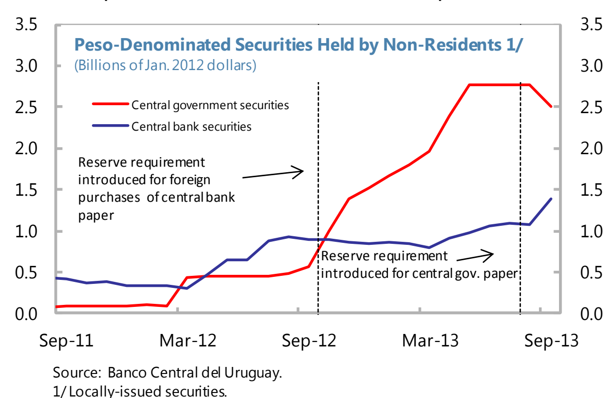
Box 2. Uruguay's Capital Flow Management Measures

Portfolio flows into Uruguay rose strongly in early 2012 as the country regained an investment grade sovereign rating, its interest differentials widened, and global risk appetite improved. Strong inflows into the public securities market added to the appreciation pressures arising from high FDI and the relatively strong performance of the Uruguayan economy. In response, the authorities introduced capital flow management measures in two steps:

- At first, most of the portfolio inflows went into the market for short-maturity central bank paper—*letras de regulacion monetaria*. Concerned with the interference of the inflows with monetary policy operations, the Central Bank of Uruguay announced in August 2012 a 40 percent reserve requirement on nonresidents' purchases of *letras* effective October 1, 2012.

- After the announcement of the reserve requirement on *letras*, nonresidents' purchases of *letras* waned, but purchases of central government paper surged. Appreciation pressures continued, with the central bank stepping up its pace of foreign currency purchases and sterilizing the monetary expansion by issuing *letras*. Between February 2012 and May 2013, non-residents holdings of locally-issued central government securities denominated in local currency rose by US$2.6 billion—from 2 to 45 percent of the outstanding stock. On May 22, 2013, the authorities announced they would introduce a 50 percent reserve requirement on nonresidents' purchases of central government paper effective July 2013. They also raised the existing reserve requirement on purchases of *letras* from 40 to 50 percent.

Nonresidents' purchases slowed to a near stop in June. The stop in purchases occurred after the authorities announced they would extend the reserve requirement on non-residents' purchases of central bank paper to purchases of central government paper, which coincided with the Fed's May 22 tapering announcement that triggered generalized depreciation pressures on emerging market currencies. Although the Uruguayan peso had bucked the depreciation trend among emerging market currencies in the first three weeks of May, in the two weeks following May 22 it depreciated by about 8 percent against the U.S. dollar.



Source: Banco Central del Uruguay.
1/ Locally-issued securities.

Box 3. Uruguay: Assessment of Balance of Payments Stability

Staff's assessment is that the peso is slightly overvalued but stability risks remain contained. Uruguay's real effective exchange rate (REER) has appreciated over the last decade and is now about 40 percent above its pre-2002 crisis levels. Much of the appreciation, until recently, reflected Uruguay's stronger fundamentals—high commodity prices and productivity gains, supported by strong FDI flows. During 2012, surging capital inflows and weakening performance in key trading partners widened the current account deficit (CAD) and added to the appreciation pressures. Although this led to concerns about the competitiveness of the economy, CGER and EBA estimates suggest that the CAD is close to its estimated norms. Specifically, the widening of the CAD to 5.4 percent of GDP in 2012 was partly associated with transient factors - higher capital goods imports (due to the construction of the Montes del Plata pulp mill) and higher imports of oil (due to a drought). Lower tourism earnings and industrial exports due to foreign exchange restrictions in Argentina and slower growth in Brazil and Europe also weighed on the current account in 2012. As these factors gradually dissipate, the current account deficit is expected to narrow to about 3.5 percent of GDP over the medium term, close to the MB and EBA norms[1]. At the same time, the CGER Equilibrium Real Exchange Rate approach suggests that as of July 2013 the currency was about 10 percent stronger than levels consistent with Uruguay's fundamentals. The depreciation of the peso against the U.S. dollar in August does not change the thrust of this assessment since the change in Uruguay's REER was limited (as Uruguay's main emerging market trading partners also experienced depreciations).

Exchange Rate Assessment

Deviation from equilibrium (in percent) 1/

I. CGER Macroeconomic Balance (MB) approach	-1.3
II. CGER External Sustainability (ES) approach	3.3
III. CGER Equilibrium Real Exchange Rate (ERER) approach 2/	8.8
IV. EBA - Current Account Model 3/	3.2
Memo Item:	
Big Mac Index 4/	9.3

Source: Fund staff calculations.
1/ Positive values indicate overvaluation.
2 / Considers the REER as of June 2013, unless otherwise stated.
3/ Using the 2012 EBA CA gap to gauge the REER gap.
4/ July 2013.

(Continued)

Box 3. Uruguay: Assessment of Balance of Payments Stability (Concluded)

A steady inflow of FDI has more than financed the current account deficit in recent years. The deterioration in the net international investment position since 2004-09 mainly reflects higher FDI liabilities. Uruguay's international reserves amply exceed various prudential benchmarks, such as the sum of short-term external debt and nonresident deposits; they are also high as a ratio to monthly imports. These factors increase the resilience to withstand external shocks, including a reversal of portfolio capital flows.

Gross International Reserves

In billions of U.S. dollars (latest) 1/	15.2
In months of imports (2012)	12.3
In percent of:	
GDP (2012)	30.5
Short-term (ST) debt (end-2012)	238.0
ST debt and foreign currency deposits (Q2 2013)	107.3
ST debt and nonresident deposits (Q2 2013)	145.0
M2 (latest)	179.8
M3 (latest)	63.5
Memo items:	
IMF's new reserve adequacy metric range in US$, billions (2013Q1)	3.9 to 5.9
Banks foreign assets (US$, billions)	8.8
Ratio of gross reserves plus banks' foreign assets to ST debt plus foreign currency deposits (percent)	169.0

Sources: Banco Central del Uruguay and Fund staff calculations.
1/July 2013.

International Investment Position, 2004-12

(In percent of GDP)

	2004-09 (avg)	2011	2012
Assets	88.7	65.0	63.3
Of which:			
Portfolio investment	10.8	9.5	8.5
Currency and deposits	48.9	29.1	24.5
Reserve assets	19.0	22.9	26.0
Liabilities	96.4	75.0	77.8
Of which:			
FDI	22.8	33.6	34.0
Portfolio investment	27.5	20.0	21.4
Loans	24.1	10.3	11.1
General government	13.1	6.5	5.5
BCU	5.9	0.0	1.5
Other	3.1	2.5	4.2
Nonresident deposits	13.4	7.6	7.4
Net position	-7.7	-9.9	-14.5

Sources: Banco Central del Uruguay (BCU), World Economic Outlook and Fund staff calculations.

1/The MB approach calculates the difference between the medium-term current account (CA) balance and an estimated equilibrium CA "norm". The ES approach calculates the difference between the actual CA balance and the NFA-stabilizing CA balance. The real exchange rate gap is calculated to bring the current account balance in line with its NFA-stabilizing level or medium-term MB norm. The ERER is estimated as a function of medium-term fundamentals.

Box 4. Uruguay: Public Debt Management Operations

The Uruguayan government has continued implementing its pro-active debt management strategy that has improved the structure of Uruguay's central government debt significantly. As a result of this ongoing strategy, the average maturity of central government debt stands around 11 years and the share of local currency debt in total central government debt is close to 60 percent.

The key debt operations over the past year included:

- *Liability management*. In November 2012, the government issued US$500 million of a new benchmark bond maturing in 2045, and exchanged US$352 million in short-term debt for the new 2045 bond.
- *Loan prepayments and new contingency credit lines.* In January 2013, the authorities pre-paid a US$520 million loan to the IDB, making significant savings on interest costs in NPV terms, while signing a new policy loan of US$550 million with a deferred disbursement option as part of Uruguay's strategy to build a strong safety net of contingent credit lines.
- *Maturity re-profiling and build-up of liquidity buffers.* In July 2013, the government issued US$2 billion due in 2024 with an amortization schedule concentrated in the three years up to maturity. Half of the proceeds were used to repurchase more expensive and shorter-maturity debt, while the other half will remain in liquid assets. With this operation, the government has pre-financed its interest and amortization obligations through the end of 2014. In addition, the government has also announced a new issuance calendar totaling US$438.6 million in peso-denominated debt for the next six months, which aims at building liquid buffers.

Uruguay: Contingent Credit Lines

Institution	Amount (US mn)	Maturity (years)	Conditionality
World Bank	520	20.5	No
IDB	550	14.3	No
CAF	400	7.0	No
FLAR	470	0.5	No
Total	**1940**		

Source: MEF - Debt Management Office, IFIs.

Box 5. Uruguay: FSAP Update 2012—Key Recommendations

Recommendations	Time Frame[1/]
Institutional and Structural Issues	
Increase supervisory independence, including by broadening the technical and operational independence of the *Superintendencia de Servicios Financieros* (SSF).	MT
Increase financial and human resources for SSF.	ST
Regulation and Supervision of the Banking Industry	
Better discriminate among banks of different risk profiles, including capturing low probability but high impact events.	ST
Enhance risk concentration rules to capture linkages among connected borrowers due to financial, commercial and operational exposures.	ST
Provide further guidance to the industry on expected risk measurement, stress testing, contingency planning, risk management, and AML/CFT standards.	MT
Require systemic and large banks to operate separate risk management units and integrate risk measures into limits/operations.	ST
Securities Market	
Prepare a comprehensive capital market development strategy, including bringing new issuers to the market.	ST
Insurance, Pension Funds and Annuities Market	
Contract an independent diagnostic of the *Banco de Seguros de Estado* (BSE), including a review of its strategy, solvency, efficiency, and governance.	ST
Liberalize pension fund rules for prudent investment abroad.	ST
Provide hedging mechanisms or allow for phased withdrawals, in view of the indexation to wages.	MT
Safety Net and Crisis Management	
Strengthen contingency planning, develop scenarios, and specify agencies' roles	ST
Undertake joint and separate crisis preparedness work among the safety net participants.	ST
Financial Infrastructure	
Amend the procedural legislation to accelerate the asset execution process, including effective measures to expedite the post-judgment phase.	MT
Finalize decisions with regard to the functionalities of the Central Securities Depository (efficient interfaces with trading systems, identification of beneficial owners).	ST
Develop and implement the payment system oversight function, including Securities Settlement Systems and retail payments.	MT
Finalize an agreement on the interbank pricing scheme for the Automated Clearing House (ACH) to become operational.	ST

[1/] 'ST' for short-term (up to 12 months) and 'MT' for medium-term (12 -24 months).

Box 6. Uruguay: New Legislation on Large-Scale Mining

A law providing guidelines for investment in large-scale mining was approved in early September by Uruguay's legislature. The passage of the law enables the exploitation of iron deposits in central Uruguay. The project, estimated to require an investment of US$3 billion, would have a life span of 20–30 years and based on proven reserves could produce 18 million tons of iron ore per year, generating exports of about US$1.5 billion per year (3 percent of 2012 GDP) at current prices. The timeline of the project remains uncertain.

In addition to environmental guidelines, the law sets out a taxation regime and a revenue allocation mechanism:

- The taxation regime would include a royalty on revenues (production canon), income tax - IRAE and an additional corporate income tax (tax on economic activity—additional IRAE). The additional tax rate would be progressive and depend on the net operating margin (NOM, net operating surplus/operational revenues) given by (0.9 x NOM-0.25). An international reference price would be set as a floor for the valuation of operational revenues. Mineral taxation regimes vary widely by country, and no one regime fits all, but the proposed taxation regime in the law is broadly in line with the Fund staff recommendations to countries with natural resources (a simple flat loyalty, an income tax, and a rent tax).

- The law creates a new sovereign intergenerational investment fund (FSII) with the broad objective of ensuring intergenerational equity in the use of natural resources.

- Tax revenues arising from mining projects would be identified in the budget as revenues from large scale mining projects, with 70 percent of the revenues flowing into the FSII and the remaining 30 percent of revenues being directed to the "geographical areas of influence" of the mining activity, including for local economic development projects on infrastructure, environmental projects, and strengthening public technical capacity.

- The FSII would be managed by a governmental committee, comprised of the Ministers of the Economy and Finance, Industry, Energy and Mining, Housing, Environment, Agriculture, Office of Planning and Budget, or technical specialists designated by them. The committee would be responsible for designing the strategic investment guidelines and supervising and evaluating their implementation.

- The investments would be administered by the Asset Management Division of the Central Bank of Uruguay, which would also advise the managing committee on the investment strategy.

(Continued)

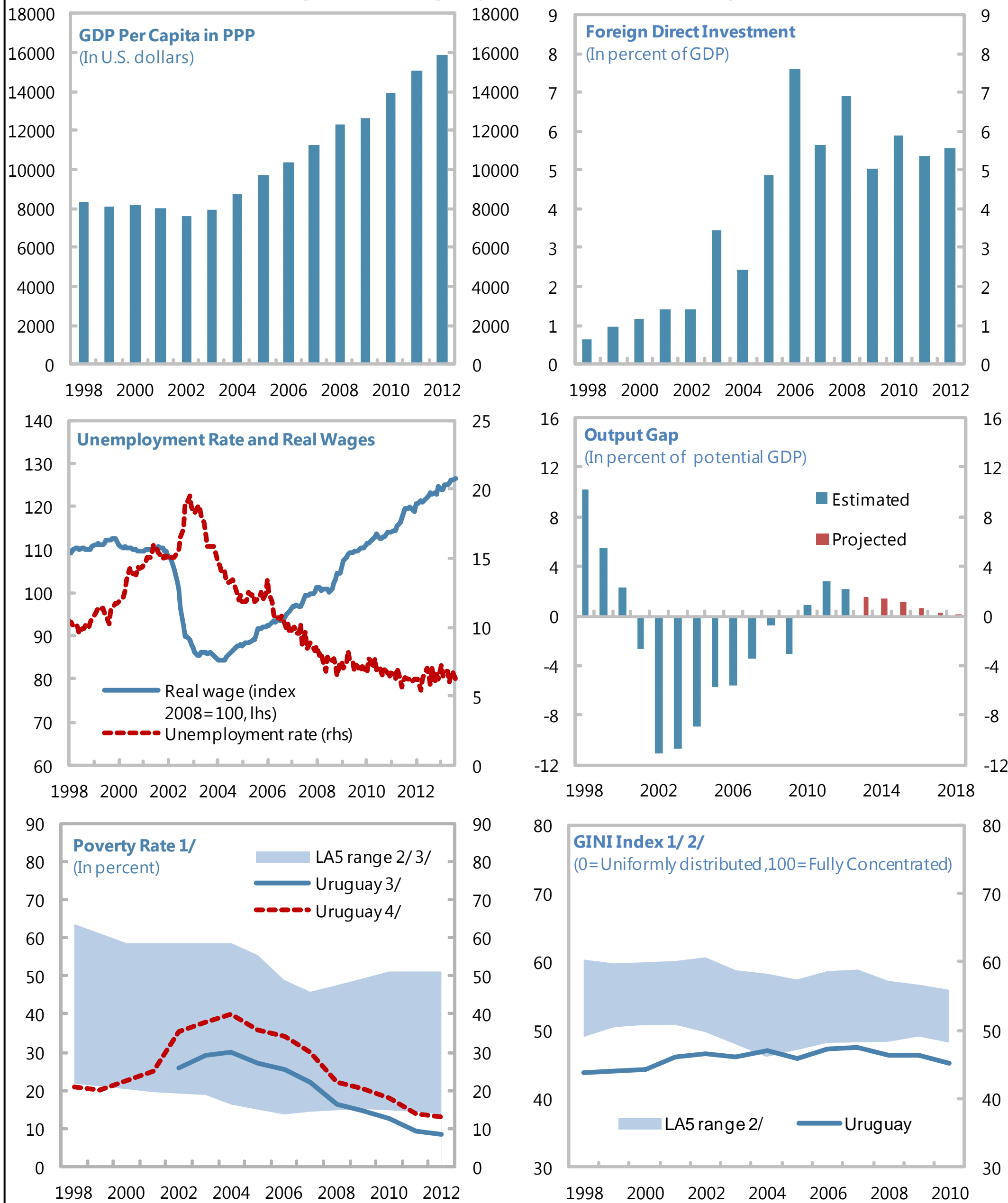
Box 6. Uruguay: Draft Law on Large-Scale Mining (Concluded)

- The funds of the FSII could be invested in Uruguayan sovereign and central bank securities, traded securities issued by Uruguayan or foreign private enterprises (subject to the approval of the financial supervisory agency), term deposits in local or foreign currency, and highly-rated fixed income securities issued by multilateral organizations or foreign governments. The amount invested in local currency assets would not exceed 20 percent of the total; there would be limits on the share of non-fixed income securities and concentration as well. The funds could also be used for paying down long-term external public debt and for financing research and development projects, integration of technology into education, and projects related to the mitigation of the effects of climate change.

As the revenues from extraction come on stream, the authorities would be advised to integrate the investment decisions for the intergenerational wealth fund into an overall sovereign asset-liability management framework. In such a framework, debt management and investment decisions would be coordinated to minimize the risk to the sovereign balance sheet, and paying down more expensive debt may be an option. Once the revenue is transferred to the fund, it should be invested to maximize the financial return subject to an acceptable level of risk set according to the fund's objectives. Clear withdrawal triggers and mechanisms to channel financial resources to specific public expenditure projects should also be put in place to avoid political pressures, while earmarking revenues should be minimized to avoid procyclicality.

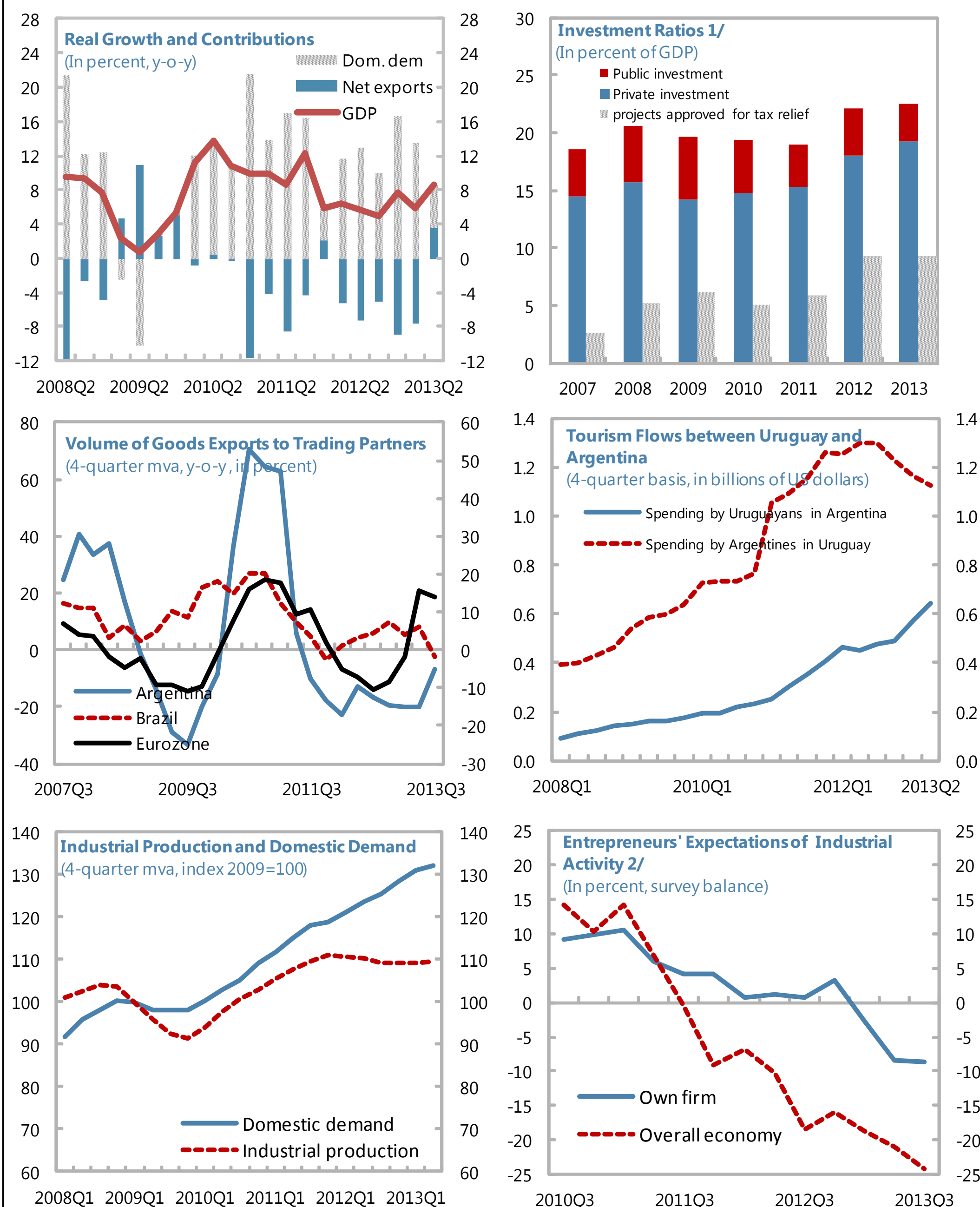
An essential governance principle is to establish a clear chain of governing bodies from the legislature down to the individual asset managers, with accountability at every level. There should be a clear and transparent division of roles between the fund's owner (the state) and the fund's manager who implements a clearly defined investment strategy according to the mandate set out by the owner. In this context, identifying clear objective for the fund and its time horizon would determine the appropriate investment strategy and risk tolerance.

Figure 1. Uruguay: Post-2002 Recovery



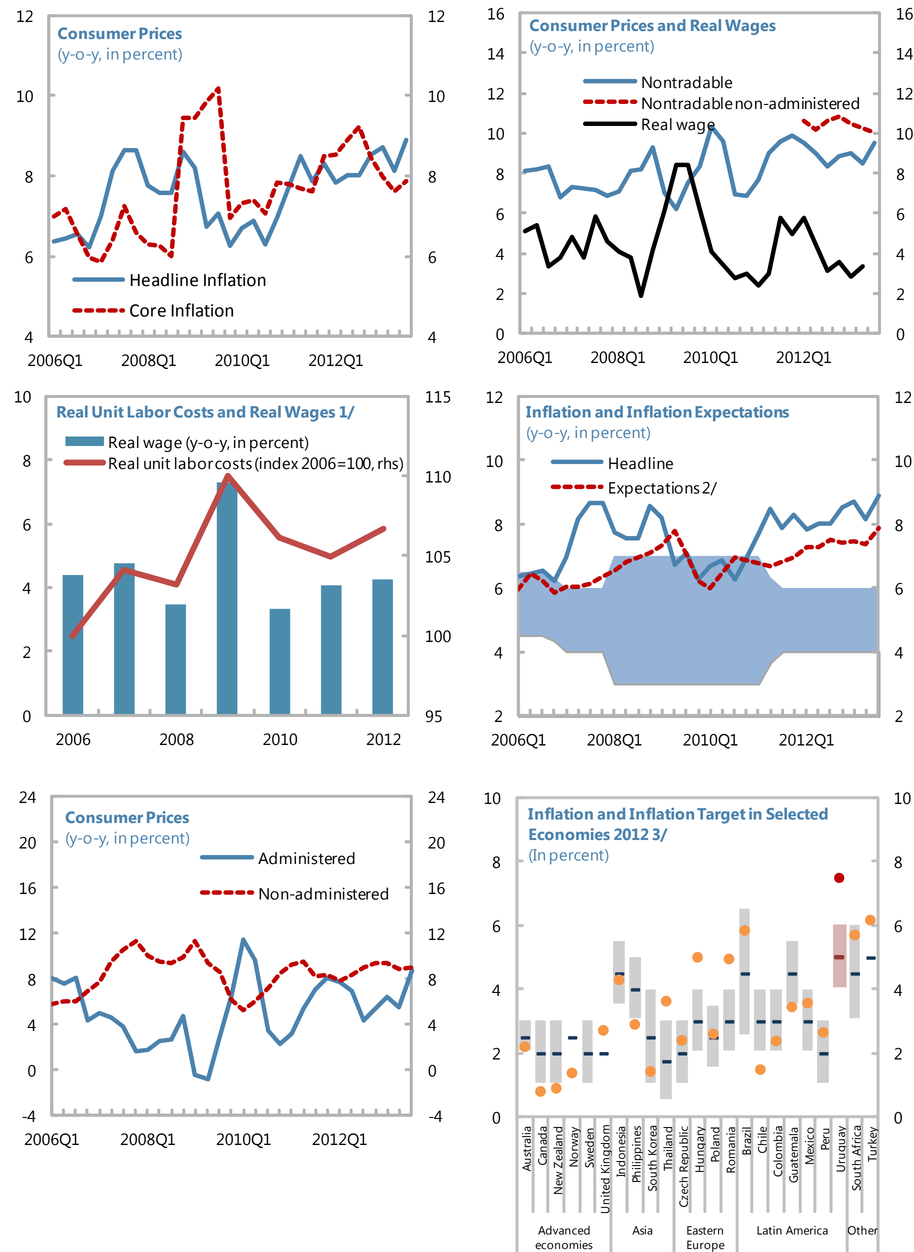
Sources: World Economic Outlook, World Development Indicators, Haver Analytics, Ministerio de Economia y Finanzas, Social Report 2013 and Fund staff calculations.
1/ Linear interpolation used to fill in missing data.
2/ LA5 includes Brazil, Chile, Colombia, Mexico, and Peru.
3/ Percent of households below poverty line
4/ Percent of population below poverty line (Rendicion de Cuentas, Ministerio de Economia y Finanzas, 2013)

Figure 2. Uruguay: Economic Activity



Sources: World Economic Outlook, Haver Analytics, Centro de Estudios de la Realidad Economica y Social (CERES), and Fund staff estimates and calculations.
1/ The 2013 figure for investment projects approved for tax relief under the investment promotion law includes information through August and the investment-to-GDP ratio for 2013 includes the first half of the year only.
2/ Balance of positive and negative expectations for the next 6 months.

Figure 3. Uruguay: Inflation



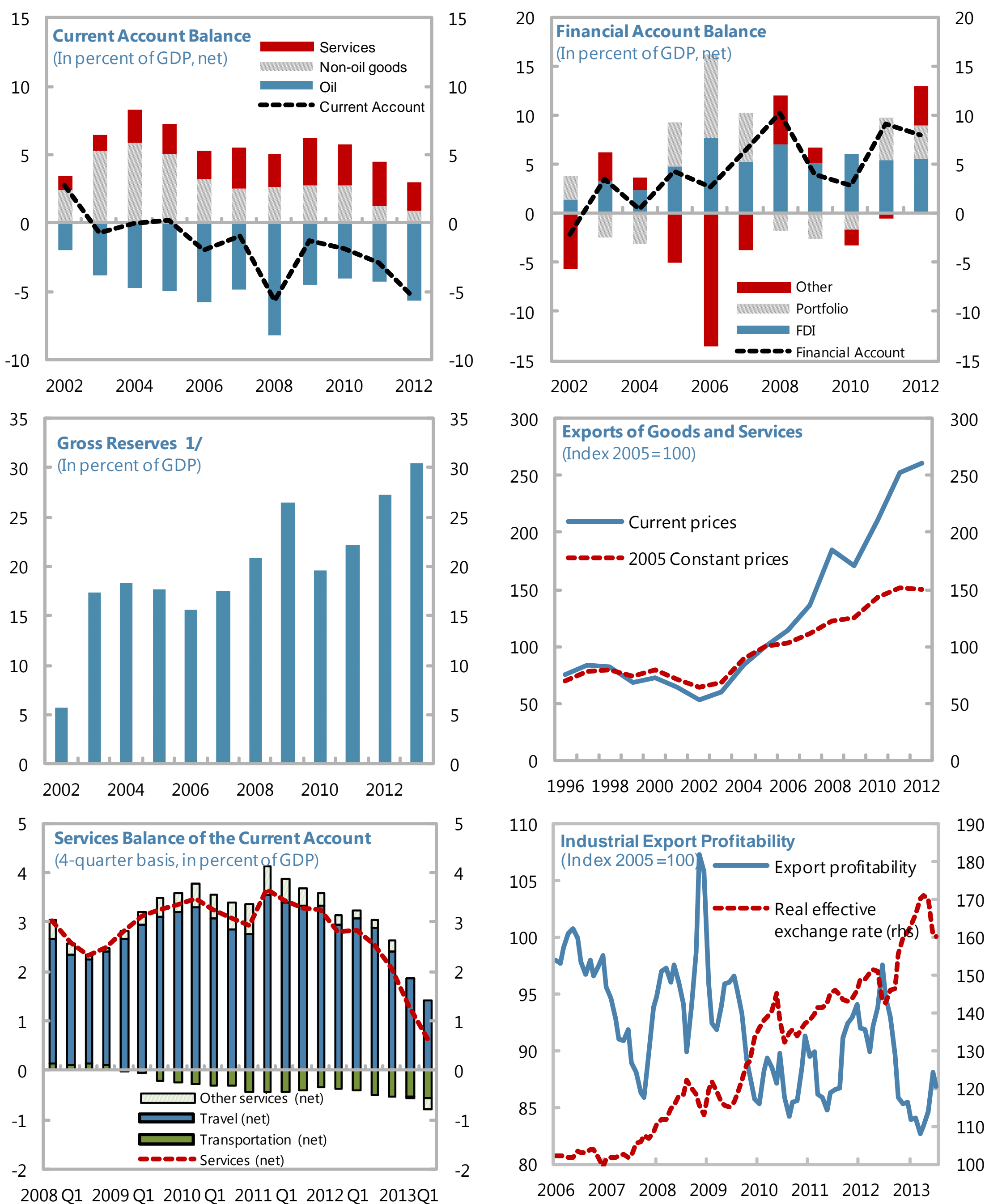
Sources: Banco Central de Uruguay (BCU), INE (Instituto Nacional de Estadistica), Central Banks, and Fund staff calculations.

1/ The measure of productivity used in the real unit labor cost calculation is given by real GDP divided by employment.

2/ BCU Survey, median of expected inflation for the 12 months ahead.

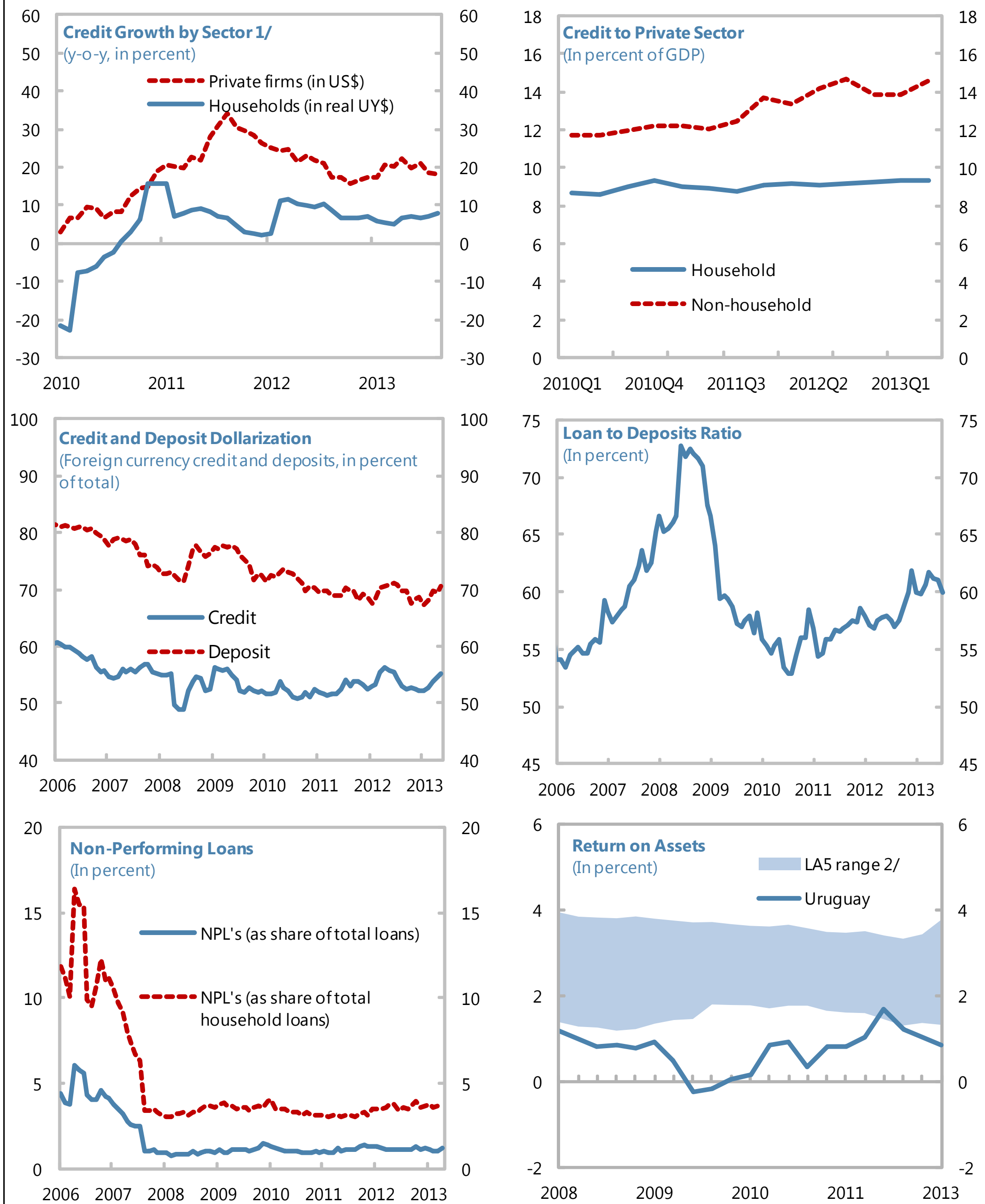
3/ Bars show the official target ranges, with the horizontal line marking the mid-point. Dots show end-year inflation for 2012.

Figure 4. Uruguay: External Accounts



Sources: Banco Central de Uruguay (BCU), World Economic Outlook, Haver Analytics, and Fund staff calculations.
1/ Reserve data as of July 2013 divided by 2012 GDP.

Figure 5. Uruguay: Credit and Banking

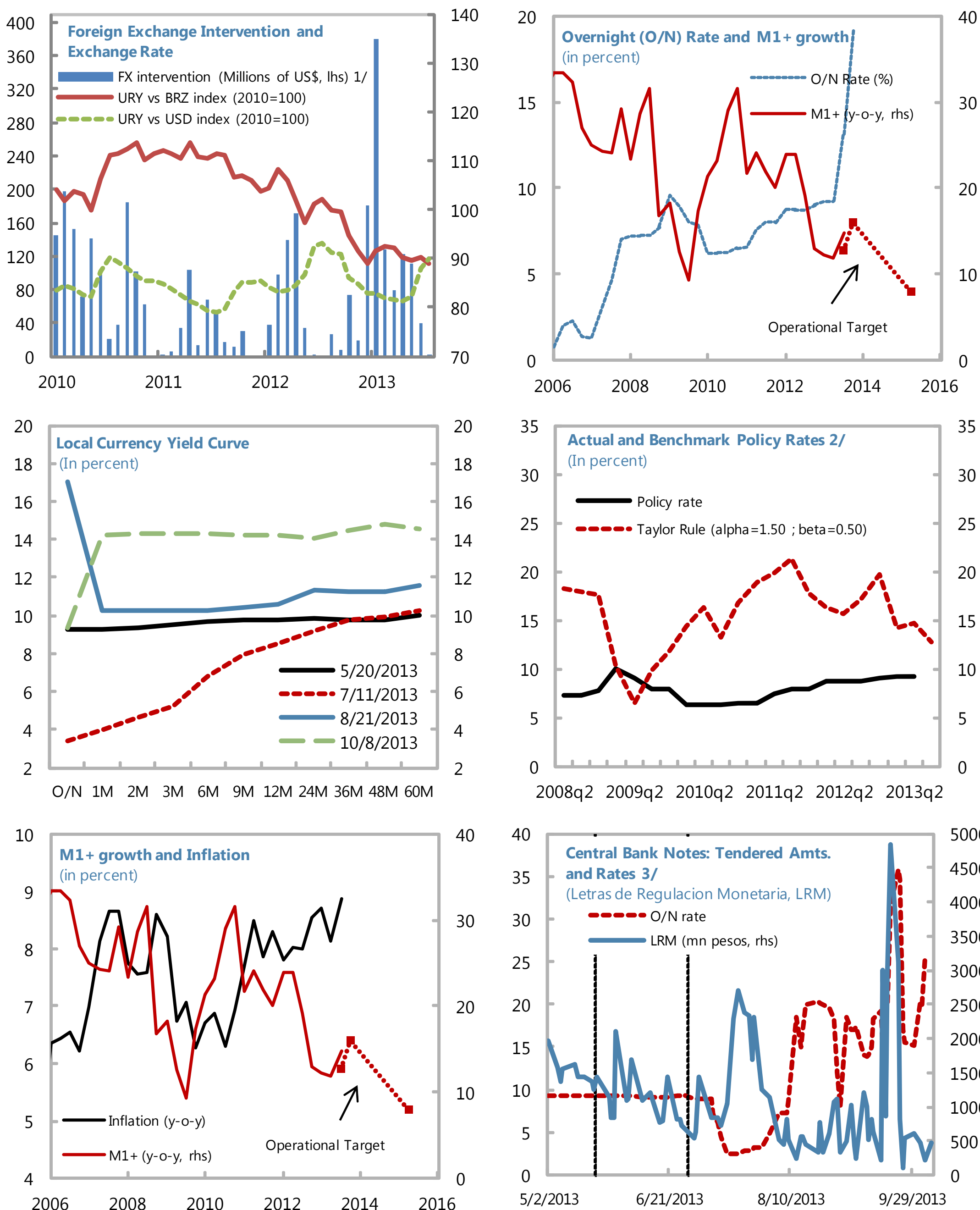


Sources: World Economic Outlook, Banco Central del Uruguay (BCU), and Fund staff estimates and calculations.

1/ BCU reports credit numbers in US$. Household credit is converted to pesos using the end of period nominal exchange rate and deflated using CPI, since the majority of household credit is denominated in local currency.

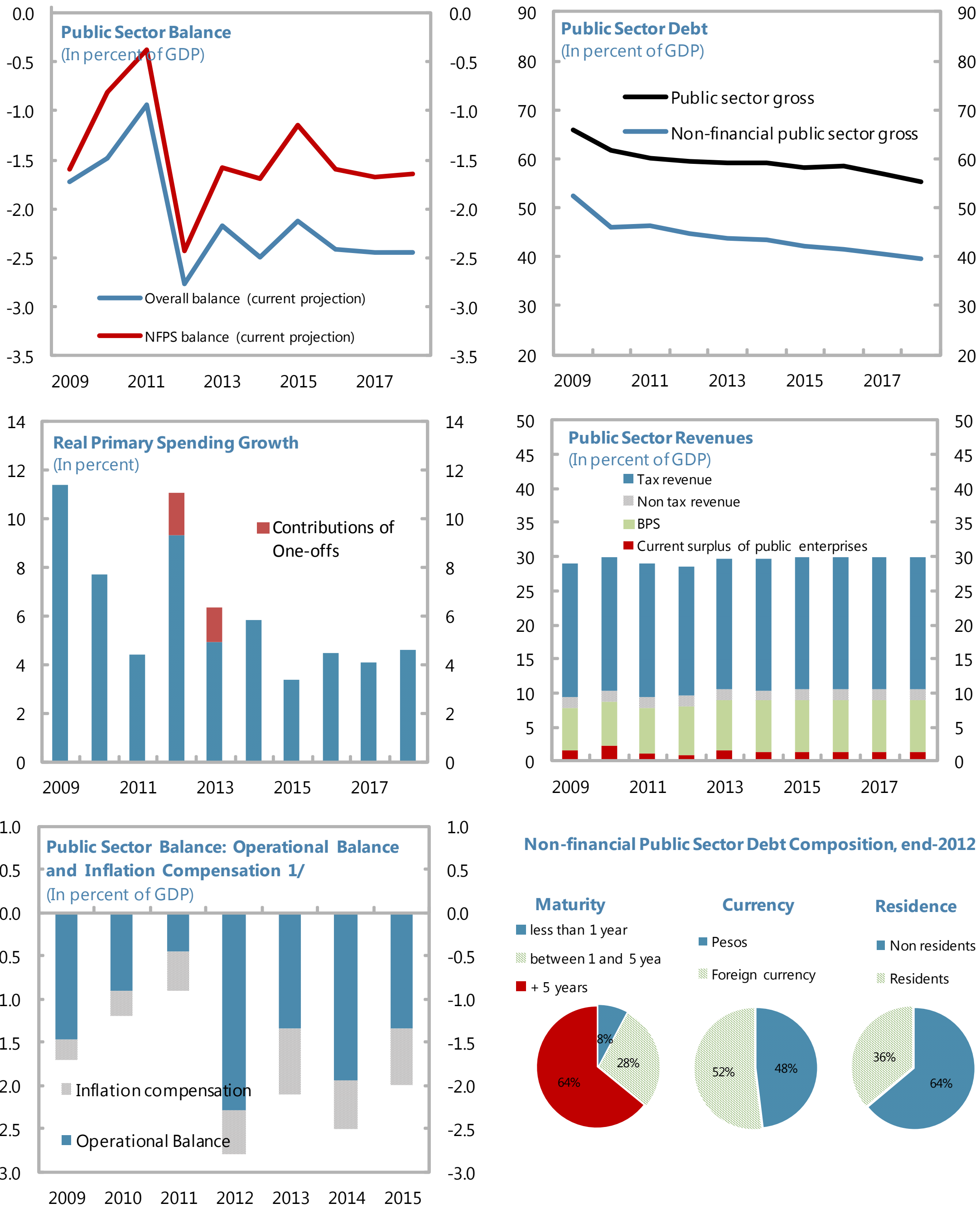
2/ LA5 includes Brazil, Chile, Colombia, Mexico, and Peru.

Figure 6. Uruguay: Monetary Developments



Sources: Banco Central del Uruguay, INE, BEVSA and Fund staff estimates and calculations.
1/ Positive values corresponds to foreign currency purchases.
2/ See details in selected issues paper "Why are inflation and inflation expectations above target in Uruguay?", IMF country report No. 13/109.
3/ The first vertical line denotes an announcement of change in the framework (May 22). The second vertical line marks the adoption of a new operational target (July 1).

Figure 7. Uruguay: Fiscal Developments and Projections



Sources: World Economic Outlook, Banco Central del Uruguay, Haver Analytics, and Fund staff calculations.
1/ Operational balance is given by the overall balance minus the estimated inflation-compensation component of the interest bill.

Table 1. Uruguay: Selected Economic Indicators

				Prel.	Projection					
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
I. Output, prices, and employment										
Real GDP (percent change)	2.2	8.9	6.5	3.9	4.0	3.5	3.3	3.5	3.8	3.9
GDP (US$ billions)	30.2	38.8	46.4	49.9	57.3	60.1	63.4	67.1	71.3	76.0
Unemployment (in percent, eop)	7.3	6.7	6.0	6.0	6.7	6.8	6.9	7.0	7.1	7.2
CPI inflation (in percent, average)	7.1	6.7	8.1	8.1	8.5	8.0	7.5	7.0	6.5	6.0
Exchange rate change (UY$/US$, average)	22.6	20.1	19.3	20.3	…	…	…	…	…	…
Real effective exchange rate (percent change, eop)	18.1	2.6	6.6	10.4	…	…	…	…	…	…
			(Percent change, unless otherwise specified)							
II. Monetary indicators 1/										
Base money	6.5	16.2	17.3	26.7	15.7	…	…	…	…	…
M-1	12.2	28.9	18.8	9.1	6.3	…	…	…	…	…
Broader M-1 (M1 plus savings deposits)	15.2	30.0	20.8	11.2	15.1	…	…	…	…	…
M-2	15.0	30.3	22.0	12.3	9.5	…	…	…	…	…
M-3	-2.6	22.1	18.0	10.0	8.6	…	…	…	…	…
Growth of credit to households (in real UY$)	-20.5	15.8	2.1	7.3	8.0	…	…	…	…	…
Growth of credit to firms (in US$)	3.4	18.8	26.5	17.5	18.3	…	…	…	…	…
Non-performing loan ratio	1.2	1.0	1.3	1.5	1.4	…	…	…	…	…
Bank assets (in percent of GDP)	55.6	58.2	61.2	58.6	60.4	…	…	…	…	…
Foreign bank market share (in percent of total loans)	53.7	54.1	56.0	56.6	57.8	…	…	…	…	…
			(Percent of GDP, unless otherwise specified)							
III. Public sector operations										
Revenue 2/	29.0	29.8	29.0	28.5	29.8	29.7	29.9	29.9	29.8	29.9
Non-interest expenditure 2/	28.2	28.5	27.2	28.7	29.2	29.5	29.3	29.3	29.3	29.3
Wage bill	5.2	5.0	5.0	5.1	5.1	5.2	5.2	5.2	5.2	5.2
Primary balance 3/	1.2	1.6	2.0	-0.2	0.8	0.3	0.6	0.6	0.6	0.6
Interest 3/	2.9	3.1	2.9	2.6	3.0	2.8	2.8	3.0	3.0	3.0
Overall balance 3/	-1.7	-1.5	-0.9	-2.8	-2.2	-2.5	-2.1	-2.4	-2.4	-2.4
Gross public sector debt	66.1	61.6	60.0	59.6	58.6	58.9	58.4	59.9	59.8	59.7
Foreign currency debt	42.5	34.1	28.8	25.4	24.4	24.6	24.1	23.9	23.1	22.6
Public sector debt net of liquid financial assets 4/	44.4	38.9	37.4	37.2	36.6	37.1	37.0	38.5	38.4	38.3
			(Percent of GDP, unless otherwise specified)							
IV. External indicators	46.5	37.2	32.4	35.5	32.1	32.0	32.3	32.6	32.5	33.2
Merchandise exports, fob (US$ millions)	6,392	8,031	9,274	9,890	10,533	11,679	12,242	13,011	13,863	14,787
Merchandise imports, fob (US$ millions)	6,896	8,558	10,704	12,258	11,693	12,481	13,137	13,995	15,063	16,311
Terms of trade (percent change)	6.6	-3.1	0.0	6.3	1.5	0.1	2.2	2.1	1.9	1.6
Current account balance	-1.3	-1.9	-3.0	-5.4	-4.9	-3.7	-3.1	-3.3	-3.3	-3.4
Foreign direct investment	5.1	5.9	5.4	5.6	5.3	4.5	4.4	4.4	4.4	4.3
Overall balance of payments (US$ millions)	1,588	-361	2,564	3,287	2,267	844	873	713	529	487
External debt 5/	46.5	37.2	32.4	35.5	32.1	32.0	32.3	32.6	32.5	33.2
Of which: external public debt	37.8	34.0	32.0	31.9	30.3	30.1	30.4	30.8	30.7	31.4
External debt service (in percent of exports of g&s)	23.9	29.9	21.5	15.2	27.8	18.8	15.5	15.3	16.4	15.8
Gross official reserves (US$ millions)	8,040	7,655	10,302	13,604	15,871	16,715	17,588	18,301	18,830	19,317
In months of imports of goods and services	9.6	7.2	8.5	11.0	12.0	12.0	12.0	12.0	12.0	12.0
In percent of:										
Short-term external (STE) debt	159.2	139.0	212.6	214.9	246.1	229.5	232.6	237.2	225.9	223.0
STE debt plus banks' non-resident deposits	89.9	80.9	126.2	140.0	129.1	127.3	131.2	134.9	132.8	133.1

Sources: Banco Central del Uruguay, Ministerio de Economia y Finanzas, Instituto Nacional de Estadistica, and Fund staff calculations.

1/ Percent change of end-of-year data on one year ago. For 2013, latest available data.

2/ Non-financial public sector excluding local governments.

3/ Total public sector. Includes the non-financial public sector, local governments, Banco Central del Uruguay, and Banco de Seguros del Estado.

4/ Gross debt of the public sector net of liquid financial assets. Liquid financial assets are given by deducting from total public sector assets the part of central bank reserves held as a counterpart to required reserves on foreign currency deposits and the domestic currency claims of the non-financial public sector on resident financial institutions.

5/ Does not include nonresident deposits.

Table 2. Uruguay: Main Fiscal Aggregates

	2009	2010	2011	Prel. 2012	Projection 2013	2014	2015
	(In millions of pesos, unless otherwise indicated)						
I. Primary balance of the non-financial public sector (IA+IB+IC)	**8,722**	**12,918**	**18,594**	**-1,222**	**10,678**	**5,342**	**11,118**
I.A. Primary balance of central government, BPS and NFPE 1/ 2/	5,487	10,237	16,066	-2,416	7,245	2,705	8,183
Revenues	197,881	232,512	260,184	288,613	342,316	379,302	424,426
Taxes	134,055	152,175	174,974	191,253	219,901	245,757	273,322
Non tax	10,820	12,449	15,473	16,238	18,383	20,446	22,753
Social security	42,922	49,742	59,930	72,601	84,788	95,146	107,893
NFPE operating balance 2/	10,084	18,146	9,807	8,520	19,243	17,953	20,457
Primary expenditures	192,394	222,275	244,118	291,029	335,071	376,598	416,242
Current	168,187	193,662	219,487	261,902	298,824	337,023	375,044
Capital	24,208	28,612	24,631	29,126	36,247	39,575	41,198
I.B. Primary balance of local governments	2,132	-167	929	-774	877	1,248	1,388
I.C. Primary balance of BSE 3/	1,103	2,848	1,599	1,968	2,556	1,389	1,546
II. Primary balance of the BCU 4/	-653	-694	-783	-450	-1,510	-1,915	-2,131
III. Primary balance of the public sector (I+II)	**8,069**	**12,224**	**17,811**	**-1,672**	**9,168**	**3,427**	**8,987**
IV. Interest	19,850	23,804	26,186	26,369	34,129	35,351	39,125
of which: BCU 4/	264	4,520	4,219	2,994	5,396	8,382	11,810
V. Overall balance of the public sector (III-IV)	**-11,781**	**-11,580**	**-8,375**	**-28,042**	**-24,960**	**-31,925**	**-30,138**
	(In percent of GDP, unless otherwise indicated)						
I. Primary balance of the non-financial public sector (IA+IB+IC)	**1.3**	**1.7**	**2.1**	**-0.1**	**0.9**	**0.4**	**0.8**
IA. Primary balance of central government, BPS and NFPE 1/ 2/	0.8	1.3	1.8	-0.2	0.6	0.2	0.6
Revenues	29.0	29.8	29.0	28.5	29.8	29.7	29.9
Taxes	19.6	19.5	19.5	18.9	19.2	19.3	19.2
Non tax	1.6	1.6	1.7	1.6	1.6	1.6	1.6
Social security	6.3	6.4	6.7	7.2	7.4	7.5	7.6
NFPE operating balance 2/	1.5	2.3	1.1	0.8	1.7	1.4	1.4
Primary expenditures	**28.2**	**28.5**	**27.2**	**28.7**	**29.2**	**29.5**	**29.3**
Current	24.7	24.9	24.5	25.8	26.0	26.4	26.4
Capital	3.5	3.7	2.7	2.9	3.2	3.1	2.9
IB. Primary balance of local governments	0.3	0.0	0.1	-0.1	0.1	0.1	0.1
IC. Primary balance of BSE 3/	0.2	0.4	0.2	0.2	0.2	0.1	0.1
II. Primary balance of BCU 4/	-0.1	-0.1	-0.1	0.0	-0.1	-0.2	-0.2
III. Primary balance of the public sector (I+II)	**1.2**	**1.6**	**2.0**	**-0.2**	**0.8**	**0.3**	**0.6**
IV. Interest	2.9	3.1	2.9	2.6	3.0	2.8	2.8
Of which: BCU 4/	0.0	0.6	0.5	0.3	0.5	0.7	0.8
V. Overall balance of the public sector (III-IV)	**-1.7**	**-1.5**	**-0.9**	**-2.8**	**-2.2**	**-2.5**	**-2.1**
Memorandum items							
GDP (in millions of pesos)	682,216	779,226	896,849	1,013,878	1,147,792	1,276,602	1,420,623

Sources: Ministerio de Economia y Finanzas, Banco Central del Uruguay, and Fund staff calculations.
1/ Banco de Prevision Social (BPS).
2/ Non-financial public enterprises (NFPE).
3/ Banco de Seguros del Estado (BSE).
4/ Banco Central del Uruguay (BCU).

Table 3. Uruguay: Public Sector Debt and Assets 1/

	2009	2010	2011	Prel. 2012	Projection 2013	2014	2015
	(In millions of U.S. dollars, unless otherwise indicated)						
Gross debt of the public sector	22,960	23,882	27,040	31,134	32,664	34,479	36,026
of which:							
Non-financial public sector debt	18,254	17,814	20,825	23,465	24,995	26,810	28,357
Central bank debt	4,706	6,068	6,214	7,669	7,669	7,669	7,669
External debt of the public sector	13,117	13,182	14,436	16,649	16,879	17,627	18,788
Domestic debt of the public sector	9,843	10,700	12,604	14,485	15,786	16,852	17,238
Foreign-currency debt of the public sector	14,759	13,216	12,965	13,291	13,643	14,385	14,887
Short-term debt of the public sector (by remaining maturity)	3,514	4,530	4,624	6,113	6,231	6,338	6,443
Gross assets of the public sector	11,779	11,584	13,872	17,457	18,386	19,181	20,006
of which:							
Financial assets of the non-financial public sector	2,838	2,902	2,693	3,049	3,211	3,350	3,494
Reserve assets of the central bank	8,941	8,682	11,180	14,408	15,175	15,831	16,513
Liquid assets of the public sector 2/	7,541	8,793	10,177	11,708	12,247	12,743	13,216
Net public sector debt	11,181	12,298	13,168	13,677	14,278	15,298	16,020
Net public sector debt based on liquid financial assets	15,419	15,089	16,863	19,426	20,417	21,736	22,810
	(In percent of GDP, unless otherwise indicated) 1/						
Gross debt of the public sector	66.1	61.6	60.0	59.6	58.5	58.9	58.4
of which:							
Non-financial public sector debt	52.5	46.0	46.2	44.9	44.8	45.8	45.9
Central bank debt	13.5	15.7	13.8	14.7	13.7	13.1	12.4
External debt of the public sector	37.8	34.0	32.0	31.9	30.2	30.1	30.4
Domestic debt of the public sector	28.3	27.6	28.0	27.7	28.3	28.8	27.9
Foreign-currency debt of the public sector	42.5	34.1	28.8	25.4	24.4	24.6	24.1
Short-term debt of the public sector (by remaining maturity)	10.1	11.7	10.3	11.7	11.2	10.8	10.4
Gross assets of the public sector	33.9	29.9	30.8	33.4	32.9	32.8	32.4
of which:							
Financial assets of the non-financial public sector	8.2	7.5	6.0	5.8	5.8	5.7	5.7
Liquid assets of the public sector 2/	21.7	22.7	22.6	22.4	21.9	21.8	21.4
Net public sector debt	32.2	31.7	29.2	26.2	25.6	26.1	26.0
Net public sector debt based on liquid financial assets	44.4	38.9	37.4	37.2	36.6	37.1	37.0

Sources: Ministerio de Economia y Finanzas, Banco Central del Uruguay, and Fund staff calculations.

1/ Stocks are converted into pesos using the end of period exchange rate and divided by GDP.

2/ Liquid financial assets are given by deducting from total public sector assets the part of central bank reserves held as a counterpart to required reserves on foreign currency deposits and the domestic currency claims of the non-financial public sector on resident financial institutions.

Table 4. Uruguay: Statement of Operations of the Central Government 1/ 2/

(Percentages of GDP, based on the 2001 GFS Manual)

	2007	2008	2009	2010	2011	2012
Revenue	**26.5**	**26.5**	**30.6**	**31.0**	**31.0**	**30.8**
Taxes	18.4	18.2	19.6	19.6	19.7	19.3
Social contributions	5.5	5.8	9.1	9.2	9.4	9.9
Grants	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	2.6	2.4	1.9	2.2	1.9	1.5
Expense	**26.5**	**25.6**	**30.5**	**30.5**	**30.1**	**31.4**
Compensation of employees	6.0	6.1	7.5	7.0	7.1	7.3
Use of goods and services	4.1	3.8	3.8	3.8	3.5	3.6
Consumption of fixed capital 3/	….	….	….	….	….	….
Interest	3.8	2.9	2.9	2.5	2.5	2.4
Subsidies	2.7	2.6	0.4	0.2	0.2	0.3
Grants	0.0	0.0	0.7	0.0	0.0	0.0
Social benefits	9.9	10.3	13.3	13.9	13.9	14.6
Other expenses	0.0	0.0	2.0	3.0	2.8	3.2
Net acquisition of nonfinancial assets	**1.6**	**1.8**	**1.6**	**1.4**	**0.9**	**-0.6**
Acquisitions of nonfinancial assets 3/	….	….	….	….	….	….
Disposals of nonfinancial assets 3/	….	….	….	….	….	….
Consumption of fixed capital 3/	….	….	….	….	….	….
Gross operating balance	0.0	0.9	0.1	0.5	0.9	-0.6
Net operating balance 4/	….	….	….	….	….	….
Net lending (+) borrowing (-)	**-1.5**	**-0.9**	**-1.5**	**-0.9**	**-0.6**	**-2.1**
Net acquisition of financial assets	**2.4**	**-0.9**	**4.7**	**-2.4**	**3.6**	**0.7**
By instrument						
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	2.7	-1.2	2.0	-2.2	3.3	0.2
Debt securities	0.0	0.0	2.0	0.1	0.4	0.0
Loans	-0.3	0.3	0.1	-0.4	-0.1	0.4
Equity and shares	0.0	0.0	0.7	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.0	0.0	0.0	0.0	0.0	0.0
By residency						
Domestic	2.4	-0.9	4.7	-2.4	3.3	0.3
External	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	3.9	0.2	6.4	-1.2	4.2	2.8
By instrument						
SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	4.0	-0.9	1.5	-0.1	4.8	2.2
Loans	0.0	1.1	4.9	-1.2	-0.6	0.5
Equity and shares	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.0	0.0	0.0	0.0	0.0	0.0
By residency						
Domestic	-0.4	1.5	3.9	-0.8	4.4	0.6
External	4.4	-1.3	2.5	-0.4	-0.2	2.1
Memorandum items						
Public sector net lending (+) borrowing (-)	0.0	-1.6	-1.7	-1.5	-0.9	-2.8
Public sector primary balance	3.6	1.4	1.2	1.6	2.0	-0.2

Sources: Banco Central del Uruguay, and Fund staff calculations.
1/ Central government and Social Security Bank. Collection of above the line data for municipalities is not feasible at this moment.
2/ Preliminary data. Authorities are in the process of revising historical data in the context of their work to improve reporting under the 2001 GFS framework.
3/ Not compiled by the authorities.
4/ Not available.

Table 5. Uruguay: Central Government Stock Positions

(Percentages of GDP, based on the 2001 GFS Manual)

	2007	2008	2009	2010	2011	2012
Stock positions						
Net financial worth	**-47.2**	**-47.9**	**-40.1**	**-36.9**	**-36.1**	**-34.4**
Financial assets	**11.3**	**9.3**	**11.5**	**9.0**	**10.7**	**10.1**
By instrument						
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	8.3	6.8	7.2	4.5	7.0	6.7
Debt securities	0.0	0.0	1.6	2.1	2.5	2.5
Loans	3.0	2.5	1.9	1.7	0.6	0.5
Equity and shares	0.0	0.0	0.7	0.6	0.5	0.4
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.0	0.0	0.0	0.0	0.0	0.0
By residency						
Domestic	11.3	9.3	11.5	8.9	10.7	10.1
External	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	**58.5**	**57.3**	**51.6**	**45.9**	**46.8**	**44.6**
By instrument						
SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	45.0	42.8	36.9	33.7	35.8	35.3
Loans	13.5	14.4	14.7	12.1	11.1	9.3
Equity and shares	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.0	0.0	0.0	0.0	0.0	0.0
By residency						
Domestic	19.6	20.7	21.0	18.5	21.7	19.9
External	38.9	36.5	30.6	27.3	25.1	22.2

Sources: Banco Central del Uruguay, and Fund staff calculations.

Table 6. Uruguay: Summary Accounts of the Banking System

(End of period, in billions of pesos)

	2009	2010	2011	2012	2013 1/
	I. Banco Central del Uruguay (BCU)				
Net foreign assets	**161.6**	**153.9**	**205.4**	**254.4**	**292.6**
Net international reserves 2/	157.8	153.8	205.0	263.9	305.4
Other net foreign assets	3.8	0.1	0.4	-9.5	-12.8
Net domestic assets	**-101.3**	**-86.5**	**-123.7**	**-155.0**	**-184.0**
Net credit to the public sector	19.4	51.0	22.2	43.0	61.1
Net credit to the financial system	-52.9	-35.7	-51.8	-82.5	-110.3
Credit to the private sector	0.3	0.3	0.3	0.3	0.3
Securities issued by the BCU	-87.0	-123.3	-120.5	-155.2	-183.8
Other	18.9	21.1	26.1	39.4	48.7
Peso monetary liabilities 3/	**60.3**	**67.4**	**81.7**	**99.4**	**108.6**
	II. Public and private banks 4/				
Net foreign assets	**54.8**	**98.6**	**94.8**	**70.9**	**75.4**
Net domestic assets	**214.4**	**224.3**	**287.3**	**346.2**	**401.0**
Net credit to the public sector	24.0	11.1	25.8	25.1	22.6
Net credit to the financial system	100.7	94.0	110.8	148.6	179.6
Credit to the private sector	146.3	179.8	213.4	243.9	275.1
Other	-56.6	-60.6	-62.7	-71.4	-76.2
Liabilities to the private sector (residents)	**269.1**	**322.8**	**382.1**	**417.1**	**476.4**
Public banks	137.0	160.8	191.6	213.6	238.5
Local currency	46.2	56.3	70.5	82.0	88.3
Foreign currency	90.9	104.5	121.1	131.6	150.2
Private banks	132.1	162.0	190.5	203.5	237.9
Local currency	35.5	46.9	57.2	59.1	66.1
Foreign currency	96.6	115.1	133.3	144.4	171.8
	III. Banking system (central, private, and public banks)				
Net foreign assets	**216.3**	**252.5**	**300.2**	**325.3**	**367.9**
Net domestic assets	**62.8**	**88.5**	**102.1**	**117.1**	**130.7**
Credit to the public sector	43.4	62.1	48.0	68.1	83.7
Credit to the rest of financial system	-2.5	9.1	-2.4	-8.1	-17.0
Credit to the private sector	146.6	180.1	213.7	244.2	275.4
Other	-124.7	-162.8	-157.1	-187.2	-211.3
Broad money (M-3)	**279.2**	**341.0**	**402.4**	**442.4**	**498.6**
	(Percentage change) 5/				
Memorandum items: 5/					
Base money	6.5	16.2	17.3	26.7	15.7
M-1	12.2	28.9	18.8	9.1	1.2
Broader M-1 (M1 plus savings deposits)	15.2	30.0	20.8	11.2	15.1
M-2	15.0	30.3	22.0	12.3	4.6
M-3	-2.6	22.1	18.0	10.0	16.4
Credit to households (in real UY$)	-20.5	15.8	2.1	7.3	8.0
Credit to firms (in US$)	3.4	18.8	26.5	17.5	18.3

Source: Banco Central del Uruguay.
1/ Latest available data (June 2013).
2/ Includes all outstanding liabilities to the IMF, but excludes liabilities to resident financial institutions.
3/ Peso monetary liabilities includes base money and non-liquid liabilities.
4/ The Banco de la Republica Oriental de Uruguay (BROU), Banco Hipotecario de Uruguay (BHU; mortgage institution), private banks, casas financieras and cooperatives.
5/ Percent change of end-of-year data on one year ago. For 2013, latest available data. In pesos, unless indicated otherwise.

Table 7. Uruguay: Balance of Payments and External Sector Indicators

(In millions of U.S. dollars, unless otherwise indicated)

					Prel.	Projection					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Balance of payments						
Current account	**-1,729**	**-382**	**-731**	**-1,371**	**-2,690**	**-2,835**	**-2,200**	**-1,958**	**-2,190**	**-2,364**	**-2,605**
Trade balance	-1,714	-504	-527	-1,431	-2,369	-1,160	-803	-895	-984	-1,200	-1,524
Exports, f.o.b.	7,095	6,392	8,031	9,274	9,890	10,533	11,679	12,242	13,011	13,863	14,787
Imports, f.o.b.	8,810	6,896	8,558	10,704	12,258	11,693	12,481	13,137	13,995	15,063	16,311
Of which: Fuel products	2,504	1,354	1,593	2,011	2,851	2,135	2,576	2,623	2,730	2,896	3,112
Of which: Non-fuel products	6,306	5,542	6,965	8,693	9,407	9,559	9,906	10,514	11,266	12,167	13,199
Services	753	1,025	1,157	1,519	1,032	-97	122	279	398	534	769
Exports, f.o.b.	2,277	2,319	2,688	3,594	3,392	3,030	3,466	3,912	4,364	4,890	5,570
Imports, f.o.b.	1,523	1,295	1,531	2,075	2,360	3,127	3,345	3,633	3,966	4,356	4,801
Income (net)	-917	-1,041	-1,501	-1,614	-1,469	-1,696	-1,639	-1,466	-1,731	-1,829	-1,985
Transfers (net)	148	138	140	154	116	117	120	124	127	131	135
Financial and capital account	**3,098**	**1,184**	**1,057**	**4,196**	**6,460**	**5,102**	**3,044**	**2,831**	**2,903**	**2,893**	**3,092**
Foreign direct investment	2,106	1,529	2,289	2,498	2,776	3,023	2,682	2,818	2,964	3,116	3,271
Portfolio investment	-558	-821	-683	1,977	1,642	1,105	1,898	1,770	1,762	2,039	2,097
Other capital flows (net)	992	493	-609	-285	2,004	975	-1,534	-1,753	-1,820	-2,259	-2,273
Unidentified financing	11	-16	60	7	38	-2	-2	-2	-3	-3	-3
Errors and omissions	864	786	-687	-261	-482	0	0	0	0	0	0
Reserve assets (- increase)	**-2,232**	**-1,588**	**361**	**-2,564**	**-3,287**	**-2,267**	**-844**	**-873**	**-713**	**-529**	**-487**
					Reserve adequacy and external indicators						
Gross official reserves (stock)	**6,362**	**8,040**	**7,655**	**10,302**	**13,604**	**15,871**	**16,715**	**17,588**	**18,301**	**18,830**	**19,317**
In months of imports of goods and services	9.3	9.6	7.2	8.5	11.0	12.0	12.0	12.0	12.0	12.0	12.0
In percent of short-term debt	151.4	159.2	139.0	212.6	214.9	246.1	229.5	232.6	237.2	225.9	223.0
					(As percent of GDP)						
Exports of goods	23.4	21.1	20.7	20.0	19.8	18.4	19.4	19.3	19.4	19.4	19.5
Imports of goods	29.0	22.8	22.0	23.1	24.6	20.4	20.8	20.7	20.9	21.1	21.5
Of which: Fuel products	8.2	4.5	4.1	4.3	5.7	3.7	4.3	4.1	4.1	4.1	4.1
Of which: Non-fuel products	20.8	18.3	17.9	18.7	18.8	16.7	16.5	16.6	16.8	17.1	17.4
Goods balance	-5.6	-1.7	-1.4	-3.1	-4.7	-2.0	-1.3	-1.4	-1.5	-1.7	-2.0
Non-goods balance	0.0	0.4	-0.5	0.1	-0.6	-2.9	-2.3	-1.7	-1.8	-1.6	-1.4
Current account	-5.7	-1.3	-1.9	-3.0	-5.4	-4.9	-3.7	-3.1	-3.3	-3.3	-3.4
Financial and capital account	10.2	3.9	2.7	9.0	12.9	8.9	5.1	4.5	4.3	4.1	4.1
Of which: Foreign direct investment (net)	6.9	5.1	5.9	5.4	5.6	5.3	4.5	4.4	4.4	4.4	4.3
Other capital flows (net)	5.1	1.6	-1.6	-0.6	4.0	1.7	-2.6	-2.8	-2.7	-3.2	-3.0
Changes in gross international reserves	-7.4	-5.3	0.9	-5.5	-6.6	-4.0	-1.4	-1.4	-1.1	-0.7	-0.6
Total external debt	39.5	46.5	37.2	32.4	35.5	32.1	32.0	32.3	32.6	32.5	33.2
Short-term debt (residual maturity)	13.8	16.7	14.2	10.4	12.7	11.3	12.1	11.9	11.5	11.7	11.4
External public debt	42.4	37.8	34.0	32.0	31.9	30.3	30.1	30.4	30.8	30.7	31.4
Total external debt + non-resident deposits	50.7	59.4	47.4	39.5	42.3	42.3	41.7	41.5	41.3	40.7	40.9
					(As percent of annual exports of goods and services)						
Total external debt	128.1	161.4	134.9	116.7	133.5	134.3	124.5	123.1	120.3	116.1	114.3
Total external debt (including nonresidential deposits)	164.3	206.1	171.9	142.5	159.0	177.5	163.1	159.3	154.0	147.3	143.0
Debt service	21.7	23.9	29.9	21.5	15.2	27.8	18.8	15.5	15.3	16.4	15.8
Of which: interest payments	8.9	9.2	7.7	6.7	5.4	6.5	5.1	3.4	4.4	4.2	4.3
					(Annual percent changes)						
Exports of goods in US$ (merchandise)	39.1	-9.9	25.6	15.5	6.6	6.5	10.9	4.8	6.3	6.5	6.7
Imports of goods in US$ (merchandise)	56.1	-21.7	24.1	25.1	14.5	-4.6	6.7	5.3	6.5	7.6	8.3
Export prices in US$	14.7	-8.5	7.5	12.7	4.4	-0.6	-1.9	-0.5	0.7	0.9	1.0
Import prices in US$	17.9	-16.1	11.8	13.3	-2.5	0.1	-0.3	-1.6	-0.7	-0.2	0.1
Terms of trade	-1.2	6.6	-3.1	0.0	6.3	1.5	0.1	2.2	2.1	1.9	1.6
Export volume	10.1	2.5	14.2	6.5	-1.1	0.2	11.3	5.2	5.5	5.6	6.3
Import volume	22.7	-6.8	10.8	12.5	16.4	1.0	6.6	6.9	7.3	7.8	8.1
Of which: Fuel products	59.9	-15.1	-8.1	-4.1	40.4	-24.8	24.4	8.3	8.8	9.4	9.8
Of which: Non-fuel products	40.0	-4.4	16.1	20.7	12.3	10.6	5.0	6.6	7.0	7.5	7.8

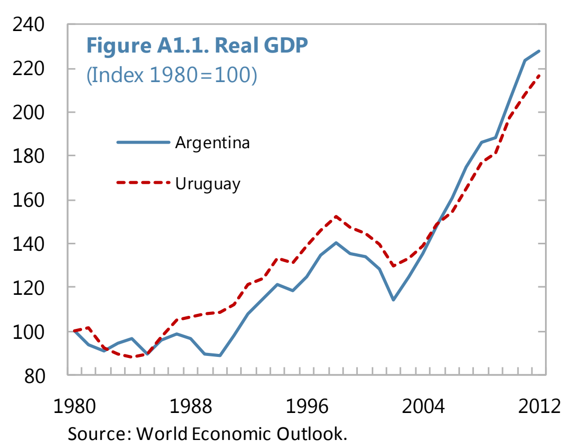
Sources: Banco Central del Uruguay and Fund staff calculations and projections.

Annex I. Is the Uruguayan Economy Decoupling from its Neighbors? An Empirical Analysis of Inward Spillovers to Uruguay[1]

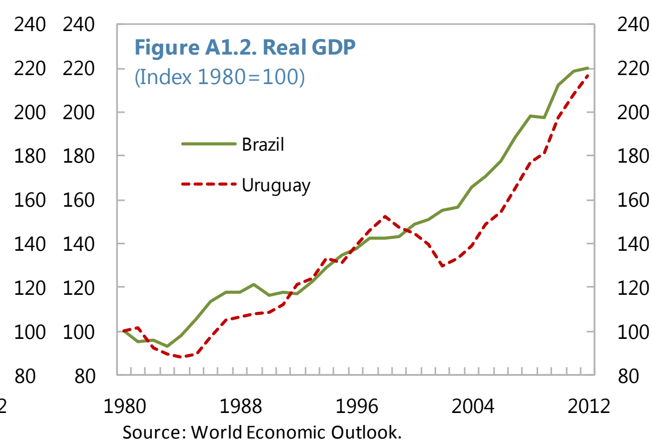
Uruguay is a small open economy vulnerable to inward spillovers through trade, tourism, and investment flows. The economy is integrated significantly with its two large neighbors, Argentina and Brazil, and its economic cycle has historically been highly synchronized especially with that of Argentina. While trade and financial linkages with Argentina has been diminishing in recent years, Brazil has remained Uruguay's main export destination in the past decade. In the meantime, China has become an important source of demand for Uruguay's exports. Uruguay maintained a robust growth in 2012, in contrast to the notable deceleration in its neighbors Argentina and Brazil, which may suggest a moderating impact of spillovers from the region and the growing importance of other factors. Against this backdrop, this annex documents Uruguay's external linkages and estimates the sensitivity of its GDP growth to external factors.

Uruguay's External Linkages

Uruguay's economic activity has historically been highly correlated with the two large regional economies, especially Argentina, and to a lesser extent, Brazil (Figures A1.1 and A1.2). The main linkages that tie these economies are trade in goods, and services and investment flows (mostly FDI). Financial linkages, primarily in the form of foreign currency deposits in the Uruguayan banking sector, were significant prior to the Argentinean crisis in 2001. However, its importance has declined since then.



Source: World Economic Outlook.



Source: World Economic Outlook.

[1] Prepared by Sumiko Ogawa, with inputs by Garth P. Nicholls.

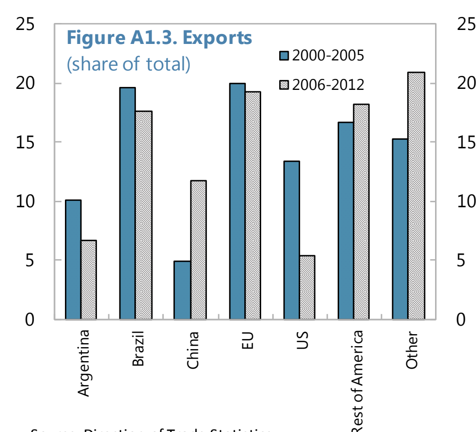
Table A1.1. Uruguay's External Linkages
(in percent of total)

	Goods exports	Goods imports	Tourism revenues	Tourism spending	FDI 1/
Argentina	5.8	15.0	59.1	55.7	29.1
Brazil	19.3	18.0	20.1	8.8	5.8
China	9.2	14.3	...	...	...
EU	14.9	11.0	7.7	12.4	13.4
USA	3.6	7.5	6.6	9.2	0.1
Other	47.2	34.2	6.5	14.0	51.6
Total (US$ millions)	9907	12217	2076	878	2505
In percent of GDP	19.8	24.5	4.2	1.8	5.0

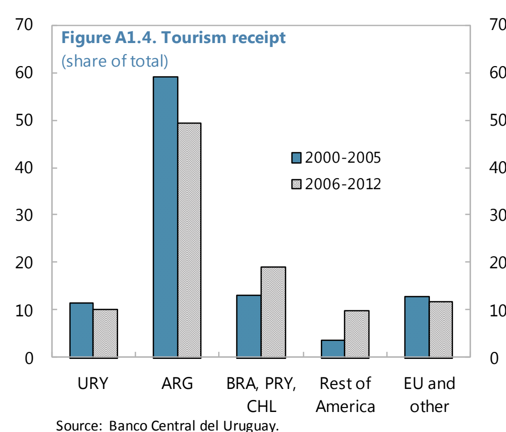
Source: Banco Central del Uruguay.
1/ Data for 2011.

Trade in Goods

Uruguay's exports (20 percent of GDP in 2012) are fairly concentrated in both products and markets. Brazil and Argentina account for roughly 25 percent of total exports, having declined from over 40 percent on average during 1990s, and the EU continues to account for about 20 percent. China and the rest of Americas are becoming increasingly important export markets, with 10.8 percent and 17.8 percent shares of total exports on average during 2005–12 (5.5 percent and 14.3 percent in 1996–2004, respectively).



Food remains the most important product (accounting for about 48 percent of total exports in 2012), while the export of crude materials- mainly soy beans - increased significantly over the last ten years (23 percent of total exports in 2012 from 5 percent in 2000) as China emerged as an important export market. Brazil and Argentina are particularly important as export markets for manufactured goods, machinery and transport equipment, mineral fuels and chemical products (see Tables A1.2A and A1.2B).



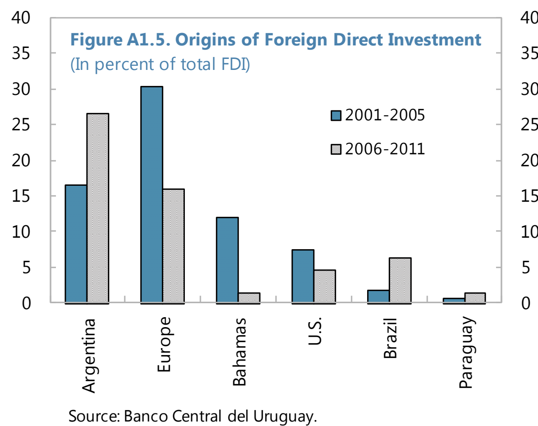
Tourism

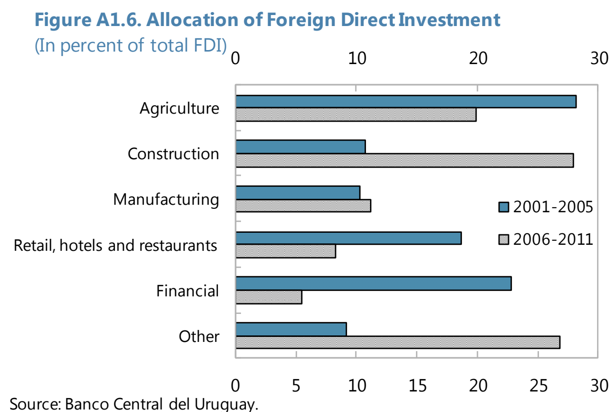
Argentina is by far the main source of tourism revenues, contributing 54.8 percent of tourist arrivals and 49.4 percent of tourism receipts on average during 2006–12. Brazil, Paraguay, and Chile combined are the second largest source of

tourism market, followed closely by non-resident Uruguayans travelling to the country. Uruguay is a net exporter of tourism services, with tourism receipts (4.2 percent of GDP in 2012) more than twice the tourism spending (1.8 percent of GDP, more than half to Argentina).

Foreign Direct Investment (FDI)

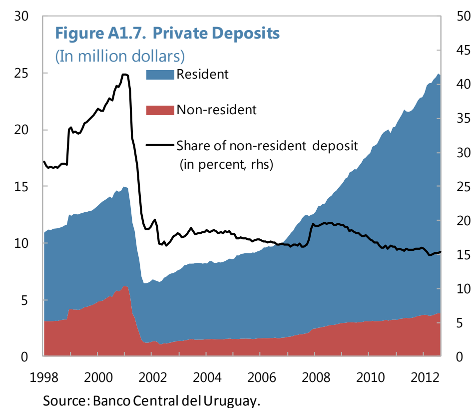
FDI increased significantly over the last ten years, from 1.4 percent of GDP in 2001 to the peak of 7.6 percent in 2006 before moderating to 5.4 percent in 2011. Argentina and Europe are the main sources of foreign direct investment in Uruguay. Argentina has increased in its importance as a source of FDI in the recent years, while Europe's share dropped in the last two years. The sectoral allocation of FDI shifted in important ways in the recent years; in particular, FDI in the financial sector declined to less than 10 percent of total in 2010–11 from about 40 percent in 2001–02. At the same time, FDI in the agriculture and construction sectors rose to about 15 percent and 25 percent of total FDI, respectively.





Non-Resident Deposits

Private sector deposits in the banking system have gone through an important change following the Argentinean crisis. Non-resident foreign currency deposits drove the growth of private deposits prior to 2002, with its share of total deposits rising to over 40 percent at the peak (or 45 percent of GDP). Non-resident deposits noted a more than 80 percent decline in nominal value from the peak in late 2001 to trough in early 2003, and their share dropped to around 16 percent of total deposits (or about 7 percent of GDP at end-2012).



Inward Spillovers

This section updates the analysis in SM/12/285 to assess the impact of spillovers to the Uruguayan economy from various external factors.[2] The approach draws on Sosa (2006) and Adler and Sosa (2012), and analyzes the sensitivity of Uruguay's real GDP growth to different types of shocks, such as global growth and those of regional key economies (Argentina and Brazil), terms-of-trade, and global financial conditions (real LIBOR rate). Quarterly data for 1990Q1 to 2012Q4 is used for the analysis. Uruguay's export and import price indices are used instead of broader global commodity price indices as in earlier works, to better capture international price shocks specific to key export products from Uruguay. Uruguay's export prices should also reflect better the similarities in its export basket to that of Argentina, and help to disentangle common shocks versus the direct effect of idiosyncratic shocks to Argentina. The model includes the variables in the order of most to least exogenous to Uruguay: first the global variables (output, real short-term interest rate, and export and import prices); second regional variables (Brazil and Argentina's output); and then Uruguay's GDP.

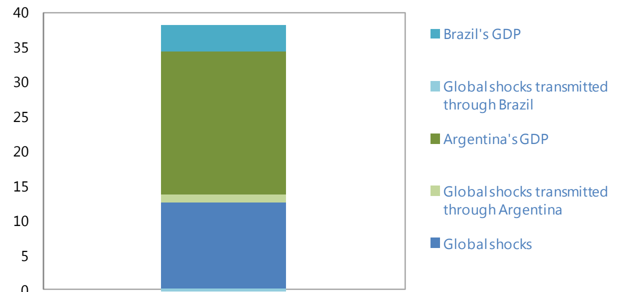
The estimated impulse responses indicate that the sensitivity of Uruguay's GDP growth to growth in Argentina remains significant, although it has diminished over time. For the overall sample period, the impact lasts for six to seven quarters, and the cumulative impact of a 1 percentage point change in Argentina's GDP growth translates into roughly 1.85 percentage points over the eight quarters. This large sensitivity is primarily due to the amplified effect in the earlier period of 1990–2003, and the elasticity declines sharply to 0.5 percentage points for the more recent period of 2004–2012, consistent with reduced financial and trade linkages after the crisis in early 2000s. Spillovers from Brazil, on the other hand, are found to be negative but largely insignificant. As Brazil's economy is much larger and more diverse, its overall GDP may not appropriately represent the shocks that are relevant to Uruguay's economy. Shocks to global GDP and export prices have positive effects on Uruguay's GDP, whereas shocks to import prices only have a minor impact. An increase in the real short-term interest rate is found to have a positive impact initially, followed by a lagged negative impact.

External factors are found to explain about 36 percent of the variation in Uruguay's GDP growth. The total share attributable to external shocks reflects the sum of the direct effects of global and regional factors, as well as the indirect effects of global shocks transmitted through Argentina and Brazil. To assess the extent to which the global shocks are transmitted through Uruguay's neighbors, the impact of the global shocks in the above baseline model is compared against those in models including Argentina and Brazil's GDP growth as exogenous variables. If the impact of global factors is larger under the baseline model compared to those alternative models, the difference can be interpreted as the indirect spillover of global shocks through these two neighboring economies (Adler and Sosa, 2012).

[2] There are a number of studies on spillovers based on vector autoregressions (VAR) approach. Dabla-Norris, Espinoza and Jahan (2012) studied the importance of dominant regional emerging market economies on low income countries; Bayoumi and Swiston (2007) analyzed the spillovers in advanced economies from the U.S., Euro area and Japan; Alturki, Espinosa-Bowen and Ilahi (2009) looked at the influence of Russia on growth in the CIS countries. For Latin America, Adler and Sosa (2012) analyzed spillovers from Brazil to South American countries through the export channel and shocks to exchange rate.

The results show that most of the external spillovers on Uruguay's GDP growth reflect direct effects rather than indirect global effects transmitted through Argentina and Brazil. In particular, the bulk of the 25 percentage point contribution by Argentina to Uruguay's fluctuations represents direct effects. For Brazil, about half of the 3 percentage point contribution represents the direct effects of Brazil-specific shocks while the other half represents the effect of global shocks transmitted through Brazil. The direct effect of global shocks accounts for 8 percentage points of the fluctuations attributable to external factors. As the share of Argentina in trade has declined over time, the importance of global factors is likely to have grown compared to the averages estimated in these regressions.

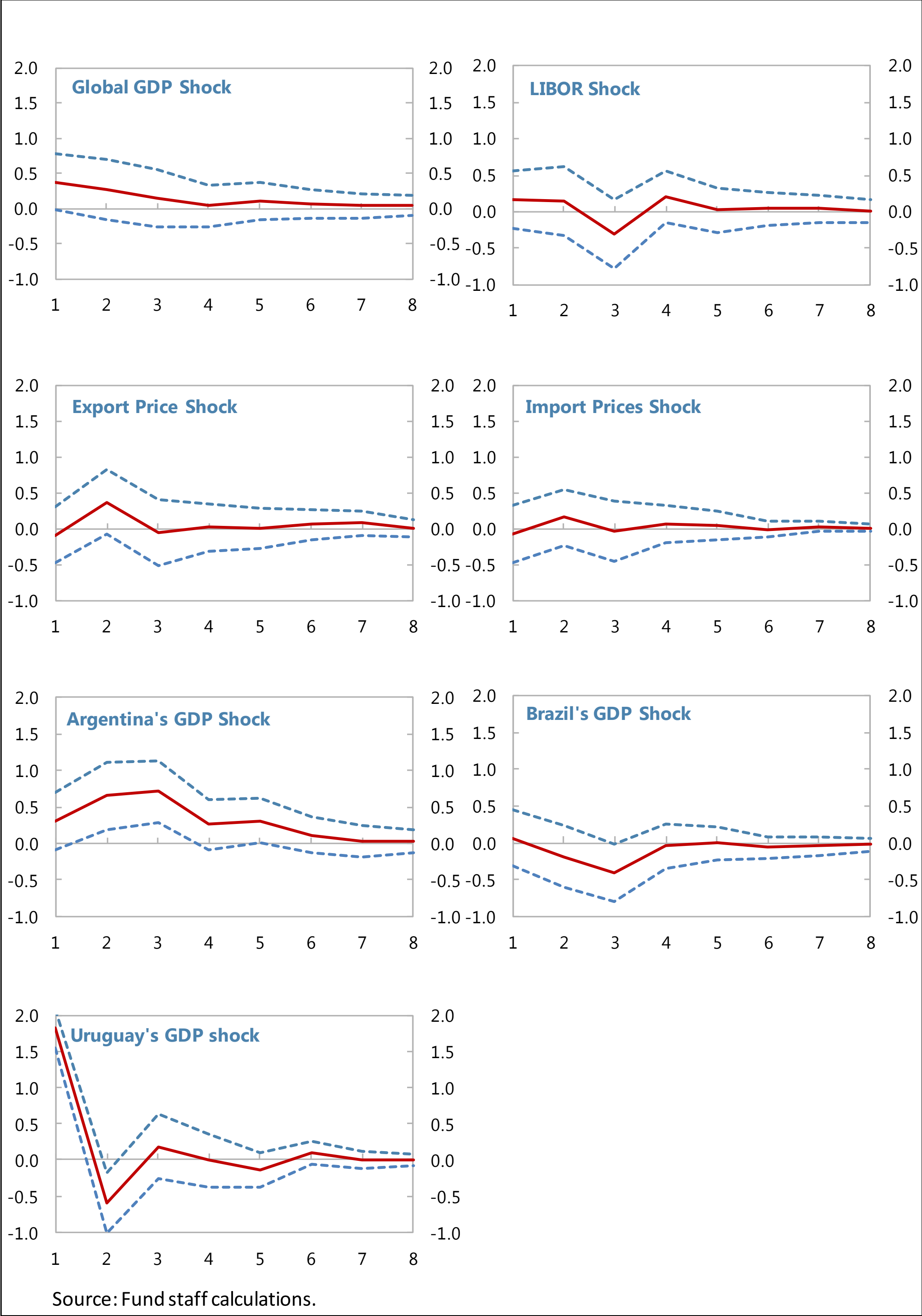
Figure A1.8. Fraction of GDP Variance Explained by External Factors
(In percent)



Source: Fund staff calculations.

Figure A1.9. Dynamic Responses of Uruguay's GDP Growth to Shocks

(Response to one standard deviation shocks +/-2 standard errors)



Source: Fund staff calculations.

Table A1.2A. Exports by Destination and Products, 2000

(In percent of total exports)

	SITC Shares in total exports	Argentina	Brazil	Chile	China	EU	Korea	Paraguay	Russia	USA	Venezuela	Other Countries
Food and Live animals (SITC 0) 1/	42.4	2.3	12.3	1.1	1.1	3.0	0.6	0.2	0.2	5.4	0.6	15.7
Beverages and Tobacco (SITC 1)	2.6	0.0	0.2	0.0	0.0	0.0	0.0	2.3	0.0	0.0	0.0	0.0
Crude Materials (SITC2) 2/	12.9	0.3	0.4	0.0	2.5	9.0	0.1	0.0	0.0	0.5	0.0	0.1
Chemicals & related products (SITC 5)	7.7	2.0	2.2	0.2	0.0	0.1	0.0	0.5	0.0	0.3	0.0	2.3
Manufactured goods classified by materials (SITC 6)	15.1	4.0	3.7	0.5	0.4	1.1	0.0	0.2	0.0	0.0	0.0	5.1
Machinery & Transport equipment (SITC 7)	8.1	5.6	2.1	0.1	0.0	0.0	0.0	0.1	0.0	0.2	0.0	0.0
Miscellaneous manufactured articles (SITC 8)	7.3	2.6	1.5	0.4	0.0	0.7	0.0	0.1	0.0	1.8	0.0	0.2
Other 3/	4.0	1.1	0.7	0.2	0.0	1.0	0.0	0.1	0.0	0.0	0.0	0.8
Memo:												
Share of exports to total exports		17.9	23.1	2.5	4.0	14.9	0.7	3.6	0.3	8.3	0.7	24.1

Sources: World Integrated Trade Solution (WITS), IMF Direction of Trade Statistics and Fund Staff calculations.

1/ SITC - standard international trade classification.

2/ Includes soybeans.

3/ Includes mineral fuels, lubricants and related matter (SITC 3), animal & vegetable oil, fats & waxes (SITC4), and other commodities, nes (SITC 9).

Table A1.2B. Exports by Destination and Products, 2012

(In percent of total exports)

	SITC Shares in total exports	Argentina	Brazil	Chile	China	EU	Korea	Paraguay	Russia	USA	Venezuela	Other Countries
Food and Live animals (SITC 0) 1/	47.7	0.5	9.7	1.8	2.1	9.4	0.6	0.1	3.6	2.3	3.1	14.6
Beverages and Tobacco (SITC 1)	0.8	0.0	0.1	0.0	0.0	0.0	0.0	0.5	0.1	0.0	0.0	0.2
Crude Materials (SITC2) 2/	24.6	0.1	0.5	0.0	14.8	2.0	0.3	0.0	0.2	0.2	0.0	6.3
Chemicals & related products (SITC 5)	6.7	1.0	3.2	0.2	0.0	0.1	0.0	0.6	0.0	0.2	0.2	1.2
Manufactured goods classified by materials (SITC 6)	8.4	1.6	2.1	0.2	0.8	2.4	0.0	0.2	0.0	0.4	0.1	0.6
Machinery & Transport equipment (SITC 7)	3.0	1.8	0.4	0.2	0.0	0.1	0.0	0.1	0.0	0.1	0.1	0.3
Miscellaneous manufactured articles (SITC 8)	4.9	1.0	2.3	0.1	0.2	0.5	0.0	0.1	0.0	0.1	0.0	0.6
Other 3/	3.9	0.2	0.5	0.0	0.0	0.1	0.0	0.3	0.0	0.2	0.0	2.6
Memo:												
Share of exports to total exports		6.2	18.7	2.5	18.0	14.6	0.9	1.8	3.9	3.5	3.5	26.4

Sources: World Integrated Trade Solution (WITS), IMF Direction of Trade Statistics and Fund staff calculations.

1/ SITC - standard international trade classification.

2/ Includes soybeans.

3/ Includes mineral fuels, lubricants and related matter (SITC 3), animal & vegetable oil, fats & waxes (SITC4) and other commodities, nes (SITC 9).

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Adler, G. and S. Sosa, 2012, "Intra-Regional Spillovers in South America: Is Brazil Systemic after All?" IMF Working Paper 12/145 (Washington: International Monetary Fund).

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Annex II. Public Sector Debt Sustainability Analysis (DSA)

In Uruguay, large public sector liquidity buffers, and the favorable maturity and currency composition of public debt, mitigate public sector financing risks. The gross debt level of Uruguay's consolidated public sector stood at 59.6 percent of GDP at the end of 2012. However, the associated macroeconomic vulnerabilities are mitigated by the high level of liquid financial assets of the public sector—22.4 percent of GDP at end-2012—as well as the high average maturity and domestic currency share of the public debt. The short-term part of the public debt primarily consists of securities issued by the central bank to manage liquidity and is more than covered by the central bank's gross international reserves.

The gross debt of the public sector has a broad institutional coverage. It includes:

- *Central government debt*, which stood at 39.5 percent of GDP at end-2012. The average maturity of central government debt is close to 12 years and about 55 percent of this debt is denominated in local-currency.
- *Central bank debt*, at 14.7 percent of GDP at end-2012. The debt of the central bank mostly consists of securities issued to manage liquidity, including for the sterilization of a strong accumulation of foreign exchange reserves in recent years. The maturity of these instruments is 2 years or less, and about 85 percent are denominated in local currency.
- *Public enterprises' debt*, which stood at 5 percent of GDP at end-2012.

The public sector has contingent credit lines of 4 percent of GDP (see Box 4) and had total gross financial assets of 33 percent of GDP at end-2012:

- *The gross foreign reserve assets of the central bank* reached 27.6 percent of GDP at end-2012.
- *The financial assets of the non-financial public sector* amounted to 5.8 percent of GDP at end-2012. Most of these holdings reflect the pre-financing of the central government's debt service needs through end-2014.
- *The stock of liquid foreign assets of the public sector* stood at 22.4 percent of GDP, given by total gross public sector assets minus the reserve requirements held at BCU for foreign currency deposits and domestic currency claims of the nonfinancial public sector on resident banks.

Net public debt – gross debt minus liquid assets – stood at 37.2 percent of GDP in 2012.

Baseline and Alternative Scenarios

Under the DSA baseline scenario, gross debt would remain broadly stable at around 60 percent of GDP (Figure A.2.4). Public gross financing needs gradually increase over the forecast horizon due the upward trend in global and domestic interest rates. Public sector debt net of liquid assets remains around its current level of about 37 percent of GDP. The baseline scenario assumes the debt profile to remain robust, with the maturity remaining tilted to the medium and long term, and a high share of local currency debt.

The analysis of past forecast errors for key macroeconomic variables suggest that the baseline assumptions are generally realistic. The level of the projected primary balance for Uruguay is comparable to those seen in the past. Uruguay has recently experienced rapid growth in bank credit, which, based on empirical regularities in cross-country data, could portend risks of a

boom-bust cycle. Despite its strong pace of growth, however, the level of bank credit to the private sector remains low at about 24 percent of GDP and part of the credit growth reflects a process of financial deepening; with a small and well-regulated banking system, Uruguay's macro-financial vulnerabilities are contained.

A "historical" scenario (that assumes that the key macroeconomic variables behave as in the last decade) yields a downward sloping gross debt path, since Uruguay experienced high growth rates and an exchange rate appreciation as part of its recovery from its 2002 crisis.

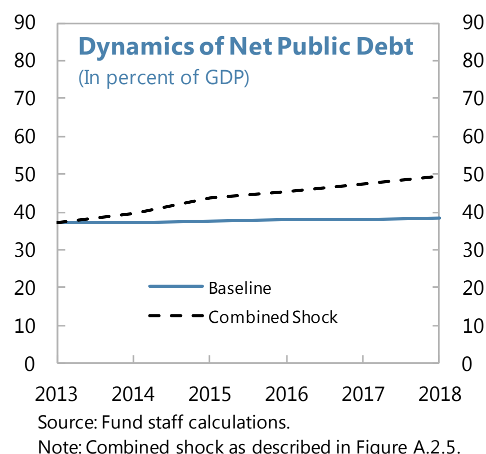
Vulnerability of the Financing Profile

Uruguay's gross public financing needs do not imply near-term vulnerabilities. The heat map reveals that Uruguay's gross financing need is above the benchmark of 15 percent of GDP. This reflects primarily the short-term nature of the central bank securities. Refinancing risks are contained as this short-term debt stock is smaller than the central bank's liquid foreign reserves. The relatively high value of the change in short-term public debt in 2012 also mostly reflects the issuance of short-term central bank debt to mop up the liquidity created by the accumulation of international reserves.

The share of public sector debt held by non-residents and total external financing needs in 2012 are also found to be slightly above the benchmarks, but risks are once again contained by the presence of high liquidity buffers—strong levels of financial assets and contingent credit lines. In addition, the current account in 2012 (which accounts for part of the external financing need) was smaller than the FDI into Uruguay and continued strong prospects for FDI would also help mitigate external financing risks going forward. Market perceptions of Uruguay's public debt are favorable—the moderate risk signaled for market perception in the heat map and in the analysis of debt profile vulnerabilities reflects a temporary spike in the EMBI bond spread for Uruguay in August 2013 in the context of generalized financial volatility in emerging markets—the spread has been below the risk assessment benchmark since mid-September.

Stress Tests

Debt dynamics in Uruguay remain sensitive to shocks. In a stylized downside scenario that combines a permanent 20 percent exchange rate depreciation (relative to the baseline) with a temporary drop in growth and primary balances and a permanent increase in real interest rates, the gross debt ratio rises by about 15 percentage points over the five-year forecast horizon. Net debt rises by about 10 percentage points in the same scenario. The sensitivity of net debt to exchange rate shocks is lower than that of gross debt, since the roughly similar amounts of foreign currency debt and assets imply offsetting valuation effects in response to exchange rate changes. Fan charts of the projected gross debt distribution confirm generally manageable debt dynamics under statistical distributions of combined shocks.



Source: Fund staff calculations.
Note: Combined shock as described in Figure A.2.5.

A2.1. Uruguay Public DSA Risk Assessment

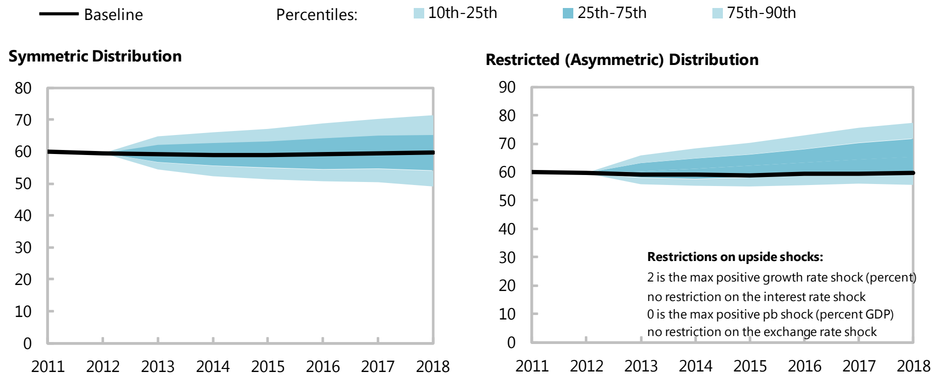
Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

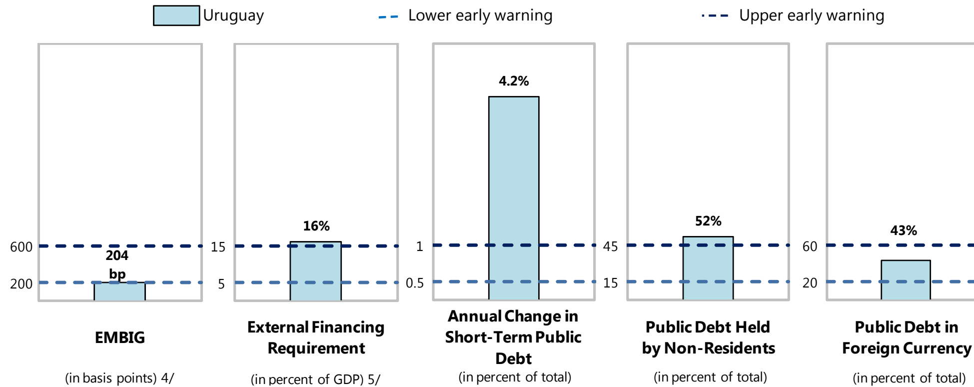
Baseline Percentiles: 10th-25th 25th-75th 75th-90th



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2012)

Uruguay Lower early warning Upper early warning



Source: Fund staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

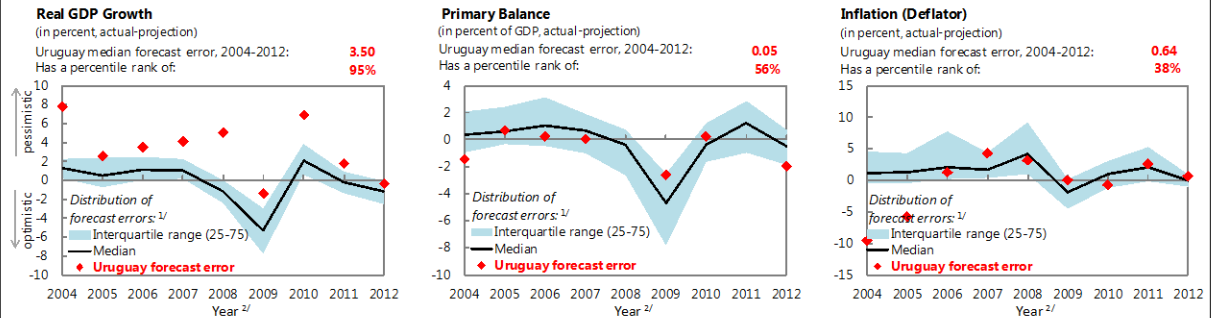
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 24-Jul-13 through 22-Oct-13.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

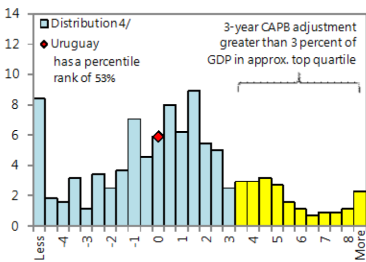
A2.2. Uruguay Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

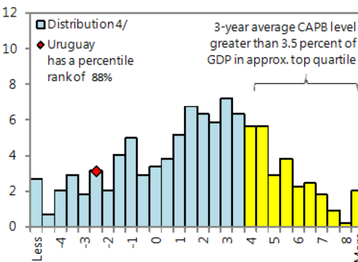


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

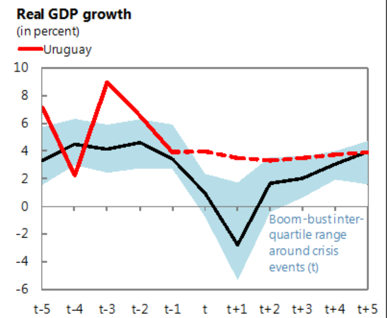


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : Fund Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Uruguay has had a positive output gap for 3 consecutive years, 2010-2012. For Uruguay, t corresponds to 2013; for the distribution, t corresponds to the first year of the crisis..
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

A2.3. Uruguay Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

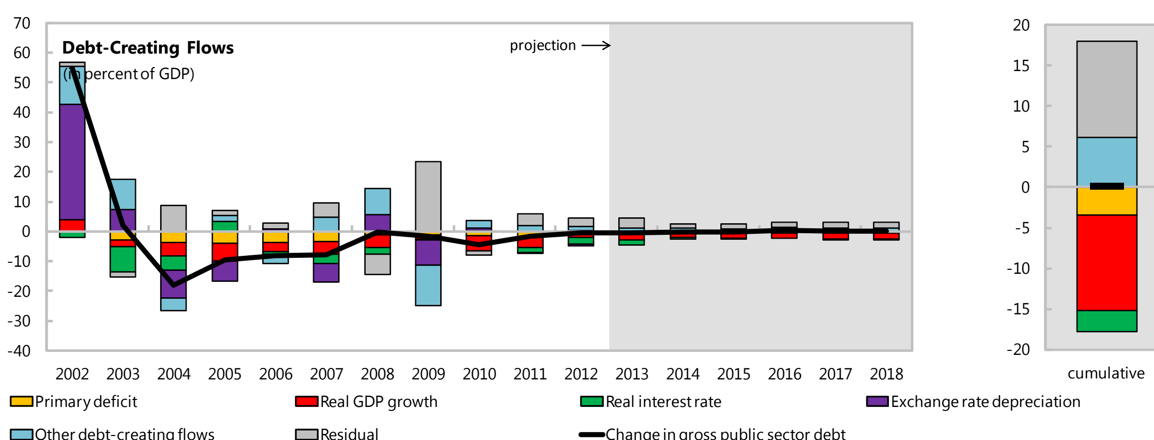
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	82.0	60.0	59.6	59.2	59.0	58.9	59.3	59.5	59.7
Of which: guarantees	0.6	0.8	0.9	0.8	0.7	0.6	0.6	0.5	0.5
Public gross financing needs	14.8	10.9	14.8	16.1	17.1	20.3	17.5	20.0	18.2
Net public debt	51.0	37.4	37.2	37.3	37.2	37.5	37.9	38.1	38.3
Real GDP growth (in percent)	4.0	6.5	3.9	4.0	3.5	3.3	3.5	3.8	3.9
Inflation (GDP deflator, in percent)	8.0	8.0	8.8	8.9	7.5	7.7	7.2	6.8	6.4
Nominal GDP growth (in percent)	12.2	15.1	13.0	13.2	11.2	11.3	11.0	10.8	10.5
Effective interest rate (in percent) [4/]	5.6	5.5	5.0	5.7	6.6	7.7	7.6	6.9	6.5

As of October 22, 2013		
Sovereign Spreads		
EMBIG (bp) 3/		191
5Y CDS (bp)		166
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.7	-1.6	-0.4	-0.4	-0.2	-0.1	0.4	0.2	0.2	0.1	
Identified debt-creating flows	-2.7	-5.6	-3.4	-3.7	-1.8	-1.7	-1.3	-1.5	-1.7	-11.8	
Primary deficit	-2.5	-2.0	0.2	-0.8	-0.3	-0.6	-0.6	-0.6	-0.6	-3.5	-1.1
Primary (noninterest) revenue and grants	30.8	31.9	31.3	32.7	32.6	32.8	32.7	32.7	32.7	196.2	
Primary (noninterest) expenditure	28.3	29.9	31.5	31.9	32.3	32.1	32.1	32.1	32.2	192.7	
Automatic debt dynamics [5/]	-2.5	-5.4	-5.0	-4.0	-2.5	-1.9	-1.8	-2.1	-2.2	-14.4	
Interest rate/growth differential [6/]	-5.0	-5.1	-4.3	-4.0	-2.5	-1.9	-1.8	-2.1	-2.2	-14.4	
Of which: real interest rate	-2.0	-1.6	-2.2	-1.9	-0.6	-0.2	0.1	0.0	-0.1	-2.7	
Of which: real GDP growth	-3.0	-3.5	-2.1	-2.1	-1.9	-1.8	-1.9	-2.0	-2.1	-11.7	
Exchange rate depreciation [7/]	2.5	-0.3	-0.7	…	…	…	…	…	…	…	
Other identified debt-creating flows	2.3	1.8	1.4	1.1	0.9	0.8	1.1	1.1	1.0	6.1	
Privatization Receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (asset purchases)	2.3	1.8	1.4	1.1	0.9	0.8	1.1	1.1	1.0	6.1	
Residual [8/]	3.5	4.0	3.0	3.3	1.6	1.6	1.7	1.8	1.9	11.9	



Source: Fund staff.

1/ Public sector is defined as consolidated public sector (non-financial public sector and central bank) and includes public guarantees of the central government to the non-financial public sector.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

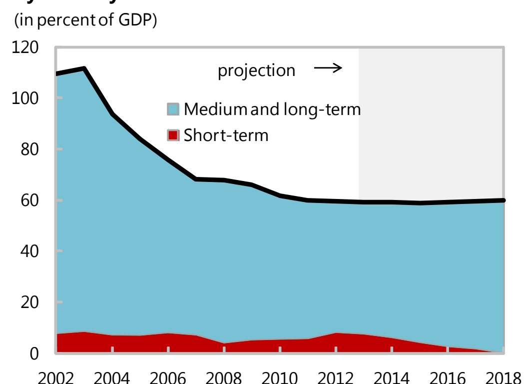
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

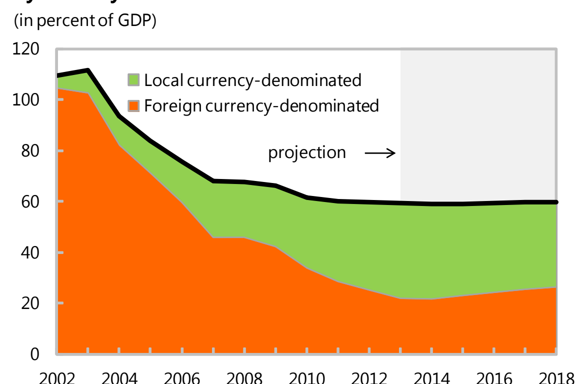
8/ Includes changes in the stock of guarantees and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

A2.4. Uruguay Public DSA - Composition of Public Debt and Alternative Scenarios

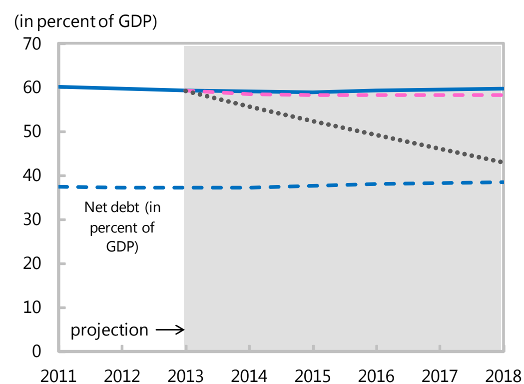
Composition of Public Debt

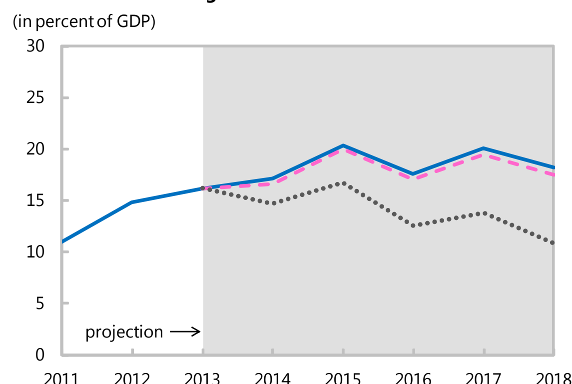




Alternative Scenarios

Baseline — Historical — Constant Primary Balance





Underlying Assumptions

(in percent)

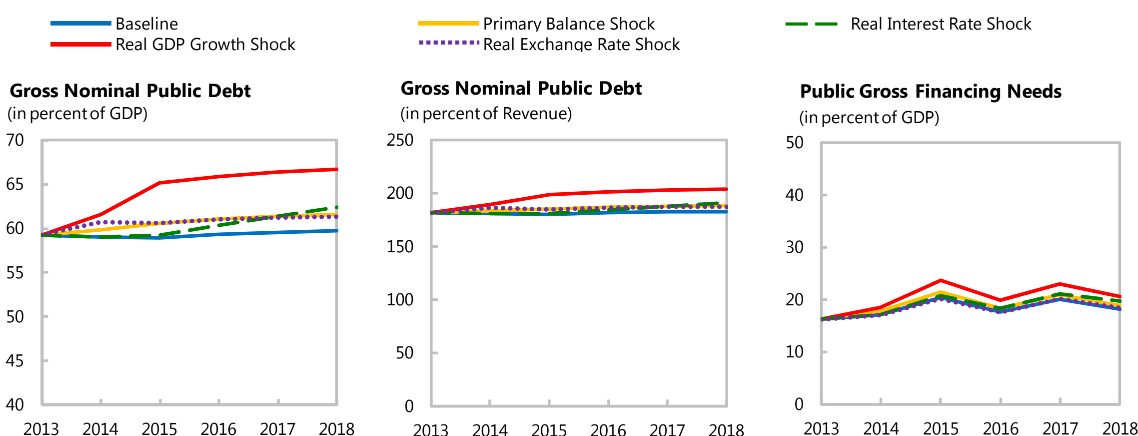
Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	4.0	3.5	3.3	3.5	3.8	3.9
Inflation	8.9	7.5	7.7	7.2	6.8	6.4
Primary Balance	0.8	0.3	0.6	0.6	0.6	0.6
Effective interest rate	5.7	6.6	7.7	7.6	6.9	6.5
Constant Primary Balance Scenario						
Real GDP growth	4.0	3.5	3.3	3.5	3.8	3.9
Inflation	8.9	7.5	7.7	7.2	6.8	6.4
Primary Balance	0.8	0.8	0.8	0.8	0.8	0.8
Effective interest rate	5.7	6.6	7.6	7.6	6.9	6.5

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	4.0	5.3	5.3	5.3	5.3	5.3
Inflation	8.9	7.5	7.7	7.2	6.8	6.4
Primary Balance	0.8	2.4	2.4	2.4	2.4	2.4
Effective interest rate	5.7	6.6	7.1	6.7	5.9	5.4

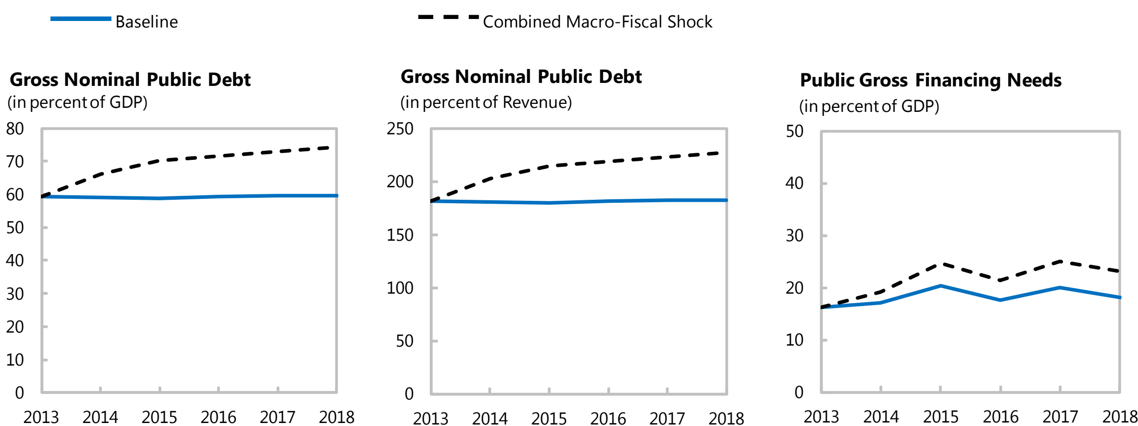
Source: Fund staff.

A2.5. Uruguay Public Gross DSA - Stress Tests 1/

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2013	2014	2015	2016	2017	2018
Primary Balance Shock						
Real GDP growth	4.0	3.5	3.3	3.5	3.8	3.9
Inflation	8.9	7.5	7.7	7.2	6.8	6.4
Primary balance	0.8	-0.4	-0.1	0.6	0.6	0.6
Effective interest rate	5.7	6.6	7.7	7.8	7.0	6.6
Real Interest Rate Shock						
Real GDP growth	4.0	3.5	3.3	3.5	3.8	3.9
Inflation	8.9	7.5	7.7	7.2	6.8	6.4
Primary balance	0.8	0.3	0.6	0.6	0.6	0.6
Effective interest rate	5.7	6.6	8.2	8.7	8.2	8.0
Combined Shock						
Real GDP growth	4.0	1.3	1.1	3.5	3.8	3.9
Inflation	8.9	6.9	7.2	7.2	6.8	6.4
Primary balance	0.8	-0.6	-1.1	0.6	0.6	0.6
Effective interest rate	5.7	7.0	8.1	8.7	8.2	8.0
Nominal Exchange rate deviation from baseline	0.0	20.0	20.0	20.0	20.0	20.0

	2013	2014	2015	2016	2017	2018
Real GDP Growth Shock						
Real GDP growth	4.0	1.3	1.1	3.5	3.8	3.9
Inflation	8.9	6.9	7.2	7.2	6.8	6.4
Primary balance	0.8	-0.6	-1.1	0.6	0.6	0.6
Effective interest rate	5.7	6.6	7.8	7.9	7.1	6.6
Real Exchange Rate Shock						
Real GDP growth	4.0	3.5	3.3	3.5	3.8	3.9
Inflation	8.9	12.5	7.7	7.2	6.8	6.4
Primary balance	0.8	0.3	0.6	0.6	0.6	0.6
Effective interest rate	5.7	7.0	7.5	7.5	6.9	6.5
Nominal Exchange rate deviation from baseline	0.0	20.0	20.0	20.0	20.0	20.0

Source: Fund staff.
1/ For a description of the scenarios see http://www.imf.org/external/pubs/ft/dsa/mac.htm.

Annex III. External Debt Sustainability Analysis (DSA)

Table A3.1. Uruguay: External Debt Sustainability Framework, 2008-2018
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	**Debt-stabilizing non-interest current account 7/**
1 **Baseline: External debt 1/**	50.7	59.4	47.4	39.5	42.3			**42.3**	**41.7**	**41.5**	**41.3**	**40.7**	**40.9**	**-5.7**
2 Change in external debt	-12.5	8.7	-12.0	-7.9	2.8			0.0	-0.6	-0.2	-0.2	-0.6	0.1	
3 Identified external debt-creating flows (4+8+9)	-15.6	-3.5	-17.2	-10.2	-2.9			-1.8	-2.2	-2.7	-2.5	-2.5	-2.4	
4 Current account deficit, excluding interest payments	3.0	-1.4	-0.3	1.1	3.9			3.4	2.4	2.2	2.1	2.2	2.3	
5 Deficit in balance of goods and services	3.2	-1.7	-1.6	-0.2	2.7			2.2	1.1	1.0	0.9	0.9	1.0	
6 Exports	30.9	28.8	27.6	27.7	26.6			23.7	25.2	25.5	25.9	26.3	26.8	
7 Imports	34.0	27.1	26.0	27.5	29.3			25.9	26.3	26.5	26.8	27.2	27.8	
8 Net non-debt creating capital inflows (negative)	-6.9	-5.0	-5.9	-5.4	-5.6			-5.3	-4.5	-4.4	-4.4	-4.4	-4.3	
9 Automatic debt dynamics 2/	-11.6	2.9	-11.0	-5.9	-1.3			0.1	-0.1	-0.4	-0.2	-0.3	-0.3	
10 Contribution from nominal interest rate	2.7	2.7	2.1	1.9	1.4			1.5	1.3	0.9	1.1	1.1	1.1	
11 Contribution from real GDP growth	-3.5	-1.1	-4.1	-2.6	-1.4			-1.5	-1.4	-1.3	-1.4	-1.5	-1.5	
12 Contribution from price and exchange rate changes 3/	-10.9	1.4	-9.0	-5.2	-1.3			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 4/	3.1	12.2	5.2	2.3	5.7			1.8	1.6	2.5	2.4	1.9	2.5	
External debt-to-exports ratio (in percent)	164.3	206.1	171.9	142.5	159.0			178.6	165.4	162.8	159.5	154.9	152.6	
Gross external financing need (in billions of US dollars) 5/	6.4	5.9	8.2	8.8	8.8			12.1	10.7	11.2	11.6	12.4	13.3	
in percent of GDP	21.2	19.4	21.0	18.9	17.7	10-Year	10-Year	21.0	17.8	17.7	17.4	17.3	17.5	
Scenario with key variables at their historical averages 6/								**42.3**	**34.3**	**27.8**	**21.5**	**15.3**	**9.9**	**-6.1**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	7.2	2.2	8.9	6.5	3.9	5.3	2.2	4.0	3.5	3.3	3.5	3.8	3.9	
GDP deflator in US dollars (change in percent)	20.8	-2.6	18.0	12.2	3.4	8.6	10.6	10.4	1.3	2.1	2.2	2.5	2.6	
Nominal external interest rate (in percent)	5.6	5.2	4.6	4.7	3.9	5.3	0.9	4.2	3.2	2.2	2.9	2.9	3.0	
Growth of exports (US dollar terms, in percent)	35.2	-7.1	23.0	20.0	3.2	18.0	13.6	2.1	11.7	6.7	7.6	7.9	8.6	
Growth of imports (US dollar terms, in percent)	52.5	-20.7	23.2	26.7	14.4	20.9	19.1	1.4	6.8	6.0	7.1	8.1	8.7	
Current account balance, excluding interest payments	-3.0	1.4	0.3	-1.1	-3.9	1.3	3.2	-3.4	-2.4	-2.2	-2.1	-2.2	-2.3	
Net non-debt creating capital inflows	6.9	5.0	5.9	5.4	5.6	5.3	1.5	5.3	4.5	4.4	4.4	4.4	4.3	

1/ External debt includes non-resident deposits.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes.

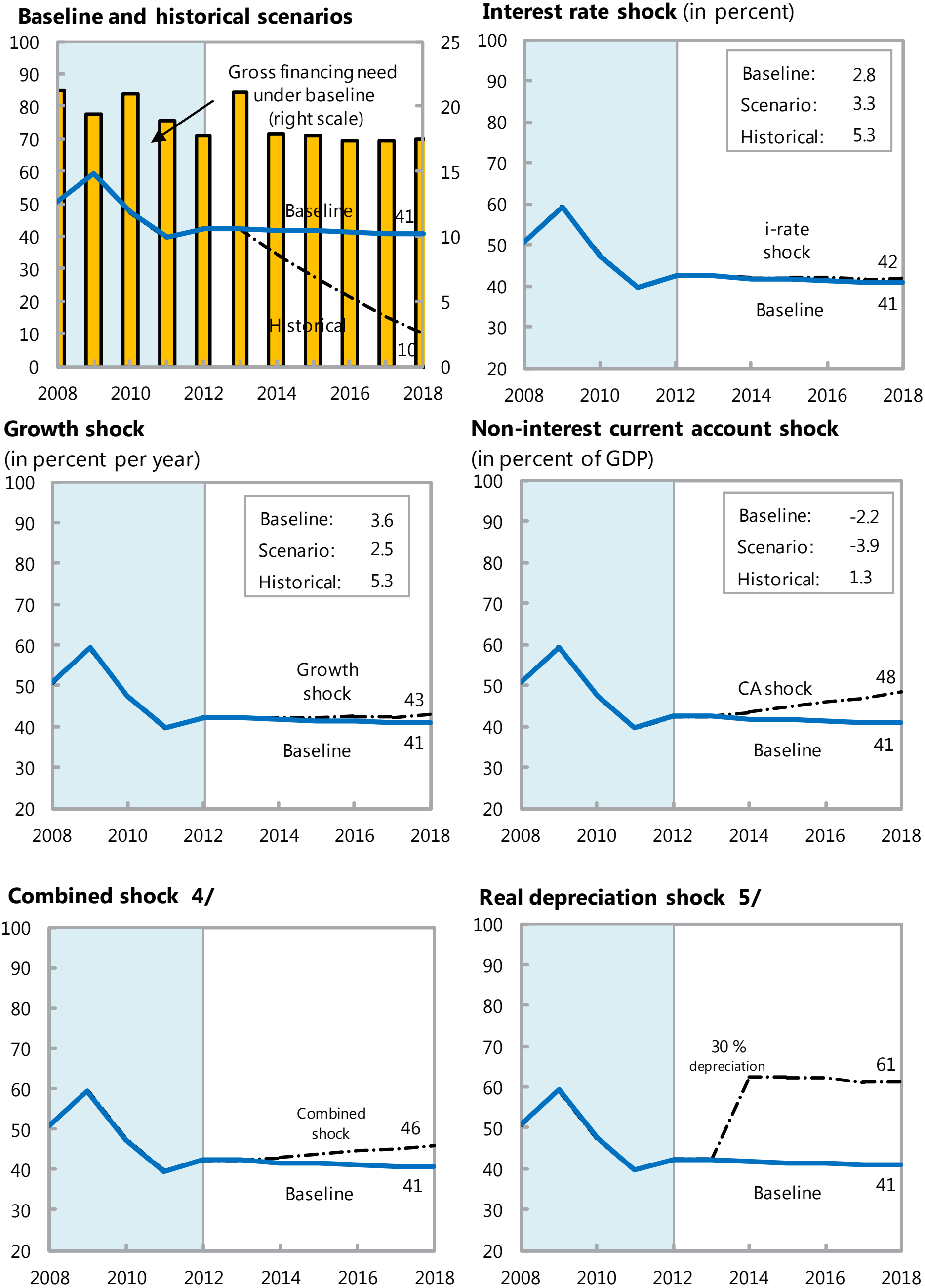
5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure A3.1. Uruguay: External Debt Sustainability: Bound Tests 1/ 2/ 3/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ External debt includes non-resident deposits.

4/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

5/ One-time real depreciation of 30 percent occurs in 2010.

INTERNATIONAL MONETARY FUND

URUGUAY

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 29, 2013

Prepared By The Western Hemisphere Department

CONTENTS

FUND RELATIONS 2

RELATIONS WITH THE WORLD BANK UNDER JMAP 4

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK 5

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FUND RELATIONS

(As of August 31, 2013)

Membership Status: Joined: March 11, 1946 Article VIII

General Resources Account:	**SDR Million**	**% Quota**
Quota	306.50	100.00
Fund holdings of currency	198.39	64.73
Reserve Tranche Position	108.12	35.28

SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	293.26	100.00
Holdings	245.68	83.78

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Jun 08, 2005	Dec 27, 2006	766.25	263.59
Stand-By	Apr 01, 2002	Mar 31, 2005	1,988.50	1,988.50
Of which: SRF	Jun 25, 2002	Aug 08, 2002	128.70	128.70
Stand-By	May 31, 2000	Mar 31, 2002	150.00	150.00

Projected Payments to Fund [1/]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.01	0.03	0.03	0.03	0.03
Total	**0.01**	**0.03**	**0.03**	**0.03**	**0.03**

1/ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Ex-Post Assessment. The last Ex-Post Assessment of Longer-Term Program Engagement was considered by the Executive Board on August 29, 2007 (Country Report No. 08/47).

Exchange Rate Arrangement. The currency is the Uruguayan peso (Ur$). Uruguay has followed an independently floating exchange rate regime since July 29, 2002. Since July 2013, targets for M1 plus saving deposits have replaced the overnight interbank rate, as intermediate monetary policy

instrument. In 2008, Uruguay's de facto exchange rate regime was reclassified from a managed float with no predetermined path for the exchange rate to a floating exchange rate regime. On October 14, 2013, the exchange rate in the official market was Ur$ 21.657 per U.S. dollar. Uruguay has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on payments and transfers for current international transactions.

FSAP Participation and ROSCs. The Financial Sector Stability Assessment (FSSA) was considered by the Executive Board on June 28, 2006 (Country Report No. 06/187). An FSAP Update was considered by the Executive Board on December 10, 2012 (Country Report No.13/152). The ROSC-module on fiscal transparency was published on March 5, 2001. A ROSC-module on data dissemination practices was published on October 18, 2001. The ROSC on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) was published on December 2006 (Country Report No. 06/435). A data ROSC reassessment mission was undertaken during August 2012.

Technical Assistance 2008–12

DPT	Purpose	Date of Delivery
FAD	Private public partnerships.	May 2010
	Tax, customs, and social security administration.	November 2012, March 2011, September 2010.
LEG	TA to assist the authorities on the launch of the recently designed AML/CFT national strategy.	June 2012
	TA to assist the authorities on the elaboration of a risk-based national strategy enhancing the AML/CFT regime.	December 2010
	TA to conduct a money laundering/terrorist financing country risk assessment consistent with the objectives of the national AML/CFT strategy.	January, April, and July 2009
MCM	FSAP update.	September 2012
STA	ROSC reassessment mission.	August 2012
	Government Finance Statistics, to assist in improving the quality of public debt data.	February 2008

Article IV Consultation. The 2012 Article IV consultation was concluded by the Executive Board on December 10, 2012 (Country Report No. 13/108). Uruguay is on the standard consultation cycle governed by the provisions approved by the Executive Board on July 15, 2002.

RELATIONS WITH THE WORLD BANK UNDER JMAP

Title	Products	Provisional Timing of Missions	Expected Delivery Date*
A. Mutual Information on Relevant Work Programs			
	A. Lending		
Bank work program for next 12 months	1. UY Public Sector Management and Social Inclusion DPL/DDO		October 2012
	2. UY 2nd Programmatic Public Sector Management, Competitiveness and Social Inclusion DPL/DDO		September 2012
	3. UY Full-Time School Expansion Project		July 2012
	4. Road Rehabilitation and Maintenance Program		November 2012
	5. Support to Uruguayan Public Schools Project		November 2012
	6. UY OSE Sustainable and Efficient		September 2012
	B. ESW		
	1. Uruguay Social Programs Assessment		September 2013
	2. Pro-growth public policies, competitiveness and business investment climate		June 2015
	3. Water for Uruguay		April 2015
	4. Social Protection and Early Childhood Development Policies		May 2015
	C. Technical Assistance		
	1. UY Access to Finance		March 2014
	2. Designing the Uruguay Rail Sector Regulator		June 2014

*This corresponds to Delivery to Board in lending projects, and delivery to client in of AAAs.

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of August 31, 2013)

The Inter-American Development Bank's Board of Executive Directors approved in August 2011 the new Country Strategy with Uruguay (2010–2015). Sovereign-guaranteed lending under the new program is expected to reach approximately US$1.8 billion, which is considered to be consistent with Uruguay's five year budget. The program includes additional non reimbursable financing for technical assistance and analytical work. Lending under the previous Country Strategy (2005–2009) reached approximately US$1.3 billion.

Under the new Strategy, the national authorities and the Bank identified the following priority sectors in which the IDB Group would focus both its financial and non-financial products and services: (i) transport; (ii) energy; (iii) water, sanitation, and solid waste; (iv) science and technology; (v) social protection; (vi) education and job training; (vii) agribusiness; (viii) services exports; (ix) public management and finances; and (x) urban development and citizen security. It is also expected that all four of the Bank's private sector windows will approve loans and technical assistance in the energy, transport, agribusiness and global services sectors. The strategic areas were selected taking into account: (i) a context of strong economic growth, which imposes heavy investment requirements on a number of sectors; (ii) business opportunities, which in turn contribute to the Bank's institutional goals within the framework of the 9th General Capital Increase; (iii) greater complementarity between the multilateral financial institutions working in Uruguay;

(iv) the Bank's accumulated operational experience and technical knowledge from having worked for several decades in the country; and (v) the government's interest for continued IDB engagement

As of August 31th 2013, the Bank's portfolio in Uruguay includes loans for the financing of 40 projects; six of which are without sovereign guarantee. The lending portfolio amounts to US$2,435.4 million, of which US$1,333.7 million are pending disbursement. Disbursements in 2013 are expected to total US$185.4 million. The current portfolio includes lending to support the Government in the following sectors: infrastructure and environment (19 loans adding US$905.1 million and representing 37% of the approved amounts); social sector (4 loans adding US$97.2 million, representing 4% of the approved amounts); institutional capacity and finance (12 loans adding US$229.0 million and representing 9% of the approved amounts) and integration and trade (5 loans,

adding US$577.0 million; 24% of the approved amounts). The portfolio also includes 7 loans to the private sector for US$627.1 million (26% of the approved amounts).In 2013, the Bank approved loans to the public sector in the areas of integration (US$550 MM) and transportation (US$18.3 million).

Financial Relations with the Inter-American Development Bank[1]

(In millions of U.S. dollars)

Total Outstanding Loans: US$1,855.1 (As of August 31, 2013)

	Loan Transactions									
	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013p**
Disbursement	57.6	242.3	114.8	112.9	337.2	477.3	54.3	177.2	272.8	185.4
Amortization	113.0	222.3	520.8	142.1	138.7	160.8	463.9	114.2	119.5	591.9
Net Loan Flows	**-55.5**	**20.0**	**-406.0**	**-29.2**	**198.5**	**316.5**	**-409.6**	**63.0**	**153.2**	**-406.5**

Source: Inter-American Development Bank.

1/ Only loans with sovereign guarantee are considered.

STATISTICAL ISSUES

(As of September 30, 2013)

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings, but broadly adequate for surveillance. Most affected area is national accounts.
National accounts: In 2009, the Uruguayan authorities completed a revision of national accounts statistics, in which they updated the benchmark year (from 1983 to 1997 and 2005) and adopted the *System of National Accounts 1993 (SNA93)*. However, national accounts statistics still have some shortcomings, limited coverage of the enterprise survey, poor quality source data for some components of GDP, inadequate information on the informal economy, and incomplete quarterly accounts. Household consumption is not independently derived and changes in inventories are obtained as residuals. Household income and expenditure survey are conducted every ten years. The central bank (BCU) compiles and disseminates annual GDP estimates in current and at previous year prices by the production and expenditure approaches, as well as quarterly constant price GDP estimates by the production and expenditure approaches. Gross national income, gross disposable income and gross savings are also available annually.
Consumer prices: Both the consumer and wholesale price indices are reported on a regular and timely basis for publication in the *IFS*. The new base period for the consumer price index is December 2010 = 100. The CPI has national coverage and includes more than forty thousand price quotations. It does not cover either the implicit rent or the net acquisitions of owner-occupied dwellings. The base of the wholesale price index has been updated to 2001. Producer price indices (March 2010 =100) for national products have been recently disseminated. The PPI does not cover utilities, construction, business and other services and exported output. The authorities do not provide trade price and volume indices for publication in the *International Financial Statistics (IFS)*.
Government finance statistics: Official data on the central administration, the state enterprises and the social security system are complete and current, but there are problems with the timeliness of the data on local governments. There are also problems with the timeliness of financing and debt data reported for inclusion in the Fund's statistical publications. Information on a monthly and quarterly basis for financing and debt data respectively, are disseminated on the BCU website from 1999 onwards for the central government and total public sector, but no information is reported for publication in the *International Financial Statistics*. The information reported for publication in the *Government Finance Statistics Yearbook* covers transactions on revenue and expense for the consolidated central government (data on revenue and expense for local governments have not been reported since 1994), and the general government's operations on financial assets and liabilities, both in terms of flows (financing) and stocks (debt).

Monetary and financial statistics: Monetary and financial statistics are prepared in accordance with the IMF's *Monetary and Financial Statistics Manual (2000).* Authorities report monetary data for the central bank, other depository corporations, and other financial corporations (OFCs) using the standardized reporting forms (SRFs). However, data for the OFCs are limited to off-shore financial institutions. A mission could be fielded to expand the institutional coverage of the OFCs and compile the SRF for OFCs with full institutional coverage. Authorities reported annual Financial Soundness Indicators (FSI) for 2008, 2009, and 2010. The authorities have not responded to the queries sent regarding the 2009 and 2010 data. Historical series and updates have not been submitted.	
External sector statistics: Balance of payments statements are compiled and published on a quarterly basis. Data are compiled following the recommendations of the fifth edition of the *Balance of Payments Manual*. Uruguay compiles and reports to STA quarterly data on balance of payments and annual data on the international investment position (IIP) for publication in the *IFS* and the *Balance of Payments Statistics Yearbook*. New surveys are allowing for improved coverage of the private sector in the IIP. Uruguay started disseminating the international reserves and foreign currency liquidity data template on the Fund's external website in 2005. The BCU also disseminates quarterly external debt statistics in the format prescribed by the SDDS on the National Summary Data Page (NSDP).	
II. Data Standards and Quality	
Uruguay subscribed to the SDDS in February 2004 and is in observance.	Data ROSC published on October 1, 2001. A data ROSC mission on CPI and NA was conducted in August 2012.
III. Reporting to STA (Optional)	
Annual GFS are regularly reported to STA for publication in the *Government Finance Statistics Yearbook*. No high frequency GFS are reported for publication in the *International Financial Statistics*.	

Uruguay: Common Indicators Required for Surveillance
(As of October 29, 2013)

	Date of Latest Observation	Date Received	Frequency of Data [6/]	Frequency of Reporting [6/]	Frequency of Publication [6/]
Exchange Rates	Oct. 08, 2013	10/09/13	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities [1/]	July 2013	9/30/13	M	M	M
Reserve/Base Money	July 2013	9/30/13	M	M	M
Broad Money	July 2013	9/30/13	M	M	M
Central Bank Balance Sheet	July 2013	9/30/13	M	M	M
Consolidated Balance Sheet of the Banking System	July 2013	9/30/13	M	M	M
Interest Rates [2/]	Oct. 08, 2013	10/09/13	D	D	D
Consumer Price Index	Sept. 2013	10/03/13	M	M	M
Revenue, Expenditure, Balance and Composition of Financing [3/] – Central Government[4/]	Aug. 2013	9/30/13	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt [4,5/]	Q2/13	9/30/13	Q	Q	Q
External Current Account Balance	Q2/13	9/27/13	Q	Q	Q
Exports and Imports of Goods and Services	Q2/13	9/27/13	Q	Q	Q
GDP/GNP	Q2/13	9/13/13	Q	Q	Q
Gross External Debt	Q2/13	9/30/13	Q	Q	Q

[1/] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2]/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3]/ Foreign, domestic bank, and domestic nonbank financing.
[4]/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5]/ Includes currency and maturity composition.
[6]/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND

Press Release No. 13/461
FOR IMMEDIATE RELEASE
November 20, 2013

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with Uruguay

On November 13, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Uruguay.

Uruguay has experienced a decade of strong and inclusive expansion since its 2002 crisis, resulting in an impressive rise in Uruguayan living standards. Key drivers of this performance included important institutional reforms, large foreign direct investment (FDI) projects attracted by Uruguay's stable macroeconomic environment and business-friendly investment climate, and favorable external conditions. The result has been a strong rise in employment, real wages, and consumption. Poverty rates have declined sharply.
Growth has moderated to a more sustainable pace since 2012, mostly owing to weaker external demand. Real GDP growth is projected at 4 percent in 2013 and 3.5 percent in 2014. Fiscal policy loosened in 2012 and is set to remain slightly expansionary in 2013. Annual inflation, at 9.0 percent in September, remains outside the current target range (4–6 percent). The Uruguayan peso appreciated against the backdrop of swelling capital inflows in the year to May 2013. In June 2013, the authorities announced a new reserve requirement on foreign purchases of Treasury notes to discourage further portfolio inflows and tightened the monetary policy stance significantly. Since then, portfolio inflows appear to have come to a stop and the Uruguayan peso has depreciated against the U.S. dollar, also reflecting a tightening in global financial conditions following the U.S. Federal Reserve's signal of a prospective tapering of its asset purchases.

The outlook for the Uruguayan economy is solid, but risks and challenges remain. The economy is exposed to the risk of inward spillovers from external developments and risks from domestic wage and cost pressures. Uruguay's financial vulnerabilities are modest, and the government has reduced debt vulnerabilities significantly and built important financial buffers. Still, above-target inflation and the desirability of reducing further the net debt of the

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

public sector constrain the policy space. The longer-term policy priority is to sustain high growth rates for productivity, and human and physical capital investment.

Executive Board Assessment[2]

Executive Directors commended Uruguay's strong economic performance and success in reducing poverty over the past decade. Directors noted that the outlook for the economy remains solid, but there are risks stemming from domestic factors and the uncertain external environment. They agreed that policies going forward should be geared towards preserving the gains made so far by facilitating a smooth landing in the near term, and boosting potential growth in the medium term, while lowering inflation and safeguarding competitiveness.

Directors supported the recent tightening of the monetary policy stance in view of the above target and rising inflation. They took note of the change in the operational target for monetary policy and encouraged the authorities to enhance their communication of the targeted policy stance. It will also be important to monitor the effectiveness of the new framework in delivering the inflation targets. While Directors considered the broadening of capital flow management measures to be useful given Uruguay's macroeconomic situation, they generally underscored that such measures should be temporary.

Directors agreed that prudent wage growth would help in lowering inflation, curbing the risk of overheating, and safeguarding competitiveness. They stressed that reducing the use of backward-indexation in wage contracts would make employment more resilient against adverse shocks. Directors welcomed the authorities' recent guidelines for the design of non-indexed wages and encouraged them to promote these guidelines.

Directors considered that a tighter fiscal policy stance would be better aligned with the goal of reducing inflation and further decreasing net public debt. In this context, they emphasized the desirability to reduce the overall deficit, exploring both revenue and expenditure options, while protecting priority social and infrastructure spending.

Directors underscored that maintaining solid and stable growth will require additional financial and structural reforms. They commended the progress made in implementation of the 2012 FSAP and looked forward to implementation of the envisaged financial sector reform agenda, including further steps relating to financial deepening. Priority should also be given to boosting public infrastructure and raising the efficiency of labor markets, while ensuring appropriate protection for workers.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Uruguay: Selected Economic Indicators, 2009-15

				Prel.	Projection		
	2009	2010	2011	2012	2013	2014	2015
	(Annual percent change, unless otherwise indicated)						
Real GDP	2.2	8.9	6.5	3.9	4.0	3.5	3.3
Real consumption	-0.9	12.0	8.3	6.4	5.9	4.3	4.1
Real investment	-5.7	13.3	5.5	19.4	8.3	-4.3	3.6
Prices							
CPI inflation (average)	7.1	6.7	8.1	8.1	8.5	8.0	7.5
Terms of trade	6.6	-3.1	0.0	6.3	1.5	0.1	2.2
	(In percent of GDP)						
Public sector finances							
Total revenues	29.0	29.8	29.0	28.5	29.8	29.7	29.9
Non-interest expenditure	28.2	28.5	27.2	28.7	29.2	29.5	29.3
Primary balance	1.2	1.6	2.0	-0.2	0.8	0.3	0.6
Overall balance	-1.7	-1.5	-0.9	-2.8	-2.2	-2.5	-2.1
Gross public sector debt	66.1	61.6	60.0	59.6	58.6	58.9	58.4
Outstanding external debt	46.5	37.2	32.4	35.5	32.1	32.0	32.3
Of which: Public external debt	37.8	34.0	32.0	31.9	30.3	30.1	30.4
	(Annual percent change, unless otherwise indicated)						
Money and credit 1/							
Base money (eop)	6.5	16.2	17.3	26.7	15.7	...	...
M-1	12.2	28.9	18.8	9.1	1.2	...	...
M-2	15.0	30.3	22.0	12.3	4.6	...	...
M-3	-2.6	22.1	18.0	10.0	16.4	...	...
Growth of credit to households (in real UY$)	-20.5	15.8	2.1	7.3	8.0	...	...
Growth of credit to firms (in US$)	3.4	18.8	26.5	17.5	18.3	...	...
	(In percent of GDP, unless otherwise specified)						
Balance of payments							
Current account balance	-1.3	-1.9	-3.0	-5.4	-4.9	-3.7	-3.1
Merchandise exports, fob	21.1	20.7	20.0	19.8	18.4	19.4	19.3
Merchandise imports, fob	22.8	22.0	23.1	24.6	20.4	20.8	20.7
Services, income and transfers (net)	0.4	-0.5	0.1	-0.6	-2.9	-2.3	-1.7
Capital and financial account	3.9	2.7	9.0	12.9	8.9	5.1	4.5
Foreign direct investment	5.1	5.9	5.4	5.6	5.3	4.5	4.4
Overall balance of payments (in millions of U.S. dollars)	1588.3	-360.8	2564.4	3287.0	2267.0	844.0	873.0
Gross official reserves (in millions of U.S. dollars) 2/	8039.8	7655.3	10301.9	13604.4	15871.4	16715.4	17588.4
In percent of short-term debt	159.2	139.0	212.6	214.9	246.1	229.5	232.6
In percent of short-term debt and non-resident deposits	89.9	80.9	126.2	140.0	129.1	127.3	131.2
External debt service (percent of exports of goods and services)	23.9	29.9	21.5	15.2	27.8	18.8	15.5

Sources: Banco Central del Uruguay, Ministerio de Economia y Finanzas, Instituto Nacional de Estadistica, and IMF Staff calculations.

1/ Percent change of end-of-year data on one year ago. For 2013, latest available data.

2/ Includes reserves buildup through reserve requirements of resident financial institutions.

Statement by Pablo Garcia-Silva, Executive Director for Uruguay and David Vogel, Advisor
November 13, 2013

Uruguay's Potential Growth vs. Historic Growth Rates (4:1)

During the second half of the twentieth century, Uruguay exhibited very languid growth rates of about 1 percent on average. In contrast, 2013 will be the eleventh consecutive year of positive growth, in a period which has presented a much higher average rate. More importantly, the future poses promising perspectives: Uruguay's potential growth is estimated at about 4 percent.

The country's robust growth has been accompanied by other remarkable developments in many areas, which are related to creating better conditions of life for society as a whole, especially for the most vulnerable sectors; reinforcing economic and financial stability; and increasing room for maneuver to face eventual external shocks.

The Fate of a Country

Do external factors determine the fate of a small country? What are the contributions of domestic policies and reforms? On these questions, the Uruguayan authorities believe that domestic policies and structural reforms do matter, being the most critical factors to understand the different paths that countries take. Indeed, shocks could be similar for countries in the same region or with economic similarities, but results could be very different.

It is worth noting that over this decade, Uruguay has been one of the most dynamic economies in the region. However, contrary to what occurred in other countries in the region, in most of the decade Uruguay—which is an energy importer and does not export minerals—has dealt with unfavorable terms of trade. Meanwhile, the country has also suffered severe trade restrictions (especially on a regional level) and, more recently, the economic slowdown of neighboring countries; in past times these factors would have generated substantial negative effects on the country's growth and investment. Nonetheless, economic activity continues expanding on a sound path, in line with the country's potential growth, and it is expected that productive investment will continue to thrive. Evidently, beyond the undeniable significance of the external factors (whose total contribution for Uruguay's case should be further elaborated), domestic policies and reforms are forging Uruguay's present and future.

A Period of Critical Changes

As noted, Uruguay has shown a critical transformation over the past years. Without trying to establish an exhaustive list of reforms and results, it is possible to cite the following aspects:

- Diversification of trade

The country's unrelenting search to diversify markets is reflected in the export figures which, for instance, show that Uruguay is exporting about 24 percent of its total external sales to Argentina (5.7 percent) and Brazil (18.1 percent), while this percentage was almost double at the end of the nineties.

- Continued enhancement of governance and transparency

  Among other indicators, according to Transparency International's corruption perception index, Uruguay and Chile (with a score of 72 – on a scale of 0-100) occupy the highest position in the region.

- Reform of the revenue administrations and the tax system

  Evasion of VAT in Uruguay was estimated at 13.4 percent in 2012—relative to potential revenue of the above-referred tax—, presenting a huge decrease compared, for instance, with the levels observed ten years ago (about 40 percent); and Uruguay currently shows the lowest evasion rate in the region. Meanwhile, the transformation of the tax system aimed at increasing its efficiency and transparency, and contributing to the government's objectives of creating an appropriate investment climate and increasing social justice.

- Creation of the Debt Management Unit

  Risks have been substantially mitigated by extending maturities (average time to maturity increased from 7.4 years in 2004 to 11 years currently), reducing the percentage of debt denominated in foreign currency (from 89 percent to 47 percent) and in floating rate (from 23 percent to 5 percent). Of course, many of the transformations observed in Uruguay's debt profile have generated an important fiscal cost, but, at the same time, have critically minimized risks and vulnerabilities looking forward.

- Reform of the Central Bank and the Financial Services Superintendency of Financial Institutions

  The reform process of the Central Bank has led to a modern structure and functioning of the institution. Meanwhile, the sound indicators exhibited by Uruguay's financial system in terms of capitalization, liquidity and non-performing loans clearly reflect the enormous transformation of the system and, particularly, of the body in charge of its regulation and supervision. Another critical aspect is the vital reduction of non-resident deposits, which literally eliminated what was an important transmission channel of regional shocks. Many other changes have been implemented in the financial system, of which the 2006 and 2012 FSAP suggestions were valuable inputs.

- Drastic transformation in the governance and incentives of the Banco de la República Oriental del Uruguay (BROU) and Banco Hipotecario del Uruguay (BHU).

  To cite just one dimension of the BROU's performance, there is a negligible level of 1.5 percent of non-performing loans (in the past, the BROU's quality of assets signified an important fragility); meanwhile, the BHU has undergone a critical and historic transformation.

- Draft Law for Financial Inclusion

  In many countries the lack of access to credit is a key obstacle that prevents them from enjoying more inclusive growth and more equal opportunities. In this regard, the law would encourage better and higher access to the financial system, particularly for weak sectors of society.

Reflecting Uruguay's Transformation: The Illustrative Case of Investment

The very low investment rates were the Achilles' heel of Uruguay's economy, and a key factor in explaining the country's tepid growth performance in the past. Historically, foreign direct investment (FDI) was negligible in Uruguay. Nonetheless, things have changed drastically. Figures 9 and 10 in the staff's chapter on Competitiveness Trends in Uruguay provide an excellent picture of the transformation: between 2005 and 2012 FDI in the country doubled in terms of GDP, while among Latin American countries Uruguay is currently second (behind Chile) in attracting FDI (relative to countries' GDP).

It is important to note that the substantial rise in capital imports—closely related to the surge of FDI—is a key element in explaining the widening of Uruguay's current account deficit. The huge increase of investment, meanwhile, is critical to illustrate the new dynamic and perspectives of the country's trade and the huge diversification of markets, all of which constitute a virtuous cycle. The country has been able to access markets that pay better prices for high quality goods. Comparative advantages always existed but, in recent years, investment has led to boosting production technologies, productivity, and quality, which is also pointed out in the above-referred chapter on competitiveness.

Some Dimensions of Uruguay's Public Debt and Fiscal Position

As a member country of the IMF, Uruguay would like to express a few comments regarding the Fund's assessments on debt issues, which goes well beyond this particular case. The Uruguayan authorities consider that the Fund should adapt its analysis to the new circumstances of the world and, particularly, of the emerging markets.

It is clear that monetary policies undertaken in some key advanced economies have "obligated" emerging markets to intervene in the exchange rate markets so that transitory shocks do not entail permanent effects. In that vein, Uruguay has had to accumulate a large amount of international reserves (more than 30 percent of its GDP), which is more than would have been desirable under normal circumstances. To a large extent, fiscal deficits have

been higher than expected in recent years due to the above-referred interventions. Uruguay's net public debt has critically decreased. However, the Fund's analysis is much more focused on gross debt, which impedes a more comprehensive and fair assessment of the country's fiscal situation, perspectives and eventual risks.

Analysts and the public in general compare countries' debt ratios. However, are they comparable? Does the staff use the same definitions and coverage? For instance, how is the treatment of debt issued for sterilization operations in Uruguay and other similar countries? *The staff's comments are welcome*.

Furthermore, how are contingent liabilities considered? Uruguay's Central Bank has been capitalized. How is this positive development, which is recommended worldwide by the Fund, considered in the fiscal and debt figures? Likewise, Uruguay's reform of the security system has allowed the country not to have contingent liabilities related to this matter to the extent that debt has been made explicit, and for this reason, gross debt is 20 percentage points higher compared with what would have been the case if reforms were not implemented.

Are transparency and reforms rewarded by the Fund's analysis? The Uruguayan authorities believe that the Fund needs to redouble efforts to have better and more evenhanded assessments on debt issues, and to make ratios more comparable among countries. The authorities urge the IMF's Management and staff to address this issue as soon as possible.

The Government's Commitment to its Objectives

The Uruguayan authorities are fully committed to its highest priority of reducing inflation in the context of a flexible exchange rate system. In recent times, the country has had to deal with abundant portfolio inflows, which were related to ultra-loose monetary policies in advanced countries, but also, among other things, to Uruguay's new investment grade status. Meanwhile, a vibrant domestic demand (to a large extent linked to higher employment and incomes, while it is also important to note that credit to the private sector relative to GDP remain at a modest—and sound—level of about 24 percent) and some constraints on the supply side exacerbated inflationary pressures.

As noted, the authorities are firm with their objectives and are flexible with the instruments used to reach them. In this regard, the government believed that changing instruments was sensitive and timely. Therefore, they introduced capital flow management measures which, of course, will have a temporary nature. For the reasons explained in the staff report, the Central Bank also decided to make changes to its policy framework and, particularly, its operational targets. Moreover, the authorities further tightened the monetary policy stance. After some months, it is possible to observe a more comfortable level of the real exchange rate; and, after a couple of months where depreciation intensified pressures, the last monthly report shows that inflation decreased from 9 percent in September to 8.67 percent in October. Admittedly, the figure is still high and pressures do not appear to have significantly receded, thus the authorities will continue monitoring developments and, if needed, will reinforce policies and instruments.

Economic and Social Achievements: Hand in Hand

As noted at other opportunities, the Uruguayan authorities understand the meaning of "stability" as a global concept which involves economic, financial, social and political stability. Of course, in times of robust growth and historic low records of unemployment, there are increasing wage pressures. However, wages (which decreased substantially during the 2002-03 crisis) have not been misaligned from the productivity path. In any case, the government carefully monitors these developments and has recently suggested restraining the growth of real wages. Beyond that, Uruguay has traditionally enjoyed a social, peaceful environment, and the current labor frameworks reinforce the tradition of searching better and sustainable social equilibrium and a fair treatment for all sides.

The results of the above-referred policies and reforms and, of course, active social policies are eloquent in the social area: poverty decreased from 25.7 percent in 2006 to 8.4 percent in 2012, and extreme poverty from 1.5 percent to 0.3 percent in the same period. Substantial progress has also been made with regard to the reduction of inequality. As one of the multiple dimensions of Uruguay's social achievements, it is worth underlining the information provided in Box 1 of the staff report: "as a result of government efforts to include previously excluded segments of the population, health insurance has become near universal with about 95 percent of Uruguay's population covered".

As a political dimension, which may reflect the importance of gaining social consensus and increasing sustainability, an article about democracy in Latin America, published in the last issue of The Economist, brought about a survey among the countries in the region, asking "how satisfied are you with the way democracy works in your country?" 80 percent of Uruguayans responded "very satisfied" or "somewhat satisfied" which is double the regional average.

Conclusion

Of course, as any small and open economy, Uruguay is exposed to the changing circumstances of the world economy. The expected monetary tapering in advanced countries has the potential of creating noises and transitory volatility. Protectionist policies constitute another critical risk for an open economy like Uruguay. Beyond that, as noted, the country's policies and reforms have created appropriate conditions to keep growing at a robust rate (in line with its potential growth), to be ready to withstand eventual global or regional shocks, and to continue improving the social conditions of its inhabitants. Clearly, much remains to be done in many areas. It is important to reiterate that reducing inflation constitutes a highest priority. Meanwhile, improving levels of education and infrastructure will be vital to face Uruguay's future challenges and pave the way for further social and economic development.