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**Statement by Mr. Chodos and Ms. Bustillo on Uruguay  
Executive Board Meeting  
November 29, 2021**

On behalf of the Uruguayan authorities, we would like to thank the Mission team for the open and constructive dialogue during the Article IV Consultation. The authorities highly value staff's analytical work and relevant contributions to policy discussions.

During most of 2020, Uruguay successfully contained the virus spread without imposing a mandatory lockdown. The new government that came into office only two weeks before the COVID-19 outbreak in March of last year appealed to the citizens' "freedom with responsibility".

Yet the country faced its first wave of coronavirus cases and a surge in fatalities in the first half of 2021. The government responded by launching a massive vaccination campaign, securing enough vaccines for the whole population and deploying an efficient rollout throughout the country. As of November 16, 2021, Uruguay is one of the countries with the highest percentage of people vaccinated against COVID-19 in the world: 78 percent of the total population has received at least one dose, and more than 74 percent of the population has received two doses. In August 2021, the government started providing a third booster shot, which has been taken up by 36 percent of the total population. As a result of the steadfast vaccination program and the effectiveness of the vaccines, the spread of the virus has significantly abated, which has allowed a faster normalization of business activity and community mobility. In November, the country reopened its borders to fully immunized non-residents.

Economic policymaking requires careful judgment and a recognition of tradeoffs within budget constraints, particularly in the current uncertain environment. During the pandemic, the government secured the necessary public savings to provide well-targeted support to firms, employment, and the most vulnerable while prudently balancing fiscal sustainability objectives. At the same time and despite the COVID-19 outbreak, the government moved forward with an ambitious agenda of fiscal, monetary, and structural reforms, managing the crisis with a long-term view to place the economy on a higher growth trajectory.

## **Uruguay's economy is recovering from the COVID-19 shock**

After contracting by 5.9 percent in 2020, Uruguay's economy is showing clear signs of recovery with real GDP projected to grow by 3.5 percent in 2021, broadly in line with staff estimates. This growth has been led by exports, private consumption, and investment. Leading indicators for the third quarter are encouraging, reflecting continued growth in economic activity across sectors. The opening of borders bodes well for tourism inflows and is expected to reinforce the recovery in the last quarter of this year.

The economic recovery has been accompanied by the strengthening of the labor market. In the last five months, total beneficiaries of the unemployment insurance have declined by 36 percent. Three out of four jobs lost in 2020 during the pandemic are expected to be recovered by year-end 2021. Unemployment insurance and measures introduced by the authorities in support of workers during the pandemic have cushioned the loss of employment. Moreover, the partial modality of unemployment insurance has enabled workers to return to their jobs once activity picks up.

Notwithstanding the success of the vaccination campaign and the strengthening of the economic recovery, Uruguay is a small, highly open economy and is exposed to downside external risks, including weaker commodity prices and a tightening of global financial conditions. The authorities are prepared to bolster the economy with additional support as needed. They broadly concur with staff that sustaining growth in the medium term requires actions on various fronts. The previously noted reform agenda strengthens fiscal and monetary frameworks, critical to macroeconomic stability, and focuses efforts to enhance inclusive and sustainable growth.

### **Fiscal policy and debt management**

Since the onset of the pandemic, the authorities have taken effective and timely measures to protect household income and human capital, including through social transfers, enhanced unemployment and health insurance, tax credits, and regulatory forbearance. They also took measures for credit preservation and loan guarantees for micro, small and medium-sized enterprises. These measures have been adjusted to meet the unfolding demands of the most vulnerable population and firms. The authorities are pleased that staff recognizes that country-specific circumstances are critical to the appropriateness of fiscal responses across countries. As well noted in the report, Uruguay's strong social protection and health coverage were instrumental in calibrating the appropriate level of fiscal response to the pandemic.

The authorities have a firm commitment to high standards of transparency and accountability, including managing resources and expenditures tied to the COVID-19 response. To this end, the COVID-19 Solidarity Fund (Coronavirus Fund) was created by law in April 2020 with the support of all political parties, making it possible to clearly distinguish and report between non-pandemic and pandemic-related budgetary expenditures, with strict requirements for earmarking and timely disclosure of information. Budgetary resources amounted to 1.4 percent of GDP in 2020 and 1.7 percent of GDP in 2021. In addition, credit guarantees amounted to 1.3 percent of GDP in 2020 and are estimated at 0.3 percent of GDP in 2021.

At the same time, the authorities took decisive actions to strengthen public finances that had been steadily deteriorating in the years prior to the pandemic. The 5-year Budget Law 2020-2024 approved by Congress in December 2020 laid the foundation for changes in fiscal policy decision-making and execution. The new fiscal rule is based on structural balance targets, to account for business cycle fluctuations and one-off/temporary spending and revenue items, together with a cap on real growth in primary expenditures in line with potential real economic growth. The framework also establishes a limit to the central government net indebtedness, which effectively caps the observed fiscal deficit. During 2020, the government met all three pillars of the new fiscal rule, restoring fiscal credibility amid the global pandemic.

While the response to the pandemic widened the fiscal deficit, the reduction of inefficient public spending unrelated to the COVID-19 pandemic, restrictions on public sector hiring, and spending oversight contained the fiscal deterioration, which was one of the smallest in Latin America, helping to stabilize the debt burden over GDP in 2021, in a context of declining debt service costs. In addition, fiscal estimates in the annual budget law have started to be made over a rolling five-year period, beyond the current administration. Also, public debt sensitivity analysis is now included in the budget analysis. All in all, important first steps were taken in a cautious and deliberate way.

More generally, the government believes that the road to improving fiscal accounts is through greater efficiency in structural spending, and not by increasing taxes on the private sector. Quite to the contrary, the government has provided broad tax incentives for construction projects and other economic activities under the General Investment Promotion Regime (COMAP), underpinning investment and formal employment generation.

Going forward, the authorities remain committed to fiscal prudence grounded on the rules-based fiscal framework and have made progress in setting up the external fiscal councils. The Fiscal Advisory Council held its first meeting on September 29, 2021, and its central mandate is assessing the Ministry of Finance's structural fiscal estimates and overall implementation of the fiscal rule. The Committee of Experts, on the other hand, is in its final stage of formation and will be tasked with providing the macroeconomic assumptions to the Ministry of Finance to calculate potential GDP growth.

The authorities have pursued a proactive financing strategy that has included disbursement of credit lines from multilateral institutions, as well as bond issuance in both international and domestic markets, mostly in local currency. Despite the increasing debt burden, the country kept its investment grade status across all credit rating agencies and favorable access to international capital markets even in the worst stage of the COVID-19 crisis. More recently, in May 2021, Uruguay made another successful debt issuance equivalent to US\$1.7 billion, of which almost US\$1.2 billion correspond to a new global bond denominated in fixed-rate nominal pesos.

### **Monetary policy**

To respond to the current Covid-19 health emergency, monetary policy pivoted into an accommodative stance. The Central Bank of Uruguay (BCU) lowered interest rates and deployed countercyclical monetary policy tools, including decreasing reserve requirements conditional on credit expansion, authorizing financial institutions to provide automatic maturity

extension, and loan payments deferral, as well as other measures to inject liquidity in the financial system.

As the pandemic has started to ease and economic activity picks up, the BCU has gradually started exiting the expansionary phase of monetary policy to anchor medium term inflation expectations. The monetary policy rate has been raised by 125 basis points to 5.75 percent since August 2021. As long as there are no setbacks in the evolution of the pandemic and economic recovery, this gradual process of monetary tightening is expected to continue.

The BCU is committed to addressing Uruguay's long periods of above-target inflation and rebuilding central bank credibility. To this end, the authorities have introduced changes to the institutional design and practice of monetary policy. An enhanced monetary policy framework reaffirms price stability as the primary mandate, notwithstanding support to be provided in economic emergencies. The BCU changed its main policy instrument away from targeting money supply growth to the short-term interest rate, allowing for fine-tuning of monetary policy at higher frequency. The inflation target range will be reduced from 3-7 percent to 3-6 percent starting in September 2022 to provide forward guidance. The authorities have also introduced new practices in communication and transparency, including doubling the frequency of monetary policy meetings, issuing the minutes of monetary policy with forward looking statements, publishing official inflation projections and surveys of firms' inflation expectations, and improving communications with forecasters and the press. The BCU concurs with staff that a well communicated strategy is essential to continue guiding expectations. In May 2021, the BCU requested the Fund to assess its monetary policy communication to complement the work already undertaken.

Moreover, the BCU has made explicit the objective of de-dollarizing the economy and rebuilding the Uruguayan peso currency markets, aiming to enhance monetary policy transmission. Monetary authorities understand that financial de-dollarization is a long-term process, which can be slow and halting, and involves changes not only in regulations, but also in borrowing, saving, and cultural practices in the private sector. For these reasons, the BCU has launched a wide dialogue with all interested parts in the financial system, public institutions, and businesses and consumer groups.

The authorities concur with staff's assessment that gains in credibility from the reforms are apparent. Inflation had been declining since it peaked in mid-2020—although it has temporarily increased to 7.89 percent year-on-year in October 2021 (above the upper ceiling of the target range), mainly driven by new underlying pressures from commodity and other tradable prices. The convergence of inflation expectations to the inflation target has thus slowed down and remains slightly out of range. As long as there are no setbacks in the health situation, the priority of monetary policy will be to drive inflation and inflation expectations to the center of the target range in the monetary policy horizon.

The BCU remains committed to preserving exchange rate flexibility while avoiding undue and non-fundamental market volatility. With Uruguay being a small, open, and dollarized economy, the central bank intervenes in the foreign exchange market to prevent disorderly market conditions. International reserves, which are well above the upper bound of the IMF reserve

adequacy benchmark, remain an important backstop for external stability and a key policy anchor. At the end of September 2021, international reserves amounted to 30 percent of GDP.

### **Financial sector**

The financial sector is resilient due to prudent supervision and regulation measures in place. As of the end of June 2021, the capital structure of financial institutions almost doubled the minimum regulatory requirement. Regarding liquidity risk of the banking system, the ratio of liquid assets to total assets remained at a healthy 60 percent. The profitability of banks represented a return on assets of 1.6 percent and a return on equity of 15.1 percent in the second quarter of 2021. The general delinquency of credit dropped to 2.4 percent from 2.7 percent in March 2021, which also represents a reduction from 3.1 percent from a year ago. Stress tests of the banking system showed that it would withstand a severe recession scenario. Going forward, the authorities are working on deepening capital markets based on international best practices. On February 2021, the authorities requested an FSAP assessment and look forward to its policy recommendations.

### **Reform agenda**

As noted by staff in the Selected Issues Paper Chapter on Uruguay's Potential Growth, tackling structural impediments to growth requires action on several fronts. Over the last year and a half, the authorities made progress in passing legislation and advancing measures laying the foundations of a structural reform agenda, including a new fiscal framework to strengthen fiscal discipline, reforming the pension system, introducing a new governance to increase the efficiency of state-owned enterprises (a significant part of the Uruguayan economy), developing capital markets development, and promoting trade openness and integration.

The authorities' priorities include the improvement of the business environment, the generation of jobs, and the promotion of human capital. An additional priority is to increase investments in education, health care, and housing to reduce the poverty rate of children aged three and under, which remains considerably higher than in the rest of the population and has worsened during the pandemic. Incentives and subsidies have been made available to facilitate the entry or reintegration to the labor market of young people aged 15 and 29 years of age, workers over 45 years of age, people with disabilities, and women. Efforts to increase the rates of permanence and graduation in basic and higher secondary education and improve the quality of the curricula are underway with support from multilateral institutions, as well as an early childhood action plan to improve early childhood care.

The pension reform is advancing and is critical to fiscal sustainability in the longer run. The Committee of Experts on Social Security (CESS) tasked with preparing a diagnosis and reform proposals concluded its work in November 2021, after ample consultation with stakeholders and civil society. The next reform steps are the drafting of a bill by the Executive Power and its subsequent debate and parliamentary process.

**Addressing climate change and climate finance**

Uruguay remains at the forefront of environmentally friendly policies and is a sustainable-focused country. Over the past decade, it has transformed its energy matrix by increasing and diversifying its renewable sources of electricity generation. Uruguay is one of the leading countries in the world in terms of clean energy and wind energy production with 94 percent of its electricity production generated using renewables sources.

As we move from pandemic response to recovery, the authorities are committed to a growth path consistent with low greenhouse gas emissions and a climate-resilience economy. For this purpose, the Helsinki Principles were explicitly incorporated in the 2020-2024 Budget Law, putting climate change mitigation and adaptation objectives at the center of the planning and design of economic policies and fiscal management.

The authorities are launching the second generation of renewable energy transformation and decarbonization of heavy transportation and industry through a national strategy for green hydrogen and promotion of electric mobility, in line with an aspirational goal of becoming net CO<sub>2</sub>- zero by 2050. As a testament to these efforts, Uruguay ranks first among emerging market countries in MIT's Green Future Index, which tallies countries' progress and commitment toward building a low carbon future.

In addition, the authorities are connecting the objectives of sovereign debt funding with the imperative of tackling climate change. The Ministry of Finance, in coordination with the Ministries of Environment, Industry and Energy and Agriculture and Livestock, is working on a novel Sustainability-Linked Sovereign Bond that explicitly embeds Uruguay's forward-looking environmental targets, as set out in its Nationally Determined Contributions (NDCs) under the Paris Agreement. The authorities consider that the cost of borrowing should be increasingly linked to environmental performance and linked to countries' contribution to global public goods.

**Final remarks**

Amid the challenges posed by the global pandemic, the authorities have advanced reforms to build a credible macroeconomic policy framework and a structural reform agenda to achieve higher and inclusive growth. Uruguay remains a bastion of democracy, solid institutions, freedom, judicial independence and political stability. Going forward, these attributes remain an important source of strength in an uncertain global landscape.