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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/11-1

10:00 a.m., February 13, 2019

1. Uruguay—2018 Article IV Consultation

Documents: SM/19/31 and Correction 1; and Correction 2; and Supplement 1; and Supplement 1, Correction 1; SM/19/32

Staff: Berkmen, WHD; Haksar, SPR

Length: 34 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Nainda (AE), Temporary
	T. Nguema-Affane (AF), Temporary
	D. Vogel (AG), Temporary
	M. Kikiolo (AP), Temporary
	B. Saraiva (BR)
	P. Sun (CC)
L. Villar (CE)	
	M. Sylvester (CO), Temporary
	S. Benk (EC)
	A. Castets (FF)
	K. Merk (GR)
	P. Dhillon (IN), Temporary
	M. Psalidopoulos (IT)
	Y. Saito (JA)
	K. Badsi (MD), Temporary
	F. Al-Kohlany (MI), Temporary
	V. Rashkovan (NE)
	J. Sigurgeirsson (NO)
A. Mozhin (RU)	
	F. Rawah (SA), Temporary
	A. Srisongkram (ST), Temporary
	V. Djokovic (SZ), Temporary
	O. Haydon (UK), Temporary
	P. Pollard (US), Temporary

H. Al-Atrash, Acting Secretary
H. Malothra, Summing Up Officer
V. Sola, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Legal Department: C. DeLong, N. Rendak. Strategy, Policy, and Review Department: V. Haksar. World Bank Group: M. Sabella. Western Hemisphere Department: S. Berkmen, D. Gershenson, J. Restrepo Londono, C. Soares Goncalves, J. Torres Trespalacios. Alternate Executive Director: J. Di Tata (AG), P. Fachada (BR), A. Guerra (CE), L. Palei (RU), F. Sylla (AF). Senior Advisors to Executive Directors: N. Jost (NE), W. Kuhles (GR),

R. Morales (AG), E. Rojas Ulo (AG). Advisors to Executive Directors: M. Albert (FF), A. Arevalo Arroyo (CE), J. Corvalan (AG), A. Grohovsky (US), C. Moreno (AG), H. Mori (JA), M. Mulas (CE), P. Snisorenko (RU), N. Vaikla (NO), Y. Zhao (CC).

1. URUGUAY—2018 ARTICLE IV CONSULTATION

Mr. Lopetegui and Mr. Vogel submitted the following statement:

An Unprecedented Period of Growth

Uruguay has posted positive economic growth each year since 2003, which constitutes its longest uninterrupted period of expansion in modern times.

What Decoupling Means

Uruguay managed to sustain growth despite economic recessions in Argentina and Brazil. This is a stark departure from past episodes of regional volatility, when Uruguay systematically suffered economic contractions, often even deeper than its neighbors. In the past, this was due to its domestic financial vulnerabilities, low levels of export diversification, and the lack of instruments or policies that prevented Uruguay from appropriately absorbing external shocks.

During this period of growth, Uruguay has managed to smoothly transit an extremely bumpy road. This included, among others, the 2008 global crisis, Brazil’s deepest recession in its history during 2015-16, and three years of recession over the past five years in Argentina, which comprised a sudden and sharp depreciation of its local currency in 2018, especially during the third quarter.

Evidently, economic and financial decoupling is an appropriate concept to illustrate the critical reduction of Uruguay’s exposure to its two big neighbors, and its significant policy buffers. Of course, decoupling does not mean that the country does not suffer the impact of regional shocks; indeed, the robustness of Uruguay’s growth is not the same as was until 2013, while fiscal and external accounts, as well as labor market indicators, have been clearly impacted by regional episodes.

Hence, decoupling means that Uruguay has been able to continue growing amidst negative external shocks, keeping macroeconomic and financial indicators fully under control, sustaining the process of social improvements, and enjoying the confidence of investors and rating agencies, all of which constitute a testament of the country’s sound economic policies, a long process of structural reforms, and the quality of its institutions.

The Fundamental Objective of Inclusive Growth

One essential development to underscore is that this period of economic expansion has been simultaneously accompanied with a substantial improvement in social conditions, especially for society's most vulnerable sectors. Poverty rates have systematically declined, for instance, from 32.5 percent in 2006 to 7.9 percent in 2017 (the latest available figure), without recording a single year of increase. Furthermore, extreme poverty decreased from 2.5 percent to 0.1 percent in the same period of comparison, while the Gini Index, declining from 0.455 to 0.38, reflects significant progress towards reducing inequality.

As previously noted, even in years in which growth rates, although positive, have been more tepid, the process of social improvements has continued unabated, in line with one of the key objectives of the authorities' economic policies, which is inclusive growth. As others worldwide, Uruguay's case demonstrates that growth and social progress can, and should, go hand-in-hand.

The authorities would like to express their satisfaction with the IMF's strong emphasis on the need to reduce inequalities, which, for instance, is highlighted in the last World Economic Outlook (WEO) update as one of the potential triggers of downside risks for the global economy.

Orientations, Policies, and Reforms

Diversification

An increasing integration of the country into the global economy has constituted another key objective of the Uruguayan authorities. The evolution of merchandise exports reflects, to a good extent, the process of diversification carried out by the country. While twenty years ago merchandise exports to Brazil and Argentina represented about 50 percent of Uruguay's exports, currently the figure is half of what it used to be. Diversification has happened not only in terms of markets and origins of foreign direct investment, but also with regards to products, where non-traditional exports of goods, and especially services, have been substantially spread; service exports, which include software, financial consultancy, audiovisual products, and logistics, among others, have significantly increased with a consequent impact on skilled-labor demand and wages. That said, Uruguay does remain heavily dependent on Argentine demand within the country's borders, representing around two thirds of total tourism revenue.

Prudence

The Uruguayan authorities are fully aware of the need to intensify efforts in the fiscal area and continue to be absolutely committed to fiscal consolidation, a key priority for the government, with the objective of reducing debt levels relative to GDP. Admittedly, fiscal figures and targets are different from those projected in the budget under very different realities. As stressed before, decoupling does not mean being impervious to regional shocks. When the current budget was prepared, the IMF's April 2018 WEO projected growth rates of 2 percent for 2018 and 3.2 percent for 2019 for Argentina; and 3.9 percent for the world economy for this year (instead of the current 3.5 percent). Amidst this adjustment in global growth and in the region, and in line with what has been mentioned regarding growth developments, the fiscal situation continues to be under control, but, as may have been expected, it has not been (and will not be) immune. Among other things, private investment reacted to the less benign circumstances, leading the authorities to introduce tax incentives aimed at reactivating it, which is starting to bear fruit.

Consistency

It is impossible to have a sustainable economic expansion and social progress without macroeconomic stability. In that vein, as underlined by the authorities, consistency among policies (which refers to fiscal, monetary, exchange rate, debt-management, and income policies) is crucial.

After reaching two-digit inflation rates in the first quarter of 2016, the Central Bank adopted a tighter stance of its monetary policy, which led to a reduction of inflation and inflation expectations. Inflation was within the target range (and close to its middle point) from March 2017 to April 2018 (with the exception of February 2018, when inflation stayed a little above the band). As noted in the staff report, the impact of a drought and peso depreciation were relevant factors to understand inflationary developments thereafter. Nonetheless, once the above-referred factors dissipated, inflation restarted a declining trend, with the latest figure (7.4 percent accumulated during a 12-month period until January 2019) approaching even closer to the target range. The Central Bank has announced that it will maintain a contractionary policy bias to help contain inflationary pressures.

The authorities' disinflation efforts also center on reducing inertial price pressures. Many of the ongoing multi-year wage negotiations are closing in line with the guidelines—which continue to eschew indexation—, thereby anchoring non-tradable prices and tempering inflation inertia.

Meanwhile, the authorities reaffirm their full adherence to a flexible exchange rate regime, a key element to cushion external shocks. Interventions will continue to be reserved to limit excessive volatility. Amidst a period of volatility during the third quarter of 2018, which evidently was not consistent with fundamentals but a clear over-reaction following regional developments, interventions in the foreign exchange market were more frequent.

The Central Bank has maintained high levels of international reserves, which are well above prudential international norms. By end-December 2018, international reserves totaled USD15.6 billion (approximately 25.4 percent of GDP). More importantly, these levels have remained largely stable over the last few years, with reserves-to-GDP ratios consistently surpassing 25 percent since 2012.

The authorities take note of the staff's assessment that the external position is broadly consistent with fundamentals and desirable policy settings.

Financial buffers

Over the past decade and a half, the Uruguayan authorities have worked toward strengthening macroeconomic and financial stability. Active debt management has played an important role in mitigating financial vulnerabilities associated with currency and maturity mismatches. Debt management strategy has limited refinancing risk by lengthening the maturity of the debt and smoothing the redemption profile. Debt in foreign currency is currently 54 percent of total debt (it was 89 percent in 2005); average time to maturity has been extended to 14.5 years (compared to 8 years); and debt at fixed-rate is 94 percent (vs. 78 percent).

Regarding the latest developments, it is noteworthy that at the beginning of 2019, Uruguay was the first Latin American sovereign to tap international debt markets, issuing a new dollar-denominated global bond with maturity 2031 at 175 bps over US Treasuries.

As noted in the most recent IMF Fiscal Monitor, the country has made substantial progress in measuring and managing sovereign risk exposures across the consolidated public sector. The authorities have implemented transactions across public-sector institutions designed to offset risks, attain hedging gains, reduce borrowing costs, and increase asset returns within the entire public sector.

Rating agencies' assessments also reflect confidence in the country. In their latest releases, Moody's reaffirmed Uruguay's Baa2 rating with stable outlook, while R&I and DBRS also confirmed the country's ratings.

Soundness

Uruguay's substantial efforts and reforms in the financial system, in terms of governance of public banks, as well as regulation and supervision of the system, are perfectly mirrored in the system's developments over the years.

Macro-prudential measures anchored in the implementation of the Basel regulatory framework have played an important role for ensuring financial stability; the banking sector continues to present sound financial indicators, including high capital levels and adequate liquidity buffers.

Local effects on regional shocks have been negligible in the financial sector, which was once a major transmission channel of crises. Figure 6 of the staff report exhibits the drastic reduction of the financial system linkages to Argentina. Although increasing due to transitory factors, non-performing loans, at about 4 percent, remain at low levels, not only at regional but also global levels.

Developments at the Banco República Oriental del Uruguay (BROU), Uruguay's public bank, constitute an excellent example of the benefits entailed by reforms. Once a critical source of vulnerabilities (largely stressed in IMF reports before the 2002 crisis), good governance and professional management have led to excellent results. Therefore, in 2018, BROU presented a record in its profits and a further improvement in capital indicators.

Institutions

It would not be possible to fully understand Uruguay's economic and social developments without considering the fundamental role of its strong institutions as the pillars of the country. In order to mention just a few indicators that reflect the above-referred robustness, we underline that Uruguay is within the group of 20 countries—out of 167 around the world—characterized as full democracies by the Democracy Index 2018 of The

Economist Intelligence Unit, with an overall score of 8.38 (scores are between 0 and 10), recording 10 or about 10 in the sub-indexes of Civil Liberties and Electoral Process and Pluralism.

Moreover, the latest report on Corruption Perception Index from Transparency International ranked Uruguay 23rd out of 180 countries, with a score of 70 (0-100), occupying the first place among all emerging economies, and above many advanced economies.

Looking Forward

A number of developments, at global, regional and domestic levels, entail substantial challenges for the country. As noted before, fiscal consolidation is a key priority for the authorities. The staff report stresses the impact on fiscal accounts that population aging, which is especially relevant in Uruguay, is going to have, noting that “early action will help smooth the transition to a revised system and reduce costs compared to a delayed response when aging pressures become more acute”. Growing consensus among Uruguay’s political spectrum and society in general will be key in this regard. Attaining more vigorous private investment will be essential for growth and employment creation; significantly more efforts are needed in this area. Improvements in education will be essential for Uruguay to successfully face the future and the continuation of the country’s insertion in the global economy. Inclusiveness is always a work in progress, and sustained efforts are essential; financial inclusion is one of the multiple dimensions of inclusiveness, in which the authorities have attained important achievements, such as those underlined in the staff report, when noting that “low-income households and small and micro enterprises have access to free bank accounts and debit cards”.

On-going infrastructure planning is key to establish the foundation for long-term economic growth. Infrastructure investments will become a sustainable pillar of GDP growth moving forward. Along with the potential construction of a new pulp mill by Finland’s UPM, the government’s 2015-19 infrastructure plan actively targets new investments in transportation, energy, communications, and social infrastructure under PPP schemes. The flagship project in the country infrastructure’s program will be a new railway line in the corridor of the country.

In sum, positive results, as well as the recognition of the international community, markets, multilateral institutions, and rating agencies, do not by any means constitute reasons for complacency, but further stimulus to keep working along the lines of robust policies and institutions.

Mr. Merk and Ms. Kuhles submitted the following statement:

We thank staff for the informative set of reports and Mr. Lopetegui and Mr. Vogel for their insightful buff statement. We concur with staff's assessment to a large extent. Not least owing to a strong track record of prudent macroeconomic policies, the Uruguayan economy has shown resilience in the face of heightened regional and international volatility. Growth has remained relatively stable while unemployment and inflation have risen further from elevated levels and the current account has softened somewhat. Concerning the economic outlook, staff appears cautiously optimistic, emphasizing substantial risks both to the downside and the upside. Regarding staff's risk assessment, we were somewhat surprised by the inclusion of large infrastructure projects as an upside risk. Could staff provide some additional comments on the respective assumptions underlying the baseline scenario? In a certainly challenging environment, we call on the authorities to further entrench macroeconomic stability by putting public debt on a firm downward path, containing inflation and implementing structural reforms to boost the economy's growth potential.

Especially with a view to the significant downside risks, reinforcing fiscal sustainability appears of the essence. We thus echo staff's call for additional fiscal measures to bring down the elevated public debt level. The path for the reduction in public debt envisaged by staff should represent the minimum of the authorities' ambition. In this regard, we see merit in a thorough review of current expenditures and in tightening the fiscal framework by introducing a medium-term objective and a truly binding fiscal rule. Could staff provide their assessment of the evolution of public debt over the next years corrected for the temporary effect of "cincuentones" transactions? Further, could staff provide additional comments on potential implications for public financing costs and debt sustainability?

A tighter monetary stance appears appropriate. Ensuring sufficiently high real interest rates appears essential to lastingly lower inflation and anchor expectations firmly at the center of the Central Bank of Uruguay's target range. We second staff's call for reforms to strengthen the monetary policy framework. Maintaining a high level of exchange rate flexibility and securing ample FX buffers will be essential to guard against potentially elevated external pressures going forward. The financial system appears broadly robust, but elevated NPLs, high dollarization and the volatile exchange rate require supervisory vigilance.

We welcome the authorities' commitment to structural reforms. As staff rightly points out, sustained efforts are necessary to strengthen competitiveness, further diversify the economy and realize the benefits of free trade through international trade agreements. Not least in order to rein in contingent fiscal risks, ambitious and timely structural reforms will be of the essence to set the pension system and the SOE sector on a long term sustainable footing.

Mr. Fachada and Mr. Antunes submitted the following statement:

We thank staff for the reports and Messrs. Lopetegui and Vogel for their thorough statement. We commend the Uruguayan authorities for their skillful management of macroeconomic and social policies. In recent years, Uruguay's economy showed resilience in face of regional developments, keeping positive and sustained growth rates. At the same time, the country continued to successfully improve living standards and reduce poverty, without jeopardizing fiscal discipline. That said, we agree with the authorities that the recent positive achievements should not constitute reason for complacency, but rather incentive to maintain sound policies.

Uruguay's short-term fiscal position is solid, but medium-term risks should not be ignored. Although Uruguay's public debt is moderate and sustainable, and the debt profile is manageable, the authorities should remain committed on delivering their fiscal targets. Even though the postponement of the deficit target of 2.5 percent of GDP from 2019 to 2020 was justified given the cyclical position of the economy, repeated failure to meet fiscal targets may affect the authorities' credibility and negatively impact expectations. We commend the authorities for the transparent recording and communication related to the extraordinary transfers of private funds to the public pension system in the context of the cinquentones, which are providing a temporary fiscal relief. Nevertheless, we agree that the fiscal targets should discount this effect, which will represent pressure on public spending in the future. Over the medium-term, we tend to agree with staff that additional measures may be necessary to achieve the overall 2.5 percent of GDP deficit target and put the public debt on a firm downward trend.

The monetary authorities are committed to bringing inflation back within the target range. Inflation has risen above the authorities' ceiling, fueled by one-off factors—including the drought in the first half of 2018—

coupled with a sizable depreciation of the currency. In the current environment, short run real interest rates still seem below the neutral, making it difficult to anchor inflation expectations. We concur with staff's recommendation that the central bank should aim at bringing inflation to close to the center of the 3 to 7 percent target range. In parallel, we welcome ongoing efforts to enhance central bank communication and reduce indexation and dollarization, with a view on increasing the efficacy of the monetary policy.

Uruguay's external position is solid. The diversification of export markets—especially to Asia—and the flexible exchange rate regime were key in enabling Uruguay to decouple from adverse regional developments. The country generated a small current account surplus in 2016-2017, and international reserves remain at a comfortable level and should be preserved. We take note that, according to the EBA current account model, the external position is broadly consistent with fundamentals and desirable policy settings. Although the staff report accurately reflects implications of recent global developments on Uruguay's external position, we have doubts about the characterization in the Risk Assessment Matrix (RAM) of Brazil as a downside risk to Uruguay. In our view, staff is underestimating the potentially positive impact of the forecasted recovery of the Brazilian economy on the country, and the assessment in the staff report seems outdated and disconnected from other publications of the IMF, such as the January World Economic Outlook update. Could staff brief the Board on their more recent expectations regarding the Brazilian economy and explore its impacts on Uruguay?

Uruguay has been successful in reducing poverty and inequality, in a context of fifteen years of sustained economic growth. The challenge ahead is to enhance inclusive growth under possible less benign international conditions. As population ages and the fiscal space for social policies shrinks, efficiency in public spending becomes vital. Accordingly, Uruguay needs to adopt policies that would lead to long-lasting effects in terms of increased productivity. For that reason, we commend the authorities' focus on education, infrastructure, and the rule of law. Finally, we agree with staff's assessment that Uruguay's solid institutional framework constitutes a valuable asset for the attraction of foreign direct investment.

Mr. Saito and Ms. Mori submitted the following statement:

We thank staff for the reports and Mr. Lopetegui and Mr. Vogel for their informative statement. We welcome that Uruguay has successfully differentiated itself from its neighbors and preserved macroeconomic stability in a deteriorating external environment thanks to strong institutions, prudent policies, and accumulation of buffers over the years. However, to maintain resilience, further efforts are needed to reduce inflation within the target band and to achieve the 2.5 percent of GDP fiscal deficit target by 2020. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

Fiscal consolidation is a key to preserve the credibility of fiscal policy and put public debt on a firm downward path. Given the current external environment, we support the one-year postponement of fiscal deficit target of 2.5 percent of GDP from 2019 to 2020 as a counter-cyclical response. Having said that, we note staff's assessment that the new target is not accompanied by adequate fiscal measures to achieve it and introducing at least 0.3 percent of GDP additional measures are needed. In this context, could staff elaborate more on recommended measures to achieve the target and whether the authorities are considering to implement such measures under current government? It is commendable that the authorities' active debt management mitigates financial vulnerabilities by reducing debt in foreign currency, lengthening the maturity of the debt and smoothing the redemption profile. We also positively note the broad coverage of the debt data. While the large financing needs for 2019 are well managed, we encourage the authorities to implement necessary fiscal adjustment to achieve fiscal deficit target as the debt level remain elevated.

Monetary Policy

Tighter monetary policy stance should be kept to reduce inflation and inflation expectation within the target range. Considering the above the target range medium-term inflation expectations and a further depreciation of the peso, we welcome the central bank's announcement to maintain a contractionary policy bias to help contain inflationary pressures. In a longer-term perspective, addressing a high degree of dollarization as well as enhancing communication strategies is required to further strengthen monetary policy transmission mechanism. In this regard, did staff have any discussion regarding the authorities' strategy to de-dollarization during the mission?

Financial Sector

It is encouraging that the financial sector has remained resilient reflecting limited linkages to Argentina and enhanced supervision. We welcome the authorities' effort to boost financial inclusion by utilizing Fintech while protecting consumers and guarding against money laundering by introducing regulation. In this context, do the authorities consider any next steps including involvement of banks regarding the e-peso?

Structural Reforms

We welcome that Uruguay has successfully diversified exports while continuing growth and lowing income inequality and poverty. We positively note the diversification of both export product and destinations. In this regard, we would like to know more about the strategy which the authorities took to diversify the economy and the lessons which other countries can draw on. To achieve income convergence to advanced economy level, we encourage the authorities to make further effort to create fiscal space for infrastructure investment, improve business environment, and increase employment and labor force participation. Given the ongoing population aging and its impact on pension system, we agree with staff that pension reform is needed, and early action will help smooth the transition and reduce costs compared to a delayed response. In this point, social understanding to reform is indispensable and we positively note the growing consensus on the need for the social security system reforms.

Ms. Levonian and Mr. Sylvester submitted the following statement:

We thank staff for the well-written set of papers and Messrs. Lopetegui and Vogel for their insightful buff statement.

We broadly concur with staff's main recommendation that near-term policies should focus on maintaining resilience in the context of Uruguay's worsening outlook and the less favorable external environment. Prudent macroeconomic policies, strong institutions, and sizeable buffers accumulated over the years have helped Uruguay weather the recent turbulence in the Latin American region. However, while macroeconomic stability has been preserved, growth has moderated, and growing near-term uncertainties weigh on the outlook. In this context, we share staff's call for continued credible economic policies to address the immediate challenges and to further advance social and economic objectives. We limit ourselves to the following additional comments.

We welcome the authorities' commitment to fiscal sustainability to put debt on a firm downward trajectory. The broad consensus between staff and the authorities on the appropriate fiscal path to maintain credibility and contain fiscal risks is welcome. We urge the authorities to finalize and implement measures to achieve the fiscal target of 2.5 percent by 2020. Moreover, the authorities should focus their attention on improving the governance of state-owned enterprises (SOEs) and on strengthening the fiscal framework, including to enhance the credibility of the existing fiscal rule. We share the authorities' view on the importance of flexibility as part of the fiscal responsibility framework so that it does not constrain growth-friendly spending, especially in light of Uruguay's huge infrastructure gap.

We urge the authorities to take further measures to bring inflation down to the desired level and to maintain exchange rate flexibility as a shock absorber. Since May 2018, inflation has exceeded the target range of 3-to-7 percent. As staff has alluded, this requires further tightening of monetary policy and improving of the monetary policy transmission mechanism. In this regard, we urge the authorities to implement the appropriate monetary policies and reforms in line with staff's recommendations. We take positive note of the authorities' commitment to maintaining the flexibility of the exchange rate as an important stabilizer for external shocks and stress that they only intervene in the FX market to prevent disorderly market conditions. Staff's Selected Issues Paper (SIP) provides useful context and advice in this area. We also urge further progress on de-dollarization.

We stress continued vigilance regarding financial sector developments. Uruguay's financial system has demonstrated some resilience in the recent past. That said, the sector faces considerable risks associated with exchange rate volatility and high dollarization. Moreover, non-performing loans remain elevated and require close monitoring. This calls for continued vigilance by the authorities and reforms to bolster financial sector stability and to increase the sector's contribution to growth. We welcome reforms to deepen financial inclusion, including through leveraging advances in financial technology while safeguarding against potential risks.

Finally, accelerating structural reforms will support continued income convergence to advance economy status. We commend the authorities for the progress made in reducing income inequality and poverty. The indication that there is consensus across the political spectrum for further structural reforms to achieve this development goal augurs well. Accordingly, we encourage the authorities to remain steadfast in their implementation of reforms to enhance inclusive growth and competitiveness.

Mr. Agung and Mr. Srisongkram submitted the following statement:

We thank staff for the concise set of reports as well as Mr. Lopetegui and Mr. Vogel for their informative buff statement.

Uruguay's uninterrupted economic growth despite recent shocks to the region is a testament to the authorities' sound macroeconomic management, strong reform implementation, and quality institutions. While the overall risk outlook appears balanced, growth is moderating and further deterioration in the external environment could materially weigh on the near-term prospects especially given Uruguay's high degree of dollarization. Against this background, we agree that the main policy priority is to bolster Uruguay's macroeconomic resilience and competitiveness through a combination of prudent policies and productivity-enhancing reforms. We agree with the thrust of the staff appraisal and offer the following comments for emphasis.

Stronger fiscal consolidation efforts are needed to keep public debt firmly on a downward path. We note the counter-cyclical objective of the recent budget relaxation that would still allow the fiscal deficit target to be met, albeit slightly later than originally planned. However, higher pension liabilities from cincuentones transfers and further global market tightening could erode fiscal space and put debt sustainability at risk. As such, we see merit in staff's suggestion to employ additional measures to reduce the budget deficit. These include reviewing current expenditures and adjusting utility tariffs, both of which are consistent with the assessment of fiscal multipliers from the previous Article IV. We also welcome the broad agreement between staff and the authorities on improving fiscal sustainability through enhancements to SOE governance, fiscal rule, and the pension system.

Keeping inflation under control remains a key policy priority. While inflation is projected to gradually decline, we agree that the tight monetary policy stance should be maintained to contain inflationary pressures. Together with wage de-indexation, this would also help to better anchor inflation expectation and strengthen central bank credibility. In this regard, we are pleased with the favorable progress of the ongoing multi-year wage negotiations. On strengthening the monetary policy framework, could staff discuss the possible enhancements to policy instruments and communication in more detail? More broadly, attaining the inflation target will buttress the authorities' commitment to achieving price stability and facilitate the ongoing de-dollarization process in Uruguay. The degree of dollarization seems to have edged up more recently (Figure 7). Could staff comment on the progress towards de-dollarization since the last assessment?

The financial sector remains sound but continued vigilance is warranted. We note that improved capital and liquidity standards have resulted in adequate buffers in banks. The active debt management strategy has also materially reduced exposure to currency- and maturity-related risks. However, NPLs remain elevated and could be further exacerbated by the high degree of dollarization. We therefore join staff in encouraging the authorities to closely monitor these exposures so that remedial actions can be appropriately taken in a timely manner.

We welcome the authorities’ achievements in promoting financial inclusion. We commend the authorities for their active implementation of measures under the Financial Inclusion Law and leveraging on technology to broaden the reach of financial services. In addition, the practical experience from the E-Peso project could provide valuable input to ongoing research on the consequences of CBDCs which remains at a very nascent stage of development. Could staff share some insights on the key takeaways from the pilot phase of E-Peso project? Have the authorities discussed any plans to take this project further?

Enhancing competitiveness and further diversification of exports would improve resilience against external shocks. Improved export diversification has succeeded in uplifting Uruguay’s global market share, but the composition has shifted towards primary commodities at the expense of manufacturing products’ share. As further explored in the selected issues paper, this may be attributed to declining competitiveness as reflected in the REER appreciation. We therefore agree with staff on the need for additional efforts to maintain competitiveness and further diversify away from commodity exports which are highly susceptible to price swings and commodity cycles.

We wish the authorities success in their endeavors.

Mr. Rashkovan and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers and Messrs. Lopetegui and Vogel for their informative buff statement. We welcome the consistently sound economic developments in Uruguay, despite less advantageous external developments in the region. We commend the authorities for their prudent economic governance and maintaining strong institutions, which certainly contributed to this success, also illustrated by low income inequality and poverty rates. As the Risk Assessment Matrix (RAM) outlines, the majority of risks that the country is facing according to staff, could be classified as external. In that sense, we welcome the authorities' ambitions to continue focusing their policies on maintaining the country's resilience, including on the fiscal side.

In order to continue ensuring fiscal and economic sustainability, and as clearly outlined by Messrs. Lopetegui and Vogel in their statement, efforts should continue. A close monitoring of the deficit figures is warranted. While we understand that the debt data refer to the consolidated public sector, and the current budget relaxation is in an appropriate counter-cyclical measure, the adverse trend of the public deficit should be reversed in due time. We support staff's recommendation to consider introducing a fiscal framework. Cognizant of the sensitive political economy of the matter, we agree with the authorities that gradual pension reform will be important, including for reasons of inter-generational equity. As staff, we believe that the authorities should aim at reallocating resources towards human capital and infrastructure investment. Improving the governance of SOEs could also prove useful. We welcome the fact that Uruguay reports debt figures on a consolidated basis for the whole public sector, as staff explains in the Debt Sustainability Analysis (DSA). We note that public sector gross debt stood at 66 percent of GDP at end-2017, while central government debt was lower, at 48 percent. Staff explains that "debt from other public cooperations" was 4 percent of GDP. Is this SOE-related debt? Are SOEs included in the DSA? Are they relevant in the case of Uruguay? We thank staff for their comments.

In the executive summary, staff mentions that drought conditions were one of two key factors impacting inflation, which rose above the 7 percent ceiling. Given this assessment, and in light of the fact that the Government declared an emergency in early 2018 in this context, we would be interested to better understand why staff did not list extreme weather events as an external risk in the RAM? In a similar vein, we would like to ask whether this occurrence was in line with expectations, or the situation has worsened over time? We thank staff for their comments.

Mr. Sigurgeirsson and Mr. Vaikla submitted the following statement:

We thank staff for a comprehensive set of papers and Mr. Lopetegui and Mr. Vogel for the informative buff statement. Uruguay is a stable and strong economy which has, during the last decade, significantly improved its social conditions, diversified its exports and implemented economic reforms. While Uruguay´s prudent policies and strong institutions have also supported the economy through recent regional turmoil, its relatively small size and openness still makes the economy vulnerable to shocks. Maintaining resilience should therefore continue to be an important priority. This requires implementation of prudent fiscal policy and maintaining exchange rate flexibility and strengthening of monetary and fiscal frameworks. Moreover, investments towards infrastructure, strengthening education, and fostering private sector development would improve growth perspectives over the long run. We broadly concur with the staff appraisal and would like to highlight the following points for emphasis.

Fiscal consolidation is critical to achieve budget objectives and improve fiscal sustainability. We note staff´s assessment, that excluding the impact of one-off fiscal transfers, meeting the 2020 fiscal target without additional measures could be challenging. Given the external risks and Uruguay´s elevated debt levels, we agree with staff on the merits of additional measures to improve the public sector's overall balance and place public debt firmly on a downward path by decreasing current expenditures, adjusting utility tariffs, and improving SOE governance. These measures would help safeguard Uruguay´s fiscal position against market volatility, regional shocks, and provide fiscal space for discretionary spending, if needed. To improve fiscal discipline in the long run, the authorities should consider developing a medium-term fiscal framework and improving the current fiscal rule, which should be anchored on a medium-term debt objective. Sustaining a prudent fiscal stance would also serve to decrease the burden on the monetary policy and thus decrease potential capital flow risks.

Efforts are needed to bring inflation back to the target range. The inflation rate accelerated in 2018 on the back of drought and the depreciation of the peso; but following an interest rate increase and the base-effect, it is expected to decelerate slightly this year. However, to further lower inflation rate and medium-term inflation expectations, the authorities should maintain a tight monetary policy and strengthen the monetary policy framework, as recommended by staff. Furthermore, we encourage measures aimed at reducing dollarization in the economy and enhancing central bank communication to bring inflation to the central bank´s target range. The authorities should also take further steps to remove backward indexation from the wage-setting process, which seems to contribute to the inflation rate. We concur with staff, that allowing for exchange rate flexibility is needed to absorb external shocks.

Implementing growth enhancing structural reforms would raise potential growth over the medium term and improve competitiveness. Fostering private investment, enhancing the business environment and improving the quality of education would help to increase employment levels and thereby support strong and inclusive growth. We concur with the authorities that infrastructure planning is key to establishing strong economic growth. We welcome authorities´ comprehensive infrastructure plan to improve communication, energy, and transportation linkages.

Mr. Beblawi and Mr. Al-Kohlany submitted the following statement:

We thank staff for the report and Mr. Lopetegui and Mr. Vogel for their buff statement. The Uruguayan authorities are commended for maintaining a period of economic expansion for over a decade. However, growth has moderated this year against the backdrop of a weakened external environment and lower agriculture yields, which were brought on by the recent drought. Uruguay remains well positioned to manage external shocks, due to the authorities' prudent policies, strong institutions, and ample buffers. Looking ahead, strengthening the fiscal framework and implementing structural reforms are needed to raise employment and improve diversification and competitiveness. We agree with the staff's appraisal and offer the following comments for emphasis:

The authorities are facing fiscal challenges from high social and security spending, as well as high current expenditures. Fiscal deficit reduction has stalled and fiscal adjustment is needed over the medium term, in order for the authorities to meet their deficit objective and place debt on a downward path. We agree with staff that the needed fiscal adjustment should come from reducing the elevated level of current expenditures and improving the efficiency of capital and social spending. Tax revenue from megaprojects coming online (i.e., the pulp paper plant) should be used to build fiscal buffers, and other revenue rising measures could also be considered. To this end, we would appreciate staff's assessment of the effectiveness and impact of the tax incentive introduced in 2018. On the financing side, we note that the gross financing needs over the short term are manageable, due to the authorities pre-financing policy. However, Uruguay should remain vigilant over the medium term in the context of potentially increasing global financial market volatility.

Monetary policy stance is appropriate at this juncture. Inflation is projected to moderate in 2019, driven by the July reduction in monetary indicative references, successful round of wage negotiations, and dissipating weather and peso depreciation pass-through effects. Bringing inflation close to the middle of the central bank's target range is important to anchor expectations. However, further monetary easing should remain contingent on the evolution of inflation expectations and the impact of the end-December reduction in the monetary indicative references, once it has worked through its lag. We note staff recommendation, over the long term, to further strengthen the monetary policy framework with a focus on improving strategies and instruments. Would staff provide additional information on the key measures in this regard.

The external position is broadly consistent with fundamentals and can withstand the unfavorable external environment. We agree that peso flexibility should continue to provide an important shock absorber and to limit foreign exchange intervention to smoothing excessive exchange rate volatility. However, the central bank is expected to meet the FX needs of the government and large domestic institutional investors' portfolio shifts, when needed, as it is the case for countries with small FX market. Even though the economy is becoming less correlated with neighboring economies, they remain important trading partners. To this end, we encourage the authorities to double their efforts to diversify exports and export markets.

The banking sector continued to show adequate profitability and improved capitalization. However, credit to the private sector is very low, notwithstanding the introduction of the Financial Inclusion Law, which aims at improving financial deepening and inclusion. Dollarization remains high, despite some improvements over the past three years, with dollar deposits at about 75 percent of total bank deposits. In this regard, we encourage the authorities to control the risks associated with dollarization levels on the asset and liabilities side, particularly the potential vulnerabilities from the large share of foreign currency credit to unhedged borrowers.

We welcome the central bank's leadership in the area of Fintech. The authorities successfully introduced the e-peso, one of the world's first Central Bank's Digital Currency (CBDC) pilot program. While the e-peso pilot's objectives included encouraging financial innovation and increasing financial inclusion, the results of the pilot remain under evaluation. We look forward to staff's assessment of the pilot in future reports; particularly, the impact of a widely adopted e-peso on the stability of the banking sector and on monetary policy transmission.

Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for the report. The Uruguayan authorities have managed to preserve macroeconomic stability in a difficult economic environment. We encourage them to stay on the course of a prudent and consistent policy path, as highlighted by Messrs. Lopetegui and Vogel in their helpful buff.

We broadly agree with the staff's appraisal, even though we feel that the report could have benefited more by including context in their analysis. Staff's recommendation to safeguard the delivery of budget targets by taking additional measures for 0.3 percent of GDP in 2019 seems to be overall reasonable. It strikes a balance between buttressing fiscal policy credibility and avoiding compounding the current slowdown. However, the report should have clarified why the medium term fiscal targets were lowered in the first place. Does it reflect a worsening of the structural balance or just a weaker economic growth in 2018? Further elaboration from staff would be useful. Moreover, beyond the different growth assumptions, the sources of different fiscal projections are unclear to us. Further elaboration from staff would be useful. In reaching the targets, capital spending needs to be especially protected, as the last year SIP has shown that associated multipliers are particularly high in Uruguay. Age-related spending can pose challenges going forward and we welcome the authorities' intention to work on a social system reform.

We would welcome a more explicit discussion of the monetary policy stance and of the actions needed to improve the framework. The report seems to suggest the need for tighter monetary stance, based on a Taylor rule estimate. We would like more clarity about the policy actions that staff suggest should be taken by the authorities to steer inflation back the target. In this respect, can staff elaborate more on to what extent an estimation based on a Taylor rule provides relevant information in a monetary targeting regime, especially if characterized by a weak transmission? We agree that durably lowering the inflation rate and expectations requires improving the monetary policy framework. Therefore, more determined efforts from the authorities are needed to remove impediments to an effective transmission of monetary policy. Can staff elaborate more on the advice provided to the central bank to strengthen its monetary framework, beyond what is said on the use of fintech to promote financial inclusion?

We commend the authorities for the large coverage of debt statistics as it provides a transparent picture of debt sustainability. Uruguay is one of the few countries reporting consolidated debt data, including its central bank. To ensure consistency staff has appropriately focused the risk analysis on the gross NFPS debt, while conducting the stress tests on the whole public sector. By doing so the additional elements of strength that can mitigate the impact of a severe downturn, such as Uruguay's large stock of liquid assets, are taken into account.

We welcome the authorities' commitment to preserve the flexible exchange rate as a key shock absorber and to limit interventions to episodes of excessive volatility.

Mr. Mozhin and Mr. Snisorenko submitted the following statement:

We thank staff for a set of comprehensive reports, and Messrs. Lopetegui and Vogel for their informative buff statement. Uruguay is in its sixteenth year of consecutive annual economic growth despite the acute crises in the neighboring countries. The economic growth with an annual average rate of 4.3 percent between 2003 and 2017 was accompanied by significant progress towards reducing poverty and inequality. The per capita income increased by almost 80 percent during this period. While prudent macroeconomic policies have been relatively successful in dampening the effects of negative external shocks, over the medium term, the authorities should focus on further improving the fiscal and monetary policy frameworks and implement additional structural reforms aimed at fostering long term growth.

We agree with staff that achieving the fiscal deficit target of 2.5 percent of GDP in 2020, instead of 2019, is appropriate. Securing this deficit target while promoting a growth-friendly structure of public spending and taxation should remain the top priority for the government. We concur with staff that the strengthened fiscal rule would help to free up additional fiscal space for much-needed infrastructure investment and recalibration of the pension system. The fiscal reforms should be complemented with careful monitoring of the fiscal risks pertinent to the operations of SOEs and PPPs' implementation. In this regard, we would encourage the authorities to undergo the Fiscal Transparency Evaluation, which could better inform further advancements in the fiscal policy framework.

The authorities' adherence to the floating exchange rate regime plays a major role as the first-line absorber of the external shocks. At the same time, monetary policy implementation continues to face challenges related to still high dollarization, a low depth of the FX market, and widespread indexation.

As a result, inflation expectations remain insufficiently anchored. While we appreciate the analysis of the effectiveness of the FX interventions, provided in the SIP, we would also have liked to see the discussion on how monetary policy framework can be improved in order to better cope with the aforementioned challenges. For example, how can the authorities improve the intervention mechanism to facilitate the development of the deeper, more liquid and more efficient FX market? What are the options to address indexation system without negative social consequences? Do the authorities consider undertaking any measures to address high dollarization, in line with the recommendations in last year's SIP? Staff's comments are welcome.

Uruguay is leading the continent in more equitable income distribution. It also has a favorable perceptions-based ranking on corruption. At the same time, more ambitious structural reforms should enhance medium-term growth. The economy has a rather low ranking in the World Bank Doing Business index, which points to the urgent need to improve the business climate. The authorities need to enhance access to financial resources. A declining workforce associated with population aging needs to be addressed by enhancing education levels, improving labor market flexibility, and redistributing labor resources to more productive sectors.

We welcome the analysis in the insightful SIP of the impact of the real exchange rate changes on sectoral exports. The analysis concludes that continuing appreciation of the REER since 2003 has adversely affected manufacturing imports. Staff consider it a sign of the need to further enhance productivity and promote competitiveness. Continued efforts are needed to improve market access, enhance cross-border trade, and further diversify export products. What are the authorities' recent plans in these areas?

Mr. Inderbinen and Mr. Djokovic submitted the following statement:

Uruguay has weathered the headwinds of regional economic turmoil and the bouts of market volatility well. This owes much to its strong institutions, economic buffers and prudent macroeconomic management. We note that the medium-term outlook remains positive and that the economy is again expected to grow above potential following the weaker outcomes in 2018 and 2019. Going forward, macroeconomic policies should be geared toward strengthening fiscal and monetary frameworks and preserving confidence, and structural reforms should focus on bolstering growth potential, competitiveness and diversification. We thank staff for their valuable set of papers, and Mr. Lopetegui and Mr. Vogel for their informative buff statement, and provide the following comments for emphasis.

Fiscal policy should increasingly focus on achieving the fiscal target, reducing public debt, and preserving credibility. At this juncture, the moderate relaxation of the policy stance seems appropriate. However, achieving the authorities' fiscal target without further delay by 2020 should remain a priority. This will be instrumental in preserving credibility and putting public debt on a downward path. Furthermore, the composition of expenditures needs to be rebalanced toward capital spending.

Overall public financial management would be strengthened by introducing a medium-term fiscal framework and modernizing the fiscal rule. The fiscal framework would benefit from an overhaul of the fiscal rule to provide binding operational guidance. Also, containing pension spending will need to remain a priority. We note the high social cohesion in Uruguay and the importance of the near-universal pension coverage. Still, given the adverse demographics and the high and increasing outlays, a timely reform of the pension system would be critical to ensure its sustainability and preserve intergenerational equity.

Strengthening the monetary framework will be key to durably restoring inflation to the mid-point of the central bank's target range. We note that inflation has been above the target range for most of the past decade, indicating entrenched expectations and inflation inertia, but also deficiencies in the monetary policy framework. High dollarization, the remaining wage indexation, and the relatively low credit-to-GDP ratio pose continuous challenges. Going forward, stepped-up efforts to promote the use of the peso, as well as enhanced central bank communication, will be needed to anchor expectations and improve monetary policy transmission.

Further policy action is needed to ensure continuous income growth. We note the commendable decline in poverty and inequality. However, enabling continuous income convergence would require additional policy efforts. Low and declining investment and weak labor market are weighing on growth outcomes. Policies should be oriented toward closing the infrastructure gap and improving educational quality and outcomes. Furthermore, the economy would benefit from improved access to credit, enhanced labor market flexibility, and the alignment of wage growth with productivity. This would also benefit competitiveness and the diversification of the economy.

Mr. Benk and Mr. Zaborovskiy submitted the following statement:

We thank staff for the informative set of papers, and Messrs. Lopetegui and Vogel for their insightful buff statement. Sound counter-cyclical and structural polices, as well as accumulated buffers have helped Uruguay weather challenging external developments, including turbulence in the main export markets. However, the growth momentum and external sector balance have somewhat weakened. We commend the authorities for their prudent policy response, and the impressive structural and institutional achievements outlined in the buff statement. Well-designed and carefully implemented policies have aided Uruguay in strengthening its macroeconomic fundamentals and fostering inclusive growth. We broadly agree with the thrust of the staff's assessment and offer the following comments for emphasis.

Advancing structural fiscal reforms could help preserve fiscal space and public debt sustainability. The authorities' gradual and growth-friendly fiscal consolidation strategy seems well-justified, striking a fine balance between growth and debt sustainability objectives. We commend the Uruguayan authorities for their prudent approach to public-sector debt reporting, as Uruguay is one of few countries that report debt figures on a consolidated basis for the whole public sector, including the central bank. In this regard, we welcome staff's further elaborations on how to better align and operationalize the debt anchor for this wide definition of public debt with the budget deficit target, and specifically, on how staff developed the consolidation target of at least 0.3 percent of GDP in 2019. We positively note the broad agreement between the authorities and staff on the fiscal policy objectives, and welcome their efforts to strengthen the overall fiscal framework, including the fiscal rules and budget risk management.

Maintaining prudent monetary policy and exchange rate flexibility remain critical for macroeconomic stability. Since staff points to the evolving inflationary pressures, continued vigilance by the monetary authorities is warranted to keep inflation under the firm control. We note that the central bank has lowered M1 money supply growth in response to above-target inflation and encourage the authorities to ensure an anti-inflationary monetary policy stance, as well as further strengthen the monetary policy framework to better anchor inflation expectations. On the exchange rate policy, we agree that exchange rate flexibility should continue to serve as a shock observer, while limiting interventions to preventing disorderly market conditions. Considering that Selected Issues Paper found the asymmetry in the effectiveness of FX interventions in Uruguay, while the External Sector

Assessment results point to the signs of peso's overvaluation, we would like staff to elaborate more on their views on how to minimize this asymmetry and excessive currency appreciation in case of temporary surges in capital inflows.

Boosting financial inclusion and innovations should continue to go hand-in-hand with advancing supervision. We positively note the E-peso pilot project implemented by the central bank to test the innovative ways to reduce transaction costs, encourage financial innovation, and increase financial inclusion. This project also seems to be very interesting in the broader context of decoupling cash from electronic money, widely being discussed nowadays. We agree that further analysis is needed to assess the balance of risks and benefits associated with e-currencies, including the impact on monetary policy transmission and the banking system, and encourage staff to continue looking into these emerging issues linked to the IMF's core mandate. We agree with staff that the Uruguayan authorities deserve full credit for their effort to expand the reach of the financial system while ensuring that it remains resilient. We also appreciate that Messrs. Lopetegui and Vogel's buff statement provides helpful insight on the strategic policies and results Uruguay has achieved in ensuring financial stability and banking sector resilience over the last two decades.

Enhancing inclusive growth and competitiveness requires structural reforms to be sustained. Further human capital development; investments in infrastructure, including public-private partnership schemes; and a labor market reform could further boost potential growth and accelerate convergence to advanced countries' income levels. The business climate should also be improved to reinvigorate private sector investment. In this regard, we welcome the authorities' efforts to strengthen the state-owned enterprise governance and expand room for the private sector, as well as their focus on aging-related issues. We also note that during the Article IV mission, staff conducted outreach to the unions, civil society, and opposition. As the election period is approaching, could staff comment on the results of this outreach, including major economic policy issues that significantly differ from the authorities' views, as well as staff's recommendations, if any.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Raghani, Mr. Sylla and Mr. Nguema-Affane submitted the following statement:

We thank staff for the set of papers on Uruguay, and Mr. Lopetegui and Mr. Vogel for their informative buff statement.

Uruguay's economy has showed strong resilience against a deteriorating external environment and a drought in 2018. The economy has continued to grow, and macroeconomic stability has been broadly preserved owing to decade-long implementation of prudent macroeconomic and financial policies, and a wide range of reforms. However, growth is moderating, inflation rose above the inflation target range and the current account balance turned negative. In addition, employment is declining, and investment appears insufficient to increase growth potential. Regarding risks to the outlook, the risk assessment matrix (RAM) lists cyberattacks as a moderate risk. We would like staff to further elaborate on this, notably whether this is a specific risk to Uruguay. We agree that the authorities' main challenge going forward is to maintain economic resilience and adequate buffers in the face of a more difficult external environment, notably a protracted slowdown in neighboring countries. As the near-term outlook is worsening, the authorities' efforts to further improve the policy framework and address infrastructure gaps are positive steps towards strengthening the resilience and competitiveness of the country.

We welcome the authorities' continued commitment to fiscal and debt sustainability over the medium-term and their intention to adopt additional fiscal measures to achieve their medium-term fiscal and debt objectives. We find appropriate the relaxation of the budget in 2018 and the postponement of the 2.5-percent fiscal deficit target for one year, given the unfavorable external environment. Going forward, fiscal adjustment should focus on further streamlining spending notably by improving efficiency of social expenditures, to create additional fiscal space for investment. Moreover, further enhancing the fiscal framework should be a priority of the fiscal reform agenda. In this regard, we see merit in introducing a medium-term fiscal framework in order to ensure continuity of fiscal policy over time. We note the authorities' agreement that escape clauses to the fiscal rule should be tightened, while preserving flexibility, to improve confidence in fiscal policy. We encourage the authorities to make further progress in the reform of the pension system and the strengthening of the governance of the SOEs to limit fiscal risks.

Anchoring inflation expectations within the central bank's range target is a priority. We praise the authorities' commitment to price stability and exchange rate flexibility. The ongoing disinflation process following the recent monetary tightening, and the subsiding effects of factors that pushed inflation above the target range in 2018 is welcome. However, more remains to be done to bring persistent above-target inflation expectations within the target range. The authorities are invited to consider staff's recommendations on further strengthening the monetary policy framework to firmly anchor inflation expectations within the target range. That said, it is not clear whether staff recommend further monetary policy tightening at this moment. Staff comments will be appreciated.

The financial system resilience to the regional turmoil is particularly noteworthy. Despite higher NPLs due to the drought and the economic slowdown, the banking system remains sound thanks to a reinforced supervisory and regulatory framework. Given the current environment, greater vigilance over banks' exposures will be needed to preserve financial stability. As regards financial inclusion, we commend the authorities for taking pioneering actions towards promoting greater use of technology and enhancing related regulations, while addressing the concerns stemming from the development of Fintech. In particular, we welcome the recent introduction of the e-peso which has an enormous potential to increase financial inclusion. We look forward to the findings of the central bank's analysis on the implications of the use of the e-peso on payments systems and traditional banking systems.

The authorities should take advantage of the political consensus for reforms to make further progress towards reaching the advanced-economy status. We find appropriate the actions already taken in this regard, notably the implementation of large infrastructure projects and reform of the education system. We note from the Selected Issues paper, among others, that the manufacturing sector is sensitive to changes in the real effective exchange rate and welcome the authorities' plan to further enhance competitiveness and diversify export products and markets, notably through trade arrangements.

Mr. Mouminah, Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for well-focused set of reports and Mr. Lopetegui and Mr. Vogel for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

We welcome the assessment that Uruguay is well-positioned to withstand deteriorating external environment and would like to underscore the importance of maintaining resilience. It is encouraging to note that Uruguay managed to sustain growth despite external shocks especially in the context of economic recessions in neighboring countries, thanks to Uruguay's prudent policies, ample reserves, and strong institutions. Also, Uruguay's continuous progress in diversification of export markets and products as well as poverty and inequality reduction are commendable. Nonetheless, the near-term outlook, although stable, has worsened and the external environment remains challenging. Here, we agree with staff that preserving resilience including through putting debt on a firm downward trajectory, bringing inflation down to the central bank target, preserving the financial sector stability while further enhancing inclusive growth and competitiveness is warranted.

We support staff's call for implementing additional measures to ensure a gradual public debt reduction and to maintain fiscal sustainability. This includes addressing the still elevated current expenditure and limiting the increase in pension spending, while ensuring adequate coverage going forward. As rightly noted by staff, fiscal sustainability could also benefit from the introduction of a medium-term fiscal framework, underpinned by a binding fiscal rule. Separately, we take note of staff's assessment that the delay of the 2.5 percent fiscal target to 2020 is justified on the basis of worsening near-term outlook.

We support the authorities' emphasis on continuing to monitor the quality of bank assets. While banks are well-capitalized and profitable, the increase in NPLs, although on the back of temporary factors, warrants close monitoring to ensure that the banking system remains on a sound footing. On a separate note, the authorities' strides to boost financial inclusion including by capitalizing on Fintech advancements are welcome.

Finally, we encourage the authorities to continue their structural reform implementation to secure more inclusive growth and enhance competitiveness. On the latter, we broadly echo staff's view on the key measures proposed to enhance Uruguay's competitiveness as explained in ¶11 in the first topic of the SIP.

With these remarks, we wish the authorities further success.

Mr. Villar, Mr. Guerra and Ms. Arevalo Arroyo submitted the following statement:

We thank staff for the excellent set of papers and Mr. Lopetegui and Mr. Vogel for their comprehensive buff statement. Uruguay has remained resilient in the context of large external shocks and increasing domestic challenges. The authorities have followed a prudent policy stance and have constituted large buffers. During more than a decade and a half of continued growth in Uruguay, there has been a substantial improvement in social conditions and poverty rates have diminished considerably. Looking forward, demographic factors could increase pressure on public finances making it necessary for the authorities to implement adequate measures to ensure fiscal sustainability and to maintain buffers to confront commodities' price shocks as the economy becomes more dependent on their exports of these staples.

While economic growth has moderated in the margin, consumption has contributed to sustain domestic demand as private investment has become sluggish. Nevertheless, as the effects of the severe drought recede, growth should continue at a higher rate. We want to ask staff about the factors that explain investment deacceleration. Also, given the continuous growth rates during the last years, what explains the still high unemployment rates between 7 and 9 percent?

We support the authorities' key commitment to fiscal consolidation in order to secure a sustainable reduction in debt levels relative to GDP. The efforts of fiscal prudence have been reflected in higher buffers and a more resilient economy. Looking ahead we agree with staff on the need to have a medium-term fiscal anchor and utility tariffs that reflect the cost structure and investment needs of public enterprises. Also, we are reassured by the growing consensus on the need for a comprehensive reform of the social security system. Uruguay has one of the highest pension spending, as percentage of GDP, and dependency ratios in the Latin American region. Age-related fiscal pressures could undermine the current strong fiscal stance in the medium term. We agree with staff that addressing pension reform and other improvements in the efficiency of social spending will be required to create savings to close infrastructure gaps and reforming the education sector to enhance human capital. We notice in Figure 8 of the report, that even though Uruguay has one of the highest GDP per capita in the region, its secondary completion rates are below the regional average. Staff comments are welcome.

Regarding monetary policy, we note the efforts by the authorities to keep inflation within the Central Bank's target range. This commitment will contribute to further strengthen the monetary policy framework and better anchor inflation expectations. Inflation should return to the range once the effects of temporary climate-related factors dissipate. In this regard, we concur with staff on the need for indicative references to continue to be adjusted so that real interest rates increase. The signaling effects of interest rates would be enhanced in a framework that allowed for lower volatility of short-term interest rates. We would like to know staff's assessment of the possibilities of gradually moving from targeting money aggregates towards an inflation targeting framework. Furthermore, we must recognize that there is a high level of uncertainty related to the measurement of neutral policy rates. This is even more complex in an economy with inertial price pressures and highly dollarized. In this vein, we support staff's call to further strengthen the monetary framework, including enhancing the communication strategies.

Finally, we support the authorities' efforts to further improve the regulatory and supervisory framework of the financial system. Local financial institutions have weathered the different regional shocks well given high capital levels and adequate liquidity buffers. Nevertheless, banks still have a relatively high level of non-performing loans. Also, an important percentage of deposits and credits are in dollars, and around one third of outstanding FX lending is to the non-tradable sector. In this regard, could staff comment on the different measures that the authorities could undertake in order to reduce dollarization in the economy?

Ms. Pollard and Mr. Grohovsky submitted the following statement:

The Uruguayan economy continues to show resilience. While Uruguay's relatively strong external position has contributed to the economy's out-performance against its neighbors, over the medium term we encourage the authorities to strengthen fiscal buffers. We generally agree with staff's assessment and recommendations and focus our comments on the following points.

Exchange rate intervention: We welcome the sufficient attention paid to exchange rate intervention in both the Staff Report and the Selected Issue papers. Given the important role of the Fund in exchange rate issues, this level of attention should be paid across Article IV reports in countries where intervention is present. Given Uruguay's significant foreign exchange reserve holdings well above traditional metrics, we urge the authorities to intervene only in cases of considerable exchange rate volatility and otherwise allow the exchange rate to act as a shock absorber.

Fiscal adjustment: While external buffers are considerable, debt levels remain elevated and the fiscal adjustment has stalled. However, given a brief period of expected slower growth, we welcome staff's flexibility in recommending a slower fiscal adjustment in order to help support the economy. The generally positive outlook over the medium term should provide the authorities with the ability to reduce fiscal vulnerabilities in a growth-friendly way. Additionally, is there scope for the new government to introduce a medium-term fiscal framework to allow more continuity, including the achievement of the fiscal target, between governments?

Monetary policy: Finally, given that inflation has persistently remained above its considerable target range, we encourage the authorities to take further steps to strengthen the monetary policy framework. Can staff comment on the strategies, instruments, and communication practices that the central bank can employ to further strengthen the monetary policy framework and bring inflation within the target range? Undertaking measures to bring inflation and inflation expectations down into the target range can reinforce the credibility of the target and make expectations self-fulfilling, enhancing the ability of the central bank to control inflation.

Mr. Ray and Mr. Kikiolo submitted the following statement:

We thank staff for the useful set of reports and Mr. Lopetegui and Mr. Vogel for the informative buff statement. Uruguay showed strong resilience amid an unfriendly external environment, benefiting largely from well-coordinated prudent policy measures the authorities undertook over the years. The country has sufficient reserve buffers and social indicators as shown by the Gini coefficient and the poverty index showed positive improvements. However, weak investment, anemic credit growth combined with elevated external risks could dampen growth. In this regard, we urge the authorities to build on the strong institutions they have by accelerating reforms to boost productivity and support private sector activities. We agree with the staff assessment but offer the following comments for emphasis.

We welcome the authorities' ongoing commitment to fiscal sustainability in view of the worsening outlook. This commitment must be accompanied by actions not only to reduce recurrent expenditure but to mobilize revenue and raise capital spending. We agree with the postponement of the fiscal deficit target of 2.5 percent of GDP to 2020. However, there is so much uncertainty whether a newly elected government would be committed to the deficit target. Persistent decline in capital investment in recent years is quite concerning as it could undermine potential growth. While we note the investment gap will be filled by PPPs, the implementation phase is slow and unclear. Can staff provide an update on the PPP funded capital projects?

The contractionary monetary policy is warranted in view of the persistently high inflation in the country. We are pleased to note from the buff statement that inflation has trended towards the Central Bank's inflation range of 3.0 - 7.0 percent, standing at 7.4 percent in January 2019. However, this is still on the upside and we hope this could be driven down further and sustained with the inflation band to anchor inflation expectations. Like staff we agree that the monetary policy transmission mechanism should be strengthened, accompanied by improved communication strategies and effective policy instruments. We noted from staff projections that medium term inflation is expected at the upper end of the central bank's targeted band. This in our view could undermine the credibility of the central bank's target band and the effectiveness of staff recommendations to drive down inflation. Staff comments are welcomed.

Accelerating structural reforms and infrastructure investment to boost productivity and competitiveness. Noting the need for the country to diversify its export base further, we see merit in the country accelerating reforms in the education and labor market. Prompt actions on the proposed comprehensive reform on the country's social security system would be welcomed as a positive step towards addressing higher social spending pressures down the track. This should be complimented with sustained improvements in infrastructure projects. We value the Selected Issues Paper on real exchange rate and sectoral competitiveness in Uruguay and welcome the authorities' commitment to maintaining flexible exchange rate. We also noted that the sharp appreciations against the Brazil and Argentina may continue to affect exports including agricultural exports. The ratio of private sector credit to GDP is surprisingly low by regional comparisons given Uruguay's favorable macroeconomic conditions. To boost private sector activities, we would encourage more credit intermediation by the financial sector.

Mr. Sun and Ms. Zhao submitted the following statement:

We thank staff for the informative report and Mr. Lopetegui and Mr. Vogel for the helpful buff statement. We commend the authorities for maintaining prudent monetary and fiscal policies as well as effectively diversifying the export markets. In light of the less friendly external environment, the authorities are encouraged to improve fiscal and monetary frameworks, control inflation, and enhance structural reforms. We broadly agree with the staff appraisal and offer the following points for emphasis.

Fiscal adjustments with emphasis on the expenditure side are needed to maintain fiscal sustainability. We note that the authorities' overall fiscal deficit target of 2.5 percent of GDP will be difficult to reach by 2020 without additional measures. Given the low private investment and declining employment, we agree with staff that fiscal adjustment should mainly come from the expenditure side. We welcome staff's comments on the priorities to reduce current expenditures while ensuring growth enhancing projects.

Monetary policy needs to focus on curbing inflation and improving transmission mechanism. Given that inflation is beyond the central bank’s target range and short- and medium-term real rates are below the range of estimated real neutral rates, continuation of the tight monetary stance would be appropriate. We also note that a high degree of dollarization, limited banking intermediation, and market segmentation have weakened the monetary policy transmission mechanism and constrained bank credit. In this regard, we welcome the authorities’ implementation of the pilot program on Central Bank Digital Currency (CBDC) to encourage financial innovation and increase financial inclusion. At the same time, since banks did not participate in the pilot program, will there be any side effects of the CBDC such as bank disintermediation? Staff’s comments are welcome.

Structural reform efforts are needed to enhance medium-term growth. In the context of low investment and declining employment, further efforts are needed to ensure continued income convergence. We share staff’s view that efforts should be made to improve the quality of education, make the labor market more flexible, and address infrastructure gaps. We also highlight the importance of deepening domestic FX and securities markets and promoting financial inclusion. These efforts would also help strengthen the flexible exchange rate regime and facilitate investment activities.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. de Villeroché, Mr. Castets and Ms. Albert submitted the following statement:

We thank staff for their insightful set of papers, as well as Mr. Lopetegui and Mr. Voguel for their informative buff statement. We welcome the reinforcement of Uruguay’s economic resilience during the past years, supported by a sound institutional framework and cautious macroeconomic policies. Importantly, those good performances have been accompanied by reduction in poverty and inequalities. However, on the fiscal side, while we agree that adapting the fiscal trajectory is adequate to deal with a more difficult environment, maintaining a downward trajectory will be challenging in the context of elections at the end of the year. Additional efforts are therefore necessary to ensure the sustainability in the long term in the context of an ageing population. Keeping inflation in the central bank range target remains also challenging. Against such a background and as the external environment might deteriorate further, we encourage the authorities to pursue their reforms to enhance competitiveness and the functioning of the labor market. We agree with the thrust of staff's appraisal and would like to add the following comments:

Outlook and Risks

We commend the authorities for the improvement of the macroeconomic framework, which will help Uruguay to perform well in an increasingly uncertain environment. GDP growth is projected at around 2 percent this year and to increase to 3 percent from 2020 onwards. Over the past years, the resilience improved thanks to a sound and prudent macroeconomic management. Could staff explain the differences between its growth projections and the ones underpinning the budget of the authorities? The country remains exposed to several risks, including relatively low growth levels in Argentina and Brazil, the tightening of global financing conditions, the impact of protectionist measures, and lower than expected investment levels. Could staff provide an assessment of the potential high impact of the paper pulp plant project and associated railway system on GDP growth?

Fiscal Stance

We encourage the authorities to continue to adapt to a rapidly changing environment while maintaining their efforts to put debt on a downward trajectory. As staff, we deem the postponement of the achievement of the 2.5 percent of GDP deficit target to 2020 (against 2019) as adequate and we note that it remains ambitious. Could staff indicate how the deficit target could be achieved in FY 2020 (the introduction of at least 0.3 percent of GDP additional measures)? We welcome the efforts to increase the maturity of the debt. Going forward, we concur with staff that adopting an appropriate reform pension is necessary to ensure the financial sustainability of the pension system as population is ageing and special regimes coexist. Moreover, staff assesses that transactions related to cincuentones will add a burden of about 4 percent of GDP (net present values) on the public pension over the next 30 years. Could staff provide more details about the appropriate design of the pension reform and the management of SOE in order to strengthen the fiscal position?

Monetary Policy and Exchange Rate

Inflation remains above of the central bank range target and anchoring medium-term expectations remains a challenge. While the current level is partly explained by some temporary factors such as the drought, it is also largely driven by past and expected inflation levels, as well as wages dynamics. Consequently, going further on the revision of the wage indexation mechanism and ensuring a successful round of wage negotiations, along an improvement of central bank communication and the maintaining of a tight monetary policy, should help to stabilize inflation, bring it back to the target range and better anchor medium-term expectations. It should also support the de-dollarization process. Exchange rate is overvalued by 8 percent according to the EBA-lite REER model because of its recent appreciation. As underlined in the dedicated SIP, "the results indicate that FX sales are effective in stemming excessive domestic currency depreciation (at daily frequency). In contrast, FX purchases appear not to reverse the level of the exchange rate, but they might have prevented further appreciations." We concur with staff that a flexible exchange rate should be the first shock-absorber and that the high level of reserves should be mobilized to address disorderly market conditions.

Financial Sector

We commend the authorities for the significant progress made on regulation and supervision of the financial sector. Banks' capitalization and profitability improved, and the level of non-performing loans (4 percent of total loans) is closely monitored. The pilot program on Central Bank Digital Currency is also an interesting initiative and we encourage staff to go further on their impact analysis on monetary policy transmission and the whole banking system.

The Acting Chair (Mr. Furusawa) noted that Uruguay had sustained positive growth for 16 years, underpinned by prudent policies and institutions. The good performance also delivered good social outcomes. The country had demonstrated strong residuals despite the difficult external environment. It was important that the authorities use the current period to enhance the fiscal and monetary frameworks by putting debt on a firm downward path and reducing inflation to within the target band. Policy priority should also be given to implementing further structural reforms to preserve the country's resilience, support inclusive growth, safeguard social gains, address infrastructure gaps, and enhance competitiveness.

Mr. Fachada made the following statement:

I thank the staff for the reports and Mr. Lopetegui and Mr. Vogel for the candid buff statement, unconventional in a certain way, in a positive way, but very good buff statement.

We are pleased to agree with the staff that the Uruguayan economy is consistently showing positive results thanks to its solid fundamentals. Real GDP growth is stable and has been growing for 16 years now. Public debt as a share of GDP is relatively low. Inflation is under control. International reserves remain at comfortable levels, and social indicators have improved enormously over the last 15 years. In this environment, the authorities have given repeated proof of their commitment to sound macroeconomic policies.

The soundness of the Uruguayan macroeconomic policy became evident over the last two years, particularly when contrasted with less fortunate outcomes in Brazil and Argentina. Nevertheless, 15 years of continued growth and stability can only be understood as the result of a long-term process of confidence building and institutional consolidation. Therefore, short-term deviations in meeting fiscal inflation targets should be put in context.

Naturally, the good results attained by Uruguay do not constitute reasons for complacency. We trust that in due time, Uruguay’s fiscal and monetary authorities will continue to take the appropriate measures to deliver on the fiscal deficit and inflation targets.

There is one particular point where the staff report seems a bit heavy handed. Although it is undeniable that Uruguay’s bigger neighbors recently passed through severe economic crisis, the repeated use of the term “turmoil” is somewhat out of place since the various institutional disruptions did not take place in any of the two countries in the last few years. The term “turmoil” or “regional turmoil” appears six times in staff report. It is the subtitle of the context section on page 4 and appears in the draft press release, certainly the part of the report most read by the public. According to the Merriam-Webster dictionary, “turmoil” is a word of unknown origin that means confusion, upheaval, turbulence, tumult, disorder, commotion, disturbance, agitation, unrest, trouble, disruption, chaos, pandemonium, uproar, and I can provide further synonyms. Accordingly, we believe that turmoil is not really the best way to characterize the recent context of Argentina and Brazil.

I checked the other Fund documents such as Argentina program papers, and the recent blog of the Director of the Western Hemisphere Department, and there are reference to financial turmoil in these countries, but financial turmoil gives a specific and different context compared to what we find in the Uruguay staff report. Perhaps the staff can confirm if they are trying to refer to financial turmoil instead of turmoil more generally, and I would appreciate the clarification.

> Furthermore, in the case of Brazil, the baseline scenario assumed for the near future is not up to date or in line with other Fund publications. The current outlook for Brazil can hardly be seen as an adverse risk for Uruguay as mentioned in the risk assessment matrix. In response to technical questions, the staff explained that their scenario is based on the October World Economic Outlook (WEO), which we know was based on projections made in August and September. I understand that, but this is a document circulated to the Board on January 31 that will be released to the public in mid-February or March. I know that the Fund has procedures. There are time lags, but the risk assessment matrix gives the impression that Fund staff is well behind the curve in identifying economic developments and risks. This is not good for the Fund's reputation and credibility. I would like the staff to elaborate on current views on risks from Brazil to Uruguay's economy.
>
> In conclusion, we congratulate the Uruguayan authorities for their sound policies and the good economic and social results that have been attained. The challenge ahead for Uruguay is to enhance inclusive and sustainable growth and skip the middle-income trap and the less favorable global conditions. For that reason, we commend the authorities for their focus on education, infrastructure, technical innovation, good governance, and the rule of law.

The staff representative from the Western Hemisphere Department (Ms. Berkmen), in response to questions and comments from Executive Directors, made the following statement:[1]

> I would like to offer a few updates on recent data since the staff report, and then I would like to provide context for our policy advice and discussions given the broader set of questions from Directors, and I will answer Mr. Fachada's questions after that. I would also like to mention one factual correction in the information annex.
>
> With respect to data updates, as Mr. Vogel mentioned in his buff statement, inflation declined from 8 percent in December to 7.4 percent in January, close to the team's forecast for the 2019 inflation rate, and the decline can be largely attributed to the dissipation of the temporary effects that have been mentioned in the staff report. Medium-term inflation expectations remain at around 7.5 percent.

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[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

Reserves have increased from US$15.6 billion from end-December to US$16.5 billion, reflected in the foreign exchange purchases done by the central bank in response to the new capital inflows, as we see in the rest of the emerging markets.

Nonperforming loans declined slightly in December to 3.9 percent from the 4 percent that we report in the staff report.

The authorities took advantage of the favorable market conditions in January by issuing a dollar bond maturing in 2031. With this issuance, the authorities covered about one-fourth of their 2019 gross financing needs estimated by the staff and extended the maturities of some of the shorter-term bonds. This is in line with the authorities' pre-financing policy that we mentioned in the staff report and will help mitigate fiscal risks.

Finally, the fiscal deficit in December 2018 was 4 percent of GDP, which is higher than the 3.7 percent of GDP that we projected at the staff report. This reflects both lower revenues from state-owned enterprises and the high current expenditures relative to our projections.

Turning to the context of our policy discussion and advice, Uruguay is duly famous for its strong social cohesion and the high degree of consensus on the needed policy changes. Our visit took place at a time when there is a broad-based conversation on the challenges facing Uruguay ahead of the upcoming presidential elections. We reached out to the opposition, the labor unions, think tanks, academics, in addition to the government. What we found is a consensus across the political spectrum and society on what these challenges are. We wanted to leave our mark and highlight the key issues that will have to be tackled by the next government, and these included the fiscal adjustment, the pension reform, addressing the decline in employment, the need to improve the conditions for private investment, measures to improve competitiveness and access to foreign markets, and education reform. We will discuss the details on how to achieve these goals and how to address these issues with the incoming government, and we will update the Board on these issues and the results of our discussions.

Having said that, let me mention our fiscal and monetary policy advice given the set of questions that we received from Directors. On fiscal policy, starting from the 4 percent of fiscal deficit, excluding the effects of the *cincuentones* transactions, the authorities' overall fiscal deficit target of 2.5 percent of GDP will be difficult to reach by 2020 without additional measures. We recommended at least 0.3 percent of GDP in additional measures in 2019 to put public debt on a firm downward path with the purpose of maintaining credibility and containing fiscal risks. However, according to our projections, further measures would be needed to achieve the 2.5 percent target by 2020, and the authorities expressed their commitment to the targets.

On the medium-term fiscal issues such as introducing a medium-term fiscal framework, enhancing the fiscal rule, improving spending efficiency and the pension reform in particular, we will work with the new government.

On monetary policy, there were some questions on what exactly our recommendation is in the short and medium term. We provided some answers, but I would like to emphasize that if inflation expectations do not move toward the center of the target range by the central bank's next monetary policy meeting, which will take place in April, our advice would be to adjust the references accordingly to ensure inflation and inflation expectations converge toward the middle of the target.

On the monetary policy framework, which is a medium-term issue, we are in broad agreement with the central bank about the key challenges for the implementation of the monetary policy, the need to further reduce dollarization, and further improve the communication practices. We will continue our dialogue with the authorities on various aspects of these issues, and we will update the Board on the results of these discussions.

I would like to note that there was a factual error in the informational annex, the latest table on common indicators required for surveillance. For some of the indicators, the latest submission date was not updated. We will issue a correction for that update in the latest edition.

Now I will turn to the questions from Mr. Fachada. We take note of the assessment of Brazil's current economy. The information and data in the staff report as of now reflects the data that we have at the beginning of January, whereas the updated outlook for the entire region and the WEO was available by late January. With that in mind, we take note of the differences between the current outlook, and as far as I know, the Brazil team is currently in the field having consultation with the authorities. When we were in the field in late November and early December, we were using the latest data available at the time; but we take note of the differences, particularly given the time lags.

On the use of the term "turmoil," obviously we do not mean something else. What we mean by regional turmoil is the financial turmoil. If one looks at May 2018 or late August 2018, when there was a huge exchange rate depreciation that hit the region, there were huge capital flow outflows from the region and the associated exchange rate depreciation. What we had in mind was that Uruguay has differentiated itself in this financial turmoil. Despite the significant depreciation of the Uruguayan peso, their borrowing costs remained broadly constant during that period. In the background section, which does not refer to the turmoil, we note that Uruguay's growth performance has been maintained—despite the growth reductions in Argentina in the range of 1.5 percent and 2.5 percent, and the deep recession in Brazil. The Uruguayan economy continued to grow.

Mr. Fachada made the following statement:

I fully agree with the explanation of the mission chief, so we are talking about the same thing, using the same language. What she meant was financial turmoil, not turmoil per se, or regional turmoil, which gives a completely different idea. I am sure that the Transparency Policy allows staff to correct parts in the staff report to clarify that it is financial turmoil.

With regard to the other explanation about the process, the staff had a baseline that was a baseline presented in the WEO in October, which was based on projections made by the country teams in August and September, and the team went on mission in November. Then in January, the Fund had a new update of the WEO. This was discussed by the Board on January 14. This was released to the public on January 20. The staff report was circulated on January 31, and although the review process had already started, it is strange that staff report cannot be updated with the most recent information that was already available Fund-wide. I would be concerned about the lack of agility in the review process, which does not incorporate the most recent information and still reflects information that was four or five months delayed in the report.

The staff representative from the Strategy, Policy, and Review Department (Mr. Haksar), in response to questions and comments from Executive Directors, made the following statement:

Staff reports are based on the discussion with the authorities and the information available at the time of the discussion. The mission to discuss the Uruguay Article IV took place in November. The normal practice is that the staff report would be based upon the information available as of the time of the discussion with the authorities. The published version of the staff report has a clear disclaimer that this is based upon information available as of the date, and the date is typically indicated on the cover.

Under our policy, the staff may issue a supplement to the staff report to be able to capture more recent developments that are deemed warranted and worthy of mention. Our view is that the updates that were received between the holidays and into the January WEO assessment would not have materially changed the staff's policy advice in the case of Uruguay, so there was not a call for issuing a staff supplement. We have to be able to make some decision about where to draw the line, otherwise we would be in the business of having almost constant updates, which we do in the context of the WEO, but in the context of bilateral surveillance, if there are not changes in circumstances that would materially change our policy advice, that is something that we would be careful about doing.

I want to pick up on the turmoil point. I would make two points, as a matter of fact. The first is the term "turmoil" used in the singular is used in Fund staff papers. If one looks at the last WEO from October, there is a reference to a particular country case using the word "turmoil" in the singular. When it comes to what the background context is and what the turmoil may refer to, the Fund is an organization that focuses typically on economic and financial matters, so that is the context within which these terms are typically interpreted, but I would just make that one factual observation. The context within which this consultation—like many other emerging market consultations—took place was the period of March through September where there was significant turmoil, and the term is used in many of the reports out of this period. In September, the *Financial Times* had a large piece doing a retrospective about developments in emerging markets, which is headlined "emerging market turmoil." That terminology is used. I believe the report is quite clear that the references and the concerns are really related to the developments in Argentina, and I would imagine that Mr. Fachada would agree that given the close historical relationships between Argentina and Uruguay, that this is naturally a matter of concern for the authorities in thinking about how they assess the overall risk environment as well.

Mr. Castets supported Mr. Fachada's points and encouraged the staff to reflect on how to characterize the situation in the region more precisely. He remarked that the Fund should have different standards than the *Financial Times* when describing the situation.

Mr. Fachada agreed with Mr. Castets that the comparison with the *Financial Times* was not appropriate given that the Fund was not a media organization. He was not opposed to descriptions of “market turmoil” or “financial turmoil,” but noted that more care should be taken with the general term “turmoil.”

Mr. Vogel made the following concluding statement:

I thank Directors for their comments and recommendations, which I will convey to my Uruguayan authorities.

I would like to especially express the authorities’ satisfaction and gratitude for the massive recognition from the Board of Uruguay’s sound policies and robust institutions. Mr. Fachada and Mr. Antunes rightly underlined that the challenge is to enhance inclusive growth under possibly less benign international conditions. This challenge meanwhile comprises a number of areas which will require further efforts and reforms.

Diversification has been key to achieve a decoupling from regional shocks which in the past had virulent impacts on Uruguay. We thank Mr. Beblawi and Mr. Al-Kohlany for their encouragement to double efforts to diversify exports. Mr. Saito and Ms. Mori asked for a further elaboration on the diversification process, including strategies. This is an interesting case to analyze in the future. Beyond the excellent response provided in the staff’s document, I would say in my humble opinion, that the origin of the process was the general understanding that this small economy must be open, think well beyond its borders, and be a strong advocate of the advantages of international trade.

Fiscal consolidation is a priority for the authorities. I would say the priority. Macroeconomic stability is the sine qua non condition for Uruguay to fulfill its objectives. Mr. Merk and Ms. Kuhles, as well as Mr. Mouminah, Mr. Alkhareif, and Mr. Rawah and many other Directors appropriately emphasized the importance of reinforcing fiscal sustainability.

Mr. Mozhin and Mr. Snisorenko rightly recommend carefully monitoring the fiscal risks pertinent to public-private partnership implementation, an issue which the authorities have undertaken with due care. The authorities fully agree with Ms. Levonian and Mr. Sylvester’s comments, as well as Mr. Rashkovan and Mr. Just, on the need to improve the governance of state-owned enterprises.

Age-related spending can pose challenges going forward, as pointed out by Mr. Psalidopoulos and Mr. Di Lorenzo. Mr. Villar, Mr. Guerra, and

Ms. Arevalo Arroyo are on the same page when stating that age-related fiscal pressures could undermine the fiscal outlook in the medium-term.

Mr. Inderbinen and Mr. Djokovic note the high social cohesion in Uruguay and the importance of the near universal pension coverage, while at the same time highlighting the importance of ensuring the sustainability of the pension system and preserving intergenerational equity.

Keeping inflation under control remains a key policy priority, as noted by Mr. Agung and Mr. Srisongkram. Uruguay's central bank has recently announced the continuation of its contractionary policy bias. The remaining policies and instruments will be consistent with this objective. Ms. Pollard and Mr. Grohovsky made an important recommendation that the authorities should intervene only in cases of considerable exchange rate volatility and otherwise allow the exchange rate to act as a shock absorber. In the past, inflexible regimes were a critical source of vulnerability for the country. Therefore, the authorities are fully committed to this flexible exchange rate regime. Mr. Raghani, Mr. Sylla, and Mr. Nguema-Affane's remarks about the financial system's resilience to regional shocks are encouraging.

Once another critical social vulnerability, Uruguay's financial system is a pillar of the country's current stability. Mr. de Villeroché, Mr. Castets, and Ms. Albert stressed the progress made on this regulation and supervision, reminding that banks' capitalization and profitability improved and the level of nonperforming loans, at 4 percent of the loans, is closely monitored. Mr. Benk and Mr. Zaborovskiy rightly recommended that boosting financial inclusion and innovation should continue to go hand in hand with advancing supervision. Mr. Ray and Mr. Kikiolo appropriately emphasized the need to invigorate investment and credit. The authorities fully agree with Mr. Sigurgeirsson and Mr. Vaikla, as well as Mr. Sun and Ms. Zhao, among others, on the need to improve the quality of education and address infrastructure gaps in order to boost medium-term growth.

Finally, on behalf of the Uruguayan authorities, I thank Ms. Berkmen and her team for the outstanding work. Ms. Berkmen is a trusted advisor for the Uruguayan authorities, having made substantial contributions and recommendations to them. I would also like to express Uruguay's gratitude to Ms. Alonso-Gamo and Mr. Werner.

The Acting Chair (Mr. Furusawa) noted that Uruguay is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They noted that prudent macroeconomic policies combined with strong reform implementation, and quality institutions have enabled Uruguay to maintain macroeconomic stability, accumulate sizeable buffers, improve social outcomes, and differentiate itself in the region. Directors noted that policy priorities ahead should focus on maintaining resilience, keeping public debt on a sustainable path, sustaining low inflation, and implementing structural reforms to boost the economy's growth potential.

Directors welcomed the authorities' commitment to maintain fiscal sustainability. They considered that the postponement of the fiscal deficit target by a year is appropriate given the current outlook. However, Directors underscored that additional fiscal measures would be needed to achieve the deficit target. They highlighted that fiscal sustainability could benefit from a medium-term fiscal framework which focuses on the nonfinancial public sector and is supported by an appropriate fiscal rule. Directors encouraged the authorities to introduce measures to put public debt on downward path. They also recommended that adjustment efforts should focus on reducing current expenditure while further improving its efficiency to increase capital spending. Priority should also be given to making further progress on the reforms of the pension system and the state-owned enterprises.

Directors welcomed the authorities' commitment to bring inflation to within the central bank's target range. Looking ahead, they encouraged the central bank to further strengthen the monetary policy framework by addressing the high degree of dollarization and enhancing its communication strategies, thereby better anchoring inflation expectations. Directors underscored the need to maintain exchange rate flexibility and limit interventions to address disorderly market conditions. They acknowledged the resilience of the financial sector and encouraged the authorities to remain vigilant about the non-performing loans and continue their efforts to increase financial inclusion while ensuring that it remains resilient in the face of regional shocks.

Directors welcomed Uruguay's success in reducing poverty and inequality. To foster inclusive growth and ensure continued income convergence to advanced country levels, they encouraged the authorities to sustain implementation of structural reforms. Directors highlighted that reform efforts should focus on further increasing public investment, employment and labor force participation, enhancing competitiveness, and improving overall business environment and educational outcomes.

It is expected that the next Article IV consultation with Uruguay will be held on the standard 12-month cycle.

APPROVAL: April 7, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. Regarding staff's risk assessment, we were somewhat surprised by the inclusion of large infrastructure projects as an upside risk. Could staff provide some additional comments on the respective assumptions underlying the baseline scenario?

- Staff's baseline assumptions include the recovery in the soy production from last year's drought, decline in tourism revenues from Argentina, and some recovery in private investment (consistent with some high frequency indicators).

- The UPM's pulp-processing plant and the associated large infrastructure projects could meaningfully impact Uruguay's growth. The project could amount to 5 percent of GDP and lead to higher GDP growth rates during the construction phase and permanently higher exports thereafter. However, since the project has not been finalized yet (contingent on the decision by the company in the first half of 2019), it is not incorporated in the staff's baseline. It is considered as an upside risk instead.

- To answer the question further, some of the money directed to infrastructure projects will be provided by the public sector, either through public-private partnerships, or directly. Even though there can be fiscal risks associated with this kind of public expenditure, staff's view—expressed in the report—is that additional public investment is needed to address Uruguay's infrastructure gaps (see, in particular, Figures 5 and 8).

2. Could staff brief the Board on their more recent expectations regarding the Brazilian economy and explore its impacts on Uruguay?

- Staff's discussion of the outlook with the authorities and the Risk Assessment Matrix were based on the October 2018 WEO projections, which in turn were published before the second-round elections took place on October 28 and incorporated the attendant uncertainty. In the October 2018 WEO, Brazil's projected growth for 2018 was revised down by 0.4 percentage points vis-à-vis the July 2018 forecast, reflecting on account of the disruptions caused by the nationwide strike by truck drivers and tighter financial conditions.
- Staff's most recent views on the outlook for Brazil can be found in Mr. Werner's January 25 blog. Specifically,

- In Brazil, growth is projected to rise over 2 percent in 2019-20 for the first time since 2013. The new administration's market-friendly reformist agenda has helped boost business confidence and improve the near-term growth prospects. The key policy priorities are to reform the pension system and reduce the budget deficit to ensure public debt sustainability.

3. In the executive summary, staff mentions that drought conditions were one of two key factors impacting inflation, which rose above the 7 percent ceiling. Given this assessment, and in light of the fact that the Government declared an emergency in early 2018 in this context, we would be interested to better understand why staff did not list extreme weather events as an external risk in the RAM? In a similar vein, we would like to ask whether this occurrence was in line with expectations, or the situation has worsened over time?

- By the time of the Article IV discussions in late 2018, the drought had already taken place, and staff, in consultation with the authorities, included its estimated impact in the baseline. Furthermore, the authorities indicated that the climatic conditions for the coming harvest were expected to be good. Accordingly, staff did not include adverse weather events in the RAM.

4. Regarding risks to the outlook, the risk assessment matrix (RAM) lists cyberattacks as a moderate risk. We would like staff to further elaborate on this, notably whether this is a specific risk to Uruguay.

- This is not a specific risk to Uruguay, but a risk at the global level. Cyber-security breaches and cyber-attacks on critical financial, transport, or communication infrastructure could undermine payment systems and disrupt the flow of goods and services. Cyber-attacks are among the key risks to financial stability in recent global surveys. At the global level, theft of consumers' personal information, fraud using SWIFT, hacked crypto-asset exchanges, and business disruptions across the supply chain have materialized. Given Uruguay's relatively high degree of internet penetration and efforts to promote electronic transactions, Uruguay—similar to other emerging market economies—is subject to these risks.

5. We want to ask staff about the factors that explain investment deacceleration. Also, given the continuous growth rates during the last years, what explains the still high unemployment rates between 7 and 9 percent?

- Low investment is an acute problem, especially since investment in both labor and capital was a key component of growth over the previous three decades (see *IMF Country Report 18/24*). Investment were low in recent years reflecting both cyclical (such as the cyclical slowdown, decline in public investment, competition from other emerging markets) and structural factors (such as high labor costs, limited financial intermediation). Uruguay's relatively high unemployment rate could be driven by a combination of factors, including the inadequate skill mix (as reflected in high dropout rates for the secondary schools), a shift towards more capital intensive sectors (from manufacturing to high technology primary sectors), and high labor costs (including because of the wage increases that has often outpaced the increases in export prices, a crucial consideration for an economy as export-dependent as Uruguay's (see *IMF Country Report 18/23)*).

- The authorities are aware of these challenges and are taking steps to address them. Investment incentives are in place; the PPP program is gathering steam; one of the objectives of the 2018 wage round was to keep costs under control and to limit labor conflicts; and the opportunities for vocational training are being expanded.

6. Could staff explain the differences between its growth projections and the ones underpinning the budget of the authorities?

- As noted in the staff report, the authorities' growth projections—which underpin the 2019-20 budget—had been prepared in May-June 2018, before the full ramifications of the regional turmoil were known. Staff's macroeconomic projections that were prepared at that time were very close to the authorities' projections.

- As the regional turmoil gathered force, staff has revised its projections, primarily to incorporate the negative impact of the lower growth in Argentina, which Uruguay's key partner. As a result, staff's projections became more pessimistic than those of the authorities, since the authorities' budget projections were not subsequently revised.

7. Could staff provide an assessment of the potential high impact of the paper pulp plant project and associated railway system on GDP growth?

- The project has not been finalized yet, and staff does not have additional information compared with what was known last year and shared with Directors during the January 2018 Board meeting. To recap:

- During the construction phase, foreign direct investment inflows would be balanced to a significant extent by imports of capital inputs, but some value added and a significant temporary boost to employment would be expected.

- After construction, the plant would produce cellulose for export, using local labor and forestry resource inputs. The current account balance would be expected to improve to reflect the domestic value added, but a significant component of the gross cellulose exports would be offset in the current account by primary income outflows that reflect profits accruing to the foreign parent company.

- The effect of the plant on value-added in the forestry sector would depend on the extent to which the additional required wood production would be fulfilled by employing currently unused land or by re-purposing otherwise productive agricultural land. Similarly, the plant could be expected to put some upward pressure on the real exchange rate and resource input costs, which would have spillover implications for firms in all sectors of the economy. These kinds of general equilibrium effects make it difficult to readily estimate the GDP impact of the project.

Fiscal Policy and Debt

8. Could staff provide their assessment of the evolution of public debt over the next years corrected for the temporary effect of "cincuentones" transactions? Further, could staff provide additional comments on potential implications for public financing costs and debt sustainability?

- Staff projections already exclude the temporary effect of the *cincuentones* transactions. As mentioned in the report, these transactions will improve the fiscal deficit in the near term but weaken the government balance sheet after 5 years. Moreover, they will also lower the stock of public debt but not significantly alter the financing needs, as the additional revenues are placed in a trust fund ring-fenced for 6 years. For these reasons, as agreed with the authorities, the debt projections are based on the overall balance excluding the cincuentones transactions (to reflect that the financing needs are broadly unchanged). In this context, the cost of financing for the projection horizon will not be affected by these transactions and will instead depend on the credibility of the fiscal policies implemented. The authorities estimate that after 5 years the additional pension liabilities will exceed the additional revenues and that the burden on the public pension system from this operation will be about 4 percent of GDP (in net present value terms over the next 30 years).
- ***In this context, could staff elaborate more on recommended measures to achieve the fiscal target and whether the authorities are considering to implement such measures under current government? We welcome staff's comments on the priorities to reduce current expenditures while ensuring growth enhancing projects. Could staff indicate how the deficit target could be achieved in FY 2020 (the introduction of at least 0.3 percent of GDP in additional measures)?***

- Measures of at least 0.3 percent of GDP in 2019 are required to put non-financial public-sector debt on a firmly downward path. However, given staff projections, further measures would be needed to meet 2020 targets.

- Given that central government revenues (including social security) are relatively high compared to regional counterparts or to countries with a similar level of development (about 29 percent of GDP) and the low level of public investment (gross public investment of about 2 percent of GDP), the adjustment should mainly come from current expenditures. Current primary expenditures are currently about 28 percent of GDP. Social spending (education, health, pensions and social transfers) is about 25 percent of GDP. Some of these expenditures (such as pensions, about 10 percent of GDP) are constitutionally linked to wage increases, and some (such as wages, 5 percent of GDP) increases in line or above the inflation. Therefore, possible reductions should focus on the remaining discretionary spending. The moderate increases from the most recent round of wage negotiations (close to zero average real increases) and the reduction in inflation are expected to tame spending pressures. In addition, public tariffs need to be adjusted to reflect costs, while further improvements in the efficiency of public spending and in SOE governance will also be required.

- The government continues to express its commitment to fiscal discipline and is looking for opportunities to moderate current spending. They also note the challenges stemming from the high "endogenous" component of the current spending.
- ***Staff explains that "debt from other public cooperations" was 4 percent of GDP. Is this SOE-related debt? Are SOEs included in the DSA? Are they relevant in the case of Uruguay?***

- Yes, the debt of public enterprises is about 4 percent of GDP and is included in the DSA. Public corporations' balance sheet is about 25 percent of GDP, are 100-percent publicly owned, and constitute an important source of fiscal revenues (including taxes and dividends). The government has an important degree of control over the magnitude of these contributions by setting the administered prices that the SOEs charge. The current government has strengthened the oversight of public enterprises through agreed management objectives for each entity, increased monitoring and transparency, and with limits on the investment budget of the largest SOEs. Despite these improvements, given the significant role of SOEs, and past problems regarding the financial health of the state oil company (which has been resolved), SOEs remain relevant for Uruguay.

We would appreciate staff's assessment of the effectiveness and impact of the tax incentive introduced in 2018.

- A complete evaluation of the recently introduced changes (mid-2018) to the investment regime has not been completed (with the transition phase—where projects could be presented under the old or new regime—concluded in November 2018, a complete evaluation is expected by 2020). However, according to the authorities' data until December, the number of projects submitted for approval increased by about 25 percent compared to the average of 2015-17 and the committed amounts increased by about 40 percent (although the increase mostly reflects the investment by UPM for the new cellulose plant).

9. However, the report should have clarified why the medium term fiscal targets were lowered in the first place. Does it reflect a worsening of the structural balance or just a weaker economic growth in 2018? Further elaboration from staff would be useful. Moreover, beyond the different growth assumptions, the sources of different fiscal projections are unclear to us. Further elaboration from staff would be useful.

- The Budget for 2018 delayed the attainment of the medium term fiscal target of 2.5 percent of GDP by one year (until 2020), due to higher than expected quasi-fiscal costs from FXI and unexpected spending needs (from the resolution of an old labor dispute with the judiciary, faster execution of a social housing program and compliance with a new law that recognizes higher night pay for the police). In the Budget, which was presented before the Argentina crisis, the authorities' intention for 2018 was to improve the cyclically adjusted primary balance (CAPB) by 0.5 percent of GDP. However, given the growth deterioration, staff estimates that the CAPB did not change in 2018. Thus, the worse-than-projected fiscal outturn could be partly attributed to the lower-than-expected growth. In particular, the deviations of the outturns for 2018, compared to the budgeted amounts, are due to lower revenues (from SOEs and from payroll taxes due to the deterioration the labor market) and from the higher current primary spending (including due to the lower-than-projected growth). It should also be noted that the primary balance of SOEs has deteriorated since 2016 partly due to changes in oil prices and the exchange rate.

10. We welcome staff's further elaborations on how to better align and operationalize the debt anchor for this wide definition of public debt with the budget deficit target, and specifically, on how staff developed the consolidation target of at least 0.3 percent of GDP in 2019.

- Staff will discuss with the next government the new budget and their intentions for introducing a medium-term fiscal framework that operationalizes the fiscal targets and debt anchor.

- The estimate of at least 0.3 percent of GDP of additional measures, is based on the minimum amount needed to tilt the non-financial public debt projections on a firmly downward path. According to staff estimates, further measures are needed to achieve the 2020 targets.

11. Additionally, is there scope for the new government to introduce a medium-term fiscal framework to allow more continuity, including the achievement of the fiscal target, between governments?

- Staff believes that introducing a medium-term fiscal framework supported by a binding fiscal rule would help strengthen multi-year fiscal discipline and achieve policy objectives with a more efficient use of limited resources, while avoiding the lack of continuity and attendant uncertainty as the budgetary horizon shrinks. The current government acknowledges the benefits of medium-term framework, and staff will work with the incoming government to communicate the merits of a revamped framework.

- Can staff provide an update on the PPP funded capital projects?

- The government had an ambitious agenda to update the infrastructure with the use of PPP projects, but the authorities recognize that the process has been slow, reflecting some learning process and challenges in developing financing structures (the PPP Law was enacted in 2011 and regulations were issued in 2012). However, the authorities believe that the bottlenecks have been resolved, particularly on the availability of financing with the creation of dedicated PPP funds. CAF is a critical player which takes investments from local pension funds and advises potential investors (while co-financing 10 percent of the projects).
- Two investment funds have been created (US$350 and US$500 million) to upgrade roads and schools. Additionally, a railroad that is required to transport the output from the new pulp mill to the port (US$800 million) will be financed in a similar way (a trust fund where pension funds would provide about 40 percent of the financing and the rest of the money would need to come from development agencies and large international banks).

- Currently, only some road investments (financed from the first fund) are under construction, but the remaining three projects (from the first fund) are expected to begin construction in 2019. Going forward, it should be noted that given the ceiling for PPP financing, once all the projects are implemented, there will be limited space for additional PPP investments.

12. Could staff provide more details about the appropriate design of the pension reform and the management of SOE in order to strengthen the fiscal position?

- Given the ongoing discussions within the Uruguayan society and various ongoing studies, staff did not discuss specific measures for this Article IV Consultation. Specific pension reform measures for Uruguay were analyzed two years ago in an SIP

(*IMF Country Report 17/19*). Given high contribution rates, the SIP suggested raising the retirement age as a possible measure. Specifically, the SIP noted that:

- "Increasing the retirement age to 65 could improve both fiscal sustainability and adequacy. The legal retirement age of 60 years is still relatively low in Uruguay and typically well below that of advanced economies facing similar aging challenges. Simulations suggest that a gradual increase in the retirement age to 65, along with the corresponding change in the computation of benefits, would prevent pension spending from the PAYG pillar from increasing above their current level at least until 2065. An increase in the retirement age would also lead to an increase in the individual savings accounts, since workers would contribute for more years, as well as in the annuity paid to retirees as it would in addition partly compensate the increase in life expectancy at retirement. Theoretical replacement rates would therefore also increase."
- The authorities believe that there is wide consensus on the need for reform given population aging, but that there is no desire for abrupt changes (also not needed as they foresee that the system would be broadly stable for about two more decades even in the absence of reforms). Staff stands ready to discuss with the next government their plans for pension reform.
- Regarding the SOEs, as mentioned in the report, the government should continue to improve the governance and efficiency of state owned enterprises—as part of the measures to promote fiscal stability—while guaranteeing their financial health by adjusting tariffs in line with their cost structure.

Monetary Policy

13. Did staff have any discussion regarding the authorities' strategy to de-dollarization during the mission? Progress since the last assessment? Could staff comment on the different measures that the authorities could undertake in order to reduce dollarization in the economy? Do the authorities consider undertaking any measures to address high dollarization, in line with the recommendations in last year's SIP?

- Staff covered this issue extensively in the last year's Article IV report and the Selected Issues paper (see *IMF Country Reports 18/23* and *18/24*). In our discussions this year, the authorities noted the challenges that dollarization brings to the monetary policy implementation, such as an unstable money demand. They acknowledged that this problem will require a comprehensive solution, including keeping inflation low and stable and getting a buy-in from the society at large. They noted that they are studying other country examples and evaluating broad range of measures implemented in other places such as the effectiveness of different charges for the FX deposits, developing hedging markets to better manage FX risks, and experiences regarding regulations to set prices in local currencies.

- As noted in the last year's documents, measures to achieve de-dollarization could include differentiated reserve requirements for local- and foreign-currency deposits (which the authorities had already implemented), mandatory listing of prices in local currency, and further development of the domestic capital market.

On strengthening the monetary policy framework, could staff discuss the possible enhancements to policy instruments and communication in more detail?

We note staff recommendation, over the long term, to further strengthen the monetary policy framework with a focus on improving strategies and instruments. Would staff provide additional information on the key measures in this regard.

14. Can staff elaborate more on the advice provided to the central bank to strengthen its monetary framework, beyond what is said on the use of fintech to promote financial inclusion?

15. Can staff comment on the strategies, instruments, and communication practices that the central bank can employ to further strengthen the monetary policy framework and bring inflation within the target range?

- The central bank adopted an inflation targeting framework in 2007 with short term interest rates as the operational target at that time. Then in 2013, the authorities switched from the overnight rate as the operational target to reference rates for the growth of base money. They felt that transmission from the overnight rate to deposit and lending rates was relatively weak in a context of dollarization and excess liquidity, and that targets for a monetary aggregate might have a stronger and more direct impact on domestic demand.

- In this year's discussions, staff noted that short-term interest rates remain volatile (due to instability of money demand), inflation expectations track actual inflation, and, in the past, inflation has persistently remained above the target range.

- Both staff and authorities acknowledged the challenges conducting monetary policy in the presence of dollarization, low credit-to-GDP ratios, and remaining wage indexation. The authorities noted that they are constantly evaluating the effectiveness of their instruments (monetary targeting) and their communication strategies.

- In this context discussions regarding further improvements on strategies, instruments, and communication practices focused on the following elements:

Dealing with structural challenges by reducing dollarization

- Staff covered this issue extensively in the last year's Article IV report and the Selected Issues paper (see IMF Country Reports 18/23 and 18/24). In our discussions this year, the authorities noted that this problem will require a comprehensive solution, including keeping inflation low and stable and getting a buy-in from the society at large. They noted that they are studying other country examples and evaluating broad range of measures implemented in other places such as the effectiveness of different charges for the FX deposits, developing hedging markets to better manage FX risks, and experiences regarding regulations to set prices in local currencies.

Further improvements on communications

- Discussions focused on how to manage expectations, also based on examples from other inflation targeting countries (such as press releases, speeches by the governors). Given dollarization and unstable money demand, the authorities noted that extra efforts are required in terms of communication to enhance the signaling channel. In this context, the central bank is considering further improvements to their communication including potentially by outreach to the private sector. In addition, the authorities are also considering further improvements in various survey-based inflation expectation measures to better track expectations.

- As a part of their communication strategy, the authorities highlighted the progress made in wage setting mechanisms. The wage negotiations for the private sector have removed the backward indexation and improved the link of nominal wage increases with productivity developments. This has helped in anchoring of the non-tradable prices.

Balance of objectives

- In terms of monetary policy objectives, the authorities highlighted the dual mandate for delivering price stability which contributes the objectives of growth and employment. They noted that the central bank's monetary policy is a balancing act between these objectives. In this context, their policy making takes into account the impact of interest rates on capital flows, exchange rate, and therefore on competitiveness.

- Staff suggested that (particularly in the current context in which the fiscal policy taking a countercyclical stance), monetary policy could focus on reducing inflation towards the middle of the target range.

Instruments

- The authorities noted that their current instrument (monetary references) is suitable in the presence of dollarization as it is directly linked to portfolio balance channel. They also noted that they are regularly considering the effectiveness of alternative instruments (such as interest rates).

  We would like more clarity about the policy actions that staff suggest should be taken by the authorities to steer inflation back the target. In this respect, can staff elaborate more on to what extent an estimation based on a Taylor rule provides relevant information in a monetary targeting regime, especially if characterized by a weak transmission?

- Following the team's visit in early December, the central bank tightened the monetary indicative references in late December, which was in line with the staff advice. Following this tightening, long-term nominal interest rates have remained broadly constant at around 10 percent and short-term interest rates rose slightly and fluctuated at around 8-9 percent. In addition, medium-term inflation expectations remain at around 7½ percent, above the target range. The central bank's next monetary policy meeting will be held in April 2019. If until that time, real interest rates do not rise further within to the neutral range, and if inflation expectations do not converge towards the middle of the target, staff recommends further tightening.

- While the monetary targets are the operational targets, they work through interest rate, signaling, and portfolio balance channels. In this respect, staff uses a variety of indicators to assess the stance of the monetary policy. Taylor rule estimates are one of the indicators that staff considers relevant regarding the stance of monetary policy. Other relevant indicators include the neutral rate estimates—which shows where the equilibrium rates when the economy is at potential and inflation is non-accelerating—and medium-term inflation expectations—which is a good indicator working through the signaling channel.

16. For example, how can the authorities improve the intervention mechanism to facilitate the development of the deeper, more liquid and more efficient FX market?

- The foreign exchange market in Uruguay is small, so even the relatively small flows can potentially cause disruption. Accordingly, the central bank has remained vigilant and, if needed, anticipated the needs of the large market players by engaging in foreign exchange operations that are scheduled ahead of time (see the discussion in the 2017 Article IV staff report). The authorities are actively working on developing the domestic financial markets, including by introducing benchmark bonds and looking for options for improving the hedging mechanisms. In the medium term, as the foreign exchange market and the financial sector develop further, they both will be able to withstand a higher degree of exchange rate volatility, thereby contributing to an increased efficiency of the system.

What are the options to address indexation system without negative social consequences?

- In approaching this issue, the authorities consider the social aspect of indexation together with its macroeconomic impact. Accordingly, during the last two wage rounds, the authorities have successfully moved away from the wage increases in the private sector directly tied to inflation to the wage increases specified in the nominal terms (that are also linked to productivity growth in different sectors). This policy has had a broad support in society, especially in light of widely-shared concerns over high unemployment and the possible loss of competitiveness.

17. Considering that Selected Issues Paper found the asymmetry in the effectiveness of FX interventions in Uruguay, while the External Sector Assessment results point to the signs of peso's overvaluation, we would like staff to elaborate more on their views on how to minimize this asymmetry and excessive currency appreciation in case of temporary surges in capital inflows.

- As noted in the Selected Issues paper, the results on asymmetry of FX interventions are not unique to Uruguay. In particular, while FX purchases may not have a statistically significant impact on the level of exchange rate—a common finding in the literature—it does not necessarily mean that they are ineffective against appreciation pressures. Accordingly, staff advice remains that the authorities should intervene (on either buy or sell side) to avoid disorderly market conditions. The central bank has been successful in this endeavor during the past year, while allowing the exchange rate to adjust in line with fundamentals, at the time of great turbulence in the region.

18. The authorities are invited to consider staff's recommendations on further strengthening the monetary policy framework to firmly anchor inflation expectations within the target range. That said, it is not clear whether staff recommend further monetary policy tightening at this moment. Staff comments will be appreciated.

- Following the team's visit in early December, the central bank tightened the monetary indicative references in late December, which was in line with the staff advice. Following this tightening, long-term nominal interest rates have remained broadly constant at around 10 percent and short-term interest rates rose slightly and fluctuated at around 8-9 percent. In addition, medium-term inflation expectations remain at around 7½ percent, above the target range. The central bank's next monetary policy meeting will be held in April 2019. If until that time, real interest rates do not rise further within to the neutral range and inflation expectations do not converge towards the middle of the target, staff recommends further tightening.

We would like to know staff's assessment of the possibilities of gradually moving from targeting money aggregates towards an inflation targeting framework.

- The central bank adopted an inflation targeting framework in 2007 with short term interest rates as the operational target at that time. Then in 2013, the authorities switched from the overnight rate as the operational target to reference rates for the growth of base money. They felt that transmission from the overnight rate to deposit and lending rates was relatively weak in a context of dollarization and excess liquidity, and that targets for a monetary aggregate might have a stronger and more direct impact on domestic demand. Staff in earlier staff reports highlighted various challenges facing the current system—as documented, for example, in the last year's Article IV report—due to "the difficulty of predicting money demand (especially given the ongoing changes in deposit dollarization)." There is no easy answer to the question of which instrument is preferable in an economy as dollarized and with such a small financial sector as Uruguay's, and the staff and the authorities plan to explore these issues in the future.

19. We noted from staff projections that medium term inflation is expected at the upper end of the central bank's targeted band. This in our view could undermine the credibility of the central bank's target band and the effectiveness of staff recommendations to drive down inflation. Staff comments are welcomed.

- Given the current medium-term inflation expectations above the ceiling of the target range, the authorities' policy stance, and historical evolution of inflation, staff projects inflation to settle at the upper bound of the target range. To bring the inflation firmly at the center of target range (5 percent) further tightening would be needed.

Financial Sector

20. Do the authorities consider any next steps including involvement of banks regarding the e-peso? Could staff share some insights on the key takeaways from the pilot phase of e-peso project? Have the authorities discussed any plans to take this project further?

We welcome the authorities' implementation of the pilot program on Central Bank Digital Currency (CBDC) to encourage financial innovation and increase financial

inclusion. At the same time, since banks did not participate in the pilot program, will there be any side effects of the CBDC such as bank disintermediation?

- E-peso pilot was implemented for verification of technical issues, while keeping potential risks under strict control. In particular, the pilot tested (i) the systems technical components, such as E-peso production, digital vault, digital wallets, transactional system, infrastructure; and (ii) business continuity. Main takeaways from the pilot include the following:

- Legal framework was sufficient for the issuing of electronic bills as a complement of paper bills.
- In terms of security, cyber and information risks have been reasonably mitigated and other risks, such as financial, have been reasonably hedged.
- Overall, the pilot was developed according to expectations, with no technical incidents and is assessed by the authorities as a positive experience.

- After the successful implementation of the E-peso pilot, before moving to the second stage, the authorities would like to understand better how the payment systems function in Uruguay and how the E-peso would interact with the banking system and other electronic money. In this context, for the next 1-2 years, the central bank will undertake research on these issues before making a decision on how to proceed.

Structural Issues

21. We would like to know more about the strategy which the authorities took to diversify the economy and the lessons which other countries can draw on.

- Strong and stable institutions, the rule of law, as well as the authorities' commitment to free trade, allowed Uruguay to attract significant foreign investment. The most noticeable has been in forestry and the in production of wood pulp, but there has also been FDI in soybeans and beef, which allowed the country to increase productivity significantly and take advantage of the opportunities offered by the large Chinese and other international markets.

Continued efforts are needed to improve market access, enhance cross-border trade, and further diversify export products. What are the authorities' recent plans in these areas?

- The authorities are committed to free trade and free investment flows. They have been very active in the negotiations of the free trade agreement with various countries and regions. Some negotiations, however, are proceeding slowly, given the global and regional context. The authorities are also working on agreements with other countries, including Canada, Korea, and Singapore. Within Mercosur, the authorities are working with their regional partners to facilitate free movement of goods and services, as well as cross-border investment and procurement.

We notice in Figure 8 of the report, that even though Uruguay has one of the highest GDP per capita in the region, its secondary completion rates are below the regional average. Staff comments are welcome.

- The problems of the education system are a topic of perennial discussion in Uruguay, and have often been acknowledged in staff documents as a macro-critical issue. According to our counterparts, there are several issues facing the system, including (i) the school program that is perceived as outdated by many students; (ii) the difficulty in engendering a meaningful reform; (iii) a perceived small benefit of education. Among other things, this problem manifests itself in the high rate of youth unemployment, currently at 26 percent.

Outreach

22. We also note that during the Article IV mission, staff conducted outreach to the unions, civil society, and opposition. As the election period is approaching, could staff comment on the results of this outreach, including major economic policy issues that significantly differ from the authorities' views, as well as staff's recommendations, if any.

- Uruguay is duly famous for its strong social cohesion and the resulting high degree of consensus. Accordingly, most participants in the political process agree on the main issues that will have to be tackled by the next government, namely, fiscal adjustment, pension reform, declining employment, access to foreign markets, and education reform. The differences across political spectrum reflect different degree of emphasis attached to particular issues rather than fundamentally incompatible visions of the future of the country.