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Uruguay—Assessment Letter for the World Bank

May 27, 2020

Uruguay faces important medium-term challenges, and the COVID-19 pandemic is putting a significant strain on the economy. The government that took office in March is taking steps to address these challenges and manage the pandemic. While many details remain to be seen, these steps appear broadly appropriate and in line with staff recommendations made in the recent Article IV consultation.

I. Recent Developments, Outlook, and Risks

1. Before the COVID-19 pandemic, economic activity was expected to rebound in 2020, following a 0.2 percent growth in 2019. In recent years, after more than a decade of strong growth, economic activity, investment, and labor participation have been on a declining trend, and internal imbalances (higher fiscal deficits, rising unemployment, above-target inflation) have accumulated. However, private investment growth turned positive in the second half of 2019, following years of decline, as large foreign direct investment and infrastructure projects have started to support economic activity. Spillovers from Argentina have remained limited, working through the real sector and exchange rate channels.

2. The pandemic is putting a significant strain on the economy, and the authorities have quickly adopted a series of public health and economic measures to limit its impact. Following restrictions on economic activity and travel, school closures, and social distancing measures—all introduced in mid-March—there were 746 confirmed cases and 20 deaths as of May 21, and daily infections have declined to about one third of their late-March peak. The government—which assumed power in March and whose agenda is to undertake a series of structural and fiscal reforms and deliver a much-needed fiscal adjustment—is also using fiscal, liquidity, and credit policies to ease the burden of the pandemic-related economic slowdown. After a 20-percent depreciation against the U.S. dollar between mid-February and mid-March, the peso has subsequently regained some value, but inflation, driven by the depreciation and higher prices of some food items, rose to 10.9 percent in April from 8.8 percent at end-2019. The sovereign spreads have increased since February (to 250 basis points as of May 21) in line with peers in the region.

3. Uruguay's economy is expected to contract in 2020, followed by a strong recovery in 2021. Real GDP is expected to decline by 3 percent in 2020 (compared with the pre-pandemic projection of a 2.1-percent growth), reflecting both the direct impact of the outbreak and the rapid deterioration of global economic conditions. Nevertheless, Uruguay benefits from the decline in oil prices (partly offsetting the negative impact of lower export prices and external demand), a well-developed social safety net, and large investment projects already in the pipeline, which are expected to cushion the recession and support the recovery. As a result, real GDP is expected to grow by 5 percent in 2021. The current account balance (a 0.7-percent of GDP surplus in 2019) is expected to decline due to lower tourism revenues and exports and higher investment-related imports, but gross reserves provide sufficient buffers (27 percent of GDP). At the time of the recent staff report, Uruguay's external position was assessed to be broadly consistent with fundamentals and desirable policy settings (see *IMF Country Report 20/51*). Since then, the impact of the pandemic-related shock on Uruguay's terms of trade has been limited—as both export and import prices were affected—and the central bank allowed the peso to depreciate.

4. Uncertainties and downside risks are large. Most notably, a more severe COVID-19 pandemic could deepen the negative growth impact and weigh on the fiscal balance. Economic developments in Argentina remain a large risk, although the likelihood of direct financial spillovers is small. A host of global risks (capital flow reversals, sharp rise in risk premia, geopolitical tensions, weaker-than-expected global growth, and further declines in agricultural prices) and local ones (loss of credibility and further increases in debt due to insufficient fiscal adjustment or delayed reforms and PPP projects) may undermine the expected recovery and limit medium-term growth. On the upside, the growth boost from investment projects may be larger than expected, given the uncertainty about their indirect effects.

II. Policy Framework and Setting

Fiscal Policy

5. The outbreak forced the postponement of the implementation of fiscal adjustment plans, but reforms to the fiscal framework are in motion. In early March—just before the outbreak—the government announced a series of fiscal adjustment measures: a combination of expenditure reductions, increases in administered utility prices, and restrictions on public sector hiring. Details will be outlined in the draft budget to be submitted to Parliament in August, but the impact of the announced measures could be larger than incorporated in the 2019 Article IV staff report. Following the outbreak, however, the authorities have appropriately focused on addressing the ongoing health emergency. In addition, the government submitted to Parliament an "Urgent Consideration bill," covering a spate of structural and fiscal reforms, including a new fiscal rule, reforms to state-owned enterprises, and the establishment of a commission of experts on pension reform. While elements of the proposed legislation will likely be modified in the course of the discussion and will need to be subsequently assessed, these measures are broadly in line with recommendations of the 2019 Article IV Consultation.

6. The government has introduced a series of measures to mitigate the economic impact of the COVID-19 outbreak. They include extensions of unemployment insurance and sick leave benefits, assistance to the most vulnerable, tax deferrals, and a temporary reduction in payroll taxes. The fiscal cost of these measures are estimated at around 1½ percent of GDP. The authorities also established a transparent Coronavirus fund to ensure accountability. The fund will be financed by activating some contingent credit lines (around 2½ percent of GDP), additional taxes, savings from the reduction of salaries for higher-paid civil servants, and contributions from certain state-owned enterprises.

7. The adopted measures are appropriate and timely, but continued action is needed to ensure medium-term fiscal sustainability. Staff projects that the primary deficit of the non-financial public sector (excluding the one-off *cincuentones*[1] transactions) will deteriorate from 1.7 percent of GDP in 2019 to 2.8 percent of GDP in 2020 (in contrast with the ½-percent of GDP improvement envisaged in the recent staff report), reflecting the impact of the pandemic-related

[1] The *cincuentones* transactions—taking place from 2018 through 2022—are related to the pension reform, which allows eligible persons to return to the public pension system. See Box 1 in *IMF Country Report 19/64*.

measures, some savings in other areas, and cyclical deterioration. NFPS gross debt is expected to increase from 67 percent of GDP in 2019 to about 72 percent of GDP in 2020 (up from the projected 67 percent of GDP in the recent staff report), before it declines to 70 percent of GDP in 2021, as growth picks up and fiscal adjustment plans are implemented. This forecast is, however, highly uncertain, and the projected deficit is likely to increase further as the pandemic progresses and additional measures are incorporated in staff projections. Once the health emergency passes, fully implementing the fiscal adjustment will be essential to maintain debt sustainability and investor confidence. Bringing debt to its 2012–14 levels (about 10 percentage points of GDP lower) over the medium term would place Uruguay comfortably within the range of investment-grade peers and rebuild space to accommodate future shocks without endangering sustainability. If downside risks materialize, pandemic-related costs increase, and fiscal adjustment is delayed further, debt and the adjustment needs will increase. This will add to the challenges in designing an adjustment plan given expenditure rigidities (as described in the staff report). Given these risks, continued emphasis on medium-term fiscal framework is important to introduce fiscal anchors and ensure fiscal sustainability, as the economy goes through this temporary but severe shock.

Monetary Policy and Financial Sector

8. In response to the pandemic, the central bank (BCU) and the government have appropriately supported the provision of liquidity and credit. The measures include a temporary reduction in reserve requirements on local currency deposits, an extension of loan maturities for households and businesses, SME loan guarantees, and soft loans and working capital credit to enterprises.

9. Faced with rising inflation and lower money growth, the BCU let the exchange rate adjust and lowered the monetary indicative references. The BCU allowed the exchange rate to depreciate while intervening in the foreign exchange markets to maintain orderly market conditions. In response to rising inflation, above-target medium-term inflation expectations (at around 8 percent in April), and the M1+ growth below the indicative references (5.1 percent in March), the BCU lowered the growth rate of monetary indicative references for 2020Q2 to 3-5 percent to contain inflationary pressures in its April monetary policy meeting.

10. The BCU has also begun to enhance the monetary policy framework and its communication. It has doubled the frequency of its monetary policy committee meetings to better react to the rapidly changing conditions and started publishing minutes to improve transparency and communication. These changes are in line with the recommendations of the recent staff report, which called for further enhancements to the inflation targeting framework to keep inflation low and stable at the mid-point of the target range (3-7 percent).

11. Given high and rising inflation, monetary policy faces a difficult tradeoff between supporting economic activity and containing price increases. In this context, liquidity and credit support should continue to be directed at preventing potential adverse macrofinancial feedback, and monetary policy should aim at containing inflation. Continued improvement of the monetary policy framework and BCU communication is important to anchor expectations. Foreign exchange intervention should continue to aim at maintaining orderly market conditions while allowing the exchange rate to move in line with fundamentals. At the same time, high reserve buffers are an important backstop for local U.S. dollar funding liquidity and should be preserved.

12. The financial sector has remained resilient. Vulnerabilities arising from the pandemic and potential spillovers from Argentina have been limited by banks' comfortable capitalization, profitability, and liquidity positions, as well as small financial exposures to Argentina. According to the stress test presented in the recently published BCU financial stability report, the financial system can withstand sizable shocks (more severe than the current shock). Nevertheless, pressures will likely increase. Even though the share of non-performing loans is low (fluctuating at 3-4 percent of total loans), it is expected to increase as economic activity slows, particularly in sectors affected by the pandemic. Furthermore, if depreciation pressures persist, financial dollarization may pick up, raising longer-term challenges for monetary policy and financial stability. While a further large exchange rate depreciation would increase the external financing requirements and debt, risks to external debt sustainability are mitigated by Uruguay's sizable gross international reserves and liquidity buffers.

13. While the immediate policy priority is to prevent a negative macrofinancial feedback loop and to preserve financial stability, the medium-term priority is to facilitate financial development. In this context, the authorities should continue to remain vigilant and monitor signs of impaired credit intermediation as a result of a liquidity crunch, strains in corporate and household cash flows and balance sheets, and financial institutions' solvency and funding positions. Over the longer term, sustained efforts to reduce the high degree of dollarization and indexation and to deepen financial markets are needed, given the chronically low level of financial intermediation, high degree of dollarization, and segmented credit markets.

Macrostructural Issues

14. Building on Uruguay's institutional strengths, structural reforms are needed to raise medium-term growth. Uruguay enjoys political stability, strong governance, institutions, and social cohesion, low levels of poverty, inequality and informality, and a resilient financial sector. While ongoing infrastructure and investment projects will support the recovery from the expected pandemic-caused recession, they will not be sufficient to raise growth to the levels seen in the past decade. A revival of productivity growth and private investment is critical to sustain the coverage and support level of Uruguay's welfare state and ensure fairness across generations. In this context, action is needed to improve education outcomes and youth employment. Further wage flexibility (for small firms, low-productivity regions, and during downturns) could be considered to preserve labor rights and provide incentives for firms to create more stable jobs and invest in on-the-job training. A corporate governance reform would improve the management and efficiency of SOEs, which play a key role in the Uruguayan economy. The increase in crime, albeit from a low base, also needs to be addressed before it becomes macro-critical.

IMF Relations

15. Uruguay is on a standard 12-month Article IV consultation cycle. The 2019 Article IV consultation was concluded by the IMF's Executive Board on February 19, 2020.

Table 1. Uruguay: Selected Economic Indicators

	2016	2017	2018	2019	Projections 2020 Art IV	2020 Current	2021 Art IV	2021 Current
Output, prices, and employment								
Real GDP (percent change)	1.7	2.6	1.6	0.2	2.1	-3.0	2.5	5.0
GDP (US$ billions)	52.7	59.5	59.8	56.7	58.4	54.6	61.5	59.0
Unemployment (in percent, eop)	7.9	7.9	8.4	9.4	8.4	10.5	7.7	8.1
Output gap (percent of potential output)	-0.3	0.1	0.0	-1.4	-0.6	-3.8	-0.1	-0.7
CPI inflation (in percent, end of period))	8.1	6.6	8.0	8.8	8.0	8.0	7.5	7.5
Exchange rate (UYU/USD, average)	30.2	28.7	30.6	34.9	...	...	...	...
Real effective exchange rate (percent change, eop)	-8.5	5.9	1.8	-2.1	...	...	...	...
Monetary and banking indicators 1/	(Percent change, unless otherwise specified)							
Base money	9.7	3.6	10.4	7.7	...	...	...	...
Broader M1 (M1 plus savings deposits)	8.4	15.2	8.8	5.1	...	...	...	...
M2	14.4	13.4	10.4	5.7	...	...	...	...
Growth of credit to households (in real pesos)	-0.5	2.5	1.2	1.7	...	...	...	...
Growth of credit to firms (in US$)	1.5	-4.2	2.4	-3.7	...	...	...	...
Bank assets (in percent of GDP)	68.7	64.6	66.3	71.9	...	...	...	...
Private credit (in percent of GDP) 2/	28.1	26.1	27.4	28.1	...	...	...	...
Fiscal sector indicators 3/	(Percent of GDP, unless otherwise specified)							
Revenue NFPS	29.3	29.7	31.3	30.8	30.6	29.8	30.4	30.2
excluding *cincuentones* transactions	29.3	29.7	30.0	29.7	29.7	28.9	30.0	29.8
Cincuentones transactions	0.0	0.0	1.3	1.2	0.9	0.9	0.4	0.4
Primary expenditure NFPS	29.9	29.8	30.6	31.3	31.0	31.7	30.7	31.1
Primary balance NFPS	-0.5	-0.1	0.6	-0.5	-0.5	-1.9	-0.3	-0.9
excluding *cincuentones* transactions	-0.5	-0.1	-0.7	-1.7	-1.4	-2.8	-0.7	-1.3
Primary balance BCU	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Interest NFPS	2.6	2.6	2.6	2.4	2.7	2.8	2.8	2.9
Interest BCU	0.7	0.7	0.8	0.5	0.5	0.6	0.2	0.2
Overall balance NFPS	-3.1	-2.7	-2.0	-2.9	-3.2	-4.7	-3.0	-3.8
excluding *cincuentones* transactions	-3.1	-2.7	-3.3	-4.1	-4.1	-5.6	-3.4	-4.2
Overall balance PS 4/	-3.8	-3.5	-2.9	-3.5	-3.8	-5.3	-3.3	-4.1
excluding *cincuentones* transactions	-3.8	-3.5	-4.2	-4.6	-4.7	-6.3	-3.7	-4.5
Gross debt NFPS	61.4	60.8	63.2	67.4	66.7	71.7	66.8	70.3
Gross debt PS	61.6	65.3	67.7	72.3	73.5	79.4	74.4	78.4
Net debt NFPS	49.7	49.5	52.1	56.4	55.8	60.8	56.0	59.5
PS debt net of liquid financial assets 5/	35.9	36.5	38.8	43.2	43.8	48.2	43.9	47.0
PS debt net of total financial assets	29.9	32.1	33.7	32.1	33.4	37.0	33.9	36.7
External indicators	(Percent of GDP, unless otherwise specified)							
Merchandise exports, fob (US$ billions)	10.4	11.1	11.5	12.1	12.7	11.5	13.4	13.1
Merchandise imports, fob (US$ billions)	8.5	8.7	9.1	9.0	11.2	8.7	12.2	10.2
Terms of trade (percent change)	3.7	0.6	-0.6	3.6	5.2	5.7	2.5	1.2
Current account balance	-0.1	0.7	0.1	0.2	-2.7	-2.5	-3.4	-3.1
Foreign direct investment	1.4	3.8	1.9	1.7	0.5	0.5	0.5	0.5
Total external debt + non-resident deposits	74.4	68.1	69.3	72.2	75.6	77.8	77.1	79.2
Of which: External public debt	31.6	30.4	32.6	36.5	36.8	39.6	38.3	40.4
External debt service (in percent of exports of g&s)	87.9	68.2	62.5	57.6	58.3	67.4	60.2	60.1
Gross official reserves (US$ billions)	13.5	15.9	15.5	14.5	15.6	15.7	16.8	16.9
In months of imports of goods and services	13.7	15.4	14.2	13.3	12.1	14.7	12.3	13.3
In percent of:								
Short-term external (STE) debt	196	242	255	249	251	269	257	266
STE debt plus banks' non-resident deposits	210	317	314	263	265	278	269	276

Sources: Banco Central del Uruguay, Ministerio de Economia y Finanzas, Instituto Nacional de Estadistica, and Fund staff calculations.
1/ Percent change of end-of-year data on one year ago.
2/ Includes bank and non-bank credit.
3/ Non-financial public sector (NFPS) includes the Central Government, Banco de Prevision Social, Banco de Seguros del Estado, and Non-Financial Public Enterprises.
4/ Total public sector (PS). Includes the NFPS and Banco Central del Uruguay.
5/ PS gross debt minus PS liquid financial assets. Liquid financial assets equal total PS assets minus the part of central bank reserves held as a counterpart to required reserves on foreign currency deposits.