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Minutes of Executive Board Meeting 20/18-3

10:30 a.m., February 19, 2020

3. Uruguay—2019 Article IV Consultation

Documents: SM/20/32 and Correction 1; and Supplement 1; SM/20/33; and Correction 1

Staff: Berkmen, WHD; Zettelmeyer, SPR

Length: 1 hour, 2 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	**Alternate Executive Directors**
	I. Mannathoko (AE)
	F. Sylla (AF)
	D. Vogel (AG), Temporary
	C. White (AP)
	B. Saraiva (BR)
	Y. Liu (CC), Temporary
	A. Guerra (CE)
	J. Weil (CO), Temporary
	C. Just (EC)
	P. Rozan (FF)
R. von Kleist (GR)	
	R. Goyal (IN), Temporary
	M. Psalidopoulos (IT)
	K. Chikada (JA)
	S. Alavi (MD), Temporary
	F. Al-Kohlany (MI), Temporary
	V. Rashkovan (NE)
	J. Sigurgeirsson (NO)
	A. Biriukv (RU), Temporary
	R. Alkhareif (SA)
	S. Chea (ST), Temporary
	P. Trabinski (SZ)
	D. Ronicle (UK)
	R. Farber (US), Temporary

H. Al-Atrash, Acting Secretary
J. Morco, Summing Up Officer
D. Al-Jarbou / V. Sola, Board Operations Officers
C. SEC, Verbatim Reporting Officer

Also Present
Legal Department: C. DeLong. Strategy, Policy, and Review Department: S. Sanya, J. Zettelmeyer. World Bank Group: M. Sabella. Western Hemisphere Department: S. Berkmen, X. Che, D. Gershenson, L. Herrera Prada, J. Torres Trespalacios. Alternate Executive Director: S. Benk (EC), B. Lischinsky (AG). Senior Advisors to Executive Directors: L. Dips (AG), N. Jost (NE), R. Morales (AG), T. Nguema-Affane (AF),

C. Sassanpour (MD). Advisors to Executive Directors: M. Albert (FF), M. Bernatavicius (NO), T. Chrimes (UK), J. Corvalan (AG), A. Grohovsky (US), G. Khurelbaatar (AP), A. Korinthios (IT), C. Moreno (AG), A. Muradov (SZ), A. Nainda (AE), A. Zaborovskiy (EC), Y. Zhao (CC), F. Antunes (BR), T. Herold (GR).

3. URUGUAY—2019 ARTICLE IV CONSULTATION

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

Uruguay and the Fund

The Uruguayan authorities would like to express their gratitude to staff and Management for the frank and fruitful dialogue held over the past years. In many cases, through this dialogue, the authorities and staff concurred with similar views, while differences prevailed in other cases; beyond that, the relationship between Uruguay, a founding member of the institution, and the IMF has been absolutely candid and respectful. In this opportunity of the 2019 Article IV Consultation, IMF staff, particularly Ms. Berkmen and her team, have made relevant contributions by clearly assessing Uruguay's strengths, challenges, risks, and opportunities always in a constructive and collegial manner.

"Enviable Position"

The authorities were pleased to read the concept underlined by staff in the first paragraph of the report: "Uruguay is in an enviable position in many respects. The country enjoys political stability, strong governance and institutions, and a high degree of social cohesion". In times where some of the most relevant risks that the global economy and, particularly, the region are stemming from social and political instability, Uruguay remains a bastion of institutional and social stability.

For example, the country ranks first in Latin America in the widely followed Democracy Index 2019 published by The Economist Intelligence Unit, and in fifteenth position worldwide, placed in the select group characterized as "full democracies". Furthermore, according to Transparency International, Uruguay has the lowest level of perceived corruption among its Latin American peers and it is almost in the first decile among 180 countries in the world. In addition, among some other indicators, Reporters without Borders ranks Uruguay 19th in the 2019 World Press Freedom Index. It is worth mentioning that during Uruguay's electoral year, which ended in November 2019, and the subsequent transition period that will end on March 1, 2020, there has been no kind of noise in the economic, political, and social fields. Uruguay is very proud of these institutional achievements built throughout an important part of the country's history.

Growth, Investment, and Employment: Uruguay is Poised for a Significant Boost in Foreign Direct Investment (FDI)

In 2019, Uruguay posted its seventeenth year of consecutive growth rates. Admittedly, over the past years, since 2015, growth has been more tepid. In the Selected Issues paper's chapter on Dissecting Economic Growth in Uruguay, staff mostly focus on the external factors behind the substantial growth observed in 2004-14. It is also important to highlight what happened in the following five years: Uruguay continued growing although at smaller rates, while Argentina suffered three years of recession, financial turmoil, and extreme volatility of its exchange rate system. Meanwhile, Brazil suffered a severe recession in 2015 and 2016 and, thereafter, an anemic recovery until 2019. The diversification process carried out by Uruguay over the past two decades, in terms of markets and products, constitutes a critical factor to understand how Uruguay has been able to avoid correlating with regional trends.

Needless to say, sluggish investment and unemployment have been matters of concern. It is important to mention that for this year and the coming years, growth projections are higher than the rate observed in 2019, more in line with Uruguay's potential growth. It is important to note that the upcoming large FDI inflows will be predominantly headed into the export sector and transport infrastructure network.

The Uruguayan authorities broadly agree with the set of reforms suggested by staff in the Selected Issues paper. This would allow Uruguay to further increase its potential growth and inclusiveness. Particularly, the authorities concur with the importance of enhancing the quality of education, and the fact that low population growth and aging pressures could be alleviated by further raising female participation and further facilitating integration of immigrants into labor market. Meanwhile, in recent years, Uruguay has also undertaken a process of financial inclusion, with objectives related to continue reducing evasion and informality, progress on decreasing inequality, and advancing financial development.

Fiscal Issues: Concerns and Strengths

Developments in terms of economic activity have substantially impacted fiscal accounts, which have been a matter of concern for the authorities. The authorities and staff agree on the need to put debt on a firm downward path. Although Annex II of the staff report rightly notes that projected debt distribution confirms that debt dynamics are generally manageable, it is quite clear that the debt dynamic has deteriorated over the past years and should be addressed. In this regard, staff poses relevant suggestions throughout the report, for instance, in paragraph 18.

There are many reasons to be optimistic that these challenges will be successfully faced. One of these reasons relates to Uruguay's political stability and maturity. Given the rigid government spending profile, staff highlights the consensus across the political spectrum regarding key challenges; one of the most important challenges, in this regard, is associated to addressing growing pension spending. The authorities fully agree with what is stated in the report: "reforms should be based on a comprehensive review of the entire system, supported by an informed social dialogue".

Another important institutional aspect to be underscored is associated with the country's Medium-Term Fiscal Framework (MTFF), which is well-described in Annex IV of the staff report, stressing the significant progress observed in the country's MTFF. Naturally, there are areas which need improvements. In this regard, the authorities have mentioned the importance of increasing the quality of spending and performance evaluations.

Inflation and the Exchange Rate

Inflation pressures have built up over the past few months from an acceleration of tradable prices, especially meat prices, which was partially offset by more subdued non-tradable inflation. Of course, inflation has been another matter of concern for the authorities, who have maintained a moderately contractive bias in their monetary policies. Meanwhile, Uruguay continues with its flexible exchange rate regime, a key policy to cushion external shocks; interventions on both sides of the market have been limited to smooth abrupt movements that do not respond to fundamentals. The Uruguayan authorities take note of staff's assessment that "Uruguay's external position is broadly consistent with fundamentals and desirable policy settings". Furthermore, the current account of the Balance of Payments has been in surplus since 2017, which compares favorably with other regional economies.

Financial buffers

Uruguay has made substantial achievements in strengthening macroeconomic and financial stability. International reserves are close to 25 percent of GDP, providing the Central Bank with substantial foreign exchange liquidity in an eventual event of a temporary shock. International reserves remain above the upper bound of the IMF reserve adequacy metric range.

Prudential measures anchored in the implementation of the Basel regulatory framework also played an important role in ensuring financial stability: the banking sector continues to present sound financial indicators, including high capital levels and adequate liquidity buffers. Meanwhile, during the economic slowdown, Uruguay's sound financial system reaped the fruits of years of critical reforms in its public banks and regulatory and supervisory frameworks.

Active debt management has played a key role in mitigating financial vulnerabilities associated with risks of currency and maturity mismatches. This was accomplished by reducing the share of government debt denominated in foreign currency, lengthening the average maturity of debt, and smoothing its redemption profile. Today, the average maturity of Uruguay's debt is 14 years, debt in local currency is close to 44 percent, while debt is at a fixed rate of 94 percent of the total.

Uruguay's authorities are pleased with the recently issued IMF Working Paper (WP/19/290) entitled "Sovereign Asset and Liability Management in Emerging Market Countries: The Case of Uruguay". The study provides an overview of the experience of Uruguay in measuring and managing financial risk exposures within the consolidated public sector. It also describes the coordination mechanisms established between public sector institutions (DMU, Treasury, Central Bank, and main State-Owned Enterprises) to bring sovereign assets and liabilities within the scope of portfolio decision-making. Using Uruguay as a case study, it distills policy-relevant lessons that could apply to other emerging markets in achieving a more cost-effective management of public sector debt and resilience of public finances.

While the robustness of Uruguay's financial buffers does not at all substitute the need to reinforce the country's fiscal consolidation process, it mitigates the need to take hasty measures over a short period of time.

Environmental, Social and Governance (ESG) Practices, and Sustainability Commitments

Sustainable and impact investments are becoming key drivers of global capital allocation decisions. Investors are increasingly embedding ESG factors into their sovereign creditworthiness assessments, reshaping their fixed-income investment strategies. Likewise, multilateral institutions are more frequently incorporating responsible investment and sustainability standards to their loan disbursement programs.

As staff notes, Uruguay is a top performer on ESG fundamentals among emerging markets. Over the last five years, Uruguay's energy matrix has shifted towards renewable resources: in 2019, 98 percent of electricity generation was based on renewal sources of energy, on the back of a dramatic increase in wind power. In turn, less reliance on fossil fuels has limited the exposure of fiscal finances to climate-related risks (such as droughts). As underscored on many other occasions, Uruguay is distinguished for the stability of its political system, social cohesion, low poverty rates and inequality indicators, as well as the absence of civil unrest. All these factors are reflected in J.P. Morgan's ESG-adjusted benchmark index, where Uruguay has the largest country weighting across 73 emerging markets.

Conclusion

Amidst multiple negative external shocks from the region and world economy over the past years, Uruguay has stayed the course, warranting the IMF staff's laudatory concepts. Naturally, there are a number of relevant challenges lying ahead, particularly from the domestic side on the fiscal front. At the same time, Uruguay exhibits important strengths and assets which provide clear reasons to be optimistic that the country will be able to successfully address them. These include its robust financial buffers, sound institutions, the ample consensus across the political spectrum on how to address key challenges, and Uruguay's impeccable record of honoring commitments.

Mr. Bhalla and Mr. Goyal submitted the following statement:

We thank Staff for the informative report and Mr. Chodos and Mr. Vogel for the helpful buff statement.

Uruguay witnessed sustained growth for one and a half-decade until recently, which led to high per capita income, low levels of poverty and inequality, and social cohesion. The country also enjoys strong governance and institutions. However, in the very recent period, investment, growth, and labour participation has started declining. Fiscal parameters have worsened, and inflation has moved above the target range.

Given that Uruguay is a small economy, growth is largely dependent upon global demand and economic conditions. A sharp drop in tourists from Argentina, uncertain global economic environment, and softening of commodity prices are slowing down the Uruguay economy, and the output gap has turned negative. Worsening fiscal conditions are reflecting weak revenue growth with economic slowdown and rising social security expenditure with unfavorable demographic trends.

As per Staff assessment, the short-term outlook has improved. Growth is expected to pick up from 0.5 percent in 2019 to 2.1 percent in 2020 and 2.5 percent in 2021, supported mainly by investment. The fiscal deficit is expected to be lower going forward but inflation may stay above the targeted range.

It appears that the Uruguay economy slowdown is mainly structural in nature, and fiscal stimulus is unable to prop up the economy and is instead resulting in higher inflation and an elevated real effective exchange rate. Latter has further weakened external competitiveness and has adversely impacted the economy. We would welcome Staff's comments on this aspect.

We support the suggestions made by the Staff and encourage the authorities to make concerted efforts to reduce the fiscal deficit and adjust the policies to contain inflation and inflationary expectations. These, in turn, should help in staving off the currency overvaluation and in restoring external competitiveness. These efforts, coupled with initiatives to boost productivity and improve education outcomes, should place the economy on a higher growth trajectory.

We wish the authorities every success in future endeavors.

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

Thank you to staff for the helpful reports, and to Mr. Chodos and Mr. Vogel for their insightful buff statement in which they outlined how Uruguay has enjoyed stability amidst significant regional instability.

We support the staff's appraisal and encourage Uruguay to seize the current window of opportunity to address internal imbalances. Despite less favorable external conditions, the short-term growth outlook has improved. The authorities now have the opportunity to leverage a combination of a favorable political economy, strong institutions and governance, and social cohesion to tackle imbalances in the wake of the recent economic slowdown, namely fiscal deterioration and rising unemployment. Spillovers from economic and financial developments in Argentina will need to be monitored closely. The RAM includes contagion from financial turbulence in Argentina as a key risk. How would spillovers from a downside economic and financial scenario in Argentina impact staff's advice?

A well-communicated fiscal adjustment plan would help ensure debt sustainability. A reduction in current expenditures should be accompanied by a streamlining of regressive tax expenditures. We agree with staff that this adjustment should be supported by improvements to the medium-term fiscal framework, including by reducing spending rigidities, adopting rolling forecasts, improving accountability, discussing risks around budget projections, and introducing a credible fiscal anchor. There is also scope to improve the governance of SOEs to improve their management and efficiency.

Structural policies should focus on tackling deteriorating labor market conditions. In particular, Uruguay has one of the highest rates of youth unemployment in the world, at 30 percent, and many young people are precariously employed. Left unchecked, this trend could put social cohesion at risk. We support staff's proposal for increased wage flexibility and encourage the authorities to invest in vocational training to employ more youth in sectors that are less exposed to economic downturns and associated job losses. We also encourage the authorities to continue their efforts to integrate women into the workforce.

Mr. Chikada, Mr. Tan, Mr. Chea and Mr. Kuretani submitted the following joint statement:

We thank staff for the comprehensive set of reports and Mr. Chodos and Mr. Vogel for their informative buff statement. We commend the Uruguayan authorities for their solid macroeconomic management track-record, strong reform implementation and improvement in poverty reduction and social outcomes over the last decade. Notwithstanding the authorities' significant progress, Uruguay's near-term growth is subject to downside risks stemming from rising debt level and unfavorable external economic conditions. Also, continued weak anchoring of inflation expectations warrants caution. In this context, further efforts are needed to strengthen the fiscal and monetary framework as well as structural reforms in order to maintain economic resilience and foster long-term sustainable growth. We broadly agree with staff's appraisal and would like to offer the following comments for emphasis.

While we welcome the authorities' commitment in maintaining fiscal sustainability, additional fiscal adjustments are needed to put public debt firmly on a downward path. Given the uncertain growth environment, further fiscal consolidation is crucial to secure sustainable reduction in public debt. This will help reduce fiscal imbalances, speed-up debt reduction and promote better capital spending efficiency in most needed sectors such as health, education and infrastructure. To ensure medium-term fiscal credibility, we share staff's view and encourage the authorities to make further progress towards capital expenditure prioritization and pension reform, along with the reinforcement of the medium-term fiscal framework to place debt on a sustainable trajectory. With respect to the pension reform, staff's comments are welcome on the authorities' emphasis to preserve rights while seeking compatibility with fiscal constraints at the same time.

Anchoring inflation expectation within the Central Bank's target range will help contain inflationary pressures and enable a flexible exchange rate function as a shock absorber. We note with concern that actual inflation rate and inflation expectations continue to overshoot the target range, reflecting the peso's depreciation trend and wage indexation. At this juncture, a flexible exchange rate seems to be acting as a shock amplifier rather than a shock absorber for Uruguay. Accordingly, we welcome the authorities' ongoing commitment in reducing dollarization and indexation. This will help to better anchor inflation expectations and improve resilience against external shocks. In this regard, could staff comment on the authorities' progress made towards de-dollarization and de-indexation?

Advancing on structural reforms will be crucial to foster long-term sustainable and inclusive growth. We have concerns that the unemployment rate has risen, particularly among the young and females. In this context, we share staff's intention that youth unemployment should be addressed with the education reform to revive the productivity growth. We would appreciate it if staff could elaborate how other policy measures, such as labor legislation reforms, could address the unemployment problems, and how to prioritize and progress the employment reforms. We commend the Uruguayan authorities for their success in reducing poverty and inequality. Given the low growth environment and the declining employment growth, we also share staff's view and encourage the authorities to improve the business climate, promote economic diversification and enhance labor market flexibility. In supporting these initiatives, further efforts to close the infrastructure gap and improve education outcomes in order to attract foreign direct investment and raise potential growth will be equally important.

The financial system is noted to be sound and profitable, however, it remains susceptible to near-term challenges. We encourage the authorities to deepen the financial markets, remain vigilant on banking supervision, in particularly, in the implementation of AML/CFT measure, and preserve financial sector resilience. While it may be the source of profitability of the banking sector, could staff elaborate why the lending rate in pesos remain highly elevated?

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

Mr. Bevilaqua, Mr. Saraiva and Mr. Antunes submitted the following statement:

We thank staff for the insightful report and Mr. Chodos and Mr. Vogel for the candid buff statement. Uruguay has navigated well the turbulent decade in the aftermath of the global financial crisis. The economy continues to grow, albeit at a slower pace, and social development achievements are remarkable. Key to the country's success were prudent macroeconomic policies and solid institutions, grounded on high levels of social cohesion, low poverty rates and relatively low inequality. Nevertheless, macroeconomic imbalances have been mounting over the last few years, leaving no room for complacency. The priorities ahead include implementing a careful fiscal consolidation, curbing inflation, and increasing potential growth through productivity-enhancing reforms. On a positive note, the current economic recovery in Brazil may boost Uruguay's exports and tourism revenues, contributing to the country's rebalancing efforts.

Current primary and overall deficits continue to raise debt-to-GDP levels. Gross NFPS debt is projected to creep up to 68.9 percent in 2024. While it does not pose immediate risk of debt distress, the rising debt trajectory is a cause for concern and should be reversed. Although we acknowledge that the long average maturity of the debt and the significant volume of liquid assets provide some comfort, we concur with staff's assessment that it will be necessary to introduce a credible adjustment plan to put debt back on a more sustainable path. That said, and given that this is not an emergency situation, the authorities should be trusted to define the appropriate pace and the extent of the upcoming consolidation efforts. We are reassured by the fact that the need for long-term fiscal consolidation commands broad political consensus in Uruguay.

Inflation has fluctuated above the upper bound of the target range for too long. Although both headline and core inflation remain under control, the continued overshooting of the target range indicates the existence of structural monetary policy challenges. Efforts to reduce dollarization and indexation are steps in the right direction. The authorities should take advantage of the current global scenario of subdued inflation and low interest rates to firmly anchor inflation expectations. With inflation in the current levels, Uruguay remains vulnerable to a sudden reversal in international interest rates and inflation dynamics. At the same time, foreign reserves are at adequate levels, and flexible exchange rates have been providing an effective first line of defense against external volatility. Could staff comment on how the significant and opposite inflation rate differences between Uruguay and its Mercosur partners may affect Uruguay's monetary policy strategy?

Productivity-enhancing reforms, capable of boosting potential growth and dynamizing the labor market will be paramount to bring the Uruguayan economy to the next level. We take positive note that ongoing large-scale investment projects are expected to mature, sustaining growth over the next few years. Going forward, considering the shrinking fiscal space for public investments, growth will need to be underpinned by productivity gains. Therefore, the authorities should strive to address productivity bottlenecks that are still hindering the Uruguayan economy, as reflected in the relatively low levels of investment. The selected issues paper presents a number of valid policy suggestions. We highlight the importance of enhancing education outcomes and devising targeted policies to address Uruguay's disproportionately high rates of youth unemployment. Furthermore, we missed more detailed considerations on Uruguay's demographic trends and related macrocritical challenges.

We agree that, on balance, risks are tilted to the downside, but the report should also account for the possible incidence of positive risks over the next twelve months. The risk assessment matrix rightfully includes a number of downside risks, such as rising protectionism and retreat from multilateralism, sharp rise of risk premia and weaker than expected global growth. Nevertheless, a full picture of risks should also include potentially positive developments. For instance, we share Uruguayan authorities' optimism with a potentially more robust economic recovery in Brazil. Could staff elaborate on the impacts of risks stemming from potentially positive regional developments?

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

We thank staff for the informative set of reports and Mr. Chodos and Mr. Vogel for their helpful buff statement. Following more than a decade of robust economic performance, growth has slowed down, inflation remained persistently above target, fiscal accounts deteriorated, and labor market conditions have become more challenging. However, Uruguay's institutional strength, flexibility of the exchange rate, political stability and resilient financial system provide a good opportunity and there appears to be a general political consensus for addressing these challenges. We concur with staff's overall appraisal and would like to provide a few additional points for emphasis.

Structural reforms to remove constrains to the private sector development will be key for achieving more robust economic growth going forward. There is a pressing need to improve the governance, efficiency, and transparency of the SOE sector, which plays a dominant role in the Uruguayan economy. We also encourage the authorities to focus on health and education outcomes and increase labor market flexibility to support the medium-term potential growth, especially in the context of an aging population.

The fiscal deficit has deteriorated considerably, in particular over the past 18 months. We support staff's recommendation on the need to introduce a credible fiscal adjustment plan. It should be underpinned by an enhanced medium-term fiscal framework with a binding expenditure rule and a credible debt anchor. The authorities could also consider establishing an independent fiscal council, which could support enforcing rules. There also appears to be room to reduce various tax exemptions, which are estimated at about 7 percent of GDP.

We note with concern, that inflation has remained persistently above the target. In the context of the upcoming BCU strategic review, we encourage the authorities to consider enhancing Central Bank communication by emphasizing the primacy of the price stability objective. Further policy efforts in reducing credit and deposit dollarization will be crucial for enhancing the effectiveness of monetary policy. In the context of persistently high inflation and considering a relatively high per capita income level, what would be staff's view on the possibility of lowering the current inflation target range of 3-to-7-percent? A lower inflation target range, together with the revamped Central Bank communication strategy could send a strong signal to market participants and lead to a better anchoring of inflation expectations.

Labor market conditions have deteriorated significantly since 2014, amid a rising unemployment rate and declining labor force participation. The youth unemployment rate is one of the highest in the world, as even the well-educated young experience high unemployment rates, but as indicated in the report one explanation may be a mismatch of skills. However, as staff's analysis reveals, standard control variables such as marital status, education, region, gender, and the economic cycle cannot explain the gap between youth and adult unemployment. We encourage staff to continue their analysis in this area.

Mr. Psalidopoulos, Mr. Rashkovan, Ms. Korinthios and Mr. Zedginidze submitted the following joint statement:

We thank staff for the informative set of reports and Mr. Chodos and Mr. Vogel for their helpful buff statement. Following a severe crisis in the early 2000s, Uruguay experienced 15 years of robust growth, thanks to which the country can rely on high per capita income, low levels of poverty and inequality as well as resilient financial sector. However, most recently, growth, investment and employment have slowed because of regional shocks and global uncertainties. Thanks to a diversification process carried out on markets and products, Uruguay was able to react despite the regional trends. Addressing these challenges is paramount in order to maintain past achievements and raise potential growth. In this regard, we wish to express our appreciation for the Selected Issues Paper on the causes of the economic boom during 2004-2014, which is a very useful input for the design of a long-term growth strategy. We broadly agree with staff's assessment and offer the following comments:

As Uruguay's fiscal space is at risk, a gradual fiscal adjustment would be the right recipe to reduce debt while creating space for reforms. At the same time, we agree with staff that a revamped medium-term fiscal framework would enshrine credibility of the adjustment plan. Moreover, we strongly encourage the authorities to establish an independent fiscal council, which would provide a public and independent assessment of government's fiscal policies, plans and performance against macroeconomic objectives related to the long-term sustainability of public finances.

We take good note of the resilience of the financial sector and we are pleased with the prudent supervision and regulation thanks to which the financial sector weathered the bouts of the regional financial volatility well. At the same time, we share staff's view on the importance to continue working to preserve this resilience. According to staff, the authorities are on the right path and are proceeding with the appropriate steps, namely with regulations on the net stable funding ratio and regulation on countercyclical buffers. However, we would like to hear more details from staff on the mentioned regulations and on the next steps (p. 16 of the report).

Monetary policy should aim to reduce inflation towards the mid-point of the target range. Even if we recognize that a high level of dollarization may affect the effectiveness of monetary policy, nevertheless we think that there is scope for domestic monetary policy to be successful. In particular, we concur with staff that the central bank should focus on keeping inflation low in order to reduce dollarization, deepen financial markets and strengthen policy credibility.

Further structural reforms would be useful to raise potential growth, ensure continued income convergence and maintain social achievements for future generations. In order to support growth, various measures are required: first, an education reform is essential not only to improve education outcomes, but also because it represents the first strategy to address youth unemployment. With respect to this issue, the education reform should be coordinated with a labor market reform, which would also improve wage flexibility and labor-employer cooperation. We also agree on the importance to develop a corporate governance reform in order to improve the management and efficiency of SOE's. Finally, we really appreciate that over the last five years, Uruguay's energy matrix has shifted towards renewable resources; as a consequence, in 2019 98 percent of electricity generation was based on renewal sources of energy (p. 4 of the buff statement). In a world severely impacted by climate change, we think that this represents a significant result as well as a big lesson for other economies.

Mr. Farber and Mr. Grohovsky submitted the following statement:

The Uruguayan economy has been sound for several years, marked by strong governance and institutions, low levels of poverty and inequality, and continued political stability. However, the economic slowdown this year has highlighted some risks, including widening fiscal imbalances and persistently above target inflation. We encourage the incoming administration to continue supporting conditions that have enabled previous achievements and to address Uruguay's economic challenges over the coming years. We generally agree with staff's assessment and focus our comments on the following areas.

Fiscal Policy: Given the slowdown, we are less concerned than staff with the recent widening of the fiscal deficit. However, while financing needs are moderate, the authorities should use the projected economic recovery as an opportunity to put forward a credible fiscal adjustment plan that rebuilds fiscal space over the next five years. The authorities could complement expected increasing tax revenues from the cyclical upswing by increasing the low corporate tax rate. They could also reduce tax expenditures and current spending, which crowds out capital expenditure and limits budgetary flexibility.

Monetary Policy: The trajectory of inflation and persistently-high inflation expectations also requires action. Could staff provide details on the specific drivers of inflation? We encourage the authorities to continue tightening policy to enable inflation and inflation expectations to converge to the target range, especially given the window of opportunity provided by the economic rebound. We also agree with staff's assessment that enhancing the inflation targeting framework and improving the authorities' communication strategy could help shift expectations toward the target range. Furthermore, reduced dollarization should help strengthen monetary transmission.

Structural Reforms: Political stability and social cohesion are conducive to undertaking structural reforms. We particularly note the poverty rate, which is considerably lower than in comparable countries. We encourage the new government to continue to foster private investment and focus on raising productivity growth, while implementing incentives to boost foreign direct investment. Another priority is reform of SOEs, and we welcome Box 2 which laid out detailed governance reforms that could be taken.

External Sector: Finally, we agree with staff that the authorities should allow the exchange rate to act as a shock absorber, with interventions limited to addressing disorderly market conditions, and also that net reserves are more than adequate to offset possible disorderly conditions. Could staff define how markets are determined to be disorderly in the Uruguay case, particularly related to recent interventions?

Mr. Buisse, Mr. Rozan and Ms. Albert submitted the following statement:

We thank staff for their interesting set of papers, as well as Mr. Chodos and Mr. Voguel for their buff statement. The sound institutional framework and cautious macroeconomic policies have served Uruguay well and helped the country converge to advanced country incomes levels faster than its regional peers. This being said, Uruguay is facing several economic challenges, and we are encouraged by the authorities' intention to address fiscal consolidation, enhance the inflation targeting framework, and implement structural reforms. Finally, we share staff's view that the increase in crime needs to be addressed before it becomes macro-critical. We agree with the thrust of staff's appraisal and would like to add the following comments:

We commend the authorities for their progress regarding poverty and inequality reduction but note the lower than expected potential growth compared with last year. Growth is less dynamic, investment has been low for many years and there was no significant FDI during the past three years. We note that growth is expected to recover due to the investment projects, notably the paper pulp plant project and that staff considers that more boost from these projects represent an upside risk. However, direct and indirect effects could not be as important as expected, since their materialization depends on many factors, as mentioned in the useful SIP. We note that the potential growth should be around 2.2 percent, against 3 percent in the last staff report one year ago. As the demographic effect is not a new phenomenon, could staff detail the elements which explain the revision and especially regarding capital accumulation?

More efforts to put debt on a downward trajectory are needed, and we are encouraged by the authorities' resolve in this regard. We note that public debt has reached 70 percent of GDP last year, and the important gap between the 2.5 percent of GDP deficit target for the consolidated public sector (excluding cincuentones transactions) and the 4.6 percent of GDP foreseen in 2019. We welcome the authorities' ambition in terms of fiscal consolidation efforts and encourage them to put in place a fiscal rule, a counter-cyclical buffer and reinforce the medium-term fiscal framework, which should help to improve governance and credibility. We note that 80 percent of revenues comes from taxes on consumption and labor only 10 percent from taxes on corporate income, which is a low level. In addition, does staff see any social risk linked with the implementation of adjustment measures? Finally, we find appropriate the methodology change regarding fiscal reporting from the consolidated public sector to the non-financial public sector and continue to find important the clear identification of the cincuentones transactions regarding their weight in the public deficit. We encourage an appropriate communication of the authorities and staff on this issue.

As the inflation has been out of the 3 to 7 percent target range since 2017, more readability of the monetary policy is needed to anchor inflation expectations. Inflation reached 8.8 percent in 2020, due to the peso depreciation and the increase or the price of meat, but inflation expectations remain high and we note that staff expects only a gradual inflation slowdown towards 7 percent in 2024. The improvement of the central bank communication, the wage moderation and the maintaining of a tight monetary policy should help to reduce inflation and better anchor medium-term expectations, especially in a dollarized economy. Is there still room to improve the remaining wage indexation and is it still an issue to control inflation? We share staff's view considers that FX interventions should remain mobilized to address only disorderly market conditions and see the importance of the reserves at 180 percent of the ARA metric as useful in case of external shock. Given the economic slowdown since 2015, could staff comment on the potential impact of too restrictive a policy mix on growth?

We welcome the resilience of the financial sector which helped the country face the spillovers coming from Argentina and encourage them to pursue their efforts to improve financial intermediation. Indeed, the strengthening of supervision and regulation was useful to prevent financial spillovers from Argentina. The level of financial intermediation has improved, but the credit to private sector remains at a low level. We understand that the authorities are looking into using cash for transactions to give more flexibility to the private sector, what is staff's view on this issue?

Regarding structural reforms, we see three important areas: first, the large unemployment rate among the young at 30 percent, one of the highest in the world. We thank staff for their focus in the SIP, but we note that the phenomenon is not yet fully understood and encourage further work on this issue, as specifying more the recommendations in this area is paramount. Second, regarding the importance of the demographic challenges, it remains necessary to ensure the sustainability of the pension system and we welcome the authorities' willingness to reform it. Third, we share staff's recommendation regarding a corporate governance reform to improve the management and efficiency of SOEs. Does staff have recommendations regarding privatization? Finally, we note that staff considers that the increase in crime should be "addressed before it becomes macro-critical".

Mr. Ronicle and Mr. Chrimes submitted the following statement:

We thank staff for the interesting report, annexes and selected issues papers, as well as Mr. Chodos and Mr. Vogel for a fascinating buff statement.

As the selected issues paper details, Uruguay's economic recovery in the decade to 2014 was remarkable. We agree with staff and the authorities on the value of Uruguay's strong governance, institutions and social cohesion, among many other attributes. Nevertheless, the economic situation is becoming increasingly challenging, in part due to external factors (including in relation to Argentina), and there are some parallels with issues facing other economies in the region. Fundamentally, Uruguay faces difficult trade-offs, with a negative output gap, above-target inflation and above-target inflation expectations – one or both of monetary and fiscal policy will need to tighten in order to deliver macroeconomic stability, leaving policymakers with a difficult choice over which objectives to target, at what pace and with which instruments.

We broadly agree with staff's fiscal policy recommendations. Stepping back from the specifics of Uruguay's situation, in the current global climate we see merit in using fiscal space where available, especially for delivering important long-term investments. However, with debt expected to rise, inflation persistently above target, political consensus on the need for an adjustment, and anticipated growth support from large investment projects, we see a case for some near-term consolidation in Uruguay, despite staff estimating a negative output gap at present. We therefore welcome staff's suggestions on how to deliver the necessary adjustments, as well as the authorities' intention to ease the impact of the consolidation on the most vulnerable. We are pleased to see the report's attention to pension system reform, and the authorities' commitment to consider comprehensive reforms, supported by an informed social dialogue (including with young people). We would appreciate more detail from staff on the authorities' perspectives on the specific proposals for further improvements to the Medium-Term Fiscal Framework.

We share concern that 24-month inflation expectations are above the target range. We note the role of temporary factors in pushing up inflation, and that changes to wage bargaining council guidelines should help curb indexation but will take time to feed through. Core inflation excluding meat has not come down despite interest rate rises in recent months. We note the authorities' expectation that inflation will fall back into the target range later this year – but there is still a marked gap between staff's projections (CPI inflation settling around 7 percent) and the middle of the target range (5 percent). Anchoring inflation expectations towards the middle of the target range should be an important objective. We welcome the authorities' continued commitment to exchange rate flexibility, a helpful cushion against external shocks.

Structural issues remain key to unlocking long-run growth potential in Uruguay. The high ratio of youth unemployment relative to the population as a whole is concerning. We see value in further work, not least as the current analysis necessarily stops short of proposing policy solutions. We welcome the authorities' focus on developing human capital. Better integrating young people, women and migrants into the labor force would be beneficial. We share staff's views on the merit of pursuing SOE corporate governance reforms, and on promptly implementing AML/CFT recommendations. Staff are right to highlight the need to address rising crime before this becomes macro-critical. Finally, we note that climate change has not featured in recent Article IV reports, but that environmental and sustainability commitments are highlighted in the buff statement. Given the importance of the agricultural sector in the country, the positive shift towards renewables-based electricity generation, that a majority of the population lives near the coast, and that there have been significant extreme weather events in recent years, we wonder whether climate change-related policies may be a useful area of focus for a future report.

Mr. Trabinski and Mr. Muradov submitted the following statement:

We thank staff for their valuable reports and Mr. Chodos and Mr. Vogel for their informative buff statements.

Uruguay has enjoyed more than a decade of robust growth supported by political stability, strong institutions, and prudent macroeconomic policies. Nevertheless, external and internal economic conditions are becoming more challenging, thus warranting an adequate policy response. Public debt is mounting, inflation remains above the target, while growth, investments and employment have slowed down. We share the thrust of the staff appraisal and main recommendations.

We concur with staff that there is a need to introduce a credible adjustment plan to bring debt on a downward path. This could include staff's recommendation to introduce a medium-term fiscal framework (MTFF) with a binding fiscal rule. The implementation of an MTFF in the context of favorable growth projections would create an opportunity to bring debt down faster, and ensuring its sustainability. Moreover, we deem the high level of pension spending in the context of population ageing very challenging. We therefore encourage the authorities to ensure sustainability of the social security system through its comprehensive review and reform. Could staff elaborate more on the demographic dynamics in Uruguay and provide their view on a possible policy response that could be considered by the authorities?

Inflation has been persistently above the target, leaving Uruguay vulnerable to negative shocks that could potentially drive inflation further up. We note that high dollarization, the low credit to GDP ratio, wage indexations and frequent shocks to the exchange rate pose challenges for sound monetary policy. We see a scope for further enhancement of the inflation targeting framework complemented by reducing high dollarization, indexation and improving communication. In this context we welcome the authorities' commitment to maintaining a flexible exchange rate regime and efforts aimed at enhancing monetary policy.

Structural bottlenecks warrant additional reforms. Uruguay has high per capita income, low levels of poverty and inequality and a high degree of social cohesion. However, employment and labor force participation have been falling recently, with crime levels increasing, although from a low base. Could staff provide more information on the factors that are fueling crimes in Uruguay? We welcome the authorities' commitment to establishing human capital as a competitive advantage of Uruguay's and to improving the quality of education to generate employment and provide a skilled labor force. We also take note of the existing infrastructure gap. Could staff shed more light on the level and structure of the infrastructure deficit in Uruguay? At the same time, we agree with staff's recommendations to further enhance structural reforms to raise potential growth and maintain the achievements of social policies for future generations. This should include governance reform of the SOEs, as well as improved public infrastructure management.

Mr. White and Mr. Khurelbaatar submitted the following statement:

We thank staff for the reports and Mr. Chodos and Mr. Vogel for their buff statement. Uruguay's strong governance and institutions, political stability and prudent macroeconomic policies have resulted in a remarkable economic recovery since 2002 and provided the basis for a resilient economy. The country has built sufficient reserve buffers, reduced poverty and lifted per capita income. As external conditions are becoming more challenging and risks to the outlook are on the downside, the authorities should focus on improving the fiscal position and reducing debt, taming inflation and implementing structural reforms to boost productivity and growth. We broadly agree with the report and have the following comments.

Fiscal reforms are needed to reverse a worsening fiscal position. Unless appropriate fiscal adjustment is undertaken, the path of a deteriorating fiscal deficit could undermine debt sustainability. Reforms are needed to alleviate future spending pressures especially from current expenditures.

Reforms should focus on restraining public wages and employment levels as well as reducing tax expenditures. Given the high and growing level of pension expenditures which are linked to an aging population, we agree with staff that early action is required including a comprehensive review of the pension system. This is a complex and difficult task that needs to balance financial sustainability with considerations around social cohesion and stability. Fund TA could be helpful to support the authorities on this matter.

We also welcome the introduction of a medium-term budget planning framework and the new fiscal reporting approach. The adoption of these tools will support better longer-term planning and execution of fiscal policies which could be further enhanced by the introduction of a strengthened fiscal rule.

Inflation needs to be contained to preserve stability. Given that inflation remains stubbornly above the central bank's target band, enhancement in monetary policy and communications are needed. Expansionary fiscal policy, a high degree of dollarization, and a volatile exchange rate, as well as the central bank's commitment to multiple objectives, diminish the authorities' efforts to contain inflation and inflation expectations. Continued higher inflation poses risks to economic stability and to the credibility of the central bank's monetary policy. Thus, we would recommend prioritizing price stability as the major objective of monetary policy. We welcome the authorities' continued commitment to a flexible exchange rate, which will be essential in absorbing external shocks.

SOE governance reforms. SOEs in Uruguay account for a quarter of the economy, employ 17 percent of the workforce and contribute a significant part of the government's revenues. We welcome staff's view that some SOE organizational and management practices are aligned with the international best practice. Given SOEs' share of the economy, there is also considerable potential in further reform. There is an opportunity to build on a track record of strong governance and institutional settings with a suite of corporate governance reforms aimed at lifting transparency and accountability, strengthening operational independence and eliminating opaque cross-subsidies. This should improve the both efficiency and service quality of SOEs.

Youth unemployment. The labor market reforms of 2005 and robust economic growth allowed the country to greatly reduce unemployment and improve the living the standards of the population. Despite the strong progress on many fronts, youth unemployment remains high and compares poorly to Uruguay's peers. We thank staff for a good analysis in the selected issues paper about the labor market in Uruguay. While the slower economic growth period since 2014 appears to be one contributor, it seems that youth unemployment is a structural issue that may be driven by inflexibility in the labor market, elevated labor costs and informality in low-skill sectors. Further careful analysis of labor market regulations, efficiency and competitiveness is necessary to inform reforms that address unemployment as a whole but especially among young people, which if left unaddressed can set foundations for other social problems in the future.

Mr. Beblawi, Mr. Mouminah and Mr. Raghani submitted the following joint statement:

We thank staff for the set of interesting reports and Mr. Chodos and Mr. Vogel for their helpful buff statement.

We welcome Uruguay's continued economic expansion, now in its seventeenth year, reflecting the authorities' prudent policies. However, over the past few years, growth has moderated while investment and labor participation are on a declining trend and internal imbalances are accumulating. While the external position remains solid, continued weak external conditions are adding to the policy challenges facing Uruguay. Uruguay's robust financial buffers, sound institutions, and broad consensus allow the authorities to face these challenges from a position of strength. Looking ahead, strengthening the fiscal and monetary frameworks and pursuing structural reforms are needed to raise employment and potential growth as well as safeguarding the notable socioeconomic achievements. We broadly share the thrust of staff's policy recommendations and offer the following comments for emphasis.

Fiscal consolidation is needed to preserve fiscal and debt sustainability. We encourage the authorities to take advantage of the current favorable environment and the broad-based political consensus to improve the fiscal position and reduce debt. In this regard, the incoming government's intention to undertake a fiscal adjustment is welcome while continued efforts to further improve the MTFF are encouraged. Ideally, the fiscal reform package needs to balance between fiscal consolidation and preserving the authorities' impressive progress in reducing poverty and inequality. The authorities should make further progress in reforming the social security system to ensure its sustainability and address its growing fiscal cost. Early action in this area is needed, including a comprehensive review of the pension system. Likewise, pursuing the improvement of SOEs efficiency and transparency is essential to fiscal sustainability.

Bringing inflation and inflation expectations down within the target band is crucial to increase monetary policy credibility and reduce dollarization. While acknowledging that inflation is partially impacted by temporary external factors, it remains above the central bank's target range despite a negative output gap and the latest round of momentary policy tightening. Bringing inflation towards the mid-point of the target range is challenging given the high degree of dollarization, weak monetary transmission channel, wage indexation, and high inflation expectation. The authorities' ongoing efforts to address these issues, including by reducing indexation, deepening the financial market, encouraging de-dollarization, and improving policy coordination should be supported by a robust communication strategy in order to firmly anchor inflation expectations.

Efforts to further deepen financial markets should continue. The financial system successfully weathered the impact of the regional financial volatility thanks to Uruguay's ample reserve buffers and prudent supervision. Non-performing loans have declined, and banks capitalization and profitability improved. We commend the authorities for their efforts to strengthen financial sector resilience and deepen financial markets, with notably the adoption of regulations on the net stable funding ratio, countercyclical buffers, and peer-to-peer lending. However, we note that financial intermediation remains limited, credit to private sector is low, and the credit markets are segmented. Could staff elaborate on recommended measures to address these issues? In addition, we also would like staff to update on the implementation of the e-peso project that was discussed in last year's report. Going forward, we urge the authorities to swiftly implement the recommendations of GALIFAT's AML/CFT assessment.

Structural reforms aimed at improving business environment and sustaining an inclusive growth should continue and focus on productivity and human capital development. We welcome the analysis in the well written Selected Issues paper on growth and its drivers, and we agree with the reform recommendations to support private sector development, close infrastructure gap, and improve productivity by strengthening educational outcomes to raise potential growth and address youth unemployment. As regard labor market issues, we welcome the agreement between stakeholders on the introduction of productivity and flexibility considerations in the wage-setting mechanism. The authorities should continue addressing remaining shortcomings by notably increasing female labor participation and facilitating the integration of migrants in light of the aging population.

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

We thank staff for the interesting set of papers, and Messrs. Chodos and Vogel for their insightful buff statement. Prudent economic policies and sound institutions have enabled sustained economic growth and poverty reduction in Uruguay. We commend the authorities for these remarkable achievements. Recently, growth has slowed on the backdrop of external headwinds, including from the main trading partners and global economic factors, and the political landscape have evolved. The new government will face the challenges of revitalizing economy while preserving social cohesion. We concur with the thrust of staff's appraisal.

A broad consensus between staff and the authorities about the need to contain the non-financial public sector deficit is welcome. We agree that growth-friendly fiscal consolidation would help preserve fiscal space and should be pursued. The new government has announced its intention to undertake a fiscal adjustment. Given the difficult external environment and Uruguay's developmental needs, the fiscal policy tightening should be well-calibrated, and underpinned by further fiscal structural reforms and measures on the revenue and expenditure sides, focusing on current spending and tax exemptions. Could staff comment on the authorities' plans and whether they are in line with staff's recommendations? We also note that staff and the authorities use the different methodologies to calculate debt-to-GDP ratios. Could staff comment on the pros and cons of each approach, as well as the best practices recommended by the IMF? We are encouraged to learn about Uruguay's experience in sovereign asset and liability management, which proved to be instrumental in containing fiscal risks and achieving a more cost-effective management of public sector debt.

Further enhancements to the inflation-targeting framework would help reduce inflation to within the target band. Close coordination between the monetary and fiscal policies is critical, and we welcome the change in the fiscal reporting framework which helps better delineate the impact of the policy decisions on the monetary and fiscal accounts. Further efforts should be geared towards enhancing the monetary policy communication and instruments, while reducing dollarization and carefully balancing the objectives of maintaining price and financial stability under the flexible exchange rate regime. We positively note staff's assessment that Uruguay's external position is broadly consistent with fundamentals and desirable policy settings, with FX reserves close to 25 percent of GDP. A flexible exchange rate serves the economy well, being a key shock absorber, and FX interventions should be limited to addressing disorderly market conditions.

Preserving financial stability and advancing financial inclusion would support long-term growth. We note that the banking sector posted sound financial indicators, including high capital levels and adequate liquidity buffers, notwithstanding some exposure to regional volatility. However, as pointed out by staff, further efforts are warranted to improve financial intermediation, reduce credit market segmentation, and advance financial regulation. In the 2018 Article IV Staff Report, staff discussed the results of the E-peso pilot project implemented by the central bank to test the innovative ways to reduce transaction costs and increase financial inclusion. Could staff share some insights on the follow-up on this project?

As we learned from the buff statement, we welcome that the Uruguayan authorities broadly agree with the set of structural reforms suggested by staff in the Selected Issues paper. The authorities' commitment to sustainable environmental and social governance are welcome. We agree with Messrs. Chodos and Vogel that with the robust financial buffers, sound institutions, and consensus across the political spectrum, Uruguay is well-set to address challenges it faces.

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

We thank staff for the set of insightful papers on Uruguay and Mr. Chodos and Mr. Vogel for their informative buff statement. We generally agree with the thrust of the staff appraisal and would like to highlight several points.

We encourage the incoming administration to reap the benefits of a favorable political landscape and address Uruguay's economic challenges that have emerged in the wake of economic slowdown. In particular, the public finances need to be strengthened. Public debt has been on an upward trend over the last decade and is projected to get close to 70 percent of GDP by 2024 if no adjustment is made. Against this background, we support staff's proposal to introduce a credible adjustment plan as early as this year to put debt on a credible downward path and rebuild fiscal space to accommodate future negative shocks. On the revenue side, reduction of tax expenditures would support the fiscal adjustment. On the expenditure side, we see merit in early action to comprehensively review the current social security system in the context of aging population and already high pension spending. Could staff elaborate on what could be the key pillars of the future pension reform?

A revamped medium-term fiscal framework could complement the fiscal adjustment. The current framework, while containing important elements of risk management, has important shortcomings. The budget horizon misses a medium-term aspect. Spending rigidities make achieving targets difficult. There are also de-facto limited accountability for budget execution and the absence of a direct link of performance evaluations to budget implementation. In this respect, extension of a budget projection period, strengthened fiscal rule and enhanced accountability would be welcome.

We think there is space to tighten monetary policy further to reduce inflation and bring it down to the target range. Infrastructure investment is projected to increase in the next few years, boosting GDP growth and counterbalancing the simultaneous monetary and fiscal tightening. Low and stable inflation would help to reduce dollarization. We commend the monetary authorities for maintaining the flexible exchange rate regime and limiting FX interventions to the circumstances when disorderly market conditions, and not fundamentals, need to be addressed. However, the current monetary policy framework could benefit from more clear hierarchy of objectives and the central bank's reaction function.

On the structural front, we acknowledge Uruguay's strengths. Yet, deteriorating labor market conditions, in general, and extremely high youth unemployment, in particular, are striking. We agree with Ms. Levonian and Mr. Weil that this trend could put social cohesion at risk if left unaddressed. There has already been observed an increase in crime, albeit from a low base. In this context, urgent action is needed to improve education outcomes.

With these remarks, we wish the authorities success in facing challenges ahead.

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

We thank staff for the comprehensive reports and Mr. Chodos and Mr. Vogel for their helpful buff statement. Benefiting from over a decade and a half of sound growth, Uruguay has achieved increased welfare in the context of strong institutions and political stability. A prudent macroeconomic framework has allowed the country to weather an increasingly volatile external context. However, the current environment poses less favorable global conditions. In this context, the pace of growth has slowed down and the ongoing accumulation of imbalances present domestic challenges. Thus, the authorities should harness the solid basis of political stability, institutional strength and social cohesion to address imbalances and undertake structural reforms.

A credible fiscal consolidation plan is needed to put debt back on a downward trajectory. While debt is deemed manageable, it is projected to increase around 68.9 percent of GDP. We take note of the incoming government's commitment to fiscal adjustment and look forward to specific measures. Moderating current expenditure while maintaining public services and safety nets will be important. We agree with staff that there is room to reduce tax expenditures as these represent around 7 percent of GDP. Going forward, we encourage authorities to revamp the medium-term fiscal framework as we consider that the use of a binding fiscal rule that combines an expenditure rule with a debt anchor could help the credibility of the adjustment and ensure medium-term sustainability.

We take positive note of change to the fiscal reporting as this will provide a clearer picture of the fiscal stance. We also found the use of the new focus on the DSA useful. We agree with staff that including the central bank's balance in fiscal targets makes the line between fiscal and monetary policy less distinct and could hamper the central bank's decision-making process. We note that holdings of BCU bonds and deposits at the BCU (which amount to 6 percent of GDP) are included in the non-financial public sector (NFPS) debt. Could staff explain the rationale for this inclusion? Are these bonds used for monetary policy operation purposes? If this is the case, why are they included in the NFPS?

Effectively anchoring inflation expectations and reducing inflation towards the mid-point of the target range is needed. As inflation has been persistently high, above the upper bound of the target range, there is scope to enhance the inflation targeting framework. We would appreciate if staff could provide a more in-depth explanation of the drivers of inflation. While we note the challenges posed by a high degree of dollarization, low and stable inflation levels could contribute to advance the efforts to reduce dollarization and indexation. In this regard, we look forward to the BCU strategic review to be initiated in 2020. We agree that establishing clearer communication, pinpoint the primacy of price stability and clarity regarding the reaction function of the central bank could contribute to these efforts. In staff's view, which are the main elements that the review of the monetary policy framework should take into consideration? Foreign exchange has served the country well as a buffer and we encourage authorities to limit intervention to specifically address disorderly market conditions. We appreciate the analysis of the role of the exchange rate in growth, as presented in the SIP.

While the financial sector is sound and resilient, additional measures to increase intermediation will be important. We find interesting that credit to the private sector is quite low in comparison to peers and that the segmentation of the credit market for dollar and peso loans is weakening the monetary transmission mechanism. We would appreciate staff comments on measures that could be taken to address these issues.

Mr. Jin, Ms. Liu and Ms. Zhao submitted the following statement:

We thank staff for the informative set of reports and Mr. Chodos and Mr. Vogel for the helpful buff statement. We take positive note that Uruguay is in an "enviable position" in many respects and is well positioned to address the challenges such as increased debt and above-the-target inflation rate. In the context of a volatile region and global uncertainty, the authorities are encouraged to improve fiscal frameworks, control inflation, increase wage flexibility, and close infrastructure gaps. We broadly agree with staff's appraisal and offer the following points for emphasis.

Credible fiscal adjustment plan is needed to reduce fiscal imbalances and maintain fiscal sustainability. We note that debt is expected to rise and fiscal space would be diminishing under baseline projections despite the authorities' fiscal measures. We agree with staff that a credible adjustment plan starting from 2020 to put debt on a firm downward path is needed, with an emphasis on limiting the increase in current expenditures. We take note of staff's view that maintaining current expenditures flat in real terms may be too ambitious given expenditure rigidities. Could staff elaborate on what types of rigidities prevent a real flat current expenditure and how to garner enough political and social support to reform these rigidities?

Monetary policy needs to focus on curbing inflation and improving transmission mechanism. We agree with staff that monetary indicative references should continue to be adjusted until inflation and inflation expectations are firmly at the mid-point of the target range. Meanwhile, high degree of dollarization, limited banking intermediation, and market segmentation have weakened the monetary policy transmission mechanism. In this regard, continued efforts to reduce the high degree of dollarization and indexation are welcome. We take note from Figure 7 that the rate of dollarization has not changed much during the past five years. Could staff elaborate on the optimal sequence of de-dollarization? What experiences could be drawn from peers in the region that have made faster progress in de-dollarization in recent years, for example Peru?

Structural reform efforts are needed to enhance medium-term growth. In the context of demographic change and declining employment, further efforts are needed to establish human capital. We share staff's view that efforts should be made to improve the quality of education and make the labor market more flexible. We also highlight the importance of deepening domestic FX and securities markets and promoting financial inclusion. These efforts would also help to strengthen the flexible exchange rate regime and further encourage local currency holding.

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

Mr. Mojarrad and Mr. Alavi submitted the following statement:

We thank staff for a set of high-quality papers and Mr. Chodos and Mr. Vogel for their informative buff statement. We are in broad agreement with the staff appraisal and offer the following for emphasis.

Uruguay has experienced a long period of sustained economic expansion, weathering multiple global and regional shocks. Its economic success story and growing prosperity are attributed to the authorities' far-sighted policies and consistent reform efforts. More recently, however, the economy has started to soften due to external headwinds, and inflation has remained persistently high, while challenges are emerging in the labor market. In this context, we encourage the authorities to focus their near and medium-term efforts on lowering inflation, preserving public debt sustainability and reviving growth.

We welcome the authorities' recognition of the need to address the growing fiscal imbalances and the high and growing public debt. A gradual and carefully-designed fiscal adjustment plan is warranted to ensure adequate fiscal space and put the debt to GDP ratio on a sustainable downward trajectory. Reducing tax expenditure, reforming the pension system and controlling current spending would help contain fiscal vulnerabilities. An overhauled medium-term fiscal framework, in line with staff's recommendation, should facilitate a credible adjustment path.

We welcome the December's tightening of monetary policy against the background of elevated inflationary pressures that have kept inflation above the central bank's target band. Maintaining price stability is crucial for reducing vulnerabilities to adverse external shocks and is a critical prerequisite for the authorities' de-dollarization agenda. We welcome the authorities' commitment to maintain exchange rate flexibility, as echoed by Mr. Chodos and Mr. Vogel, and support their efforts to ensure orderly foreign exchange market conditions.

Uruguay has been outpacing its peers in several social, environmental and governance rankings reflecting its impressive structural and institutional strength, and the authorities' strong track record in eradicating absolute poverty and reducing inequality is noteworthy. Looking ahead, the country appears to be well positioned for a gradual transition to a high-income status. Closing infrastructure gaps, addressing labor market weaknesses, boosting productivity and further improving the business environment would facilitate this transition.

We wish the authorities continued success.

The Acting Chair (Mr. Furusawa) made the following statement:

This year's consultations took place immediately after the presidential elections in late November. The elections went smoothly, which is a testament to Uruguay's political stability and strong governance, institutions, and social cohesion.

At the same time, Uruguay faces important challenges, including the emergence of domestic imbalances, rising debt, a slowdown in economic growth and employment, and persistent inflation. You have called on the authorities to decisively address these challenges, taking advantage of the mandate of the new government, and consensus across the political spectrum.

We can further touch on the ways to bring debt on a firm downward trajectory; keeping inflation under control; and further understanding the root causes and addressing the youth unemployment.

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

The 2019 Article IV Consultation mission took place at a special time for Uruguay, immediately after the second round of the presidential elections.

[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.

In addition to discussing with the current government, we reached out to broad segments of the society, including labor unions, think tanks, and academics. We observed a common understanding across the society of the key challenges facing Uruguay.

In view of the forthcoming political transition, staff also visited Montevideo last week to seek the views of the incoming authorities on the staff report, and get a sense of their economic plans. We met with the incoming Finance Minister, Ms. Arbeleche; the incoming Minister of Labour, Mr. Mieres; the new head of the Office of Budget and Planning, Mr. Alfie; the new Governor of the Central Bank, Mr. Lebat, and other incoming senior officials.

In late January, President-Elect, Mr. Lacalle Pou, unveiled the first draft of the new government's comprehensive emergency law. The draft is very comprehensive, covering a spate of issues ranging from fiscal adjustment to fiscal rules, to education, security, and labor market reforms. The draft is still being discussed by the members of the coalition government, and many details are yet to be decided. Most of the proposed actions are broadly in line with staff advice.

Now, I would like to summarize the incoming authorities' view for you. They broadly agree with staff recommendations, particularly on the need to undertake a frontloaded fiscal adjustment to preserve the sustainability and engage in a program of structural reforms to re-ignite growth.

The incoming authorities emphasized that Uruguay's challenges are significant; fiscal deficits and debt are high and have continued to increase. Inflation has consistently remained outside of the target range. Labor market outcomes have kept deteriorating, particularly for the youth; and the education outcomes and quality need to be improved. In this context, they note that policy actions are needed urgently on all fronts. They add that they are committed to tackle these challenges and confirm that Uruguay's institutional strengths and social cohesion will provide a good base for a broad-based reform effort.

The incoming authorities plan to introduce incentives to spur investment and growth, but they intend to balance that with fiscal needs. They intend to lower inflation, but acknowledge that given the prevalence of backward-looking indexation and dollarization, reducing it may take time.

The incoming authorities are committed to start the fiscal adjustment in 2020. While details are still being formulated, they are planning a significant amount of adjustment early on. They noted that fiscal balances have continuously deteriorated, increasing adjustment needs going forward. They also noted that a combination of measures would be needed. These include reducing public employment through natural attrition, improving the efficiency of spending, and other efforts to implement reductions in real spending.

The incoming authorities plan to introduce a credible and binding fiscal rule, as well as some key aspects of medium-term fiscal framework. Given sizeable adjustment needs and the rigid nature of current expenditures, such as we saw in pensions, they agreed with the need to establish credibility from the onset.

They plan (i) to introduce a new fiscal rule; (ii) to improve the coordination between the Ministry of Economy and Finance and the Office of Budget and Planning; (iii) to introduce a new agency to evaluate and monitor various projects, including infrastructure projects; (iv) to reform state-owned enterprises to improve their efficiency and governance; and (v) to form a committee to analyze the much-needed social security reform.

The incoming authorities view low and stable inflation as the principal objective of the central bank and intend to improve accountability of the central bank in achieving the targets. To this end, they intend to reaffirm the inflation target, specify the time horizon for lowering inflation, improve central bank communications, and reconsider appropriate instruments to achieve targets.

The incoming authorities will work on improving central bank operations, encouraging de-dollarization, modernizing the payment and the financial system, and fostering innovation in the financial sector, including through the development of fintech.

More specifically, the incoming authorities plan to improve the central bank communications by making the central bank statements more explicit, and in cases when the inflation ceiling was breached, explaining clearly why that happened. They also plan to redesign the inflation expectations survey to make it more representative.

Finally, the incoming authorities are leaning towards reinstating the interest rates as the intermediate target, although such a change will not likely be introduced immediately.

The incoming authorities highlighted that unemployment is high—particularly for younger generations, it is one of the world's highest. They added that investment is low and has declined by about 30 percent in the past five years.

To improve labor market outcomes, they aim at reducing rigidities in the labor market by improving business and labor cooperation, taking into account the recommendations prepared by the ILO. They concurred with staff that the coordination of education policies with labor market policies is essential to both address youth unemployment and improve education outcomes. In addition, they intend to promote bilateral and multilateral trade agreements for the benefit of Uruguay and its trading partners. The authorities noted the update of initial accounts planned for this year and highlighted the importance of re-basing and benchmarking regularly.

The recent economic developments and prospects remain broadly as presented in the staff report, although according to the anecdotal evidence, the impact of the developments in Argentina on the tourism sector in January had been less severe than expected. That fact, combined with the resumption of the capital inflows, allowed the central bank to accumulate close to half a billion U.S. dollars in reserves in January.

Inflation in January was 8.7 percent, which is very similar to the 8.8 percent number that we reported in the staff report for December. Non-financial public sector (NFPS) overall balance closed the year at 4.1 percent of GDP; very similar to 4.2 percent of GDP number reported in the staff report. In January, the government conducted a successful debt reprofiling operation in line with their refinancing policy.

Potential repercussions from the coronavirus, keeping in mind that China is a key export market for Uruguay, still remain unknown, but add to the uncertainty regarding the near-term outlook, and the authorities are monitoring it.

Mr. Mannathoko made the following statement:

I wanted to commend the Uruguayan authorities on the prudent macroeconomic policies they have had, the solid institutions, the resilient financial sector, the low poverty, low inequality, high social cohesion, and political stability that we believe have supported the country's sustained growth since its graduation to high-income status in 2013.

However, recent fiscal imbalances and inflation and youth and women unemployment are a concern, and in this regard, we wanted to highlight several points.

First, regarding the deteriorating fiscal position, like most Directors, we do see an urgent need to implement a credible fiscal adjustment that will help put public debt firmly on a downward path and create the necessary space for growth-oriented reforms. Like Mr. Bevilaqua, Mr. Saraiva, and others, we also believe the authorities are well placed to define the appropriate pace and extent of fiscal consolidation. We welcome the authorities' plan to introduce a new fiscal rule, and also reform SOEs.

Second, on monetary developments, the continuation of above-target inflation and above-target inflation expectations is worrying. Like Messrs. Jin, Sigurgeirsson, Raghani, Ronicle, White and others, we just wanted to encourage the central bank to focus on this issue on curbing inflation expectations, including through strengthening communications strategy.

We note the consideration that has been given to interest rate targeting that was mentioned by Ms. Berkmen.

Like Messrs. Bevilaqua and Saraiva, we also wanted to welcome the authorities' commitment to reducing dollarization and indexation because this will complement continuing containing inflation.

Given that over half the population in Uruguay is under 40, the very high youth unemployment rate is a concern, as is the higher unemployment for women. Like many other Directors, Mr.Buisse, Mr. Sigurgeirsson, Mr. White and others, we want to encourage an increased focus and more analysis on this issue to help pinpoint specific structural reforms that will enable effective use of the country's young human resources to foster growth and also to help safeguard further social stability.

On demographics, we just wanted to say we welcome the authorities' plans to reform the pension system and ensure its sustainability. With these remarks, we wish the authorities success.

Mr. Von Kleist made the following statement:

I think the authorities are doing a good job which is good news, and we should celebrate that in this Board.

It would be really disappointing if good performers like Uruguay would fall victim to LOT procedures, and we could not celebrate good performance in the Board anymore.

We listed in our gray two vulnerabilities on the debt issues. That is the share of foreign currency in denominated debt and non-resident holdings. I am interested in the hypothetical case of an important neighbor doing a deep-reaching, restructuring of debt. Would that imply risks for the Uruguayan banking system? Just so that we are aware of which risks are out there. And obviously not all risks are homemade. Some risks are spillover risks, and so I wonder if you have any indications of additional sources of risks from that side of things happening in neighboring countries.

My last point, and here I would like to join Ms. Mannathoko on the question of high youth unemployment. Now, we see Uruguay is unfortunately at the moment, is one of the fewer countries in the region which are performing well and which have no social unrest. We look at Chile. We look at Bolivia. We look at Brazil. So the whole region, there seems to be something going on.

I was just wondering if staff had any more insight of what Uruguay did better than the others or whether there are common issues in many of these countries which share in the region. Reducing high youth unemployment is key, because if you have a large disenfranchised youth, that really calls for trouble. You can look at many, many countries around the world, but disenfranchised youth who do not see a bright economic future for themselves, that is one of the highest risks to social stability. On these two issues, the authorities are doing a very, very good job, and I hope they continue doing it.

Mr. Saraiva made the following statement:

I would join myself to what Ms. Mannathoko and Mr. Von Kleist have said this morning regarding the commendable performance of Uruguay in macroeconomic management. This is even more important given the challenging context that the whole region is going through, and I believe that

Uruguay is a very good neighbor for one to have, so it is important that it continues to perform well.

And as has been highlighted, there are mounting challenges, but I believe that they are within reach to be overcome in a smooth way. We have the issue of fiscal adjustments to ensure a sustainable path for the debt. I just want to reiterate here what we have said in our gray and Ms. Mannathoko emphasized this morning: I believe the Uruguayan authorities are in a very good position to determine the basis of the adjustment. It is not an emergency issue, but it is very important that it is taken seriously, because we know that fiscal imbalances can degenerate very sharply if there is a shock.

There are issues related to low potential growth, and here the structural reform agenda is more or less well defined. I also want to highlight the importance of addressing the issue of high youth unemployment.

Another challenge is the structurally high inflation. This is something that is well identified and maybe the main underlying factors are the high degree of the dollarization and the high indexation of the economy. It is not just a matter of macroeconomic management.

I know that improving the monetary policy framework will be helpful, but I guess those two underlying issues need to be addressed in order to bring inflation to a lower level in a sustainable way.

I would like to hear maybe a little bit more from staff more specifically on this. What are the proposals on the table to reduce both indexation and dollarization in the economy?

Finally, I just want to underscore what perhaps is the key asset in Uruguay, which is a high degree of social cohesion. This is something that needs to be maintained. I think this is a very important pillar to ensure that the economy continues to grow with the support of the whole society.

Having said that, I wish the authorities success in their endeavor.

Mr. Alkhareif made the following statement:

We have issued our joint gray with Mr. Beblawi and Mr. Raghani in which we expressed our support to the authorities’ reform agenda. Indeed, the Authorities deserve to be commended for the strong economic performance over the past ten years. I also thank Miss Berkmen and her team for the excellent work, especially on the selected issues paper.

We note that staff made a case that fiscal consolidation is needed to preserve fiscal sustainability, and we agree with that; however, when we read the selected issues paper, we saw a strong case for infrastructure investment, and it has a significant multiplier effect.

We got to wonder how much room that the government can invest in infrastructure to boost potential GDP, as mentioned by Mr. Saraiva, and which will have a greater economic return, especially in the long term. We would have appreciated more linkages to the staff analysis in the selected issues paper and the staff recommendations in the May report.

We also note in the selected issues paper that public investment multipliers is weaker in emerging markets and developing economies compared to the advanced economies, and this is understood. But when you look at a country like Uruguay when you have strong institutions, the main explanation factor is the weak interconnectedness within the country. And here we would have appreciated more analysis on the policies that stimulate local content relationship. Do you recommend the authorities to do more procurement to the domestic sector compared to the international sectors?

These discussions would inform the policy discussion on these issues, especially given the need to proceed with fiscal consolidation.

On the other issue in the selected issues paper, I agree with Miss Mannathoko and Mr. Von Kleist on the issue of high unemployment rates, especially for youth unemployment. As mentioned in the report, Uruguay has the highest unemployment rate in the world, and this is macrocritical for the country given the demographic shift. However, we note that the estimation of the staff analysis shows that about 40 percent of the modelled results are unexplained and cannot be reliable. This is a big chunk and requires more granular analysis. We note that the definition used for youth unemployment is the age between 16 years old and 24 years old. In my country, if you ask someone to go to the job market at 16 years old, that would be a catastrophe. Sixteen years old is at an age that is not even a high school graduate, and instead of asking youth to go to the labor market, we should look at the education system. How can you enhance the quality of the outcomes of the education? How can you enhance the accessibility to education? In a country like Uruguay, the demographic dividend will help the country boost the human capital and improve the social outcomes. I think these are the results of my understanding of the report. I encourage you to do more in these areas, especially in cooperation with our colleagues in the World Bank. Thank you very much. I wish the authorities continued success in their future endeavors.

Mr. Guerra made the following statement:

We issued a gray where we commended the Uruguayan authorities for the macroeconomic management and strong institutions and reform implementation, and these have been reflected a lot in reducing poverty and improving social sustainability and, as expressed by Mr. Saraiva, a strong social cohesion. I just wanted to follow up on some things that were informing during the update.

The staff report has in Annex IV, if I recall, a description of the medium-term fiscal framework and stated that there is an agenda to improve the fiscal framework. You gave some elements about improved coordination and new agency. This is new agency like kind of a fiscal council or what type of agency are we talking about?

Another part that is also in the report is that of more efficient governance of the public enterprises. And on social security reform agenda, is there any, agenda for the results of this council that is going to be formed? Is the IMF going to help the authorities through technical assistance in any of these new fiscal frameworks? I see from what you described as just the building up from this strong, very strong fiscal framework, that the authorities already have.

Finally, we also commend the authorities of the central bank on thinking to put some objectives and some timelines so that they can be assessed on reaching the inflation targets. I also want to join Mr. Alkhareif on the points he made about the location investment.

Mr. Buisse made the following statement:

We thank staff for the excellent work, and we commend the authorities for the improvement on the macroeconomic and institutional resilience over the past few years, and the progress in terms of poverty and inequality reduction.

On the policy mix, my question was exactly on the medium-term fiscal framework, and how do you see the possible improvement, and at the same time how it will help to preserve the most vulnerable during the consolidation.

On the inflation, I think that my key question would be what is the balance between the indexation in the country and how do you see the tightening of the monetary policy. If it is too tight, then the consequences on growth would be too large, and at the same time we have to anchor this inflation expectation; so, what are the tools do you see to reach this outcome?

On the structural—my colleagues have said it also—I think my main point is that it is the right time. So, we can not only encourage the authorities to do so, but they are in a good economic situation; so to tackle the SOEs, the youth unemployment, the aging population, probably a pension reform. All that reform, the education as was mentioned, all that is, difficult reform everywhere, but this is the right time to do so.

Finally, we were interested in what was said in the report on crime because it will be much, much better if it is addressed because it has become macrocritical, so also there were countries where the IMF was able to quantify the macrocriticality of crime in Latin America, and we would encourage staff to keep on working on that.

Mr. Ronicle made the following statement:

I just want to build on a few of the comments that people have made so far. I agree with Mr. Von Kleist when he says that success does not mean there are no challenges. For me the really striking challenge in Uruguay is the context of macro policy. It strikes me that they face a very difficult policy tradeoff based in terms on monetary policy and in terms of fiscal policy. Unemployment is rising. Inflation is above target. Inflation expectations are above target. So the classic thing to do is tighten policy, but maybe at a slower pace than you would ordinarily do that; but that is made additionally complicated in Uruguay because you also have a fiscal position that needs tightening, so it is a challenge in terms of policy coordination as well as the individual mandates of the Ministry of Finance and the Central Bank.

What the Uruguayan authorities are doing is very sensible. They are reviewing monetary policy. The proposals you took us through this morning sound very sensible and implementing a very medium-term fiscal framework, but for me there is a question about how they make that choice in the short term between tightening fiscal policy and tightening monetary policy, and I wondered if you could elaborate a little on your thoughts in that space.

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

These are all very relevant questions, and we had conversations with both the current government and the incoming authorities exactly, precisely on these matters.

There was a question on the possible interest rate instrument. Both with the current government and the incoming authorities, the key challenge that we highlighted for the monetary policy framework is to underline the primacy of the price stability. We do think that, as we highlighted in the staff report, clearly communicating what the inflation target is (particularly focusing on the mid-point) and improving the communications such that expectations are anchored around that inflation, would be extremely important to help anchor expectations, which will also help bring down the actual inflation. We particularly think that aspect is important.

There has been very important progress made on the deindexation, particularly in wage negotiation frameworks. In 2016, they introduced an element of productivity—by differentiating, let's say, different sectors in terms of wage increases—, and started publishing guidelines in terms of nominal increases, delinking wages from past inflation. That helped. We saw that it helped with the indexation. It helped with the inflation expectations.

Nevertheless, there are still elements of indexation. There are trigger mechanisms, for example, in the wage negotiations (if inflation is higher than a certain threshold). In addition, public sector wages by budget law are indexed to the past inflation. So anchoring inflation expectations is extremely important. That is what we highlighted, and what we agreed with the current and incoming authorities.

In terms of instruments, it is too early to speak. The way it works is that the Parliament will need to approve the new Governor, which probably will take place in April or May. They expressed their intention to have a broad review of the objectives and also the instruments, and they seemed to incline more towards the interest rate instrument; but they would like to first analyze and decide before actually making any changes.

There was a question on the potential spillovers from Argentina. One thing that we highlighted in the previous Article IV Consultation is that after the crisis in the early 2000s in Uruguay, the banking supervision has been strengthened substantially. We do see the benefit of that. Banking sector balance sheet mismatches have completely disappeared. At the same time, the exposure particularly on the financial system to Argentina has declined substantially. For example, right now, about 10 percent of the total deposits are for non-residents.

When the Argentine currency came under attack, which is some sort of a stress test in terms of the Uruguayan banking system, we did not see any significant effect. So, we do not see any lending by Uruguayan banks to Argentines. We do not see any significant deposits from Argentina. We are monitoring it closely to see whether there are any effects, for example, with respect to the exchange rate or the deposit flows to Uruguay (which have been very negligible). We have not seen any significant deposit flows. So as of now, at least from what we have seen for the last year-and-a-half, the financial sector linkages with Argentina is very low. Now, that is a good thing, given the volatility in the exchange rate.

We do see exchange rate spillovers on Uruguay. Last year, the Uruguayan currency depreciated by 13 percent, but the authorities handled that quite well. They let the exchange rate depreciate. They only intervened when there were market pressures. When capital flows were too large from the perspective of Uruguayan markets— the daily FX turnover for Uruguay is around $25 million, a relatively small market—the central bank intervened to counter large flows.

In summary, what we expect from the spillovers coming from Argentina is two folds. As we emphasized in the staff report; Argentines still would like to go to Punta del Este for tourism, so we would see some tourism sector spillovers. We can also see some spillovers to the exchange rate—Uruguay is a small, open economy. But we do not see any spillovers stemming from the financial sector.

There was another question on social cohesion in Uruguay. That is a very important question, and that is why we started our staff report with the positives. As we highlighted in the staff report, the rate of poverty in Uruguay is among the lowest in the region. The inequality outcomes is one of the best in the region. And Uruguayan authorities have a strong commitment to the welfare state. For example, we highlighted the need for pension reform, but when we look at the other side of the coin, the pension coverage is almost universal. The old-age poverty is very low in Uruguay. When growth slows down elsewhere in Latin America, it makes these problems more prominent. When the economy is declining, it is harder to deal with poverty, it is harder to deal with inequality—the perceptions of fairness arise. We have not seen any of these concerns in Uruguay. That is why we started the staff report with these important assets that Uruguay should keep going forward.

Having said that, we agree that reducing unemployment, particularly going forward, would be important, particularly to keep the concept of the fairness across the society. As more and more younger generations become unemployed, it might cause problems. That is why we are calling for a reform effort.

I will link that aspect to the set of questions on youth unemployment, and overall unemployment going forward. In the selected economic issues, we highlighted this issue that as something that needs to be addressed. And there is an agreement with the incoming authorities to tackle this issue, not only the youth unemployment, but in general the declining labor force participation, increasing unemployment. That is something to be addressed.

In terms of crime issues, in the staff report we also highlighted that the secondary school dropout rates are quite high in Uruguay; so in a situation where students are dropping out of high school and going to the labor market, looking for a job, and then not being able to find a job, this combination [high youth unemployment, secondary school dropouts, and crime rates] is something to be addressed. In that regard, that is why we highlighted the coordination of the education reform together with the labor market policies. We think that they go hand in hand; then they deserve attention. And the coordination of policies would help deal with both problems.

We had an annex in terms of possible options to improve the medium-term fiscal framework. As I summarized in my intervention today, a big chunk of those elements is being considered. We do not know in what shape and to what extent they will be accepted and implemented, but the key item that we think is quite important is that they are planning to introduce a revised fiscal rule. Within that context, there is a clause that might introduce some form of a fiscal council, but we do not know how formal it is going to be and what would be the elements. That is to be seen, but it is in the discussion.

The other element that we think is quite important is coordination of the office of budget and planning, where the strategic priority for the government is determined, and the Ministry of Economy and Finance, where the budget allocations are done. The incoming authorities are planning to work on the coordination between these two entities, which we think is quite important.

There are plans to introduce two sets of agencies: (i) a procurement agency trying to look into procurement and coordinate procurement across different sectors, which we think it is a good idea; (ii) they also would like to create a new agency to evaluate and monitor various programs. There are already agencies that are evaluating different programs, but under the new agency these will be combined (in addition to infrastructure spending, there are a lot of programs for education, and health). Assessing the achievements of these programs is also an important component. We will get to see what the final program will look like, but these are the intentions.

There was a set of questions, linked to the SIPs, and I would like to link these to the medium-term framework on infrastructure spending. We agree that infrastructure spending is important, and that is why we said capital spending should be preserved during the fiscal adjustment.

I would like to highlight that Uruguay has a set of PPP programs. The initial law was accepted in 2012, but this year is the first time that we are seeing the outcomes of these PPP projects. They are quite sizeable. They are ongoing, and they will help. And they are focusing on basically two areas Uruguay needs the most: investment in roads and railroads. These investments are quite sizeable. By PPP law, investments within the public-private partnerships should be at most 7 percent of the previous year's GDP. Uruguay is almost at that level, so these are sizeable.

In that regard, the authorities are already undertaking significant infrastructure spending. We also highlighted that the eligibility payments that are associated with those will be about half a percent of GDP every year starting from 2024, so that needs to be taken into account within the budget context. It is also good that the new evaluation agency can look at and evaluate how these investment projects are going, whether they are getting the desired outcomes and how these can be improved going forward.

Having said that, there are still infrastructure needs (for example, needs for improving the secondary roads), but we remain optimistic that there is already a sizable amount of infrastructure spending that has been undertaken.

There was a set of questions regarding the policy mix. You are right to highlight that right now we are calling for a fiscal adjustment and at the same time, a monetary adjustment. I would like to highlight maybe three things on this one. First, these infrastructure projects, together with the private investment (a big private investment FDI project that has been ongoing) provides a unique opportunity. We think it is going to give supply side stimulus to the economy, and that would be a great time to introduce adjustment measures. That is why we said that in the absence of any other negative shocks, and if these benefits materialize, now would be good a time to take such an adjustment because that will help deal with the negative effects of the fiscal and monetary adjustments. That is one.

The second thing is that if there is a negative shock, one needs to reassess how much to adjust. It may not be possible to do the fiscal adjustment. That is why we highlighted the importance of fiscal rules and medium-term fiscal framework so that it increases the space for Uruguay to deal with negative shocks without reducing credibility. If there is a medium-term plan in terms of how to address, that would help them. It is the focus of the staff report.

The third one is particularly on the monetary policy. We highlighted in the report that the interest rate channel is relatively weak in Uruguay, and that is partly because the credit to the GDP is low, partly because the dollarization is still an issue. We do think that reanchoring expectations at the midpoint of the targets and improving communications might leverage the expectations channel and, therefore, reduce the burden on the interest rate channel. So efforts to improve the inflation targeting framework, in a way to anchor the inflation expectations, might help Uruguay to deliver less monetary contraction to achieve the targets. Of course, the words need to be followed with actions, but that is why we are trying to focus on communications and reanchoring inflation expectations.

Mr. Vogel made the following concluding statement:

First of all, I would like to thank the Executive Directors for their helpful comments and suggestions, which I will convey to my Uruguayan authorities following the Board meeting.

Staff poses a well-balanced analysis on Uruguay’s strengths, challenges, and risks. The country is about to conclude a political transition from the presidential election which took place at the end of November 2019 to the integration of a new administration on March 1, 2020. Despite this relatively long period, Uruguay has not suffered any kind of noise in its economic, financial, social, or political areas. This is just part of the concept that is well illustrated in the staff report when referring to Uruguay’s political stability, strong governance and institutions, and a high degree of social cohesion. In these complex times, it is not common to see a country that has exhibited positive growth rates for 17 consecutive years.

In the selected issues chapter entitled “Dissecting Economic Growth in Uruguay”, staff timely underlines the needed structural reforms that Uruguay must make to boost potential growth as well as to successfully face the country’s important challenges and to take advantage of its opportunities. In the same chapter, staff also analyzes the factor behind the recent boom. In this regard, I could highlight some minor differences regarding the role of positive external shocks over the years of more robust growth rates. Of course, this role is relevant; it is very relevant, but many countries have had these kinds of positive shocks, or even stronger. I would say from my humble point of view, that the domestic policies and structural reforms would have merited a little bit more emphasis in this chapter to explain the period of strong growth and even the current phase, which exceeds much lower rates.

During the whole period, many reforms have been implemented. I can recall structural changes, among others, to the tax system and revenue administrations, anti-money laundering regulation and supervision of the financial system public bank, medium-term fiscal framework, which is well described in Annex IV of the report, the establishment of a debt management unit, energy sector, PPPs, and more recently, financial inclusion. We could add some more critical policies, for instance, a flexible exchange rate system and income policies.

How can we observe the fruits of these reforms and policies? I would say that fruits are more visible in periods when challenges and risks from the world economy and the region are more vigilant.

Throughout Uruguay’s history, economic recession and financial crisis in Argentina, three years of recession between 2015 and 2019, coupled with Brazil’s recession, such as the severe one in 2015 and 2016, would have caused Uruguay to suffer severe problems, sometimes enduring even more acute crisis than its neighbors. Nonetheless, in this opportunity, Uruguay avoided a recession while continuing to reinforce its financial buffers and keeping its investment grade status.

Furthermore, we like to emphasize one fundamental achievement. In 2006, extreme poverty was 1.4 percent. The latest data was from 2019, is 0.1 percent. Poverty in 2006 was 32.5 percent, and it is now 8.1 percent. Inequality indicators have also shown important progress.

These achievements did not occur by chance. Policies and structural reforms aimed towards a comprehensive concept of stability, economic, political, and social stability. Of course, there are critical risks and challenges looking forward. Further structural reforms will need to aim to boost investment and potential growth as well as decreasing unemployment. Policies must combat inflation and inflationary expectations, as well as to reduce dollarization and master debt levels to put public debt firmly on a downward path, which would predominantly require a comprehensive reform of Uruguay's entire social security system.

Uruguay's strength for over the past year provides the country a precious resource—time, time to skip past the measures and to deal with challenges appropriately with the goal of reinforcing macroeconomic and financial stability while maintaining another precious factor—social stability, which includes reinforcing rights and opportunities for every member of Uruguay's society.

Finally, once again, I would like to express the Uruguayan authorities' gratitude to Miss Berkmen and her team for the excellent reports and for the constant climate of dialogue and transparency; listening to the other side with full respect, and always focusing on what would be the best for the country and its population.

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

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended Uruguay's favorable political economy, strong governance and institutions, a high degree of social cohesion, low levels of poverty, inequality, and informality, and the resilience of the financial sector. At the same time, they noted that domestic imbalances have emerged and debt has risen, while economic growth, investment, and employment have declined, and inflation has remained outside the target range. In this context, they stressed that the political and domestic economic landscape over the next few years presents an opportunity to decisively address these challenges.

Directors noted that, while gross financing needs are manageable due to the authorities' pre-financing policy and robust buffers, a continuation of current fiscal trends could undermine debt sustainability. They agreed that there is a need to introduce a credible adjustment plan to put debt on a firm downward path and welcomed the authorities' commitment in this regard. This would require limiting the increase in current expenditure and reducing tax expenditure, while maintaining adequate provision of key public services and safety nets and preserving capital spending. Pension reforms would also be needed to ensure sustainability and adequate retirement income for future generations. Directors noted that a credible fiscal anchor could be introduced by revamping the medium-term fiscal framework with a binding fiscal rule.

Directors agreed that in the absence of negative shocks, monetary policy should continue to be focused on getting inflation and inflation expectations firmly at the mid-point of the target range. They highlighted the need for further enhancements to the inflation targeting framework and welcomed continued efforts to reduce dollarization and indexation. Improving financial intermediation will also be important. Directors noted that the exchange rate should continue to be used as a shock absorber and that reserve buffers should be kept above prudential norms.

Directors emphasized the importance of structural reforms to raise potential growth and maintain social progress. Closing infrastructure gaps is critical but needs to be complemented by actions to increase productivity growth to raise private investment. They underscored the need to improve education outcomes to help boost youth employment. Further wage flexibility could provide incentives for firms to create more, stable jobs and invest in on-the-job training to reduce the high unemployment. Continued efforts to integrate migrants and women into the labor market will also be important. Directors stressed that corporate governance reform is needed to improve the management and efficiency of state-owned enterprises.

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

APPROVAL: January 24, 2022

CEDA OGADA
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

1. We note that the potential growth should be around 2.2 percent, against 3 percent in the last staff report one year ago. As the demographic effect is not a new phenomenon, could staff detail the elements which explain the revision and especially regarding capital accumulation?

- The staff's projection for medium-term growth takes into account the recent historical evolution of investment rate, productivity growth, and employment growth, as well as the projected regional and global macroeconomic trends, including the current sectoral structure of the economy, the country's terms of trade outlook, as well as demographic considerations. Growth, the rate of investment, and labor participation in Uruguay have all declined since 2015, as the commodity prices came down. For example, the real gross fixed capital formation declined from about 21 percent of GDP in 2015 to about 16 percent in 2018 and 2019. Similarly, labor force participation declined from about 60 percent in 2015 to 56 percent recently.
- It is difficult at the onset of any structural change to fully appreciate whether the shift is cyclical or structural, as it was not immediately clear whether the slowdown would be temporary or lasting. This year, staff lowered its potential growth projections consistent with these declines. It is also important to note that staff projections also incorporate permanent level increases in level of GDP stemming from the ongoing infrastructure investments.

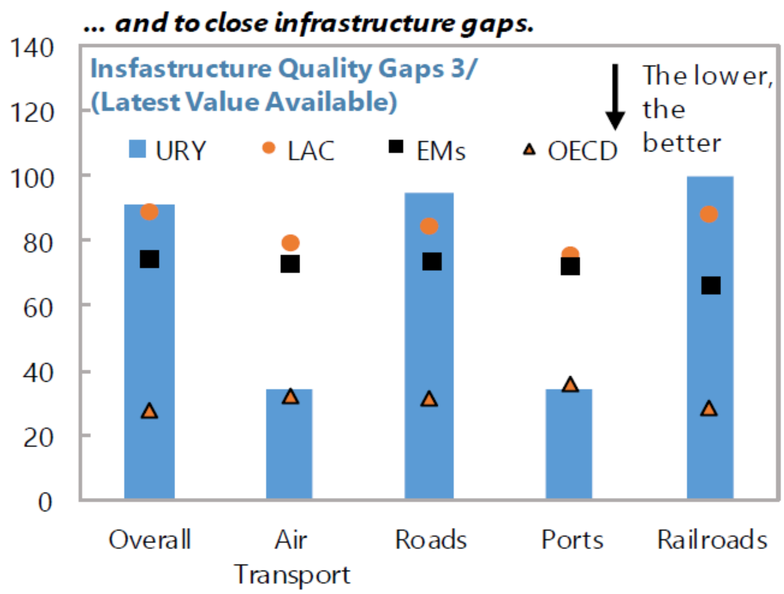
2. Could staff elaborate more on the demographic dynamics in Uruguay and provide their view on a possible policy response that could be considered by the authorities?

- Uruguay is an aging society with minimal population growth. Thus, according to the long-term population projections prepared by the Uruguay's National Institute of Statistics, the population will increase from the current 3.5 million to only 3.7 million by 2050, with the share of those 60 or older rising from 19 to 28 percent.
- In a 2017 selected issues paper (IMF Country Report No. 17/29), staff looked into various options for a potential pension reform. Possible policy steps could include a parametric pension reform, introducing incentives for staying at work longer, reducing youth unemployment, encouraging further female labor participation, and leveraging the recent pick up in immigration flows.

- Staff highlighted that these reforms should start early on as it will take time to implement. In addition, reforms should be comprehensive, covering the special regimes.
- The incoming authorities are planning to create a commission of experts to provide recommendations for reform, with preliminary diagnostic expected this year.

3. Could staff shed more light on the level and structure of the infrastructure deficit in Uruguay?

- As discussed in the Selected Issues Paper on infrastructure, although the level of infrastructure stock in Uruguay is not low by regional standard, it has barely grown since the 1980s, in contrast to many of Uruguay's peers. This has been due to the lack of new investments. According to surveys done by the World Economic Forum, the quality of transport infrastructure in roads and railroads is a particularly weak area (as demonstrated in 2018 Article IV Consultation Report, see chart).



4. Spillovers from economic and financial developments in Argentina will need to be monitored closely. The RAM includes contagion from financial turbulence in Argentina as a key risk. How would spillovers from a downside economic and financial scenario in Argentina impact staff's advice?

- Staff advice as outlined in the report incorporates the possibility of stronger-than-expected negative spillovers from Argentina. In case of such a development, the report calls for the use of countercyclical macroeconomic tools (fiscal and monetary expansion) to the extent there is space.
- This risk is balanced with the expected impact of ongoing large-scale investment and infrastructure projects (and positive risks stemming from these).

- Nevertheless, given the declining fiscal space and above-target inflation, staff emphasized the importance of introducing credible fiscal and inflation anchors early on. In the case of negative shocks, these anchors will help Uruguay to respond without losing credibility, thereby enhancing the policy space.

5. Could staff elaborate on the impacts of risks stemming from potentially positive regional developments?

- Although the Uruguayan economy has increased its diversification (both in terms of export products and destination) as was emphasized during the last Article IV Consultation, it is still linked to that of its Mercosur partners, especially Brazil and Argentina, via trade in both goods and services. Brazil is the second largest export destination for Uruguay and a main source of foreign investment. Thus, better-than-expected developments in Brazil should indeed support higher growth in Uruguay. The faster-than-expected stabilization of the Argentinian economy would also generate an upside to growth, potentially through higher tourism and capital inflows.

Fiscal policy and debt management

6. With respect to the pension reform, staff's comments are welcome on the authorities' emphasis to preserve rights while seeking compatibility with fiscal constraints at the same time.

7. Could staff elaborate on what could be the key pillars of the future pension reform?

- As Box 3 of the 2018 Article IV report highlighted Uruguay's public pension system has been a pillar of its modern welfare state. At the same time, Uruguay has one of the oldest populations in Latin America, and together with the relatively high coverage, public pension expenditures as a share of GDP are high. In this regard, reforms are needed to perpetuate Uruguay's achievements in living standards and ensure fiscal sustainability.
- The Emergency Law envisages the creation of a Social Security Reform committee, which is expected to present a diagnostic report by end-2020 and a reform proposal to Parliament by mid-2021. It is too early to assess what will be included in the reform but there seems to be a consensus that a pension reform is unavoidable given the rising imbalance in the system and population aging. The two-pillar system will likely be maintained, and the introduction of incentives for delayed or partial retirement are expected. There also seems to be a broad understanding that the reform will need to encompass all existing regimes (including special regimes for the police and the military) in order to be perceived as fair.

8. ***We would appreciate more detail from staff on the authorities' perspectives on the specific proposals for further improvements to the Medium-Term Fiscal Framework.***

- Ms. Berkmen will update the Board on the views of the incoming authorities on the staff report. Broadly, the incoming authorities plan to introduce a new fiscal rule, as well as some key aspects of medium-term fiscal framework.

9. ***Given the difficult external environment and Uruguay's developmental needs, the fiscal policy tightening should be well calibrated, and underpinned by further fiscal structural reforms and measures on the revenue and expenditure sides, focusing on current spending and tax exemptions. Could staff comment on the authorities' plans and whether they are in line with staff's recommendations?***

- Ms. Berkmen will update the Board on the views of the incoming authorities on the staff report. The incoming authorities are working on a wide range of reforms, mostly in line with staff recommendations, that would start in 2020. The incoming government is finalizing its program, to be submitted to Parliament shortly after it assumes office on March 1. The new government's draft Emergency Law (*Ley de Urgente Consideración*) is comprehensive, covering a spate of issues, including those highlighted in the staff report.

10. ***We take note of staff's view that maintaining current expenditures flat in real terms may be too ambitious given expenditure rigidities. Could staff elaborate on what types of rigidities prevent a real flat current expenditure and how to garner enough political and social support to reform these rigidities?***

- Pension spending is about 1/3 of total expenditures and have increased more than nominal GDP in the recent years, reflecting an aging society, the welcome almost universal coverage, constitutionally mandated wage indexation. In addition, by budget law, the public sector wages increase by at least past inflation.
- Given that 85 percent of current spending is classified as social spending, the staff report emphasized the importance of a transparent public information and communication strategy to build consensus around the selected measures. In addition to minimize the impact of any particular group, the staff report calls for a combination of measures, including through rationalization of tax expenditures, which also seems to be the plan of the incoming authorities.
- On the pension reform, the staff report calls for an informed social dialogue. In this context, staff is encouraged that there is a consensus across the political spectrum on the need for a pension reform.

11. We note that 80 percent of revenues comes from taxes on consumption and labor only 10 percent from taxes on corporate income, which is a low level. In addition, does staff see any social risk linked with the implementation of adjustment measures?

- Both the current and incoming authorities assess taxes to be relatively high and plan on devising adjustment strategies mostly on the expenditure side. The incoming authorities noted that a combination of measures would be needed. These include reducing public employment through natural attrition, improving the efficiency of spending, and other efforts to implement reductions in real spending.
- Focusing on the corporate income taxes, the statutory CIT tax rate is 25 percent and the marginal effective tax rate is estimated to be around 22 percent (although the incoming authorities estimate it to be higher). It is important to note that a part of low corporate income taxes reflects low investment levels and the other part reflects tax exemptions as reported in the annex IV.
- Given that 85 percent of current spending is classified as social spending, the staff report emphasized the importance of a transparent public information and communication strategy to build consensus around the selected measures. In addition to minimize the impact of reforms on any particular group, the staff report calls for a combination of measures, including through rationalization of tax expenditures, which also seems to be the plan of the incoming authorities.
- On the pension reform, the staff report calls for an informed social dialogue. In this context, staff is encouraged that there is a consensus across the political spectrum on the need for a pension reform.

12. Given the economic slowdown since 2015, could staff comment on the potential impact of too restrictive a policy mix on growth?

- The staff expects a growth recovery on account of large-scale investment and infrastructure projects. To the extent that these growth benefits materialize it would be important to deliver adjustment when growth is supported by supply-side factors, precisely to avoid the negative impacts of fiscal and monetary adjustment. Of course, the size of the adjustment would need to be reassessed if negative shocks materialize.
- Given the sizable adjustment needs and Uruguay’s exposure to risks, staff has emphasized the importance of introducing credible medium-term anchors for both fiscal and monetary policies. This would mean for fiscal policy a revised fiscal rule and improvements in medium term fiscal framework and for monetary policy improvements in inflation targeting regime.

13. ***We note that holdings of BCU bonds and deposits at the BCU (which amount to 6 percent of GDP) are included in the non-financial public sector (NFPS) debt. Could staff explain the rationale for this inclusion? Are these bonds used for monetary policy operation purposes? If this is the case, why are they included in the NFPS?***

- Fiscal statistics in Uruguay were for the consolidated public sector (including the central bank). Therefore, assets and liabilities of the central government vis-à-vis the central bank were consolidated into the public sector accounts. However, as explained in the report, in 2019 the authorities changed the reporting of the coverage of the fiscal accounts to the non-financial public sector only (excluding the central bank).
- Staff considered the change to be appropriate, as the fiscal balance (and debt statistics) of the central bank were mostly determined by the quasi-fiscal costs of conducting monetary policy (such as issuance of the central bank paper). As a result, under the new fiscal coverage, both assets and liabilities of the central government vis-à-vis the central bank are no longer consolidated.
- The capitalization bonds in question—held by the central bank and issued by the central government—are the obligation of the central government and therefore should be included in gross debt numbers. At the same time, central government deposits held at the central bank are assets of the central government and are therefore netted out in calculating net debt. Please note that capitalization bonds are not used for monetary policy purposes.

14. ***We also note that staff and the authorities use the different methodologies to calculate debt-to-GDP ratios. Could staff comment on the pros and cons of each approach, as well as the best practices recommended by the IMF?***

- Debt statistics in Uruguay are presented in dollars while the GDP aggregates are in pesos. Thus, to compute debt rations, staff converts the debt figures to pesos using the **end-of-year** exchange rate. The authorities, on the other hand, convert the GDP numbers into dollars using the **period-average** exchange rate. The two methodologies yield the debt-to-GDP ratios that tend to move together over time, but they deviate in the short term, especially when the exchange rate has large in-year variations. Given that about a half of Uruguay's debt is denominated in foreign currency, a peso depreciation results in debt ratios that are somewhat lower if one uses the authorities' methodology. Conversely, a peso appreciation results in debt ratios that are somewhat higher if one uses the authorities' methodology. Either methodology is acceptable, as long as it is applied consistently and is well understood by market participants, which is the case in Uruguay.

Monetary and exchange rate policy

15. It appears that the Uruguay economy slowdown is mainly structural in nature, and fiscal stimulus is unable to prop up the economy and is instead resulting in higher inflation and an elevated real effective exchange rate. Latter has further weakened external competitiveness and has adversely impacted the economy. We would welcome Staff's comments on this aspect.

- The economic slowdown reflects both cyclical (including spillovers from developments in Argentina) and structural factors. The structural component is reflected in the downward revision of our medium-term growth forecast. As discussed in the Selected Issues Paper on growth, the infrastructure gaps have been one of the obstacle to a sustainable growth in Uruguay. Therefore, closing these gaps through PPPs will help support the medium-term potential growth. Regarding external competitiveness, as discussed in the report, staff assesses that the external position is broadly consistent with fundamentals and desirable policy settings.
- With the expected growth support, going forward staff advice focused on the adjustment of fiscal and monetary policies.

16. Could staff comment on how the significant and opposite inflation rate differences between Uruguay and its Mercosur partners may affect Uruguay's monetary policy strategy?

- As noted in the report, inflation in Uruguay has been above target and higher than the averages for trade rivals and for emerging markets. This is the key observation that underpins our analysis and that's why staff is calling for a concerted effort to bring inflation down to the midpoint of the 3-to-7-percent target range. The inflation differentials among different trade partners may lead to different nominal exchange rate adjustments. Uruguay's current practice of letting the exchange rate adjust will help absorb these differences. An enhanced inflation targeting regime would help anchor inflation expectations towards the mid-point of the target, regardless of the temporary shocks.

17. In the context of persistently high inflation and considering a relatively high per capita income level, what would be staff's view on the possibility of lowering the current inflation target range of 3-to-7-percent? A lower inflation target range, together with the revamped Central Bank communication strategy could send a strong signal to market participants and lead to a better anchoring of inflation expectations.

- There is no single inflation rate that is appropriate for a country. Given the persistence of inflation at around 7-8 percent, the staff recommendation is to bring inflation down to 5 percent, the current mid-point of the target. Once that is established, and expectations anchored at around 5 percent, the consideration could be given whether there is a need to reduce inflation target to a lower range. The arguments of keeping the range or mid-point target higher could include ongoing high dollarization and being subject to large external shocks.

18. Could staff provide details on the specific drivers of inflation?

- In Uruguay, specific drivers of inflation have varied over time. In the last few months, a notable component of inflation was beef prices (reflecting the evolution of world beef prices). Thus, in 2019, beef prices contributed 0.8 percentage points to the overall inflation on average, compared with the 0.4 percentage points in 2018. Even more noticeably, beef prices contributed 1.6 percentage points to the December 2019 inflation of 8.8 percent. In addition, having medium-term inflation expectations above the target range could create an upward bias through the Phillips curve.

19. The improvement of the central bank communication, the wage moderation and the maintaining of a tight monetary policy should help to reduce inflation and better anchor medium-term expectations, especially in a dollarized economy. Is there still room to improve the remaining wage indexation and is it still an issue to control inflation?

- As mentioned in the staff report, there has been important progress in reducing indexation. Having said that, there is still room to reduce indexation in both private sector wage negotiations and public sector wage determination (which are linked to past inflation). Delivering low and stable inflation is in turn is key to reduce indexation, creating a virtuous circle.

20. Could staff define how markets are determined to be disorderly in the Uruguay case, particularly related to recent interventions?

- As a small open economy with close regional ties, market conditions in the region have a large impact on the Uruguayan peso exchange rate. In 2019, SPR’s Disorderly Market Conditions (DMC) Monitor indicated multiple episodes of disorderly markets in the region, including in Argentina. These had a destabilizing impact on the Uruguayan peso market as well. In addition, later in 2019, several large Uruguayan pension funds decided to make a sudden shift in their portfolio towards the foreign currency assets. In a market with low FX turnover, the central bank intervenes to provide the needed currency which is also recorded as foreign exchange intervention.

21. In staff's view, which are the main elements that the review of the monetary policy framework should take into consideration?

- The key elements is summarized in the staff report. In particular, communicating a clearer hierarchy of objectives, with the primacy of price stability at the mid-point of the target range, and explaining in more detail the central bank's reaction function would guide expectations towards the mid-point of the target range and reinforce the expectations channel, which would help reduce the burden on the interest rate channel.

22. Could staff comment on the authorities' progress made towards de-dollarization and de-indexation?
23. Could staff elaborate on the optimal sequence of de-dollarization? What experiences could be drawn from peers in the region that have made faster progress in de-dollarization in recent years, for example Peru?

- There has been a noticeable progress in reducing dollarization and indexation in recent years, although much remains to be done. The percentage of deposit dollarization declined from the mid-90s in 2005 to mid-70s today, while the percentage of credit dollarization declined from mid-60s to close to 50 percent during the same period. Still, the degree of dollarization remains high. Important steps to reduce indexation were taken as well, notably changing the wage council guidelines which now specify the wage increases in nominal (rather than inflation-adjusted) terms.
- The experience of other countries points to various factors contributing to the successful de-dollarization episodes. The necessary condition, however, is to build trust in domestic currency by way of macroeconomic and—especially—price stability. In this context, low and stable inflation is a necessary condition to reduce dollarization. Subsequently, additional policies and measures are often necessary to break persistent dollarization and encourage the use of the local currency (such as, for example, regulatory measures as was done by Uruguay). Peru is indeed a good example of de-dollarization the region. And the authorities are examining country examples, including Peru, to advance their work on dollarization.

Financial sector

24. The level of financial intermediation has improved, but the credit to private sector remains at a low level. We understand that the authorities are looking into using cash for transactions to give more flexibility to the private sector, what is staff's view on this issue?

- The incoming authorities have not decided on any changes, and staff will follow up once they take office. Addressing this issue calls for a balanced approach. On the one hand, the authorities have made great strides in improving financial inclusion and introducing electronic payments since the enactment of the 2014 Financial Inclusion Law. On the other hand, steps to encourage the private sector activity are welcome, as long as they do not jeopardize the gains in financial inclusion and integrity.

25. While it may be the source of profitability of the banking sector, could staff elaborate why the lending rate in pesos remain highly elevated?

26. We note that financial intermediation remains limited, credit to private sector is low, and the credit markets are segmented. Could staff elaborate on recommended measures to address these issues?

27. We find interesting that credit to the private sector is quite low in comparison to peers and that the segmentation of the credit market for dollar and peso loans is weakening the monetary transmission mechanism. We would appreciate staff comments on measures that could be taken to address these issues.

- Credit market segmentation is not a new issue, and it was discussed in the earlier staff work, in particular an SIP on bank lending (*IMF Country Report 16/63*). Possible steps to ameliorate the situation could include reducing dollarization and encouraging financial sector competition and innovation.

28. According to staff, the authorities are on the right path and are proceeding with the appropriate steps, namely with regulations on the net stable funding ratio and regulation on countercyclical buffers. However, we would like to hear more details from staff on the mentioned regulations and on the next steps (p. 16 of the report).

- Both are steps to reduce the risk to the financial system and bring the system in line with Basel requirements, the former to reduce risks associated with maturity transformation and the latter to limit the emergence of asset bubbles in good economic times. The net stable finding ratio (NSFR) is defined as the ratio of available financing to the financial institution's obligations in the coming year. The regulations set minima for the NSFR depending on the type of obligations. The regulation on countercyclical buffers are still in the public consultation stage, but its key element will be a requirement to accumulate additional capital in good economic times, leaving financial institutions better prepared to weather the economic downturn that may follow. Staff will follow up on the progress during the staff visit.

29. In addition, we also would like staff to update on the implementation of the e-peso project that was discussed in last year's report.

30. In the 2018 Article IV Staff Report, staff discussed the results of the E-peso pilot project implemented by the central bank to test the innovative ways to reduce transaction costs and increase financial inclusion. Could staff share some insights on the follow-up on this project?

- After the successful completion of the e-peso pilot project, the authorities continue to study the payments system and the potential impact of e-peso on the banking system before taking additional steps. Staff will follow up on future steps and specific plans after the new governor of the central bank takes office in April/May 2020.

Structural reforms

31. We share staff's intention that youth unemployment should be addressed with the education reform to revive the productivity growth. We would appreciate it if staff could elaborate how other policy measures, such as labor legislation reforms, could address the unemployment problems, and how to prioritize and progress the employment reforms?

- Any measure to increase labor market flexibility, improve business and labor cooperation, and improve skills will be important to help improve labor market outcomes. The coordination of education policies with labor market policies is also essential to both address youth unemployment and improve education outcomes. Staff will be in touch with the incoming authorities to follow up on their specific measures after they assume office.

32. We share staff's recommendation regarding a corporate governance reform to improve the management and efficiency of SOEs. Does staff have recommendations regarding privatization?

- Uruguay has a long tradition of state-owned enterprises, and in fact even partial privatizations have not been in the public agenda for at least 25 years, after a national referendum against privatization plans.
- In the report, staff emphasizes that the SOEs should have the same corporate governance and transparency requirements that the listed companies. The incoming authorities are planning a structural reform of the SOEs, and staff will follow up on the details.

33. Could staff provide more information on the factors that are fueling crimes in Uruguay?

- We are of course not specialists and are not able to provide a precise answer. With this caveat, observers in Uruguay tend to point to high school dropout rates and high youth unemployment as possible reasons.