



URUGUAY

2011 ARTICLE IV CONSULTATION

December 2011

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2011 Article IV consultation with Uruguay, the following documents have been released and are included in this package:

- **Staff report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 4, 2011, with the officials of Uruguay on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 18, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Public Information Notice (PIN)** summarizing the views of the Executive Board.
- **Statement by the Executive Director for Uruguay**

The document listed below has been or will be separately released.

Selected Issues Paper

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URUGUAY

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

November 18, 2011

KEY ISSUES

Context: The strong growth has continued into 2011, but a slowdown is underway supported by prudent macroeconomic policies. Still, the labor market is tight, wages are rising rapidly, and inflation remains above target.

Perspectives: The highly uncertain international outlook presents substantial downside risks. Uruguay's economic and financial vulnerabilities are modest, and the government has reduced debt vulnerabilities significantly and built important financial buffers; still the spillovers of a deteriorating global outlook could be significant.

Near-term challenges: The immediate challenge is to support an orderly moderation in growth and inflation while reinforcing the economy's resilience to spillovers from abroad. Staff agrees with the authorities on the key aspects of their macroeconomic framework. Maintaining the flexible exchange rate as a shock absorber is crucial. The broadly neutral fiscal stance in 2011 and also planned for 2012 is appropriate. Monetary policy has rightly been on pause since September until the outlook becomes clearer. If the economy takes a turn for the worse, monetary policy could be relaxed provided inflation expectations become reasonably anchored, while fiscal automatic stabilizers should be allowed to operate so long as prudent debt dynamics are maintained. While it would be important to accommodate a real exchange rate depreciation, if needed, part of the ample reserves could be used to contain overshooting.

Longer-term challenges: A long-term challenge is to sustain high growth with less volatility than in the past, which will require tackling infrastructure gaps, raising labor skills, and increasing further the economy's resilience to shocks.

Approved By
**Rodrigo Valdés and
 Dominique Desruelle**

This report was prepared by team comprising U. Erickson von Allmen (Head), M. Rosales, C. Perez, J. Podpiera (all WHD), T. Wezel (MCM), M. Gonzalez (Resident Representative), and N. Melgar (office in Uruguay). Discussions were held in Montevideo October 24- November 4, 2011. R. Valdés (WHD) and D. Vogel (OED) participated in the concluding meetings.

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I. RECENT PERFORMANCE AND POLICIES

1. **Uruguay's strong economic growth in the last several years has produced significant welfare gains.** Per capita income in purchasing power terms has doubled from its pre-2002 crisis levels, unemployment has fallen to record lows, and social indicators—already high in the region—have improved further. Key factors supporting this excellent performance include significant policy reforms, prudent macroeconomic policies (including a floating exchange rate), social policies, substantial inflows of foreign direct investment (FDI), and a supportive external environment.

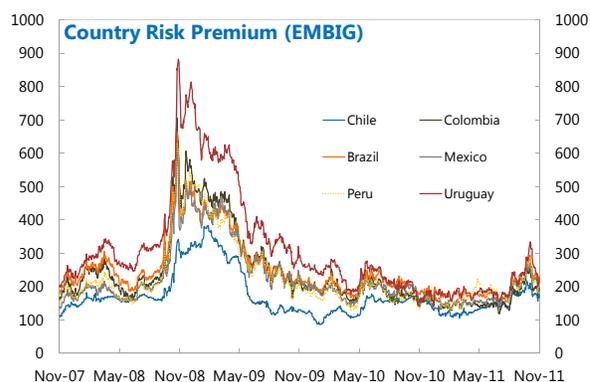
2. **Economic activity remains brisk but a slowdown is underway.** After the Lehman crisis, Uruguay experienced a sharp contraction in output in early 2009 that was followed by a quick and strong rebound. The growth momentum has continued into 2011, but a slowdown is underway driven by weakening exports (due to external demand and domestic supply factors) and moderating public investment. (Early estimates for Q3 show a rebound in growth from the weak Q2.) Domestic demand, in particular private consumption, has been resilient—boosted by rising household income (employment and real wages) and fueled by a rapid expansion in consumer lending from banks and non-bank institutions. But private consumption growth is decelerating and consumer confidence indicators point to further moderation.

GDP Growth and Contributions, 2009–11 Q2

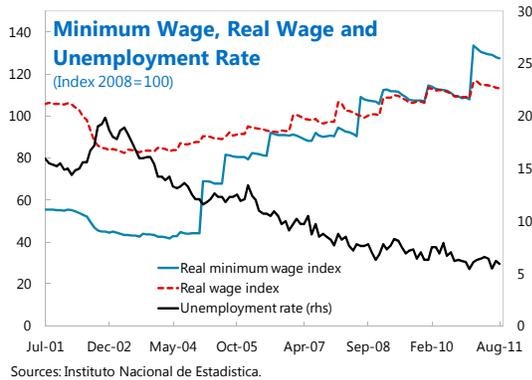
	2010				2011	
	Q1	Q2	Q3	Q4	Q1	Q2
Real GDP, quarter on quarter (S.A.)	2.0	2.2	0.5	1.6	2.1	0.5
(Contributions to real GDP growth)						
Real GDP, year-on-year	9.2	10.3	7.7	6.5	6.6	4.8
Domestic demand	11.0	10.0	7.3	14.2	9.2	11.7
Private consumption	5.9	9.1	8.4	8.6	6.7	6.8
Public consumption	0.4	0.2	0.1	0.2	0.3	0.3
Private investment	1.7	3.2	1.1	4.4	2.1	1.6
Public investment	-0.6	-0.2	-0.9	1.3	0.2	-0.3
Changes in inventories	3.6	-2.3	-1.3	-0.3	-0.1	3.4
Net exports	-1.8	0.4	0.4	-7.6	-2.6	-7.0
Exports	1.4	5.8	2.9	1.2	4.4	-1.5
Imports	-3.2	-5.4	-2.5	-8.9	-7.0	-5.5

Sources: Banco Central del Uruguay and IMF staff calculations.

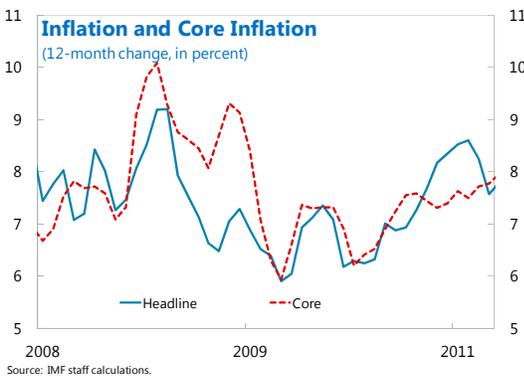
3. **The external current account deficit has widened modestly.** In the context of strong domestic demand and capital flows (mostly FDI), the peso has appreciated by 11 percent in real terms since July 2010 (the basis for last Article IV consultation analysis), and the current account deficit has widened (to 2.3 percent of GDP in the four quarters through June) despite favorable terms of trade. Spillovers from the turmoil in the euro area have so far been limited to the currency—which depreciated by about 10 percent against the dollar between end-August and late October but has since recovered—and an increase in the EMBIG in line with the region.



4. **The labor market is tight.** One success of recent years is the substantial job creation and the consequent sharp fall in unemployment (informal and formal sector) to 6 percent in September amid rising labor force participation and growing real wages. Many sectors report difficulties in hiring skilled labor and labor conflicts have been relatively frequent. The average nominal wage increased by 14 percent (September, y/y). In the 2010–11 wage negotiation round, nine out of 10 agreements include inflation-indexation clauses.



5. **Inflation remains above target.** Inflation was 7.9 percent in October, above the official target range (4–6 percent) reflecting second-round effects from the spikes in global food and fuel prices last year and early this year: staff’s estimate of core inflation (which excludes fuel, food, and administratively set prices) rose to 8.4 percent in October.



6. **Policies in 2011 have focused on moderating domestic demand and inflation, reinforcing buffers against global spillovers, and advancing on the social and structural agenda.** The Frente Amplio-coalition government led by President Mujica that took office in March 2010 has balanced cautious macroeconomic policies with progress on its social agenda. The balancing of the range of views within the coalition was not without episodes of tension earlier in the year. Key measures include:

- **Domestic demand and inflation.** The authorities tightened monetary policy in the first half of the year, including via reserve requirements, and delayed part of the pass-through of international fuel prices. On September 30, in the context of increased global uncertainty, the Banco Central del Uruguay (BCU) left its policy rate unchanged to reassess the outlook. Furthermore, the fiscal policy stance has become broadly neutral (compared with a slightly positive stance projected in the last Article IV report) as capital spending has been moderated (current spending has continued to expand, though).



Box 1. Social Policies and Income Distribution in Uruguay

Uruguay has made progress in improving social conditions. This trend towards better social indicators has been fostered by rapid growth and targeted social programs.

Socio-economic Indicators in Uruguay and Comparators				
	Uruguay		LAC-5 1/	OECD
	2004	2010	2010	2010
GDP per capita (PPP US\$)	9,844	14,022	11,605 3/	33,078 3/
Income inequality GINI index (lower value=less inequality) 2/	46.0	42.1	54.1 4/	31.6 4/
Human Development Index ranking (169 countries: lower value=better ranking)	50	52	63.2 4/	22.0 4/
Unemployment (average)	13.3	7.0	7.1 3/	8.4 3/
Population (in millions)	3.3	3.3	60 4/	36 4/
Poverty (percent of population below poverty line) 2/	31.9	18.6	30.7 3/	n.a 3/
Illiteracy (percent of population age 15 years and over) 2/	2.4	1.8	7.1 4/	1.6 4/
Life expectancy at birth (years average)	75.5	76.7	76.2 4/	79.5 4/

Sources: UNDF Human Development Report, World Bank Indicators, Worldwide Governance Indicators, World Economic Outlook, and Instituto Nacional de Estadística.

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

2/ Latest survey.

3/ Weighted Average with population.

4/ Simple Average.

The main social policies in recent years include the following:

- Reform of the health system to increase gradually the coverage by over 2.2 million people by 2016.
- Expansion of the Family Allowance Program, which covers over 185,000 low-income households (2010). The average monthly transfer is US\$70.
- Establishment of the Family Food Card Program, which covers 88,000 households with a monthly allowance of about US\$40.
- Expansion of unemployment benefits and provision of old-age pensions to people who had not contributed to the pension system.
- Increase in the progressivity of the tax system with the introduction of the personal income tax.

The government has put forward several new initiatives:

- Refund the 22 percent VAT on purchases made with Food and Family Allowance cards to 200,000 low-income households.
- Increase the non-taxable base of the personal income tax while broadening the base for the 25 percent bracket and introduce a new 30 percent bracket;
- Allow mortgage deductions for houses valued up to US\$93,370 (benefiting about 6 percent of households).
- Add nearly 400,000 retirees to the health system.

- **Debt management and financing.** The gross public debt has continued to decline, reaching 55 percent of GDP in June 2011—net debt is lower at 28 percent—and debt management has reduced debt vulnerabilities significantly. Out of concern with the global outlook, the government also has built deposits at the BCU covering 18 months of scheduled debt service and has arranged contingent credit lines with the Corporación Andina de Fomento (CAF), the Fondo Latino Americano de Reservas

(FLAR), and the World Bank for a total of US\$1.1 billion, while exploring an additional line with the Inter-American Development Bank.

- **Structural and social agenda.** In July, the law for Public-Private Partnerships (PPP) was approved. The government's social agenda includes tax reforms in favor of low-income households and a significant expansion in the public health system coverage (Box 1).

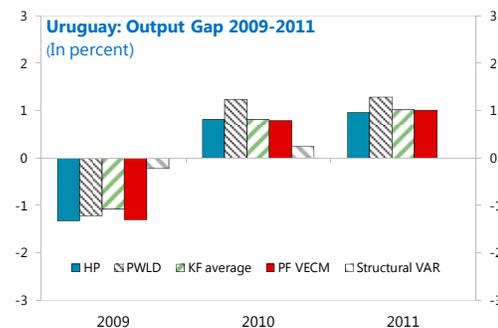
Four Questions about the Current Conjuncture

7. **Is the economy still at risk of overheating?** The 2010 Article IV staff report warned about overheating risks and recommended more restrictive monetary and fiscal policies. Although recent indicators—a positive output gap, core inflation and inflation expectations above target, the widening current account deficit, the tight labor market—suggest such risks persist, they are being mitigated by the slowdown underway, supported by the monetary and fiscal policy tightening in 2011 (Box 2). Still, inflation is likely to decline only gradually due to wage indexation and the imperfect traction of the target.

8. **Is there a property price bubble that could burst?** Real estate prices, for which data is limited to Montevideo, rose by roughly 12 percent a year in dollar terms in 2005-10, less in local currency (Annex I). While considerable, this increase does not appear

Box 2. The Output Gap¹

Following the strong economic growth in recent years, Uruguay's output gap is now positive. Output gaps are notoriously difficult to estimate, so the results should be interpreted with caution. For Uruguay, potential output was estimated with a battery of techniques—including the Hodrick-Prescott filter, which rely on GDP time series, economic models using the Kalman filter, the standard growth accounting technique, a Vector-Error Correction model, and a structural Vector Autoregression (VAR). All approaches point to a small positive output gap in 2010 and 2011 averaging about 1 percent of potential GDP. The reduced gap may reflect that the methods used capture a large part of the fall in actual GDP in the 2002 crisis as a fall in potential output, followed by a strong recovery in actual and potential output. Using a long-term trend output as potential output would produce a larger positive output gap in 2010-11.



Sources: IMF staff calculations.

¹ Based on the Selected Issues paper: *Uruguay: Estimating Potential Output and the Output Gap and Spillovers from Agriculture*, by M. Rosales.

out of line with fundamental factors, including the growth in household disposable income, the increase in construction costs and land prices, the fall in structural unemployment, and the sizeable foreign demand. However, there is anecdotal data that price increases are larger in certain parts of the country, and also that prices in some segments are high compared with other countries. Nonetheless, and importantly, housing activity has been funded mostly through FDI and cash (self-financed) so while a fall in property prices could have important wealth effects and consequences for construction activity, it would not trigger major ripple effects in the banking system.

9. **Is the peso overvalued and are there external stability risks?** The real effective exchange rate has appreciated substantially over the past eight years and it is now 12 percent above its pre-2002 crisis levels. However, productivity and price gains in the tradable sector have raised the equilibrium rate, and CGER estimates, while dispersed, do not suggest overvaluation. The deterioration in the current account balance lends weight to the view that the peso is on the strong side, but the deficit is too small to present immediate stability concerns. Broader macroeconomic signs of overvaluation are not evident: tourism had a record season in 2011 and a strong season is expected for 2012; Uruguay's exports, despite a weakening lately, remain buoyant and have risen faster than world exports; and economic growth is still robust. Other external stability risks appear

Exchange Rate Assessment 1/
(REER deviation from equilibrium, in percent)

	2011
I. Macroeconomic Balance 2/	0.4
II. External Sustainability 2/	2.6
III. Equilibrium Real Exchange Rate 3/4/	0.3
IV. Vector Error Correction Model 5/	-0.5
Overall CGER misalignment (average I-III)	1.1
Overall REER misalignment (average I-IV)	0.8

1/ Please refer to Country Report No.11/62 for a summary of the methodologies used.

2/ Considers an underlying current account balance that strips out temporary factors.

3/ Considers the REER as of July 2011.

4/ A worsening of the terms of trade by a cumulative 10 percent in 2011-16 from the baseline projection would lead the REER to be overvalued by 7.5 percent.

5/ Considers the average REER as of 2011Q2.

Gross International Reserves

In billions of U.S. dollars (latest)	10.2
In months of imports (2012)	8.7
In percent of:	
GDP (end of 2011)	21
Short-term debt (end of 2011)	653
ST debt and nonresident deposits (end of 2011)	155
M2 (latest)	144
M3 (latest)	66
Memo Item	
<i>New reserve adequacy metric range</i> <i>(in billions of U.S. dollars)</i>	5.3-7.9

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

International Investment Position
(In percent of GDP)

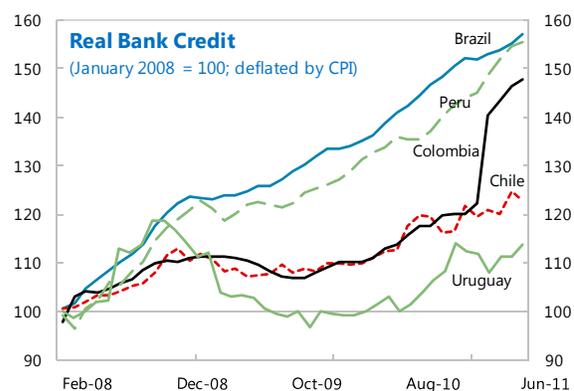
	1999	2003	2007	2010
Assets	53	118	85	68
Of which:				
Portfolio investment	4	15	10	10
Currency and deposits	29	66	50	33
Reserve assets	13	17	17	19
Liabilities	61	128	94	84
Of which:				
FDI	7	15	27	37
Portfolio investment	10	23	33	21
Loans	20	57	15	11
General government	8	24	10	8
BCU	1	23	1	0
Other	11	10	5	3
Nonresident deposits	21	20	12	10
Net position	-7	-10	-8	-17

Sources: Banco Central del Uruguay, World Economic Outlook, and IMF staff calculations.

modest: sudden-stop risks are contained (though not eliminated) by the dominance of FDI, the moderate stock of short-term external liabilities, and the substantial reserves holdings. Moreover, the international investment position (IIP) seems solid. In sum, external stability risks appear low and the real exchange rate is not out of line with fundamentals.

10. Is there a credit boom underway that could negatively affect the banking system? Bank's consumer lending expanded by 48 percent in real terms in August (y/y), albeit from a small base (5 percent of GDP). There also has been a surge in consumer lending from less regulated non-bank institutions, and it now equals one-quarter of banks' consumer lending. However, there is no generalized credit boom in Uruguay, and the overall credit growth has been more muted than elsewhere in the region. Banks are well-capitalized and liquid, and delinquency rates are low and provisioning is high. The low vulnerabilities owe significantly to Uruguay's strong supervision and pioneering (in Latin America) dynamic provisioning system. One vulnerability is the still high dollarization of

deposits and credits (including to borrowers without a natural hedge). Profitability is an issue for some banks, though recently it has been understated by the official reporting standards.¹



Sources: IMF Regional Economic Outlook Western Hemisphere and Haver Analytics.

Uruguay: Selected Financial Soundness Indicators

	2006-2009	2010	2011 2/	LA5 2/
Regulatory capital in percent of risk-weighted assets	17.1	15.2	17.1	16.9
Non-performing loans in percent of total loans 1/	1.8	1.0	1.1	2.7
Household non-performing loans in percent of total household loans	4.9	3.1	3.2	n.a
Specific loan-loss provisions in percent of non-performing loans	61.0	72.2	70.4	167.1
Efficiency ratio (net operating costs in percent of net income)	75.8	78.6	77.0	108.5
Return on assets	1.4	1.2	1.2	2.4
Return on equity	14.7	12.1	12.2	24.2
Liquidity ratio (maturities of up to 30 days)	63.5	56.9	54.1	30.6
Deposits (private resident and public) in percent of total liabilities	63.7	64.3	67.9	49.8
Dollarization of loans 1/	73.2	74.2	67.9	13.2 4/
Dollarization of deposits	79.8	74.3	73.3	13.1 4/
Private sector credit to GDP	23.6	22.9	20.5	31.8
Household consumer credit to GDP	3.5	4.9	5.0	n.a
Implicit exchange rate risk index 3/	34.5	31.4	31.4	n.a

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

Banco Hipotecario del Uruguay.

1/ Loans to the nonfinancial sector.

2/ Latest data (June, July, August).

3/ 2011 data is preliminary.

4/ Excludes Brazil.

¹ See the Selected Issues Paper: *Uruguay: Some Aspects of Financial Intermediation*, by J. Podpiera and T. Wezel.

II. OUTLOOK AND RISKS

11. **Uruguay's near-term prospects will be shaped by the uncertain global and regional developments, but the baseline is good.** In staff's baseline scenario—very similar to that of the authorities—Uruguay's real GDP growth would decelerate to 6 percent in 2011 and to 4 percent over the medium term but subject to episodic volatility related to external developments. Private consumption, which will remain the principal driver of GDP growth in 2012-13, will cool further as household income growth continues to moderate. Large FDI inflows in the pipeline, in particular in the pulp sector, will also bolster growth and widen the current account deficit temporarily in 2012-13. The demand for Uruguay's exports has held up well—reflecting the diversification to dynamic emerging markets; still, export growth will be less buoyant than in recent years because of the anemic growth outlook in advanced economies and slowdown in other key partner countries.

12. **Although there are upside risks to this outlook, they are dwarfed (at this time) by the severe downside risks in the major advanced economies.** The immediate downside risk is that the global economy tips into a downward spiral of increased uncertainty and risk aversion with falling demand—e.g., by further turmoil in Europe. Even in a less severe scenario, major advanced economies could face protracted low growth. For the longer term, a challenge is to advance

quickly in improving key infrastructure and raising labor skills. The newly discovered sizeable iron mining resources (about 2 billion metric tons) present a substantial upside opportunity.

13. **Uruguay's economic and financial vulnerabilities are modest, and somewhat lower than pre-Lehman; still the effects of a deteriorating global outlook could be significant.** Uruguay does not have major macroeconomic imbalances, the external position is robust, the floating exchange rate is not overvalued, households are not heavily leveraged, and there is no credit or property price boom that would amplify an external shock. Also, Uruguay's relatively lower integration into global capital markets should dampen direct effects from international financial volatility as in 2009. Nonetheless, a shock involving sharply lower export earnings (terms of trade and volume) and FDI inflows could inflict an economic downturn and hurt medium-term growth prospects.

Selected Vulnerability Indicators

	Pre-Lehman	Latest
Locally issued Gov't Security 1/ (Yield)	Aug-2007 4.2	Oct-2011 4.6
GDP Growth (In percent)	2007 7.3	2011 6.0
Government Debt (In percent of GDP) (Dollarization)	2007 63 69	Jun-2011 55 53
Reserves (In US\$ billion) (In % of ST debt)	2007 4 472	Latest 10 683
NPLs (In % of total Loans)	7-Dec 1.0	Latest 1.0
Nominal GDP (In US\$ billion)	2007 24	2011 48
Gross Public Financing Need (In percent of GDP)	2009 3.0	2012 2.4

Sources: Banco Central del Uruguay and IMF staff calculations.
1/ 5 year inflation adjusted bonds.

14. **The authorities broadly agreed with this outlook and risk assessment.** They thought Uruguay should be able to withstand slower growth in advanced economies so long as commodity prices hold up or recover quickly—as they did after the Lehman crisis—a view shared by many private sector

representatives. One broadly shared concern was the risk of rising protectionism (in the region and elsewhere) in response to a downturn in the global economy. Several analysts expressed concern over the outlook for FDI from Argentina into real estate.

III. POLICY DISCUSSIONS

The near-term challenge is to balance domestic cyclical policy requirements with the risk of spillovers from abroad. The longer-term challenge is to bolster growth prospects while reducing Uruguay's relatively high output and employment volatility.

A. Near-term Policies

15. **The authorities and the staff agreed that the uncertain outlook warrants continued prudent economic policies and efforts to reinforce buffers further.**

- **Monetary policy.** Staff supported keeping monetary policy unchanged until the outlook becomes clearer. There was broad agreement that it is too early to start easing given core inflation and inflation expectations (6.8 percent 18 months out) above targets, and given the prevalence of wage indexation. Indeed, absent a major downward revision to the baseline scenario, a resumption of tightening may be needed to bring inflation toward the target range, though any rate adjustment should be tailored to the evolving growth and inflation outlook. The authorities also stressed that the policy stance should maintain a long-term perspective, looking

through the short-term noise. Staff noted (as in the last Article IV staff report) that bringing inflation to the mid-point of the target would create space for cutting rates in a downturn.

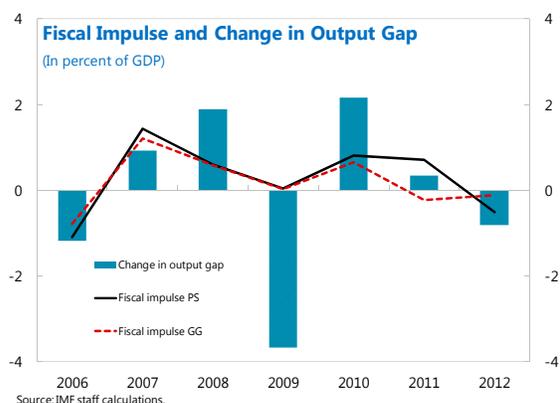
- **Fiscal policy.** Staff welcomed the shift to a broadly neutral fiscal stance in 2011 and that the fiscal plans—still anchored in reducing the public debt to 40 percent of GDP by 2015—imply a similar (or somewhat tighter) stance in 2012. Staff welcomed that the net costs of the government's social agenda, including the changes to the income tax (see Box 1), as well as a planned cut in the VAT from 22 to 20 percent for purchases with debit and credit cards, are not expected to be large in part because of the planned gradual implementation. Staff suggested slower growth in real current spending (which was

- 7.3 percent a year in 2009–11) in the coming years would help ensuring adequate room for investment. While staff supports the authorities' plans to overcome infrastructure gaps through PPPs, it is not clear that PPP investments can expand quickly enough to replace a large portion of public investment in the short term. The authorities did not see much scope to reduce current spending growth given expenditure rigidities and also because some of the new spending relates to recent social reforms.

Public Sector Operations, 2009–11
(In percent of annual GDP, unless otherwise noted)

	January–September			Annual	
	2009	2010	2011	2010	2011 Est.
Public sector revenue	20.3	21.5	21.1	28.8	28.3
Public sector primary spending	19.5	19.9	19.2	27.2	27.0
percent change, real terms 1/	13.5	9.4	0.4	7.2	4.2
Of which : Current spending 1/	11.3	7.8	5.2	6.5	5.7
Of which : Capital spending 1/	33.7	21.4	-31.8	11.7	-6.4
Public sector primary balance	1.1	1.8	2.2	1.7	1.5
General government primary balance 2/	1.5	1.2	1.7	1.1	1.4
Public sector overall balance	-1.1	-0.4	0.0	-1.2	-1.4

Sources: Ministerio de Economía y Finanzas del Uruguay and IMF staff calculations.
1/ Change from same period in previous year.
2/ Defined as central government plus Social Security Bank.



- Exchange rate policy.** The authorities and staff agreed that the floating exchange rate is crucial for dealing with external shocks, for de-dollarization, and for monetary policy traction. The authorities

saw the excess global liquidity as a likely temporary situation and, while fully committed to a flexible exchange rate system, they were taking a pragmatic approach to intervention, focusing on containing possible overshooting and being prepared to ensure orderly market conditions in case of stress. Staff was encouraged by the more limited exchange rate intervention recently, as, in the staff's view, large-scale and frequent interventions risk complicating the conduct of monetary policy—and are generally not effective in preventing a trend real appreciation. If substantial appreciation pressures resume, staff would favor some more fiscal restraint with a focus on current expenditures and taxes to help ease the pressure on monetary policy.

- Debt management.** Staff praised the active debt management—an area where Uruguay can be a model for other countries—which has reduced debt dollarization to 53 percent (95 percent in 2003), lengthened maturities to an average of 12 years and thus reducing rollover requirements, and increased the share of public debt at fixed interest rate to close to 90 percent. Indeed, the improved debt outlook and declining dollarization has contributed to Uruguay being raised to one-notch below investment grade by the three major credit rating agencies, and (de facto) enjoying investment-grade level market spreads for most of 2011 (Box 3).

Box 3. Uruguay's Road Toward Investment Grade¹

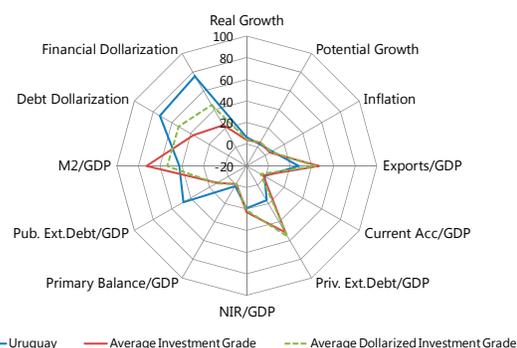
In recent years, Uruguay has moved close to regaining investment grade status—lost in the aftermath of the 2002 crisis. The three main global credit rating agencies upgraded Uruguay's sovereign risk rating to one notch below investment grade in the summer of 2011. The reduction in sovereign debt spreads suggests that the market already (implicitly) has awarded Uruguay such a status.

A study on the determinants and effects of obtaining investment grade finds the following:

- The external public debt burden and a trend of public debt and financial de-dollarization are significant determinants of investment grade.
- There are large benefits from getting investment grade in the form of lower sovereign debt spreads, though the benefits are somewhat lower for dollarized economies.

- Countries, like Uruguay, that trade at investment grade levels when classified below this grade can show resilience during financial stress episodes.

Comparative Key Fundamentals, Average 2005-10 1/ 2/



Source: IMF staff calculations based on data from WEO, IFS, and rating agencies.

1/ For countries that were Investment Grade in 2010.

2/ Cutoff of financial dollarization chosen at 30 percent of deposits denominated in foreign currency.

¹ Based on the Selected Issues Paper: *Investment Grade for Dollarized Countries: The Uruguayan Case*, by M. Gonzalez and L. Shui.

B. Coping with Spillovers and Risks

16. **Global and regional spillovers have been positive for Uruguay in recent years, but at this time they present also substantial downside risks.** Uruguay has benefited from strong growth in key trading partners, low global interest rates, and favorable terms of trade. At this time, though, the most acute risks and tail risks to the outlook stem from potential spillovers from the euro area and from the region via extensive real and financial linkages.

17. **Uruguay's real and financial links to the global economy and regional partners have changed, with implications for**

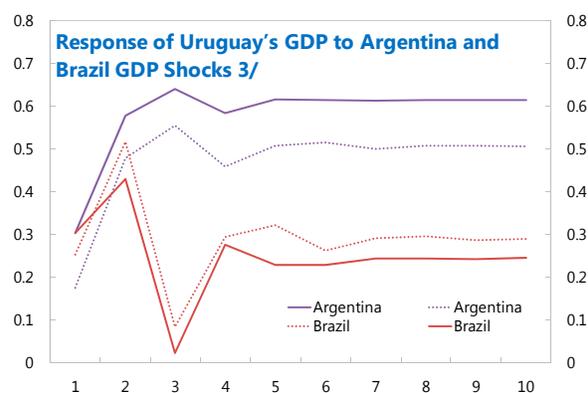
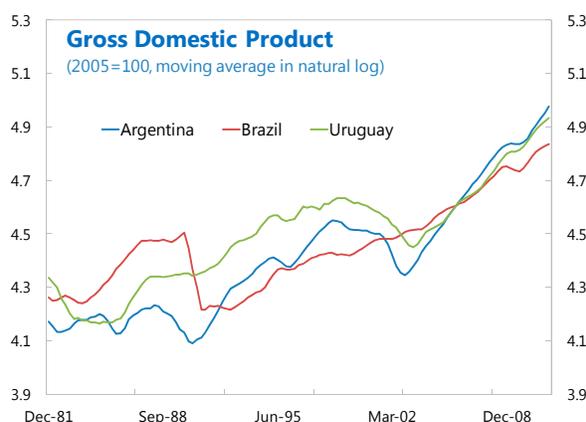
potential spillovers. The growing reliance on commodities exports (mainly food items) has increased Uruguay's exposure to changing global commodity demand conditions, though (as many noted) food demand is less sensitive than other commodities to cyclical conditions and eventual rebalancing in China. Uruguay has also broadened its export base (soy and pulp are recent additions) and export markets (with Russia and, in particular, China rising). Still, Argentina and Brazil remain key partners via the extensive trade and FDI links (Box 4). Uruguay's broader global financial integration, as measured by the gross IIP asset and liability positions, has declined even if it remains high

Box 4. Real Links and Spillovers from Argentina and Brazil

Argentina and Brazil are Uruguay's two most important partner countries. About one third of Uruguay's exports go to Argentina and Brazil, and over half of tourism receipts and one third of FDI come from Argentina. The correlation between GDP growth in Uruguay and Argentina is 0.94 and between Uruguay and Brazil it is 0.83. These two countries affect Uruguay directly and indirectly by amplifying shocks from the rest of the world. This box quantifies some spillover effects using simple trade elasticities and a Vector Auto Regression (VAR) model.

Trade elasticities. A simple elasticity calculation shows that a decrease of 10 percent in Argentina imports will reduce Uruguay's GDP by 2.7 percent; the response from Brazil is similar.¹ The Brazil effect is roughly similar to those found in the *Regional Economic Outlook—Western Hemisphere*, Fall 2010 (Box 2.6).

VAR. The standard VAR model builds on Sosa (2010) and includes real GDP in Uruguay, Argentina, Brazil, and the rest of the world, as well as some external factors such as world real interest rates, oil prices, and non-fuel commodity prices.² It is estimated using quarterly data for 1980Q1–2011Q2. Impulse responses show that the impact of a 1 percentage point increase in Argentina's GDP growth leads to an increase in Uruguay's GDP of 0.6 percentage points after three quarters. The impact from Brazil is similar, but lasts only for two quarters.



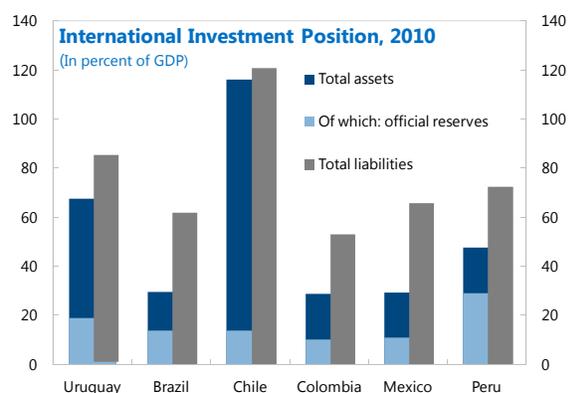
Note: Continuous lines based on a VAR that controls for a number of international exogenous variables; dotted lines based on a VAR that does not include international variables.

¹ From a linear regression $\text{LN}(\text{URYGDP}) = C(1) + C(2)\text{LN}(M_i)$ Where M_i =Imports from Brazil and Argentina.

² Sosa, Sebastian. "The influence of "Big Brothers:" How Important are Regional Factors for Uruguay?" IMF Working Paper No. 10/60 March, 2010.

³ Ratio of cumulative impulse responses of Uruguay GDP to a shock in Argentina (Brazil) GDP.

compared with the region. Notably, non-resident deposits (mostly from Argentina)—a critical link in the 2002 crisis—have fallen from 36 percent of total deposits in 2000 to 15 percent in 2011, and banks back match these with very liquid foreign currency assets.



Sources: Haver Analytics, World Economic Outlook, and IMF staff calculations.

18. **In case of negative spillovers via the extensive exports and FDI links, the macroeconomic policy response should be prudent and flexible as it has been so far.** Sharply weaker global growth and surges in risk aversion could hit Uruguay by the trifecta of weaker terms-of-trade, lower external demand (volumes), and tighter global financial conditions (as after Lehman)—amplified with knock-on effects from Argentina and Brazil. The staff and the authorities agreed on the importance of accommodating a real exchange rate depreciation, if needed, but also that using part of the ample reserves could be appropriate to limit overshooting—given the high degree of bank and debt dollarization. A monetary policy easing should proceed so long as prospects for disinflation increase and inflation expectations become reasonably aligned with the target. The authorities broadly

agreed, noting that inflation and inflation expectations would also fall in a downturn. It was also agreed that a reduction in reserve requirements could help support credit growth. Staff and the authorities concurred that there is room to allow fiscal automatic stabilizers (mostly revenue) to operate, although in the event of a lasting downturn the space would be limited by the need to preserve prudent debt dynamics, which are sensitive to growth and the exchange rate (Annex II). The risk to government funding is contained by the modest government's financing need (2 percent of GDP in 2012) and the buffers that the government has built.

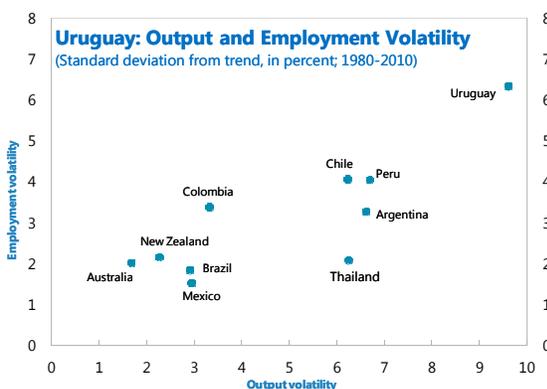
19. **A specific financial risk relates to how funding or deleveraging pressures in Europe could affect Uruguay via the two large Spanish bank subsidiaries.** Santander and BBVA account for about one-fifth of all bank credit in Uruguay. In the tail risk event of a large and sudden scaling down of their activities, the macro-economic impact could be significant though less severe than in other countries in the region with similar links (see *Regional Economic Outlook—Western Hemisphere*; October 2011, IMF). The staff and the authorities agreed that the risk of contagion through this channel is moderated not only by these banks' strong liquidity positions and balance sheets, and their (like all banks in Uruguay) reliance on local deposit funding, but also because all foreign subsidiaries are subject to BCU's limits on net placements with parent banks. For the banking

system more broadly, the BCU's stringent stress tests indicate that banks should be able to absorb even a severe output shock and depreciation.² Furthermore, in October 2011, the BCU announced changes that will

strengthen capital requirements further. The authorities have also established a Systemic Financial Sector Risk Committee to strengthen further the surveillance of systemic macro-financial risks.

C. Longer-term Issues

20. **A long-term policy challenge is to sustain strong and balanced growth with less volatility than in the past.** Staff concurred with the authorities that Uruguay's growth prospects are generally bright, but sustaining growth at around 4 percent a year will require efforts to boost productivity growth. In parallel, efforts to strengthen further the economy's resilience to shocks will help reduce Uruguay's exposure to large fluctuations in output and employment.



Source: International Labor Organization, Haver, and IMF staff calculations.

21. **Private-Public Partnerships will play an important role in tackling the infrastructure gaps, and there has been**

² The BCU's stress tests involve combined shocks to GDP, the exchange rate, international interest rates, country risk, and inflation. In its June 2011 Financial Stability Report, the crisis scenario involves a 31.7 percent depreciation and an 8 percent GDP contraction.

important progress on the PPP framework.

Staff welcomed the passage of the PPP Law in July, and its assurances to fiscal sustainability—e.g., the limits on the stock of PPP-related liabilities and future spending. Staff also welcomed the authorities' commitment to transparent reporting of such liabilities, the inclusion of checks and balances throughout the process, and a fair risk sharing mechanism.

22. **Staff and the authorities discussed how Uruguay's prudent macroeconomic policy management could be enhanced further, including to deal with new challenges.**

- **Public finances.** To impart less pro-cyclicality in the budget, staff welcomed the authorities' intentions to cast budget presentations around the structural fiscal balance. Staff also encouraged consideration of making certain key expenditures less pro-cyclical. Moreover, the staff fully supported the government's prudent and inclusive approach for considering the management of the newfound iron resources (e.g., exploration framework, tax regime, and wealth fund design). Finally, parametric reforms in recent years have had an impact on

pension liabilities, and staff welcomed the plan to assess the medium and long-term outlook for the pension system 15 years after the two pillar system was introduced.³

- **Monetary policy.** Given the high dollarization and wage indexation, staff suggested that the BCU could strengthen further its influence over inflation expectations (and enhance monetary policy traction) by being more explicit in its communications about the inflation forecast and how it would respond to typical shocks. The BCU underscored that in the context of Uruguay's small market where a few agents have considerable market power, the merits of such communication had to be balanced against the need to retain an element of surprise in monetary policy.

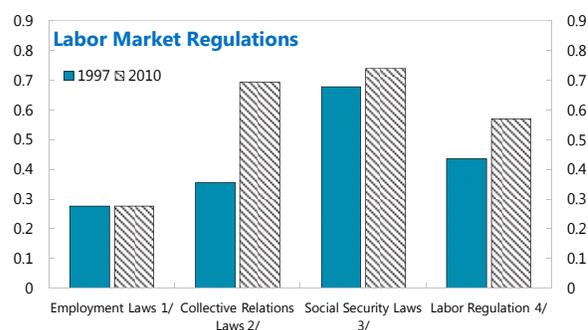
23. **The labor market has a key role in supporting growth prospects and adjustments to shocks.** Staff welcomed the initiatives to enhance labor skills, including new university educational programs, a strategy for improving labor market policies, and the new National Institute of Employment and Training. At the same time, reforms in recent years seem to have intensified labor regulations, and it will be important to monitor the implementation of the new framework to ensure it allows for sufficient flexibility to

³ See the Selected Issues Paper: *Uruguay's Pensions System: An Overview*, by M. Rosales.

support a dynamic economy and reduce the adjustment cost to shocks, while fostering equity (Box 5). The authorities considered that the labor market framework worked well, producing real wage increases broadly in line with productivity growth.

Box 5. The Uruguayan Labor Market¹

Uruguay's labor market has undergone significant changes in recent years. The unemployment rate has fallen to record lows amid rising labor force participation and increasing real wages. There has also been significant reform. Notably, since 2005, the minimum wage has been increased substantially, though it does not appear to be binding for wage dynamics and it is not excessive in a cross-country comparison. Collective bargaining was restored in 2005 and amended by a new wage negotiation law in 2009. In this context, wage indexation with respect to inflation has increased. Wage Philips curve estimates show that wage indexation and employment volatility is higher in Uruguay than in the region.



Sources: Botero et al. (2004) and IMF staff calculations.
 1/ Employer's incremental cost of deviating from a hypothetical contract with specified job conditions and where worker cannot be fired.
 2/ Protection of workers from employers through collective action.
 3/ Generosity of benefits in percent of net previous salary covered.
 4/ Average of the three sub-indices.

¹ Based on the Selected Issues Paper: *The Uruguayan Labor Market*, by N. Melgar and J. Podpiera.

24. **A robust and deeper financial sector can help foster long-term investment and growth.**

- **Regulations.** Staff welcomed the reforms announced in October (effective during 2012) to strengthen banks' capital (in line

with Basel III), complete implementation of other Basel II requirements, and overhaul the design of the dynamic provisioning system (which has led to very high provisioning levels). In light of the expanding activities of the non-bank institutions, most of which have links to local banks, staff also welcomed that credit card administrators will be monitored more closely starting January 2012. Staff encouraged the authorities to consider increasing the information provision requirements for all non-bank institutions to allow closer monitoring. While noting that the scope of supervision must reflect the risk profile and systemic importance of these institutions, the authorities indicated they would increase the frequency of data collection from non-bank financial institutions (in 2012) and consider extending the data collection to money lenders.

- **Intermediation.** Bank credit intermediation is low (at 24 percent of GDP). The financial sector is more concentrated and exhibits a somewhat lower degree of competition than in peer countries.⁴ The authorities' *bancarización e inclusión financiera* reform should help improve access to financial services. Staff also welcomed the BCU's plans to expand the central credit registry, noting that it

could help promote greater competition in the sector. Staff also raised the idea of mutual credit guarantee funds to spur lending to small enterprises. Finally, staff suggested that the authorities consider eliminating the inflation adjustment in the official reporting of bank profitability as inflation is consolidating at low levels.

25. **There has also been progress towards complying with the OECD's international tax standards and in strengthening further Uruguay's AML/CFT regime.** With the purpose of complying with the OECD international tax standard, the government has implemented six tax-information sharing bilateral treaties, and several more have been agreed or are under negotiation. The authorities clarified that they will work toward addressing the pending issues reflected in the latest OECD review, including through establishing tax agreements with key partners to ensure information sharing in compliance with the international standard while preventing double taxation. Moreover, Uruguay's 2009 AML/CFT assessment report by Grupo de Acción Financiera de Sudamérica (GAFISUD) showed improved compliance with the Financial Action Task Force (FATF) standards and the government has been working on updating its 2007 AML/CFT national strategy with a risk-based focus, supported by Fund technical assistance. The revised strategy is expected to be put in place in the coming months.

⁴ See Selected Issues Paper: *Uruguay: Some Aspects of Financial Intermediation*, by J. Podpiera and T. Wezel.

IV. STAFF APPRAISAL

26. **Uruguay's impressive economic growth in recent years has produced significant welfare gains.** This is the result of steady adherence to prudent policies, significant reforms, and positive external factors.

27. **The baseline outlook is positive but with considerable downside risk stemming from the highly uncertain global outlook.** Although the overheating concerns mentioned in the 2010 Article IV Consultation have diminished with the slowdown underway, private consumption remains buoyant and inflation is above target. At the same time, the risks are tilted considerably to the downside and relate to potential fallout from advanced economies and developments in the region.

28. **The uncertain external outlook warrants continued implementation of prudent economic policies.** Staff welcomes the monetary tightening in the first half of the year, and the pause since September until the outlook becomes clearer. It seems premature to start relaxing monetary policy given core inflation, inflation expectations, and the relatively high degree of wage indexation. Indeed, absent a worsening in the baseline scenario, a resumption of tightening may be needed eventually to bring inflation closer to target, though any rate adjustment should be tailored to the growth and inflation outlook. Staff also welcomes the shift to a broadly

neutral fiscal stance in 2011 and that the plans imply a similar stance in 2012. The floating exchange rate is crucial for dealing with external shocks, supporting the de-dollarization in the private sector, and enhancing monetary policy traction further. Staff is encouraged by the more limited exchange rate intervention recently. If substantial appreciation pressures resume, staff would favor some more fiscal restraint with a focus on current expenditures and taxes to help ease the pressure on monetary policy. Finally, the active debt management has helped reduce public debt vulnerabilities significantly. Staff welcomes the building of large deposits at the BCU and the contingent credit lines arranged with international financial institutions.

29. **In the case of external shocks, the macroeconomic policy response should be prudent and flexible as has been the case so far.** A monetary policy easing could proceed so long as prospects for disinflation increase and inflation expectations become reasonably aligned with the target. Fiscal automatic stabilizers should be allowed to operate, although in the event of a lasting downturn, the fiscal space would be limited by the need to maintain prudent debt dynamics. With respect to the exchange rate, while it will be important to accommodate a real depreciation, if needed, part of the ample reserves could be used to limit overshooting—

important given the still high degree of bank and debt dollarization.

30. **A long-term policy challenge is to sustain strong and balanced growth with less volatility than in the past.** Continued progress in many areas will be needed. PPPs will play a key role in tackling the infrastructure gaps and staff welcomes the progress on the PPP framework, including its assurances to fiscal sustainability. Staff also welcomes the authorities' commitment to transparent reporting of PPP liabilities, the inclusion of thorough checks and balances throughout the process, and a fair risk sharing mechanism. Finally, staff applauds the government's prudent and inclusive approach for considering the management of the newfound nonrenewable iron resources.

31. **Uruguay's prudent macroeconomic policy management could be enhanced further to deal with new challenges.** To limit risks of pro-cyclicality, staff welcomes the authorities' intentions to cast budget presentations around the structural fiscal balance. Staff would also encourage consideration of changing certain expenditure rules to make them less pro cyclical. On monetary policy, given the high dollarization and significant wage indexation, staff suggested that the BCU might strengthen further its influence over inflation expectations (and enhance monetary policy traction) by being more explicit in its communications about the inflation forecast and how it would respond to typical shocks. As a general point,

bringing inflation to the mid-point of the target range would create space for cutting rates in case of a downturn.

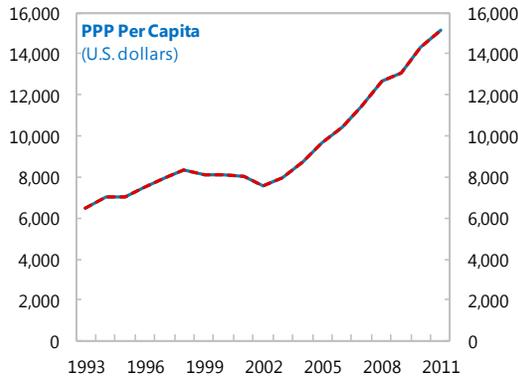
32. **The labor market has a key role in supporting growth prospects and adjustment to shocks.** Staff welcomes the authorities' various initiatives to enhance the skills of the labor force. Reforms in recent years seem to have intensified the degree of regulation in the sector, and it will be important to monitor the implementation of the framework to ensure it supports a dynamic economy and reduces the cost of adjustment to shocks, while fostering equity.

33. **A robust and dynamic financial sector can support long-term investment and growth.** Recently announced reforms will strengthen banks' capital and improve the dynamic provisioning. Staff welcomes that credit card administrators will be monitored more closely starting in 2012. While acknowledging that non-bank supervision must be tailored to the risk profile and systemic importance of financial institutions, staff encourages the authorities to raise the information requirements for all non-banks to allow closer monitoring of this dynamic market segment. Staff also suggests eliminating the country-specific inflation-adjustment in the official reporting of Uruguayan bank profitability.

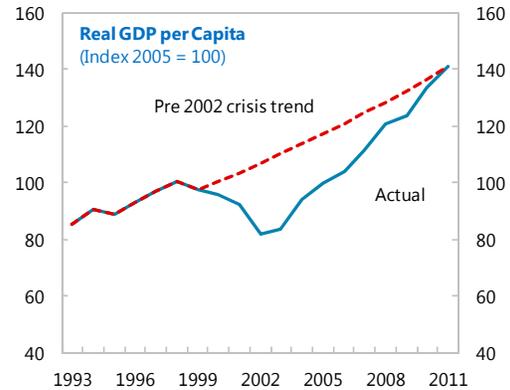
34. **Staff proposes that Uruguay remain on the 12-month Article IV consultation cycle.**

Figure 1. Uruguay: The Long Term Economic Revival

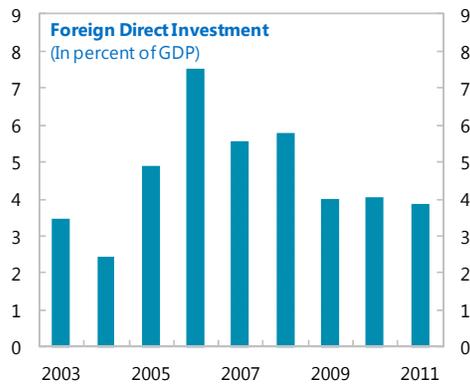
Per capita income has doubled from pre-2002 levels ...



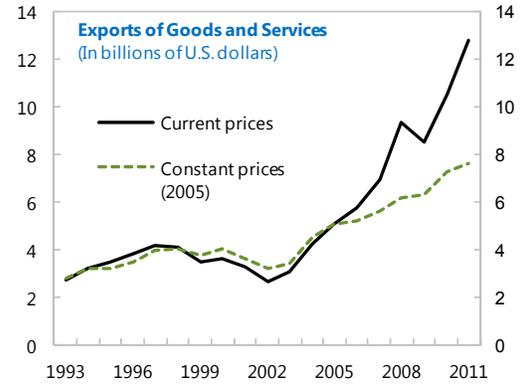
... and the output loss (from pre-2002 trend) has been recovered.



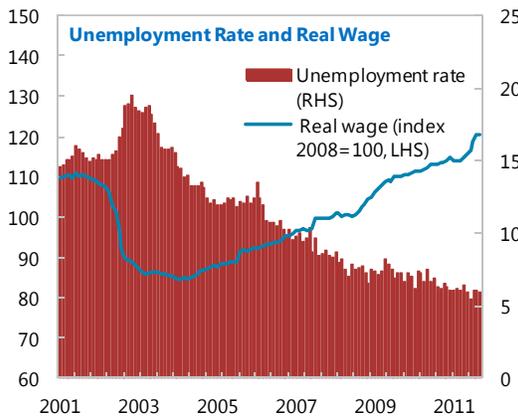
Substantial FDI inflows have spurred growth ...



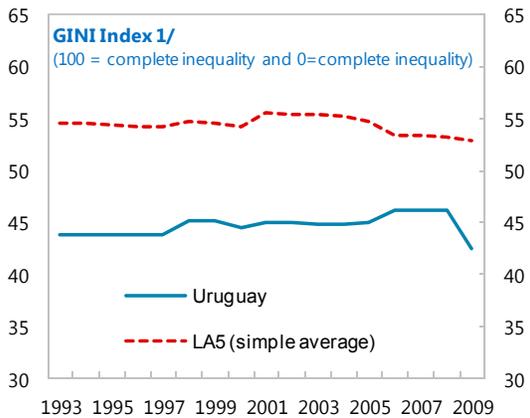
... and bolstered exports, which have been helped also by favorable prices.



Unemployment has fallen to record lows while real wages have risen...



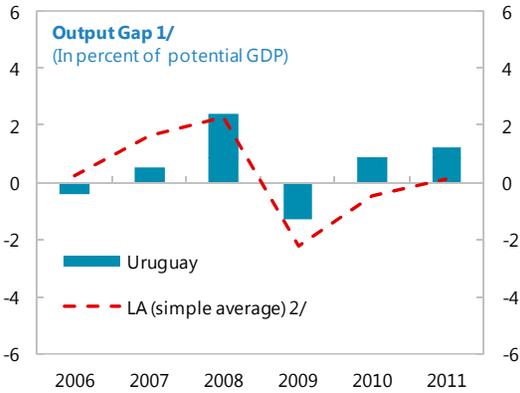
... and income inequality remains below the regional average.



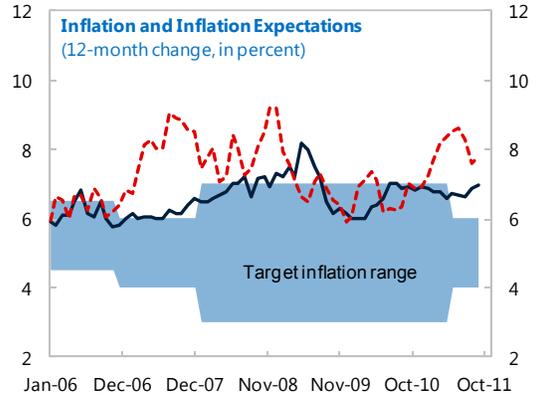
Sources: World Economic Outlook, World Development Indicators, Haver Analytics, and IMF staff calculations with 2011 projections.
1/ Use preceding data to fill in the missing gap.

Figure 2. Uruguay: The Current Conjuncture

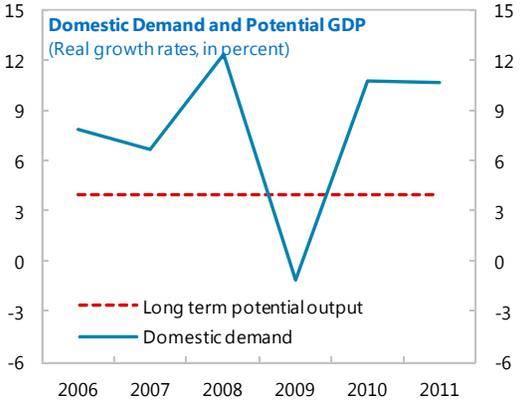
Activity is above potential, ...



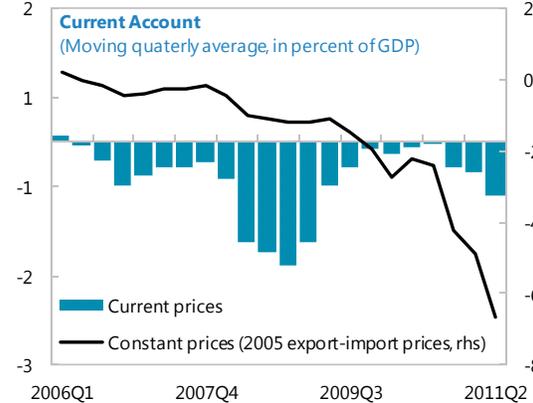
... inflation and inflation expectations are above the official target ...



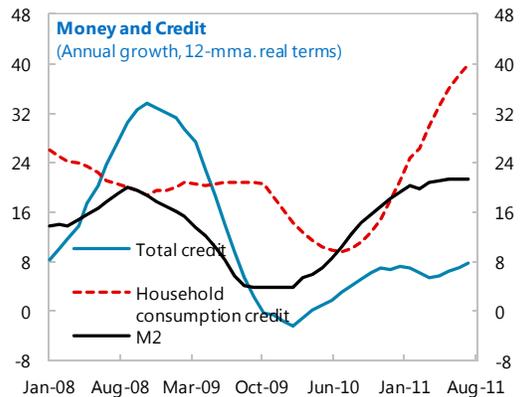
... and domestic demand has been buoyant.



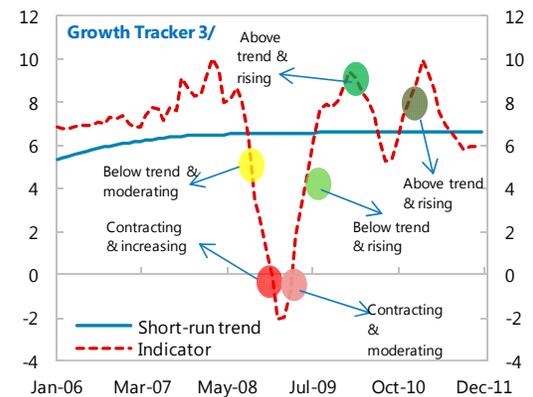
The current account balance has deteriorated, but the deficit is not large thanks to favorable terms of trade.



Total credit is expanding at a moderate pace, while consumer credit is booming (from a small base) ...



... but overall economic activity is moderating.



Sources: World Economic Outlook, Haver Analytics, and IMF staff calculations.

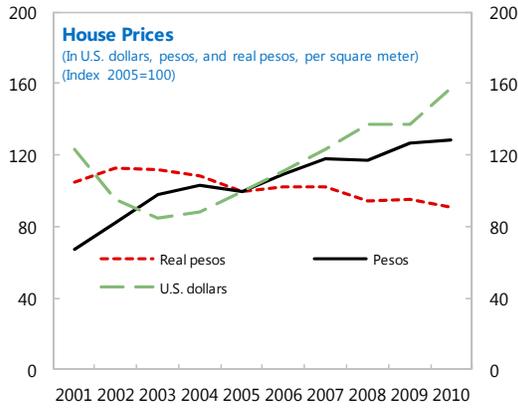
1/ Output gap calculated with the Hodrick-Prescott filter.

2/ LA includes Brazil, Colombia, Chile, and Peru.

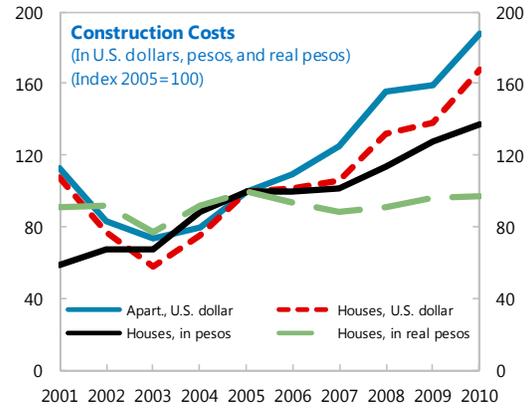
3/ Constructed with a large set of daily, monthly, and quarterly indicators and a dynamic factor forecasting model that summarizes available data. The tracker is estimated and forecast at the monthly frequency and reflects the behavior of a centered 7-month moving average.

Figure 3. Uruguay: Real Estate Price Developments

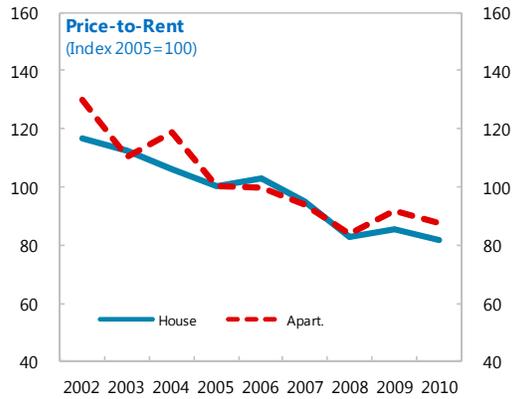
Housing prices have increased in U.S. dollar terms but less in peso terms.



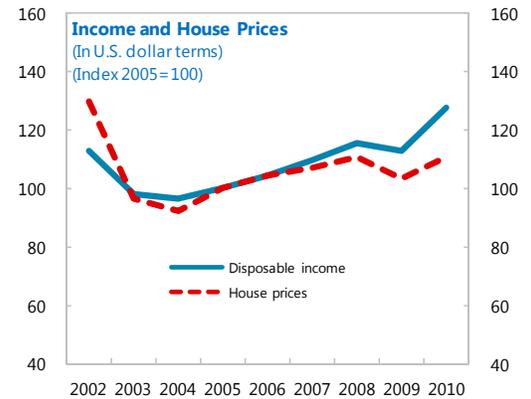
The rising house prices reflect a similar trend in construction costs.



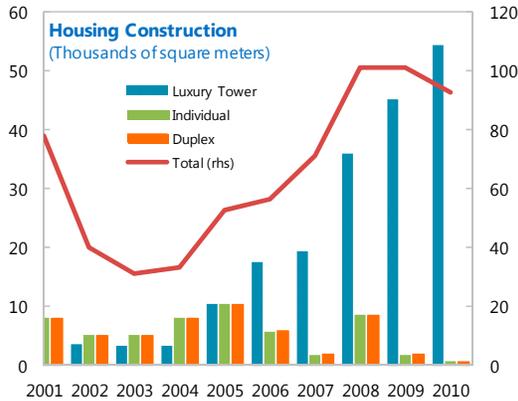
Still, the price-to-rent ratio does not suggest overvaluation...



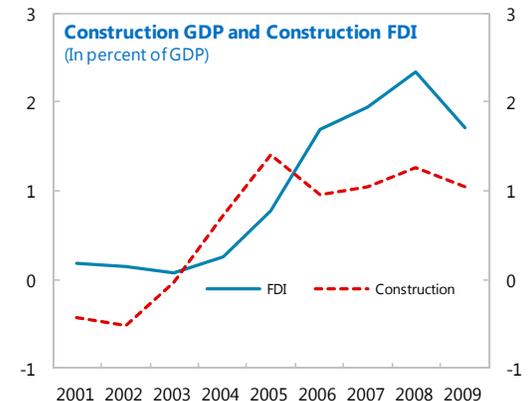
...and prices have risen in line with income.



Construction activity has been strong...



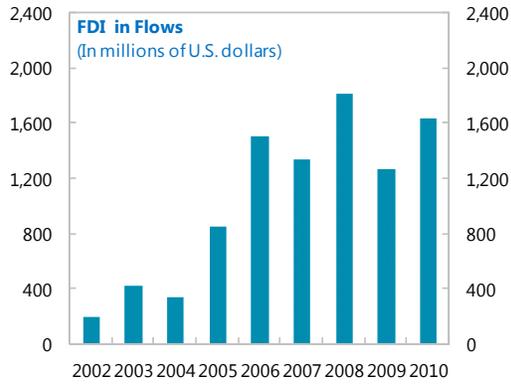
... with substantial FDI financing.



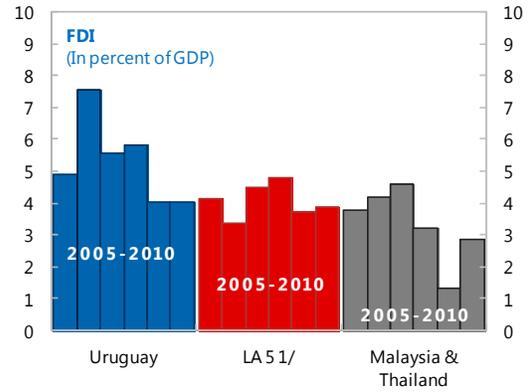
Sources: Instituto Nacional de Estadística del Uruguay and IMF staff calculations.

Figure 4. Uruguay: Trends in Foreign Direct Investment Inflows

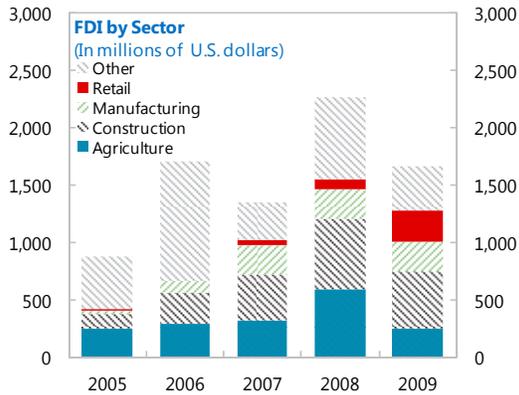
FDI inflows have been substantial in recent years...



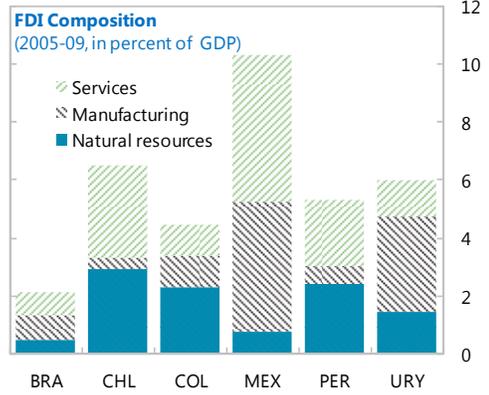
... also when compared with other countries.



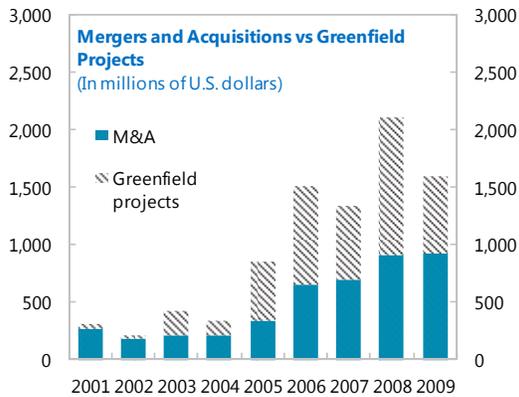
FDI has gone to many sectors in the economy...



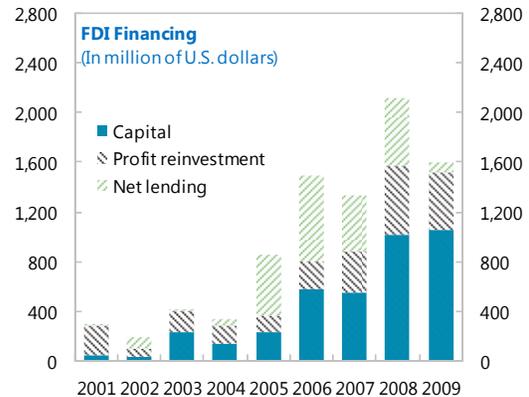
... with manufacturing and services getting the lion's share.



Both M & A and Greenfield investment have increased.



Most FDI is new capital.

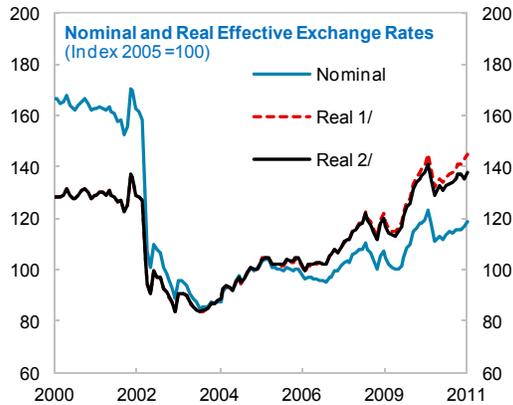


Sources: Banco Central del Uruguay and IMF staff calculations.

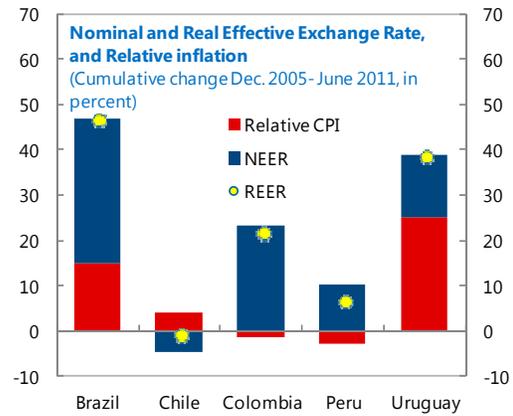
1/ Brazil, Chile, Colombia, Mexico, and Peru.

Figure 5. Uruguay: External Stability

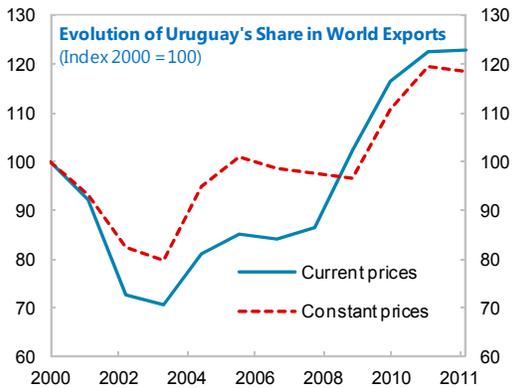
The REER has appreciated significantly in recent years...



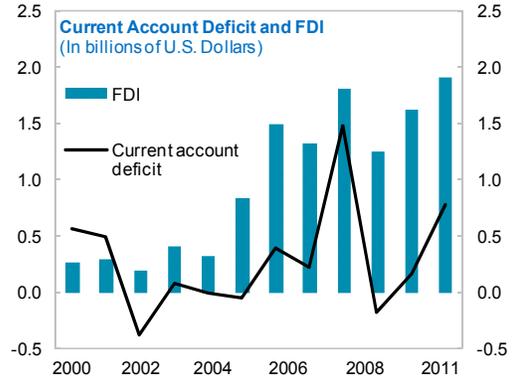
...since 2006 mostly because of higher inflation than in partner countries.



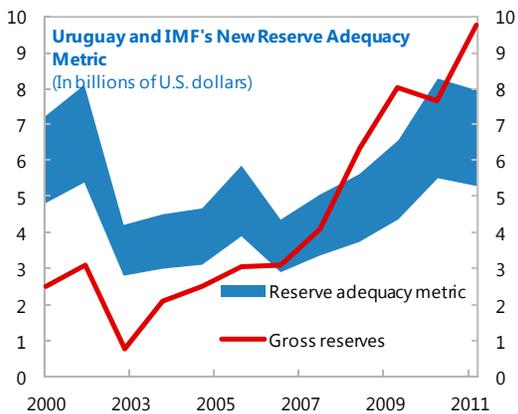
However, Uruguay's exports have increased faster than world exports.



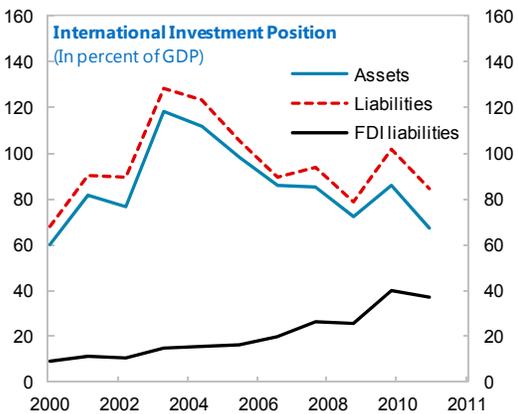
The current account deficit is not large and it is amply covered by FDI.



The reserves position is strong.



The IIP position is also robust.



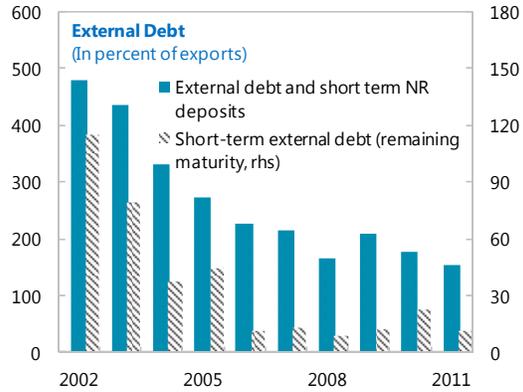
Sources: World Economic Outlook, Haver Analytics, and IMF staff calculations.

1/ Calculated using official CPI for Argentina.

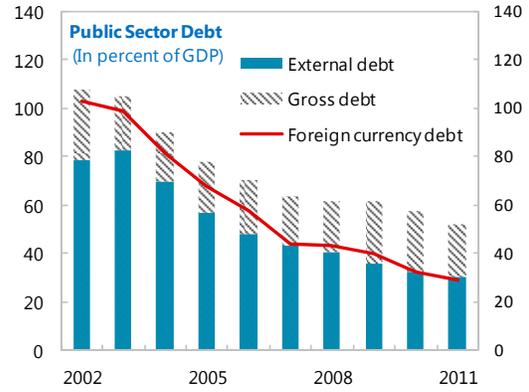
2/ For the inflation rate in Argentina, we use IMF staff's estimate of the average inflation rate in 11 provinces, excluding Buenos Aires. A Laspeyres index is used to aggregate price changes across provinces, using weights derived from the 2004/5 National Household Expenditure Survey (ENGH). Based on data for 11 provinces for which data on their provincial CPI are available through 2011.

Figure 6. Uruguay: Balance Sheet Vulnerabilities

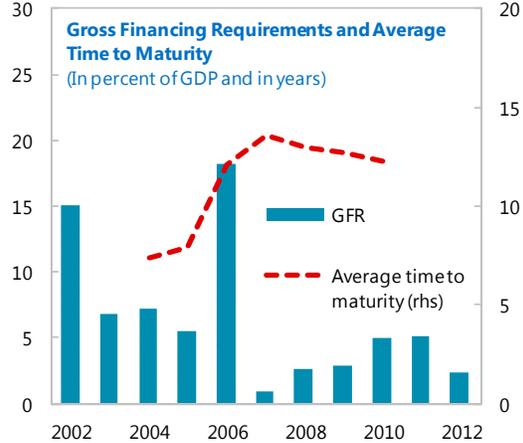
Uruguay's external debt position has improved significantly.



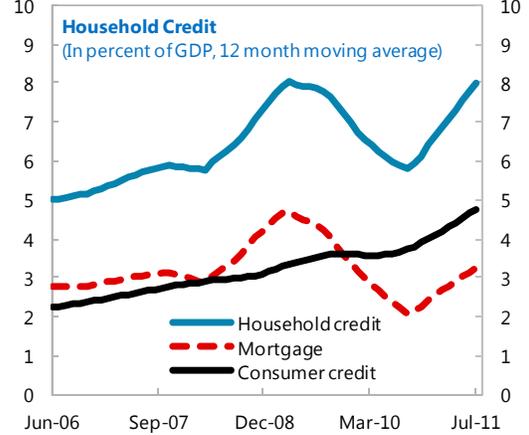
The public debt has also fallen, and mostly the external and foreign currency components.



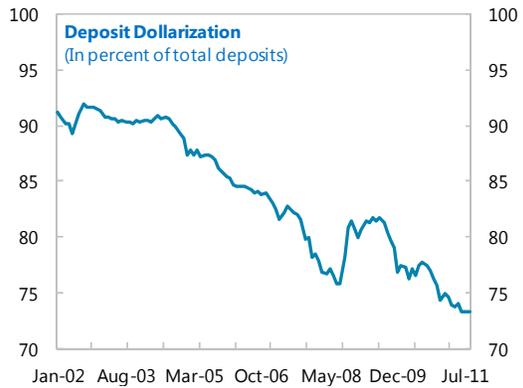
Gross public financing requirements have declined.



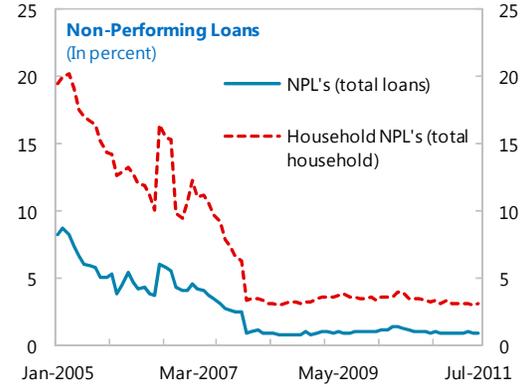
Household indebtedness is moderate.



Banking sector dollarization has continued to decline...



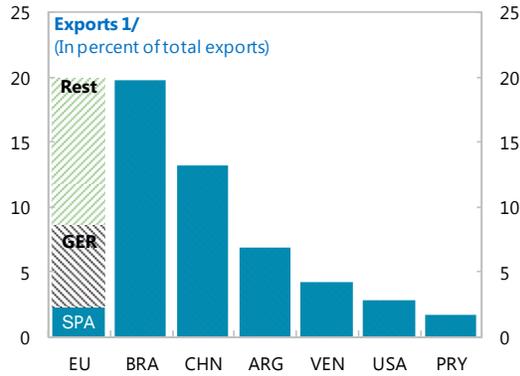
...and bank NPLs remain very small.



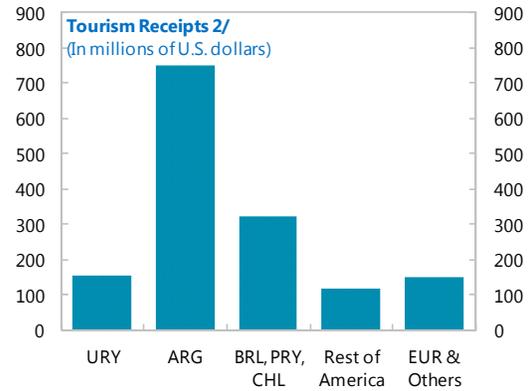
Sources: World Economic Outlook and IMF staff calculations.

Figure 7. Uruguay: External Linkages

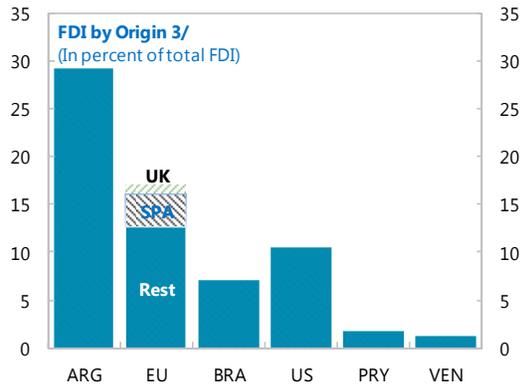
Europe and Brazil are top export markets...



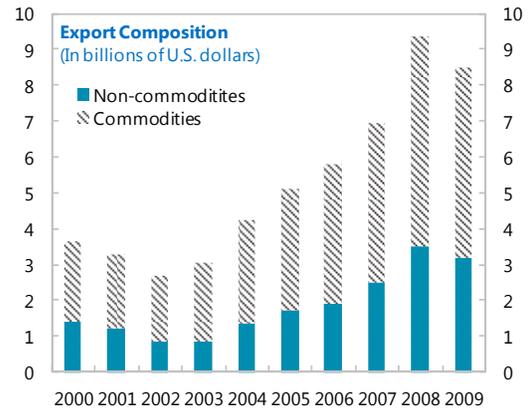
...while Argentina dominates tourism...



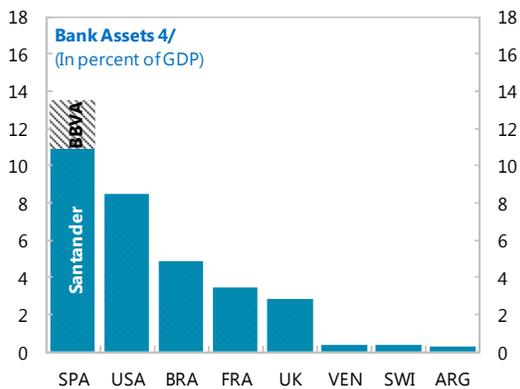
... and also FDI, but Europe is also an important source of FDI.



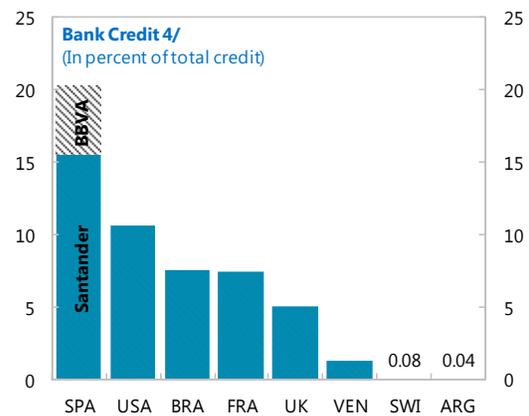
Exports remain dominated by commodities.



Spanish banks play a significant role in Uruguay's banking system as measured by their share in total assets...



...and by their share in total credit.



Sources: JP Morgan, Haver Analytics, and IMF staff calculations.

1/ BCU Report on exports as September 2010.

2/ URY corresponds to Uruguayans living abroad.

3/ BCU Report on FDI as 2008.

4/ BCU Financial Stability Report, second quarter of 2010.

Table 2. Main Fiscal Aggregates 2006-2016 1/
(In million of pesos and percentages of GDP, unless otherwise indicated, based on the 1986 GFS Manual)

	Projections										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
(In millions of Pesos, unless otherwise indicated)											
Public Sector											
Non Financial Public Sector											
Revenues	133,714	157,132	170,943	197,234	232,293	259,197	295,159	329,764	366,391	404,312	447,029
<i>Taxes</i>	92,955	105,054	120,560	134,334	152,175	174,362	194,171	214,609	236,923	261,198	287,800
<i>Non Tax</i>	9,028	10,234	10,190	10,541	12,396	14,069	15,653	17,259	19,026	20,978	23,128
<i>Social Security</i>	25,155	28,473	34,778	42,922	49,742	58,116	67,338	77,299	87,685	97,041	108,448
<i>SOE Operating balance</i>	6,577	13,370	5,414	9,438	17,981	12,650	17,997	20,596	22,757	25,094	27,653
Primary expenditures	117,229	138,955	163,784	192,167	219,736	247,164	278,197	310,291	343,325	378,763	418,175
<i>Current</i>	105,009	122,836	142,593	168,187	191,163	218,288	246,070	274,642	304,648	337,073	373,721
<i>Capital</i>	12,220	16,119	21,191	23,980	28,574	28,876	32,127	35,649	38,678	41,690	44,455
Primary balance (Local governments)	1,726	1,053	925	2,132	872	863	707	1,104	1,212	1,336	1,473
Primary balance (NFPS)	18,211	19,230	8,084	7,200	13,429	12,896	17,669	20,577	24,277	26,885	30,326
Primary balance (BSE and BCU)	-839	509	686	450	664	806	422	448	474	523	577
Primary balance (Public Sector)	17,373	19,740	8,770	7,649	14,093	13,703	18,091	21,025	24,751	27,408	30,903
<i>Interest</i>	19,928	19,681	18,630	19,850	23,861	26,599	29,360	32,309	35,625	38,372	41,762
Overall balance	-2,555	58	-9,860	-12,200	-9,768	-12,897	-11,269	-11,284	-10,874	-10,964	-10,859
Public Gross Debt, million US dollars	13,717	16,319	16,534	21,891	23,085	24,374	24,978	25,536	26,021	26,282	26,478
External	9,330	11,081	10,748	12,775	12,981	14,068	14,638	15,194	15,678	15,939	16,027
Domestic	4,386	5,238	5,786	9,116	10,105	10,307	10,341	10,343	10,343	10,343	10,451
Foreign-currency debt, million US dollars	11,187	11,323	11,543	14,304	13,060	13,624	13,923	13,980	14,054	13,678	13,387
Short term debt (remaining maturity), million of US dollars	835	1,135	992	2,445	3,575	3,648	3,678	3,728	3,769	3,833	3,980
(In percent of GDP, unless otherwise indicated)											
Public Sector											
Non Financial Public Sector											
Revenues	28.0	28.0	26.2	27.9	28.8	28.3	28.9	29.3	29.6	29.6	29.7
<i>Taxes</i>	19.5	18.7	18.5	19.0	18.8	19.0	19.0	19.1	19.1	19.1	19.1
<i>Non Tax</i>	1.9	1.8	1.6	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
<i>Social Security</i>	5.3	5.1	5.3	6.1	6.2	6.3	6.6	6.9	7.1	7.1	7.2
<i>SOE Operating balance</i>	1.4	2.4	0.8	1.3	2.2	1.4	1.8	1.8	1.8	1.8	1.8
Primary expenditures	24.6	24.8	25.1	27.2	27.2	27.0	27.3	27.6	27.7	27.7	27.8
<i>Current</i>	22.0	21.9	21.8	23.8	23.7	23.8	24.1	24.4	24.6	24.7	24.8
<i>Capital</i>	2.6	2.9	3.2	3.4	3.5	3.2	3.2	3.2	3.1	3.1	3.0
Primary balance (Local governments)	0.4	0.2	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Primary balance (NFPS)	3.8	3.4	1.2	1.0	1.7	1.4	1.7	1.8	2.0	2.0	2.0
Primary balance (BSE and BCU)	-0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Primary balance (Public Sector)	3.6	3.5	1.3	1.1	1.7	1.5	1.8	1.9	2.0	2.0	2.1
<i>Interest</i>	4.2	3.5	2.9	2.8	3.0	2.9	2.9	2.9	2.9	2.8	2.8
Overall balance	-0.5	0.0	-1.5	-1.7	-1.2	-1.4	-1.1	-1.0	-0.9	-0.8	-0.7
Public Gross Debt	70.3	63.2	61.7	61.0	57.1	51.8	49.4	47.5	45.5	43.1	40.7
External	47.9	42.9	40.1	35.6	32.1	29.9	28.9	28.2	27.4	26.2	24.6
Domestic	22.5	20.3	21.6	25.4	25.0	21.9	20.4	19.2	18.1	17.0	16.1
Foreign-currency denominated debt	57.4	43.8	43.0	39.9	32.3	29.0	27.5	26.0	24.6	22.4	20.6
Short term debt (remaining maturity)	4.3	4.4	3.7	6.8	8.8	7.8	7.3	6.9	6.6	6.3	6.1
Memorandum items											
Real revenues growth, in percent	5.7	8.7	0.8	7.8	10.4	3.3	6.5	5.4	4.8	4.1	4.3
Real primary spending growth, in percent	7.0	9.6	9.3	9.6	7.2	4.2	5.3	5.2	4.4	4.1	4.1
GDP, billions of Pesos	476,707	560,412	653,136	706,883	807,685	916,695	1,019,908	1,124,572	1,239,665	1,366,881	1,506,939

Sources: Ministerio de Economía y Finanzas, Banco Central del Uruguay, and IMF staff calculations.

1/ Authorities are working on preparing fiscal accounts under the 2001 GFS Manual, but coverage includes central government only at this stage. The mission will continue monitoring and publishing consolidated data for the public sector under the 1986 GFS Manual to avoid a loss of information until the full accounting can be provided with the new manual.

Table 3. Statement of Operations of the Central Government 1/ 2/

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

	2006	2007	2008	2009	2010
Revenue	27.1	26.0	25.8	29.5	29.9
Taxes	18.8	18.1	17.8	18.9	18.9
Social Contributions	5.6	5.4	5.7	8.8	8.9
Grants	0.0	0.0	0.0	0.0	0.0
Other revenue	2.7	2.5	2.4	1.9	2.1
Expense	26.6	26.0	24.9	29.4	29.4
Compensation of employees	6.0	5.9	5.9	7.2	6.8
Use of goods and services	4.1	4.0	3.7	3.7	3.7
Consumption of fixed capital 3/	....	....	....	....	....
Interest	4.2	3.7	2.8	2.8	2.4
Subsidies	2.1	2.6	2.5	0.3	0.2
Grants	0.0	0.0	0.0	0.6	0.0
Social benefits	10.2	9.7	10.0	12.9	13.4
Other expenses	0.0	0.0	0.0	1.9	2.9
Net acquisition of nonfinancial assets	1.4	1.5	1.8	1.6	1.4
Acquisitions of nonfinancial assets 3/	....	....	....	....	....
Disposals of nonfinancial assets 3/	....	....	....	....	....
Consumption of fixed capital 3/	....	....	....	....	....
Gross Operating Balance	0.5	0.0	0.9	0.1	0.5
Net Operating Balance 4/	....	....	....	....	....
Net lending (+) borrowing (-)	-0.9	-1.5	-0.9	-1.5	-0.9
Net acquisition of financial assets	-2.2	2.3	-0.9	4.6	-2.3
<i>By instrument</i>					
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0
Currency and deposits	-1.7	2.6	-1.1	1.9	-2.1
Debt securities	0.0	0.0	0.0	1.9	0.1
Loans	-0.5	-0.3	0.3	0.1	-0.3
Equity and shares	0.0	0.0	0.0	0.7	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0
Derivatives	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.0	0.0	0.0	0.0	0.0
<i>By residency</i>					
Domestic	-2.2	2.3	-0.9	4.6	-2.3
External	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-1.4	3.9	0.2	6.2	-1.2
<i>By instrument</i>					
SDRs	0.0	0.0	0.0	0.0	0.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0
Debt securities	10.2	3.9	-0.8	1.4	0.0
Loans	-11.6	0.0	1.0	4.8	-1.1
Equity and shares	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0
Derivatives	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.0	0.0	0.0	0.0	0.0
<i>By residency</i>					
Domestic	0.5	-0.4	1.5	3.8	-0.8
External	-1.9	4.3	-1.3	2.4	-0.4
Memorandum items					
Public Sector Net lending (+) borrowing (-)	-0.5	0.0	-1.5	-1.7	-1.2
Public Sector Primary Balance	3.6	3.5	1.3	1.1	1.7

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

1/ Central government and Social Security Bank. Collection of above the line data for municipalities is not feasible at this moment.

2/ Preliminary data. Authorities are in the process of revising historical data in the context of their work to improve reporting under the 2001 GFS framework.

3/ Not compiled by the authorities.

4/ Not available.

Table 4. Central Government Stock Positions

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

	2006	2007	2008	2009	2010
Stock positions:					
Net worth	....	....	....	....	....
Nonfinancial assets	....	....	....	....	....
Net financial worth	-56.9	-46.3	-46.7	-38.7	-35.6
Financial assets	11.4	11.1	9.1	11.1	8.7
<i>By instrument</i>					
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0
Currency and deposits	7.2	8.2	6.6	7.0	4.4
Debt securities	0.0	0.0	0.0	1.5	2.0
Loans	4.2	2.9	2.4	1.9	1.6
Equity and shares	0.0	0.0	0.0	0.7	0.6
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0
Derivatives	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.0	0.0	0.0	0.0	0.0
<i>By residency</i>					
Domestic	11.3	11.0	9.0	11.1	8.6
External	0.0	0.0	0.0	0.0	0.0
Liabilities	68.3	57.4	55.8	49.8	44.2
<i>By instrument</i>					
SDRs	0.0	0.0	0.0	0.0	0.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0
Debt securities	50.6	44.1	41.7	35.7	32.5
Loans	17.7	13.3	14.0	14.2	11.7
Equity and shares	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0
Derivatives	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.0	0.0	0.0	0.0	0.0
<i>By residency</i>					
Domestic	24.2	19.2	20.2	20.3	17.9
External	44.1	38.2	35.6	29.5	26.4
<i>Memorandum items</i>					
Central Government Gross Debt	68.3	57.4	55.8	49.8	44.2
General Government Gross Debt	69.4	58.2	56.5	50.3	44.6
Public Sector Gross Debt	70.3	63.2	61.7	61.0	57.1
Public Sector External Debt	47.9	42.9	40.1	35.6	32.1

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

Table 5. Uruguay: Summary Accounts of the Banking System

(In millions of U.S. dollars)

	2006	2007	2008	2009	2010	2011 4/
1. Banco Central del Uruguay						
Net foreign assets	3,282	5,208	7,034	8,255	7,659	9,973
Net international reserves 1/	3,085	4,124	6,362	8,040	7,655	10,232
Gross international reserves	3,085	4,124	6,362	8,040	7,655	10,232
Reserve liabilities 1/	0	0	0	0	0	0
Other net foreign assets	198	1,086	674	217	4	-258
Net domestic assets	-1,769	-3,263	-4,858	-5,473	-4,307	-6,301
Net credit to the public sector	931	-55	1,512	991	2,540	1,136
Net credit to the financial system	-1,735	-1,799	-3,314	-2,695	-1,776	-2,576
Credit to the private sector	15	15	14	15	14	15
Securities issued by the BCU	-1,443	-2,564	-2,545	-4,431	-6,134	-6,328
Other	464	1,140	-526	647	1,049	1,452
Peso monetary liabilities	1,513	1,945	2,176	2,782	3,353	3,673
2. Public and Private Banks 2/						
Net foreign assets	2,162	2,345	1,722	2,790	4,906	5,143
Net domestic assets	6,522	7,706	9,856	10,922	11,161	13,435
Net credit to the public sector	317	142	-1	1,222	551	1,287
Net credit to the financial system	2,907	3,352	4,858	5,129	4,678	5,441
Credit to the private sector	4,612	5,968	7,260	7,456	8,949	10,011
Other	-1,313	-1,756	-2,261	-2,885	-3,018	-3,304
Liabilities to the private sector (residents)	8,684	10,051	11,578	13,712	16,067	18,578
Public banks	4,643	5,367	5,978	6,981	8,004	9,385
Local currency	1,140	1,618	1,751	2,352	2,804	3,532
Foreign currency	3,503	3,749	4,227	4,629	5,200	5,853
Private banks	4,041	4,684	5,599	6,731	8,063	9,193
Local currency	702	1,122	1,226	1,808	2,335	2,593
Foreign currency	3,338	3,562	4,373	4,923	5,729	6,600
3. Banking System						
Net foreign assets	5,444	7,552	8,756	11,044	12,566	15,117
Net domestic assets	3,362	2,822	2,501	3,179	4,405	523
Credit to the public sector	1,248	87	1,511	2,213	3,091	2,423
Credit to the rest of financial system	-220	-67	-953	164	453	-3,746
Credit to the private sector	4,626	5,983	7,274	7,471	8,964	10,025
Other	-2,293	-3,180	-5,331	-6,669	-8,103	-8,180
Broad money (M3)	8,806	10,375	11,257	14,224	16,971	15,639
(Percentage change, otherwise indicated)						
Memorandum items (in pesos):						
Base money (end-of-period)	10.3	16.4	29.3	6.5	16.2	11.4
Currency issued	27.7	11.6	14.8	13.2	19.3	19.1
M-1	20.1	29.4	18.6	12.2	33.5	17.9
M-2	21.7	30.6	17.1	15.0	30.3	24.6
M-3	11.6	3.8	28.6	-2.6	22.1	10.0
Credit to private sector (constant exchange rate)	17.3	22.1	28.0	-7.5	21.3	23.8
"Free" international reserves (in millions of US\$) 3/	899	1,847	2,615	4,882	5,808	7,272

Source: Banco Central del Uruguay.

1/ Includes all outstanding liabilities to the IMF, but excludes liabilities to resident financial institutions.

2/ The Banco de la Republica Oriental de Uruguay (BROU), Banco Hipotecario de Uruguay (BHU; mortgage institution), private banks, casas financieras and cooperatives.

3/ Net of liabilities to resident financial institutions.

4/ August/September data.

Table 6. Uruguay: Balance of Payments and External Sector Indicators

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

	2006	2007	2008	2009	Prel.	Projections					
					2010	2011	2012	2013	2014	2015	2016
1. Balance of Payments											
Current account	-392	-220	-1,729	-115	-466	-973	-1,503	-1,372	-1,296	-1,236	-1,228
Trade balance	-499	-545	-1,714	-269	-261	-1,054	-1,734	-1,742	-1,581	-1,571	-1,656
Exports, f.o.b.	4,400	5,100	7,095	6,408	8,059	9,773	10,379	10,955	11,619	12,378	13,260
Imports, f.o.b.	4,898	5,645	8,810	6,677	8,320	10,826	12,113	12,697	13,200	13,949	14,916
Of which: Fuel products	1,138	1,148	2,504	1,354	1,593	2,352	2,400	2,563	2,734	2,885	3,088
Services	409	703	753	950	1,029	1,452	1,648	1,763	1,828	1,942	2,102
Exports, f.o.b.	1,387	1,833	2,277	2,241	2,600	3,403	3,810	4,139	4,466	4,790	5,131
Imports, f.o.b.	979	1,130	1,523	1,291	1,571	1,951	2,162	2,377	2,638	2,848	3,029
Income (net)	-428	-516	-917	-934	-1,352	-1,496	-1,546	-1,525	-1,679	-1,747	-1,819
Transfers (net)	126	137	148	138	118	124	129	132	137	141	145
Financial and capital account	528	1,505	3,098	1,353	1,539	3,190	1,699	1,573	1,486	1,430	1,421
Foreign direct investment	1,493	1,329	2,106	1,593	2,358	2,398	3,623	3,227	3,004	3,154	3,341
Other capital flows (net)	-965	176	992	-240	-819	792	-1,925	-1,654	-1,518	-1,724	-1,920
Portfolio investment (net)	1,686	1,151	-558	-716	-548	...	...	...	...	...	...
Loans (net)	-549	422	667	928	-921	...	...	...	...	...	...
Deposits (net)	222	-1,595	1,316	-955	492	...	...	...	...	...	...
Other flows, net	-2,339	281	-445	520	113	...	...	...	...	...	...
Unidentified Financing	8	-86	11	-16	44	...	...	...	...	...	...
Errors and omissions	-152	-279	864	350	-1,433	0	0	0	0	0	0
Reserve assets (- increase)	15	-1,005	-2,232	-1,588	361	-2,217	-195	-201	-190	-194	-192
2. Reserve Adequacy and External Indicators											
Gross official reserves (stock)	3,085	4,124	6,362	8,040	7,655	9,872	10,068	10,269	10,459	10,653	10,846
In months of next year's imports of goods and services	5.5	4.8	9.6	9.8	7.2	8.3	8.0	7.8	7.5	7.5	7.5
In percent of short-term debt	491.2	471.8	797.2	772.3	318.8	683.3	448.4	378.3	365.8	335.1	254.4
(As percent of GDP)											
Exports of goods	22.2	21.4	22.8	20.5	20.0	20.5	20.5	20.4	20.3	20.3	20.4
Imports of goods	24.7	23.6	28.3	21.3	20.7	22.7	23.9	23.6	23.1	22.9	22.9
Current account	-2.0	-0.9	-5.5	-0.4	-1.2	-2.0	-3.0	-2.6	-2.3	-2.0	-1.9
Financial and capital account	2.7	6.3	9.9	4.3	3.8	6.7	3.4	2.9	2.6	2.3	2.2
Of which: Foreign direct investment (net)	7.5	5.6	6.8	5.1	5.9	5.0	7.2	6.0	5.3	5.2	5.1
Other capital flows (net)	-4.9	0.7	3.2	-0.8	-2.0	1.7	-3.8	-3.1	-2.7	-2.8	-3.0
Changes in GfR	0.1	-4.2	-7.2	-5.1	0.9	-4.7	-0.4	-0.4	-0.3	-0.3	-0.3
Total external debt	54.3	47.4	44.9	39.3	35.1	32.9	33.5	33.5	32.6	31.4	29.8
Short-term debt (residual maturity)	3.2	3.7	2.6	3.3	6.0	3.0	4.4	5.0	5.0	5.2	6.6
External public debt	47.9	42.9	40.1	35.6	32.1	29.9	28.9	28.2	27.4	26.2	24.6
Total external debt + NR deposits	66.7	57.6	57.6	50.2	46.0	42.7	43.3	43.2	42.3	41.1	39.5
(As percent of annual exports of goods and services)											
Total external debt	182.8	176.5	128.4	163.0	132.9	117.3	119.4	119.2	116.0	111.4	105.6
Total external debt (including nonresidential deposits)	224.6	214.6	164.7	208.1	174.5	152.2	154.3	154.0	150.6	145.8	139.8
Debt service	83.6	26.1	21.7	22.9	28.5	27.2	18.2	16.5	16.6	17.0	21.4
Of which: Interest payments	15.7	12.5	8.9	9.3	7.8	7.1	6.5	5.6	5.8	5.4	5.1
(Annual percent changes)											
Exports of goods (merchandise)	16.6	15.9	39.1	-9.7	25.8	21.3	6.2	5.6	6.1	6.5	7.1
Imports of goods (merchandise)	30.5	15.2	56.1	-24.2	24.6	30.1	11.9	4.8	4.0	5.7	6.9
Export prices in US\$ (year-on-year percent change)	10.3	11.6	22.8	-10.0	9.9	15.6	-0.7	0.7	0.8	1.8	2.6
Import prices in US\$ (year-on-year percent change)	8.6	9.0	24.3	-15.6	9.5	11.3	-0.3	0.0	0.0	0.2	0.7
Terms of trade	1.6	2.3	-1.2	6.7	0.4	3.9	-0.3	0.7	0.8	1.6	1.9
Export volume	3.2	7.4	10.1	2.5	12.1	3.3	8.3	5.5	5.6	4.8	4.4
Import volume	15.3	5.7	22.7	-8.6	13.4	15.2	12.1	5.5	5.0	5.8	6.1

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

ANNEX I. URUGUAY: TRENDS IN REAL ESTATE PRICES¹

This annex reviews recent real estate price developments in Uruguay. The analysis is hampered by data availability but our preliminary finding, based on standard indicators, is that real estate prices (at least in Montevideo) do not seem overvalued.

A. Introduction

1. **Uruguay's real estate market has been very dynamic in the past five years.**

Several intertwined factors have contributed: first, the economic boom since 2004 has led to a strong increase in households' disposable income and a decline in unemployment—both of which have contributed to the demand for housing; second, an international environment of low global interest rates and high commodity prices has contributed to a substantial foreign demand (via FDI) for real estate and land for agriculture, meat, and paper/pulp production. These demand factors have led to rising prices and increasing construction activity.

2. **The price developments are different depending on whether measured in U.S. dollars or in pesos because of the appreciation of the peso/dollar rate in recent years.**² Given the prevailing dollarization in Uruguay, many Uruguayans still save in U.S. dollars (foreign currency deposits

are some 72 percent of total) and real estate prices are often quoted in foreign currency. At the same time, most workers' salaries are in pesos so looking at peso prices makes sense when considering affordability. Thus, there is no right or wrong measure and this note will look at prices in dollars, pesos, and "real pesos", i.e., adjusted for inflation to provide a comprehensive view.

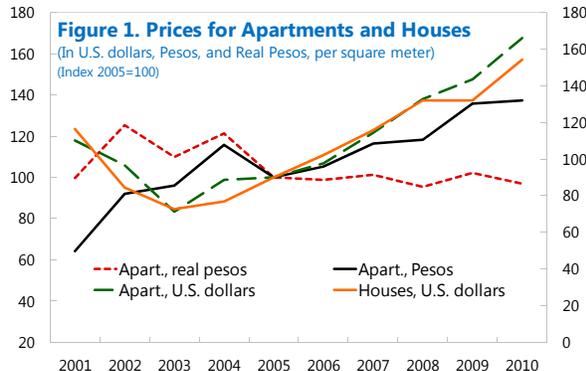
3. **The analysis is hampered by important data constraints so it should be seen as preliminary.** Although there is significant information on the real estate market, most of it is limited to Montevideo, and there is no publicly available data for regions such as Punta del Este and other areas that have attracted much of the foreign capital inflows (e.g., agricultural and forestry areas). Furthermore, there is no disaggregation between new and old stock of houses and apartments sold and the available data for 2010 is incomplete.

¹ Prepared by M. Rosales.

² The Peso has appreciated by 30 percent since 2004.

B. Price Developments

4. **Prices for houses and apartments have increased by about 11 and 13 percent a year, respectively, in dollar terms over the last five years.** For apartments, this translates into an increase of about 7 percent a year in peso terms, and in real peso terms there has



Sources: Instituto Nacional de Estadística del Uruguay and IMF staff calculations.

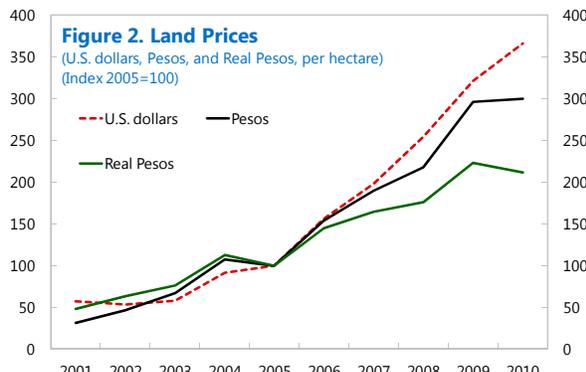
been no increase (Figure 1 and Table 1). There is, however, anecdotal evidence from private analysts, real estate developers and intermediaries of sharper price increases in certain markets, such as in Punta del Este.

Table 1. Uruguay: Trends in Housing Prices, (Annual Change)

	Apartments			Houses		
	In U.S. dollars	In Pesos	In Real Pesos	In U.S. dollars	In Pesos	In Real Pesos
2002	-11.3	30.3	20.6	-29.9	18.6	7.3
2003	-27.0	4.3	-9.9	-12.3	15.4	2.8
2004	15.6	17.1	9.3	4.0	5.7	-3.2
2005	1.2	-15.8	-22.3	11.8	-3.4	-9.2
2006	6.5	4.9	-0.6	9.7	8.2	2.9
2007	12.0	9.8	2.8	9.9	7.6	0.5
2008	12.0	1.4	-6.3	10.4	-0.4	-8.4
2009	6.3	13.0	6.5	0.2	7.4	0.5
2010	12.0	1.0	-5.6	12.4	1.5	-5.0
2005-2010	67.5	37.2	-2.5	57.0	28.6	-8.6

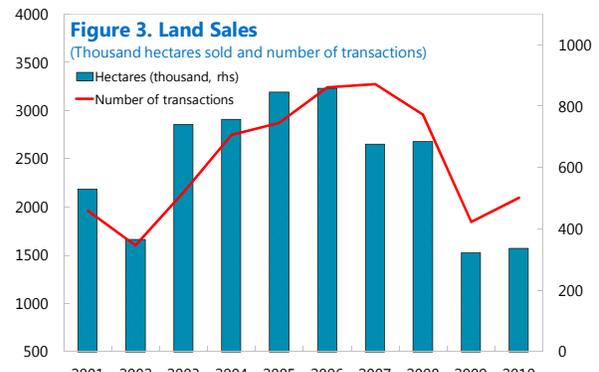
Sources: Instituto Nacional de Estadística del Uruguay and IMF staff calculations.

5. **Land prices have increased at a much faster pace, at close to 53 percent a year in dollar terms (Figure 2).** The strong demand for land in Uruguay reflects the expansion in agriculture production and global prices. For example, soy prices rose by nearly 125 percent in dollar terms over the five year period between 2005 and 2010. International producers have moved to Uruguay, and the



Sources: Instituto Nacional de Estadística del Uruguay and IMF staff calculations.

country's soy production has tripled since 2005, while the cultivated area has increased from around 300,000 hectares in 2005 to around 1 million hectares in 2010. The greater demand for land is also evident in the number of land sale transactions. Measured in terms of number of transactions and areas sold, the sale of land peaked in 2006 and has since been on a declining trend (Figure 3).



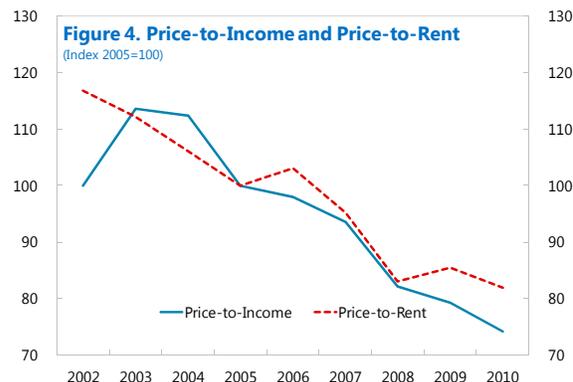
Sources: Instituto Nacional de Estadística del Uruguay and IMF staff calculations.

C. Price Comparisons

6. Neither the price-to-rent nor the price-to-income ratio suggests overvaluation.

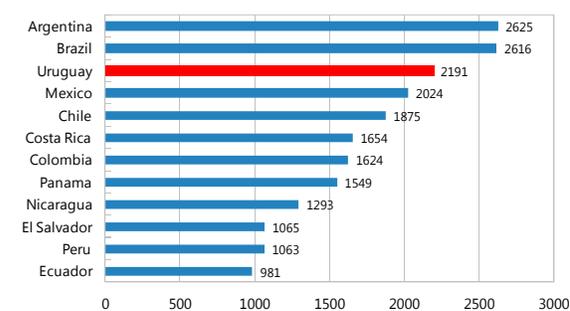
House prices that rise persistently faster than rent or income are typically seen as indications of overvaluation.³ In Uruguay, the price-to-rent ratio—calculated based on renting costs from the consumer price index—has actually declined steadily in recent years (Figure 4). The price-to-income ratio has also declined in recent years suggesting that real estate (at least in Montevideo) has become more affordable.

7. **The prices for apartments in Uruguay are among the highest in the region.** The Global Property Guide ranks Uruguay as having the third most expensive apartments in Latin America (Figure 5).



Sources: Instituto Nacional de Estadística del Uruguay and IMF staff calculations.

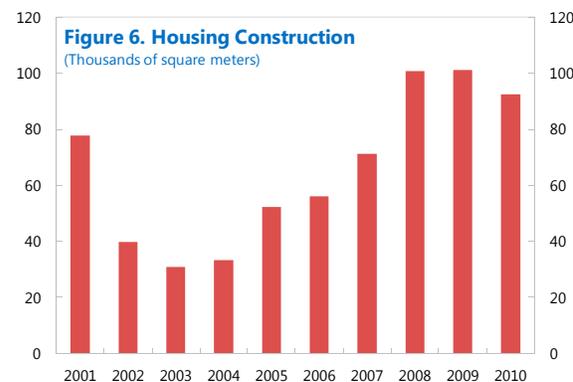
Figure 5. Apartment Prices in Latin America (Per square meter)



Source: Global Property Guide.

D. Supply Response

8. **The strong real estate demand has led to an important response in construction.** The sector expanded rapidly during 2005-08, as measured by housing construction in square meters, but has been stable since then (Figure 6). Looking at construction activity as measured in the national accounts gives a relatively similar picture: construction sector GDP growth averaged 7 percent a year in 2005-10.



Sources: Instituto Nacional de Estadística del Uruguay and IMF staff calculations.

³ The international evidence is that the long-run elasticity of house prices with respect to disposable income is about one, abstracting from quality improvements. See e.g., Andrews, D., A. Caldera Sanchez and Å. Johansson (2011), "Housing Markets and Structural Policies in OECD Countries", OECD Working Paper No. 836.

E. Construction Costs

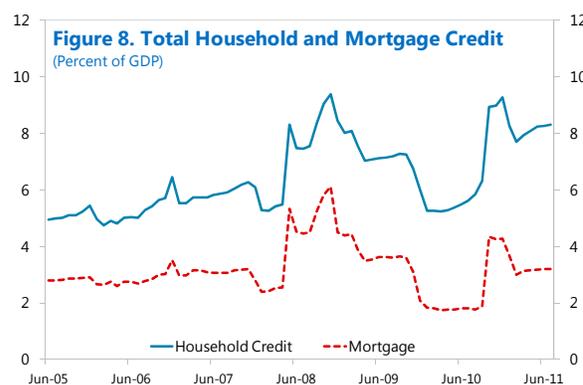
9. **Construction costs have increased rapidly and contributed to higher real estate prices.**⁴ The construction costs for apartments increased by about 18 percent a year in dollar terms on average in 2005-10 (11 percent when measured in pesos). (Figure 7)



Sources: Instituto Nacional de Estadística del Uruguay and IMF staff calculations.

F. Financing

10. **Banking credit has not been a main source of financing for the housing activity.** Most of the financing has been in the form of FDI or cash, including through pooling in trust funds. Total mortgage credit is fairly low as a percentage of GDP, despite a jump in 2010 (the mortgage data is hard to interpret because it is affected by balance sheet changes in the state-owned Banco Hipotecario). Figure 8.

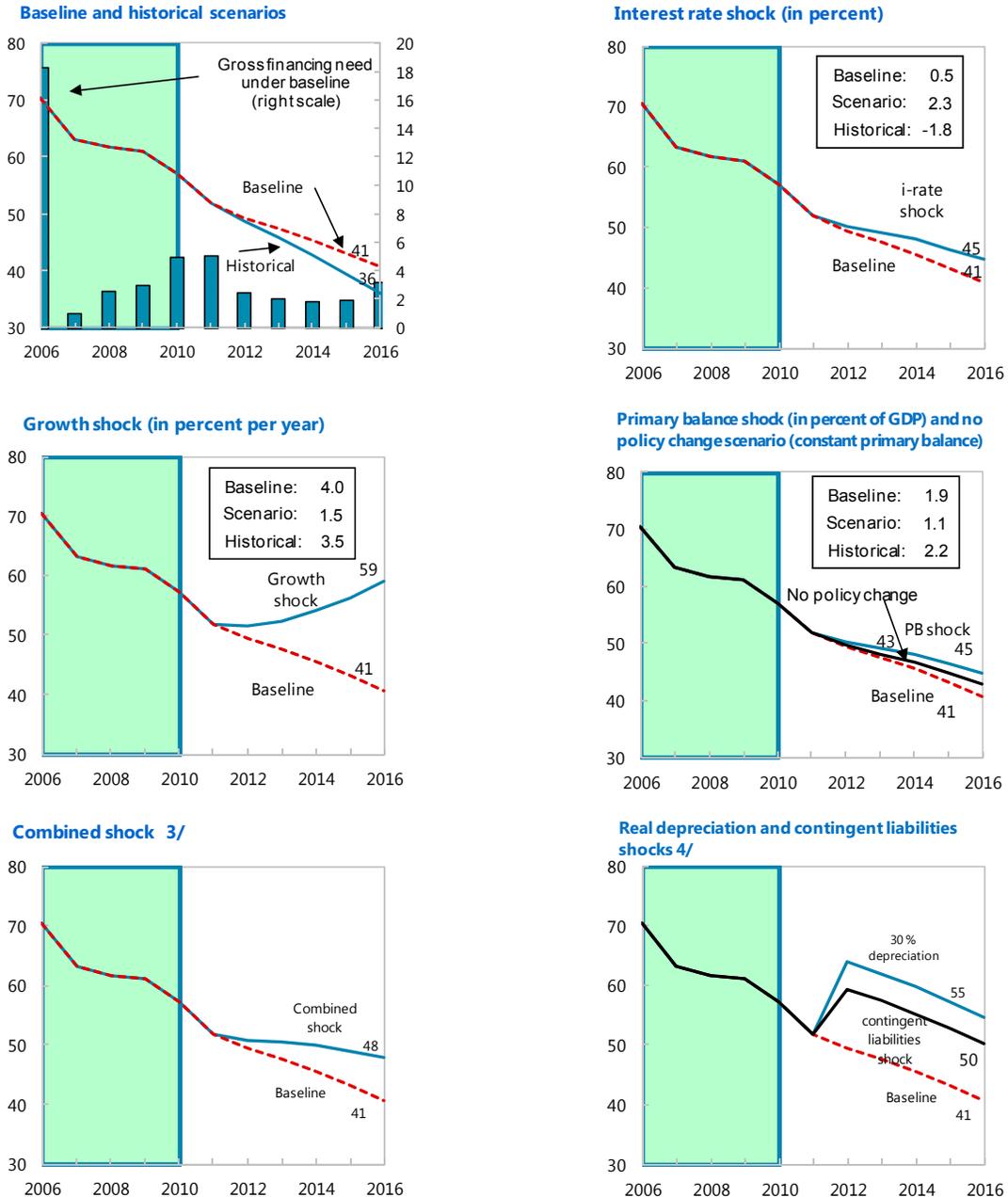


Sources: Banco Central del Uruguay and IMF staff calculations.

⁴ In OECD countries, there are estimates that a 10 percent rise in constructions costs is associated with a 4 percent increase in real house prices. Andrews, D., (2010), "Real House Prices in OECD Countries: The Role of Demand Shocks and Structural and Policy Factors," *OECD Working Paper* No. 831.

ANNEX II. URUGUAY: DEBT SUSTAINABILITY ANALYSIS

Figure A2.1. Uruguay: Public Debt Sustainability: Bound Tests 1/ 2/ (Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and IMF staff estimates.
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
 4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2012, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A2.1. Uruguay: Public Sector Debt Sustainability Framework, 2006-16
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 9/ -0.5
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	
Baseline: Public sector debt 1/	70.3	63.2	61.7	61.0	57.1	51.8	49.4	47.5	45.5	43.1	40.7	
o/w foreign-currency denominated	57.4	43.8	43.0	39.9	32.3	29.0	27.5	26.0	24.6	22.4	20.6	
Change in public sector debt	-7.3	-7.2	-1.5	-0.6	-3.9	-5.3	-2.5	-1.9	-2.0	-2.4	-2.4	
Identified debt-creating flows (4+7+12)	-5.7	-16.3	-2.6	-11.0	-5.9	-5.4	-4.1	-3.6	-3.5	-3.4	-3.3	
Primary deficit	-3.6	-3.5	-1.3	-1.1	-1.7	-1.5	-1.8	-1.9	-2.0	-2.0	-2.1	
Revenue and grants	31.0	30.8	28.9	30.5	31.5	31.1	31.7	32.1	32.4	32.4	32.5	
Primary (noninterest) expenditure	27.4	27.3	27.6	29.5	29.7	29.6	30.0	30.3	30.4	30.4	30.4	
Automatic debt dynamics 2/	-2.1	-12.8	-1.2	-9.9	-4.1	-3.9	-2.4	-1.7	-1.5	-1.4	-1.2	
Contribution from interest rate/growth differential 3/	-4.2	-7.0	-6.1	-1.9	-4.7	-3.9	-2.4	-1.7	-1.5	-1.4	-1.2	
Of which contribution from real interest rate	-1.2	-2.6	-1.5	-0.4	-0.1	-0.9	-0.4	0.1	0.2	0.2	0.3	
Of which contribution from real GDP growth	-3.0	-4.4	-4.7	-1.5	-4.5	-3.0	-2.0	-1.8	-1.7	-1.6	-1.6	
Contribution from exchange rate depreciation 4/	2.2	-5.8	4.9	-8.0	0.5	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-1.5	9.1	1.1	10.3	2.0	0.1	1.6	1.7	1.5	1.1	0.8	
Public sector debt-to-revenue ratio 1/	226.7	204.8	213.1	199.7	181.4	166.8	155.5	147.8	140.5	133.2	125.3	
Gross financing need 6/	18.3	1.0	2.6	3.0	5.0	5.1	2.4	2.0	1.8	1.9	3.1	
in billions of U.S. dollars	3.6	0.2	0.8	0.9	2.0	2.4	1.2	1.1	1.0	1.1	2.0	
Scenario with key variables at their historical averages 7/						51.8	48.7	45.8	42.9	39.6	36.2	-1.3
Scenario with no policy change (constant primary balance) in 2011-2016						51.8	49.6	48.1	46.6	44.8	42.9	-0.6
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.3	7.3	8.6	2.6	8.5	6.0	4.2	4.0	4.0	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	6.0	5.9	5.3	4.9	5.5	5.8	6.2	6.4	6.7	6.8	7.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.5	-3.7	-2.1	-0.6	0.2	-1.4	-0.6	0.4	0.7	0.8	1.1	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.3	12.7	-10.9	23.6	-1.4	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	7.5	9.5	7.3	5.5	5.3	7.1	6.8	6.0	6.0	6.0	6.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.9	7.1	9.7	9.6	9.5	5.4	5.5	5.0	4.4	4.0	4.1	
Primary deficit	-3.6	-3.5	-1.3	-1.1	-1.7	-1.5	-1.8	-1.9	-2.0	-2.0	-2.1	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1+r)$.

5/ For projections, this line includes exchange rate changes.

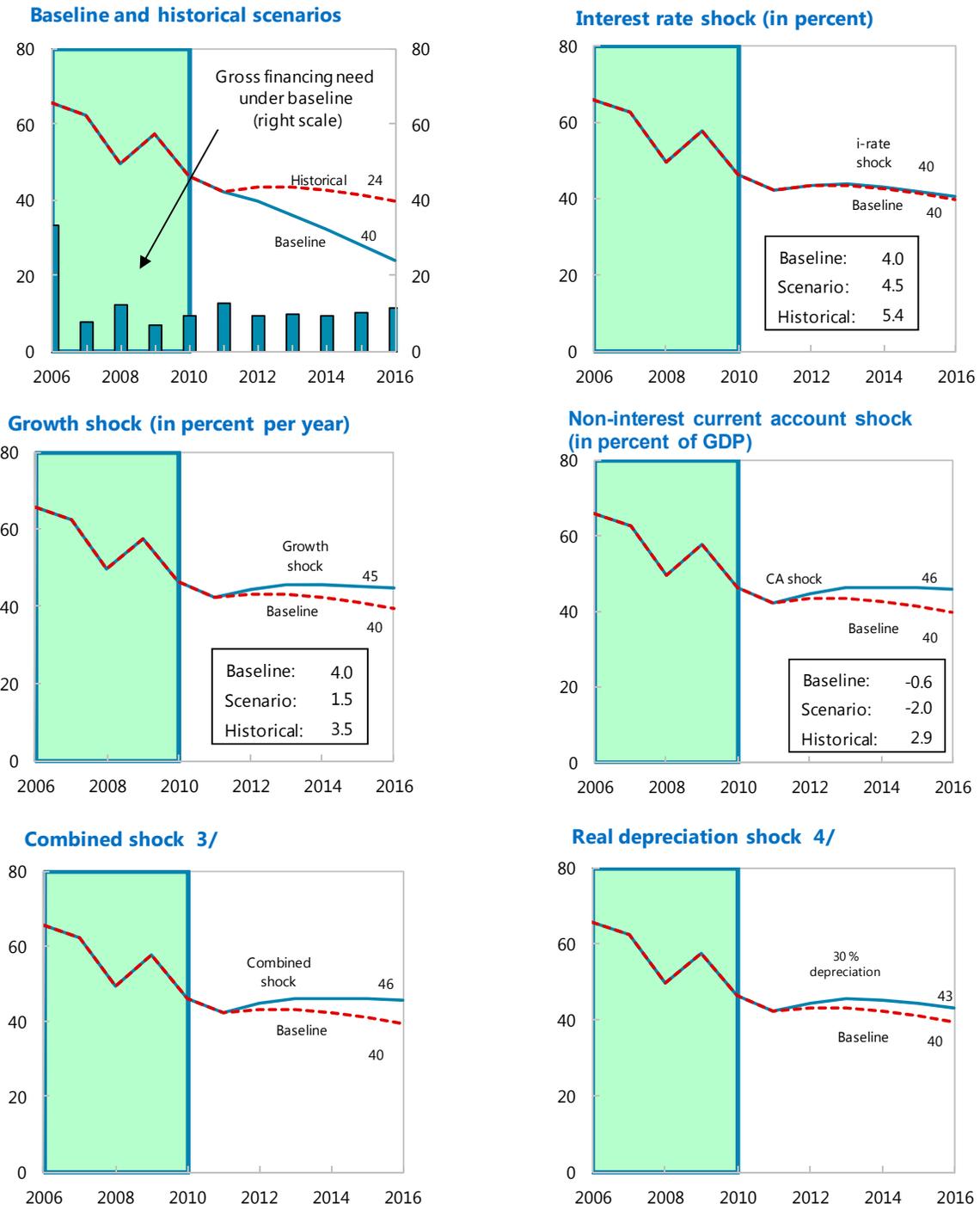
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Figure A2.2. Uruguay: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



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

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

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

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

4/ One-time real depreciation of 30 percent occurs in 2012.



URUGUAY

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 18, 2011

Prepared By

The Western Hemisphere Department

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ANNEX 2. RELATIONS WITH THE WORLD BANK-UNDER JMAP	4
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ANNEX 1. FUND RELATIONS

(As of October 31, 2011)

I. Membership Status: Joined: March 11, 1946

II. General Resources Account:	SDR Million	% Quota
Quota	306.50	100.00
Fund holdings of currency	217.89	71.09
Reserve Tranche Position	88.62	28.91

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	293.26	100.00
Holdings	245.61	83.75

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

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

VI. Projected Payments to Fund⁹

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2011	2012	2013	2014	2015
Principal					
Charges/Interest	<u>0.04</u>	<u>0.15</u>	<u>0.15</u>	<u>0.15</u>	<u>0.15</u>
Total	<u>0.04</u>	<u>0.15</u>	<u>0.15</u>	<u>0.15</u>	<u>0.15</u>

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

VIII. Exchange Rate Arrangement. The currency is the Uruguayan peso (Ur\$). Uruguay has followed an independently floating exchange rate regime since July 29, 2002. Since September 2007, monetary policy uses the policy rate, and no longer monetary targets, as intermediate instrument. In

⁹ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

2008, Uruguay's de facto exchange rate regime was reclassified from a managed float with no predetermined path for the exchange rate to a floating exchange rate regime. On October 31, 2011, the exchange rate in the official market was Ur\$ 19.345 per US dollar. Uruguay has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on payments and transfers for current international transactions.

IX. FSAP participation and ROSCs. The Financial Sector Stability Assessment (FSSA) was considered by the Executive Board on June 28, 2006 (Country Report No. 06/187). The ROSC-module on fiscal transparency was published on March 5, 2001. A ROSC-module on data dissemination practices was published on October 18, 2001. The ROSC on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) was published on December 2006 (Country Report No. 06/435)

X. Technical Assistance 2007–11

Department	Purpose	Date of Delivery
FAD	Private public partnership	May 2010
	Tax, customs, and social security administration	March 2011, September 2010, and February 2007
	Resident advisor on social security administration, 1 year	July 2006 to June 2007
LEG	TA to assist the authorities on the elaboration of a risk-based national strategy enhancing the AML/CFT regime	December 2010
	TA to conduct a money laundering/terrorist financing country risk assessment consistent with the objectives of the national AML/CFT strategy	January, April, and July 2009
	TA to develop a framework to elaborate and implement a national AML/CFT strategy consistent with the recommendations of the Fund's 2005 AML/CFT assessment report	February 2007
MCM	Strengthening the formulation and conduct of monetary and exchange rate policies	May 2007
STA	Monetary and financial statistics	November 2007
	Government Finance Statistics, to assist in improving the quality of public debt data	February 2008

XI. Article IV Consultation. The 2010 Article IV consultation was concluded by the Executive Board on January 28 2011 (Country Report No. 11/62). Uruguay is on the standard consultation cycle governed by the provisions approved by the Executive Board on July 15, 2002.

XII. Resident Representative. Mrs. María Gonzalez. The Resident Representative covers Uruguay from the Buenos Aires' office.

ANNEX 2. RELATIONS WITH THE WORLD BANK- UNDER JMAP

Title	Products	Provisional timing of Missions	Expected delivery date*
Bank work program for next 12 months	A. Lending <ol style="list-style-type: none"> 1. UY Second Programmatic Public Sector (DPL) 2. UY Sustainable Natural Resources Management Loan 3. UY Institutions Building Technical Assistance 4. UY OSE Response to Climate Change 5. UY Transport Infrastructure 		October, 2011 October 2011 November 2011 March 2012 April 2012
	B. ESW <ol style="list-style-type: none"> 1. UY Health Reform Assessment 2. UY Public Expenditure and Financial Accountability 3. Public Sector Expenditure Review <ol style="list-style-type: none"> a. Towards structural balance-based fiscal management b. Assessing fiscal risks in health and pensions c. Quality and efficiency of public expenditure d. Public expenditure in performance-based budgeting framework. 4. UY One Laptop per Child 5. UY Low Carbon Study 		September 2011 October 2011 May 2012 March 2012 May 2012
	C. Technical Assistance <ol style="list-style-type: none"> 1. UY Capacity Building to the Ministry of Economy and Finance on Private Public Partnerships 		July 2011

*Delivery date refers to the Board date in lending projects, and to delivery to client in case of AAA.

ANNEX 3. RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of October 31, 2011)

11. The Inter-American Development Bank's Board of Executive Directors approved in August 2011 the new Country Strategy with Uruguay (2010-2015).

Sovereign-guaranteed lending under the new program is expected to reach approximately US\$1.8 billion, which is considered to be consistent with Uruguay's five year budget. The program includes additional non reimbursable financing for technical assistance and analytical work. Lending under the previous Country Strategy (2005-09) reached approximately US\$1.3 billion.

12. Under the new Strategy, the national authorities and the Bank identified the following priority sectors in which the IDB Group would focus both its financial and non-financial products and services:

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

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

13. As of September 30th 2011, the Bank's portfolio in Uruguay includes loans for the financing of 35 projects; two of which are to the private sector without sovereign guarantee.

The lending portfolio amounts to US\$1,000.4 MM, of which US\$455.0 MM are pending disbursement. Disbursements in 2011 are expected to total US\$150 MM. The portfolio includes lending to support the Government in the following sectors: infrastructure and environment (12 loans adding US\$516.4 MM and representing 52% of the approved amounts); social sector (5 loans adding US\$172.2 MM, representing 17% of the approved amounts); institutional capacity and finance (14 loans adding US\$266.8 MM and representing 27% of the approved amounts) and integration and trade (2 loans, adding US\$17.0 MM; 2% of the approved amounts). The portfolio also includes two loans to the private sector for US\$28 MM (3% of the approved amounts).

14. The 2010 lending program included the approval of US\$40 MM investment loan to support the implementation of the National Strategy for Childhood and Adolescence and an investment loan in support of secondary education

(US\$48 MM). In 2011, the Bank approved loans to the public sector in the areas of agricultural productivity (US\$28.4 MM), e-Government (US\$10.9 MM) and off-shoring (US\$ 10 MM) as well as a (US\$200 MM) non-sovereign guaranteed loan for a pulp mill. By the end of 2011, the Bank expects to approve

loans in the areas of transportation (US\$80 MM), local development and municipal management (US\$70 MM), water and sanitation (US\$63.3 MM) and tourism (US\$5 MM) as well as a non-sovereign guaranteed loan of US\$65MM loan to an agribusiness company.

Financial Relations with the Inter-American Bank

(In millions of U.S. Dollars)

Total outstanding loans: US\$1,948.1^{1/}

	Loan Transactions									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 ^{2/}
Disbursements	558.6	367.2	53.1	242.3	114.8	112.9	337.2	477.3	54.3	150.0
Amortization	73.1	103.7	113.3	220.0	519.6	133.8	138.7	162.0	462.7	116.2
Net loan flows	485.5	263.6	-60.2	22.3	-404.8	-20.9	198.5	328.8	-408.4	33.8

Source: Inter-American Development Bank

^{1/} As of September 30, 2011.

^{2/} IDB staff projection.

ANNEX 4. STATISTICAL ISSUES

(As of November 1, 2010)

I. Assessment of Data Adequacy for Surveillance
<p>General: Data provision has some shortcomings, but broadly adequate for surveillance. Most affected area is national accounts.</p>
<p>National Accounts: In 2009, the Uruguayan authorities completed a revision of national accounts statistics, in which they updated the benchmark year (from 1983 to 1997 and 2005) and adopted the <i>System of National Accounts 1993 (SNA93)</i>. However, national accounts statistics still have a number of shortcomings, limited coverage of the enterprise survey, long publication lags, inadequate information on the informal economy, and incomplete quarterly accounts. The central bank (BCU) compiles and disseminates annual GDP estimates in current and at previous year prices by the production and expenditure approaches, as well as quarterly constant price GDP estimates by the production and expenditure approaches. Gross national income, gross disposable income and gross savings are also available annually.</p>
<p>Consumer prices: Both the consumer and wholesale price indices are reported on a regular and timely basis for publication in the <i>IFS</i>. The new base period for the consumer price index is December 2010 = 100; coverage of the CPI, which was previously limited to the capital city, CPI now has national coverage and a more detailed basket with nearly fifty thousand price quotations included in the index. The base of the wholesale price index has been updated to 2001. Producer price indices (March 2010 = 100) for national products have been recently disseminated. The authorities do not provide trade price and volume indices for publication in the <i>International Financial Statistics (IFS)</i>.</p>
<p>Government finance statistics: Official data on the central administration, the state enterprises and the social security system are complete and current, but there are problems with the timeliness of the data on local governments. There are also problems with the timeliness of financing and debt data reported for inclusion in the Fund's statistical publications. Information on a monthly and quarterly basis for financing and debt data respectively, are disseminated on the BCU website from 1999 onwards for the central government and total public sector, but no information is reported for publication in the <i>International Financial Statistics</i>. The information reported for publication in the <i>Government Finance Statistics Yearbook</i> covers transactions on revenue and expense for the consolidated central government (data on revenue and expense for local governments have not been reported since 1994), and the general government's operations on financial assets and liabilities, both in terms of flows (financing) and stocks (debt).</p>

Monetary and financial statistics: Monetary and financial statistics are prepared in accordance with the IMF's *Monetary and Financial Statistics Manual (2000)*. Authorities report monetary data for the central bank, other depository corporations, and other financial corporations (OFCs) using the standardized reporting forms (SRFs). However, data for the OFCs are limited to off-shore financial institutions. A mission could be fielded in FY 2012 to expand the institutional coverage of the OFCs and compile the SRF for OFCs with full institutional coverage. Authorities reported annual Financial Soundness Indicators (FSI) for 2008, 2009, and 2010, but the historical series and updates have not been submitted.

External sector statistics: Balance of payments statements are compiled and published on a quarterly basis. Data are compiled following the recommendations of the fifth edition of the *Balance of Payments Manual*. Uruguay compiles and reports to STA quarterly data on balance of payments and annual data on the international investment position (IIP) for publication in the *IFS* and the *Balance of Payments Statistics Yearbook*. New surveys are allowing for improved coverage of the private sector in the IIP.

Uruguay started disseminating the international reserves and foreign currency liquidity data template on the Fund's external website in 2005. The BCU also disseminates quarterly external debt statistics on its website, although not in the format envisaged by the SDDS.

II. Data Standards and Quality

Uruguay subscribed to the SDDS in February 2004 and is in observance.

Data ROSC published on October 1, 2001.

III. Reporting to STA (Optional)

No data are currently reported to STA for publication in the *Government Finance Statistics* or in the *International Financial Statistics*.

TABLE. URUGUAY: COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of October 31, 2011)

	Date of latest observation	Date received	Frequency of Data 6/	Frequency of Reporting 6/	Frequency of Publication 6/
Exchange Rates	Oct. 31, 2011	11/01/11	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1	Oct. 2011	11/01/11	M	M	M
Reserve/Base Money	Sept. 2011	10/17/11	M	M	M
Broad Money	Sept. 2011	10/17/11	M	M	M
Central Bank Balance Sheet	Sept. 2011	10/17/11	M	M	M
Consolidated Balance Sheet of the Banking System	Aug. 2011	10/17/11	M	M	M
Interest Rates 2/	Oct. 31, 2011	11/01/11	D	D	D
Consumer Price Index	Oct. 2011	11/03/11	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	Sept. 2011	10/31/11	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt 5/	Q2/11	9/30/11	Q	Q	Q
External Current Account Balance	Q2/11	9/30/11	Q	Q	Q
Exports and Imports of Goods and Services	Q2/11	9/30/11	Q	Q	Q
GDP/GNP	Q2/11	9/14/11	Q	Q	Q
Gross External Debt	Q2/11	9/30/11	Q	Q	Q

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

3/ Foreign, domestic bank, and domestic nonbank financing.

4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

5/ Including currency and maturity composition.

6/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).



INTERNATIONAL MONETARY FUND

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December 9, 2011

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IMF Executive Board Concludes 2011 Article IV Consultation with Uruguay

On December 5, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the 2011 Article IV consultation with Uruguay.¹

Background

Uruguay's strong economic growth in recent years has produced significant welfare gains. Per capita income in purchasing power terms has doubled from its pre-2002 crisis levels, unemployment has fallen to record lows, and social indicators have improved further. The key factors behind this performance include important policy reforms, prudent macroeconomic policies, social policies and a favorable external environment.

The growth momentum has continued into 2011 but a slowdown is underway led by weaker exports and slower public investment. Real Gross Domestic Product (GDP) growth is projected at 6 percent in 2011 and 4.25 percent in 2012. Inflation at 7.9 percent in October remains above the target range (4-6 percent). The central bank tightened monetary policy in the first half of 2011 but it has left the tightening cycle in pause since late September to allow the global outlook to become clearer. The fiscal deficit has narrowed, and the gross public debt has continued to fall (to 55 percent of GDP in June).

The baseline outlook is positive but with downside risks stemming from the highly uncertain global outlook. Uruguay's economic and financial vulnerabilities are modest, and the government has reduced debt vulnerabilities significantly and built important financial buffers; still the spillovers of a deteriorating global outlook could be significant. A long-term policy challenge is to sustain strong and balanced growth with less volatility than in the past.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Executive Board Assessment

Executive Directors commended the authorities' skillful macroeconomic management that has underpinned Uruguay's excellent economic performance, lowered public indebtedness, and strengthened buffers against shocks. Uruguay's economic outlook is positive, although with downside risks stemming from the uncertain outlook for advanced economies.

Directors agreed that the main near term challenge will be to frame domestic policies to address both the cyclical requirements and the risk of negative spillovers from abroad. A flexible approach to policymaking will be crucial in the period ahead. For the longer term, Directors stressed that further fiscal and structural reforms are needed to secure a stable high growth path.

Directors welcomed the monetary tightening in the first half of 2011 to bring inflation toward the target range. They agreed that a "wait and see" approach is appropriate at present, given lack of clarity about the general direction of the global economy. A resumption of the tightening cycle will be warranted if global risks recede. Directors agreed that the central bank could explore ways to better anchor inflation expectations by communicating more clearly its inflation forecast and its responses to shocks. Directors considered that the flexible exchange rate regime has served Uruguay well, and encouraged the authorities to limit market intervention to smoothing operations.

Directors generally agreed that maintaining a broadly neutral fiscal stance is appropriate, although automatic stabilizers should be allowed to operate as developments warrant, so long as debt dynamics remain favorable. Directors commended the authorities' public debt management, and supported their goal to further reduce the public debt ratio over the medium term. They also welcomed progress on the public private partnership framework to tackle infrastructure gaps.

Directors saw merit in ongoing initiatives to upgrade workers' skills, but noted that other recent reforms may have reduced the flexibility of the labor market. They stressed the importance of reforms that support a dynamic economy while fostering equity. A few Directors cautioned that widespread indexation in wage agreements would complicate inflation targeting and could undermine competitiveness.

Directors welcomed the announced reforms to strengthen banks' capital and improve dynamic provisioning. They supported closer monitoring of credit card companies, and encouraged more extensive information requirements for non banks. Directors encouraged the authorities to continue their efforts to promote de dollarization.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Uruguay: Basic Data

	2006	2007	2008	2009	2010	Projections	
						2011	2012
(Annual percent change, unless otherwise specified)							
Real GDP	4.3	7.3	8.6	2.6	8.5	6.0	4.2
Real consumption	5.9	6.3	8.2	2.3	10.1	8.3	3.5
Real investment	16.8	8.1	28.9	-12.7	13.2	12.6	6.9
Prices							
CPI inflation (average)	6.4	8.1	7.9	7.1	6.7	8.0	6.9
CPI inflation (eop)	6.4	8.5	9.2	5.9	6.9	8.0	6.4
Terms of trade	1.6	2.3	-1.2	6.7	0.4	3.9	-0.3
(In percent of GDP)							
Public sector finances							
Total revenues	28.0	28.0	26.2	27.9	28.8	28.3	28.9
Non-interest expenditure	24.6	24.8	25.1	27.2	27.2	27.0	27.3
Primary balance	3.6	3.5	1.3	1.1	1.7	1.5	1.8
Overall balance	-0.5	0.0	-1.5	-1.7	-1.2	-1.4	-1.1
Gross public sector debt	70.3	63.2	61.7	61.0	57.1	51.8	49.4
Outstanding external debt	54.3	47.4	44.9	39.3	35.1	32.9	33.5
Of which: Public external debt	47.9	42.9	40.1	35.6	32.1	29.9	28.9
(Annual percent change, unless otherwise specified)							
Money and credit 1/							
Base Money (eop)	10.3	16.4	29.3	6.5	16.2	11.4	...
M-1	20.1	29.4	18.6	12.2	33.5	17.9	...
M-2	21.7	30.6	17.1	15.0	30.3	24.6	...
M-3	11.6	3.8	28.6	-2.6	22.1	10.0	...
Credit to the private sector (constant exchange rate)	17.3	22.1	28.0	-7.5	21.3	23.8	...
(In percent of GDP, unless otherwise indicated)							
Balance of payments							
Current account balance	-2.0	-0.9	-5.5	-0.4	-1.2	-2.0	-3.0
Merchandise exports, fob	22.2	21.4	22.8	20.5	20.0	20.020.5	20.5
Merchandise imports, fob	24.7	23.6	28.3	21.3	20.7	22.7	23.9
Services, income, and transfers (net)	2.1	2.9	2.4	3.0	2.6	3.0	3.3
Capital and financial account	2.7	6.3	9.9	4.3	3.8	6.7	3.4
Foreign direct investment	7.5	5.6	6.8	5.1	5.9	5.0	7.2
Overall balance of payments (in millions of U.S. dollars)	-15.4	1,005.4	2,232.4	1,588.3	-360.8	2,217.2	195.1
Gross official reserves (in millions of U.S. dollars) 2/	3,085.0	4,124.0	6,362.0	8,040.0	7,655.0	9,872.0	10,068.0
In percent of short-term debt	491.2	471.8	797.2	772.3	318.8	683.3	448.4
In percent of short-term debt and FX deposits	101.3	117.2	151.4	162.6	112.1	163.2	140.1
External debt service (percent of exports of goods and services)	8.6	26.1	21.7	22.9	28.5	27.2	18.2

Sources: Banco Central del Uruguay, Ministerio de Economía y Finanzas, Instituto Nacional de Estadística, and IMF staff calculations.

1/ August/September data for 2011.

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

**Statement by Alfredo Mac Laughlin, Executive Director for Uruguay and David Vogel
Advisor to Executive Director**

December 5, 2011

I. Background

Uruguay has exhibited critical transformations in recent years. The country went through some complicated episodes in its economic history. While these episodes had some differences among them, we can also find common patterns. In a considerable part of these episodes, crises in neighboring countries severely affected Uruguay's economic situation due to its high level of trade and financial exposure to the region; rigid exchange rate systems turned unsustainable and were abandoned, generating, together with significant slowdowns in economic activity, huge distortions on the financial system—also frequently weakened due to its own vulnerabilities—and on public and private debt indicators. Public finances came under stress, requiring fiscal adjustments, which further aggravated growth outlooks and social conditions.

Even in regular times since the mid-fifties, investment was scarce and growth was anemic or stagnant. We recall that less than a decade ago, some IMF staff reports expressed serious concerns about Uruguay's lack of sources of investment and growth.

Nevertheless, the current situation is substantially different. GDP is expanding robustly and soundly; foreign direct investment is in abundance; unemployment is at historical lows; inflation is under control; credit remains at moderated levels; and social indicators are displaying noticeable improvements.

More importantly, looking ahead, Uruguay's outlook is promising, though the new virulent phase of the global crisis brings about substantial challenges and risks worldwide and, Uruguay, as a small country with an open economy, is of course not immune. At the same time, the country demonstrates a number of conditions, stemming from the authorities' policies and reforms, and founded on the country's sound institutions, which allow us to conclude that Uruguay is facing the difficult external circumstances from a position of strength. Nonetheless, satisfactory results do not generate complacency. It just prompts further impulse to keep working and dealing with the outstanding challenges.

II. The Firm Pillars of Sound Institutions

Uruguay possesses critical intangible assets, and is committed to keep reinforcing them. It is a very respectable democracy around the world, with solid political parties, which have fully demonstrated responsibility and accountability, especially at times when the country must face difficult circumstances.

Uruguay's institutions have exhibited important progress over time. Among other things that may reflect the above-referred comment, the last report of Transparency International on corruption perceptions placed Uruguay in 24th position (with a score of 6.9) out of 178 countries, while the World Bank's Governance Indicators are going in the same

direction, showing Uruguay at very high percentile ranks, for instance, in terms of control of corruption, political stability, voice and accountability and rule of law. Furthermore, according to the last annual survey of Latinobarometro, most of the Uruguayan people consider that Uruguay's citizens act following the law. Moreover, the country's long tradition of honoring commitments and debts signifies another factor that helps us to understand Uruguay's developments over time.

III. Mitigating Vulnerabilities and Reinforcing Strengths

III.1 Lower Exposure to the Region

In the context of a comprehensive trade strategy pursued over the last decade, which has constantly looked for expanding exports to markets outside the region, Uruguay is presenting a considerable diversification. Reflecting that, exports of goods to Mercosur countries currently comprise 29 percent of Uruguay's total external sales, while they used to be above 50 percent during the nineties.

In particular, there has been a critical decrease in exposure to Argentina, considering that currently exports of goods to that country represent just 7 percent of total external sales. More importantly, deposits from non-residents (particularly from Argentina) have undergone a substantial decline, which makes Uruguay much less exposed to regional circumstances.

Box 4 of the staff report presents some references on the links and spillover from Argentina and Brazil, but these results are based on information between 1980 and 2010, and, as noted above, many developments and transformations have occurred during that period, thus these results do not reflect the current situation and outlook. The same applies to the staff's comments on fluctuations in output and employment and, in this regard, the mild impact observed in Uruguay's economy after the Lehman crisis may constitute relevant proof of the country's greater resilience to shocks.

III.2 Sound Fiscal Balance

Bold reforms have been waged in recent years on the tax system and revenue administration, which have not only aimed to increase revenues, but also, and especially, to further improve the system's transparency and efficiency, as well as diminish vertical and horizontal inequality. Among other results, Uruguay is exhibiting a huge reduction in tax evasion (according to the revenue administration's estimates, VAT evasion was at 15 percent in 2010, compared with 16.7 percent in 2009, and 40 percent in 2002). Meanwhile, as a virtuous cycle, the taxpayer's perception of the system's transparency and fairness (for instance, among other things that could be underscored in this regard, the country does not discriminate between residents and non-residents) tends to reinforce the country's culture of tax compliance. Mirroring the above-referred developments, public sector revenue-to-GDP ratio, at 28.3 percent, shows an elevated indicator relative to Uruguay's peers in the region.

On the expenditure side, the authorities maintain a prudent approach, focusing on some key areas, mainly education, infrastructure, housing, and health, which are crucial to critically

boost Uruguay's medium-term economic and social prospects. The authorities are fully aware that public infrastructure imperiously requires a further impulse from the private sector. It is worth mentioning that the PPP framework has already been established, and will start operating following the best international practices and, in this regard, the authorities would like to thank the IMF for the excellent technical assistance received on this matter.

III.3 Declining Public Debt; Less Dollarized and Longer Maturity

Consistent with the previous paragraph, the government is on the way to attaining the debt targets established in its five-year budget, which forecasts a declining debt-to-GDP ratio, set to reach 40 percent in 2015. Other objectives, such as that related to the de-dollarization of the public debt has almost been attained to the extent that the current share of debt in local currency is about 41 percent (the target for 2014 is 45 percent), while it was less than 5 percent six years ago. Furthermore, a debt maturity increase to an average of 12 years and the size of the debt at a fixed interest rate is 93 percent, underlining a significant reduction of risks in all of the debt dimensions. The Uruguayan authorities appreciate the staff's comment that debt management constitutes "an area where Uruguay can be a model for other countries".

Chapter II of the Selected Issues Paper underscores that "the findings suggest that Uruguay is well placed to reach investment grade, and could benefit from such an upgrade in terms of further spread reductions". Actually, many local and global analysts and investors believe that the upgrade to the investment grade for Uruguay could be imminent, although, as usual, rating agencies seem to react with some delay. In any case, as noted in the staff report, Uruguay is trading at investment grade levels (on November 29, EMBIG Sovereign Spreads for EMBIG Latam was 479 bps, for Brazil 239, Chile 160, Colombia 209, Mexico 234, Peru 238 and for Uruguay 229).

III.4 Inflation under Control; Flexible Exchange Rate System

As in many developing countries, inflationary pressures have been considerable in Uruguay during the last years, to a large extent as a result of the increasing trend of commodity prices and a vigorous domestic demand. Therefore, inflation rates have been above the central bank's target range, which required a tightening of the monetary policy in the first half of 2011. Meanwhile, considering that inflation remains under control, and especially the expected slowdown of the economic activity driving growth for the coming years to be closer to Uruguay's potential growth, the authorities have decided on a pause in their monetary policy stance, while waiting to see how the regional and global economy evolves. In any case, the authorities have expressed their strong commitment to return inflation to the target range as soon as possible.

The authorities consider that a flexible exchange rate system constitutes an effective buffer to cushion external shocks. Under the current scenario characterized by outstanding global uncertainties, the authorities are of the view that intervention in the exchange market should be circumscribed to contain eventual overshooting. Meanwhile, they have been urging firms to hedge their positions through a more active participation in the forward market.

III.5 A Comfortable Level of International Reserves; More Contingent Loans

The authorities have taken advantage of the global liquidity and built an important buffer by accumulating a considerable amount of international reserves, which represents almost 9 months of imports, or 683 percent of short-term debt. The authorities consider that this may be a comfortable level of reserves (according to the new reserve adequacy metric range it could be somewhat high), although they are also of the view that global conditions do not allow for a conclusive assessment on this issue.

Furthermore, Uruguay has attained some important contingent credit lines from a number of regional and international financial institutions. In sum, the government's financing needs for the coming years are small, and the coverage remains proper.

III.6 The Financial System

One of the most relevant structural changes in Uruguay has occurred in the financial system. Eminently, the regulation and supervision of the sector has been substantially strengthened, while developments and results in public banks reflect a dramatic transformation in their governance and incentives.

Although showing an increasing trend—which, according to the latest information, has been moderating over the last two months—the credit-to-GDP ratio is low compared with peer countries' indicators and even with historical levels in Uruguay. The real estate market has presented a reasonable increase in dollar terms, but, as noted in Annex 1 of the staff report, prices do not seem overvalued, and, more importantly, the financial system is not significantly exposed to that market, taking into account that “banking credit has not been a main source of financing for the housing activity”.

Moreover, non-performing loans exhibit a negligible level. Some might argue about the level of provisioning entailed in Uruguay's dynamic provisioning system. Notwithstanding, the authorities consider that during uncertain times it is appropriate to follow cautious policies. At the same time, indicators related to banks' capital adequacy and liquidity point to a solid situation of the financial system, and, as stressed in the staff report, the authorities continue undertaking structural reforms in the system to further reinforce it.

III.7 Social Stability

As often stressed by the Uruguayan authorities, economic stability and social achievements are fully compatible and synergetic. Prudent macroeconomic policies have been successful in keeping inflation under control—a vital factor to protect the most vulnerable groups of the society—and making room for devoting a higher amount of resources to transparent, efficient and well-targeted social plans. As illustrated in Box 1 of the staff report, Uruguay has made important progress in terms of mitigating poverty conditions and reducing income inequality, which, as a virtuous cycle, increases social and political ownership of prudent policies and structural reforms.

Likewise, social stability is also related to establishing fair conditions for both, employers and workers. It is possible that Uruguay's labor market framework has produced some normal tensions—which are not frequent at all. At the same time, it is important to take into account that labor changes could have been useful to contribute to rebalancing market forces in the labor market. In any case, it is worth mentioning that these normal tensions are tackled in the civilized and democratic manner deeply enrooted in Uruguay's sound traditions.

Meanwhile, significant changes are needed in the labor market in order to reinforce “one of the great success stories in the Uruguayan economy”, as noted in the staff report. In this regard, the authorities consider that meeting Uruguay's productivity challenges necessarily requires, among other things: closer links between salaries and productivity; a further reduction of informal employment (Uruguay shows one of the lowest rates of informality in the region); more training and capacity building programs; and significantly more efforts to increase competitiveness in the public sector, which entail further transformations in the sector.

IV. Uruguay's Future Challenges

As noted, Uruguay's performance has been robust. However, the global economic situation poses key challenges for the coming years, and, of course, prudent policies and structural changes will continue to be the authorities' means to further strengthen the considerable buffers Uruguay displays in the fiscal, monetary, financial, and social sectors. Nonetheless, the expected slowdown and the financial distress in the world's economy are not the only risks. Global and regional protectionism risks often emerge in times of crisis, and Uruguay, as a loyal member of the international community, hopes that detrimental policies in this regard are refrained.

At the outset we underscored that Uruguay has undertaken substantial transformations in recent years. In the past, amidst an anemic economic situation, characterized by an under-utilization of resources, productivity did not seem to be a high priority. Currently, the country is growing robustly, even above its potential; the unemployment rate is very low, which also means that many sectors do not easily find skilled labor; the vitality of the economic activity also produces infrastructure gaps; and, innovation and entrepreneurship are needed to support and reinforce the country's new stage. Therefore, Uruguay has to face a new situation, referred to by the authorities as “the productivity challenge”, and, in this regard, they reaffirm their efforts and commitments towards critically heightening productivity in all of its dimensions, which constitutes an imperious step for the country in order to keep improving the welfare of Uruguay's population.