

República Oriental del Uruguay

2020–2024 Budget Law, Government's Financing Strategies and new Monetary Policy Framework



BANCO CENTRAL
DEL URUGUAY

October 2020



Ministerio
**de Economía
y Finanzas**

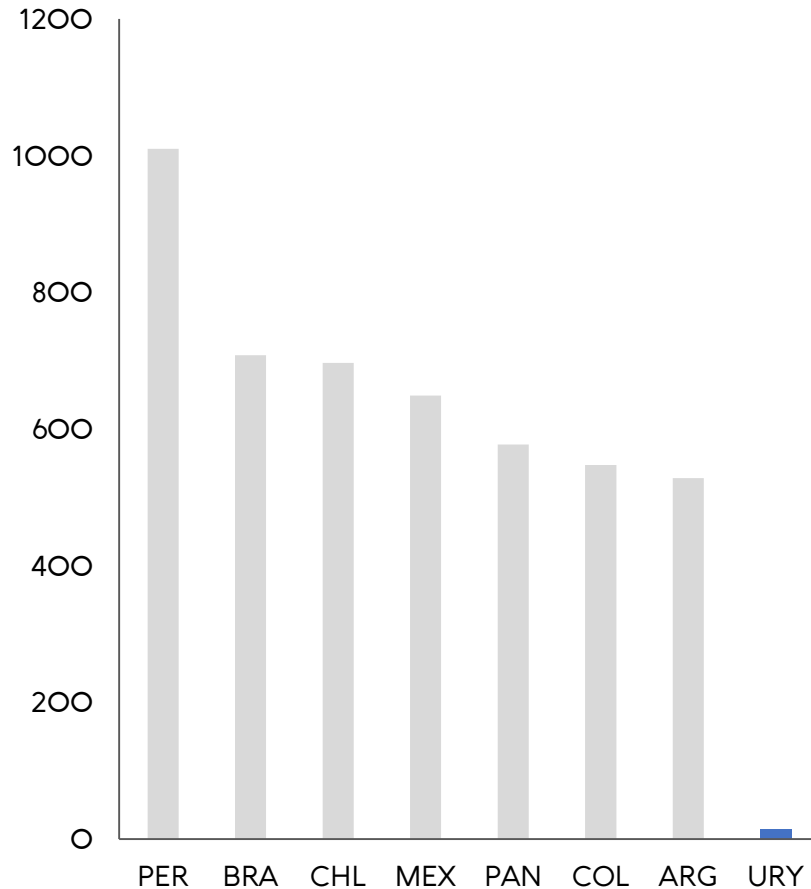
KEY HIGHLIGHTS: MINISTRY OF FINANCE

- Priority is to restore fiscal consolidation and stabilize the government's debt burden under realistic revenue projections.
- Commitment to meeting fiscal targets is anchored in a new fiscal framework and an austere 5-year budget law based on expenditure restraint.
- Skillful public health response to the Covid-19 crisis has limited virus spread and allowed a faster re-normalization of economic activity, tempering fiscal slippages.
- Despite the Covid-19 outbreak, the Government moved forward with an ambitious agenda of fiscal and structural reforms through market-friendly policies to boost output and employment.
- Consistency between fiscal discipline, disinflation strategy and wage policies based on close coordination on policy-making between Ministry of Finance, Central Bank and Office of Budget and Planning.

Successful containment strategy has limited virus spread, keeping the death toll subdued, although there is no room for complacency

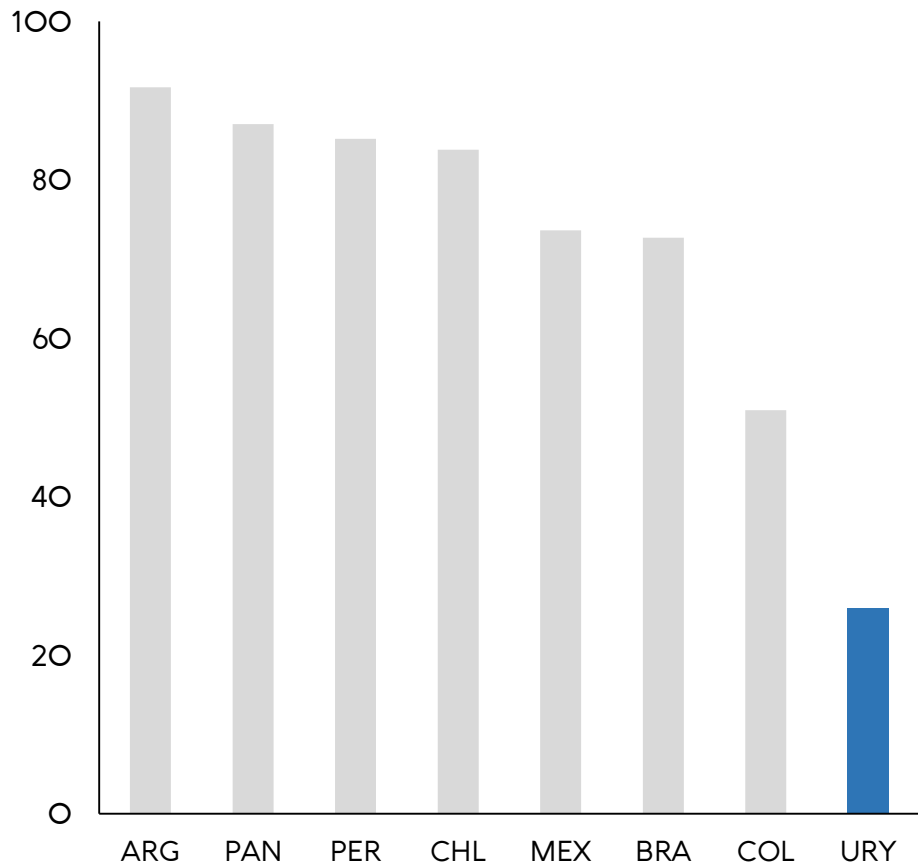
Covid 19-related deaths per million population

(As of October 12th, 2020)



Containment Stringency

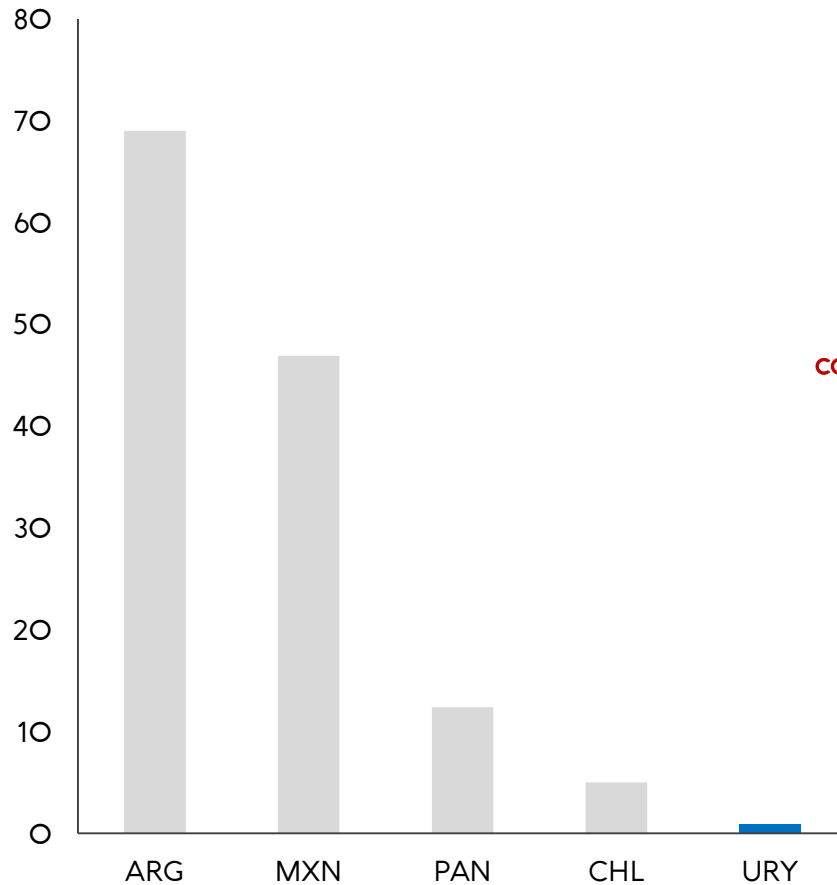
(Index, as of September 22, 2020)



Progress in response to the Covid-19 measures has allowed Uruguay the swiftest renormalization of the economy among Latam countries

Share of Covid-19 tests that are positive ^{1/}

(Daily positive rate, rolling 7-day average, in %)



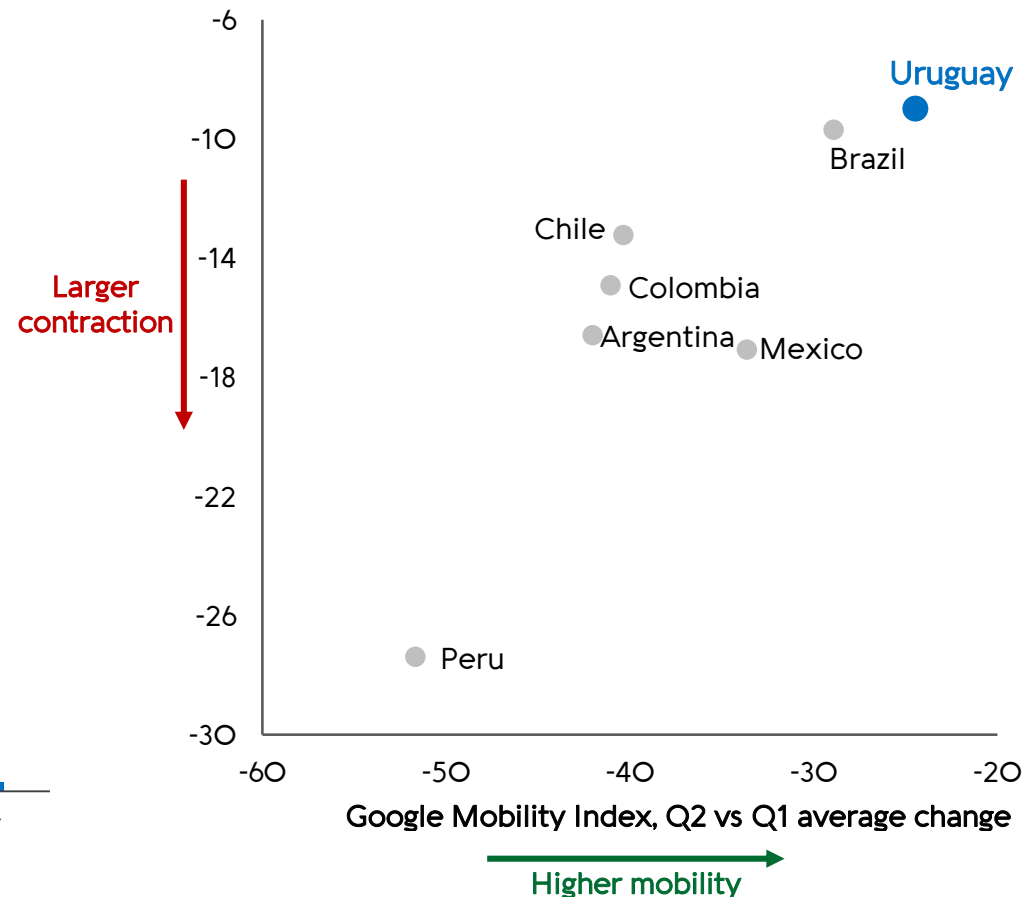
No data available for Brazil, Colombia and Peru

Source: Our World in Data; Google

GDP growth and community mobility in Latam

(In %)

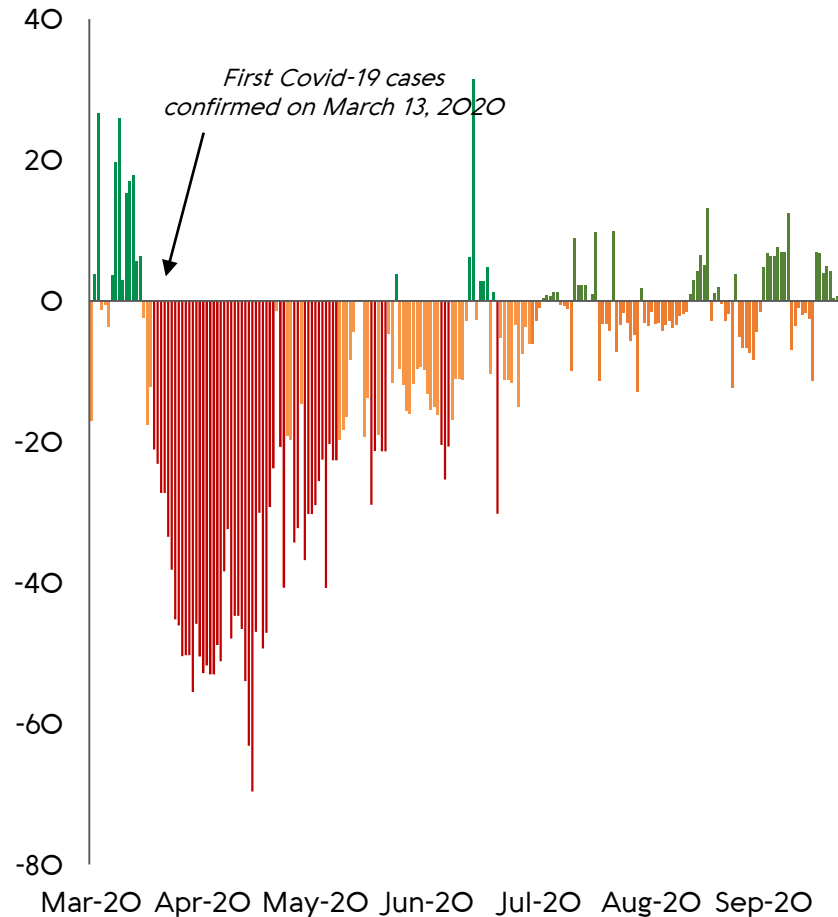
Real GDP, Q2 vs Q1 s.a. change



Leading indicators suggest that the economic downdraft has bottomed-out, and a gradual recovery is underway...

Fuel demand

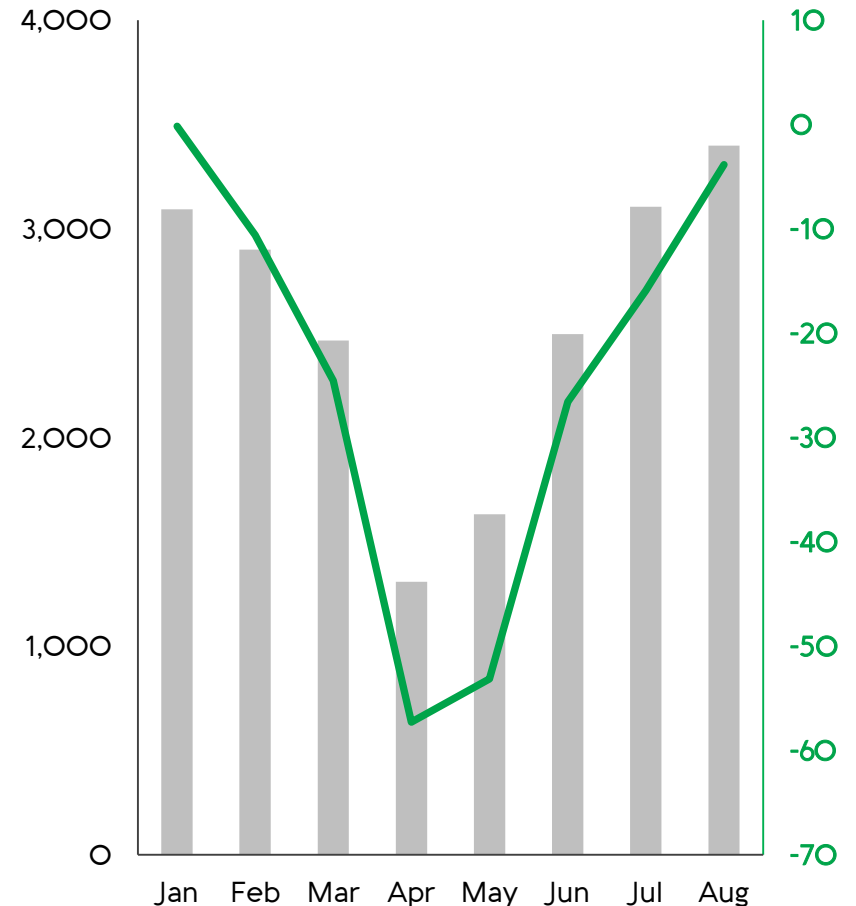
(Rolling 7-day average, YoY change in %)



Car sales in 2020

Number of cars sold

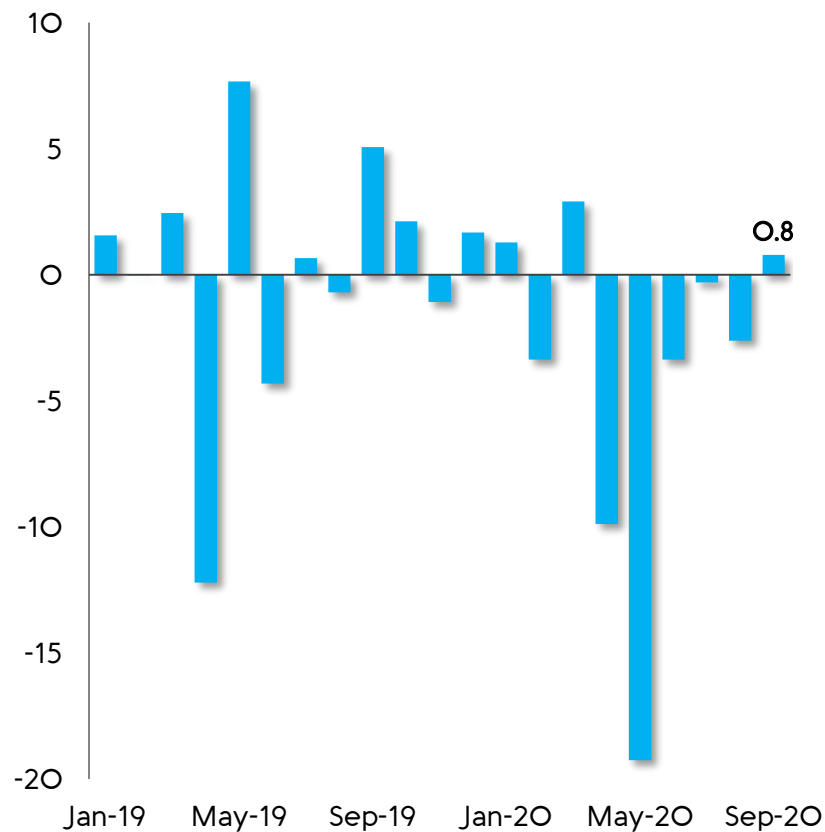
YoY change, in %



... which is reflected in fiscal revenues and automatic stabilizers

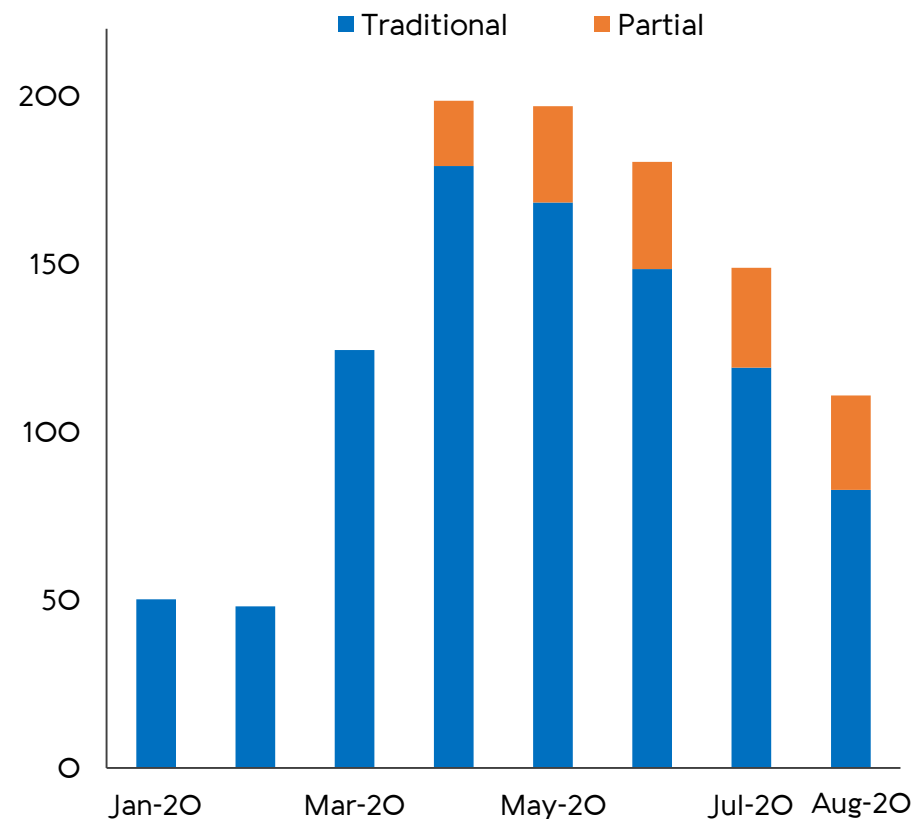
Tax revenue collection

(YoY real change, in %)



Unemployment insurance

(Number of beneficiaries by type of regime, in thousand workers)

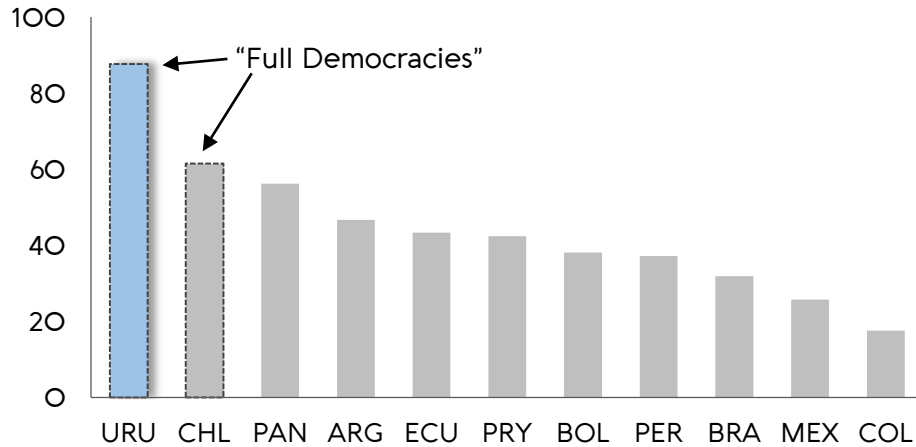


Fully transparent fiscal registration

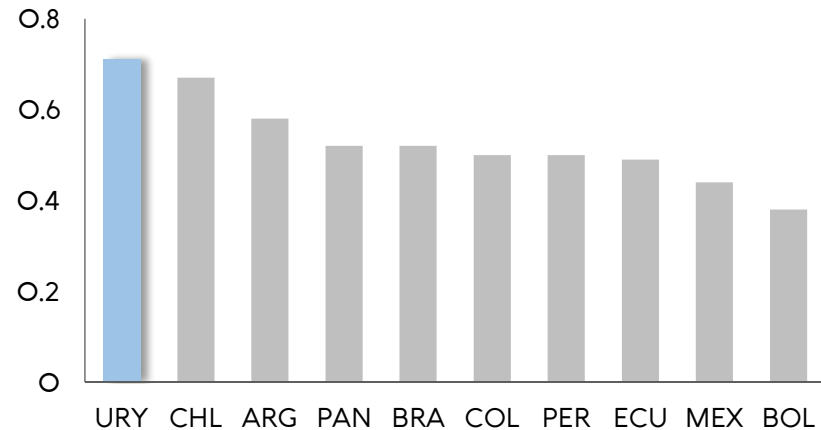
- **COVID-19 Solidarity Fund.** Created by Law (voted unanimously by all parties), to be managed by the Executive branch. The Fund clearly earmarks the budgetary resources to address the emergency, keeping tabs of the Covid-related expenditures and where and how the money is spent.
- **Transparent registration of fiscal statistics.** Frequent, timely and comprehensive disclosure of loan guarantees and contingent liabilities, allowing ex-post evaluation and accountability review.

Throughout the Covid-19 crisis, Uruguay has remained a bastion of institutional and political stability in Latin America

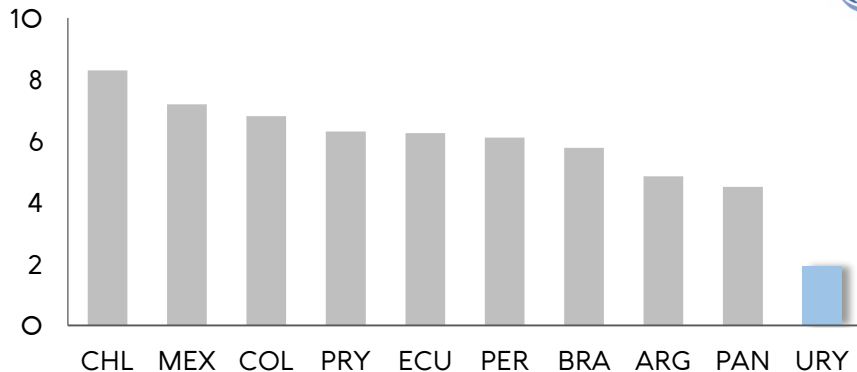
Strongest political stability and full democracy ^{1/ 2/}



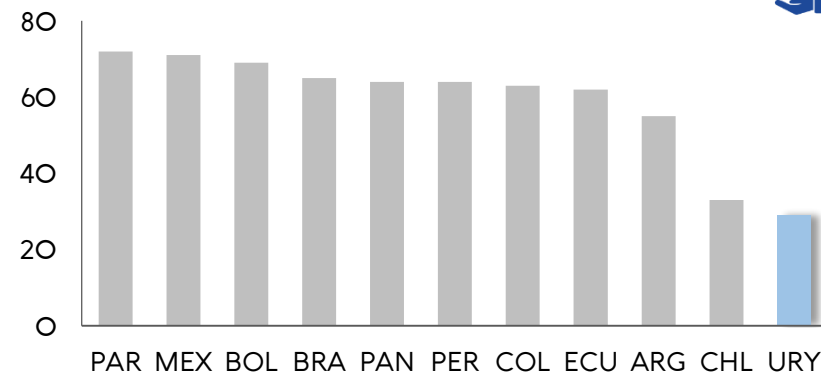
Highest adherence to the rule of law ^{3/}



Lowest civil unrest ^{4/}



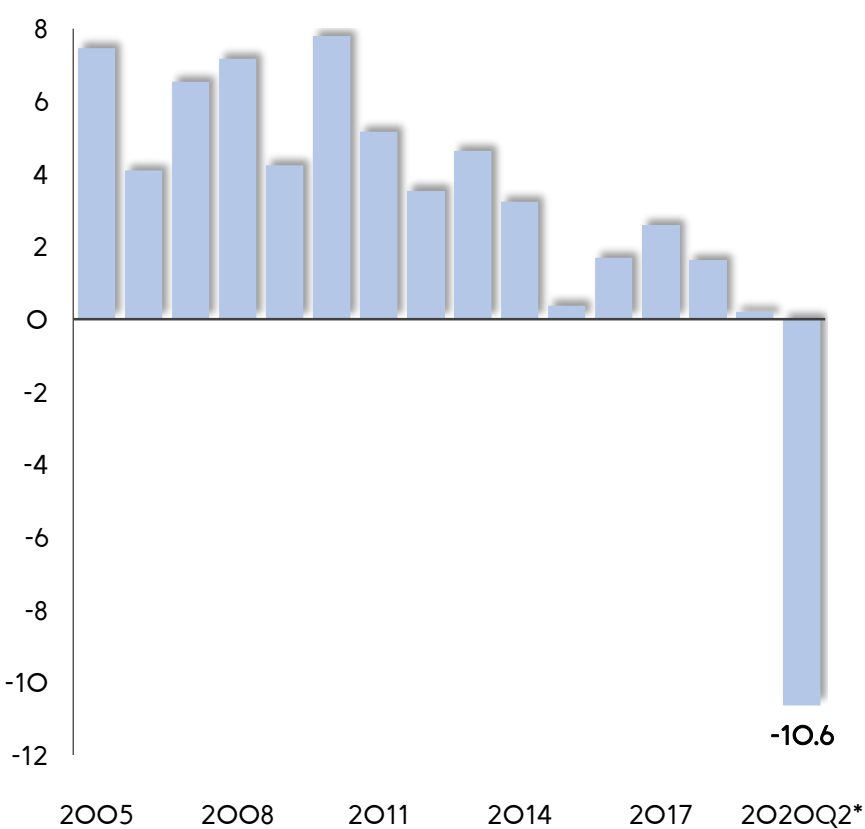
Lowest corruption perception ^{5/}



Backdrop before Covid-19 outbreak: decelerating economy on the back of low investment and weak labour market...

Real GDP

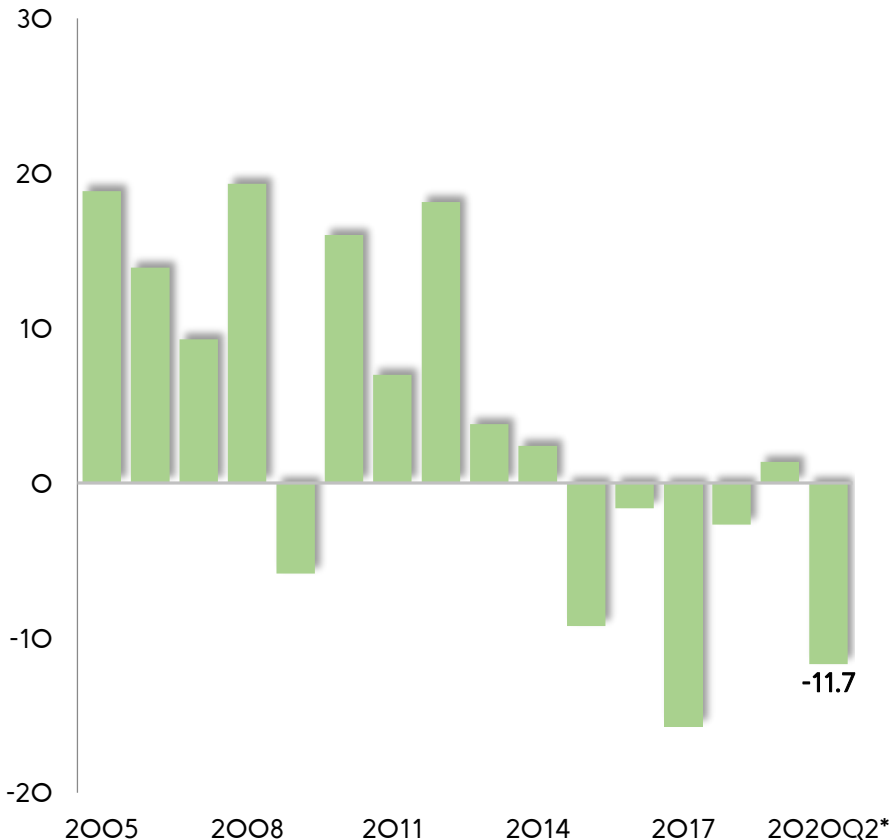
(Annual change, in %)



(*) YoY

Real gross fixed capital investment

(Annual change, in %)

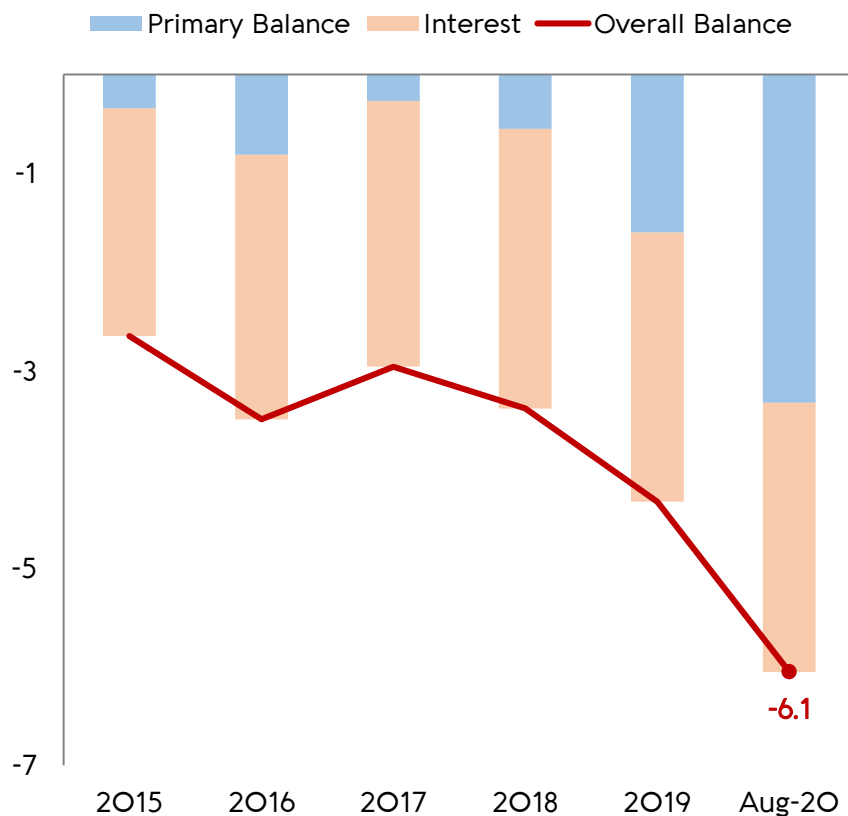


(*) YoY

... together with a persistent fiscal deterioration and increasing debt burden

Central Government fiscal balance ^{1/}

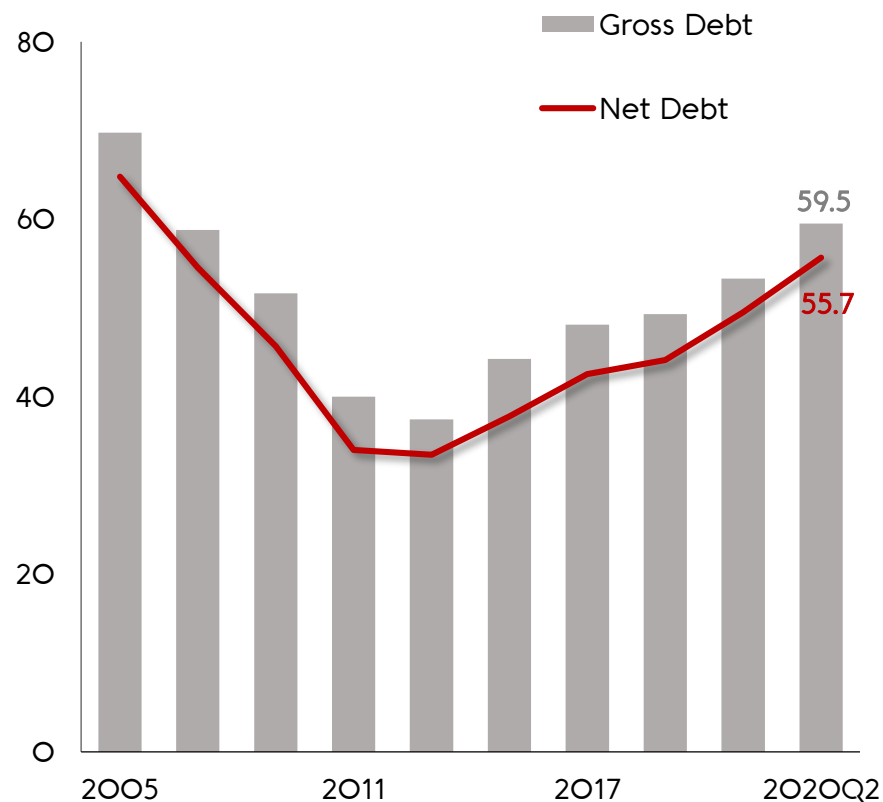
(12-month period, in % of GDP)



^{1/} Does not Include extraordinary inflows of funds to the Social Security Trust.

Central Government debt

(In % of GDP, end of period)



Sources: Central Bank of Uruguay; Ministry of Economy and Finance of Uruguay

The government is forging ahead with an ambitious reform agenda backed by political majority in Congress

Key Milestones and Timing of Political Process



New 5-Year Budget Law 2020-2024 sets out a credible medium-term fiscal consolidation plan and institutionalizes fiscal prudence

Lays the foundations for significant changes on fiscal policy decision-making and rationale of budget preparation, with medium-term fiscal savings:

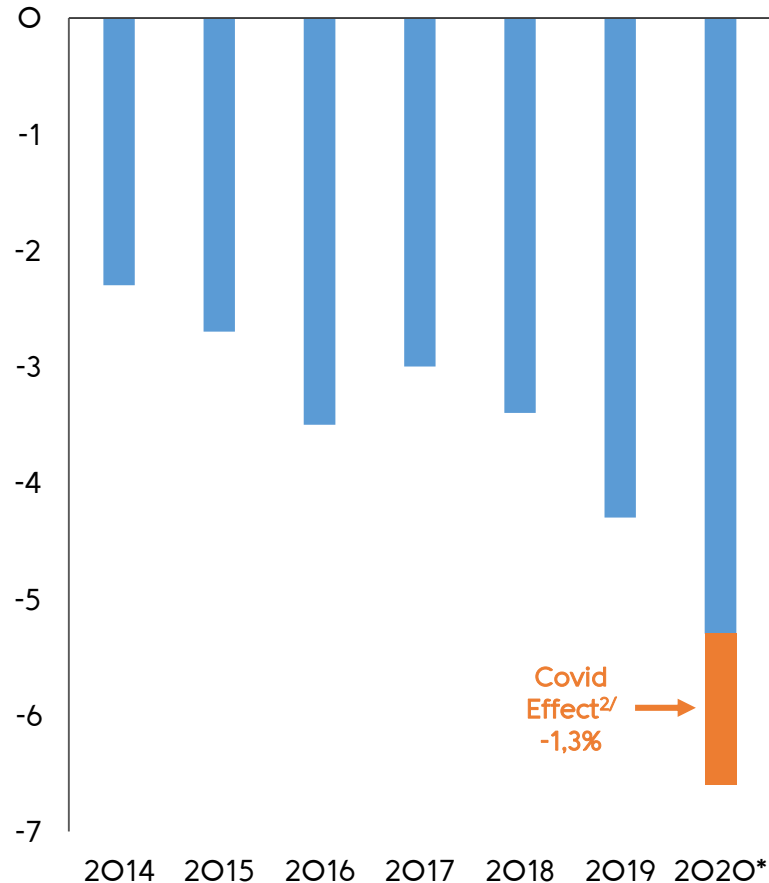
1. New fiscal framework to foster counter-cyclicity over the business cycle and sustainable finances over the medium term.
2. “Zero-base” budget strategy that reviews and reallocates existing spending, replacing “incremental” budgeting approach.
3. Austerity measures based on more efficient discretionary spending, restrictions on public sector hiring and spending oversight and auditing.
4. New governance policies, performance targets and accountability requirements for public enterprises.

In addition, the Law of Urgent Consideration creates a Commission of experts to make proposals by mid-2021 for a comprehensive pension reform.

Material improvement in public finances relies on reducing primary expenditures as a percent of GDP, given the already elevated tax burden

Central Government Fiscal Balance^{1/}

(In % of GDP)



(*) Projection

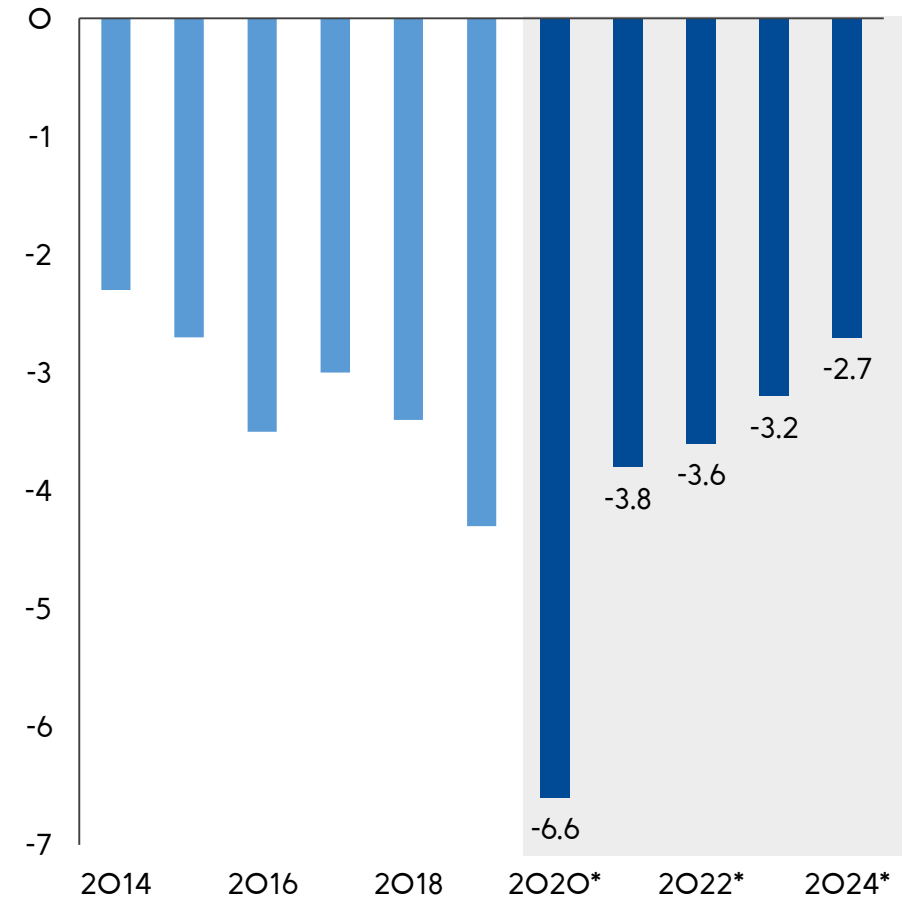
1/ Does not Include extraordinary inflows of funds to the Social Security Trust.

2/ Above the line (fiscal) effect, i.e. expenditures minus extraordinary revenues as per established in the Covid-19 Solidarity Fund law.

Source: Ministry of Economy and Finance

Central Government Balance: budget projections^{1/}

(In % of GDP)

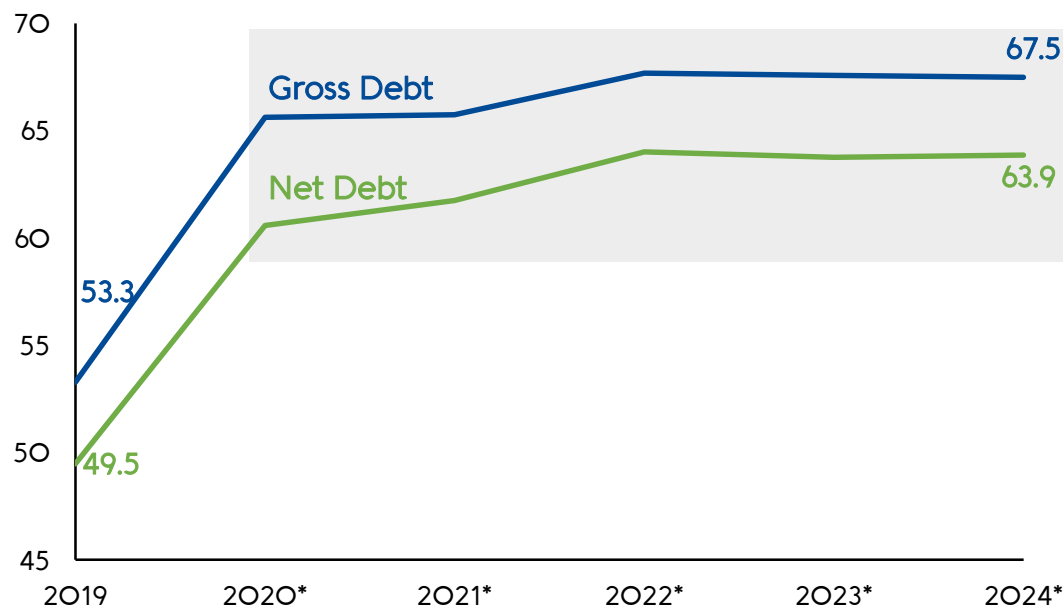


(*) Projections

..to stabilize debt burden under realistic revenue assumptions

Central Government Gross and Net Debt to GDP Ratio

(In %)



Debt Sustainability Analysis Outcome

| | 2019 | 2020* | 2021* | 2022* | 2023* | 2024* |
|--|------|-------|-------|-------|-------|-------|
| Gross Debt (in % of GDP) | 53.3 | 65.6 | 65.7 | 67.7 | 67.6 | 67.5 |
| Net Debt (in % of GDP) | 49.5 | 60.6 | 61.7 | 64.0 | 63.8 | 63.9 |
| Foreign Currency Debt (in % of total) | 56.1 | 56.7 | 54.8 | 52.8 | 51.7 | 49.9 |
| Effective Interest Rate (annual, in %) ^{1/} | 5.2 | 4.7 | 4.5 | 4.4 | 4.2 | 4.2 |

1/ Total annual interest payments as a share of year-end debt stock of last year.

(*) Projections.

New Fiscal Framework: Key features

1. Fiscal rule:

- Structural balance targets, to account for business cycle fluctuations and one-off/temporary spending and revenue items.
- Cap on real growth in primary expenditure in line with potential real economic growth (estimated currently at 2,3% annually).
- New debt authorization framework sets a binding level of annual net indebtedness.

2. Independent fiscal councils:

- Committee of experts to provide estimates of capital growth, labor and factor productivity.
- Advisory fiscal council will provide estimates of GDP growth potential and structurally-adjusted fiscal numbers.

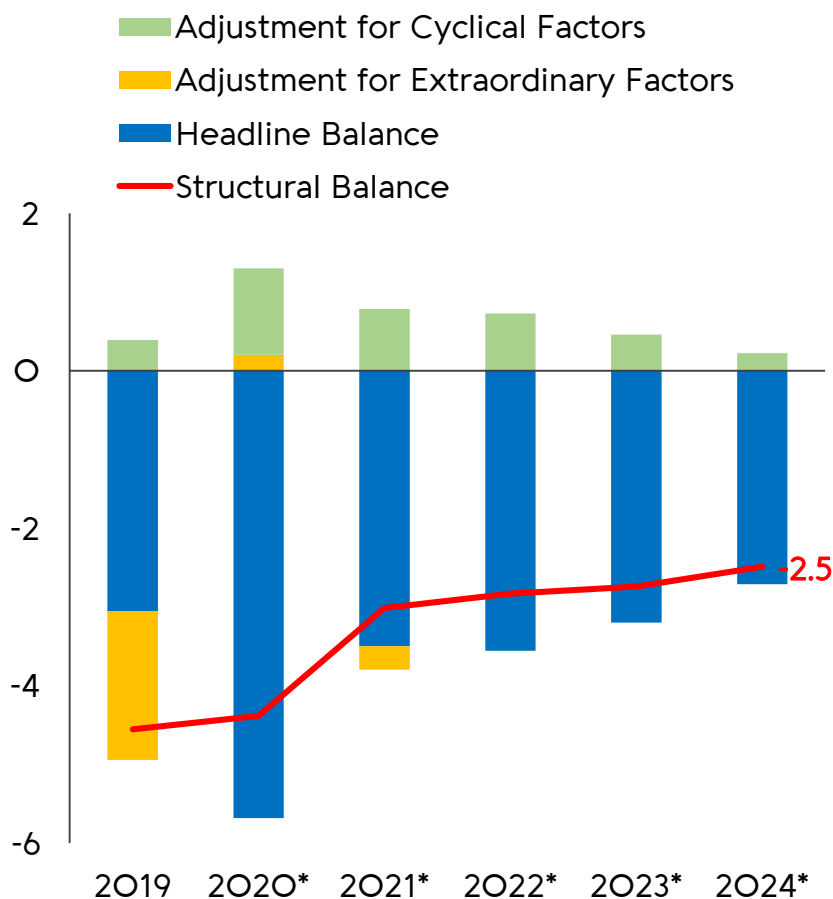
3. Transparency and communication: The Government will communicate, semi-annually, the government's overall assessment of the fiscal situation.

4. Medium-term budget forecasts and risk analysis: Macroeconomic projections will be provided over a rolling five-year period and will account for uncertainty around baseline forecasts.

Fiscal Rule (1): Structural Balance and New Spending Cap

Central Government Structural Balance

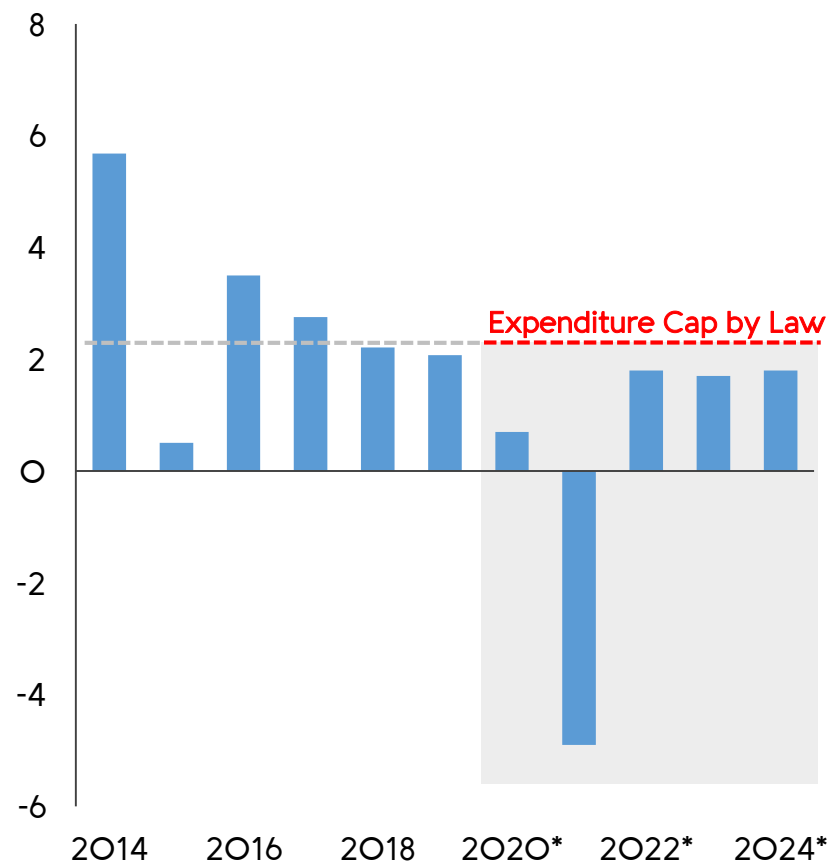
(In % of GDP)



(*) Projections

Central Government Primary Expenditures

(YoY real change, in %)



(*) Projections

Fiscal Rule (2): a new legal framework that limits Central Government indebtedness, tied to observed fiscal deficit

- The proposed framework establishes a limit to the Central Government Net Indebtedness, defined as gross debt issuance (bonds and loans) excluding amortizations and the variation in financial assets. This measure is equivalent to the fiscal deficit (up to mostly valuation effects).
- The new limit is USD 3.5bn for 2020 and USD 2.3bn for 2021.
- An escape clause allows for an additional 30% indebtedness, but only under restrictive circumstances and overseen by the Fiscal Council.

Consistent set of macroeconomic policies: fiscal targets, inflation targets and wage-setting guidelines

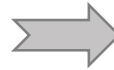
Fiscal consolidation plans are consistent with:

- (1) Central Bank's commitment to lower inflation and breaking inflation inertia.
- (2) New wage-setting guidelines for the private sector that reduce backward indexation and prioritize employment creation.
- (3) Office of Budget and Planning's heightened oversight for efficient discretionary spending.

Largest-ever private investment in the country proceeding as scheduled: Uruguay poised to receive large FDI inflows

Construction of new pulp mill

- Finnish company UPM will build a second cellulose plant in the country
- Overall investment: approx. USD 3 billion (5.5 % of GDP)
- Will have a material positive impact on GDP growth, employment and Balance of Payments
- World-class design with proven high environmental performance
- *UPM and the new Government of Uruguay have signed a MoU on pending items related to UPM's growth project in Uruguay that will further strengthen the implementation of UPM's growth project and existing operations in the country as well as the local economy.*



Railway infrastructure project

- Central Railway will run from city of Paso de los Toros to the port of Montevideo (273 km long)
- Public-Private-Partnership (PPP) modality
- USD 1,000 million investment



Growth agenda: the private sector should lead the way of the cyclical recovery and underpin medium-term growth prospects

In addition to the UPM project, the new administration is focused on jump-starting the economy by attracting and promoting private investment:

- Recent changes to the General Investment Promotion Regime providing more tax incentives encouraging employment creation (housing, offices and urbanization construction) and clean technologies.
- New incentives for foreign investors to obtain residency in the country, leveraging Uruguay's handling of the pandemic.
- Microeconomic reforms to enhance productivity and growth potential, by improving business climate and competitiveness, and pledge not to raise taxes.

Financing and Debt Management Goals

- Mitigate refinancing risks through proactive liability management operations, conservative pre-funding policies and contingency credit lines from multilateral institutions.
- Continue to increase local currency funding in both domestic and international markets, while developing secondary markets (liquidity, depth and points in the curve). Commitment to de-dollarization strategy included in the Budget, aiming to reach 50% of total debt denominated in local currency by 2024.
- Assess funding options to integrate the ESG matrix in the financing strategy, leveraging Uruguay's standing in sustainability indicators.

Central Government's flow of funds for 2020

In USD million, projections

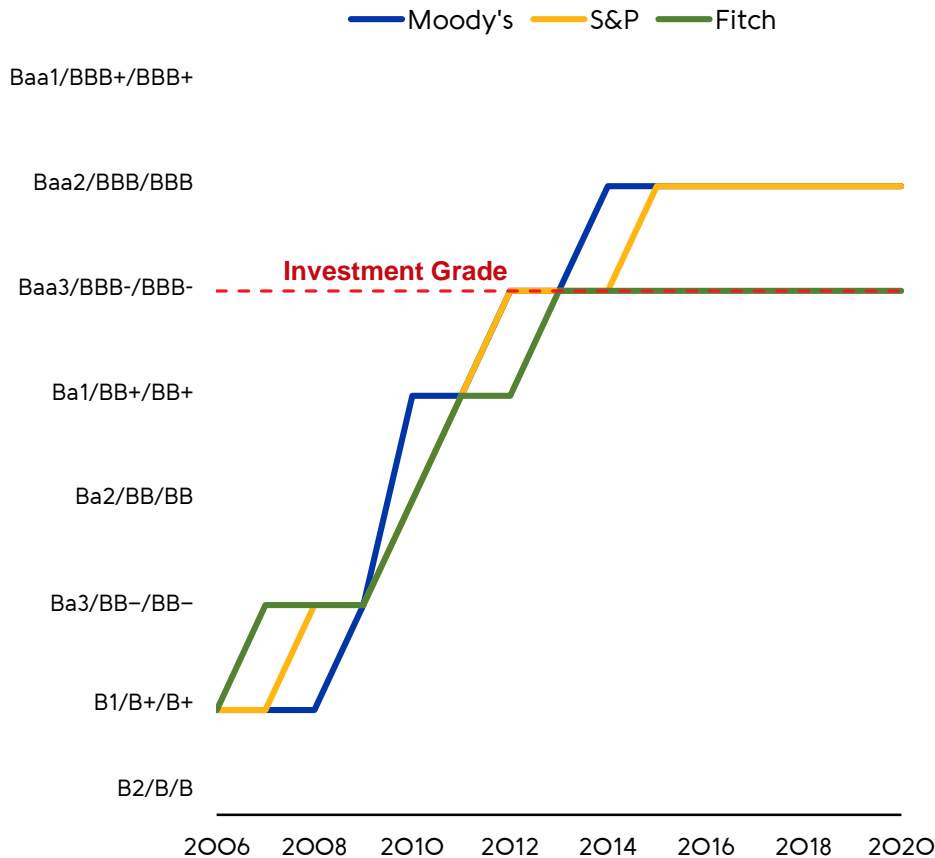
| | |
|--|--------------|
| FINANCING NEEDS | 5,805 |
| Primary Deficit ^{1/} | 1,757 |
| Interests Payments ^{2/} | 1,517 |
| Amortizations of Bonds and Loans ^{3/} | 2,152 |
| Change in Financial Assets | 379 |
| Liquid Assets | 289 |
| Other Financial Assets ^{4/} | 90 |
| FUNDING SOURCES | 5,805 |
| Disbursements from Multilaterals | 1,527 |
| Total Issuance of Market Debt ^{5/} | 4,242 |
| Others (net) ^{6/} | 36 |

Around 90% issued in local currency YTD, as of mid-October

- (1) Excludes extraordinary transfers to the public Social Security Trust Fund (SSTF).
- (2) Includes interests payments to the SSTF on its holdings of Central Government debt.
- (3) Includes obligations coming due on a contractual basis and bonds repurchased and early redeemed through July 31st, 2020.
- (4) Change in assets held by the government-owned trust guaranteeing loans for banks to SMEs.
- (5) Includes bonds issued domestically and in international markets.
- (6) Includes exchange rate and market price valuation effects and other transactions with the rest of the public sector.

Uruguay's credit rating performance

Evolution of Uruguay's sovereign credit ratings



Latest credit rating actions



October 2020. Affirmed Uruguay's rating at BBB-, outlook remained negative.



April 2020. Affirmed Uruguay's rating at BBB, outlook remained stable.



February 2020. Affirmed Uruguay's rating at BBB, and changed outlook to Positive from Stable.



January 2020. Confirmed Uruguay's rating at BBB (low) with Stable trend.

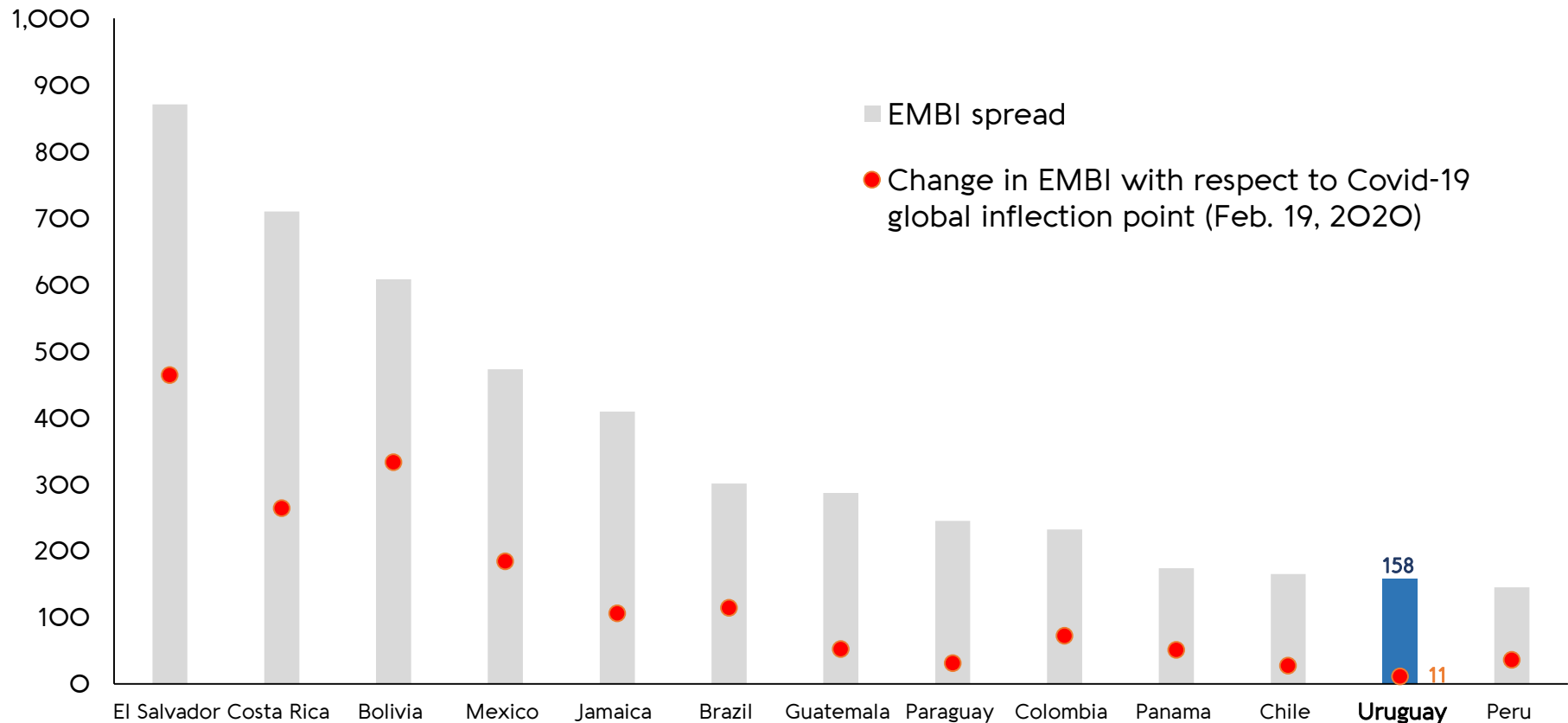


August 2019. Uruguay's rating affirmed at Baa2 with Stable outlook.

Markets are pricing a solid sovereign creditworthiness for Uruguay

EMBI spreads in LatAm and Caribbean countries

(In bps, as of October 14th, 2020)



KEY HIGHLIGHTS: CENTRAL BANK

- To respond to the current Covid-19 health emergency, monetary policy has geared into expansionary mode. To anchor medium term inflation expectations, the central bank signaled it will switch to tighter monetary policy once the impact on the economy from the pandemic eases.
- Key focus is to bring inflation structurally down and anchor inflation expectations within the target band.
- To rebuild Central Bank credibility, we are working on a new institutional framework and practice of monetary policy.
- Search for a quality currency: reconstruction of peso markets to mitigate financial dollarization.
- Consistency between fiscal targets, disinflation strategy and wage policies based on close coordination across institutions.

Central Bank deployed countercyclical measures in response to the Covid-19 pandemic, but signaled return to contractionary stance once crisis is over

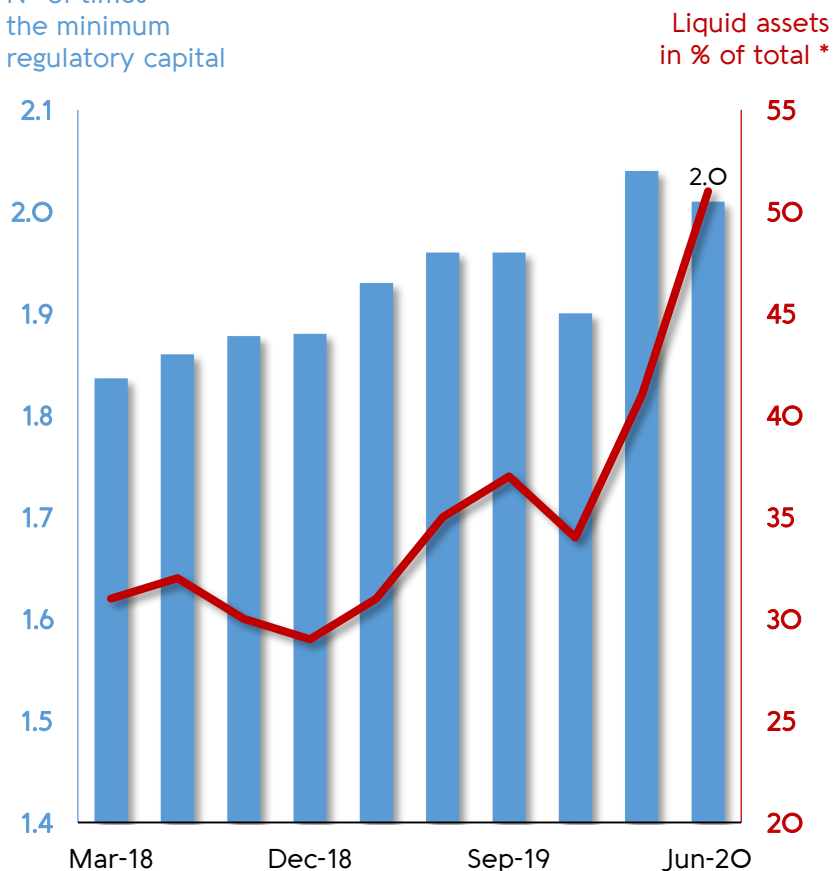
Deployed monetary policy tools to inject liquidity in the financial system and stabilize money markets:

- Reduced commercial banks' local currency reserve requirements, conditional on credit expansion.
- Eased bank regulations, authorizing financial institutions to defer companies' loan payments and provide automatic maturity extensions.
- Support to Ministry of Finance's guaranteed lending programs to leverage banking system loans to SMEs.
- To anchor long term inflation expectations, the Central Bank started to signal a contractive monetary policy once the emergency had passed.

Banks' strong liquidity position supports credit measures of the loan guarantee system and the Central Bank; no spillovers from Argentina

Solvency and liquidity of the banking system

Nº of times
the minimum
regulatory capital

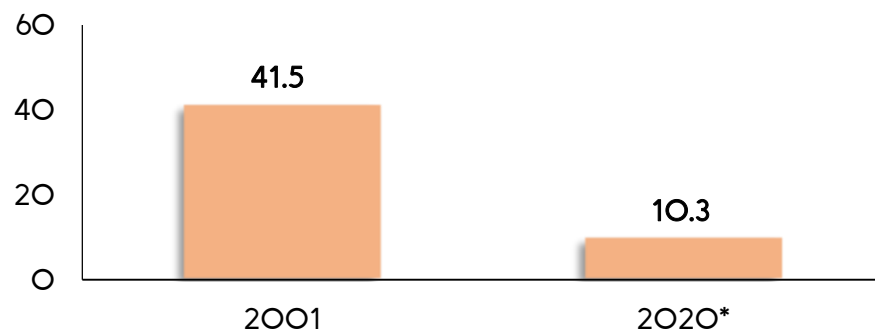


(*) Liquid assets are those available within 30 days

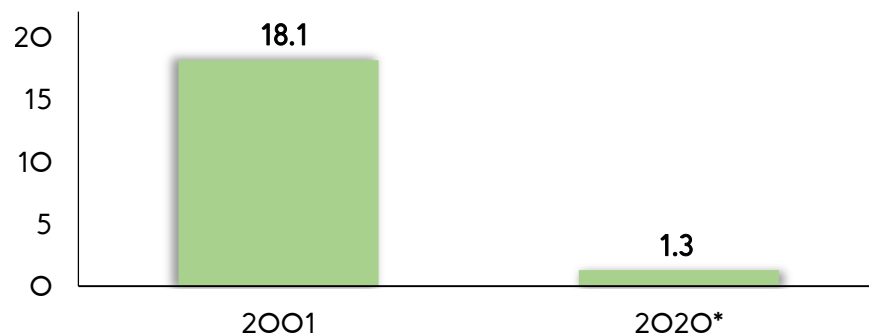
Banking system's balance sheet exposure to Argentina

(To the non-financial sector, % of total)^{1/}

Deposits



Loans



^{1/} End-period; data for deposits includes only private non-financial sector

(*) As of August

The quest for the Peso as a quality currency: roadmap and progress so far

The Central Bank is working on two mutually reinforcing policies:

1. **New monetary policy framework under IT regime to reduce inflation and anchor inflation expectations.**
2. **Rebuilding and developing local currency peso markets and de-dollarization.**

1. New monetary policy framework under IT regime

To improve central bank credibility we are working on changes to the institutional design and institutional practice of monetary policy:

1. Key mandate: Monetary policy will assist the economy during temporary emergencies, but in normal times the mandate will be primarily price stability.

2. Change in monetary policy instrument:

- In September 4th, the Central Bank announced the change in its policy instrument moving away from targeting money supply growth to a short-term policy rate (initially set at 4.5%).
- Improves market signals and allows for fine-tuning of monetary policy at higher frequency.

3. Forward guidance:

- Reduction of the inflation target range to (3%-6%) starting September 2022, implying lowering the midpoint to 4.5%.

1. New monetary policy framework under IT regime

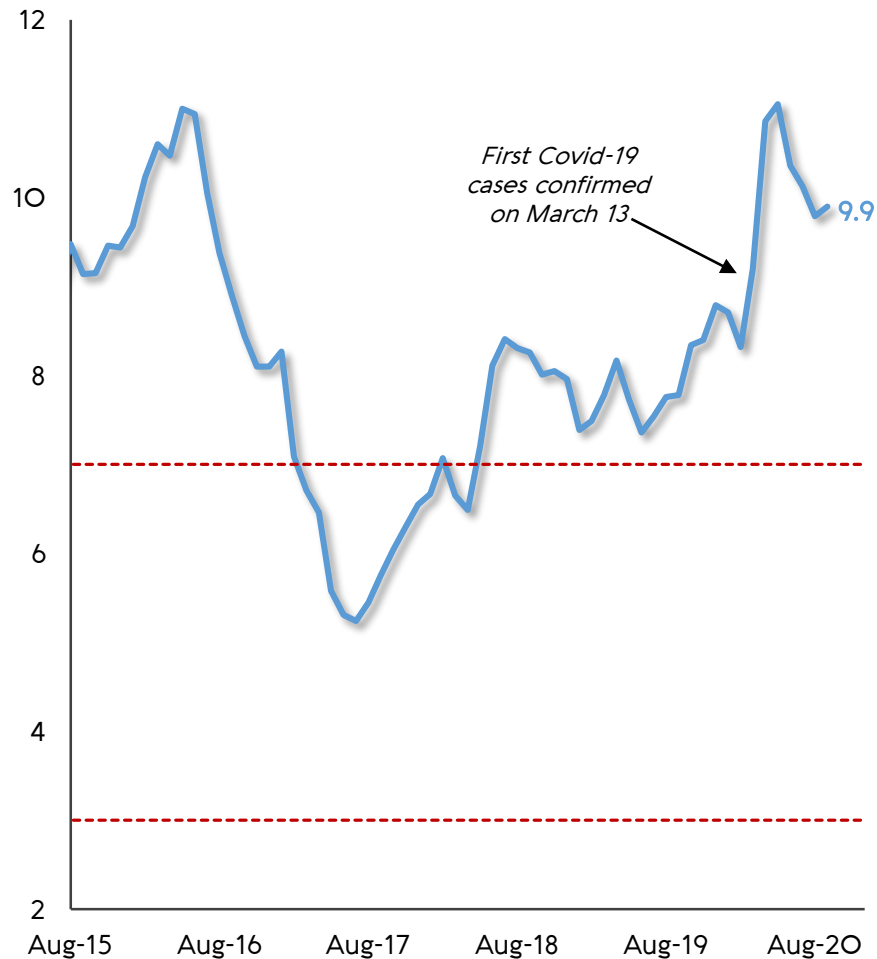
4. Introduced some best practices in terms of communication and transparency:

- Doubled the frequency of its Monetary Policy Committee (MPC) meetings and started publishing minutes of the MPC.
- Included forward looking statements in the MP minutes and press releases
- Relaunched and improved the professional forecasters' survey, significantly increasing number of respondents
- Further changes are under way: publication of firms' inflation expectations survey, publication of Central Bank models and projections, among others.

Inflation decelerating on the back of lower tradable inflation, yet still above target

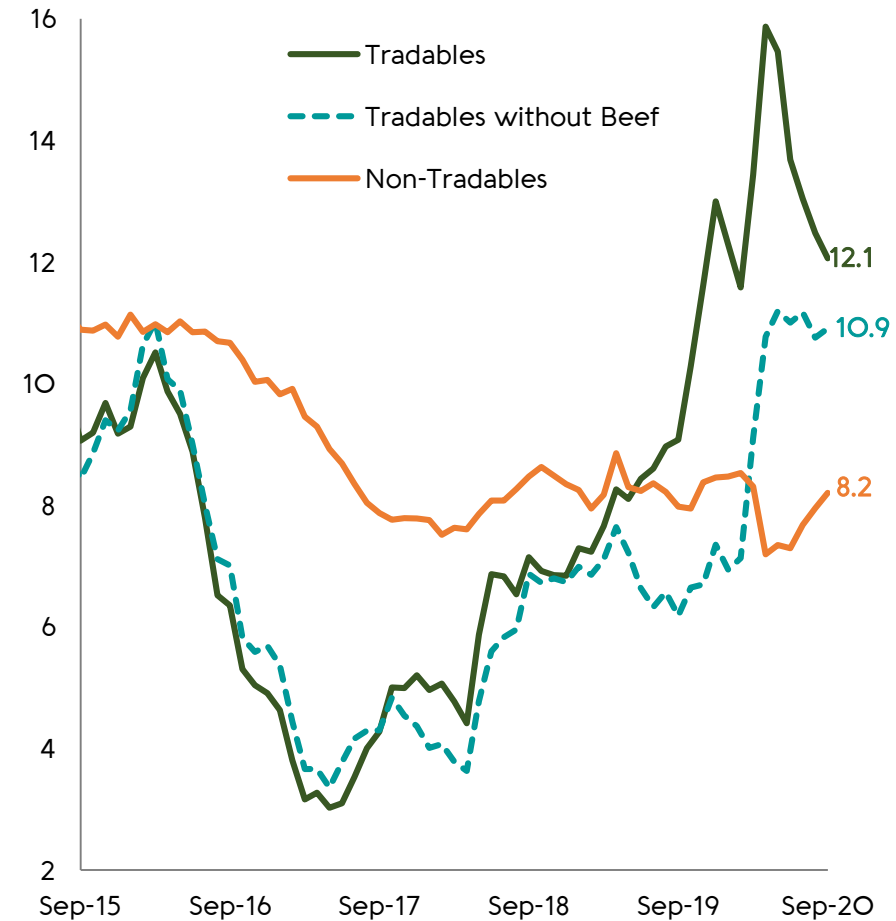
Headline inflation

(Annual, in %)



Tradable and non-tradable inflation components^{1/}

(Annual, in %)

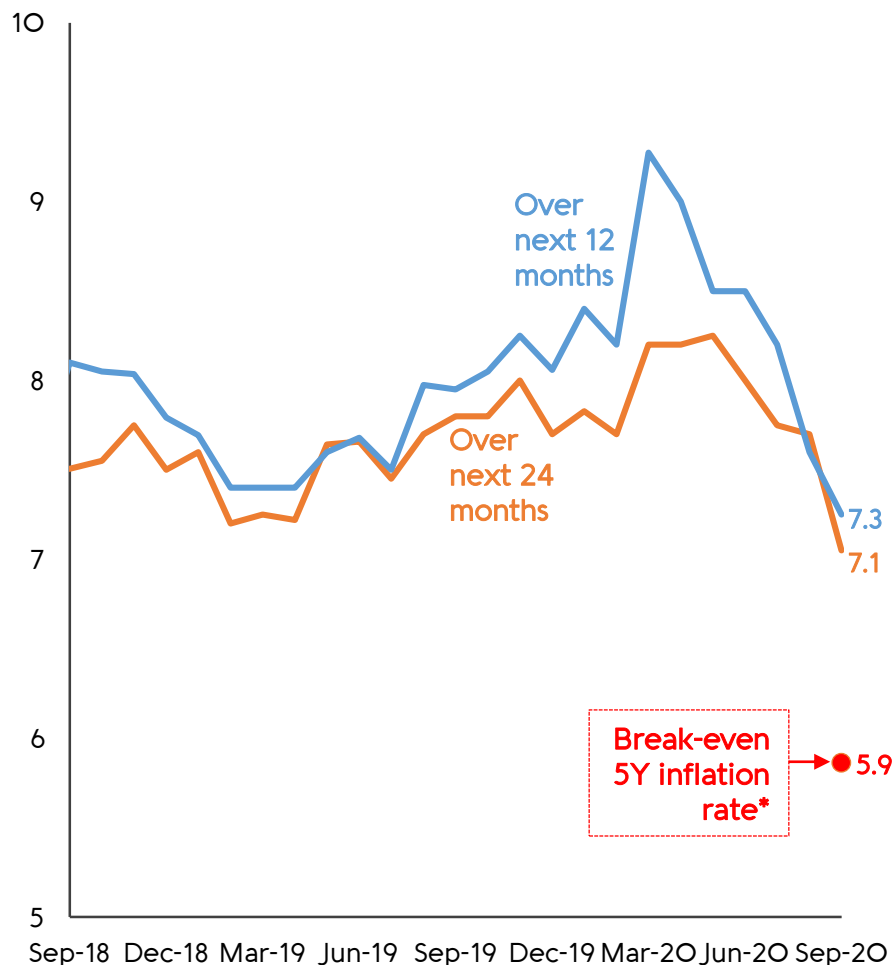


^{1/} Excluding fruits and vegetables, and administered prices

Falling inflation expectations are consistent with the declining inflation path included in the Budget Law

Median inflation survey expectations

(Annual, in %)

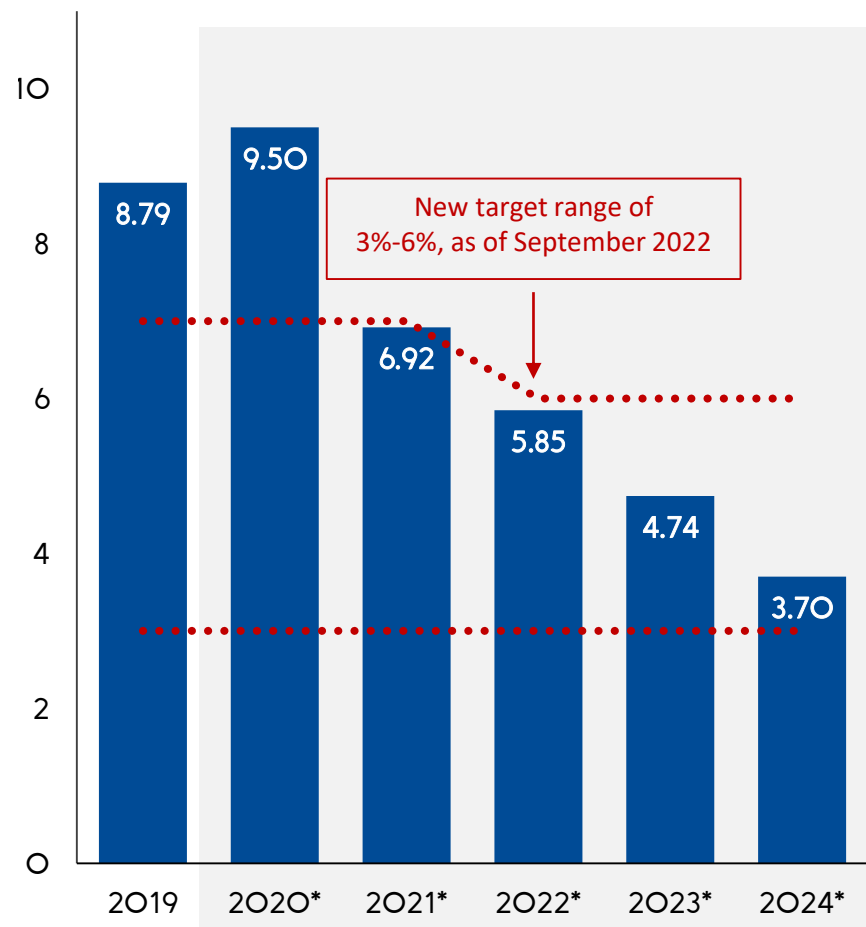


(*) As of October 15, 2020

Source: Central Bank of Uruguay; Ministry of Economy and Finance

Inflation: 5-year budget forecasts

(Year end, in %)

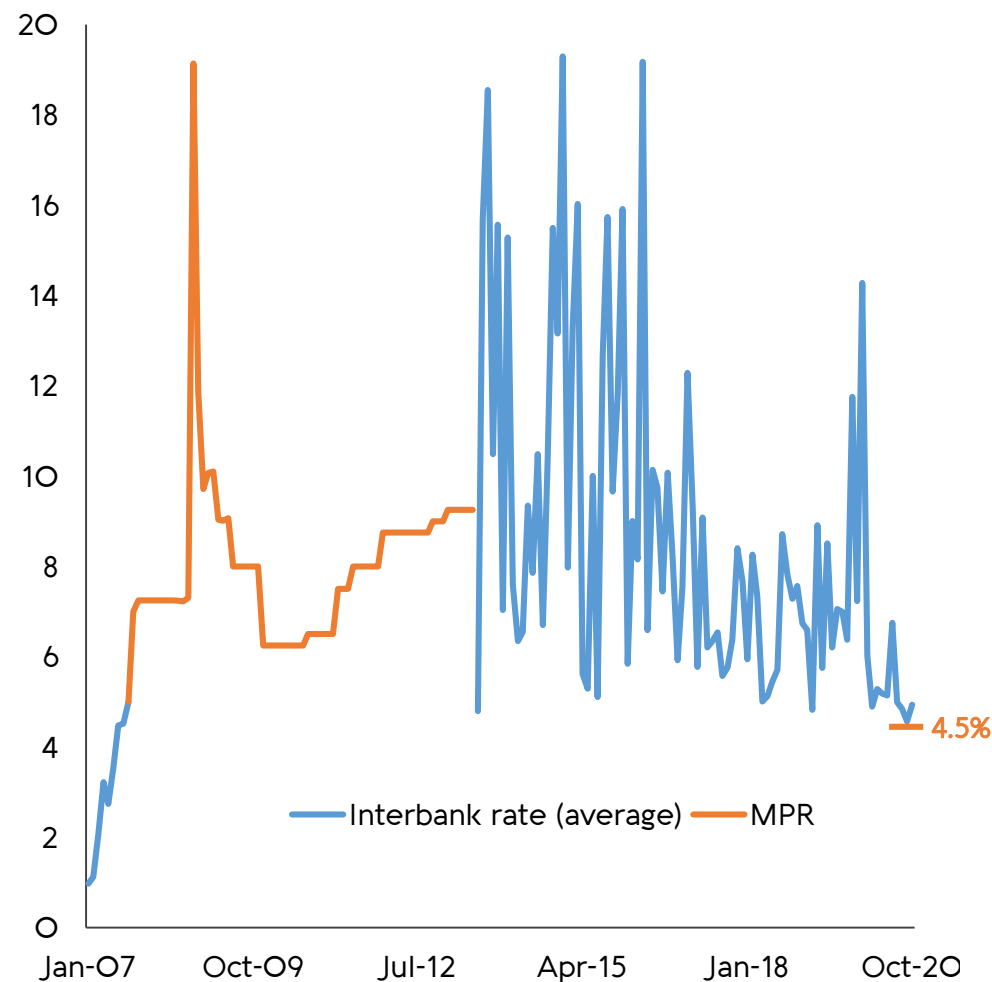


(*) Projections

Impact of change to short term interest rate as the policy instrument

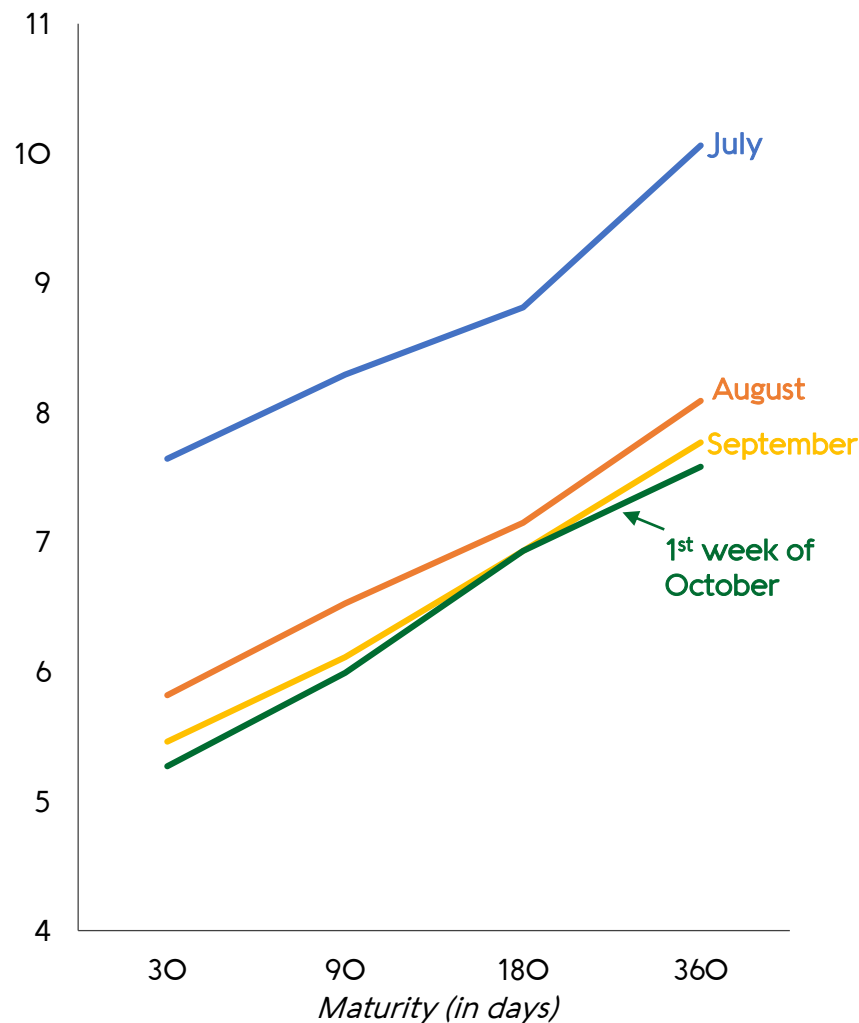
Interbank rate and Monetary Policy Rate (MPR)

(In %)



CBU-Bills auction interest rates during 2020

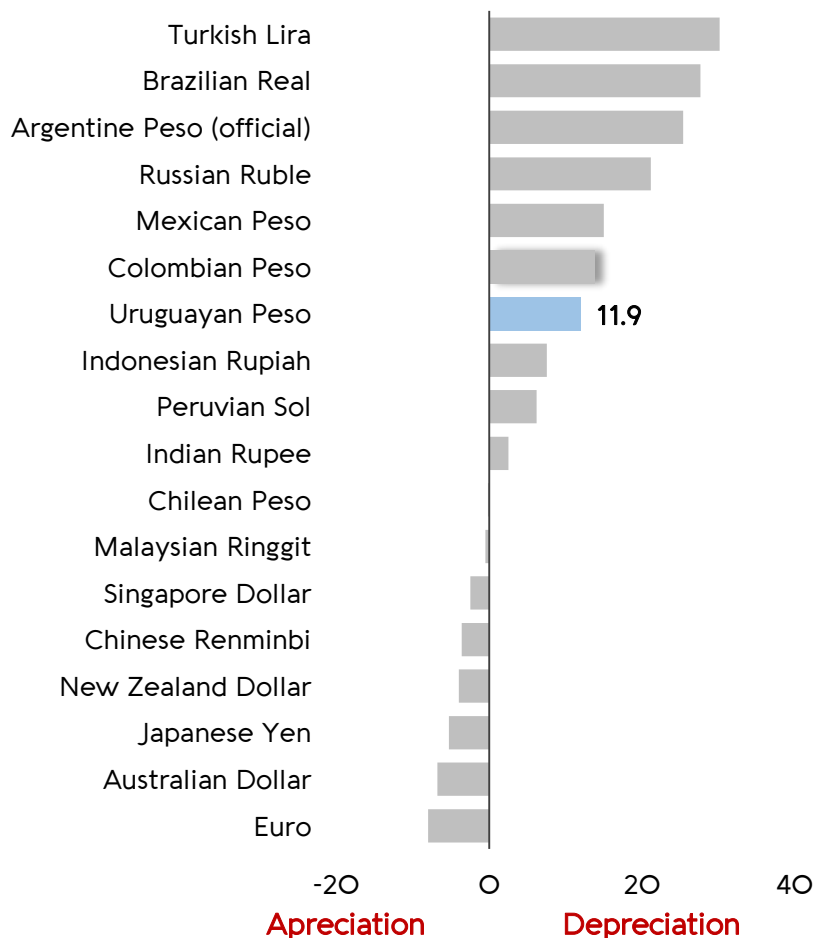
(Weighted average per issued amount, in %)



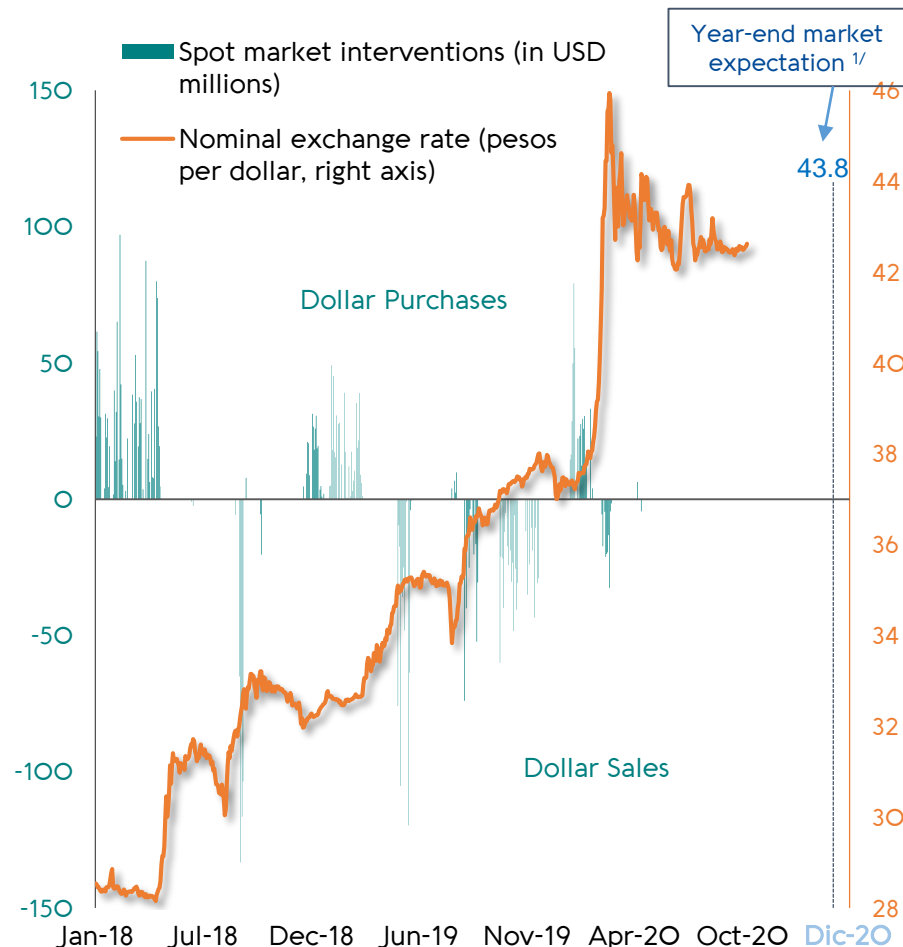
Floating exchange as a shock absorber; Central Bank intervenes on both sides of the market to smooth out undue volatility

Currency performance vs USD since Covid-19 world outbreak

(Change since February 19th, through October 13th, 2020, in %)



Uruguay: exchange rate and Central Bank FX intervention

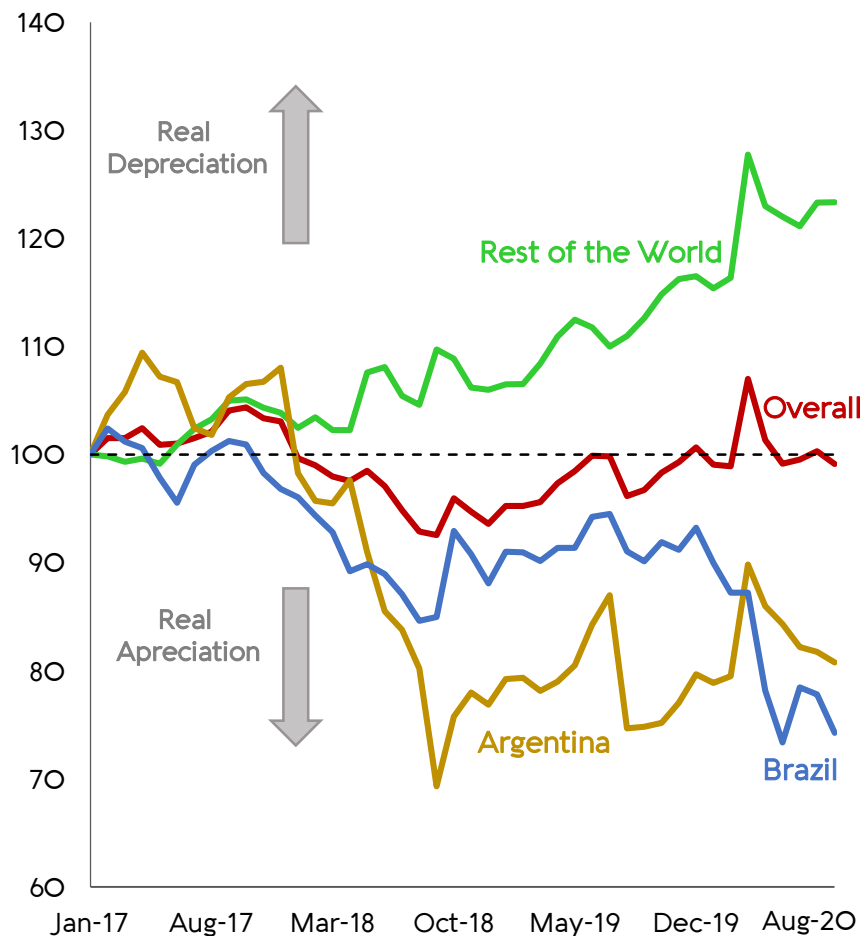


1/ Median expectation in Central Bank's market survey as of September 2020

Overall RER broadly in line with fundamentals; sizable international reserves are an important backstop for external stability and key policy anchor

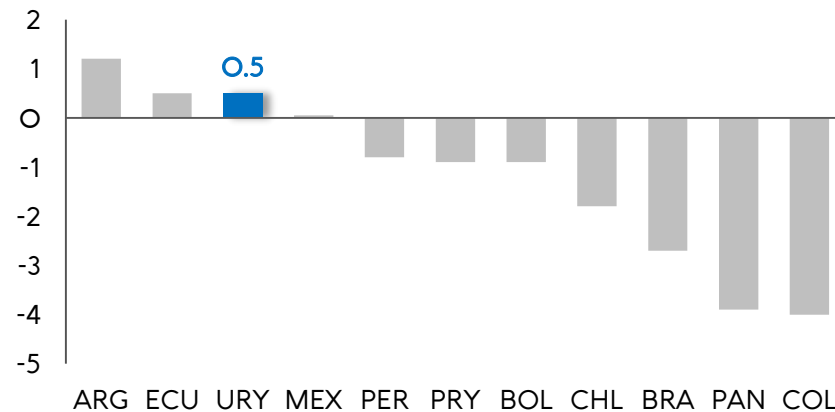
Real exchange rate (RER)

(Index base 100 = January 2017)



Current account balance compared with Latam

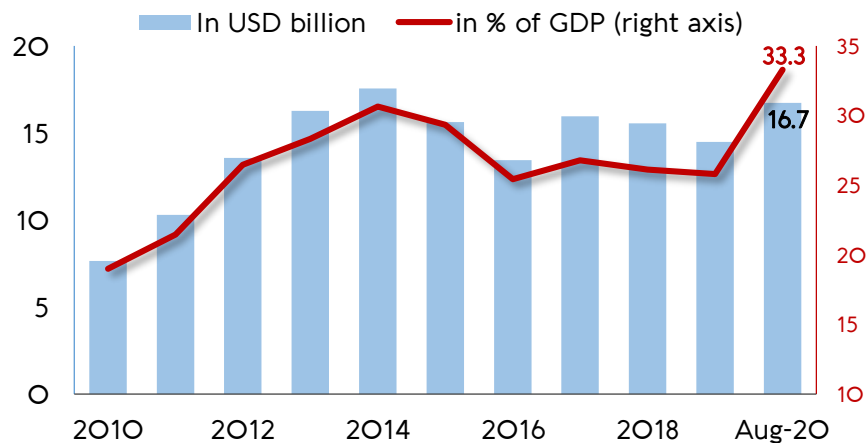
(In % of GDP, 12-month period to 2020Q2^{1/})



1/ Except Panama which is for 2020Q1.

Uruguay: International reserves

(End of period)



2. Rebuilding and developing local currency peso markets and de-dollarization strategy

- Launch of a working group to lead a process of peso market reconstruction/de-dollarization.
- This group will be in charge of setting up, in dialogue with the financial industry and other stakeholders, the following agenda:
 - Invoicing and price dollarization.
 - Regulation reform (we are already working on a reduction of reserve requirements on peso deposits).
 - Financial education and public communications.
 - Develop the FX derivative market: more market players and more transparency on OTC transactions (repository).

THANK YOU