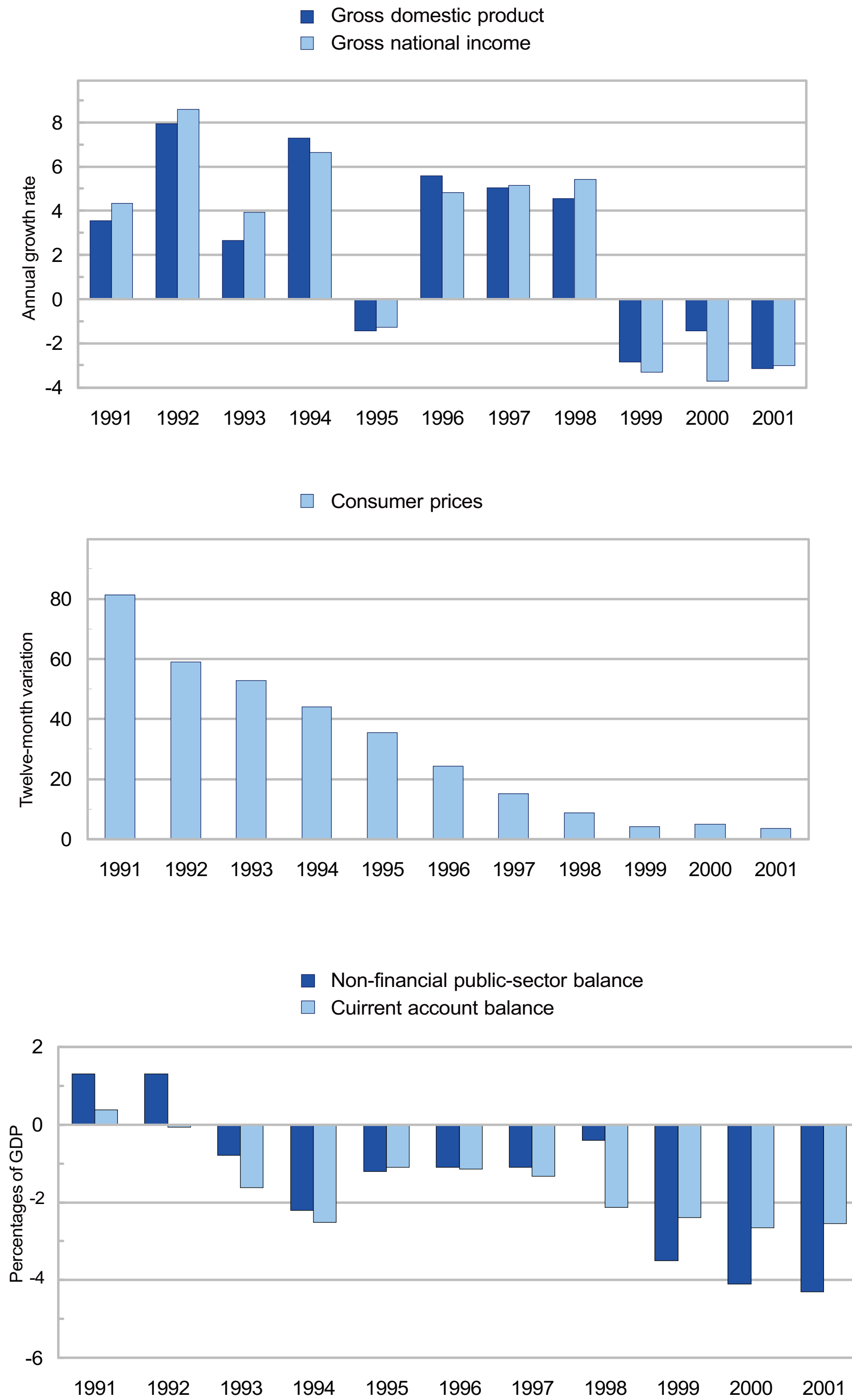
URUGUAY

1. General trends

The Uruguayan economy's 3% contraction in 2001 marked the third consecutive year of a recession in which GDP shrank by 7% and per capita income, by 12%. Economic activity was badly hurt in 2001 by the slowdown in the world economy and global trade, by instability in neighbouring countries and, especially, by a fresh outbreak of foot-and-mouth disease, which was thought to have been eradicated several years earlier. The public-sector deficit remained obdurately above 4% of GDP and had to be financed by means of increased external borrowing. In recent years repeated resort to external borrowing has greatly increased the non-financial public sector's foreign-currency debt burden, which, at the end of 2001, was equivalent to 43% of output. The ban on beef sales sent exports plummeting; nevertheless, as the slump in imports was even steeper, the balance-of-payments current-account deficit widened only slightly, to 2.6% of GDP. The private sector posted a new surplus, this time in excess of 1.5% of GDP. The simultaneous drop in domestic and external demand translated into a steep rise in unemployment, with over 15% of the economically active population out of work, and eased pressure on domestic prices, which climbed by less than 4%.

IN EARLY 2002, contagion from Argentina's financial meltdown cast further gloom on this already bleak picture. Trade across the River Plate came to a standstill and seasonal tourism revenues were sharply down. The freezing of bank deposits in Argentina had a knock-on effect in Uruguay, as it prompted Argentines with Uruguayan accounts to make huge withdrawals of funds. At the same time, the difficulty of narrowing the fiscal deficit in the face of dwindling international credit options drove down the country's sovereign debt rating, which finally lost its investment grade. This made it difficult for Uruguay to further expand its already voluminous external borrowings, and prompted lenders to impose higher rates of interest. In the second quarter, fallout from the Argentine crisis and the loss of the investment-grade rating were further aggravated by the uncertainty that dogged the financial markets in Brazil. In these circumstances the secondary market value of government securities weakened, sending Uruguay's country-risk rating soaring to over 1,000 basis points. Moreover, as both residents and non-residents continued to withdraw deposits, the Central Bank was forced to

Figure 1
URUGUAY: MAIN ECONOMIC INDICATORS



Source: ECLAC, on the basis of official figures.

intervene in two financial institutions and bail out two others. Given this state of affairs, the government obtained US$ 1.5 billion in extraordinary financing from IMF, on top of the US$ 740 million it had received at the beginning of the year. These amounts, together with the credits received from IDB and the World Bank, brought the level of financial assistance from the three international institutions to about US$ 3 billion, which will be disbursed in the course of the biennium 2002-2003. A portion of these resources and the proceeds of government securities issues will be used to establish a banking system consolidation fund, which will be able to draw on over US$ 2 billion to shore up and capitalize the financial system.

2. Macroeconomic policy

Early 2001 brought expectations of an improvement in the global and regional conditions affecting Uruguay. The main international economic and financial institutions were projecting an upswing in world demand and, in particular, strong rates of growth in Brazil. Based on these assumptions, the authorities expected GDP to rally after two years of negative growth and rise by 2%. Economic policy was geared towards narrowing the consolidated public-sector deficit from 4% to 2.6% of GDP and the external current-account deficit, from 3% to 2.4% of GDP. The local currency's monthly devaluation of 0.6% was intended to bring inflation to an annual rate of about 5% and to gradually restore the country's foreign competitiveness.

This scenario was dissipated, however, by the worsening of the Argentine crisis, the downturn in Brazilian demand in the wake of the sharp devaluation of the real (which also had the effect of seriously weakening Uruguay's competitiveness vis-à-vis Brazil), the slowdown in world trade and, above all, the reappearance of foot-and-mouth disease after several years in which Uruguay had earned the "foot-and-mouth-free without vaccination" rating that had opened the door to the more lucrative foot-and-mouth-free sector of the beef market. Moreover, the grim international outlook was further darkened by the imposition of non-tariff barriers by Uruguay's main MERCOSUR trading partners and by the spectre of recession in the developed economies. Faced with this situation, in mid-year the authorities changed the parameters of the sliding band system, doubling both the annual rate of devaluation (from 7.4% to 15.4%) and the width of the band (from 3% to 6%).

As the crisis in Argentina deepened in early 2002, the government again doubled the monthly rate of devaluation and the width of the flotation band, to 2.4% and 12%, respectively. At the same time, it adopted a battery of measures to increase taxes and cut spending, with the aim of slashing the central government deficit by more than US$ 400 million. In March it agreed on a financial programme with IMF. On the assumption that economic activity would slip by a further 2% during the year, the programme's provisions were geared towards lowering the persistent deficit of the consolidated public sector to 2.5% of GDP, which would be financed from international reserves and further external borrowing. The money supply could thus be kept at its level of late 2001, which would limit inflation to a maximum annual rate of 10%. The recession became more acute in the first quarter of the year, however, with output dropping by 10% with respect to the year-earlier period, and the government was forced to amend this programme. In June it signed an agreement with IMF which gave rise to the additional credit mentioned earlier. This new arrangement assumed that GDP would fall by around 7%, but maintained the objective of lowering the fiscal deficit to 2.5% of output. In this scenario, 2002 inflation would come in at around 12%. At the end of June the government decided to dispense with the sliding band system and float the currency, so that the exchange rate could move more freely in the current regional context of heightened volatility.

(a) Fiscal policy

The consolidated public-sector deficit stubbornly withstood attempts to bring it below the level recorded in 2000. The central government was the source of the larger deficit in the public accounts, as its negative balance increased to 4.7% of GDP, which was half a percentage point higher than the previous year's figure. This increase in the central government's deficit, despite a real expansion in fiscal revenues, reflected the rapid rise in government spending due to the exceptional increase (24%) in payments of interest on the public debt and larger transfers to the social security system. As in

Table 1
URUGUAY: MAIN ECONOMIC INDICATORS

	1993	1994	1995	1996	1997	1998	1999	2000	2001[a]
	Annual growth rates [b]								
Growth and investment									
Gross domestic product	2.7	7.3	-1.4	5.6	5.0	4.5	-2.8	-1.4	-3.1
Per capita gross domestic product	1.9	6.5	-2.2	4.8	4.3	3.8	-3.6	-2.2	-3.8
Gross domestic product, by sector	0.0								
Goods	-5.7	6.9	-0.9	5.2	1.5	4.1	-6.4	-3.5	-6.4
Agriculture	-5.9	11.8	5.5	9.4	-6.1	5.2	-7.5	-3.0	-5.1
Mining	11.1	7.1	20.8	7.6	22.1	29.4	-5.8	-8.8	-11.2
Manufacturing	-9.0	4.0	-2.8	4.0	5.9	2.3	-8.4	-2.1	-6.2
Construction	16.8	8.5	-10.3	-1.8	2.4	9.8	8.9	-11.1	-11.2
Basic services	8.1	11.8	6.5	7.0	6.2	6.3	2.6	2.4	0.7
Electricity, gas and water	-1.5	-3.3	7.3	4.3	6.7	11.5	-0.1	5.0	1.4
Transport, storage and communications	12.9	18.5	6.2	8.0	6.0	4.5	3.7	1.5	0.4
Other services	4.4	3.6	-2.8	4.5	5.8	4.3	1.6	-0.6	-0.9
Commerce, restaurants and hotels	16.8	11.0	-9.6	6.0	8.8	2.4	-3.4	-5.3	-3.3
Financial establishments, insurance, real estate and business services	-0.2	1.0	0.5	5.2	5.4	6.8	6.4	2.2	1.6
Consumption	5.1	8.3	-3.2	7.8	5.4	6.4	-1.3	-1.7	-2.3
General government	0.9	4.5	0.2	5.0	2.3	4.0	0.6	-0.3	-1.3
Private	5.8	8.9	-3.7	8.3	5.9	6.8	-1.5	-1.4	-2.4
Gross domestic investment	9.3	12.8	4.6	-1.0	8.3	12.1	-9.8	-11.6	-9.1
Exports of goods and services	8.6	15.1	-1.9	10.3	13.0	0.3	-7.4	6.4	-8.8
Imports of goods and services	17.2	18.3	-3.0	11.3	13.2	7.6	-5.8	0.1	-7.7
	Percentages of GDP [c]								
Gross national income	98.5	98.2	99.2	99.0	98.8	99.8	99.3	97.4	97.2
Gross domestic investment	13.7	14.5	15.4	14.3	14.6	15.8	14.9	13.5	12.6
National saving	12.2	12.0	14.2	13.1	13.2	13.3	12.2	10.7	10.0
External saving	1.6	2.5	1.2	1.2	1.4	2.4	2.7	2.8	2.6
	Percentages								
Employment and wages									
Labour force participation rate [d]	56.6	58.1	59.1	58.2	57.7	60.5	59.3	59.6	60.6
Open unemployment rate [e]	8.3	9.2	10.3	11.9	11.5	10.1	11.3	13.6	15.3
Real average wage (index: 1995=100)	102.0	102.9	100.0	100.6	100.8	102.7	104.3	102.9	102.7
	Growth rates								
Prices (December-December)									
Consumer prices	52.9	44.1	35.4	24.3	15.2	8.7	4.2	5.1	3.6
Wholesale prices	31.1	41.0	27.7	23.5	13.3	3.3	-0.3	9.5	3.8
External sector									
Terms of trade (index: 1995=100) [c]	94.6	94.7	100.0	96.7	96.4	103.1	94.9	86.2	87.1
Nominal exchange rate (pesos per dollar) annual average	3.9	5.0	6.3	8.0	9.4	10.5	11.3	12.1	13.3
Real effective exchange rate for imports (index: 1995=100)	114.4	104.7	100.0	99.3	97.5	97.0	90.9	92.7	94.0
	Millions of dollars								
Balance of payments									
Current account	-244	-438	-213	-233	-288	-476	-502	-532	-475
Trade balance (goods and services)	-105	-237	-62	-127	-169	-336	-519	-514	-403
Exports	2,760	3,248	3,507	3,847	4,217	4,136	3,478	3,658	3,272
Imports	2,865	3,485	3,568	3,974	4,386	4,472	3,997	4,172	3,675
Capital and financial accounts [f]	437	547	440	386	686	836	515	702	772
Overall balance	...	...	228	152	399	360	13	170	297
Variation in reserve assets (- indicates an increase)	...	...	-218	-141	-390	-521	-13	-170	-292

Table 1 (concluded)

	1993	1994	1995	1996	1997	1998	1999	2000	2001[a]
					Percentages				
External debt									
Gross debt (as a percentage of GDP)	23.8	24.3	22.9	22.9	21.9	23.2	24.8	27.4	30.1
Net interest (as a percentage of exports)	5.3	6.2	5.0	4.0	4.0	3.4	-1.0	-0.7	-1.5
					Percentages of GDP				
Central government									
Current income	17.0	17.3	17.4	17.8	19.0	19.5	19.2	19.4	19.7
Current expenditure	15.9	16.8	17.3	17.9	18.7	18.5	20.6	21.6	22.4
Saving	1.0	0.6	0.2	-0.1	0.3	1.1	-1.4	-2.3	-2.7
Capital expenditure	2.0	2.5	2.1	1.7	1.9	2.2	2.4	1.8	1.6
Financial balance	-1.0	-1.9	-1.9	-1.8	-1.6	-1.2	-3.8	-4.1	-4.4
					Growth rates				
Money and credit									
Net international reserves	25.5	39.2	45.0	33.5	18.5	10.2	33.8	22.8	29.7
Net domestic credit	38.9	37.4	22.7	38.9	35.9	28.3	14.0	7.5	30.8
To public sector	31.4	46.5	10.1	-5.8	-22.9	...	...	51.9	23.4
To private sector	46.8	40.1	50.2	36.2	35.0	28.7	16.9	9.3	23.6
Money (M1)	58.4	39.6	31.7	26.4	21.4	13.1	9.3	-5.6	-3.6
Local currency savings and time deposits	35.2	24.6	54.7	29.4	19.8	30.4	4.8	9.0	5.2
M2	48.8	34.0	39.8	27.5	20.8	19.9	7.4	0.5	0.4
Dollar deposits	29.5	39.2	30.4	38.6	29.6	20.8	24.7	16.6	35.1
					Annual rate				
Real interest rate (annualized, %)									
Deposit rate	-9.7	-5.5	-3.0	-0.4	-0.3	3.8	8.1	7.0	8.5
Lending rate	27.9	34.5	39.7	48.8	42.9	42.4	45.8	42.3	43.9
Equivalent interest rate in foreign currency [g]	38.8	36.3	36.9	27.7	20.6	14.9	14.2	12.0	12.8

Source: ECLAC, on the basis of official figures.
[a] Preliminary figures. [b] Based on constant 1983 new pesos. [c] Based on constant 1995 dollars. [d] Percentages of the working-age population, nationwide total. [e] Percentages of the economically active population, nationwide total. [f] Includes errors and omissions. [g] Interest rate on deposits, deflated by the variation in the exchange rate.

previous years, the deficit of the non-financial public sector was slightly lower, at 4.3% of GDP, since State-owned enterprises posted a positive balance.

Even in a climate of prolonged recession and close correlation between tax receipts and economic activity, new levies introduced during the year swelled fiscal revenues by over 1% in real terms. A new 3% tax was levied on the sale of locally-produced and imported industrial goods and import duties were raised, boosting receipts from indirect taxes. Direct tax revenues declined in nominal terms, however. In order to make domestically-produced goods more competitive, the authorities dispensed with the employer's social security contribution in the agricultural, manufacturing and road haulage sectors. These measures were part of an ongoing process of change in the structure of social security financing, aimed at increasing the proportion of funding from taxes and reducing the contribution calculated on the basis of workers' wages.

Central government spending expanded faster than receipts, however, climbing by more than 2% in real terms. The government's substantial debt interest burden and social security spending continued to hem in fiscal policy. Interest payments on the public debt rose from 1.3% of GDP in 1998 to 2.6% in 2001. Transfers to the social security system, which had accounted for less than 5% of GDP before 1992, increased to 8% of GDP in 1996 and over 10% in 2001 (public social security outlays now represent 16.5% of GDP). Since there was also a real increase in non-wage expenditure (13%), the adjustment fell mainly on capital expenditure, which was down by 11%.

Table 2
URUGUAY: MAIN QUARTERLY INDICATORS

	1999				2000				2001 [a]				2002 [a]
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I
Gross domestic product [b] (change from same quarter of previous year)	0.7	-0.2	-6.5	-4.5	0.7	-6.5	-1.6	-0.8	-1.7	2.5	-4.3	-5.0	-10.1
Consumer prices, nationwide (12-month variation, %)	7.2	6.1	4.1	4.2	4.5	4.8	5.4	5.1	4.7	4.3	3.9	3.6	5.1
Exports (millions of dollars)	509	554	556	618	566	565	614	551	595	501	482	482	439
Imports (millions of dollars)	792	796	841	928	897	823	833	913	805	770	735	751	529
Net international reserves (millions of dollars)	1,959	2,033	2,040	2,081	2,164	2,344	2,523	2,447	2,667	2,764	2,750	3,097	2,194
Real exchange rate [c] (index: 1995=100)	89.9	90.4	92.0	91.3	92.7	92.3	93.9	92.1	92.8	93.0	93.8	96.4	77.4
Money (M1) (change from same quarter of previous year)	-0.9	0.5	3.4	4.8	-0.9	-4.1	-6.9	-10.3	-3.9	-5.5	-1.1	-6.8	...
Real interest rates (annualized, %)													
Deposit rate	6.5	6.9	9.2	9.8	8.6	7.4	6.0	6.0	6.1	5.7	12.4	12.6	12.1
Lending rate (non-preferential)	49.1	43.6	43.3	47.1	45.6	42.5	41.2	39.7	41.8	42.6	45.6	51.5	62.0

Source: ECLAC, on the basis of official figures.
[a] Preliminary figures. [b] Based on figures that have not been seasonally adjusted, at constant domestic prices. [c] Refers to exchange rate for imports.

The consolidated public-sector deficit was financed with room to spare by the issuance abroad of government securities in excess of US$ 1 billion, in combination with higher borrowings –US$ 244 million– from the domestic financial sector. These funds also served to increase the Central Bank's international reserves by US$ 320 million.

(b) Foreign-exchange policy

Foreign-exchange policy in Uruguay has faced a massive challenge in the form of heavy real devaluations in the country's two large neighbours and MERCOSUR trading partners, Argentina and Brazil. In early 1999 Brazil had begun to allow its currency to float freely, whereupon it had depreciated rapidly. At the beginning of 2002 Argentina also allowed its currency to float, and the price of the dollar tripled in the first three months of the year. The sliding band system used in Uruguay has gradually increased the exchange rate against the dollar over the last few years and has caused Uruguay's currency to appreciate strongly against those of its main trading partners at given points in time. Once the initial impact had been absorbed, however, domestic price trends in the different countries narrowed the real gap between their currencies. In 1999, the Uruguayan peso's real exchange rate appreciated by 6% relative to a basket of the currencies of its main trading partners. In 2001, however, the currency's average appreciation was around three percentage points lower than the figure recorded in 1998.

By mid-June 2002, with the sliding band scheme in operation, the price of the dollar had moved up by 16%. In the days following the flotation of the currency, the exchange rate rose by a further 10%, as market liquidity was low.

(c) Monetary and financial policy

The gradual widening of the currency band from 3% in early 2001 to 12%, where it stayed until mid-2002, progressively allowed monetary policy to come

to the fore. The dollar remained within the band from mid-2001 until the system was abandoned, except on a few occasions, such as in late 2001 and early 2002, when the financial turmoil in Argentina sent the price of the dollar up to the ceiling of the band and the Central Bank responded by selling foreign exchange. The new floating system now makes monetary policy the main line of action, after a long period in which it had taken a back seat to foreign-exchange policy.

In view of the inflation target, monetary policy was tight in 2001. Demand for money trended downward against a background of recession and mounting uncertainty, with both narrow money (M1) and broad money (M2) contracting even in nominal terms. Foreign-currency deposits grew by US$ 1.8 billion, however –a 15% increase from their December 2000 level– thanks to an inflow of funds mainly from residents in Argentina.

Given larger-than-expected devaluation and the broadening of the currency band, interest rates on peso deposits moved up in the second half of 2001, yielding real returns of approximately 10% at the end of the year. Local-currency lending rates behaved in a similar manner, exceeding, in December, 50% a year in real terms for prime borrowers. Lending and deposit rates in foreign currency, which apply to more than 80% of the credit market, displayed no clear trend; annual lending rates ranged from 7% to 12%.

Inflows of deposits from non-residents, especially Argentines, changed drastically in early 2002. One particular bank in Uruguay was undermined by the fraudulent manoeuvres of several bankers who were also large stakeholders in related banks in Uruguay and Argentina, while the freezing of bank deposits in Argentina forced the temporary closure of a bank in Uruguay that catered primarily to Argentine customers, as the supply from its parent bank was cut off. These events triggered the withdrawal in early 2002 of most of the foreign-currency deposits that had been made in 2001, creating a substantial drain on the Central Bank's international reserves.

With the loss of the investment-grade rating, which coincided with the withdrawal of deposits, and the resulting difficulties in launching fresh issues of sovereign debt at low rates of interest, the authorities turned to IMF to rebuild reserves of foreign exchange. First they requested the disbursement of funds corresponding to the contingent credit line for 2000-2001, which they had not yet drawn upon. At the same time, they obtained a new contingent credit line for 2002-2004, for US$ 740 million, of which the first instalment was received in April. This was followed by new loans extended in June.

(d) Trade policy

In the 1990s, MERCOSUR had been the focus of Uruguay's trade policy. The Brazilian devaluation of early 1999 and the economic crisis in Argentina, however, badly affected Uruguay's trade with its two largest neighbours, which had formerly absorbed over half of its goods and services exports, and generated friction in the implementation of the MERCOSUR agreement. The government of Uruguay therefore took steps to negotiate bilateral agreements with other countries, especially the United States, in order to offset the collapse of demand in the subregion. Rules on the financing of imports from Argentina were adopted early in the second quarter of 2002. In practice, they serve as safeguards against Argentina's heightened competitiveness in the wake of its currency devaluation. Reference prices were also established for calculating levies due on merchandise acquired in Argentina.

3. The main variables

(a) Economic activity

Uruguay remained mired in recession for the third year running, with a 3% drop in GDP. All the components of demand displayed negative growth. Fixed capital formation sustained the heaviest fall (-11%) as a result of considerable slippage in public investment (-17%) and a further decline in private investment (-9%), which has been trending downward since 1998 owing to persistent adverse expectations with respect to economic performance. In this context of recession and fiscal adjustment, public and private spending also shrank, by 1% and 3%, respectively. Lastly, the suspension of beef exports after the outbreak of foot-and-mouth disease, combined with the poor competitiveness of Uruguayan exports and shrinking demand in its two main trading partners, translated into a contraction of over 8% in the physical volume of exports.

The downturn in output was across the board, with the exception of basic services and communications. The worst affected segment was goods production, which fell by 6%. Agricultural output declined as a result of smaller sowings of rice, in view of the decrease

in international prices, and poor yields of wheat after heavy spring rains. Wool production shrank as sheep stocks were reduced in response to steadily falling international textile prices. This was in addition to the downturn in beef production caused by the foot-and-mouth outbreak and the destruction of infected cattle. Foot-and-mouth also hurt meat packing for export, while textiles, clothing and transport equipment suffered from the downturn in external demand. The domestic recession affected the output of the beverage and chemical industries. Lastly, construction plunged by 11% owing to difficulties in funding both public and private works, which were down by 13% and 11%, respectively.

Commerce and transport both posted a lower out-turn, largely as a consequence of the decline in domestic production and in merchandise imports. Banking services and personal and household services also showed negative growth. The electricity, gas and water sector and communications were the only activities that stayed on the growth track initiated several years earlier.

(b) Prices, wages and employment

The weakness of domestic demand and external deflation helped to keep domestic inflation low. In 2001 consumer prices rose by a mere 3.6% and wholesale prices, by 3.8%, which were the lowest rates in more than 50 years. Consumer prices for food and beverages increased by less than 1%, thanks to the fall in beef prices caused by the expansion of domestic supply in the wake of the export ban. Strong competition from cheap imports helped to push down the price of clothing and footwear. The other sectors posted increases of between 3% and 7%.

Slack demand also had the effect of increasing unemployment, which reached a record 16% of the economically active population (EAP) in the second quarter of 2001. On average, the rate of unemployment increased by one and a half percentage points with respect to the year before, to stand at 15.3% of the EAP, as the labour force participation rate rose and the employment rate stood still. Weak demand for labour also prolonged the average period of unemployment, which in Montevideo now exceeds 34 weeks. In this context, real wages in the private sector declined again, this time by almost one percentage point. In the public sector, by contrast, real wages were up by almost one percentage point, which offset the backslide of the previous year. The combination of higher unemployment and lower real wages generated a 7% drop in average household income.

(c) The external sector

The outbreak of foot-and-mouth disease among beef herds and the domestic recession were the two main culprits in the plunge of Uruguay’s external trade figures in 2001. Goods and services exports were down by more than 10% in current values, resulting in a cumulative decline of 25% with respect to their 1998 level. Two export segments –beef and automobiles– bore the brunt of the downturn. Exports from the meat-packing industry fell by a drastic 37% as a result of the foot-and-mouth sales ban; this decline alone accounted for an 8% downturn in merchandise exports. Meat exports to foot-and-mouth-free countries did not resume until November, when the vaccination of herds was completed. Negative growth in sales of transport equipment, which were down by almost a third, accounted for a further 2% of the contraction in merchandise exports. The other export segments performed unevenly, more or less counterbalancing each other. Tourism revenues also suffered badly, with a slide of 14%, owing to the financial situation in Argentina and Uruguay’s loss of competitiveness vis-à-vis Brazil. MERCOSUR continued to be the country’s main trading partner, absorbing 40% of merchandise exports.

The downturn in imports was considerable. Depressed domestic demand particularly affected capital goods, which slid by 14%. Imports of non-energy inputs and consumer goods were down by 8% and 6%, respectively. The oil account fell by almost a quarter owing to low international prices. Spending by Uruguayan tourists outside the country decreased by 11% in 2001.

Capital inflows in the form of direct investment and credit to the public sector, of around 1.7% and 3% of GDP, respectively, were more than sufficient to finance the external deficit. This plentiful financing also enabled the Central Bank to add US$ 300 million to its international reserves.