

Newsalert

International Tax
Structuring Network
And Trust Services

*connectedthinking



URUGUAY

Executive Perspectives,
February 2004
PricewaterhouseCoopers New York

A new Credit Market for Uruguay

I. Uruguay's Crisis and Current Recovery

1. Uruguay and the region

Latin America and the Caribbean are experiencing a condition of economic stagnation dating back to 1997. In recent years not only have the region's people had less wealth to share (less **PIB** per capita), but salaries have been stuck at 1997 levels, employment has gone down and unemployment has risen.

The MERCOSUR countries, for their part, have been strongly affected by adverse financial conditions, both internal and external. Among the external factors are the drop in global trade, the fall in export prices and reduced capital flow into the region. These negative forces saddled economies with fiscal problems, high debt, lack of credit and high unemployment levels. Currency imbalances, inflation, debt restrictions and related issues, financial instability and bank crises have been common problems among the countries of the bloc.

Although Uruguay's per-capita **PIB** exhibited more dynamism than its neighbors when the entire region was growing (in some years Uruguay's growth rate nearly doubled the Latin American average), the consequences of Brazil's devaluation in 1999 affected the region in multiple ways, with a particular impact on Uruguay, which entered a recessionary phase that greatly worsened in 2002.

The financial crisis that took hold in 2002 restricted the possibility of bank credit (in August 2002 the banking system as a whole lost almost US\$6.9 billion of the \$14.9 billion on hand in December 2001, before the bank run began) and affected the entire transaction chain – one of the main causes of the severe drop in activity recorded that year.

2. The recovery phase

During 2003, Latin America has shown signs of recovery, after experiencing a **PIB** contraction of 0.8% in 2002.

Despite the '02 squeeze, the World Bank's projections are optimistic for the medium and long terms. Multilateral trade agreements are in negotiation and initiatives are underway to open the US and EU markets. The Bank emphasises that macroeconomic stability and the commitments made by fiscal and monetary policies are becoming the regional norm, and are already beginning to bear fruit in lower international financing costs and strengthened local financial markets. In Uruguay's case, news of successful **debt exchange**, together with the revival of deposits recorded in recent months, offers grounds for hope that the trend of return of deposits to the financial system will be sustained – a basic requirement for reestablishing credit in the economy.

With the adoption of a free-floating exchange rate in mid-2002 – heralding a major devaluation of the Uruguayan peso – corrections in the true exchange rate took place that improved Uruguay's external competitiveness.

Nevertheless, although competitiveness with the US and Europe is moving in a favorable direction, lack of credit for production, and more specifically for export activity, is one of the chief roadblocks preventing Uruguay from taking full advantage of the devaluation of local currency to boost exports.

Given this situation, PwC sees several factors that could serve as stimuli for a new credit market.

II. Stimulating a New Credit Market

1. New sources of financing

Traditionally, Uruguayan businesses have obtained a large percentage of their external financing through bank credit. Some 72% of companies in the industrial sector cite bank loans as their main source of financing, while only 55% name **profits** and 29% the contributions of partners or stockholders.

When banks reopened after the 2002 bank holiday, the Uruguayan financial system had 18% less in deposits in the national currency and 45% less in dollars. Currently, 60% of the deposits in the system is in **sight drafts** – limiting credit-granting possibilities, as does the banks' strategy of maintaining high liquidity and reducing risks in a recessionary context.

Facing the shrinkage of available credit owing to the recent crisis, companies or productive sectors in our country seeking to seize the present moment of recovery had to decide to change the structure of financing, by either injecting more of their own capital or using new financing mechanisms.

A greater commitment of businesses' own capital would clearly be desirable – they would be less vulnerable to the vagaries of external financing such as were recently experienced. However, such a change in cultural norms takes time and entails complexities beyond this article's analytical scope.

The banking system that emerges after the crisis just past may not be equal to the task of financing all the productive investment needed to trigger economic revival – or even to reach previous levels of confidence in the financial system.

Given that past foreign investment in Uruguay wasn't of great magnitude even in prosperous times, hopes that savings from abroad can contribute significantly to a productive upturn don't seem well founded.

Consequently, the first goal must be to spur the investment of domestic savings, primarily those in control of **retirement savings funds**, in productive projects. This in turn highlights the need to adapt the new financial system to new financing instruments – a task requiring creativity in mediating between saving and investment. To undertake it, PricewaterhouseCoopers has offered the business community local support, professionalism and proven experience applying products developed in the world's most demanding financial markets.

2. New financing instruments

Beginning with the passage of the Emergency Law and the Budget Law, a series of changes and innovations in certain legal frameworks began to take place in Uruguay. These changes weren't explored or understood well enough to be taken advantage of in business generally or in the credit market specifically.

Efforts thus far to create financial instruments that will promote investment in productive projects have been positive: the passage of the Securities Law, the Investment Funds Law, and the Securitisation and Factoring Law; and the improvements in the Leasing Law – these are examples of instruments now available in Uruguay similar to those found elsewhere in the world. Thus in the present context the expanded use of such instruments as factoring, leasing and securitisation of long-term credit should be a natural process in the country.

Added to the current landscape is the encouraging fact that with the passage of Law No. 17.703 on 28 November 2003, Uruguay, like other Latin American countries, will be able to make use of the legal instrument of **trusteeship**. Extraordinarily flexible, trusteeship is a mechanism to mobilise, activate and orchestrate credit that can channel the market's collective needs and rationally insure the parameters of risk assumed by the investor.

Given that financing needs are different for large, medium-sized and small companies (considering not only the sums sought but also their use), the instruments and mechanisms applied will vary as appropriate to the size and characteristics of each specific sector. Instruments used for industry may differ from those suitable for construction, agriculture, biotechnology or software; and each in its turn can be used in an interrelated way to meet the expectations and needs of all the economic actors. The existence of these new tools and the need to use them with despatch demands the cost-effective professionals, information and objective counsel PwC is in a strong position to offer.

3. The new role of the state

The role economic actors expect of the government is to facilitate the use of modern financing instruments that have had good results in other economies by ensuring a level of effective controls whose application affords security, and thus support, to investors.

The danger noted in emerging countries that use these mechanisms is the propensity of institutional investors (for example, pension fund administrators or entities of the state) to invest in securities issued by the government itself, or by sectors it regulates, in the investors' own strategic interest. In such cases, and if the state insures

yield, organises funds and directs a large part of their resources, the margin is narrowed for private operators to attract internal savings to alternative projects.

4. The problem of information

The development of direct investment funds, trusteeships, the securitisation of financial and nonfinancial assets, the use of warrants and certificates of deposit – all these will facilitate the development of a credit market. Their use requires a transparent market for the formation and determination of prices; abundant information; and trusted advisors, as well as projects that are seriously thought out and professionally presented.

The fact that the country, unlike more developed economies, lacks credit institutions specialised in particular areas makes it harder for investors to focus their analysis on projects businesses put forward that often are backed only by the guarantees of the sponsors themselves. Overcoming this problem will require more flexibility and transparency in managing information.

The key to resolving the current situation would be more use of off-balance-sheet financing tools. The easiest businesses to finance this way will be the ones with safe and predictable cash flows (providing symmetrical information for the investor) or those that have present or future credit available that can serve as a guarantee of financing operations. Investors will be disposed to base where they put their money on the quality of a part of the business set aside from the whole.

In Uruguay, it will increasingly be assets – not necessarily physical – that will determine a business's financing possibilities. The chief concern of moneylenders will be improving the assessment of credit risk, by means of which they'll seek to protect themselves not from business risk *per se* but from risks that threaten the sustainability of cash flow to the company.

PwC believes it will be necessary to obtain from businesses information not only of dependable quality, but also of different scope: management information that will allow third-party specialists in different fields to evaluate, diagnose and predict trends in the business being financed. This constitutes a change and a challenge for the nation's business and professional sector.

5. Collaboration and professionalism

In the present circumstances what's most important is beginning to try out the new instruments, getting to know them, making existing options attractive and making these products safe to implement. To accomplish this, all parties involved – business groups, investors, advisors

and government – must work together to solve the problems of financing the country's economic activity.

The work of building a credit market will require collaboration and successful experience on the part of all involved. One of the problems in our country is lack of easy contact between the productive sector and the capital market. Bringing together the securities market, operators, managers, information processors, auditors, advisors and government hasn't been easy – but it's a challenge of major importance of which PwC is keenly aware.

Devising financing solutions scaled to the needs of particular sectors or businesses will take a high level of professionalism. The most likely course is that, just as financial management is normally in the charge of financial specialists (brokers, banks and others), production management will fall to a group, separate from the original producers, that is efficient, professional and trusted by investors.

6. Simplicity and safety

Owing to the recent bank crisis, the mistrust reigning among some investors toward even investment choices as simple and classic as bank deposits makes it all the harder to develop more sophisticated options, such as using trusteeships to channel savings into productive investments.

An important factor to keep in mind about the use of new financing techniques that aim to attract noninstitutional investors is the need to overcome the latter's psychological resistance to the new mechanisms. Recognising this need, PwC will seek to promote a program to educate this market about the available instruments and their use.

In the short term the challenge consists in using investment instruments that are simple to implement, easy for the community to understand and secure in their management of risk and the information needed to measure it.

7. Fiscal considerations

Together with Uruguay's profitable fiscal system, an attractive aspect of the new instruments is confidence in their use and its results.

The appropriate application of measures to stimulate use of the new tools will permit their introduction into the economic life of the country. PwC has counseled Parliament on the business sector's need for such stimuli in order to foster the instruments' early adoption.

III. Conclusion

Because of the economic crisis – which lately shows signs of abating – the domestic financing system must be redefined and reinvented. The focus must be on using the newest and most modern financial instruments; creating an information network of business and institutional alliances that boosts competitiveness and efficiency by eliminating costs; and improving the interrelationships among different players in the financial community.

The creation of investment centers **with their own banks**, and marketing to attract investors and provide objective information to third parties on existing opportunities and tools, will contribute to the ultimate shape of the system.

By creating the instrument of trusteeship, Law No. 17.703 aims specifically at meeting the new challenges facing the country, making a mechanism of enormous versatility available to economic actors. It's PwC's hope that this makes a significant contribution to galvanizing the credit market, with direct benefit to productive investment. The ratification of this law provides the necessary framework for the construction, ranching, farming and technology industries, among others, to make their recovery.

Equally, foreign investment in the tourist industry and infrastructure improvements – highways, the port, energy – will thus have a secure and convenient fiscal vehicle for establishing its interests in the country. It's hoped that the tool will also assist in the refinancing of service sectors affected by the crisis, such as transportation and health.

Finally, the Uruguayan fiscal regime and our country's traditionally secure legal environment, as well as its proximity to neighboring countries with a similar profile, will position trusteeships organised in Uruguay as an appropriate vehicle for planning international investment.

Daniel Porcaro, a Public Accountant and graduate of the Universidad de la República-Uruguay, obtained his MBA in 2000 at the Universidad de Montevideo. Since 1998 he has been a Senior Manager in PricewaterhouseCoopers' Tax and Legal Consulting practice and has local responsibility for Financial Advisory Services. He has written publications and investigative works on financial topics, particularly those related to financial instruments.

PricewaterhouseCoopers Servicios Fiduciarios

Fideicomisos – Una alternativa flexible y conveniente para hacer negocios

En PwC Uruguay estamos capacitados para analizar su problemática para hacer negocios en forma flexible, ágil y segura mediante la utilización de Fideicomisos. Para ello proponemos la evaluación de estructuras alternativas, la identificación de ventajas y desventajas de las mismas, el diseño de los aspectos legales, financieros y fiscales y la implementación de la solución que mejor satisfaga sus necesidades y proteja su riesgo empresarial. Nuestra experiencia internacional en la utilización del instrumento para las más variadas actividades y necesidades individuales y empresariales nos permiten confiar en la obtención de resultados satisfactorios.

www.pwc.com/uy

Por mayor información no dude en comunicarse con:

Cr. Daniel García (598 2) 916 0463 Int.: 1478
Cr. Daniel Porcaro (598 2) 916 0463 Int.: 1478

garcia.daniel@uy.pwc.com
daniel.porcaro@uy.pwc.com