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Uruguay Economic Outlook

First Half 2014
Economic Analysis

- **Growth in the world economy will increase to 3.4% in 2014 and 3.8% in 2015,** but it will be affected by the slowdown in China and the Fed tapering.
- **Following the positive surprise of 4.4% growth in 2013, Uruguayan GDP growth will slow to 3.2% in 2014 and 3.3% in 2015** as investment will be lower.
- **We expect inflation to reach 8.4% in 2014 and remain around 7.6% in 2015,** as –although restrictive- the monetary policy is unlikely to prevent prices from rising.
- **We maintain our exchange rate forecast of USDUYU 23.6 at the end of 2014 and USDUYU 25.7 at the end of 2015,** which will ensure that there is no further loss of competitiveness against trade partners.
- **The current account deficit will remain high,** falling in early 2015 due to increased exports by Montes del Plata and improvements in tourism.
- **Downward stickiness in current expenditures will result in a worsening of the public deficit,** although we could see some improvement towards 2015 as activity picks up.

Index

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1. Summary

The global economy remains in the expansive phase of the cycle, which should produce GDP growth of 3.4% in 2014 and 3.8% in 2015. These figures imply a downward review of our earlier estimates due to the slowdown in China, which is expected to have an adverse effect on the performance of emerging economies in Asia and Latin America.

Domestic demand, which has been the main engine of growth in Uruguay in recent years, will begin to show signs of exhaustion in 2014 in a context of worsening labour market conditions. Investment will also fall after the completion of the Montes del Plata megaproject. We expect growth of around 3.2% in 2014 and a slight increase to 3.3% in 2015 resulting from an incipient rise in exports.

Inflation remains the main problem. Although prices slowed around the end of the first quarter and the beginning of the second, this deceleration was due basically to heterodox measures consisting of tax cuts and price agreements, which have only proved to have temporary effects. The true inflationary phenomenon is revealed by core inflation, which has lately been running at around 10% YoY. Based on the scenario defined by wage inertia, loose fiscal policy and the little aggressive monetary policy, we estimate inflation to be 8.4% for 2014 and 7.6% next year. We expect further heterodox measures to restrain prices if inflation rises above the threshold of 10% YoY again.

The central bank has ratified the direction of the monetary policy by expressing its satisfaction with evolution of prices in the present scenario of moderate astringency. We do not expect major changes in the monetary policy, the contractive thrust of which will not make up for the lack of fiscal restraints on prices and the continuation of wage bargaining mechanisms as a contributing factor to inflation.

The dollar will appreciate against emerging currencies due to the effects of tapering. Despite the effects of this devaluation scenario, the Uruguayan currency is unlikely to lose competitiveness compared to the country's main trade partners. The dollar will rise to around UYU 23.6 by December 2014 and to UYU 25.7 by the end of 2015.

Appreciation in 2013 resulted in a large current account deficit. Far from improving as we expected, the current account balance ended last year at -5.6%, as the improvement in the balance of traded goods was insufficient to compensate for the poor performance of services (especially tourism) and incomes. We do not expect a significant improvement in the current account balance in 2014, which we believe will reach -5.3% of GDP. The balance of traded goods will at best show a marginal improvement, as the downward trend in commodities prices means that only an increase in the volumes produced by Montes del Plata would make any difference. We might see a more material improvement in 2015 due to faster export growth in a more favourable regional context. Meanwhile, a sharper devaluation of the Uruguayan peso would benefit tourism, which seems to have bottomed-out in 1Q14.

However, although the external imbalances have basically been financed by capital inflows, the fact that the upward trend in FDI came to an end in 2013 is a warning light, as a change in international conditions brought on by tapering could indicate the end of funding for Uruguay's lack of domestic savings. Furthermore, a large part of the FDI in Uruguay comes from Argentina (agriculture and fisheries, and property) and the latter's own economic problems could affect the flow of funds to Uruguay.

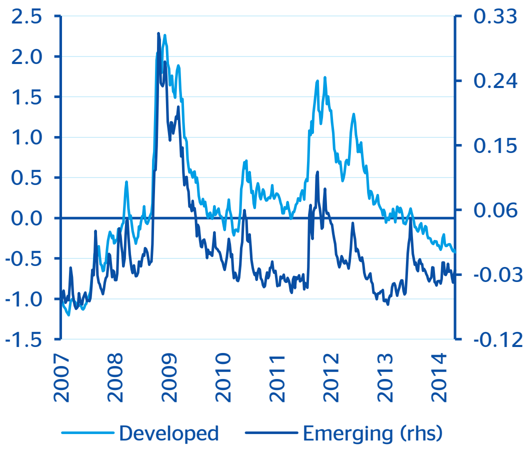
We expect a sharper deterioration in Uruguay's fiscal position in 2014 (-3.1% of GDP compared to -2.3% in 2013), as we are not expecting the application of less restrictive policies in an election year, and current spending in fact rose significantly in terms of public-sector wages and liabilities in the early months of the year. Given the lower level of business activity, meanwhile, we do not anticipate any rise in tax collection, although we may see a marginal improvement in 2015 (-2.9% of GDP) if activity picks up.

2. The deceleration in China and the Fed's tighter monetary policy will define the global scenario

The global recovery continues, but the improvement is being hampered by the deceleration in the EMs

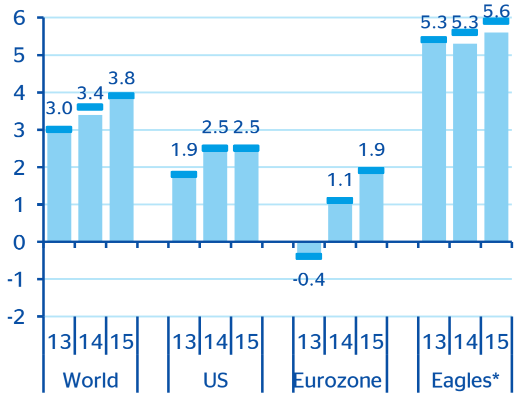
The global economic cycle remains robust at the start of 2014. According to our estimates, in the first quarter of 2014 global GDP has accelerated very slightly to around 0.8% QoQ and we expect this pace to be maintained for the first part of the year. In the wake of this sustained global recovery is the cyclical improvement in the DMs, which has offset the deceleration in some EMs in Asia and Latin America. Meanwhile, in the last few months the financial markets have performed very differently in the two regions and with more differentiation between the EMs. Capital flows, asset prices, interest rates and financial tension indicators have fundamentally performed in line with the outlook for rate hikes in the UK, but have also been affected to a greater or lesser extent by geopolitical risk events in Eastern Europe and the outlook for deceleration in China. Altogether, in the last few months, and particularly in March and April, there has been a recovery in asset prices in emerging economies and a reduction in financial tensions which had gone up slightly at the beginning of 2014 (Figure 2.1).

Figure 2.1
BBVA Research Financial Tensions Index in developed and emerging markets



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



EAGLEs is the group of emerging economies which will contribute most to world GDP in the next 10 years. The group contains China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: IMF and BBVA Research

To sum up, our assessment of the global scenario has a downward bias compared with our valuation three months ago, which is reflected in the adjustments to our forecasts. After growing at 3.0% in 2013, global GDP will start to accelerate again in 2014 and 2015 at around 3.4% and 3.8% respectively (Figure 2.2), figures that demonstrate both the variations in growth expectations in diverse regions and the increased, although slight, contribution to global growth by the developed economies. Although there have been no significant changes in either the US or the eurozone, the downward pressures in our forecasts are above all visible in the EMs in 2014 and 2015, in both Asia and Latin America, resulting from concerns due to the slowdown in the Chinese economy. In this context, there are still short- and medium-term downside risks to our forecast. Some factors with a global impact could make themselves felt more intensely than expected in the base scenario on a short-term time horizon, such as a tighter monetary policy on the part of the Fed, reduced growth of the global demand stemming from economic slowdown in China or geopolitical risks derived from Eastern Europe.

In the developed economies, the US overcomes the impact of an unusually cold winter and the perspectives for an improvement in the Eurozone have increased

US GDP has maintained steady growth at the beginning of 2014 in spite of the impact of unusually adverse weather conditions. In the labour market, employment has increased by an average of 178,000 jobs in 1Q14, in line with the print in 4Q13, and the unemployment rate has fallen to 6.7% of the labour force, a smaller than expected fall because the increase of the population available to work. As a result, the Fed has pressed ahead with the announced moderation in its balance-sheet expansion. In this context, we are expecting the Fed to complete its exit from the asset-purchase programme towards the end of the year, and the market to focus on a possible change in inflation trends as it anticipates the start of interest-rate hikes in a scenario of a gradual acceleration in GDP growth. Growth in 1Q14 reached 0.1% annualised. The leading indicators point to a more robust start to the second quarter than to the first. Altogether, we are maintaining our forecast for US growth at 2.5% in 2014, and the same in 2015 (Figure 2.2). The forecast has upside risks if the improvement in confidence provides additional incentive to corporate investment and job-creation.

In Europe, growth in the eurozone in the latter part of 2013 was driven by the recovery in exports, which has also favoured the improvement in investment. Looking at the first quarter of 2014, our short-term models point to an acceleration of around 0.5% QoQ, although the boost from the external sector could moderate in the coming months due to: i) euro appreciation; ii) the reduced demand from China; and iii) geopolitical risks if the crisis in Ukraine continues. We maintain our forecasts for the eurozone in 2014 at 1.1%, and 1.9% in 2015 (Figure 2.2), in a scenario of contained financial tensions and fiscal and monetary policies that do not put a brake on growth.

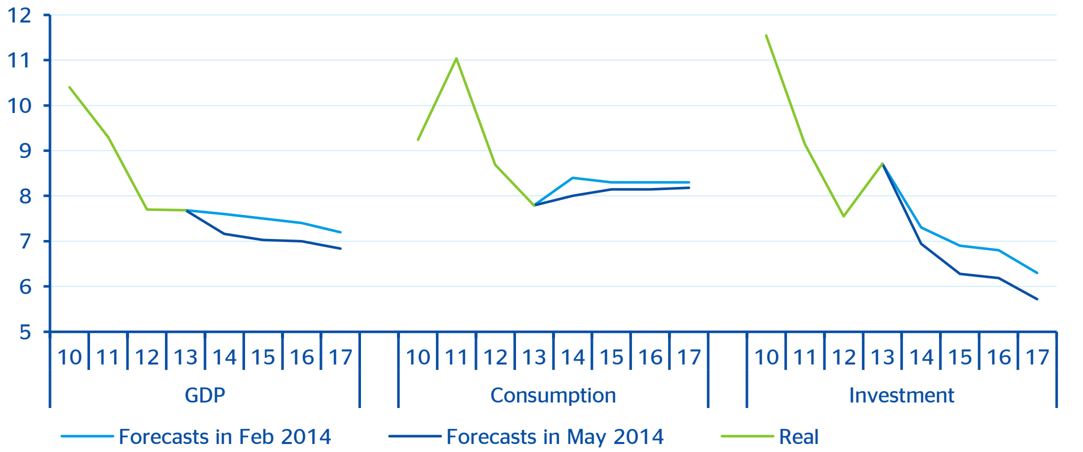
Finally, among developed economies, there is slightly more uncertainty about the growth outlook for Japan, which has had a QE programme underway since January 2013, together with fiscal stimuli to return to having inflation and favouring consumption and investment. We have revised downwards our outlook for growth in 2014 by four basis points to 1.1%, and we are maintaining our estimate for 2015 at 1.3%.

In China, the deceleration that began at the Chinese New Year is here to stay, in an environment of lower-than-expected inflation

In line with our forecasts in our last quarterly report, uncertainties about the cyclical strength of the Chinese economy have materialised, with a deceleration in activity during the first quarter of 2014, although less than anticipated by the consensus of analysts. The latest data from indicators on both domestic and foreign demand show the loss of momentum in the cycle, more so in investment than in consumption (Figure 2.3), in an environment of lower-than-expected inflation. At the same time, the authorities are starting to introduce measures to deal with the weaknesses arising from economic policy decisions taken in the last few years to support growth in the short term. This has involved postponing the deleveraging of local governments and companies, and continuing to approve infrastructure projects and excess installed capacity which are unlikely to be profitable while families, who are financing the process, are receiving negative real interest rates on their savings. This is an inefficient allocation of resources, which also encourages the development of financial systems in parallel with the more regulated one and which may be a source of problems in the future. To this end, regulations on the non-banking financial sector, shadow banking and environmental protection are all being toughened.

In view of this, we have revised Chinese growth downwards to 7.2% and 7.0%, in 2014 and 2015 respectively, nearly half a point less than forecast three months ago (Figure 2.3). The increasing importance of China as a source of world demand in the last few years is undeniable. But the differentiation between areas is unchanged, with higher exposures in Southeast Asia, some South American and African countries and, among developed economies, Germany. According to our estimates, the impact on world growth of each point of Chinese growth lost is around 4pp, principally as a result of lower demand from China itself. Note also that the expected adjustment in the local scenario is limited, and clearly not enough to unleash episodes of global financial uncertainty.

Figure 2.3
China: Growth forecasts (%)



Source: BBVA Research

In summary, there are two factors with a global impact on the forecast horizon: the tightening of the Fed's monetary policy, and lower growth of Chinese demand, with macro-economic repercussions that are clearly differentiated between economies. As we saw last May, the sudden perception by the market that the tightening by the Federal Reserve of the monetary cycle was imminent with the withdrawal of quantitative easing, raised financial volatility in emerging economies. There was a clear differentiation between different areas, however, with greater volatility in those exchange rates whose exposure to short-term foreign funding is greater. On the other hand, also among emerging economies, it is the Asian economies which are most exposed to a reduction in Chinese demand, with the further addition to the list of a few raw materials exporters, such as Chile. All these factors can be shown in a map of vulnerabilities where differentiation is a vital factor.

3. Uruguay: slower growth still driven by domestic demand

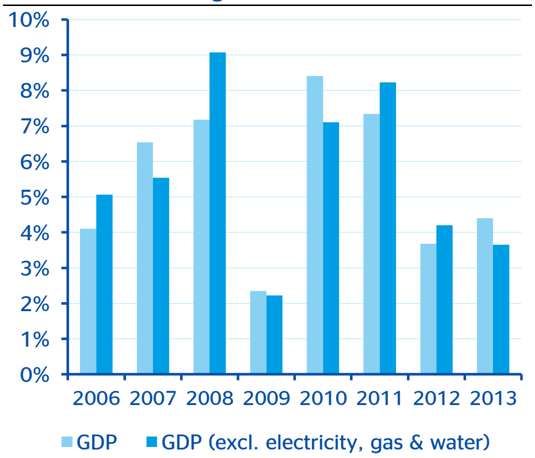
Uruguay's economic growth continues to be basically driven by domestic demand, as has been the case in recent years. GDP grew by 4.4% in 2013, above our forecast (3.7%) and average market expectations (3.9%). All sectors of the economy expanded over the course of last year except for Manufacturing Industry, which experienced a minimal contraction. However, excluding Electricity, Gas & Water, a highly volatile sector which depends to a great extent on weather conditions, the slowdown last year becomes apparent, as growth slipped from 4.2% in 2012 to 3.7% in 2013, although this is less than we had expected (see Figure 3.1).

Our forecasts envisage ongoing deceleration in growth over the course of 2014. In the early months of this year, short term indicators suggested that growth will continue to slow this year as a result of lower levels of consumer spending and above all of the decline in private investment expected when work is completed at the Montes del Plata site. In the first place, a moderate deterioration in labour conditions caused by rising unemployment (which rose to 7% in February vs. 6.1% at the end of last year) and slower growth in real wages in the private sector (real private-sector wages in fact fell by 1.3% in 1Q14 compared to the increase observed in 1Q13). We expect these conditions will be maintained throughout the year, limiting rises in consumer spending. Furthermore, lending to the private sector is flat, which will also put a lid on expansion of consumer spending.

Secondly, the rate of growth in investment is expected to slow after completion of the Montes del Plata megaproject, which cost some USD1.9bn, or 2.2% of GDP. However, the Uruguayan government has sought to encourage new private projects in partnership with the public sector in a number of sectors including oil exploration, although none will be as large as the construction of the cellulose plant.

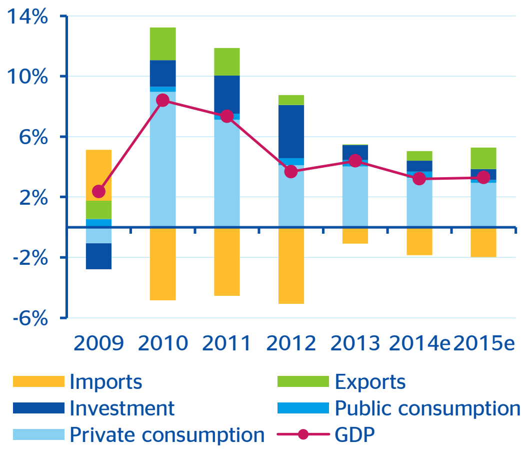
Finally, the CERES Leading Index (ILC) fell for the third time in a row in January, indicating a sharp slowdown or even a possible contraction in the economy in the first quarter of 2014 compared to the last quarter of 2013. In this regard, industrial activity fell by 3.7% in the first two months of the year (3.9% excluding oil refining) compared to the same period of 2013.

Figure 3.1
GDP and GDP excluding electricity, gas and water. (% YoY change)



Source: BCU and BBVA Research

Figure 3.2
Contribution to GDP (% YoY change)



Source: BCU and BBVA Research

In light of the above, we have revised our forecast for 2014 growth downwards to 3.2% (from 3.5%) given the statistical drag from higher than expected growth in 2013, and on the assumption that the deceleration in domestic demand will continue but will be limited because the government will not risk applying contractionary policies[1] in an election year, while the start-up of activities at Montes del Plata has been rescheduled for the middle of the year. Despite the expected slowdown, demand for imports is set to increase slightly in 2014 given the need for capital goods associated with hydrocarbon exploration and specific purchases of equipment required for investment in wind power. Growth could pick up slightly in 2015 (rising to 3.3%) if output at Montes del Plata reaches full capacity, as we expect, providing a boost for exports, which would at least partially offset any slowdown in domestic demand (see Figure 3.2).

1: The cut in VAT on certain services intended to alleviate inflationary pressures (see below) would be a step in this direction.

4. Inflation: only painkillers at the moment

Inflation remains the key issue on the economic agenda. Prices rose sharply at the beginning of the year, climbing by 2.4% MoM in January and 1.7% MoM in February, a variation of 9.8% compared to February 2013, the highest YoY rate since August 2004 when it reached 10.2%. However, inflation slowed in March (+0.6% MoM in the CPI), and April finally saw marginal disinflation of -0.06% MoM. The change in trend in the last two months was due to the implementation of a series of measures by the government designed to contain persistent price rises. However, these measures fail to attack the roots of the inflation problem.

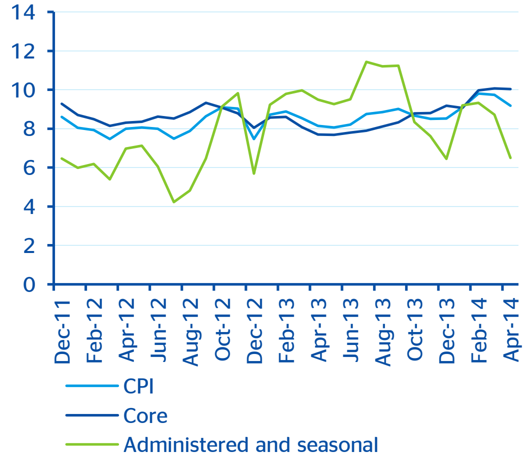
As a result, the YoY rate in April was 9.2%, fortunately still some way below the 10% YoY threshold. However, the intensity of the phenomenon is clear given that core inflation, calculated by deducting regulated and seasonal prices, has settled at around 10% in the last three months (see Figure 4.1). In these circumstances, the government approved additional heterodox measures to contain inflation and prevent the rate from rising above the psychological threshold of 10%, as we predicted in our last report. This time, the rate of VAT on telephone services and electricity was cut, the prices of a basic basket of family goods were frozen at major supermarket chains, and a subsidy was approved for private healthcare expenses. This package of measures implies a fiscal cost of some USD100mn, according to official calculations. Despite the moderation of CPI since March, the empirical evidence suggests that the effects of these measures on prices will be short-lived, and they will have scant impact on expectations. In view of the repeated application of such measures in successive years (e.g. the *Tu ahorro vale doble* power-saving scheme), it is especially important to succeed in breaking the seasonality inherent in the general level of prices, which makes it necessary to implement similar anti-inflation measures year after year to hold down the year on year rate due to the base year effect. This distortion is evident in the erratic path of our 2015 estimate, which does not include further discretionary measures (see Figure 4.2).

Although price increases show no signs of fatigue and remain above the target range, set by the Central Bank at between 3% and 7% as of July 2014 (currently 4% to 6%), the monetary authority has maintained the thrust of its new monetary policy framework[2] which provides for a gradually diminishing rate of expansion in the broad M1 aggregate (see Figure 4.3). This is supported by the contractive bias taken by COPOM (Monetary Policy Committee) at the meeting held on 8 April 2014 when the monetary policy committee maintained the target of 8% for the new monetary policy horizon, which is the second quarter of 2015.

The moderately restrictive monetary policy adopted, weak channels for its transmission and the transitory nature of price agreements and tariff cuts will only be sufficient to hold price increases down, prices which are subject to upward pressures due to the strength of demand driven by wage indexation and loose fiscal policy.

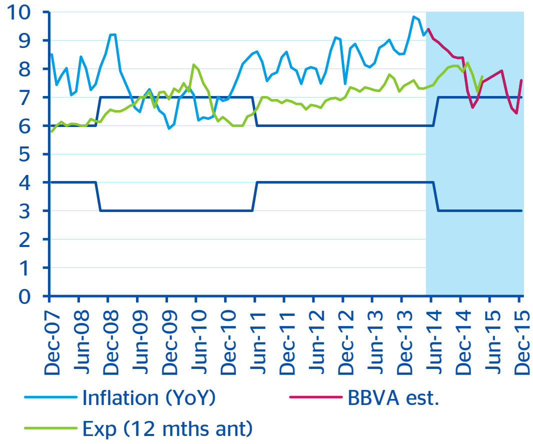
2: The new monetary policy framework and instruments were discussed in detail in the last issue.

Figure 4.1
Inflation components (% YoY change)



Source: INE and BBVA Research

Figure 4.2
Inflation, estimate and outlook (% YoY change)



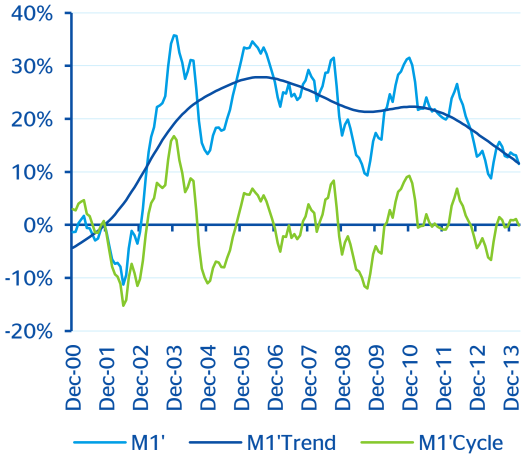
Source: INE, BCU and BBVA Research

We expect the current monetary scenario and fiscal structure to be maintained (public-sector wages have not adjusted in the same way as in the private sector in the year to date, and far from contracting they have actually increased by 6.6% in real terms), and in this light we have slightly increased our inflation estimate for 2014 from 8.2% to 8.4%, making a sharper adjustment to our 2015 estimate, which we have raised from 6.0% to 7.6% due to the delay in the transmission of monetary policy based on the current parameters and the price inertia implicit in the evolution of core inflation.

Hence, we rule out the possibility of substantial changes in the path of monetary policy established by COPOM. Our view is further supported by the current absence of additional tensions due to currency appreciation, which was the tacit trigger for the end of interest rates as a monetary policy tool. In contrast to the peso appreciation last year, the expected exchange rate trend in 2014 will put further upward pressure on prices, as explained in Box 1.

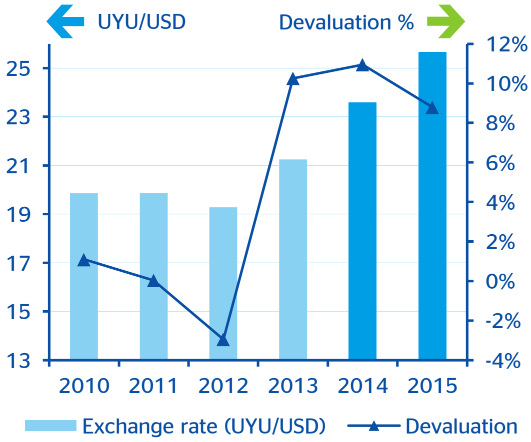
In line with the growing weakness of regional currencies, in particular the Brazilian real, we estimate that the Uruguayan peso will depreciate around 11% this year, so the country will maintain competitiveness compared to trading partners and the exchange rate will be around USDUYU 23.6 in December 2014 and USDUYU 25.7 at the end of 2015 (see Figure 4.4). Our exchange-rate forecasts are based on an international scenario involving a strengthening US dollar due to Fed tapering and the continuation of macro-prudential policy measures, which could be used to adjust capital flows by changing the parameters applied.

Figure 4.3
Broad M1. Cycle and trend (quarterly average, % YoY change)



Source: BCU and BBVA Research

Figure 4.4
Exchange rate (UYU/USD) and annual devaluation (%)



Source: INE, BCU and BBVA Research

Box 1. The impact of exchange rate pass-through to prices in Uruguay

The impact of local currency devaluation on the country's domestic prices is a key issue for any small, open economy like Uruguay, which maintains a floating exchange rate. It is therefore a relevant variable for the inflation-targeting system applied by the Central Bank (BCU) to combat rising prices. We recall the pressure brought to bear by peso appreciation on COPOM's decisions when the monetary policy committee used interest rates as a monetary policy tool.

The Uruguayan peso depreciated by 18% between April 2013 and March 2014, and the inflationary impact of this depreciation is therefore a key issue, which we try to explain in this box. In particular, we show our econometric estimates of the magnitude of the pass-through from the exchange rate depreciation to prices.

Following Mihaljek and Klau (2008)[3], we calculated an equation based on quarterly data for the period from 1965 until 2013, relating Uruguay's quarterly inflation rate with its own inflationary past (in order to capture inflationary inertia), foreign inflation (measured by inflation in Argentina and the USA), and the change in the nominal rate of exchange between the Uruguayan peso and the US dollar.

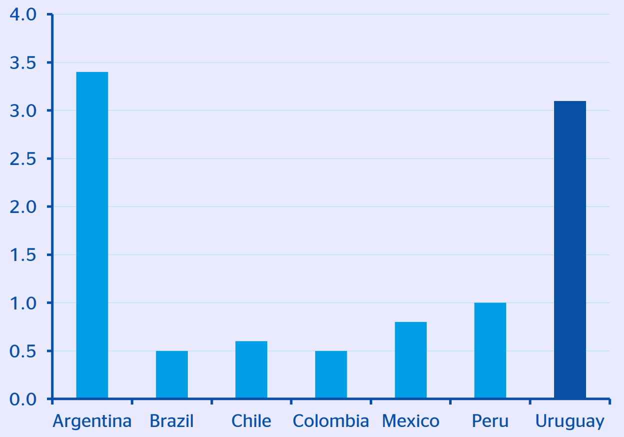
Our calculations show a pass-through rate of 3.1 percentage points in the case of a 10% exchange-rate depreciation over a period of 12 months[4].

This is a relatively high value, given that BBVA Research (2014)[5] estimated a negligible impact of between 0.5pp and 1pp on inflation over a period of 12 months for an exchange-rate depreciation of 10% (see Figure B.1.1). The only exception was neighbouring Argentina, where pass-through was 3.4pp, similar to Uruguay.

This is hardly surprising, given that Argentina and Uruguay are the most dollarized economies in the region, which increases the rate at which currency depreciation passes through into inflation. Another reason for the significant pass-through rate observed is the persistence of inflation at high levels, giving rise to considerable inertia in price increases. Moreover, imports represent a large share of goods in numerous supply-side sectors, like the hydrocarbons and automotive markets, where the pass-through of currency depreciation to domestic prices is practically 100%.

We may conclude, then, that the exchange rate has a relatively large inflationary impact in Uruguay. Currency devaluation in 2013 will contribute 3.2pp to the estimated inflation rate of 8.4% for this year, and 3.4pp to estimated inflation of 7.6% in 2015.

Figure B.1.1
Pass-through rate from exchange rates to prices (% impact of 10% currency depreciation on inflation)



Source: BBVA Research

3: D. Mihaljek and M. Klau (2008), "Exchange Rate Pass-through in emerging market economies: What Has Changed and Why?", BIS Papers No. 35, January, pp. 103-130.
4: The FMI (2008), "Pass-Through, Dollarisation, and Credibility in Uruguay", Country Report No. 08/46, calculated a pass-through of 4.5pp based on data for 1990-2005, finding that the rate had actually fallen over the period. Our differences with the IMF (2008) may be partly explained by the fact that we included 33 years' more data in the series, including 8 years of more recent data. In its six-monthly LatAm report (Oct. 2013), the World Bank also found that the Uruguayan pass-through was one of the highest in the region.
5: See BBVA Research Latam Economic Outlook, Box 3, at: http://www.bbvaresearch.com/KETD/ketd/ing/nav/geograficas/latinoamerica/index.jsp.

5. Yellow light for the external sector: how long can FDI continue to finance the current account deficit?

As usually happens in a small, open economy like Uruguay, periods of high economic growth are accompanied by current account deficits, as excess domestic demand can only be met by imports. Uruguay has enjoyed high growth rates since the middle of the last decade, driven by domestic demand in terms of both consumer spending and investment, and the country has seen successive current account deficits.

As mentioned in previous reports, strong investment growth (as high as 23.8% of GDP in 2013) and scant domestic savings (just 13.3% of GDP) mean that Uruguay has to find funding abroad. Indeed, Uruguay's fast growth after the crisis of 2002 was largely financed by foreign savings.

Last year was no the exception. Growth was unexpectedly strong and far from falling, as we expected a year ago; the current account deficit remained high, reaching 5.6% of GDP. While the trade balance improved by around USD100mn compared to 2012, when additional fuel imports were needed to compensate for the shortfall in hydroelectric generation, the services account worsened in 2013 and interest and dividend payments offset the improvement in the balance of traded goods. The deterioration in the real services account is explained basically by the net balance on the tourism account, not only because of the fall in the number of foreign tourists visiting Uruguay due to exchange-rate restrictions in Argentina (the main source of tourists to Uruguay), but also because the exchange-rate appreciation discouraged tourists from elsewhere in the region while favouring outbound tourism. As a result, the tourism surplus dropped from a high of almost 3% of GDP in 2011 to 0.5% in 2013 (see Figure 5.1).

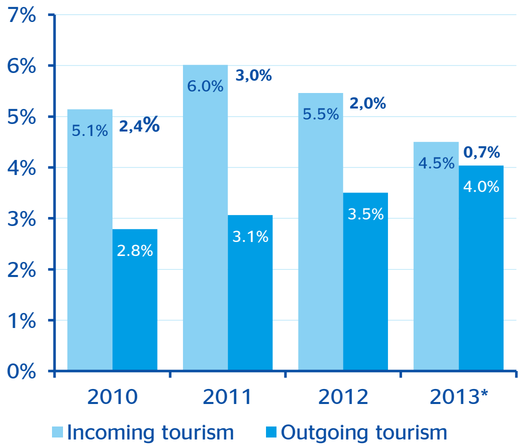
A matter we have consistently stressed with regard to Uruguay, is that the country's positive reputation and sound economic management has encouraged inflows of capital in a context of considerable international liquidity, and even more so after it recovered investment-grade status. As a result, Uruguay has had no difficulty in using FDI to finance its current account deficits, which has also helped the central bank to accumulate large reserves while maintaining an active policy of intervention in the currency markets to restrain peso appreciation. Uruguay currently holds enviable level of reserves of around 29% of GDP, while the stock of FDI reached USD20.3bn (37% of GDP) in 2013.

However, recent figures now suggest that FDI stopped rising in 2013, when it reached 5% of GDP vs. 5.4% in 2012 (see Figure 5.2), and a change in international conditions as a result of the Fed's tapering may indicate that the available funds to finance increasing investment in Uruguay will become scarcer in the future. In this light, the country may need to seek alternative sources to finance development, prioritising policies designed to encourage domestic saving. In view of the concentration of sources of FDI in Uruguay (mainly from Argentina, which accounted for 36% in 2012), meanwhile, it would no doubt be wise to diversify the sources of this capital as a first step on the way to reducing the country's dependence on foreign savings, a move that would involve the adoption of more long-term policy measures. It would also be advisable to channel more FDI into productive sectors. In this regard, most Argentine FDI is focused on real estate investments, although investment in agriculture is also significant.

Meanwhile, the government has applied restrictive measures to highly volatile short-term capital flows in order to reign in peso appreciation. As a consequence of these measures, it succeeded in reversing large inflows of short-term money, so fortunately hot money flows have not been used intensively in recent years to finance the current account deficit. This means that the implementation of policies designed to encourage domestic savings as a means of financing investment will be a priority unless Uruguay is prepared to forego a strong growth pace.

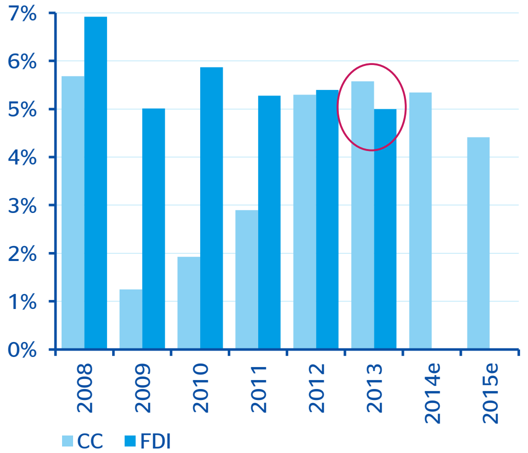
In this regard, the government's new *Financial Inclusion Act* is intended to foster savings in the formal banking system by providing a vehicle for tax cuts. According to the authorities, the new law *"aims to universalise the rights of citizens to use electronic means of payment in their transactions and to enjoy access to credit systems",* although it is also designed to reduce the level of informal money transactions, thereby also increasing control on tax evasion and money laundering. Nevertheless, the Act will not be enough to achieve savings growth on its own, unless it is accompanied by other, less expansive monetary and fiscal policies than those applied in recent years.

Figure 5.1
Inbound and outward tourism (% of GDP)



Source: BCU and BBVA Research

Figure 5.2
Current account deficit and FDI (% of GDP)



Source: BCU and BBVA Research

We do not expect a significant improvement in the current account balance in 2014, and we forecast a deficit equal to 5.3% of GDP. In the first place, there is only room for a marginal improvement in the balance of traded goods, as the expected fall in the prices of agricultural and paper and pulp commodities will have a major impact on Uruguayan exports. However, this effect may to some extent be offset by increases in the volume of exports if Montes del Plata begins operations in the middle of this year, as we expect, adding to export capacity. Meanwhile, imports will continue to grow, although more slowly now that capital investments for the construction of the cellulose plant have ended, although the needs of industry and oil exploration are set to increase. We anticipate that real services, led by tourism, will deteriorate further in 2014, and the figures for the first quarter (high season) in fact show a reduction of around 25% in the surplus generated by the sector. However, we expect this drop to diminish in the coming quarters due to forecast improvement in FX competitiveness and a certain relaxation of the restrictions in place in Argentina. Nevertheless, we would stress that the lion's share of income from tourism is generated in the early quarters of the year.

A more significant improvement in the current account balance (deficit equal to -4.4% of GDP) is possible in 2015 if exports are more dynamic not only on the back of increased output from the Montes de Plata plant but also as a result of slightly stronger demand and at least a partial recovery in the tourist industry, given that a further peso depreciation would discourage Uruguayan holidaymakers from leaving the country while favouring the arrival of visitors from elsewhere in the region.

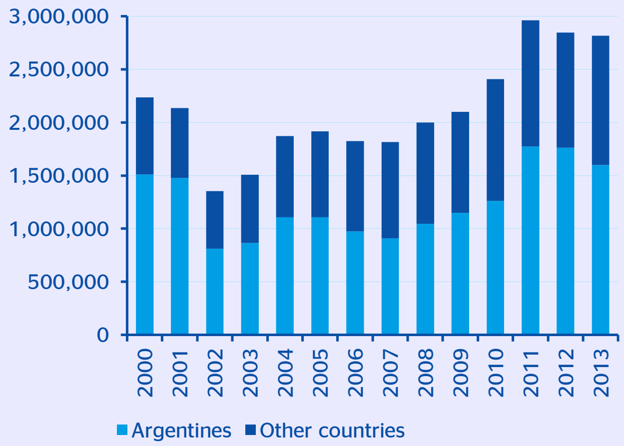
Box 2. How do realities in Argentina and Brazil affect the Uruguayan economy?

Uruguay has historically been highly dependent on the region's two largest economies, Argentina and Brazil, suffering the ups and downs experienced by these countries through a variety of channels, including trade, finance and services. However, Uruguay's exposure to Argentina in particular but also to Brazil has changed vs. 15 years ago.

In terms of external trade, Uruguay has achieved greater diversification of imports and, more especially, exports, which has reduced the spill-over of risks from its larger neighbours. In fact, only 5.4% of total Uruguayan exports went to Argentina in 2013, compared to 17.8% in 2000. The share of exports to Brazil has fallen less sharply, however, from 23.1% in 2000 to 18.9%. This diversification of destinations has reduced Uruguay's exposure to Argentina, lessening vulnerability to shocks affecting the neighbouring economy. However, the country remains highly integrated with Brazil, making it necessary for Uruguay to align its exchange rate in order not to lose competitiveness with its principal trade partner (see Figure B.2.3).

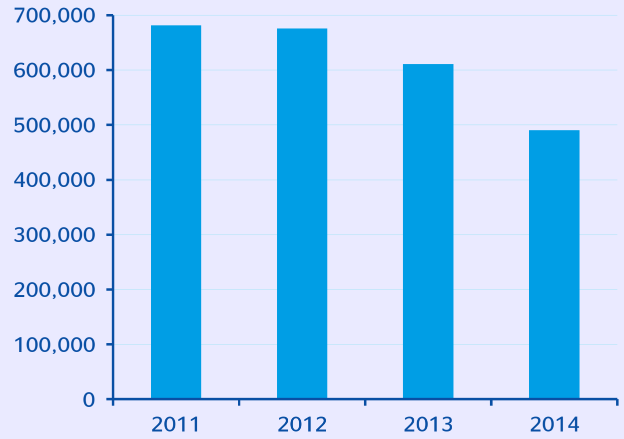
In the services sector, however, Uruguay remains highly exposed to Argentina in terms of tourism, and the consequences of this have been acutely felt in recent years after the Argentine government imposed exchange controls which discouraged tourism to Uruguay and affected average visitor spending. Brazilian tourists, the second most important group after the Argentines, were more affected by URY appreciation than by specific problems in Brazil. As a consequence, income from inward tourism peaked in 2011 at 6% of GDP, falling to 4.4% of GDP in 2013. The fall in numbers of Argentine tourists, and in their average spending (see Figures B.2.1 and B.2.2) was partially offset by visitors from other countries and domestic tourism, particularly because Uruguay became relatively more expensive than other regional destinations.

Figure B.2.1
Inward tourists visiting Uruguay (annual total)



Source: Uruguayan Ministry of Tourism and BBVA Research

Figure B.2.2
Spending by Argentine tourists visiting Uruguay in the high season (first quarter) in USD '000



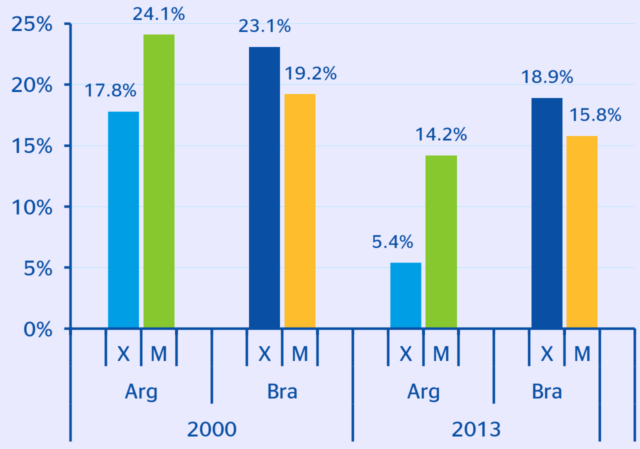
Source: Uruguayan Ministry of Tourism and BBVA Research

To end with finance, Uruguay has been the destination for major capital flows in the form of FDI from Argentina and to a lesser extent from Brazil. According to the BCU, 36.5% of FDI in 2012 came from Argentina, with Brazil in second place accounting for just 8.5% of the total. Note that FDI totalled USD2.7bn in 2012, equal to 5.4% of GDP. This situation means that Uruguay is highly vulnerable to any sharp fall in capital flows from Argentina, in particular given the restrictions on acquisitions of foreign currency by Argentine firms seeking to invest in Uruguay. This happened in real estate investment in recent years, and such a situation could affect firms investing in agriculture and farming, in particular in soybeans (see Figure B.2.4).

Meanwhile, the Uruguayan banking system has traditionally held a high proportion of non-resident deposits. Non-resident deposits in Uruguay (mostly from Argentina) fell from 38% of the total in 2001, the peak of the series, to 15% in 2013. This situation reveals how exposed Uruguay has been to economic problems in Argentina in recent years.

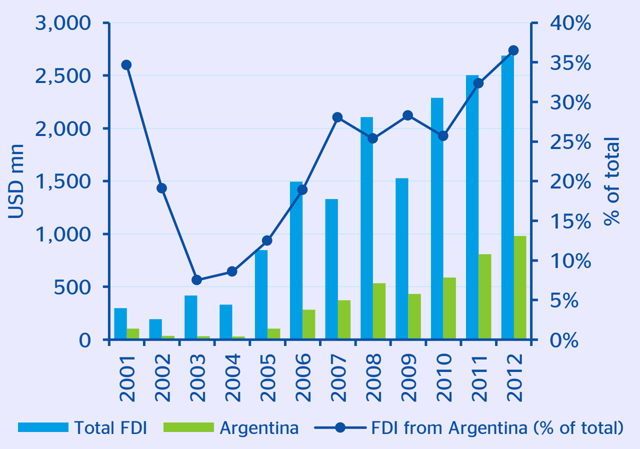
In this situation, Uruguay is going to need to be more attentive to developments in Brazil and Argentina in the future. While links with both nations have been reduced in recent years, Uruguay's trade relations with Brazil remain significant, and since that country's consumer- and credit-led growth model is showing signs of exhaustion, it would be wise for Uruguay to continue to diversify markets for its exports still further in order to avoid any new shocks to its economy as was the case with Argentina, although the exposure in that case was due to real services.

Figure R.2.3
Spending by Argentine tourists visiting Uruguay in the high season (first quarter) in USD '000



Source: BCU and BBVA Research

Figure R.2.4
Spending by Argentine tourists visiting Uruguay in the high season (first quarter) in USD '000



Source: BCU and BBVA Research

6. Foreseeable fiscal deterioration

In recent years (with the exception of 2007), Uruguay has failed to generate a sufficient primary surplus to cover debt service, resulting in successive budget deficits. In 2013, the total deficit was 2.3% of GDP, following a primary surplus of barely 0.6%.

Current spending displays a clearly upward trend, rising to 30.1% of GDP in 2013 following growth of more than 6pp in 10 years (24% of GDP in 2004), while tax collection has stagnated in relative terms (21.3% of GDP in 2013 vs. 20.9% in 2004) (see Figure 6.1). While the contribution of public-sector corporations allowed a minimal primary surplus in 2013, the significant volatility of revenues of these public-owned utilities means the deficit can be larger in other years, as was the case in 2012.

As 2014 is an election year, we do not expect to see any significant adjustment in public spending. Primaries will be held in June to select the presidential candidates in the general elections scheduled for November, but we do not expect to see any significant change in economic policy under the new government.

There was a degree of fiscal deterioration in the first two months of the year, caused by a higher wage bill and smaller revenues from public-sector enterprises. Far from growing more slowly like salaries in the private sector, public-sector wages have increased faster than last year, rising by 6.6% in real terms in January (compared to 5.7% in the previous year). However, it will be inflation in the coming months that finally determines the annual increase in wages.

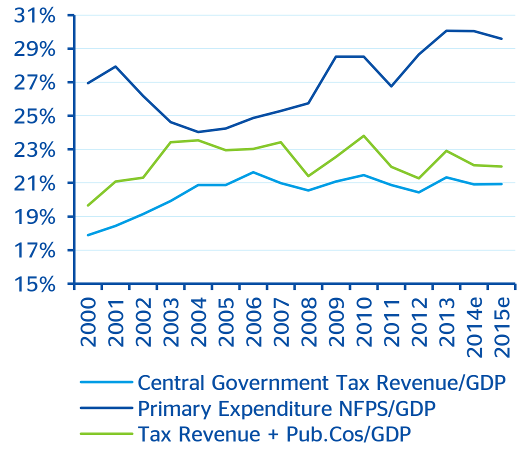
According to our estimate for 2014, the general fiscal deficit will be higher than in 2013 at around 3.1% of GDP, as noted above, with a small decline in the contribution from public-sector enterprises. Furthermore, tax revenues will be affected not only by slower growth but also by the discretionary policies announced by the government to restrain prices, which will include cuts in VAT on telecommunications services and electricity bills, and this will further undermine the fiscal position.

We continue to expect the government to have difficulties in achieving a primary surplus in 2015, given the size of current spending, mainly in wages and pension liabilities, although a slight upturn in the economy could lead to a marginal increase in revenues. On this basis, we estimate a deficit of around 2.9% of GDP for next year.

Despite the process of fiscal deterioration, we do not foresee problems in meeting the public-sector borrowing requirement, as Uruguay applies a policy of pre-borrowing which allows it to smooth the negative effects of any international liquidity squeeze or episodes of increased risk aversion. As has happened in recent years, the country has currently covered its borrowing needs for the next 18 months as a result of issues in both the local and in international markets. In addition, the government has contingent credit facilities open with international institutions for more than USD2bn and it is presently negotiating an additional facility totalling some USD550mn with the IADB.

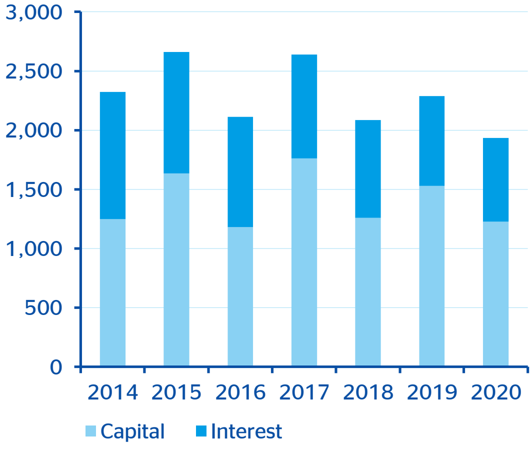
We continue to draw attention to the ongoing prudent management of public debt by the authorities in recent years. While total public-sector debt increased by almost USD2bn in 2013, gross debt measured in terms of GDP fell from 62% to 59.2%, and Uruguay has secured an advantageous maturities profile for the coming years (see Figure 6.2). In fact, maturities falling beyond 2020 total some USD19.9bn, approximately 70% of which is principal and the rest interest.

Figure 6.1
Public-sector revenues and expenses (% of GDP)



Source: MEF and BBVA Research

Figure 6.2
Public debt maturities until 2020 (USD ‘000)



Source: BCU and BBVA Research

7. Tables

Table 7.1
Annual macroeconomic forecasts

	2010	2011	2012	2013	2014	2015
GDP (% YoY)	8.4	7.3	3.7	4.4	3.2	3.3
Inflation (% YoY, eop)	6.9	8.6	7.5	8.5	8.4	7.6
Inflation (% YoY, average)	6.7	8.1	8.1	8.6	9.0	7.3
Exchange rate (vs. USD, average)	19.9	19.9	19.3	21.3	23.6	25.7
Exchange rate (vs. USD, eof).	20.0	19.2	20.2	20.4	22.8	24.7
Interest rates (%, average)	21.1	19.0	18.6	16.7	20.6	17.7
Private consumption (%, YoY)	12.8	9.8	5.5	5.3	4.3	3.8
Public consumption (%, YoY)	3.1	3.8	4.6	4.2	4.0	2.0
Investment (%, YoY)	8.7	12.5	16.6	4.2	3.0	3.0
Fiscal deficit (% of GDP)	-1.2	-0.9	-2.8	-2.3	-3.1	-2.9
Current account deficit (% of GDP)	-1.9	-2.9	-5.3	-5.6	-5.3	-4.4

Source: BCRP and BBVA Research Peru

Table 7.2
Quarterly macroeconomic forecasts

	GDP (% YoY)	Inflation (% YoY, fdp)	Exchange rate (vs. USD, eop)	Official interest rate (%, fdp)
1Q13	4.1	8.7	19.1	17.2
2Q13	6.0	8.1	19.5	15.1
3Q13	3.0	8.9	21.6	17.7
4Q13	4.6	8.6	21.4	17.4
1Q14	4.4	9.6	22.0	21.2
2Q14	3.3	9.2	22.7	20.7
3Q14	3.6	8.8	23.1	19.9
4Q14	2.6	8.4	23.5	19.7
1Q15	2.6	6.9	23.9	17.0
2Q15	2.9	7.6	24.4	18.0
3Q15	4.4	7.6	24.9	17.9
4Q15	4.8	6.9	25.5	18.8

Source: BBVA Research

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