Uruguay Economic Outlook

Second half 2014
Argentina Unit

- Global economic activity is slowly on the rise, but so are financial stress and geopolitical risks.
- The run-off election will be disputed between the incumbent party, Frente Amplio, and the Partido Nacional. In any case, we do not expect any relevant changes in economic policy.
- Uruguay heading towards a soft landing, with a gradual decline in growth to 3.4% in 2014 and 2.9% for 2015, in step with a slowdown in private consumption.
- In spite of the fall in commodity prices, the current account deficit should start showing a gradual improvement, reaching -5.3% of GDP this year and -4.5% in 2015, given the contribution of Montes del Plata exports.
- We do not expect any changes in the fiscal accounts, with a repeat deficit of 3.4% of GDP in 2014 and 2015. Based on candidates' statements, we do not foresee any significant fiscal adjustments during the next administration.
- Inflation will remain above the CBU's target range, reaching 8.4% in 2014 and 8% in 2015.
- As the UYU is not immune to the international scenario of USD appreciation, the latter will trade at UYU24.4 at the end of 2014 and at UYU26.6 in 2015.

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Closing date: 14 November 2014

1 Summary

Global growth remains on the rise and should close 2014 at 3.2%, with a rate of 3.7% for 2015. However, financial stress and geopolitical risks are also mounting. US growth remains in line with expectations and should reach 2.5% in 2015. With respect to China, we stand by our previous outlooks, though with a downward bias, due to the foreign environment and the shadow banking control measures. Lastly, the eurozone's recovery will be even slower than expected.

Uruguay has once again showed signs of political maturity and institutionality in the current electoral process, which will determine the next President and Vice-President as well as the Parliament's new lawmakers. The election will be decided on 30 November, in a run-off between the incumbent Frente Amplio's Tabaré Vázquez and Partido Blanco's candidate, Luis Lacalle Pou. In any case, **we expect continuity in the next administration's economic policy policies**.

After a decade of high growth**, the economy has now begun to slow down,** led by the moderation of private consumption, which has been the main growth driver of economic activity. Therefore, after the upward revision of 1Q14 GDP and a positive surprise in 2Q14, we expect economic growth to come in at around 3.4% in 2014, and drop to 2.9% in 2015, due to lower private consumption.

The current account deficit, which will reach 5.3% of GDP in 2014, reveals the need to correct the balance of trade and of real services, given that domestic savings are insufficient to finance higher economic activity, which increases the requirement for greater external financing. We expect the current account deficit to shrink in 2015 (4.5% of GDP), due to a higher contribution of exports of paper and pulp.

While the drop in commodity prices will have a negative impact on the balance of trade (given that the effect of lower agricultural export prices will exceed the amount saved from cheaper oil imports)**, the contribution of the Montes del Plata paper pulp mill to exports will more than make up for this effect,** leading to an improvement in the trade balance in 2014.

The fiscal balance will remain in the red, at around 3.4% of GDP, in Fiscal 2014 and 2015. None of the candidates with a chance of being elected president at the next run-off election appear to be in favour of making major fiscal adjustments. Rather, they have opted to continue with existing policies while improving efficiency in spending.

Inflation will remain above the central bank's target range for another two years, hitting 8.4% yoy in 2014 and receding slightly to 8.0% in 2015. Wage indexation conditions price inertia, in a monetary policy scenario that has yet to display effectiveness.

The Uruguayan peso will follow the regional trend towards depreciation, versus a USD that displays a marked recovery worldwide. **We expect an exchange rate against the USD of UYU24.4 at the end of 2014 and UYU26.6 by December 2015**.

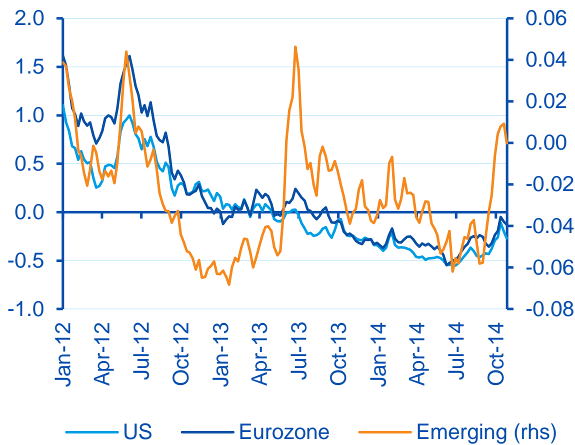
2 Slow global recovery with greater financial volatility

World growth is still rising, closing 2014 at 3.2% in 2014 and 2015 at 3.7%. But financial tensions and geopolitical risks are on the increase as well

Global economic growth continued in the third quarter. However, quarterly growth is very moderate in the more developed economies, and of these, more in Japan and the eurozone than in the US.

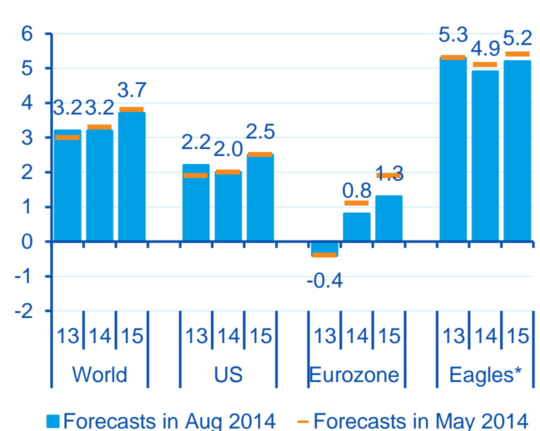
The confidence indicators for September remain consistent with the expansion of manufacturing activity, although it has been some months since they stopped improving in the key economic areas. An additional sign of the fragility of the present cyclical recovery is the uptick of the tension indicators in the financial markets since mid-September. In the case of the emerging economies (EMs), these have reached levels not seen since May 2013 (Figure 2.1). Then the market discounted a rapid withdrawal of Fed stimuli that actually never happened and is still pending. At the same time, geopolitical risks have been multiplying and negative surprises are building up on the consensus in the activity indicators, particularly in the eurozone and South America.

Figure 2.1
BBVA Research Financial Tensions Index



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. Group made up of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: BBVA Research

Altogether, the most likely scenario is that global growth improved from the second to the third quarter, rising from 0.6% QoQ to an estimated 0.8% respectively. However, there is downside risk to these figures given that the industrial activity indicators and world trade in September could still moderate, and the effects of the financial volatility on confidence could be more persistent than we expect. Also, there are the geopolitical risks associated with the situation in Syria and Iraq and the fragile agreement between Ukraine and Russia. It is worth noting that sanctions are already having an impact on activity in important sectors such as Russian energy.

In this context, monetary policy will remain focused on supporting activity, while fiscal policy will be less restrictive in tone in 2014-15 in both the US and the eurozone than in the recent past. Even in China, together with the budget consolidation at the local and regional government level it is felt that additional measures to support growth could be implemented.

Finally, we must point to the fall in oil prices as a favourable factor for global growth expectations – although not for exporter countries to the extent that this is a result of a positive supply shock.

Growth in the US remains in line with expectations, and is likely to reach 2.5% in 2015

After the unexpected and transitory drop in activity in 1Q14, the activity, spending and employment indicators have recovered, implying that the pace of GDP growth could be around 2.5% in the second half of the year, and thus average 2% for 2014 as a whole (Figure 2.2). The role of the Fed, which emphasises caution and patience before acting on the signs of improvement in the economy, continues to support our scenario of a cyclical recovery in the US underpinned by the solid creation of employment and the increase in household wealth.

Our outlook for China is unchanged, but with a downward bias due to the external environment and the supervision of shadow banking

In the third quarter GDP growth continued to decelerate, to 7.3%, reflecting the moderation in domestic activity, particularly in the construction and real estate sectors, but partially offset by an unexpected and intense upturn in exports. We maintain our outlook for GDP growth at 7.2% in 2014. Altogether, the risks to growth in China continue to be to the downside from 2015 onwards (7.0%), precisely because of the brake on external demand that the situation in Europe might imply and the adjustment underway in the real estate sector in a context of high leverage and the introduction of measures to control its less regulated banking system.

China is facing the task of managing the present deceleration of economic growth while reducing its financial risks and rebalancing growth in favour of domestic demand. In this scenario, the authorities will intervene so that the deceleration does not intensify, and growth does not fall below the targets set. Thus we would not be surprised to see additional monetary policy easing (with cuts in the reserve ratio or liquidity injections), expansive central government fiscal policy (albeit with consolidation at the local government level) and on-going execution of structural reforms.

In the eurozone the recovery will be even slower than we were expecting

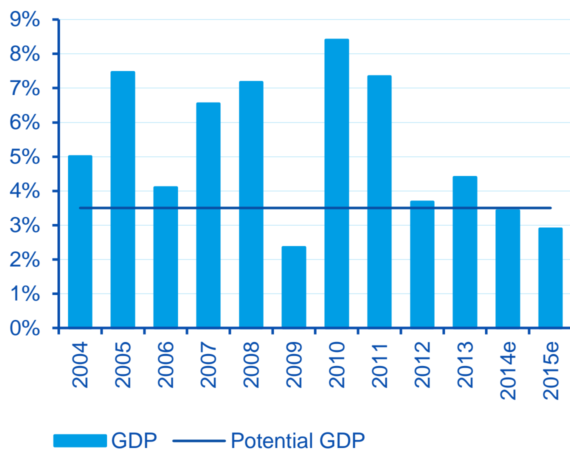
The stagnation of GDP growth in the second quarter, with weaker performances in general in the larger economies, has led us to revise our outlook for growth in the region downwards for 2014 and 2015 (Figure 2.2). The Ukraine/Russia crisis is having an impact on trade and the confidence indicators of the economies in the centre of Europe, including Germany. The ECB has continued to take action, with measures designed to bring inflation expectations more closely into line with the objective of price stability, which have been de-anchoring since 2012. In our most likely scenario, euro depreciation has to make a contribution, given the different expectations of Fed and ECB actions, with a withdrawal of stimuli by the former and balance-sheet expansion by the latter.

3 In search of a soft landing for the Uruguayan economy

The recent performance of the Uruguayan economy has been quite favourable. Over the last decade, Uruguay's GDP grew at an average rate of around 5.6%, with a high of 8.4% (2010). Uruguay was even capable of surmounting the difficulties arising from the global financial crisis in 2009, to grow 2.4%, when the rest of the region's countries displayed significant declines in GDP. In fact, this growth was reflected by an improvement in the well-being of the Uruguayan population, which displayed a 3.5 times rise in USD-denominated GDP per capita over said period, and which today boasts one of the highest in the region (Figure 3.1).

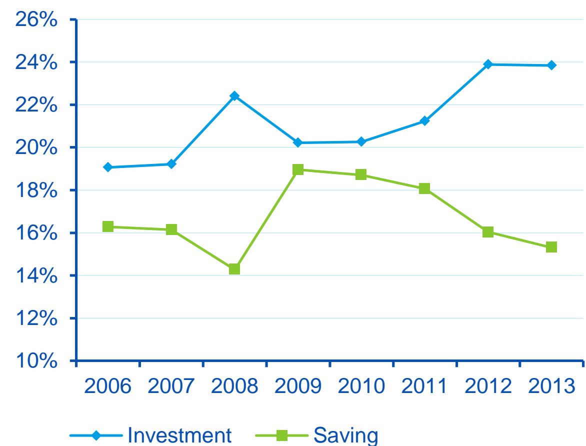
A major share of the growth achieved over the last decade was driven by a favourable international environment, which included high commodity prices and low international interest rates. Uruguay exploited these favourable conditions, by shifting its agricultural production toward items with high export prices (such as soy beans), taking advantage of the abundance of capital to build investment megaprojects such as UPM's (formerly Botnia) cellulose pulp manufacturing plants in 2008, and the more recent Montes del Plata mill (which was completed in early 2014), and seizing the opportunity of low international interest rates to restructure its debt and extend its maturities profile.

Figure 3.1
Uruguay GDP: Evolution and forecast (% real var.)



Source: BBVA Research based on central bank of Uruguay data

Figure 3.2
Savings and investment (as % of GDP)



Source: BBVA Research based on National Statistics Institute of Uruguay data

However, given the insufficient creation of domestic savings (Figure 3.2), a large part of the growth that Uruguay achieved over the last years was sustained by foreign savings. This situation is evidenced by the major current account deficits recorded over the last three years. While so far this has not been a major problem, due to the country's capital inflows over recent years (mostly as FDI, or foreign direct investment), this investment was insufficient to cover the entire current account deficit as early as 2013, which meant that shorter-term capital also had to be used.

That said, there is a perception that this model based on domestic consumption financed by foreign savings is close to its limits, and that overcoming the constraints on potential growth caused by a historically low population growth, in a labour market that is functioning at near full employment, requires a greater increase in productivity (by including new technologies or higher levels of innovation). Furthermore, and as with the rest of the emerging countries, Uruguay will receive less foreign capital to the extent, as we expect that excess liquidity will start shrinking and international interest rates will start trending upwards from mid-2015.

This will be the challenge for the next administration: venturing into economic policies that enable near-potential output growth, with less foreign reliance.

The next President of Uruguay will be elected in the run-off on 30 November. The run-off candidates are (the incumbent party) Frente Amplio's Tabaré Vázquez and Partido Nacional's Luis Lacalle Pou. Regardless of who wins (and in light of candidates' campaign statements), we do not foresee major changes in economic policy matters, but rather their continuity, perhaps with a greater or lesser degree of gradual adjustments to correct imbalances. In this regard, one of the main challenges the next administration faces is to adapt the increases in real wages agreed with the Wages Board to growth in productivity, with the purpose of reducing the inflationary inertia, which is one of the main problems currently afflicting Uruguay's economy.

After the slowdown we expect for 2015, Uruguay will have to re-embark on a course of greater investment for its potential GDP to grow. In this regard, due to the low growth rate in labour supply and the slowing rise in *Total Factor Productivity*, it is critical to keep investment at ratios of around 24% of GDP, such as those recorded over recent years, to be capable of growing at near-potential levels.

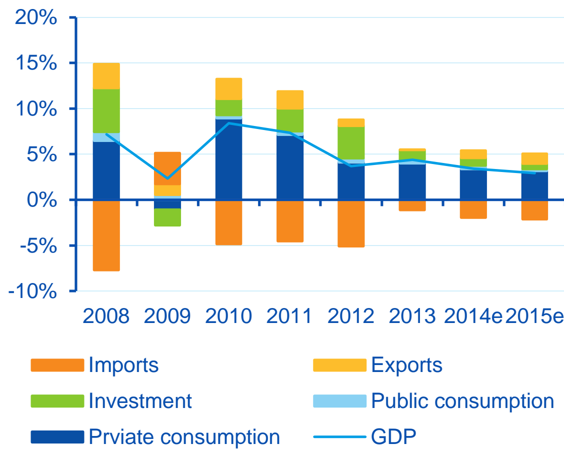
Economic activity rebound reflects the start-up of Montes del Plata

The positive surprise of a very good 2Q14 in matters of economic activity (2% QoQ deseasonalised growth) was coupled with the revision of the data for 1Q14, which climbed from a deseasonalised 0.4% QoQ fall to zero growth, warding off the spectre of a recession. Thus, GDP grew 3.7% YoY in 1H14, mainly driven by the recovery in the foreign sector, as the contribution of domestic demand to GDP remains at around 3.8%, a figure similar to those seen in 1H13. In fact, the contribution of exports was positive, and amply made up for the drop in investment associated with Montes del Plata's final stage of construction. The commissioning of Montes del Plata closes an investment cycle of more than USD3bn over three years. The plant has a cellulose production capacity of 1.3 million tons and will be capable of covering up to 7% of Uruguay's annual exports. In addition to cellulose, Montes del Plata generates its own power (biomass), and even surplus power that it subsequently sells to the grid (UTE - Uruguay's state power company).

To be noted at the sectoral level is the recovery of manufacturing industries in 2Q14, particularly the export-oriented sectors (meat-processing plants, cellulose pulp, wood), but also the poor performance of the construction sector, which heightened the impact of the completion of the pulp mill's construction.

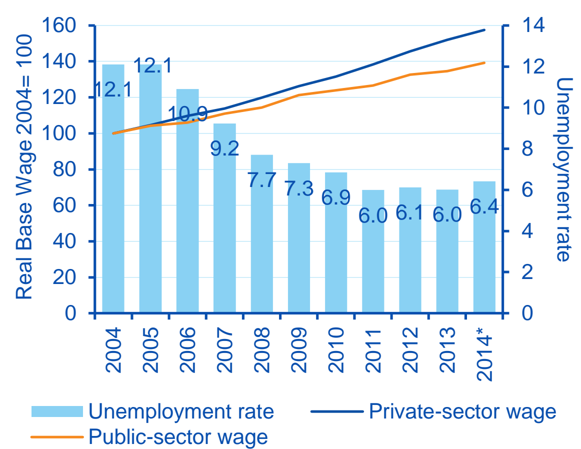
Preliminary 3Q14 information reveals that private consumption continued driving economic activity, at least when observing the significant growth in labour market and consumer confidence figures over September and October. Far from deteriorating, as we expected at the start of the year, the unemployment rate continued to fluctuate around lows, while the economy's real wage grew more than expected (Figure 3.4). The Average Real Wage Index climbed again in July, particularly in private sector wages, which had been lagging behind the public sector's due to the January increases.

Figure 3.3
Uruguay GDP: Contributions to growth (%)



Source: BBVA Research based on central bank of Uruguay data

Figure 3.4
Unemployment rate and real wage evolution



Source: BBVA Research based on National Statistics Institute of Uruguay data

We revised our 2014 growth projection to the upside from 2.7% to 3.4%, given that our original forecast would be overtaken by the data seen for the first half of the year, even when assuming a slowdown in domestic demand and a lower dynamism of exports over the last part of the year. Nevertheless, our forecast for 2015 comes in at 2.9%, as we expect less expansionary policies once the elections have passed. Therefore, domestic consumption should converge toward sub-GDP growth, which would relieve the inflationary pressures and also tend to shrink the external deficit (Figure 3.3). Moreover, the deterioration in commodity prices together with a poor performance of the Southern Cone economies (particularly Argentina and Brazil) would cap further expansion in the region's exports.

With no new large-scale projects in the pipeline over the short term, aside from the regasifier and after the completion of the Montes del Plata works, we expect investment to grow only 2.5% next year, based on smaller projects. In this regard, we note the major improvement in changing the energy mix through the development of wind power and biomass, which enables the minimisation of production costs and avoids relying solely on climate or oil import issues. In contrast with their pre-2006 insignificance, the new primary energy sources are now expected to provide around 17% of total power in 2015 (7% wind and 10% biomass). The shift toward a model based more on investment than on consumption will allow Uruguay to sustain adequate growth levels.

A marginal improvement in the external sector in spite of lower commodity prices

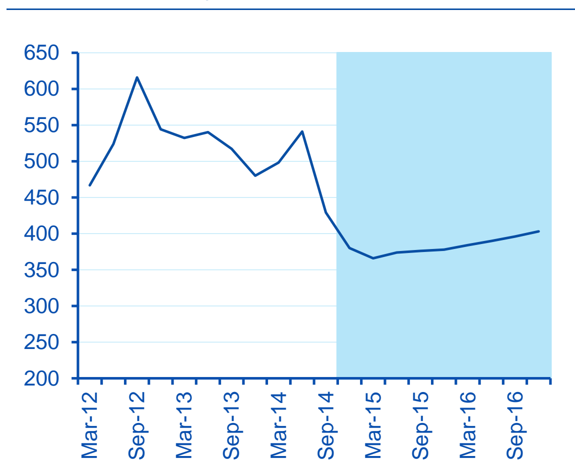
The high prices of agricultural commodities over the course of the last decade allowed Uruguay to realign production in favour of more profitable products such as soy beans, which gained significance in total foreign sales and ultimately became the top export product, overtaking the traditional meat industry.

According to information published by the central bank, which does not include the free-trade areas, for the aggregate of the first nine months of the year Uruguay's exports grew 6.3% YoY in nominal terms, as a result of the surge in exported amounts (mainly in 2Q14), given that prices remained practically free of any significant changes over the months for which there is information. For their part, imports only rose by a nominal 1.7% over the same period, but with a negative contribution of prices (-10.3% YoY). Thus, in nine months, the trade balance returns a deficit of USD1.307bn, around 18% less than in the same period of 2013. The trade deficit for 2014 is expected to come in at around USD2.3bn, revealing an improvement of roughly USD200mn versus the prior year.

The fall in commodity prices that has already been witnessed, and which we expect will persist throughout 2015, will affect a major share of Uruguay's agricultural production. The current declines in the prices of wheat and, especially, soy beans, might discourage production for next year and curtail the supply for export, a situation which would complicate the balance of trade, as these products account for 37% of total exports. Notwithstanding the drop in sales, soy beans remain at the top of the product ranking, with 20.3% of total exports.

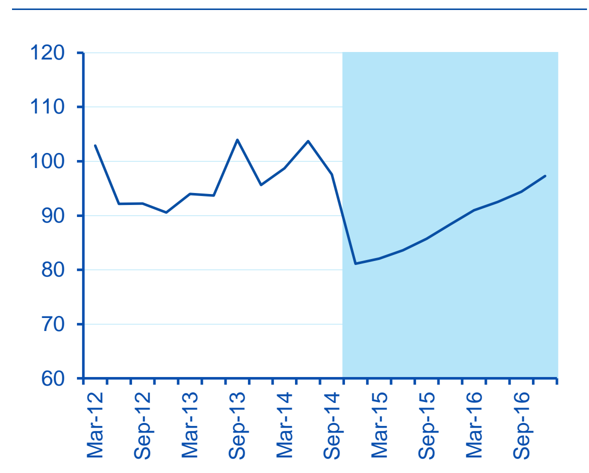
Our soy bean price forecast is around USD380 per ton for the end of 2014 with no major changes expected for the end of 2015 (USD378 per ton). However, given the high soy bean prices over the first half of 2014, the average annual price will indeed drop in 2015, by just under 20% versus the average for 2014 (Figure 3.5). Assuming that next year's exported amounts of soy beans remain at 2014 levels, Uruguay would export some USD340mn less worth of soy beans, due to the price effect. However, attention is currently focused on the production of cellulose pulp, given that the exports of UPM (formerly Botnia) are now coupled with Montes del Plata's (which would generate some USD700mn annually at current prices), which would make up for the lower contribution of grains, and avoid increasing the trade deficit.

Figure 3.5
Commodities: Soy bean price (USD/tn)



Source: BBVA Research

Figure 3.6
Commodities: Oil price (USD/barrel)



Source: BBVA Research

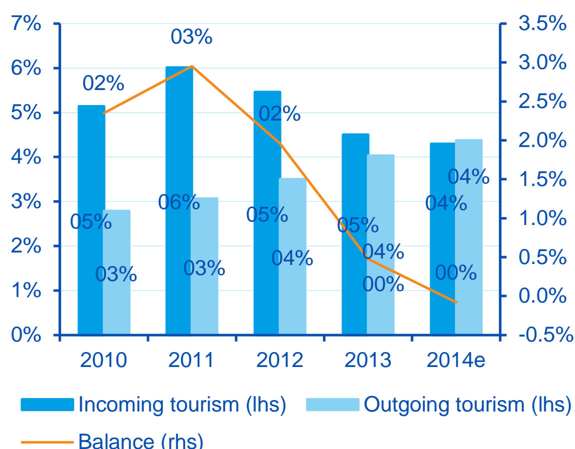
On the other hand, the fall in the oil price works in favour of Uruguay's trade balance, given that the country is a net oil importer, through state refinery ANCAP. If oil import requirements remain at last year's levels, the expected drop in the international price of crude (annual average of USD85 per barrel) versus the average of 2014 might result in a savings of roughly USD175 million on 2015 imports.

Bearing in mind these factors, which partially offset each other, and with conservative assumptions with respect to Montes del Plata's contribution to exports, the trade balance will show a marginal improvement in 2015, reaching a deficit of somewhat more than USD2bn.

Meagre tourism flows place a cap on current account deficit improvement

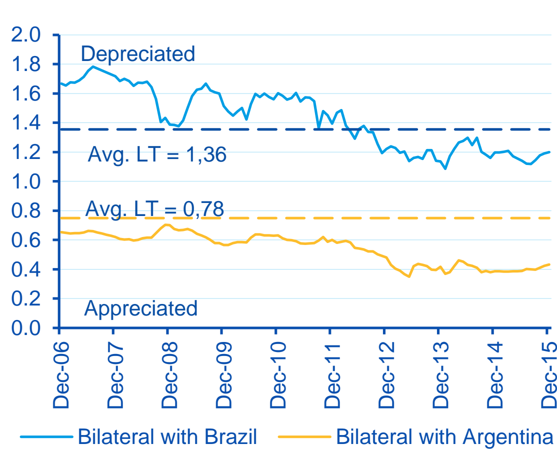
We revised the 2014 current account deficit to the downside to 5.3% of GDP (previously 6% of GDP), due to the improved result seen in the trade balance which, in this case, does take into account the figures of the free-trade areas. In fact, the numbers for 2Q14 were a surprise, with a current account deficit of only USD64mn (0.1% of GDP), when over the last quarters the deficit had ranged from 1.6% to 2.2% of GDP. This improvement was fundamentally due to the afore-mentioned trade balance, given that the meagre results of the tourism season, due to currency restrictions in Argentina (Uruguay's main source of incoming tourism), continued to reduce the scant surplus of this line item. In this regard, the tourism industry would close 2014 with a modest deficit (-0.1% of GDP) in comparison to the small surplus recorded in 2013 (0.5% of GDP), far removed from the contribution of prior years, 2012 in particular, which it closed with a surplus of 3% of GDP (Figure 3.7).

Figure 3.7
Contribution of tourism flows to external accounts (as % of GDP)



Source: BBVA Research based on central bank of Uruguay and Uruguayan Ministry of Tourism data

Figure 3.8
Bilateral exchange rate - Uruguay with Argentina (UYU/ARS) and with Brazil (UYU/BRL)



Source: BBVA Research based on central bank of Uruguay data

The improvement we expect in our current account forecast for 2015 (-4.5% of GDP) is based on a further improvement in the foreign trade balance, with greater equilibrium in the balance of real services, which would be caused by lower outgoing tourism, to the extent that the depreciation of the UYU starts having a more negative impact on Uruguayans' decisions on whether to leave the country.

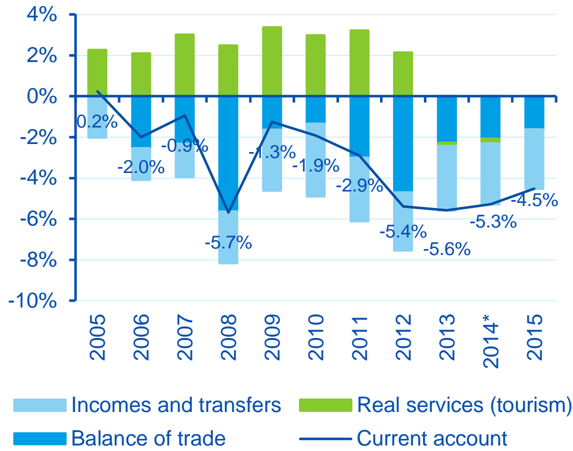
The need for foreign financing remains

The growing deficit did not pose a serious problem as long as it was entirely financed by FDI. However, and starting as early as 2013, FDI (5% of GDP) was less than the total current account deficit (5.6% of GDP) (Figure 3.9). The problem with continuing to carry large deficits is that short-term capital flows are not stable, and that the changes we expect will take place in the global economy, starting next year, may sap liquidity from the international markets.

In spite of having a level of reserves of more than 31 points of output, which could be tapped to counteract a potential problem in the balance of payments, the high reliance on foreign savings in response to the lack of domestic savings is now starting to be viewed as a vulnerability, given the need to sustain the high levels of investment achieved over the last years to drive growth close to potential. In this regard, FDI will probably decline in 2015 if no major project materialises, or if no financing is secured for smaller-scale projects capable of filling the gap left by the completion of the Montes del Plata investment at the start of 2014. If this

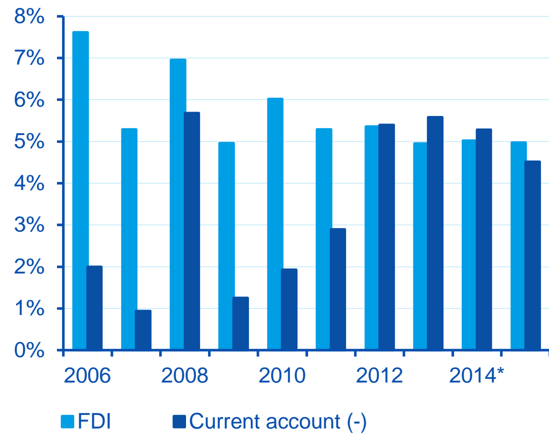
is the situation and the deficit does not shrink by much, as we expect, financing would have to come from larger amounts of shorter-term capital (Figure 3.10).

Figure 3.9
Uruguay current account, contributions as percentage of GDP



Source: BBVA Research based on central bank of Uruguay data

Figure 3.10
Current account deficit and foreign direct investment as percentage of GDP



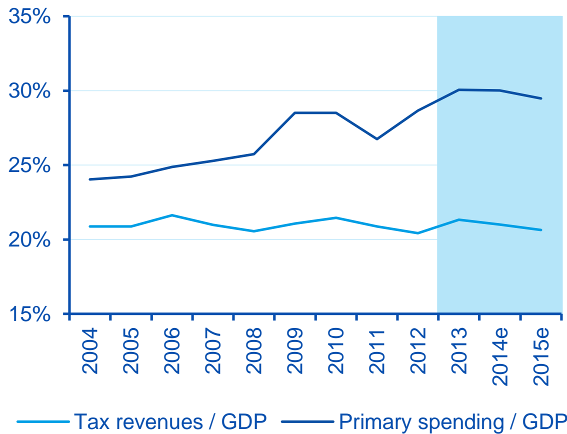
FDI: 2014, last 12 months at June 2014; 2015, average last three years
Source: BBVA Research based on central bank of Uruguay data

Scarce room for fiscal improvement in 2015

We estimate a fiscal deficit of around 3.4% of GDP for both 2014 and 2015. The fiscal front might just be the area in which the new administration will have to conduct more work, in light of the need to generate domestic savings and avoid raising borrowing levels to finance the imbalance. This turns out to be a complicated challenge, when taking into account the stiffness displayed by current expenditures, basically remunerations and pensions (14% of GDP), which account for half of total expenditures. The rise in the latter two stems principally from indexation mechanisms set forth in the legal regulation established in the wage agreements.

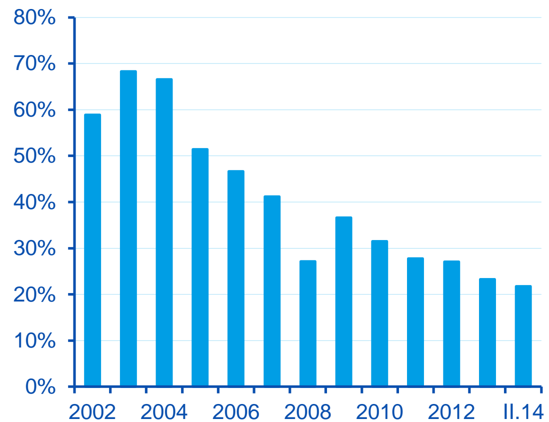
Over the last decade, the trend in Uruguay's public spending has been upward (Figure 3.11), with the exception of 2011 (due to less public investment). It reached a high in 2013 (30.1% of GDP), while tax revenues in GDP terms remained relatively stable and below spending (21.3% of GDP).

Figure 3.11
Tax revenues and primary expenditure



Source: BBVA Research based on Uruguayan Ministry of Economy and Finance data

Figure 3.12
Net public debt as % of GDP



Source: BBVA Research based on central bank of Uruguay data

Over 2014, the growth in current expenditures has remained higher than the rise in tax revenues, while the need for greater investment by public companies and the maintenance of public utility tariffs to contain inflation, also had a negative impact on the fiscal balance.

While significant fiscal policy changes are not expected, the next administration's challenge will thus be to reverse the recent deterioration of the public accounts, by trying once again to achieve primary surpluses that enable it to generate enough cashflow to face, at least partially, its debt service. However, none of the candidates who might occupy the presidency in 2015 have mentioned the need for a significant fiscal adjustment from the spending point of view. Instead, they have spoken about achieving higher efficiency in spending together with a gradual adaptation of the tax system, increasing the share of direct taxes, so that the rise in revenues improves with the level of activity and the gap with respect to spending is reduced. There is a consensus that the fiscal effort required to tame inflation is high with respect to the results obtained and the political costs, which means that we are unlikely to see a restrictive fiscal policy over the next years.

The fiscal deterioration notwithstanding, the government is proceeding with a pre-financing policy through which its needs for the next 18 months are covered, in addition to its access to some USD3bn in four contingent credit lines (CAF, WB, IDB and FLAR) plus a flexible line from the IMF that has yet to be requested.

Last but not least is the behaviour the country continues to display in matters of public borrowing, as it takes advantage of low international interest rates to reduce its short-term maturities and gradually de-dollarise the debt, with the resulting reduction in exchange rate risk. As at June 2014, according to the latest information released by the CBU, the net debt (of reserve assets) of the Global Public Sector reached a low of 22% of GDP, dispelling concerns over the sustainability of the debt (Figure 3.12). This situation was made possible by the major accumulation of reserves. However, we insist that the government is unlikely to be capable of reducing the gross debt as long as it continues to accumulate deficits.

Inflation: above the target range for another two years

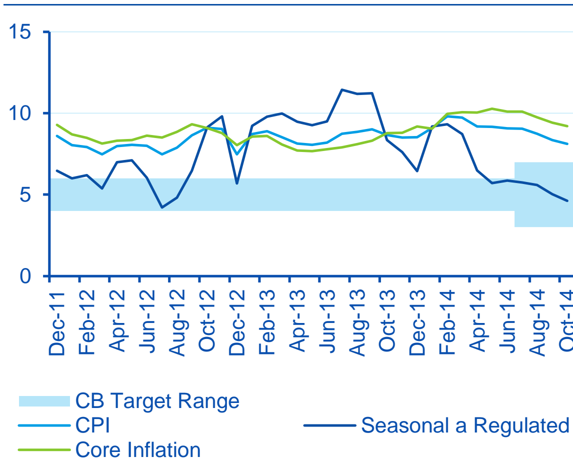
Over the first ten months of 2014, the CPI accumulated a variation of 8.7%. On a components basis, while Housing took first place with a 13.7% rise and Education climbed 13.4%, we must note the performance of Food and Non-Alcoholic Beverages, which accounts for 26% of the total. The latter category, which is a major shaper of expectations due to its own nature and its weight in the consumer basket, rose 10.4% from the end of last year (9.2% over the same period in 2013), and accounted for 31% of headline inflation by providing an impact of 2.7pp, the highest of all categories.

In YoY terms, however, inflation slowed from the 9.8% high in February to 8.1% in October, which is below the 9.0% average of the last 12 months. Core inflation, which accounts for around 75% of the total and excludes seasonal and/or regulatory effects, also confirmed a gradual downtrend, coming in at 9.2% YoY, a figure which is below the 9.7% monthly average of the last 12 months, and the 9.8% average for 3Q14. The slowing of the inflationary process was more pronounced in the rest of the prices, that is, the seasonal together with the regulated, which rose 4.6% YoY in October, markedly below the 7.0% average of the last 12 months and the 5.5% YoY average for 3Q14 (Figure 3.13). Thus, with two months remaining to close 2014, and assuming the usual downward adjustment of UTE rates in December, we stand by our forecast of 8.4% for this year, while raising next year's from 7.6% to 8.0%, in light of a greater depreciation than what we expected in previous forecasts, and a more protracted lag in the effects of monetary policy.

We thus discount another two years of CBU target non-compliance. The goal of keeping headline inflation within the established target range, now from 3% to 7%, was achieved in only 14 of the 83 months running from December 2007. In other words, inflation has been outside the target range (always above) for roughly 83.1% of the period in question. This behaviour could lead to the inference that the monetary authority's actual ceiling is a maximum level of 10%, a threshold that has triggered the use of macro prudential measures in the past.

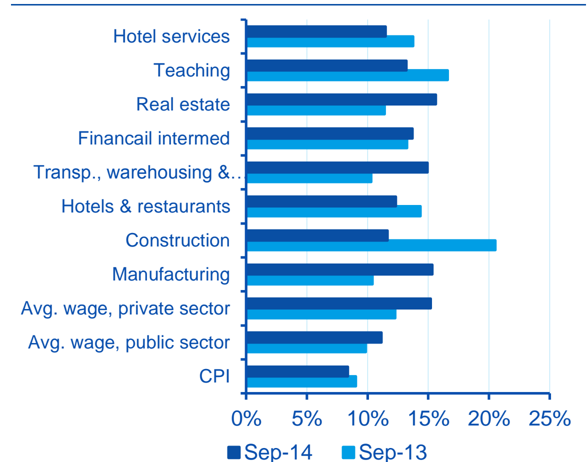
While monetary policy has met its stated goals in terms of growth of monetary aggregates, the results reveal its scarce effectiveness, especially when taking into account the little to no help from the fiscal front and the continuity of wage inertia, explained by the evolution of real wages, which rose by an average of 4.2% over 2005-14. We have a similar situation this year, as most sectors already display nominal rises that exceed not only inflation, but also the hikes recorded to September of last year. To illustrate, we note that the private sector, which accounts for 61.9% of the total wages bill, rose 15.2% YoY, versus the 8.1% YoY for the CPI in the observed period (Figure 3.14).

Figure 3.13
CPI by component (%)



Source: BBVA Research based on National Statistics Institute of Uruguay data

Figure 3.14
Average wages (% change YoY)



Source: BBVA Research based on National Statistics Institute of Uruguay data

Based on the consensus over the high cost to activity that must be borne to lower inflation, we may infer that the authorities' perfunctory stance toward the relationship between inflation and the fiscal balance reveals that they do not perceive the latter as the appropriate instrument to reduce price momentum and cause inflation to converge.

Our diagnostic points to wage indexation as possibly the main source of resistance in the convergence of inflation toward the target range. Worth stressing is that the collective wage bargaining multi-annual process generates a downwards inflexibility that places a floor under price inertia, and the fact that it tends to make short-term price events permanent is another factor that could potentially cause a protracted rise in the inflation level. Thus, the urgent challenge that arises for the new administration that will take office in 2015 is to conduct a wage “de-indexation,” by way of raises that more accurately reflect each worker's productivity.

The regional trend drags the exchange rate towards depreciation

The UYU was not immune to the USD’s appreciation throughout the world and, in particular, in the region, after the first signs that the Fed was soon to end QE. The Central Bank of Uruguay (CBU) reacted in September, easing the parameters of macroprudential measures, by cutting the reserve requirements to 0% for the purchase of government securities, and to 30% for CBU instruments by non-residents, thus enabling higher USD inflows to ease tensions in the FX market, mitigating the depreciatory pressures on the UYU. The easing of restrictions on short-term capital inflows notwithstanding, the UYU fell 5% against the USD in 3Q14. In light of these events, we raised our forecast from UYU23.75 to UYU24.4 per USD for December 2014. The global USD recovery scenario will continue in 2015, given the improvement in US activity, which will consolidate the withdrawal of stimulus and enable the Fed to start raising rates in 3Q15. Along the same lines, the depressed soy bean price will further pressure the UYU to the downside. We thus raise our exchange rate estimate for December 2015 to UYU26.63 per USD from the UYU25.75 of our previous forecast.

The latter notwithstanding, given the trend of the currencies of Uruguay's main trading partners, particularly Argentina, Uruguay is unlikely to achieve a significant reversal of the UYU’s current appreciation, which has major impacts on competitiveness. In the way of a safety net, we should mention that in addition to the CBU's healthy supply of reserves (31.9% of GDP, among the region's highest), Uruguay has contingent credit lines that would be activated if required, to prevent bouts of strong exchange rate volatility.

Box 1. The debt burden of Uruguayan households

In 2014, Uruguayan household debt burdens would remain at 13.3%, in spite of the fact that household bank credit would reach 9.5% of GDP for the same period. Different structures of average debt maturities and interest rates place Uruguay at the same debt burden level as other Latam countries with higher credit penetration.

Household debt burden is the amount of a country's outstanding household loan payments with respect to its average disposable income or, as it is computed in Uruguay, its average household income. The required variables for this calculation are the amount of outstanding debt (household credit), the maturities, the interest rates and the disposable income (or average household income). This ratio differs from household debt as published by the central bank of Uruguay, given that it is not the quotient of household debt over average household income (stock/flow), but rather the quotient takes into account the total annual payment (principal + interest) made by a household over the income received in the same period (flow/flow).Therefore, our results will always be lower when compared to the ratios published by the CBU, as they only takes into account the weight of the total payment over household income for the period.

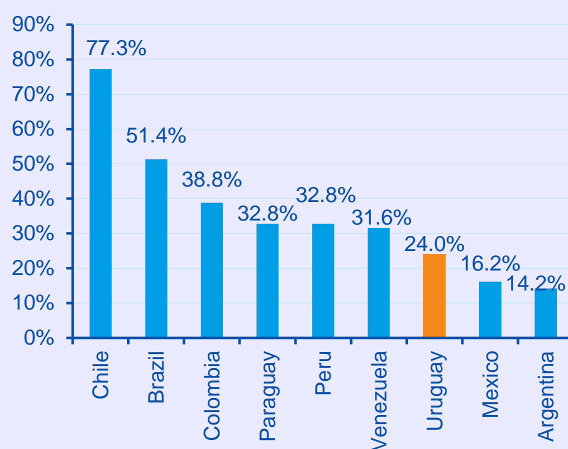
Household bank credit grows, but is low when compared to other countries

Banking system credit to the private sector has been growing over the last years, to reach an average of 24% in GDP terms in 2013. That level, however, remains one of the region's lowest, with the exception of Argentina and Mexico (Figure B.1). In particular, household credit, which includes consumer credit and mortgage credit, has risen to 9% of GDP (2013 average) and, according to our forecasts, could climb to 9.5% of GDP in 2014. Home loans reached 3.8% of GDP in 2013, while consumer credit, specifically, came in at 5.2% of GDP.

When analysing the evolution of the financial system's credit levels in YoY terms, we see that credit grew and continued to accelerate in 3Q14 versus 3Q13. However, this is caused by an exchange rate effect, given that as they are measured in USD (and extended to a greater degree in domestic currency), we are comparing the recent period against a period which includes a recovery in the exchange rate, after a short and significant currency appreciation (Figure B.2). However, when we compare the recent monthly evolution of credit, we see that credit has been losing dynamism over 2014.

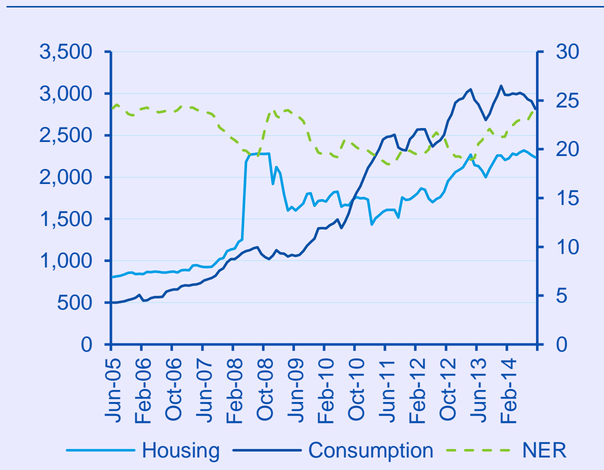
Our forecasts suggest that household bank credit will still remain expansionary over the coming years, although at lower rates than those seen in recent years. In particular, consumer credit (measured in USD) would grow by an annual average of around 7% over the next four years, while greater dynamism will be seen in home loans, which could rise by 13%, in annual average and USD terms. These projections include our forecasts for a deceleration in domestic demand over the next years, a slowdown in the rate of exchange rate depreciation beginning in 2015, and the maintenance of interest rates at similar levels.

Figure B.1.1
Loans/GDP comparing Latam countries



Source: BBVA Research

Figure B.1.2
Monthly evolution of household credit in USD millions (lhs) and nominal exchange rate (USD/UYU) (rhs)



Source: BBVA Research based on central bank of Uruguay data

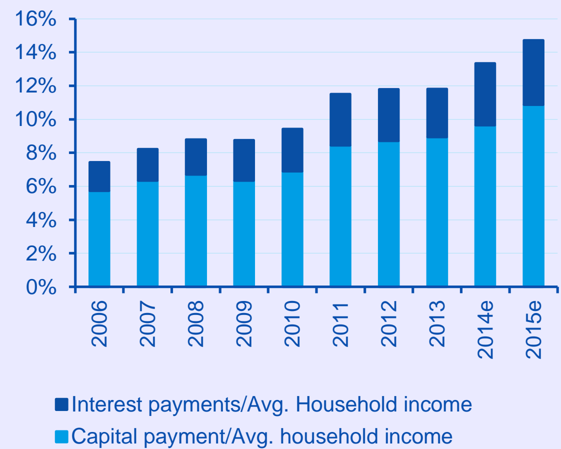
The weight of credit payments on household budgets

The higher debt of Uruguayan households, which is directly linked to consumer credit, has not yet squeezed the life out of their budgets. In fact, according to our estimates, the payment a household makes on a loan extended by a financial institution (which includes public and private banks, cooperatives, lending companies and external financial institutions) would reach 13.3% of average household income in 2014 (1.5% higher than the figure for 2013), using the average disposable income figure published by the National Statistics Institute of Uruguay (Figure B.3).

The weight of the total payment (principal plus interest) on the household budget (average household income), however, becomes similar to those seen in other countries with a higher level of banking penetration.

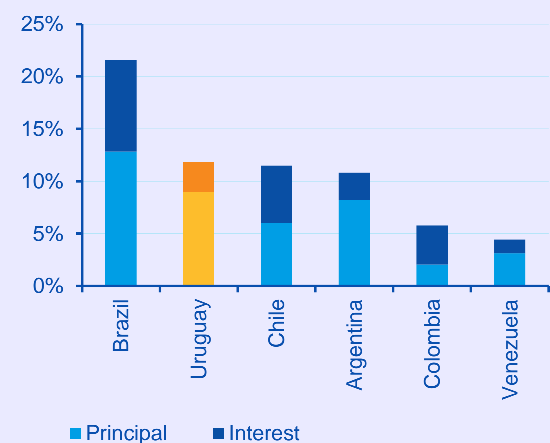
To compare the situation of Uruguayan households against those of other countries in the region, we took 2013 as the baseline. One clarification to bear in mind is that while most countries calculate the ratio on disposable income, in the case of Uruguay we use average income, due to the availability of information. In general, one would expect that the higher the level of a country's access to banking, as measured by credit to GDP (in particular, household credit in terms of GDP), the higher the payment as a share of income (or average income). In Uruguay, we see that the debt burden is at the level of other countries with a higher degree of banking penetration, such as Chile (Figure B.4).

Figure B.1.3
Debt burdens (from bank credit) with respect to Uruguayan household incomes



Source: BBVA Research

Figure B.1.4
Comparison of Latam household debt burdens



Source: BBVA Research

While the weight of payments is not a concern for the time being, given that delinquency problems have not been observed, the fact remains that it is high with respect to the level of banking credit. The

outlooks suggest that payments will continue to grow in step with the rise we expect in household credit extended by banking institutions.

However, a particular feature of Uruguay's consumer credit is that a high percentage of it is provided by consumer loan companies, which is not taken into account when discussing “bank credit.” On average, for the first nine months of the year, consumer loan company credit came in at around USD740.2mn, and revealed a declining trend over all of 2014, as did bank credit, which had already started the year at around USD793mn (in January) after ending 2013 at USD785.5mn.

Therefore, when coupling bank credit with household credit extended by consumer loan companies, the debt level would climb to 13% of GDP in 2014. In this case, the debt burden in terms of average household income would also rise to 19.6% this year.

4 Tables

Table4.1
Annual macroeconomic forecasts

	2010	2011	2012	2013	2014f	2015f
GDP (% YoY)	8.4	7.3	3.7	4.4	3.4	2.9
Inflation (% YoY, eop)	6.9	8.6	7.5	8.5	8.4	8.0
Inflation (% YoY, Avg.)	6.7	8.1	8.1	8.6	8.9	7.5
Exchange Rate (vs. USD, eop)	19.9	19.9	19.3	21.3	24.4	26.6
Exchange Rate (vs. USD, Avg.)	20.0	19.2	20.2	20.4	23.2	25.6
Loan Interest Rate (%, Avg.)	21.1	18.9	18.6	17.7	21.2	18.7
Private Consumption (% YoY)	12.8	9.8	5.5	5.3	4.4	4.1
Government Consumption (% YoY)	3.1	3.8	4.6	4.2	3.8	2.0
Investment (% YoY)	8.7	12.5	16.6	4.2	3.5	2.5
Fiscal Balance (% GDP)	-1.2	-0.9	-2.8	-2.5	-3.4	-3.4
Current Account (% GDP)	-1.9	-2.9	-5.3	-5.6	-5.3	-4.5

Source: BBVA Research

Table4.2
Quarterly macroeconomic forecasts

	GDP (% YoY)	Inflation (% YoY, Avg.)	Exchange Rate (vs. USD, Avg.)	Loan Interest Rate (%, Avg.)
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	17.9
4Q13	4.6	8.6	21.4	22.0
1Q14	3.0	9.6	22.0	22.4
2Q14	3.7	9.1	22.9	20.3
3Q14	4.6	8.7	23.6	19.9
4Q14	2.3	8.3	24.3	19.7
1Q15	2.7	6.9	24.8	18.0
2Q15	2.2	7.8	25.3	19.1
3Q15	2.8	7.9	25.9	18.7
4Q15	4.0	7.3	26.4	19.3

Source: BBVA Research

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