# Uruguay Economic Outlook

First half 2015
Argentina Unit

- Uruguay has uncoupled from Mercosur and will grow at 2.6% in 2015 and 3.0% in 2016, in spite of the weaker stimulus from domestic demand
- We do not see any great fiscal improvement in 2015 (deficit of 3.1% of GDP), even though this is one of the chief concerns of the new government, which will have to take a firmer grip of expenditure, as the fall-off in activity leaves little scope for action on the revenue side
- The current account deficit will narrow to 3.9% of GDP in 2015 and 3.5% in 2016, thanks to better terms of trade and improvements in the Tourism account
- Pushed up by wage inertia and the currency depreciation, prices will remain outside the target band for a further two years, with inflation at 8.4% in 2015 and 7.7% in 2016
- The dollar exchange rate will reach UYU28 at the end of 2015 and UYU30 in December 2016, depreciating by less than the currencies of Uruguay's trading partners, in confirmation of Uruguay's better indicators by the market

# Contents



**Closing date: 20 May 2015**

# 1 Overview

World growth for 2015 has been revised downwards to 3.5%, which is 0.1pp below the January estimate and only 0.1pp above the figure for 2014. In 2016, world GDP should grow at an average of 3.9%, partly as a result of the expansive monetary policies implemented in the developed countries, which ought to achieve their best figures since 2010. Although economic policies will remain accommodative, the downside risks for world growth remain, chief among these being how the slowdown in China progresses and the ripple effects of the start of the Fed's rate normalisation process.

On 1 March the *Frente Amplio* ("Broad Front", left wing) began its third term of office and the second of Dr. Tabaré Vázquez, and generally speaking no major changes in economic policy are expected, only just enough adjustment to turn round existing disequilibriums.

Uruguay's economic growth is slowing down as predicted. After growing at 3.5% in 2014, we expect it to do so at 2.6% in 2015, and thereafter at 3% in 2016. Although domestic demand is still the main force behind this growth, private consumption will slow down in harmony with the less buoyant labour market, while investment will also experience a loss of momentum as no major private sector initiatives on the scale of the Montes del Plata project are foreseen until last year and public investment will have been put on hold given the need to make fiscal savings.

One of the prime concerns of the new government is the high fiscal deficit (3.3% of GDP in 2014). The five-year budget (currently being drawn up) will be key to keeping expenditure under prudent control. In any case we do not expect major changes this year and forecast that the deficit will reach 3.1% of GDP, largely because of the smaller deficit of public sector companies thanks to the oil price slide.

The external sector is making headway, but only very slowly, and the current account deficit is still high. Uruguay needs to make the most of the kinder terms of trade and stimulate its industrial exports to make any further improvement. Tourism seems to have reached a watershed in 2014, which means that we expect the current account deficit to progress in 2015 to 3.9% of GDP, with more improvement in 2016 (3.5% of GDP).

Inflation is not showing any signs of turning towards the centre of the target range in the medium term. The combination of wage inertia and the passing on of the UYU depreciation to domestic prices (so far not severe) are proving too much for the central bank's efforts to rein in inflation. We have revised our inflation estimates upwards from 8.0% to 8.4% in 2015, and from 6.9% to 7.7% in 2016.

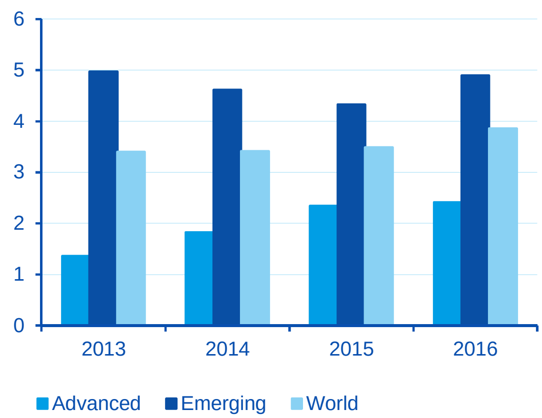
Even if the UYU does not manage to escape the global appreciation of the USD, Uruguay's fundamentals will save it from weakening to the same extent as the currencies of the country's mainstream trading partners. The UYU will therefore depreciate by 16.3% against the USD, reaching UYU28 at the end of the year, then by another 7.2% in 2016, taking the dollar exchange rate to UYU30.

# 2 World growth is suffering from the slowdown in the emerging economies

## World growth came off the pace in 1Q15

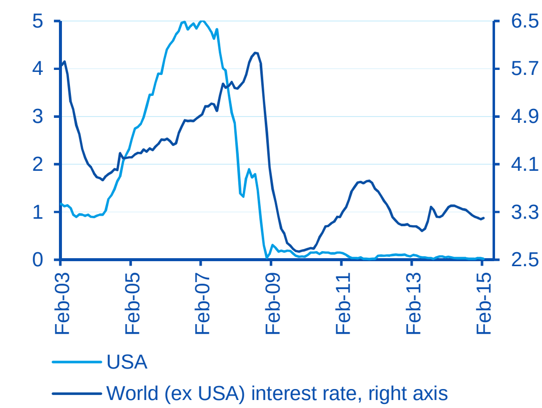
The slowdown in world growth in Q1 was produced by the slowdown in the US economy, less drive in the Chinese economy and the drop in activity in some of the most prominent emerging countries (such as Russia and Brazil). The consolidation of growth in the block of developed countries contrasts with the broad flagging trend among the emerging economies, which was more pronounced in Asia and Latin America than in Eastern Europe.

Figure 2.1
**World GDP growth: 2015-16 forecasts (%)**




Source: BBVA Research

Figure 2.2
**Short term nominal interest rates (%)**




Source: BBVA Research

We are therefore revising our world growth forecast for 2015 down to 3.5%, which is 0.1pp below the estimate from January and only 0.1pp above the figure for 2014 (see Figure 2.1). For 2016, world growth should show average growth of 3.9%, partly as a result of expansionary monetary policies in the developed countries, which ought to record their best rates since 2010. In a scenario of gradual trend deceleration in China, the emerging economies should reverse the current slowdown thanks to the pull effect from the developed economies, the gradual climb in commodity prices and a potentially more restrained rise of interest rates than in other historical episodes of Fed normalisation.

The progressive rise in commodity prices in line with our forecasts and the reinforcement of loose monetary policies worldwide have been two of the more prominent elements on the economic landscape in recent months. Central banks have in fact been more proactive, in both developed and emerging economies, and, even if the Fed decides on a strategy of gradual monetary tightening, the emerging economies have chosen to give priority to reactivating domestic demand by looking to cut interest rates (see Figure 2.2), in some cases at the cost of both taking on greater local currency volatility and discouraging inward and continued flows of foreign capital.

Despite this, and the fact that economic policies will continue to be accommodative, the downside risks for world growth persist. The biggest threats are the extent of the slowdown in China and the fallout from the start of Fed interest rate normalisation. The deflationary pressure associated with the drop in the oil price, geopolitical tensions and the potential for failure by the ECB to relaunch inflation expectations in the Eurozone are risks which, despite appearing less likely and to entail less of an impact than predicted some months ago, cannot be ruled out. Finally, a risk which remains latent is the lack of any agreement between the Greek government and the European institutions and the IMF over the refinancing of its debt.

## Growth slowed down in the United States in Q1…

The United States has begun 2015 with a significant slowdown in its growth rate to an annualised quarterly rate of 0.2%, from an increase of 1% on average in the three preceding quarters. The unusual severity of the weather conditions accounts for some of this deceleration, to which one might add the oil price fall and its impact on the energy sector and the beginnings of the effect of the stronger USD on exports. Even so, the robustness which the labour market continues to exhibit should continue to sustain household incomes and private consumption. Annual US growth could therefore reach 2.9% in 2015 and stay at rates of around 3% in 2016 too.

The Fed's interpretation of whether the slower growth in Q1 was temporary or longer-lasting will define how it reacts from now on. The most likely outcome is that the first policy rate hike will take place in September 2015, followed by a gradual rise to no further than 1.5% by the end of 2016.

## … as it did in China too

In China the economic slowdown has taken a firmer grip in the last few months, with growth for 1Q15 registering 7% YoY and featuring an adjustment in industrial production and investment, although there was a brighter relative showing from private consumption. The slowdown is attributable to the correction playing out in the real estate market, political uncertainty ahead of the National People's Congress in March, the decline in competitiveness caused by the worldwide appreciation of the CNY, and finally the effects of the fiscal consolidation of local authorities which began in 2014.

The structural character of the factors mentioned lends weight to the prediction that China will grow less in the medium term and experience greater volatility. The annual growth target of 7% for 2015 laid down by the Chinese authorities is based on the implementation of new stimulus measures, of both a monetary and a fiscal nature. Subsequently in 2016, growth will continue to adjust at 6.6%.

## The Eurozone showed the biggest recovery these past few months

Of the developed economies, it was the Eurozone which put in the best relative performance going into 2015. GDP could have grown at the highest pace since mid-2011, with Germany and Spain heading up growth in the area as a whole. The recovery has been driven by the better financing conditions and the euro's depreciation, both prompted by the ECB's quantitative easing programme, together with the drop in the oil price. The less restrictive fiscal policy and containment of the fall in nominal wages in the periphery countries are also helping to relaunch growth. This means that GDP should advance by 1.6% in 2015, which should rise to 2.2% in 2016.

# 3 Uruguay Outlook

## Soft landing for the Uruguayan economy: the slowdown is as expected

The Uruguayan economy grew at 3.5% in 2014, in line with our forecast (3.4%). In this expansive phase, which has been unbroken now for 12 years, domestic demand has been the key driver behind growth, even though it has been slowing down noticeably, particularly over the past year, in which its contribution to growth has dropped from 6.4% to 3.1%, consistent with our forecasts (see Table 1).

Not only has private consumption shown signs of decelerating, but private investment too has fallen off, as a result of the conclusion of the construction work on the Montes del Plata cellulose plant. On the other hand, the contribution of demand from abroad proved positive for the first time in several years thanks, not only to the start of exports from Montes del Plata (2H14), but also to lower oil imports, which in turn were not just from the cheaper oil price, but also on account of the reduced amounts required by public companies. This was helped by the change in the energy matrix being carried out by Uruguay. Here, mention should be made that electricity generation in Uruguay in 2014 was 74% hydraulic, 7% thermal, 13% from biomass and 6% from wind-power, whereas in 2005 the breakdown was 87% hydraulic and 13% from fossil fuels, which serves to highlight the great strides that have been made towards using renewable energy sources, thereby reducing Uruguay's reliance on oil and, to a lesser extent, weather factors.

Table 3.1
**Aggregate supply and demand: % var. YoY**

| Var. YoY | 2011 | 2012 | 2013 | 2014 | 2015e | 2016e |
|---|---|---|---|---|---|---|
| Total Consumption | 6.7% | 5.1% | 5.2% | 4.0% | 3.1% | 2.9% |
| Private Consumption | 7.2% | 5.0% | 5.2% | 4.2% | 3.3% | 3.0% |
| Public Consumption | 3.7% | 5.9% | 5.0% | 2.5% | 1.5% | 2.0% |
| Investment | 9.9% | 13.9% | 8.6% | -1.2% | 1.0% | 3.0% |
| **Domestic Demand *** | **7.6%** | **7.2%** | **6.4%** | **3.1%** | **2.9%** | **3.2%** |
| Exports | 5.8% | 3.1% | 0.2% | 1.9% | 3.0% | 4.5% |
| Imports | 12.5% | 13.5% | 3.5% | 0.5% | 3.0% | 4.0% |
| **Balance of Trade *** | **-2.4%** | **-3.9%** | **-1.3%** | **0.4%** | **-0.3%** | **-0.2%** |
| **GDP at current prices (USD mn)** | **926.356** | **1.043.637** | **1.178.197** | **1.335.977** | **1.466.773** | **1.615.772** |
| YoY | 5.2% | 3.3% | 5.1% | 3.5% | 2.6% | 3.0% |

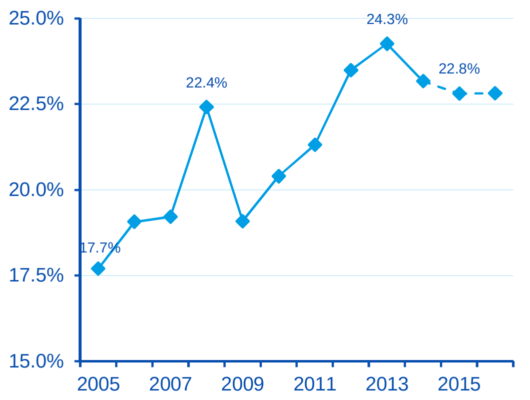
* shares
Source: central bank and BBVA Research

All the sectors of activity performed positively over 2014, with the exception of Construction with a contribution of -0.1%. The stand-out sectors in the growth process were, once again, Transport, Warehousing and Communications (due to the continued growth in telecoms) and also the Manufacturing Industries sector, spurred on by the export-oriented productive branches (meat, cellulose, among others).

In 2015, Uruguay's growth continued to slow down. Domestic consumption will pursue its process of adapting to more sustainable levels, while investment is unable to shine with any large-scale projects. We are revising our growth forecast down for this year from 2.9% to 2.6%, because external demand will continue to have a negative impact due to worse-than-expected performance by Uruguay's main regional trading partners, Brazil and Argentina.

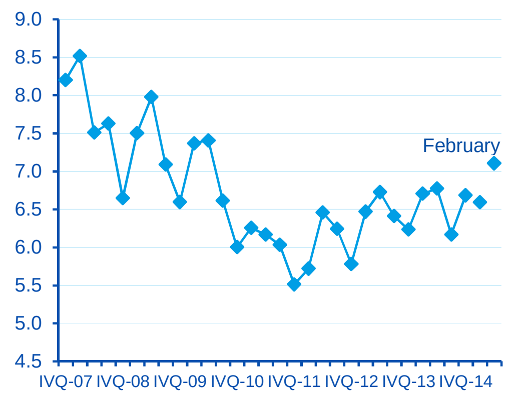
In the opening months of 2015, certain indicators continued to point to a slowdown in domestic demand, with volumes of consumer goods imports dropping 6.6% YoY during the first two-month period and tax collections growing, but at a sub-inflation level, while the decline in consumer confidence persisted in March (-6.7% MoM), confirming the negative trend since November. An equally meaningful sign is provided by the deterioration in the labour market situation in the first bi-monthly period of the year, with the February reading for the unemployment rate showing 7.1% of the economically active population, which is the highest level in the past two years within a context of historically low levels, which still prevail in Uruguay (see Figure 3.2).

Figure 3.1
**Investment within GDP over time**




Source: Central bank and BBVA Research

Figure 3.2
**Unemployment rate: quarterly averages, except January and February 2015**




Source: BBVA Research based on information from the INE

## Uruguay is uncoupling from its Mercosur partners

In spite of its slowdown, Uruguay has managed to break away from the recessionary trend shown by its major trading partners in Mercosur. In 2009, at the height of the global crisis, Uruguay also managed to elude the recession that was gnawing at the region and since 2013 it has again broken free, managing to hold onto positive growth rates ahead of the other countries, even when stagnation or recession is predicted among the main Mercosur partners (see Figure 3.3).

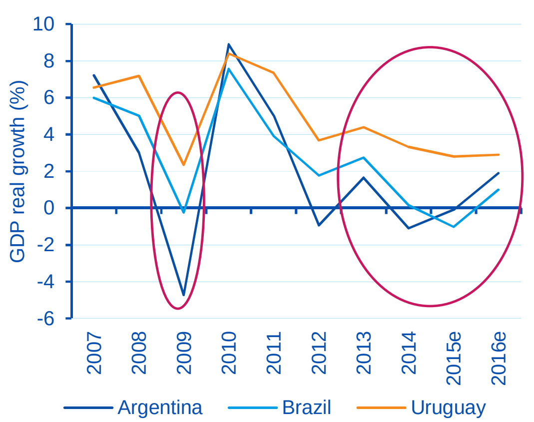
An assortment of factors has contributed to set Uruguay apart from the other countries, some of which are domestic in origin while others are external. First, the legal stability and business climate have sustained a high rate of investment. Uruguay has an international reputation for its soundness, topping rankings for the quality of its institutions and economic freedom. This allowed it to regain investment grade status in April 2012 and attract foreign capital inflows in the form of Foreign Direct Investment (FDI). The business climate has become more attractive in recent years, as domestic and foreign capital receive the same treatment alike, which means that all investors can enjoy the benefits of the Investment Promotion Law and, if foreign, they are not shackled by restrictions on transferring profits or repatriating capital. The government itself encourages investment from abroad and fosters this by passing laws to facilitate it (such as Law 156.906 on Investment Promotion and Protection) based on granting tax exemptions. Uruguay also has several regimes which provide an attractive legislative framework to draw in investment: the Free Trade Zones Law, Free Ports and Airports, Industrial Estates, Temporary Import Admission, the Public-Private Participation Law, the Subsidised Housing Act and specific legislation for each economic sector.

Another of the factors which have helped Uruguay stand out in a positive sense is its shrewd administration of public debt. It managed to make the most of those years when a more kindly international situation prevailed, with an abundance of liquidity and low interest rates, by lengthening the maturities on its debt and stepping up the proportion of its peso-denominated debt to reduce its exchange rate exposure.

Nonetheless, this growth model based on an expansion of internal demand using insufficient domestic savings made it necessary to turn to external savings, which led to a substantial increase in Uruguay's external deficit. Similarly, the greater amounts invested by public companies caused the fiscal deficit to swell, as did the regulated prices policy, which was intended to head off greater inflation and meant that official rates charged were frozen while the state companies themselves absorbed the cost.

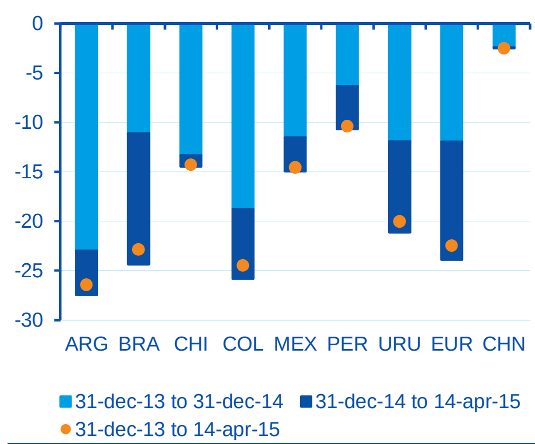
The question mark raised, looking ahead, is whether Uruguay will be able to sustain significant growth rates at the same time as it carries out a fiscal adjustment programme to allow it to achieve the same kind of primary surpluses as it managed before, without this having a negative knock-on effect on prices and investment. The main doubt focuses on the likelihood of domestic demand continuing to grow at vigorous rates, in a new international environment in which it might not be so easy to pursue a growth model that relies on using external savings.

Figure 3.3
**GDP performance in Mercosur**




Source: Haver and BBVA Research

Figure 3.4
**Exchange rates**




(-) implies depreciation against the USD.
Source: Haver and BBVA Research

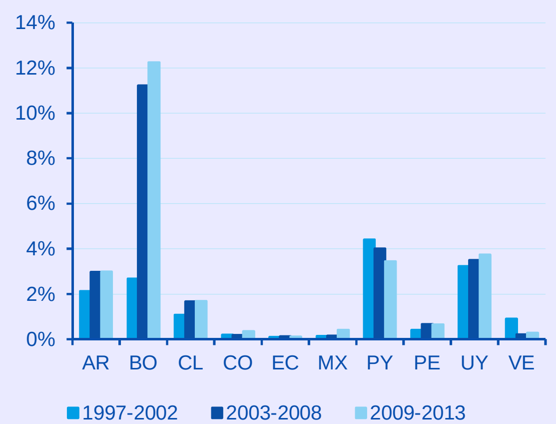
## Box 1. What impact does Brazil have on the Uruguayan economy and the region?

The recent sharp slowdown in the Brazilian economy and the concern over the impact of this on Uruguay have led us to use this box to examine the magnitude and channels involved in the spill-over of economic events in Brazil into other economies, and in this aspect we compare Uruguay to the other countries in the region.

### The trade channel: the size of Mercosur

In the past decade, Brazil's goods imports were around 9% of its GDP, with manufactures representing 75%, while the rest were commodities. On the other hand, of total buying by Brazil, 15% comes from Latin America, with a similar share by headings as that from the rest of the world. By country, the share from Argentina in total Brazilian imports stands out (around 6% in recent years), followed by Chile and Mexico (approximately 2% in both cases), while Uruguay does not even account for 1%.

Figure B.1.1
**Size of exports to Brazil (in % of the GDP of each exporter country)**

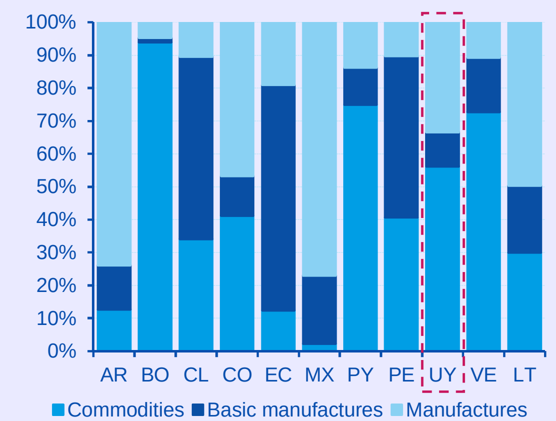



Source: Base Alice and WTO

If we observe sales to Brazil as a proportion of each country's GDP (Figure 1), the situation of the original Mercosur partners (Argentina, Paraguay and Uruguay) appears to be the most potentially exposed, followed by that of Chile.

From the qualitative standpoint, which emerges from analysing what items Brazil's imports from Latam consist of, we can again see a mixed situation among countries (Figure 2). Argentina and Mexico would be the countries most affected by a sudden drop in demand from Brazil, followed by Colombia and Uruguay. In the other countries, the goods most traded are commodities and basic manufactures, which present the least inflexibility as regards selling them to other destinations.

Figure B.1.2
**Exports to Brazil by group of goods (%, 2008–13 annual average)**




Source: Base Alice and WTO

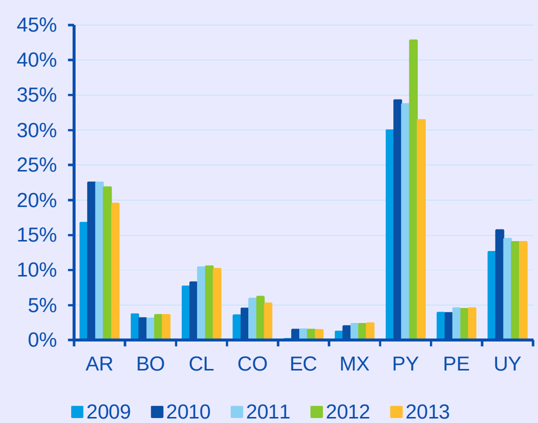
Argentina would thus be the worst hit by a fall in Brazilian demand, as Brazil has been Argentina's chief trading partner since the 90s, a situation prompted by the Mercosur trade agreement, and in 2012-13, it accounted for 21% of Argentine exports (2.8% of GDP). Notable within this close trading relationship is the auto sector agreement, which gave rise to the installation of auto production plants in both countries. Argentina's vulnerability is therefore high, as the trade volume is substantial and it includes a large proportion of manufactures, especially within the auto sector (49% of total exports to Brazil in 2013). This is a sector that is fraught with a high level of inflexibility as regards trade, because of the product turnover cycle due to technical and legal specifications in the destination market and marketing characteristics. The events of

2014 illustrate this risk: given the halt in the Brazilian economy, Argentine industrial exports to Brazil fell 16% and vehicle exports 18%.

## Tourism: Brazilians represent a substantial proportion of total tourists, though not in terms of GDP

Although tourists from Brazil represent a significant proportion of the overall flow of tourists among the original Mercosur members (Figure 3), tourism by Brazilians has a very small weight with respect to the economy of these countries: 0.5% of the GDP of Uruguay, 0.3% of that of Paraguay and 0.2% for Argentina. It thus does not represent any kind of risk beyond what it implies for certain specific niches or locations.

Figure B.1.3
**Brazilian tourists out of the total (%)**



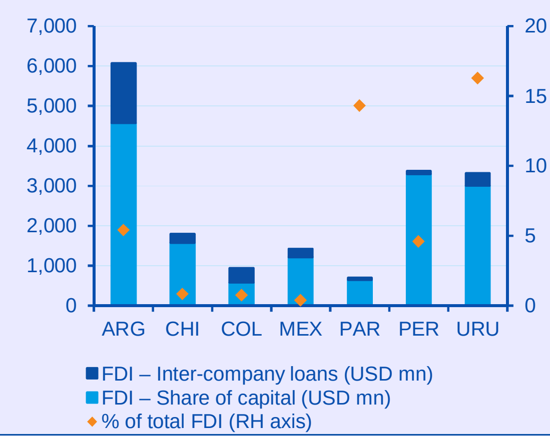

Source: National statistics and BBVA Research

## The FDI channel: a substantial weight among the Mercosur countries and in Peru

The flow of Brazilian Foreign Direct Investment (FDI) into the region's countries has swelled considerably in recent years, lifting the stock of FDI to Latam countries in 2013 to USD19.7bn, with almost one-third going to Argentina (Figure 4). In terms of the total stock of FDI in each country, Brazil's weight is substantial in Uruguay and Paraguay (16% and 14%) and significant in Argentina and Peru (approximately 5%). Thus, if we measure the stock of Brazilian FDI as a percentage of GDP of the recipient country, Uruguay reveals the greatest exposure with 6%, followed by Paraguay with 2.5%, and thereafter this becomes quite a lot less important for the other sample countries (Figure 6).

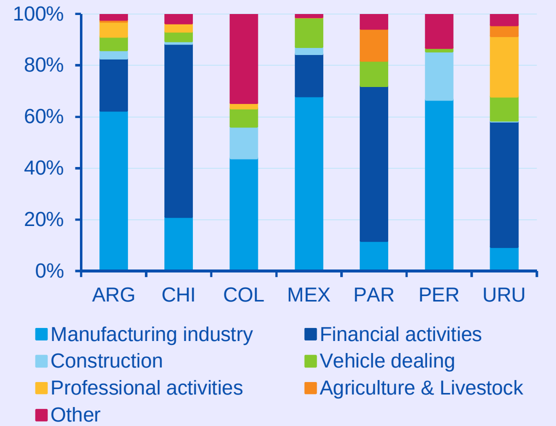
The breakdown by sectors shows that it is the manufacturing industry and financial activities which account for a large part of the stock of Brazilian FDI (Figure 5), while a substantial part of the manufacturing sector FDI is represented by Petrobras investments. Particularly as regards the corruption scandal involving Petrobras, certain countries could be hit by fallout from the financial problems besetting the oil company. This shows that, besides the possible macroeconomic impact, there are sectors which are more susceptible to any slackening of flows of Brazilian FDI. In Uruguay, there is a notable presence of investment in the financial sector, with assets that represent 11% of the total within the financial system.

Figure B.1.4
**Stock of FDI originating from Brazil in 2013 (USD mn, % of total stock)**




Source: Central Bank of Brazil, WTO

Figure B.1.5
**Brazilian FDI by sector in 2013 (% of total FDI from Brazil in the country)***

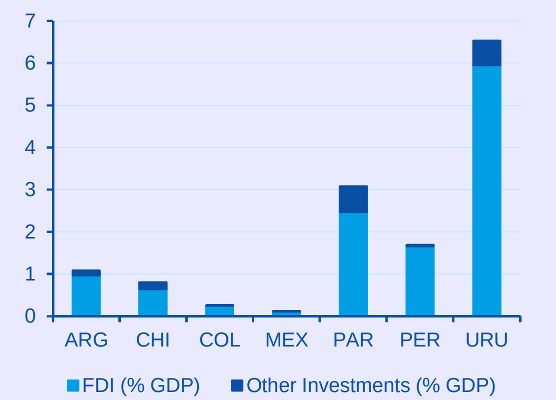



* Only FDI – Share of capital.
Source: Central Bank of Brazil

## The portfolio investment channel: of little significance

The stock of portfolio and real estate investments is largest in Argentina and Chile: USD0.6bn and USD0.4bn respectively, with the biggest weight in equity investments. In the other countries in the region, holdings of currency and deposits are relatively more significant, as well as of real estate, but in all cases these types of Brazilian investment are not very substantial in absolute terms (Figure 6).

Figure B.1.6
**Stock of Brazilian investments in 2013 (% of GDP)**

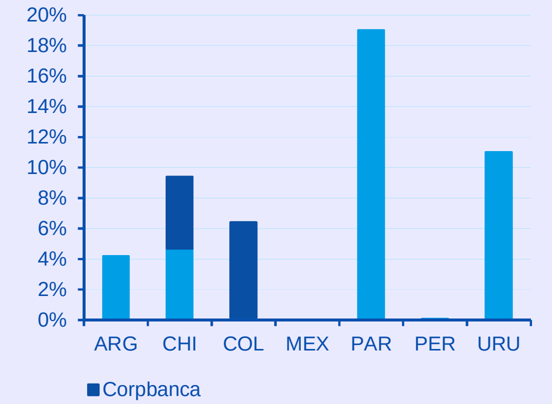



Source: Central Bank of Brazil, IMF

## The banks channel: Brazilian banks have a considerable weight in certain countries

Brazilian banks account for around 10% of the Uruguayan, Colombian and Chilean banking markets. Nevertheless, the predominance of the branch over the subsidiary models helps to keep these countries insulated from the effects of cycles and shocks originating from Brazil.

Figure B.1.7
**Share of Brazilian-controlled banks within the financial system as a whole (%)***

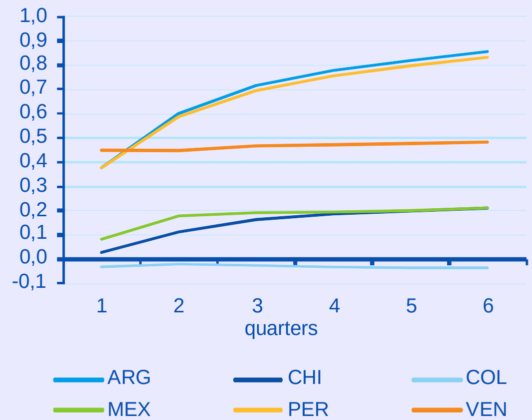



* The Corpbanca / Itaú merger is still pending authorisation.
Source: BBVA Research, national statistics

## Econometric quantification of Brazil's impact: a major effect on Uruguay

To estimate the impact of a shock in Brazil we estimate two econometric models. The first is a VAR, which includes global GDP, a measure of global financial conditions, commodity prices, and the GDPs of Brazil and the rest of Latam. This analysis suggests that Argentina is the economy that suffers most given problems in Brazil, even if all the Mercosur countries are significantly affected. Specifically, the cumulative impact after six quarters of a shock of one standard deviation to Brazil's GDP is 0.8pp in Argentina, 0.6pp in Uruguay and 0.4pp in Paraguay. With respect to the Andean countries, only in Peru is there a strong effect. For the other economies, the effect is virtually negligible.

Figure B.1.8
**Impulse-response (GVAR), cumulative impact of one standard deviation on Brazil's GDP in Latam countries**




Source: BBVA Research

The second model is Global VAR (GVAR). This model is estimated for 1980 to 2014. Unlike with a VAR, the GVAR isolates the effect of an idiosyncratic shock from Brazil from the effect which it might have on the other economies in the region. The results from this model suggest that the effects of a shock of one percentage point of GDP of Brazil's GDP are strongest in the Mercosur countries, chiefly in Argentina and Peru. In Mexico, Chile and Colombia the effect is far smaller and short-lived (Figure 8).

## Conclusions

Our analysis confirms that it is the original Mercosur members which are more closely connected with, and therefore more exposed to, Brazil, especially Argentina, due to the large scale of its exports of manufactured products. In this respect, Uruguay would be able to place its products elsewhere, since these are mainly commodities, so as to keep the eventual risk down. Thus it is the Mercosur countries and, to a lesser extent Peru, which stand to be worst hit by the recession that is likely to be observed in Brazil in 2015.

## The improvement in the external balance still seems to fall short

In 2014 the current account deficit reached 4.6% of GDP, in line with our estimate and representing an improvement of a little under 1pp with respect to 2013 (5.4% of GDP). This improved figure was basically caused by the adjustment in the balance of goods trade, as there were no great changes among the other items in the current account. Indeed, the balance of trade improved by around USD430mn in 2014, thanks to the fact that exports were up by over 1% on average at current prices, driven by sales of industrialised products, mainly meat and cellulose pulp (Montes del Plata 2H14), whereas imports fell on account of lower oil and energy purchases. This improvement in goods trade was partly offset by the decline in the Services realised (Tourism) account, which in 2014 achieved a result of only USD1.2mn, well below the figure of USD1.5bn which it attained at its best in 2011 (see Figure 3.5).

For 2015, we expect the current account deficit to go down to 3.9% of GDP. The improvement will come from both goods trade and services realised. The terms of trade will show a further improvement because import prices will reflect the sharp fall in the oil price which will be larger than the forecast downturn in export prices (basically agricultural items). Given a more complex regional situation, export volumes should stagnate this year or they could even dip slightly, although we foresee a larger fall for imports due to the effect of smaller bills for imported oil.

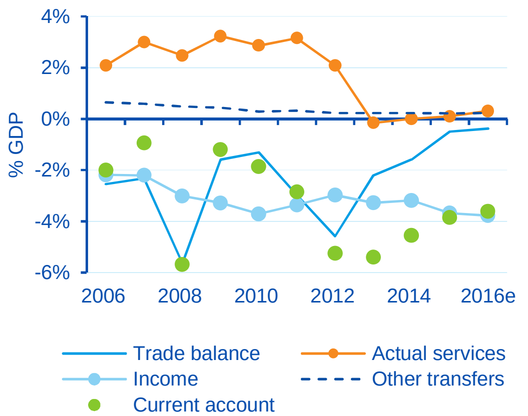
With the peak season over for Tourism (1Q15), the official information from the Ministry offers figures that are better than were initially expected. Tourist numbers were up 11.6% relative to 1Q14, although the spend rose to a lesser extent (7.6%). Argentine nationals continue to head up inflows (64% of total visitors) and were up 14.5% relative to the same period in 2014, whereas their spend grew by 18.8% over the same period. If this trend is confirmed in the next few quarters, as we expect it to be, the Tourism account will again show a modest surplus of some USD180mn (around 0.3% of GDP) in 2015.

The mild current account improvement should run on to 2016 (3.6% of GDP), as exports should grow thanks to steadier prices and a gradual improvement in the regional context, while, although the crude price will trend upwards, we forecast that the changes to the Uruguayan energy matrix that we referred to earlier will make the country less reliant on oil imports.

While it is true that last year the amount of FDI dropped back to USD2.75bn (4.8% of GDP), compared to USD3.03bn (5.2% of GDP) in 2013, this was enough to cover the current account deficit. Up to now, Uruguay has had no problems in funding its external deficits with FDI which, as Figure 3.6 illustrates, has been fairly stable in recent years, unlike short-term capital inflows, which are far more volatile and tend to fall away in tougher periods, such as 2009 and 2010.

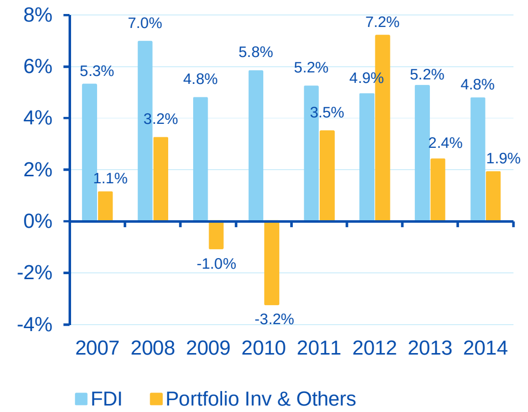
The biggest concern is that, given the turn for the worse in worldwide conditions such as those which are coming to light, less availability of international capital bound for Uruguay might mean there is not enough to cover high deficits such as those at the moment. The use of external savings should thus be cut down and domestic savings encouraged for the purposes of funding growth.

Figure 3.5
**Components of the current account (% of GDP)**




Source: BBVA based on central bank data

Figure 3.6
**FDI and other investments (% of GDP)**




Source: BBVA based on central bank data

## The fiscal disequilibrium is at worrying levels

The fiscal deficit in 2014 was the worst in the past decade (3.3% of GDP) and was in line with our forecast of 3.2% of GDP. The deterioration was almost entirely due to the weaker primary result (-0.5% of GDP) that arose from the poor figures from the central government and the social security agency. The new government has stressed the need to keep the public finances under control, with special emphasis on scheduling and coordinating expenditure and investments, particularly by public companies, which are the components that are most erratic in their contributions to the overall public sector result. Control of regulated prices and the rates charged by public companies with the intention of bringing down inflation entailed an offsetting item that implied a high fiscal cost, which the government had to take on.

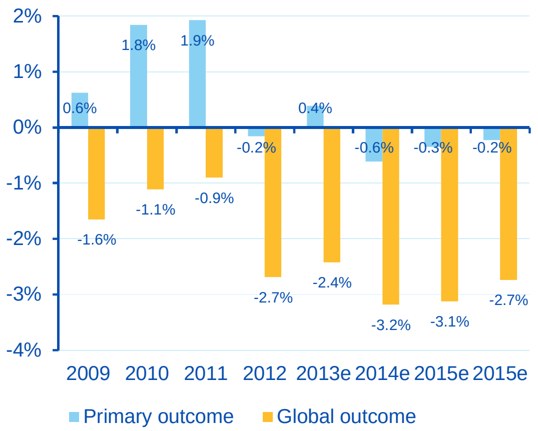
In 1Q15 the primary result showed a further decline. The consolidated public sector deficit for the moving annual figure as of March was 3.8% of GDP, but this result is distorted by the advance payment of wages and pensions by the government on the occasion of Easter Tourism Week. Applying the relevant adjustment, the fiscal result still remains on the high side, at -3.4% of GDP, showing a mild deterioration of 0.2% with respect to the February figure.

We estimate that the fiscal improvement will be very gradual in 2015, arriving at an overall result of 3.1% of GDP. The forecast slowdown in activity for this period will have negative repercussions on tax revenues, added to which a large proportion of the expenditure simply cannot be reduced (wages and salaries, and pensions), so the belt-tightening will have to come from investments or non-personal expenses. Nonetheless, the sharp fall in the oil price which began in late 2014 will enable an improvement in the result for public companies through making less use of administered prices to contain inflation. Only towards 2016 might a more significant improvement in fiscal soundness become noticeable, if the government continues to restrain expenditure and a more substantial upturn in revenues begins to emerge thanks to economic growth (see Figure 3.7).

As we were predicting, the new administration will keep to the same principles of economic policy, although it will leave its mark by orchestrating fiscal restraint without affecting welfare expenditure. The government has begun planning the five-year budget law which is vital to marshalling the public accounts during the current administration, although, aside from promoting caution and moderation as regards spending, none of the figures which the Treasury has to juggle with have been made public.

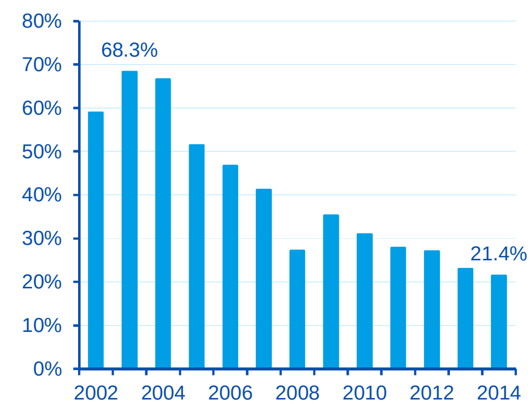
The new government has the difficult task of cutting public expenditure, or at least not allowing it to rise at the same rate as revenues, over the next few years. The question which arises is whether merely cutting back so-called capital expenditure (the most important item of spending when it comes to sustaining investments and economic growth) will be sufficient to start generating positive primary results again, without taking specific action with regard to current expenditure. The persistence of a primary deficit and the build-up of disequilibriums over time would ultimately lead to an increase in public debt in an international situation of less liquidity and greater risk aversion, which could undo all of the prudent management of the public finances applied since 2004.

Figure 3.7
**Primary and overall result as a percentage of GDP**




Source: Treasury, central bank and BBVA Research

Figure 3.8
**Public borrowing as a percentage of GDP**




Source: BBVA based on central bank data

The government again turned to the international markets on 23 February with the launch of a new USD-denominated Bono Global, due 2050 and raising USD1.2bn. The low cost at which Uruguay managed to place this new issue (5.014%, one of the lowest among the emerging economies) bears testament to the sound fundamentals of the Uruguayan economy, which are reflected in its investment grade status. This issue meant that the government managed to stretch the average maturity for debt out to 15.5 years (in December 2014 this was 14.4 years), which is one of the longest for sovereign issuance. This also means that Uruguay has succeeded in lifting its liquid assets to 6.1% of GDP, which puts it in a comfortable enough position to cover over one year of debt servicing and also still keep an additional 3.5% of GDP in contingent lines of credit with multilateral organisations. As Figure 3.8 shows, public debt ended 2014 at its lowest level for the past decade.

## Prices are still outside the target range

In the first four-month period of 2015, the CPI registered a similar 1.1% monthly average increase to the same period the year before, when measures were implemented to contain prices in April. Although the YoY reading in April 2014 reached 9.2%, whereas in April 2015 it was 8.2% YoY, the slowdown in inflation is showing signs of losing some momentum.

Core inflation, which is indicative of the inertia of the universe of prices since it includes those goods and services which are not affected by seasonal or regulatory factors, adds further evidence of a possible change of trend in prices from April. This set of prices, which extends to 75% of those recorded, showed a rise of 9.3% YoY in April, outstripping the average of 9.0% YoY reached in 1Q15.

External factors will have conflicting effects on inflationary pressures in Uruguay. Its profile as a net importer of oil could mean that the slump of the crude price gives rise to a drop in domestic fuel prices, thus pushing down on inflation. We do not envisage implementation of the ATE plan this year, or any other which implies a fiscal cost, in light of the care taken over the balance sheets of public companies that was mentioned by the new Minister for Economic Affairs, though neither do we foresee a fall in regulated energy prices. In this sense the low oil price in the medium term provides room for manoeuvre to rebuild the balance sheets of energy companies (ANCAP and UTE) without raising prices and rates, rather than for a reduction in domestic prices as occurs in other countries.

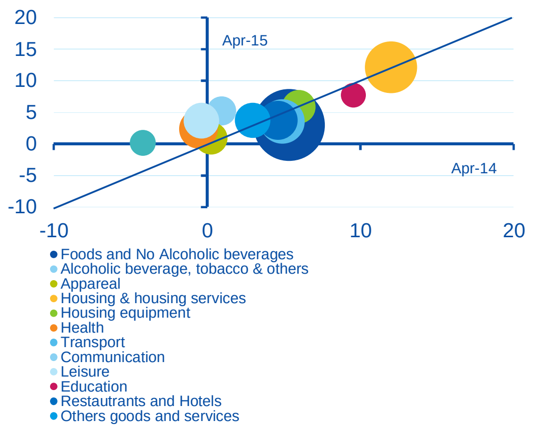
Second, the weight of the supply of imported goods in the Uruguayan consumers' basket means that the elasticity of prices in response to the exchange rate is very high. Thus the 9.1% depreciation in the first four-month period should have a lagged effect on prices. These will also continue to be sustained by demand pressure, given the inertia of pay, which, though more moderate, will manage to keep up real wage gains.

Aside from the March blip, we note the fulfilment of the quarterly commitments assumed by the central bank as regards Broad M1 growth and which were announced in its monetary policy (see Figure 3.1). This leads us to make the point that, given the nature of the Broad M1 control aggregate in the sense that it is not wholly determined by the monetary authority, we can deduce that the central bank has enjoyed some success in its learning process concerning the behaviour of those agents who, at the end of the day, are the ones that decide the aggregate.

Using this brief account of internal and external factors that are key in price formation, we can put together a thumbnail assessment to determine how prices will behave in the medium term. Prices will be driven by the pass-through effect of the UYU's depreciation and wage inertia. The impact of these elements will be moderated by the fall in the oil price, which will only rally towards 2016, as well as monetary policy on the tight side, which, given the time that has elapsed to work towards achieving its target, is gradually biting more and more, in an environment of positive real rates and a fiscal dimension which should exhibit some degree of restraint.

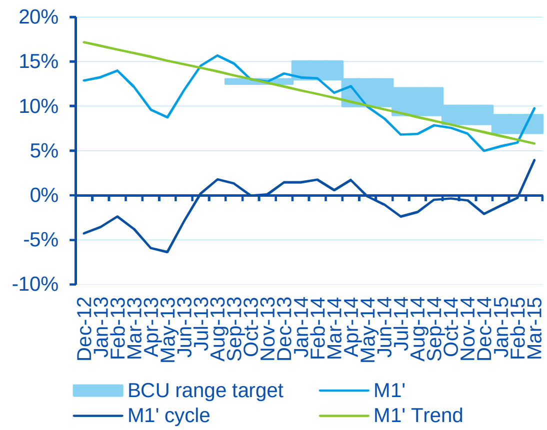
All in all, bearing in mind Uruguay's high pass-through, we estimate that the impact of the high rate of depreciation will prevail, for which reason we have revised our inflation forecast for 2015 upwards from 8.0% to 8.4%, and from 6.9% to 7.7% for 2016.

Figure 3.9
**CPI by item (% var. YoY and weighting)**




The area of the circle gives the weighting of the item in the index.
Each axis shows the YoY var. in 2014 and 2015.
Source: INE and BBVA Research

Figure 3.10
**Monetary policy: course and fulfilment**




Source: BBVA based on central bank data

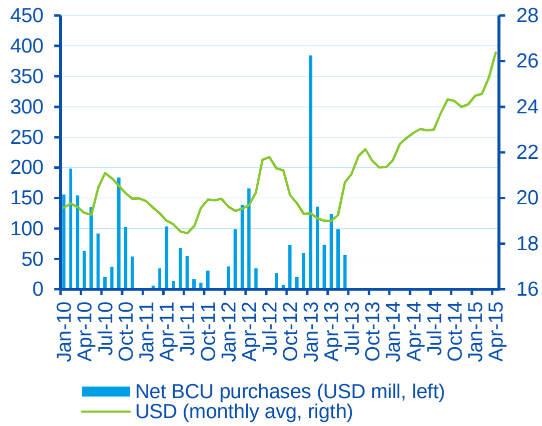
## Exchange rate competitiveness shows a slight gain in competitive edge

In the medium term, heavy foreign investments, basically in the cellulose plants and in progress in the utilisation of emerging technologies in the agricultural sector, mean that we can contemplate productivity gains in the economy that would make it possible to sustain a higher exchange rate. Nonetheless, the significant depreciation of the currencies of Uruguay's main trading partners has eroded competitiveness even more and increased the pressure on the UYU. We therefore forecast an acceleration in the rate of depreciation this year, which should improve the competitive edge and thus the external accounts, although it could have a negative impact on inflation.

The absence of the central bank in the currency market (Figure 3.11) does not mean that the monetary authority has not taken careful note of developments in the exchange rate and their consequences, as is demonstrated by the removal of the macro-prudential measures that had been implemented to dissuade inflows of foreign exchange. They thus signalled an increase in the supply of foreign exchange to relieve the market squeeze and they achieved their goal.

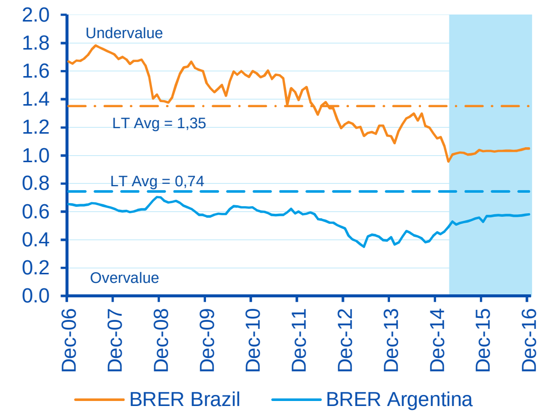
The dollar exchange rate could climb to UYU28 at the close this year, which would imply a depreciation of close to 16.3%, thereby achieving a gain in competitiveness of 2.5% (Figure 3.12). If this process proves successful, in 2016 the depreciation should only reach 8.6%, which would leave the dollar rate at UYU30.4.

Figure 3.11
**Exchange rates and intervention over time**




Source: central bank and BBVA Research

Figure 3.12
**Bilateral real exchange rates**




Source: BBVA Research based on central bank data

## External and domestic risks limited on balance

Although Uruguay is not immune to risks inherent to a turn for the worse in the international situation, its vulnerability is limited compared to what it has been in times gone by. Exposure to both local and external risk factors can affect how the economy progresses, although each of these affects it in different ways.

Starting with the external factors, an increase in volatility in world financial markets from the withdrawal of monetary stimuli by the Fed could have a moderate impact on Uruguay's country risk (which currently has investment grade status), leading to a lower inflow of foreign capital and greater depreciation of the UYU. In the short term these factors are limited, not just because of Uruguayan debt's sound rating, but also due to the fact that the largest amount of capital flowing into the country is in the form of FDI, which is far more stable than short-term capital. Moreover, the central bank has the backing of reserves worth 32% of GDP, which are enough to address an outflow of capital or avoid any sharp depreciation in the UYU that might make it harder to achieve the central bank's inflation target.

Lower world growth, particularly in China, could affect the prices of goods sold by Uruguay. Specifically, lower demand could push down the price of Uruguayan exports, mainly agricultural commodities with a high weighting among the country's exports, although the fall in the oil price softens the impact of these risks, since, although Uruguay relies less and less on this product, it is still significant among total imports. The risk could rise substantially, however, if the drop in demand occurs among countries in the region (chiefly Argentina and Brazil), as not only would trade be hit, but also tourist and direct investment flows (see Box).

In this context, Uruguay does not have much room for manoeuvre in terms of carrying out counter-cyclical policies to soften a potential contraction in economic activity on account of spill-over from neighbouring economies. The delay in seeing through any fiscal adjustment and the persistence of such levels of primary deficit would hamper the implementation of any swift expansion of public expenditure to offset the fall in private spending given an adverse scenario. Furthermore, they place public borrowing on a rising course relative to GDP, which could raise future doubts over its sustainability.

The fact that inflation remains persistently outside the central bank's target range also limits the degree of freedom of monetary policy, as it restricts the chances of implementing a substantial monetary loosening or allowing a rapid depreciation of the UYU to, in some way, offset the negative impact from the external sector.

After the brief summary of Uruguay's "focal points" of vulnerability, we conclude that the chances of a major crisis event are very low in view of our domestic and international baseline scenario. It should be stressed that many of the conditions which determine this "low vulnerability" were brought about by deliberate policies, such as debt management and applying macro-prudential measures. This does not relieve the new authorities of the task of working on the fiscal front and inflation, so as to be able to have available fire-power to implement counter-cyclical policies when they are called for.

# 4 Tables

Table4.1
**Annual macroeconomic forecasts**

| | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|
| **GDP (% YoY)** | 3.3 | 5.1 | 3.5 | 2.6 | 3.0 |
| **Inflation (% YoY, eop)** | 7.5 | 8.5 | 8.3 | 8.4 | 7.7 |
| **Inflation (% YoY, Avg.)** | 8.1 | 8.6 | 8.9 | 8.1 | 7.2 |
| **Exchange Rate (vs. USD, eop)** | 19.3 | 21.3 | 24.1 | 28.0 | 30.4 |
| **Exchange Rate (vs. USD, Avg.)** | 20.2 | 20.4 | 23.2 | 26.8 | 29.3 |
| **Loan Interest Rate (%, Avg.)** | 18.6 | 17.7 | 21.2 | 19.2 | 18.2 |
| **Private Consumption (% YoY)** | 5.0 | 5.2 | 4.2 | 3.3 | 3.0 |
| **Government Consumption (% YoY)** | 5.9 | 5.0 | 2.5 | 1.5 | 2.0 |
| **Investment (% YoY)** | 13.9 | 8.6 | -1.2 | 1.0 | 3.0 |
| **Fiscal Balance (% GDP)** | -2.7 | -2.4 | -3.2 | -3.1 | -2.7 |
| **Current Account (% GDP)** | -5.3 | -5.4 | -4.6 | -3.9 | -3.6 |

Source: BBVA Research

Table4.2
**Quarterly macroeconomic forecasts**

| | GDP (% YoY) | Inflation (% YoY, Avg.) | Exchange Rate (vs. USD, Avg.) | Loan Interest Rate (%, Avg.) |
|---|---|---|---|---|
| **1Q14** | 3.1 | 9.6 | 22.0 | 22.4 |
| **2Q14** | 3.9 | 9.1 | 22.9 | 20.3 |
| **3Q14** | 3.7 | 8.7 | 23.7 | 19.9 |
| **4Q14** | 3.3 | 8.1 | 24.2 | 19.7 |
| **1Q15** | 3.7 | 7.7 | 24.8 | 18.1 |
| **2Q15** | 2.2 | 8.4 | 26.5 | 19.1 |
| **3Q15** | 2.6 | 8.4 | 27.1 | 18.8 |
| **4Q15** | 2.1 | 7.8 | 27.8 | 19.4 |
| **1Q16** | 2.4 | 6.9 | 28.4 | 18.1 |
| **2Q16** | 3.0 | 7.0 | 29.0 | 18.2 |
| **3Q16** | 3.4 | 7.3 | 29.6 | 18.2 |
| **4Q16** | 2.9 | 7.6 | 30.2 | 18.2 |

Source: BBVA Research

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## This report has been produced by the Argentina Unit:

***Chief Economist***
Gloria Sorensen
gsorensen@bbva.com

Adriana Haring
aharing@bbva.com

Juan Manuel Manías
juan.manias@bbva.com

With the contribution of

Andrés Escardó
aescardo@bbva.com

## BBVA Research

***Group Chief Economist***
Jorge Sicilia Serrano

***Developed Economies Area***
Rafael Doménech
r.domenech@bbva.com

*Spain*
Miguel Cardoso
miguel.cardoso@bbva.com

*Europe*
Miguel Jimenez
mjimenezg@bbva.com

*US*
Nathaniel Karp
Nathaniel.Karp@bbva.com

***Emerging Markets Area***
Alicia García-Herrero
alicia.garcia-herrero@bbva.com

*Cross-Country Emerging Markets Analysis*
Alvaro Ortiz
alvaro.ortiz@bbva.com

*Asia*
Le Xia
le.xia@bbva.com

*Mexico*
Carlos Serrano
carlos.serranoh@bbva.com

*LATAM Coordination*
Juan Manuel Ruiz
juan.ruiz@bbva.com

*Argentina*
Gloria Sorensen
gsorensen@bbva.com

*Chile*
Jorge Selaive
jselaive@bbva.com

*Colombia*
Juana Téllez
juana.tellez@bbva.com

*Peru*
Hugo Perea
hperea@bbva.com

*Venezuela*
Oswaldo López
oswaldo.lopez@bbva.com

***Financial Systems and Regulation Area***
Santiago Fernández de Lis
sfernandezdelis@bbva.com

*Financial Systems*
Ana Rubio
arubiog@bbva.com

*Financial Inclusion*
David Tuesta
david.tuesta@bbva.com

*Regulation and Public Policy*
María Abascal
maria.abascal@bbva.com

*Recovery and Resolution Strategy*
José Carlos Pardo
josecarlos.pardo@bbva.com

*Global Coordination*
Matías Viola
matias.viola@bbva.com

***Global Areas***

*Economic Scenarios*
Julián Cubero
juan.cubero@bbva.com

*Financial Scenarios*
Sonsoles Castillo
s.castillo@bbva.com

*Innovation & Processes*
Oscar de las Peñas
oscar.delaspenas@bbva.com

## Contact details:

**BBVA Research – BBVA Banco Francés**
Reconquista 199. 1st floor
C1003ABC - Buenos Aires (Argentina)
Tel.: (+54) 11 4346 4000
Fax: (+54) 11 4346 4416
bbvaresearch@bbva.com
**www.bbvaresearch.com**