BBVA | RESEARCH

Uruguay
Economic Outlook

SECOND HALF 15 | SOUTH AMERICA UNIT

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In 2016, the improvement in the international context will be only marginal. Uruguay is hampered by the weak performance of Brazil and Argentina

02
Internal demand is contracting more rapidly than expected, driven by declining confidence indicators and a weaker labour market

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A five-year budget with a fiscal adjustment which looks unambitious in the context of an optimistic macro scenario

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Inflation will reach 9.2% in 2015 and 8.5% in 2016. The government is changing its strategy to undo wage indexation

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Closing date: 20 November 2015

1 Editorial

The external scenario continued to deteriorate in 2015. The rising concerns over the recovery of China together with the proximity of the Federal Reserve's interest-rate hiking cycle in the US has led to a steeper fall in commodity prices, an increase in perceptions of risk regarding the emerging economies and capital outflows from and currency depreciation in those countries. In this weaker than expected context, above all in the emerging economies, we estimate that global GDP will grow 3.2% in 2015 (vs. 3.4% in 2014) and 3.5% in 2016, in both cases 0.2 percentage points below our previous forecast.

After a decade of average annual growth of 5.4%, the Uruguayan economy is showing signs of entering a new cycle, with growth rates converging with long-term potential output. Internal demand, the main engine of growth in recent years, is already showing signs of fatigue in a labour scenario with incipient deterioration and the momentum in real wages starting to decelerate. Thus, activity will increase by 1.7% in 2015 and by 1.5% in 2016, investment will include the relaunch of public-private projects, which will partly offset the fall in external demand and the loss of momentum in consumption.

The multi-year budget has revealed the government's lack of ambition to close the fiscal gap, and proposes a consolidation of barely 1pp of GDP in five years, granting significant weight to the improvement to improving the results of state enterprises. We expect 2015 to close with a global deficit of 3.3% of GDP, largely determined by debt service, as the primary balance will be slightly negative (-0.1% of GDP). We do not anticipate any significant changes in the public accounts in 2016, with a global deficit of 3.2% of GDP, because the smaller increase in revenues will not be fully offset by lower expenditure, due to the fact that 70% of these expenses have limited scope for reduction.

The terms of trade will deteriorate slightly in 2016, after improving steadily in recent years, as we expect more of a recovery in the oil price than in agricultural commodities. The deficit on current account will fall to 3.7% of GDP, thanks to the improvement in the balance of trade and the contribution made by tourism. We are not forecasting any significant improvement for 2016, with the current account at 3.6% of GDP, a marginal improvement principally driven by lower demand for oil imports.

Even though the central bank has met its own goals in terms of monetary policy, we continue to think that these objectives remain insufficient for it to achieve rates of inflation within its own target range.

For another biennium, inflation will remain above the target range of 3-7%, reaching 9.2% in 2015 and 8.5% in 2016, due to lower demand pressures, more contained currency depreciation and sustained restrictive monetary policy. We do not rule out increased use of unconventional tools to contain prices. The positive news is that given the persistence of inflationary inertia, the government has implemented a new scheme of wage guidelines based on declining nominal increases, with the aim of deactivating the principal mechanism of indexation. However, not enough collective bargaining agreements have yet been signed under the new scheme for us to have a clear verdict on their capacity to break wage indexation.

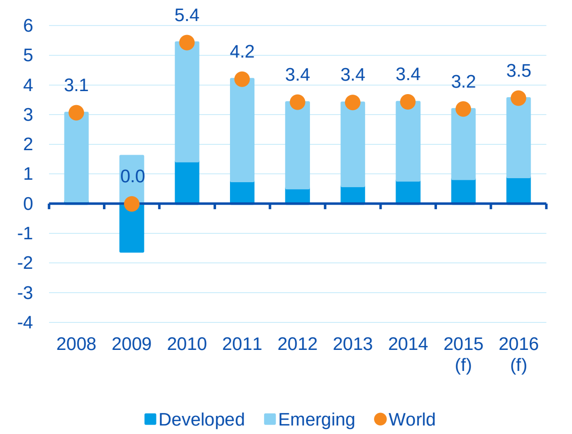
The incipient improvement in terms of Uruguay's competitiveness, measured by real multilateral exchange rates and wages in dollars adjusted for industrial productivity, has reduced the pressure on the nominal exchange rate. We expect the 2015-peso exchange rate to be around USDUYU 31, and more moderate slippage in 2016 to USDUYU 33.7.

2 Slower global growth in 2015 and a limited improvement in 2016

According to our estimates, global GDP has chalked up four consecutive quarters of growth below the 2010-14 average, mainly due to the ongoing deceleration in the principal emerging economies, in a context in which doubts over the strength of the economic cycle and the financial stability of China have triggered a significant spike in financial tensions and further corrections in commodity prices.

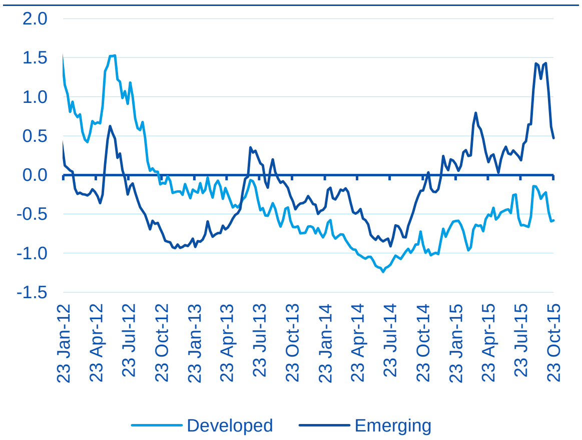
As a result, global GDP should grow at 3.2% in 2015 (0.2% less than we forecast three months ago), the lowest since 2009 (see Figure 2.1), with growth in the emerging markets moderating to barely 4% YoY, compared to average growth in the five previous years of more than 5.5%. The outlook for 2016 is slightly more favourable, with global growth recovering to 3.5% (0.3% below our forecast three months ago), sustained by a better relative performance of both the developed and the emerging economies.

Figure 2.1
World GDP: annual growth (%). Forecasts 2015-16



Source: BBVA Research

Figure 2.2
BBVA Financial Tensions Index



Source: BBVA Research and Bloomberg

All in all, the stabilisation of commodity prices at low levels and the sustained rise in financial tensions in the emerging economies — accompanied by heavy capital outflows, sharp currency depreciation and a widening of sovereign spreads — are evidence that the balance of global risks is still to the downside. Even though monetary policy in the developed countries could mitigate the impact of a scenario of slower growth, the scope it has to kick-start the economic cycle is reduced, taking into account the low levels of interest rates and the high volume of liquidity already in existence. The combination of a financial shock in China, that takes the annual growth of that economy well below 6%, with an even slower recovery of the developed economies block than has been observed to date, is without a doubt a significant risk scenario, both because of its degree of plausibility (limited, but not extreme) and its severity, given its potential impact on the world economy generally and on Latin America in particular (see Box 1 regarding the specific impact on Latin America).

USA: downward growth revision due to the deterioration in the external environment

An overview of the principal economic areas shows a notable stabilisation of economic growth in the US at lower rates than in other recovery episodes. Private consumption remains key to the dynamics of economic recovery, although it will probably not be sufficient to wholly offset the drops in both exports (owing to the dollar's appreciation and the weakness of the emerging economies) and investment in the energy sector. GDP growth should thus be 2.5% in 2015 and 2016 as well.

The risks for the US economy in a more unfavourable global environment are influencing the Fed response and when the initial rate hike takes place, which ought to be in December. Whatever happens, the pace of rate increases is expected to be very gradual, probably reaching levels at end-2016 below those that we expected a quarter ago, and no higher than 1%.

China: upward revision of GDP growth expected for 2015, although this will not dispel the uncertainties over the pace of future economic deceleration

China's cyclical position is obviously one of the principal variables to watch at a global level. The sharp stock market correction in August served as a warning of the risks posed by a financial shock in the country of a severity to compromise the growth in domestic spending. The magnitude of the capital outflows and the spike in financial volatility resulted in the introduction of a considerable battery of monetary policy measures directed at easing the deterioration in liquidity and its potential impact on the financing model of the corporate sector, which is heavily leveraged. The unexpected official announcement of change regarding the daily yuan exchange rate and the progressive cuts in reference rates fall into the same context, and are also characterised by a progressive deceleration of economic activity, which has taken GDP growth below 7% YoY in the third quarter.

It seems that the authorities will continue to employ monetary stimulus measures (further interest-rate cuts have not been ruled out) and to exploit the central government's scope to use fiscal policy to ensure that economic growth does not fall below 6% YoY. Our forecasts suggest GDP growth of 6.9% for 2015 and 6.2% for 2016.

Eurozone: resilient domestic demand with the ECB ready to avoid further declines in inflation

In the eurozone, the economic recovery continues although the pace has not intensified as we anticipated some months ago. The pace of eurozone GDP growth could increase to 1.8% in 2016 (only 10bp less than we expected last quarter) due to the upturn in Italy and France. The accentuation of the risks to the downside to inflation forecasts, largely due to cheaper imported goods, together with the recent appreciation of the euro, appears to be pushing the ECB towards adopting new stimulus measures in the short term, as it has suggested.

3 Internal demand adjusting more rapidly than expected

Negative surprise in 2Q15 GDP

Although we were expecting activity to decelerate, the central bank data were a negative surprise given the sharp contraction registered in 2Q15. In effect, activity growth went from +4.5% YoY in 1Q15 (a figure which was revised upwards from the previously published +4.0% YoY) to -0.1% YoY in 2Q15. In seasonally adjusted terms, GDP fell 1.8% vs. 1Q15.

Although activity suffered from the effects of the drought during the period, which had a sharply negative impact on hydro generation, in truth growth decelerated in the majority of sectors, with the manufacturing sector the only one to see a continuation of positive momentum.

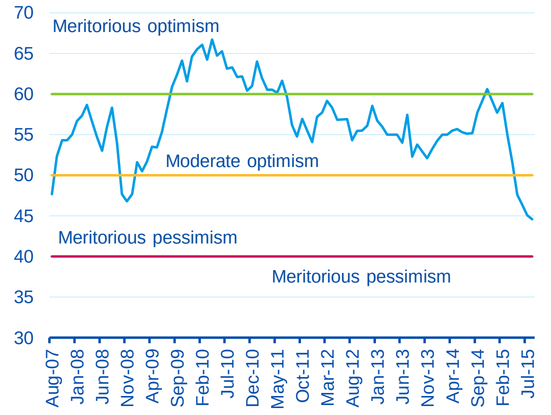
The lack of rainfall resulted in a drop in the electricity, gas and water sector of 58.5% YoY, which made a negative contribution of 1.6% YoY to 2Q15 GDP growth. With the normalisation of rainfall in recent months, this one-off and transitory effect should be reversed and translate into an improvement of this sector's contribution to growth.

As regards demand, there was a surprising 11.1% YoY drop in private consumption in 2Q15 (making a negative contribution to GDP of 0.8%). Although we were expecting a deceleration in private consumption, anticipated by market expectations and consumer confidence breaking the bounds of 'moderate pessimism', according to the Equipos studies, the adjustment was considerably sharper than we expected, as can be seen in Chart 3.1. One of the factors weighing on consumer sentiment is the gradual deterioration observed in the Uruguayan labour market. The unemployment rate is rising and in September already stood at around 8%. Meanwhile, real wages continue to rise, but more slowly than in previous years, such that consumers' purchasing power is reduced and they moderate their expenditure.

Lacking the differential Montes del Plata effect, no industrial growth in 3Q15

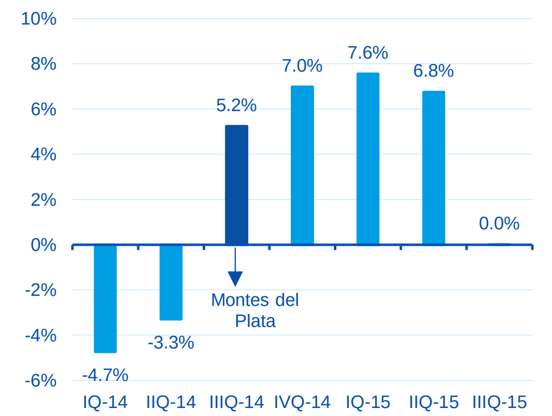
The data published by the national statistical instate (INE, in its Spanish acronym) revealed the deterioration in industrial activity during 3Q15. After more than a year of expansion, manufacturing output fell 1.2% YoY in August and 5.8% YoY in September, such that we are not expecting a positive contribution to GDP from this sector in 3Q15, as these falls offset the 7.3% YoY rise in July, as shown in Chart 3.2. This will be exacerbated by the absence of the 'Montes de Plata effect', which was reflected in a jump in output equivalent to around 1% of GDP when it came into operation in 3Q14.

Chart 3.1
Consumer Confidence Index



Source: Consultora Equipos and BBVA Research

Chart 3.2
Manufacturing Industry (% var. YoY)



Source: INE and BBVA Research

Downward revision of our growth scenario …

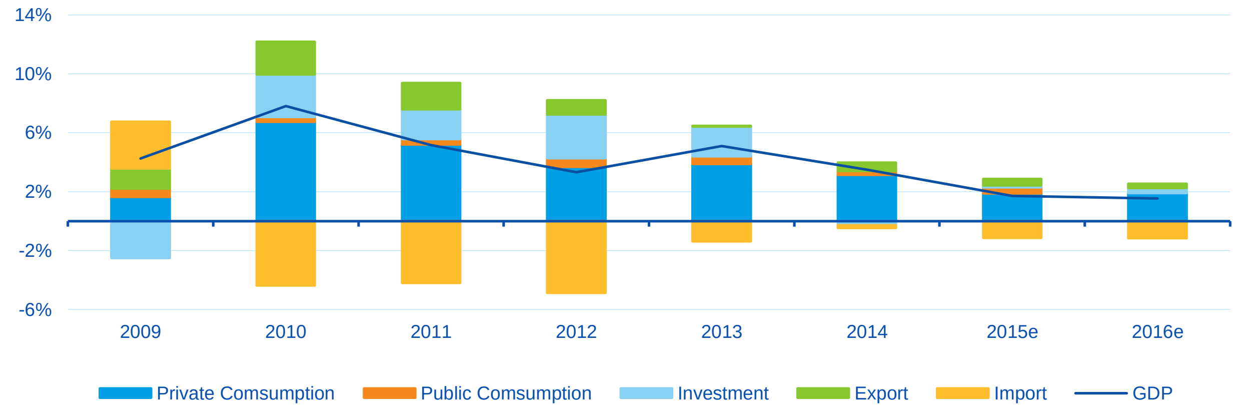
Based on the above, we are revising downwards our growth forecast for 2015 from 2.4% to 1.7%. Although activity will probably recover in 3Q15 with the normalisation of hydro availability, the external context has deteriorated substantially at a global level, and what makes the situation even more difficult are the economic difficulties of Uruguay's principal trading partners (Brazil, China and Argentina), such that we cannot count on any significant contribution from external demand to compensate for the deceleration in domestic consumption.

For 2016, we are revising our growth forecast from 2.1% to 1.5%. This new estimate reflects not only the deterioration in the regional context, in particular in Brazil, but also the lower momentum in internal demand already observed in 2015, as can be seen in Chart 3.3. In particular, private consumption will continue to be affected by low levels of confidence and a weaker labour market.

However, it also reflects the positive effect on investment of the execution in 2016 of infrastructure projects (Routes 21 and 24 are already tendered and six new road corridor packages will go out to tender in 2016), and also in the renewable energy sector driven by the possibility of public-private investments, which as well as improvements in the design of the tenders will also benefit from funding from a trust set up by the Andean Development Corporation (CAF in its Spanish acronym) to finance the construction phase of infrastructure and its risk.

We believe that there will be a break in the declining trend in activity in 2016, allowing GDP growth to converge with its potential, which we estimate at around 2.9% a year.

Chart 3.3
GDP by expenditure component: contribution to growth (%)



Source: BCU and BBVA Research

4 Reversal of the favourable terms of trade in 2016 will make it difficult to adjust the current account

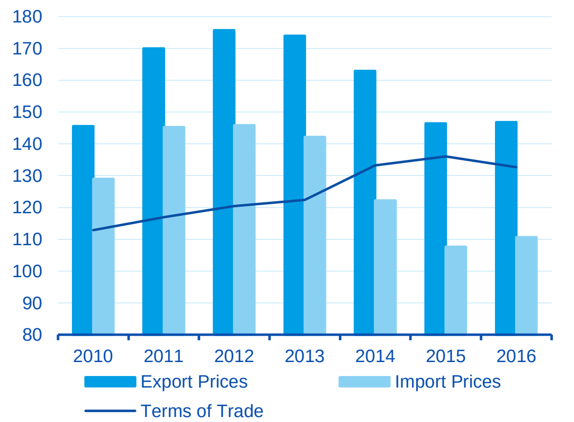
In 2015, the improvement achieved in terms of trade feeds through to the current account …

In the first half of 2015, the deficit on current account amounted to a little over USD1bn, practically half the total observed in 1H14. In terms of GDP, in the 12 months to June, the current account stood at 4.2%, while a year earlier this figure reached 5.1% of GDP. This improvement was practically all due to the improvement in the balance of trade, both for goods and real services.

As far as goods are concerned, the breakdown of exports and imports between prices and volumes in 2015 reflects the substantial impact of the fall in commodity prices on the one hand and the worsening regional and international context on the other.

During 1H15, the gain in terms of trade vs. the previous year is around 4.3%, as shown in Chart 4.1, and is related to the sharp drop in the price of oil, which Uruguay needs to import in greater quantities when there is a drought similar to the one during this period. The lower cost of oil imports more than offset the effect of the generalised drop in exports of agricultural products, which are among Uruguay's principal exports.

Chart 4.1
Terms of trade to reverse in 2016



Source: BCU, Haver and BBVA Research

Table 4.1
Exports: principal destinations and products

Main exports acummulated January-September			
Destin	**Product**	**Var.% acum y/y**	**% participation**
	Soybean	*-31.2%*	*47.1%*
China	Meet	83.0%	31.5%
88.5%	Wool and fabrics	23.8%	9.8%
	Dairy	75.0%	17.4%
Brazil	Plastics	**-26.9%**	**12.1%**
38.2%	Automovile	**-33.4%**	**8.8%**

Source: Uruguay XXI and BBVA Research

Volumes of both exports and imports started to fall more sharply YoY during 3Q15, providing evidence of both the reduced momentum of the domestic economy and the deterioration of the international context. As can be seen in Table 4.1, which shows the performance of 88.5% of the exports to China and 38% of the exports to Brazil, although sales of some products are still continuing to rise, imports of key products by Uruguay's two main trading partners are falling, due to a combination of prices and volumes – principally in Brazil – which is having a negative impact on the balance of trade.

Taking into account the trends observed and the number of months that have passed, we are forecasting that exports will fall by 9% YoY in 2015 as a whole, and imports by 13.5% YoY, both measured in current dollars, taking the balance of trade to USD1.9bn, or an improvement of nearly USD500mn vs. FY14.

… along with the recovery in tourism

As well as the improvement in the balance of trade, in 2015 there was also an improvement in the tourism sector, which is an important source of foreign currency earnings for Uruguay. According to official sources, in the first nine months of the year, the total number of visitors increased by nearly 8% vs. the same period in 2014, with the biggest rise in those with Argentine nationality (+14.4%), which more than offset the decline in numbers from other countries in the region (Brazil -2.2% YoY, Paraguay -10.3% and Chile -10.3% YoY).

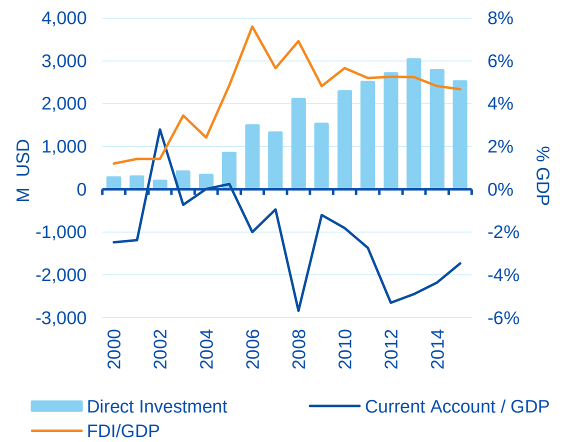
In terms of foreign currencies, in 2015 Uruguay earned USD1.4bn from tourism, equivalent to 2.6% of GDP, or growth of nearly 9% vs. the same period in 2014 (Chart 4.3). The drop in tourist numbers from Uruguay going abroad in the first three quarters (-6.7% YoY in the number of tourists and -14.8% YoY in their spending) also reflects the peso depreciation and helped to improve the tourism balance and, as a consequence, the current account.

These improvements in the exchange of goods and services gave rise to an improvement on current account of around 3.7% of GDP for 2015 as a whole, as revenues remain practically unchanged vs. the previous year.

For 2016, we are not forecasting any significant improvement in the balance on the current account (which should come in at around 3.6% of GDP). According to our projections (Chart 4.1), the terms of trade will deteriorate by 2.3%, marginally reversing the improvement achieved in recent years, while there is no great expectation of growth in export volumes given the difficult international scenario. Nonetheless, the trade balance will remain stable if, as we expect, oil imports decline as a reflection of reduced requirements to import oil to cover the production of electricity given the normalisation of the weather – and the other imports will not increase either due to the lower level of economic growth expected for Uruguay in relation to previous years.

Meanwhile, tourism could make a contribution – although less than in 2015 – given that the situations in both Argentina and Brazil are more complicated and their currencies are weaker than Uruguay's.

Chart 4.2
Balance of payments: external deficit financed by FDI



Source: BCU and BBVA Research

Chart 4.3
Revenues from tourism remain important

Source: Ministry of Tourism and BBVA Research

FDI continues to finance the deficit in domestic savings …

Fortunately, in spite of the difficult international scenario, the flow of direct investment continued during the period and financed the deficit on current account. In 1H15 alone, Uruguay received FDI inflows of USD1.256bn, which if annualised would reach the 4.5% of GDP estimated for 2015 (Chart 4.2). The question regarding this point is whether these capital inflows can continue in view of the lack of large investment projects like those undertaken up to 2014, and in a context of increased international uncertainty. The relaunch of the public-private investment programme is a good opportunity to capture more foreign investment beyond the big projects that were financed entirely with FDI in the past.

5 Little fiscal consolidation

The reduced activity has an impact on tax collection

Although accumulated tax revenues (Tax Collection Agency), which represent the majority of the government's revenues) to September rose by 2.1% in real terms, this very largely reflected taxes paid on profits by the state-owned companies and IMESI (fuel, tobacco and vehicles), which were affected by an increase in the tax rate at the beginning of the year, and thus grew by 9.2% YoY in real terms. The other taxes directly related to consumption and activity fell, such as VAT (representing practically half the DGI's tax collection) which contracted by 1.9% YoY in real terms, evidence of the weakness of private consumption.

On the other hand, given that the government's priority is to contain inflation – which is already uncomfortably high – in previous years it has regulated the tariffs of the state-owned companies in order to avoid that these have an impact on prices, even though this had a fiscal cost. We do not rule out a similar policy being implemented in the final months of 2015.

The problem continues to be the limited scope to reduce expenditure …

The bigger fiscal problem is the impossibility of moderating expenditure, which is growing faster than revenues. In real terms, in the LTM to September 2015, the government's total revenues (including the Social Security Bank and state-owned companies) grew by 0.4% YoY, while current expenditure expanded by 2.6%, preventing the gap from being closed. The impossibility of adjusting two-thirds of the expenditure (which has automatic adjustments, like wages and liabilities) reduces the room for manoeuvre to reverse the deficit. The adjustment – even though insufficient – is being carried out through public-sector investments, which have fallen by a cumulative 10.6% YoY.

… although this would not present a financing problem

We expect 2015 to close with a global deficit of 3.3% of GDP as, given the lack of a primary surplus, the operating result will be determined by the amount paid in the form of interest payments. We see no improvement in 2016: the scenario of economic deceleration will continue, which will prevent any increase in fiscal revenues, while expenditure will remain relatively stable in terms of GDP (for the reasons given above), as can be seen in Chart 5.2. Nonetheless, we do not believe that this deficit will represent a problem for Uruguay in 2015-16.

The market perception of Uruguay's low financing risk (reinforced by its Investment Grade rating in spite of Brazil's downgrade) became clear in its October placement of a USD1.7bn bond maturing in 2027 with a coupon of 4.375%, which pushed the country's average debt maturity profile out to 15 years. It is worth noting in this context that the Treasury has financed itself 18 months ahead, as well as having contingent lines of credit with multilateral entities for USD2.1bn.

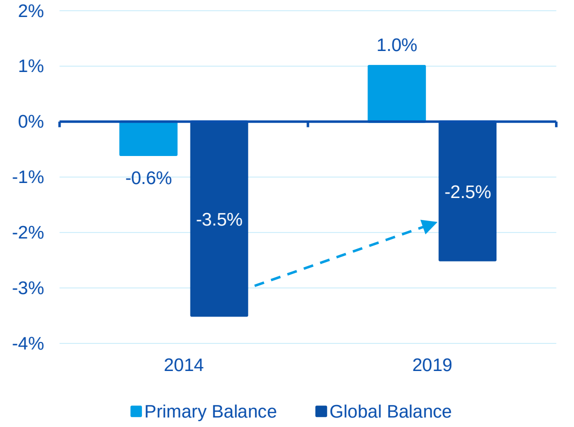
We reiterate that Uruguay's public debt is well-managed. At end-June 2015, the total debt reached 62.6% of GDP, with a significant reduction in foreign currency-denominated and floating-rate debt. Public debt net of government assets (the bulk of which are central bank reserve assets) stands at 22.9% of GDP.

An unambitious budget only envisages reducing the deficit by 1% of GDP in five years …

The Budget Law presented by the government for the 2015-19 period was approved, which includes reducing the operating fiscal deficit from 3.5% of GDP (2014) to 2.5% in 2019 (Chart 5.1). The reduction by 1pp in five years looks rather unambitious, but in fact the economic situation in Uruguay is not favourable for making a fiscal adjustment. In general terms, the budget envisages a moderate increase in expenditure focused in the first two years of the reference period and places emphasis on improving the profits of the state-owned companies.

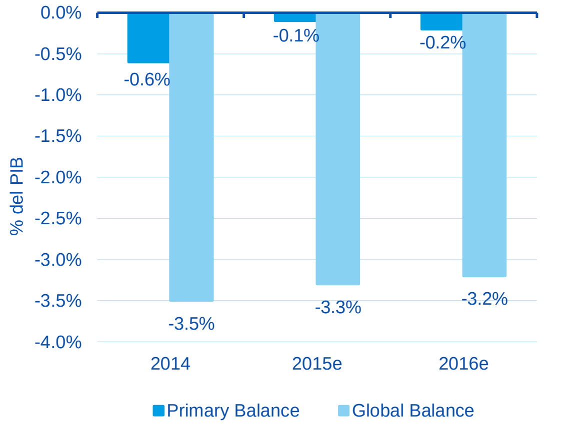
With economic growth at much lower levels than in the last decade (on average we estimate that the economy will grow by 2.3% in 2015-19, vs. 5.2% on average in the last 10 years), the chances of significantly increasing tax collection in real terms are low. Meanwhile, even though the budget estimates a moderate increase in expenditure, the high proportion of current spending devoted to wages, liabilities and previous contracts make it difficult to adjust downwards (70% of primary expenditure), such that more substantial adjustments in terms of cutting expenditure also look unlikely.

Chart 5.1
Budget: unambitious adjustment



Source: MEF and BBVA Research

Chart 5.2
Absence of primary surplus



Source: MEF and BBVA Research

Although the budget clauses recognise the deterioration in international conditions, in our view the economic assumptions underlying the principal fiscal projections for the coming years are fairly optimistic. The government is forecasting a gradual acceleration in economic growth in the next five years from 2.5% in 2015 to 3% in 2019, less currency depreciation – especially in the first few years of the period – and average inflation converging with the BCU's target range more quickly than in our own forecasts.

The government's forecast is fairly optimistic in comparison with our own macroeconomic scenario, yet even so the improvement in the public accounts over the five-year period is not very significant. If the macro scenario does not meet the government's forecasts, and expenditure is not successfully adjusted downwards more quickly (see above), the administration will have to consider additional measures, perhaps on the income tax side, which would enable it to rebalance the fiscal accounts through increased tax collection.

6 A new strategy to combat inflation?

After the first 10 months of 2015, prices had risen by 9.57% (whereas in the same period in 2014 they had risen by 8.68%) as a result of average monthly inflation of 0.92% (0.84%). However, observing CPI by components reveals that the inertia in the inflationary process is not easing, which is confirmed by core inflation which increased by a monthly average of 0.82% in the first 10 months of 2015, almost the same rate as the 0.83% in the same period in 2014. Meanwhile, administered prices, which represent 21% of the CPI basket and were clear protagonists of the deceleration in 2014, trended upwards in the first 10 months of 2015 (Chart 6.1), growing at a monthly average of 1.19% between January and October, well above the 0.79% monthly average in the same period in 2014.

As in previous years – although to a lesser extent - the pressure on prices in 2016 will basically be derived from domestic demand stoked by higher real wages not necessarily corresponding to increased productivity. After a long period during which wage indexation was one of the most important mechanisms in the transmission of inflation, the government has decided on a change of strategy. The authority has introduced new wage guidelines[1] which comprise of agreements for 24 or 36 months of decreasing nominal wage increases to make the wage rises compatible with the levels of inflation, but without any guarantee of continuous rises in real wages which cannot be absorbed by companies' growth in productivity.

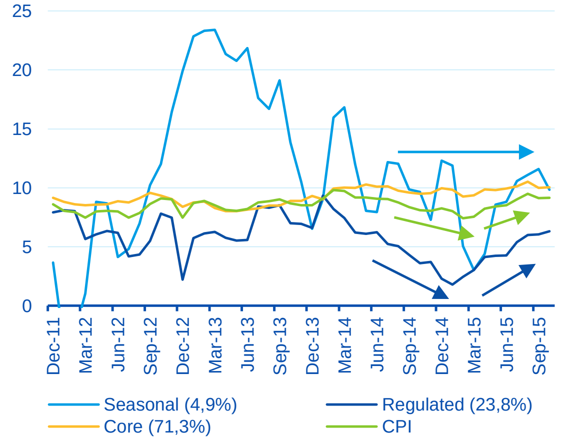
The end of all the wage agreements under the previous scheme, which ensured rises in real terms, in what remains of 2015 and 2016 makes it more urgent to show more moderate inflation in the short term, compatible with the price increases presented in the new agreements.

In line with this diagnosis and the government's high propensity to use unconventional tools, we expect the implementation of a new price-freeze agreement, this time for a longer period, from 1 November 2015 to 31 January 2016, and including more families of products, on top of the cut in fuel prices introduced by ANCAP in October.

The chances of implementing unconventional measures have increased, given that the central bank needs to contain the pass-through to prices (for the reasons already cited) from the exchange rate correction that is required. Although the central bank has achieved policy goals as regards growth rates of the benchmark aggregate figure, we maintain that it should have acted more aggressively in its attempts to bring inflation back towards the centre of the target range.

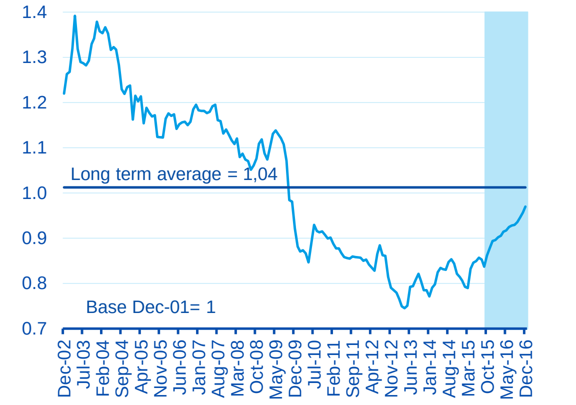
1: The new framework for wage bargaining that has been proposed by the government is based on decreasing nominal rises over periods of two to three years, with an automatic safeguard reset clause which is triggered in the event of cumulative inflation in the first year exceeding 12% YoY and "corrective adjustments" every two years for the difference between cumulative inflation and adjustments granted. To define the guidelines and taking into account the heterogeneity of the various sectors in the economy, the parties must be voluntarily scaled into three groups according to performance, where the rises are proportional to the dynamism of the sector in question. The idea of the reform is to bring wages into line with levels in keeping with price movements and for real gains to reflect increases in productivity bearing in mind sector performance.

Chart 6.1
Inflation by components (% var. YoY)



Source: INE and BBVA Research

Chart 6.2
Real multilateral exchange rate (Dec. 2001=1)



Source: Haver and BBVA Research

The combination of expectations of lower projected spending by families in a less healthy labour market, a smaller currency depreciation than that observed in 2015 and the maintenance of tight monetary policy all lead us to estimate inflation of 8.5% for 2016 (9.2% for 2015). By way of a corollary, when we note an average of 8.5% for wage rises according to the guidelines laid down by the government for sectors performing normally in the first year under the collective bargaining agreements, it is evident that the government itself is discounting another year of failure to fall within the central bank’s target range of 3-7%.

7 Competitiveness is improving only marginally

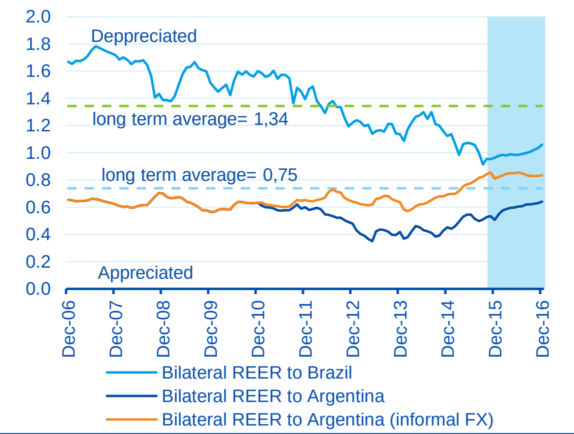
This lower inflation will mean a small increase in competitiveness in 2016 as measured by the real multilateral exchange rate, which reflects the currencies and inflation levels of Uruguay's trading partners and is weighted by the bilateral trade in each case (Chart 6.2). Specifically, at the end of 2015 the real multilateral exchange rate is likely to have built up a cumulative depreciation of only 10% with respect to the end of 2014, despite the fact that the nominal depreciation of the Uruguayan peso ended up at around 28% YoY. This is because the effect of the greater nominal depreciation of the UYU was partly offset by the strong depreciation felt by its neighbouring countries (50% for Brazil and 27% for Argentina).

The combination of currency depreciations (and inflation levels) forecast by BBVA Research for key trading partners (with the largest weighting in the multilateral rate) will mean that in 2016, despite experiencing a lower nominal depreciation than that observed in 2015, its (multilateral) competitiveness will continue to improve, i.e. there will be depreciation in real terms.

If we look at real bilateral exchange rates in relation to Brazil and Argentina (Chart 7.1), we see that in the last few months the loss of competitiveness with respect to Brazil (which saw depreciation of its currency of almost double the level experienced by Uruguay over 2015) has become more accentuated, although in 2016 this process might start to be reversed, albeit only marginally. On the other hand, in relation to Argentina, Uruguay has shown a minimal gain in competitiveness (its currency has depreciated in relative terms), which is greater if we factor Argentina's informal dollar into our calculations (which has a bigger impact on exchange rates in tourism) instead of its official counterpart.

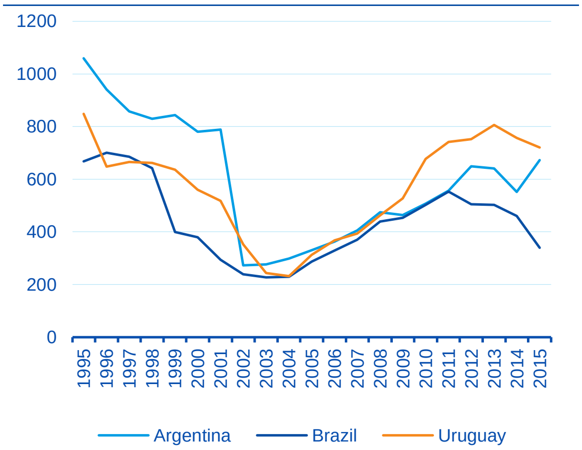
Another way of looking at the emerging improvement in Uruguay's competitiveness relative to its neighbours is to compare wages in industry in productivity-adjusted constant dollars for each of the countries concerned.

Chart 7.1
Real bilateral exchange rate (Dec. 2001=1)



Source: BCU, BCRA, BCB and BBVA Research

Chart 7.2
Average productivity-adjusted wages in industry in constant dollars (1995)



Source: INE, CIU, INDEC, Haver and BBVA Research

Chart 7.2 shows that in recent years Uruguay's wage costs had risen with respect to those in Argentina and Brazil, marking a loss of competitiveness for manufacturing exports. Although, in the last biennium, Uruguay has begun to catch up after the UYU's exchange rate depreciation and with the fall in wages in dollar terms, these are still above those of its neighbours, even after adjusting for productivity. It is also noticeable that the gap with respect to wages in Brazil is widening, as the latter have factored in the sharp depreciation of the BRL in 2015, which takes the shine off Uruguay's improvement in comparative terms.

In 2016, we estimate that the Uruguayan economy will continue to gain in competitiveness with a modest depreciation of the UYU of close to 9%. This will accompany a dearer dollar worldwide but avoid a sharp shift in keeping with the official interpretation regarding the closeness of the observed exchange rate to its equilibrium level. Finally, the willingness, and capacity in terms of reserves, to temper any sharp change in demand for currency in the FX market will help to contain the rate of depreciation.

This all leads us to conclude that the central bank has the necessary means to act with discretion in the currency market and it will be able to choreograph a depreciation in such a way as not to give rise to considerable strain on the price system and soften the blow of pass-through with the help of monetary and wage policy. The dollar exchange rate will thus end 2015 at UYU31.0 and UYU33.7 at the end of 2016 without any significant compromise to the rate of change in prices.

Box 1. Risk of a currency depreciation to Uruguay's private sector

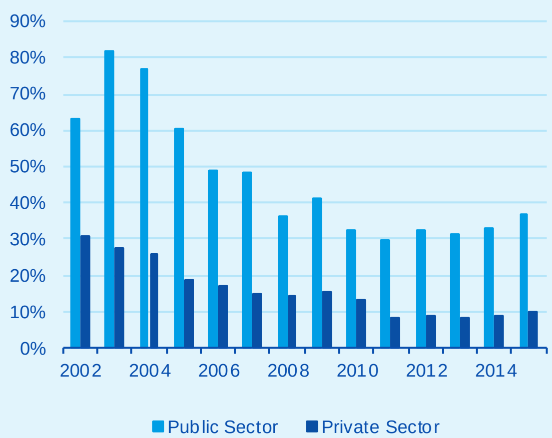
A reduction of debt in foreign currency

The scale and structure of dollarisation in Uruguay's economy make the effects of a currency depreciation deserving of study. Before examining the situation in detail, we should clarify that optimal dollarisation does not mean any absence of foreign currency assets and liabilities in the finances of economic agents, but instead a position in which they can hedge against currency risks appropriately, according to each of their particular business activities and the capital associated with them.

First, we must briefly examine the public sector as the agent that determines the risk to the rest of the economy.

Uruguay's total foreign debt as of June 2015 came to USD25.411bn, or 46.5% of GDP, which was run up after it pursued a government debt restructuring process following the 2002 crisis. Public sector external debt (Chart B.1.1) hit a high of 82.1% of GDP (2003) and then improved in the ensuing years up to its current level of 36.6% of GDP), also achieving a substantially better due date profile.

Chart B.1.1
External debt (% of GDP)



Source: BCU and BBVA Research

The same situation has been observed with respect to indicators for total foreign currency-denominated public sector debt (domestic and external). The improvement in this case was from a peak of 98.8% of GDP in 2003 to a recent level of 29.7% of GDP.

Early financing and access to markets mitigate the risks of a sudden stop

The reduction of debt ratios owes itself to the restructuring carried out in 2005, which it was possible to undertake in a favourable external context of abundant liquidity and low interest rates. Moreover, the friendly approach without haircuts succeeded in cementing the fine reputation which the Uruguayan government has managed to forge in recent years. Uruguay's reinstatement to Investment Grade status in April 2012 underpinned continuing access to credit markets and helped encourage capital inflows. This has also allowed the central bank to make the most of such times of plenty by building up reserves. These have actually burgeoned by over USD15bn in the last 10 years. Gross reserves are 29% of GDP and if we look at net reserves, which exclude foreign currency obligations featuring the government and the financial system (reserve requirements), these amount to 9.6% of GDP.

Furthermore, the government has managed to implement a programme of bond issuance to set up a buffer, thus ensuring the necessary resources to meet debt obligations over the next 18 months.

It thus emerges that the public sector does not represent a risk factor in the event of a sudden drop in foreign exchange inflows. Should there be a sharp depreciation of the UYU, debt servicing will become dearer and push up the deficit. Assuming that total redemptions in 2016 are in dollars (extreme position), an additional 10% of depreciation to our exchange rate forecast for this year will lead to an estimated 0.3 percentage point rise in the deficit, but there will not be liquidity problems when it comes to debt falling due, thanks to the buffers and reserves which Uruguay has in place.

Private external debt ratios have also improved ...

Only USD5.415bn, or 9.9% of GDP, is private sector external debt, which ratio has also come down notably after the crisis (27% of GDP in 2003).

When we examine how this external debt is structured, we can see that the highest proportion comes under the heading of *Net deposits*, which are virtually wholly determined by deposits within Uruguay's financial system by non-residents, where roughly 75% of these have been made by Argentine nationals.

The lack of firms based in Uruguay as issuers of corporate debt in international markets makes the analysis in this study easier by demarcating the universe of agents affected by the macroeconomic fallout of a currency depreciation.

Deposits by non-residents represent the main component of the Uruguayan financial system's external liabilities

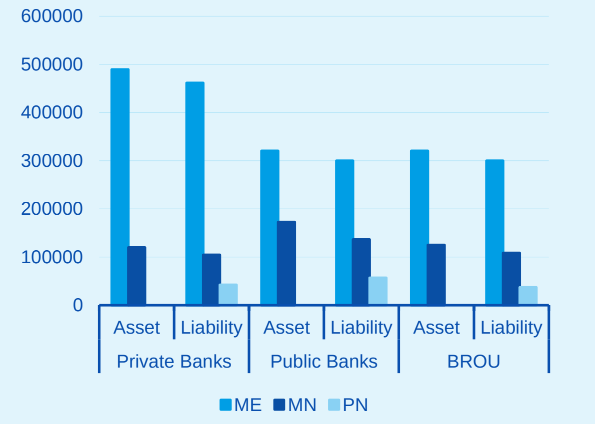
Even though the Uruguayan financial system is in good shape, the fact that it still has a high degree of dollarisation generates uncertainty with regard to the occurrence of any contingency.

When we look at the balances by groups of institutions, we see that asset positions in foreign currencies outstrip the liability positions, which removes a potential problem of capital requirements in the event of a depreciation (Chart B.1.2).

Total system deposits amount to USD27.7bn, or 50% of GDP, of which a little more than 80% are denominated in foreign currency.

Of total deposits in foreign currency, USD4.5bn (8.1% of GDP) are by non-residents (Argentines in the main).

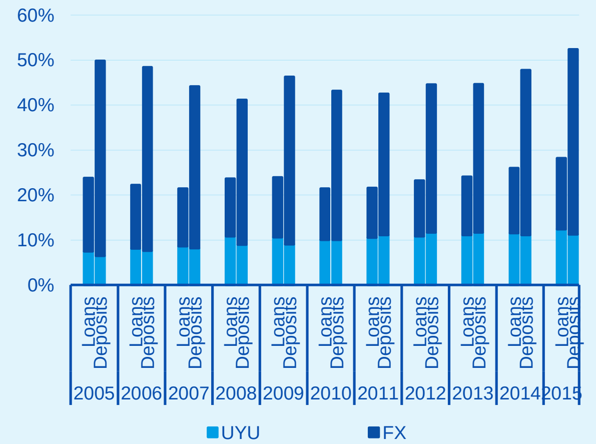
Chart B.1.2
Financial system balance sheet positions (October 2015, UYU mn)



Source: BCU and BBVA Research

On the banks' assets pages, total lending into the private sector amounts to 25.6% of GDP, of which the sum granted to non-residents is only marginal (just 1% of the total), while loans to the public sector only amount to 1.6% of GDP.

Chart B.1.3
Lending and funds (% GDP)



Source: BCU and BBVA Research

If we take the monthly average stock in 2015, in August 56% of total lending (15.8% of GDP) was granted in foreign currency, while the equivalent deposits attracted were 78% (Chart B.1.3). Risks of a flight of deposits in foreign currency are kept in check by the abundance of balancing liquid assets too.

Lending in dollars to the domestic sector gives rise to exchange rate risk

According to Uruguayan regulations, funds deposited with banks in dollars can be loaned to private individuals or firms regardless of whether these generate income flows in dollars or domestic currency, thereby producing an Implied Foreign Exchange Risk (IFER) in the event of a currency depreciation that leads borrowers of loans in foreign currency that generate income flows in the local currency to incur systemic default events.

This is why a borrower's potential to give rise to a bad debt in the event of a currency depreciation on account of a currency mismatch in their finances produces a contingency for financial institutions. Even though there are no regulations that limit the scope of eligible destinations for loans in dollars, there are several items of regulation that are aimed at reducing exchange rate risk.

Such prudential regulation includes: differential capital requirements for loans depending on whether they are in foreign currency or UYU; specific, differentiated provisions for commercial and consumer loans in foreign currency; differential liquidity requirements depending on currency, the account holder's place of residence and terms for deposits, and likewise for reserve requirements and limits on open positions in foreign currency.

Arbitraging between the actual and expected exchange rates gives rise to choices that can shift from being optimal to counterproductive very quickly as a result of movements in the currency market, which in turn depend on both domestic and exogenous factors.

Hence the importance of looking into what sectors in the financial system borrow the most heavily in foreign currency when attempting to gauge its exposure to exchange rate risk.

Borrowers within Uruguay's financial system by sector

Upon inspection of the financial system's borrowers by sector (Chart B.1.4), it emerges that the heaviest borrowing is by firms, to which some 59.6% of loans are granted, followed by families with 32.9%.

Chart B.1.4
Loans by sectors (% GDP) total currencies

Source: BCU and BBVA Research

Families do not have a lot of borrowings in dollars ...

In the case of families residing in Uruguay, a stronger dollar will make them worse off, given that large swathes of available supply are in the form of imported goods.

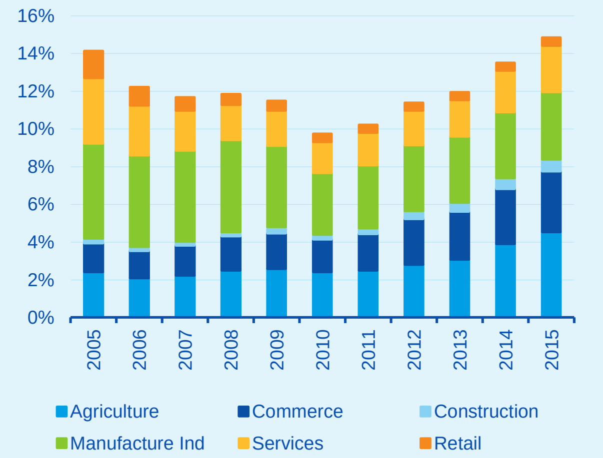
Most of the debts originated by consumer financing for families are in UYU while mortgages are in indexed units, which are hit by second-round effects when there is pass-through from the depreciation to prices, and this is captured by the index against which such contracts are referenced.

In the last instance, the consequent drop in the real wage will ratchet up the financial burden for families in real terms, though this is without being so serious as to lead to a sudden impact on the ability to honour debt commitments, due to the lack of dollarisation in liabilities.

But among firms as a whole ...

The impact of a currency depreciation on the financial position for firms linked to foreign trade will depend on the net foreign currency position. In general terms, a higher exchange rate takes business away from importers and produces new opportunities for selling Uruguayan goods and services to the rest of the world. Such restructuring of positions is the channel for transmission to the rest of the economy via the contracts that firms have with the financial sector.

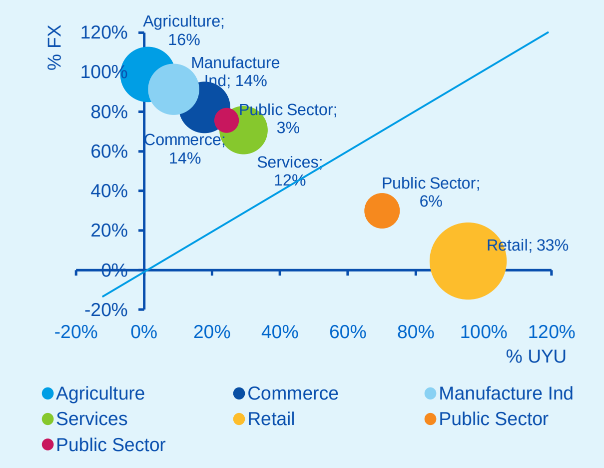
Chart B.1.5
Foreign currency lending by sector (% GDP)



Source: BCU and BBVA Research

With respect to credit in foreign currency that is granted to firms, the situation is the reverse of that for families (Chart B.1.5), given that most loans are made in dollars. When we look at which sectors account for borrowers of credit, most demand comes from the farming and livestock sector, trade and manufacturing industries. Except in the case of retail and wholesale trade, and construction[2] (which together account for only 3.9% of lending in foreign currency in terms of GDP, the others are very strongly linked to foreign trade and generate *bona fide* dollars, meaning that the implied exchange rate risk to the financial positions of banks should be mitigated. In the case of the manufacturing industry, a large part of its production is exported, while the balance goes into the domestic market. For the non-financial sector there are not many instruments available to hedge such situations in the local market, such as a futures market with enough depth, apart from OTC-type contracts with banks.

Chart B.1.6
Loans, share and dollarisation
(% total lending, percentage in Mn and FC)



Sectors situated above the diagonal line have a higher proportion of loans taken out in foreign currency. The size of the circle shows the share of total bank loans to the non-financial sector
Source: BCU and BBVA Research

By way of conclusion, when we look at the financial system's average loans portfolio we can say that the position taken by the banks (Chart R.1.6, and aside from the credit quality of each institution) stands at comfortable implied exchange rate risk acceptance levels, since the exposure of lending in dollars to non-tradeable sectors is moderate and has been falling since 2003. The low proportion of lending in foreign currency that is funded via deposits reduces the risk even further. Moreover, the financial authorities have brought in regulations aimed at dis-incentivising this type of credit and raising requirements for capital and liquidity for loans granted in foreign currency.

2: Even though the services sector is generally assumed to be Non Tradable, in Uruguay's case the high weight of Tourism from Abroad means that the sector's revenues correlate very closely with foreign currency.

8 Tables

Table 8.1
Macroeconomic forecast

	2012	2013	2014	2015f	2016f
GDP (% y/y)	3.3	5.1	3.5	1.7	1.5
Inflation (% y/y, eop)	7.5	8.5	8.3	9.2	8.5
Inflation (% y/y, average)	8.1	8.6	8.9	8.6	7.9
Exchange rate (vs. USD, average)	19.3	21.3	24.1	31.0	33.7
Exchange rate (vs. USD, eop)	20.2	20.4	23.2	27.5	32.5
Interest Rate (%, average)	18.6	17.7	21.5	22.2	22.8
Public Comsumption (%y/y)	5.9	5.0	2.5	4.0	1.5
Fiscal Balance (% GDP)	-2.7	-2.4	-3.5	-3.3	-3.2
Current Account (% GDP)	-5.3	-4.9	-4.4	-3.7	-3.6

Source: BBVA Research

Table 8.2
Macroeconomic Forecast

	GDP (% y/y)	Inflation (% y/y, eop)	Exchange Rate (vs. USD, eop)	Interest Rate (%, eop)
T1 13	4.6	8.7	24.2	17.2
T2 13	6.5	8.1	23.9	15.1
T3 13	3.7	8.9	23.9	17.9
T4 13	5.6	8.6	24.1	22.0
T1 14	3.1	9.6	22.0	22.2
T2 14	3.9	9.1	22.9	20.2
T3 14	3.7	8.7	23.7	20.0
T4 14	3.3	8.1	24.2	21.5
T1 15	4.5	7.7	24.8	21.2
T2 15	-0.1	8.4	26.5	21.3
T3 15	1.5	9.2	28.3	24.1
T4 15	1.0	9.0	30.3	24.3
T1 16	0.9	7.8	31.5	22.7
T2 16	3.1	8.2	32.1	23.1
T3 16	1.1	7.8	32.8	22.7
T4 16	0.8	8.0	33.5	23.7

Source: BBVA Research

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