BBVA | RESEARCH

Uruguay Economic Outlook

1ST HALF 2016 | SOUTH AMERICA UNIT

01
Growth in GDP will be sluggish in 2016 (0.7%), marked by the stagnation in private consumption. GDP will increase 1.5% in 2017.

02
Few chances of fiscal consolidation: the government has stressed how important it is to bring down the budget deficit even at the expense of prices.

03
The dollar will see out the year at $ 35.2 per unit, and will reach $37.1 at the end of the next year, with gains in competitiveness.

04
Inflation: 9.2% in 2016 and 8.7% in 2017: inflation inertia will be constrained by real wages.

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Closing date: 20 May 2016

1 Editorial

The global economic scenario has brightened, although world growth will remain low. Volatility on international financial markets eased significantly from February on, driven by improvement in China's economic indicators (including lower downward pressures on its exchange rate), recovery in commodity prices and cooling outlook for interest rate hikes by the Fed. All the same, global improvement remains fragile and is dependent, in the short term, both on how China's economy evolves and on how the sources of geopolitical instability present in Europe are resolved. Whatever happens, we cannot rule out further spikes of financial volatility such as those seen in early 2016.

Growth in Latin America will contract -1.1% in 2016, with the negative impact of Brazil, and, to a lesser degree, Argentina. Brazil will once again register a significant fall in GDP (-3.0%), similar to the fall in 2015, and will have a heavy impact on growth in the region as a whole in 2016. On the other hand, Pacific Alliance countries will maintain a steady pace of growth of around 2.5% over the 2016-2017 period.

Looking forward, exchange rates in the region will depreciate, pushed down by the Fed's interest rate hikes and easing off of growth in China. Following the appreciation in the last three months, future depreciations will probably be more intense and last longer in Argentina and Brazil due to high inflation rates and because these countries need to be more competitive in exports.

No signs of recovery in private consumption in Uruguay in 2016. We do not expect consumption to be able to drive GDP in 2016, given that consumer confidence is on the verge of "considerable pessimism", the rising unemployment rates in the deteriorated labour force and negligible growth in real wages. GDP will rise by only 0.7% in 2016 and will soon recover in 2017 (1.5%) through foreign trade and investment.

Still few opportunities for fiscal consolidation. We do not expect tax revenue to improve in 2016 (-3.5% of GDP): on top of the lower revenues due to the economic slowdown, the fall in spending is inflexible, while the government also has to deal with situations such that which arose in the city of Dolores. However, the government has made it clear that it intends to deal with imbalances, to conserve its Investment Grade rating and keep the public accounts in good shape, even if this means allowing an even greater deviation in inflation. In any case, the government's successful pre-financing policy averts any problems in meeting the commitments it has agreed to.

External accounts are buoyed by favourable terms of trade and a change in the energy matrix. The current account will continue to improve in 2016, not only through reducing the trade deficit but also through the real services account, where tourism is once again playing an important role. This year, the current account will reach -3.3% of GDP, with further improvement in 2017. Tourism will play a more important role, particularly in the form of Argentinian visitors, who account for over 50% of the total.

Inflation will remain high in 2016 and 2017, at 9.2% and 8.7% respectively The slowdown in economic activity and fruition of salary negotiations, under the new system, will restrain inflation inertia in the mid term. The Central Bank of Uruguay reinforced the contractive stance in monetary policy, while we expect a less expansionary fiscal policy.

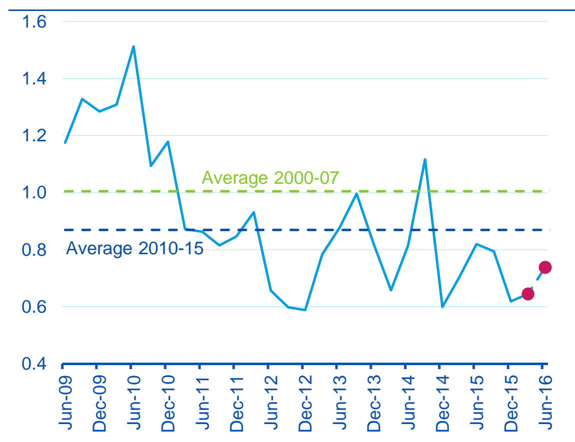
Following the pattern seen by other currencies in the region, the Uruguayan peso will weaken against the dollar, which will stand at $U35.2 per dollar at the end of 2016 and $U37.1 in 2017. Despite this depreciation, Uruguay will make output gains due to the recovery of Argentina and Brazil's currencies.

2 Global growth is fragile and reliant on China

The data available for the first quarter of 2016 confirm our forecasts of stabilising growth in the global economy, at a low rate, but slightly higher than in late 2015. The BBVA-GAIN[1] indicator puts the QoQ increase in global GDP at 0.6% (2.6% annualised rate), well below the average recorded between 2010 and 2015 (Figure 2.1). This rate of growth could accelerate slightly in the second quarter if the signs of reduced deterioration being shown by available indicators of production, trade and business confidence are confirmed, but it is still not enough for annual growth of the world economy to come in at around 3.2% (our estimate for whole-year 2016).

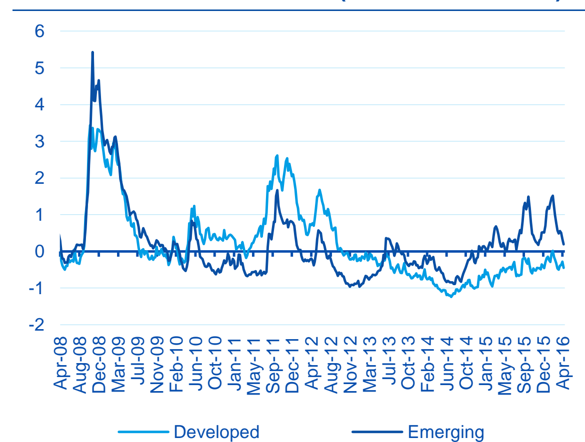
The sharp increase in financial volatility seen between December 2015 and February 2016, as well as being in response to the slowdown in global activity, also threatened to exacerbate it if it persisted with the same intensity and ended up being translated into a contraction in spending decisions. The better-than-expected balance of China's economic indicators, together with the reduced downward pressure on the Yuan exchange rate, the recovery of commodity prices and the moderation of expectations of interest rate hikes by the US Federal Reserve were crucial to the easing of financial tensions from then on and to the reduction, in turn, of the probability of occurrence of a worldwide stress scenario in the short term.

Figure 2.1
Global GDP, % QoQ 1Q and 2Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA financial stress index (normalised values)



Source: BBVA Research and Haver

China: fewer short-term risks, but more long-term doubts

The Chinese authorities' strengthening of their stimulus measures, both monetary and fiscal, have helped to soften the effects of the readjustment to the manufacturing sector on aggregate production and therefore on the country's flows of trade with the rest of the world. In the short term, the implementation of countercyclical measures may facilitate a more gradual than expected slowdown in the economy; however, if this brings with it a delay in the correction of fundamental imbalances such as the high leverage of the corporate sector or the excess supply in certain branches of industry and construction, China's vulnerability to shocks such as that seen at the beginning of the year will increase, as will its potential to destabilise the rest of the world. Taken as a whole, these factors lead us to revise our 2016 growth forecasts for China upwards to 6.4%, maintaining our growth forecast of 5.8% for 2017.

1: See https://www.bbvaresearch.com/en/publicaciones/global-gdp-growth-remains-stuck-at-2-6-yoy-in-q1-less-cloudy-outlook-but-the-same-risks/

The international environment is partly determining the US Federal Reserve's decisions and thus helping to relieve the pressure on emerging markets

The postponing of expectations of the next interest rate hike is explained by the importance that economic agents attach to the deterioration in the international environment as reflected in the reactions of the US Federal Reserve. As against the two rate hikes predicted by FOMC members for 2016, the market has postponed the next increase to early 2017. The response of the dollar, depreciating despite the continued relatively positive trend in US domestic demand, and the easing of the long segments of the dollar interest rate curve, have contributed to relieving the restrictions on financing in the emerging markets, as reflected by: (i) the BBVA financial stress index for this region, which has corrected all of the upturn seen in the first few months of 2016 (Figure 2.2), and (ii) the reactivation of inflows of foreign capital, with net capital inflows to emerging markets since mid-February, due in part to the relocation of investment to instruments with higher returns.

Furthermore, to the extent that developed countries' central banks maintain the direction of monetary policy of the past few months (strengthening or maintaining stimulus measures in the case of the ECB and the Bank of Japan; caution in normalising interest rates on the part of the US Federal Reserve), emerging market authorities will have more room for manoeuvre to prioritise economic recovery among their objectives. The gradual approach expected of the US Federal Reserve (which supports capital inflows to the region) and the recent recovery of currencies (containing the possible increase in inflation caused by dearer imported goods) limit the need for aggressive interest rate hikes.

All the same, the relative improvement in the global economic scenario in the last quarter continues to be fragile and dependent, in the short term, both on how China's economy evolves and on the resolution of the sources of geopolitical instability present in Europe. In any case, repeat bouts of financial volatility like the one seen at the beginning of this year (of greater or lesser intensity) cannot be ruled out in a context of high uncertainty about the ability of the emerging markets to manage their slowdown and of the developed countries' central banks to reactivate growth.

3 GDP will increase by only 0.7% in 2016 due to the stagnation in private consumption

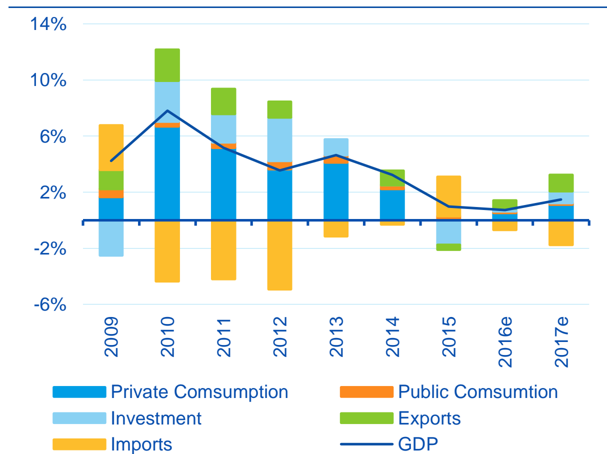
Private consumption in 2015 at the same level as 2014

In previous reports, we warned about the swift slowdown in private consumption seen after its growth peaked at 9.4% YoY in 2010. This constant downturn became virtual stagnation in 2015, when the private consumption figures were at the same levels as 2014. Domestic demand contracted in 2015 (-1.5%) due to the slump in investment (-7.7%) which was not offset by higher public consumption (+2.6%), while private consumption (which accounts for 75% for GDP) stood at the same levels as the previous year. This time, the growth observed in GDP, albeit weak, was underpinned by foreign demand (+2.5%) as a result of contraction in imports, which, as shown in figure 3.1, greatly exceeded the fall in exports.

The pattern of economic activity throughout 2015 is of limited growth in GDP (1% vs. BBVA forecast of 1.2%), virtually entirely shaped by manufacturing industry, which had an impact of +0.7% on GDP.

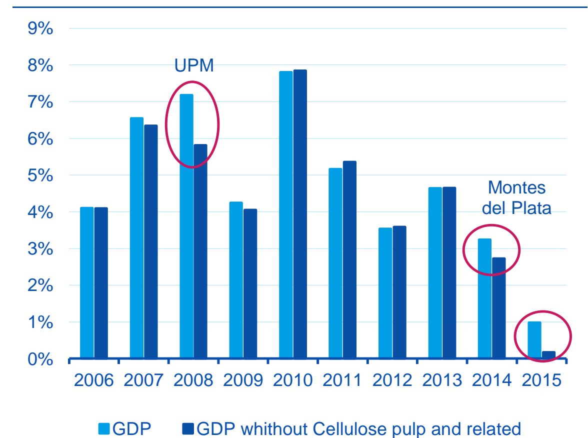
During the first months of the year, the growth in manufacturing was fuelled by the start-up at full capacity of Montes de Plata, but one year later this effect was diluted, cancelling out growth in the last quarter of 2015. Montes de Plata's contribution to GDP is shown in figure 3.2 for 2014 and 2015, as with the pulp manufacturer UPM (formerly Botnia) in 2008.

Figure 3.1
Contributions to GDP. Chge.% YoY



Source: BBVA Research based on Central Bank of Uruguay data

Figure 3.2
GDP and GDP without Pulp, paper and similar manufacturing. Chge.% YoY



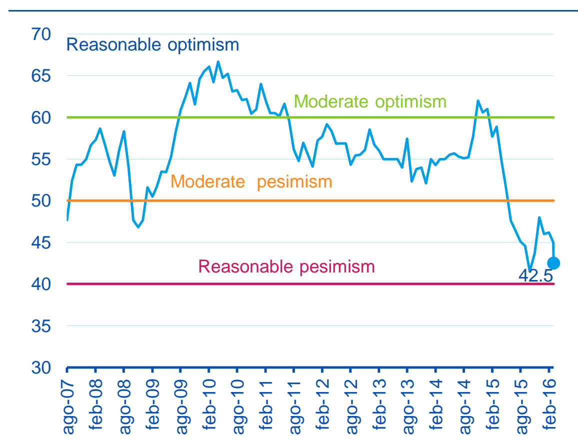
Source: Central Bank of Uruguay and BBVA Research

No signs of recovery in private consumption in Uruguay in 2016

From the standpoint of domestic demand, no signs of revitalisation in private consumption were apparent in the opening months of 2016. Consumer confidence (ICC), which is estimated by Consultora Equipos and Universidad Católica del Uruguay, deteriorated further and currently stands in moderately pessimistic territory (Figure 3.3). In 1Q16, consumer confidence was 20% lower than in 1Q15. This deterioration has been directly caused (or influenced) by three basic factors: first, the devaluation of the peso, which directly impacts consumption of durable goods, through prices; second, high levels of inflation, which have further battered consumers' purchasing power; and three, the sense that wages have been eroded. Indeed, real wages are not expected to recover in 2016, after the change applied in the collective wage agreement negotiations (see section on inflation). Instead, they are expected to fall slightly, following the stagnation in 2015 which had a

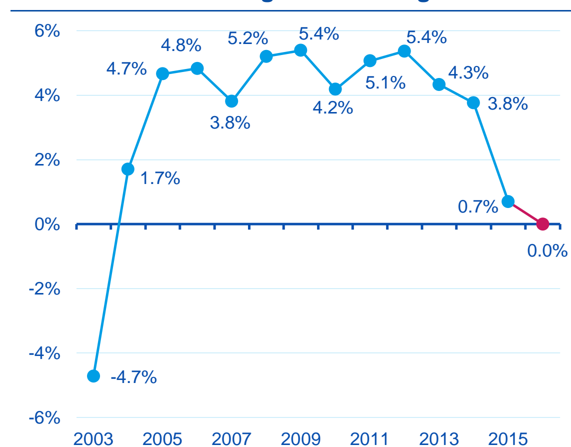
negative impact on private consumption (Figure 3.4). In early 2016, the labour market saw further deterioration; unemployment stood at 8% in March compared with an average of 7.4% in 2015, putting an additional constraint on domestic demand. We do not expect employment levels to recover during 2016. Although unemployment will remain at what are relatively low levels for Uruguay (8.3%), over the last year it has shown an uptick from the lows reached (5.7%).

Figure 3.3
Consumer confidence



Source: BBVA Research based on information by Consultora Equipos and Universidad Católica del Uruguay

Figure 3.4
Private Sector real wages index. Chge % YoY



Source: National Statistics Institute (INE) and BBVA Research

Uruguay is not immune to the gloomier outlook for global growth; we lower our estimated GDP for 2016/2017

Emerging economies are hit by the slump in commodity prices and devaluations in exchange rates. Beyond Uruguay's domestic imbalances, the global setting, and particularly the regional backdrop, is not the most ideal for the country to achieve growth rates closer to its potential.

This year, foreign demand will make a lower contribution than in 2015. Brazil is in a complicated situation: its economy will contract further this year, causing more damage to the public and private sector accounts. Argentina, meanwhile, is reshaping its economy, and does not expect GDP to rise this year, though from next year on its outlook is more positive. Last but not least, in China, which is Uruguay's most important trading partner outside Latin America, there are important question marks about the country's transition towards lower and more sustainable mid-term growth rates, which could have a negative impact on commodity price volatility.

We expect slight growth in goods and services exports of around 1% YoY- basically through the contribution made by real services, in particular tourism. Official first quarter statistics show a record number of Argentinian tourists, though their daily spending was slightly lower than in 1Q15. (see Section 5). We expect tourism to once again make an important contribution to growth, as in previous years. Goods and services imports, meanwhile, will be virtually stagnant, with hardly any growth in volume.

Lastly, the government has tried to convey a sense of optimism with its announcements of infrastructure investments (Puerto Nueva Palmira, for example) and the approval of loans for export sectors. However, investment will take some time to gain proper traction and in any case it will not suffice to offset the loss of drive in private consumption, which will register virtually no growth this year (0.1% YoY). Extra spending will be needed in order to cope with the adverse weather conditions (floods) which have affected the Dolores region and a large part of the agricultural region, so as to rebuild damages. Thus we expect investment, driven by public sector spending, to grow by 2% YoY this year.

We have lowered our estimated GDP for 2016 from 1.1%, which we made before hearing the 4Q15 figures, to 0.7%. This is mainly due to the negative surprise of zero growth in private consumption last year (private consumption has been a key growth driver in recent years). On the supply side, however, preliminary figures show industrial growth of 1.7% YoY in 1Q16, albeit strongly impacted by the refining business, as non-refining industry was down 0.3% YoY during this period. On a positive note, following a sharp slump in January (-4.8%), non-refining industry posted positive rates of year-on-year growth in February and March, of 2.2% and 1.5%, respectively, in line with our forecast of moderate growth in 2016.

We expect growth of 1.5% in 2017. We assume that the internal imbalances which have to be corrected for Uruguay to grow at close to its potential growth will need longer than was previously estimated; however, after a difficult year in 2016, a less adverse global backdrop should help to achieve better results. Private consumption should begin to recover (1.5% YoY) as soon as inflation eases off and confidence brightens.

4 Few chances of fiscal consolidation in the short term

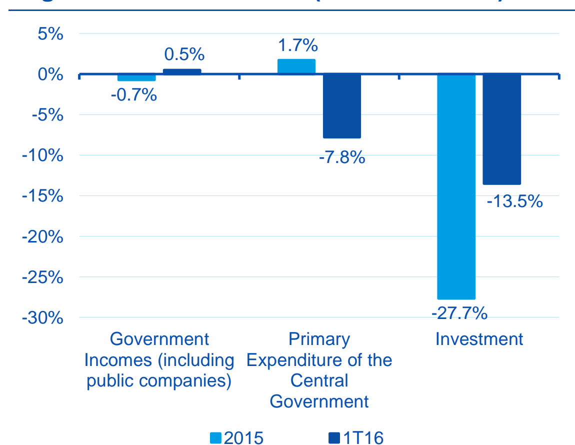
2015 saw another high budget deficit, equivalent to 3.5% of GDP

In 2015, efforts made to rein public spending proved insufficient to turn around the previous year's high deficit. Although growth in primary spending fell to 9% YoY (vs. 15% YoY the previous year), public spending still remains relatively high as a proportion of GDP (28.7%). The small degree of adjustment in 2015 took the form of a significant reduction in public spending, and, to a lesser extent, on constraining public sector salary increases, which remained virtually stable in real terms for the first time in several years. In fact, the public sector wages index posted a slight fall of around 0.1% YoY.

Similarly, public companies performed positively in 2015. Some of them benefited not only from the fall in oil prices but also from lower need for oil exports because of the consolidation of the shift in the energy matrix towards a stronger renewable energies profile. The lower economic growth also affected tax revenues, however, preventing substantial improvement in the global public sector balance.

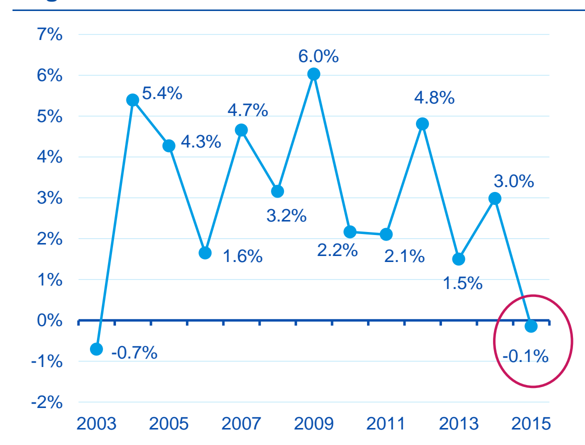
Observing the figures in detail, it is also evident that the highest adjustment was in investment, stripping out the effect of inflation on public accounts. Measured in real terms, total public sector revenues (including public company income) were down 0.7% in 2015, and current expenditure rose 1.7%, compared against the previous year, while investments fell 27.7% in real terms (Figure 4.1). Although investment spending is relatively low taking into account total expenditure, this adjustment shows that the government is committed to bringing down certain discretionary expense items while not compromising on social spending.

Figure 4.1
Revenues, Primary Spending and Investment: Chge. % YoY in real terms (deflated for CPI)



Source: MEF (Ministry of Economy and Finance) and BBVA Research

Figure 4.2
Real Wages Index for Public Sector Chg.% YoY



Source: National Statistics Institute (INE) and BBVA Research

No improvement in tax revenue in 2016 due to temporary factors, despite the priority given to “looking after investment grade”

The fiscal situation does not appear to have settled in the first quarter of 2016. In fact, according to official Ministry of the Economy and Finance figures for the month of March, the global deficit has climbed to 3.6% of GDP, once adjusting for the effect of the advance wages and liabilities for the Police and Armed Forces savings banks registered in March 2015, and which actually happened in April of that year. Stripping out this effect, the deficit would account for 2.9% of GDP, according to the Uruguayan government's report.

In real terms, there was another adjustment in investment in 1Q16, this time a reduction of 13.5% YoY. Revenue barely rose 0.4% YoY in this period while expenditure was down 7.4% YoY. The latter, figure, however, should be considered together with the advances made in March 2015, so that it would be necessary to wait until April in order to confirm a significant fall in expenditure in real term and so register the effect in both periods.

During 2016, the government will seek once again to rein in spending without compromising social programmes. In view of the strict budgetary limits, one way the government can save is by putting off expenses which are not a priority or by adjusting public companies' tariffs above inflation, as it did during January 2016. **It is important to note how the government has switched its priorities towards dealing with imbalances. Last year, its priority was to contain prices, even if this meant a higher budget deficit. This year, however, its sights are set on maintaining its Investment Grade rating and the public accounts, allowing increases in regulated prices so as to improve public companies' income even though this may trigger higher inflation.**

On top of the complicated tax situation, the government also has also recently had to cope with the fall-out from the extreme weather in the city of Dolores (tornado), and heavy rainfall across large swathes of northern Uruguay, affecting the agricultural sector. The government has had to earmark funds of USD 100mn, according to official sources, towards the region to address the problems created by the weather conditions. Part of the funds will stem from deferral of budgeted expenses and another part from emergency funds precisely for these kinds of situations.

We do not see much room for improvement in the global public sector balance this year, as the slight improvements in expenditure, which are compromised by the circumstances mentioned in the preceding paragraph, will be offset by the lower revenue caused by economic slowdown. Our estimate is of a small primary deficit for 2016 (-0.4% of GDP) against a balanced result in 2015. According to the maturities schedule, debt servicing would account to approximately 3.1% of GDP. This would give us an operating deficit of 3.5% of GDP for 2016, remaining at around the same levels in 2017 - because even though recovery would allow increasing spending to some degree, it would be affected by the expenses deferred from 2017.

Pre-financing strategy maintained

According to the recent 1Q16 Debt report, the central government's stock of liquid assets of USD 2,600 million gives it enough liquidity to offset any possible external shocks. Basically, it could use this buffer to completely cover debt services until March 2017. A large proportion of the global deficit consists of interests, and as the primary balance is slightly negative, the government will not have difficulties in covering the budget deficit.

In October 2015, the government successfully issued a total of USD 1,700 million at a rate of 4 $^{3/8}$% (with a demand of close to USD 3,000 million), as part of its pre-financing strategy. This issue is referred to as Global 2027. Part of the issue was swapped for pre-existing short-term bonds so simultaneously improving the maturity profile and bringing down debt service costs.

The government also has contingent credit facilities at its disposal, totalling USD 2,400 million in April (USD 2,200 million in March) from multilateral credit institutions such as the Development Bank of Latin America, known as the CAF, the World Bank, Inter-American Development Bank, and the Latin American Reserve Fund (*Fondo Latinoamericano de Reservas, FLAR*).

Debt ratios no cause for concern

At December 2015, the public debt ratio stood at 58.2% of GDP, at the same level as the preceding year. Last year, the most salient trends in public debt were of further reduction in short-term debt (with maturity of less than one year) as a proportion of total debt, in fact it fell from 26.6% in Dec-2014 to the most recent figure of 17.1% in Dec-2015. There were also fewer signs of vulnerability in other indicators such as the proportion of non-resident borrowers compared to resident ones and the proportion of debt at floating rate, which both fell.

Holders of debt, largely resident and institutional borrowers, switched their portfolio profile towards dollars as against domestic currency, thereby halting the dedollarisation process begun years before. Gross debt in dollars climbed to 31.6% of GDP at December 2015, compared with 25.5% of GDP in December 2014. The Central Bank of Uruguay acted to reduce pressure on the foreign exchange market against a background of high currency volatility, buying back Bills with short-term maturities with the option of swapping them for other long-term securities or obtaining dollars directly. This not only released pressure on the foreign exchange market but also reduced the quasi-fiscal deficit and improved the maturities profile, decompressing the short-term section, even if it was at the expense of reducing the Central Bank's Reserve Assets.

It was agreed to create a "Public Debt Coordination Committee, or – CCDP" to coordinate strategies for the deployment of public debt issues by both the Government and the Central Bank. The Committee will meet every quarter to coordinate, analyse and exchange points of view about what strategies to adopt to address risks associated with managing public debt.

5 Further improvement in foreign accounts in 2016

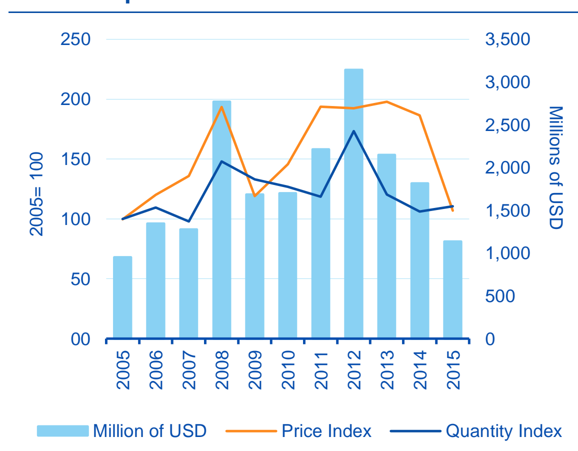
The lower demand for oil imports will bring down the current account deficit to 2.7% of GDP in 2017

Despite the troubled global backdrop, Uruguay improved its trade balance in 2015, bringing it to -3.6% of GDP (-4.6% in 2014), practically in line with our estimates (-3.5% of GDP). This improvement was possible largely because of a significant adjustment in imports, in line with the lower level of activity, but, in particular, due to lower oil imports required by industry as a result of the shift in the energy matrix towards increased use of renewable energies.

On top of the impact on the volumes imported comes the fall in the oil price observed over the last year, as shown in figure 5.1. Actually, the improvement in the terms of trade fell to 1.9% YoY in 2015 from almost 4% YoY in 2014, basically because in addition to lower import prices, mainly due to the fall in oil prices, there was also a drop in export prices (grains), as can be seen in figure 5.2.

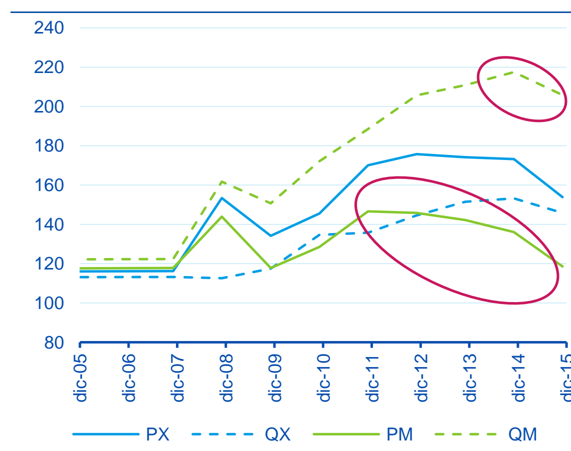
The increased surplus of real services, led by tourism, also had a strong positive impact on the trade balance, and was able to offset the slight decline of net outflows in Revenues.

Figure 5.1
Oil and Imports. Base 2005= 100



Source: Central Bank of Uruguay and BBVA Research

Figure 5.2
Foreign trade prices and volumes. Base 2005= 100



Source: National Statistics Institute (INE) and BBVA Research

For 2016, we have slightly adjusted our estimated current account ratio in terms of GDP (from -3.1% to -3.3%). Importantly, this deterioration is more the result of a lower level of GDP in dollars (due to lower growth and higher devaluation) than it is of a deterioration in the current account per se. In fact, we expect the result of the nominal current account will improve by approximately USD 360 million against 2015. As was the case in 2015, this improvement will come about through the trade balance (due to lower oil imports) and also through a more buoyant tourism industry. This pattern is already being borne out in 1Q16, when there was a more pronounced fall in imports (-31.2% YoY) than in exports (-12.8% YoY).

Throughout 2016, foreign sales should barely grow by 0.7% YoY, amidst relative stagnation. Excess rainfall in agricultural areas right in the middle of the harvest period is prompting downward revisions in soy production. Although losses have not been quantified as certain, they will definitely affected exported volumes (soy was the third-ranking most important product in 2015). This effect will be partially offset by the increase in soy prices

expected in international markets precisely because of the limited supply which can be exported from other Mercosur countries who are enduring similar adverse weather conditions.

The recession in Brazil (-3% YoY in 2016), the main trading partner, will also affect Uruguay's other exports, as Brazilian GDP is expected to contract once again this year. Imports should also drop through oil for the same reasons as in 2015, albeit to a lesser degree. Acquisition of other products will also fall, however, in view of the virtual stagnation in private consumption and the higher prices influenced by the devaluation of the exchange rate. In 2016, we expect imports to fall by roughly 2%.

The first quarter has the greatest weight in the year as far as tourism is concerned, and in fact this year the number tourists rose against 1Q15 (+18.5% YoY), although foreign currency inflows were down 5% YoY due to visitors' lower daily spending. (Figure 5.4) The positive thing about these figures is that the number of Argentinian tourists (55% of the total) during the quarter rose 33% YoY. This phenomenon is certainly due to the release of exchange restrictions in Argentina, because otherwise it has occurred against a background of moderate recession in the country and with a much more strongly depreciated real exchange rate in real terms than one year before. Thus, we should expect a buoyant performance from this sector over the next few quarters as Argentina gets back on track with higher growth rates, according to our estimates.

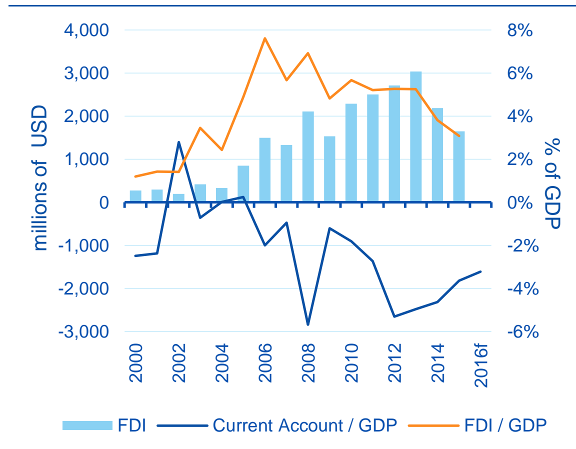
Looking towards 2017, we have revised our estimate for the trade balance slightly downwards, on the exports side, due to the gloomier outlook for growth in Brazil, with lower than expected growth after the sharp fall in 2016, although we still expect a steady improvement in tourism revenues. Thus, the current account deficit would fall by USD 200 million against 2016, although in terms of GDP it would come out at -2.7% (formerly -3%), as in 2016 due to a lower level of GDP in dollars.

Slowdown in Foreign Direct Investment although still funding part of the foreign-currency deficit

During 2015, capital inflows from Direct Investment slowed against the levels seen in previous years. Last year, USD 1,647 million of FDI flowed into Uruguay, an amount which represented 3.1% of GDP. Despite this slowdown in capital inflows, compared with 2014, where FDI amounted to USD 2,188 million (3.8% of GDP) and the record in 2013 of USD 3,032 million (5.2% of GDP), these inflows sufficed to finance 85% of the current account deficit.

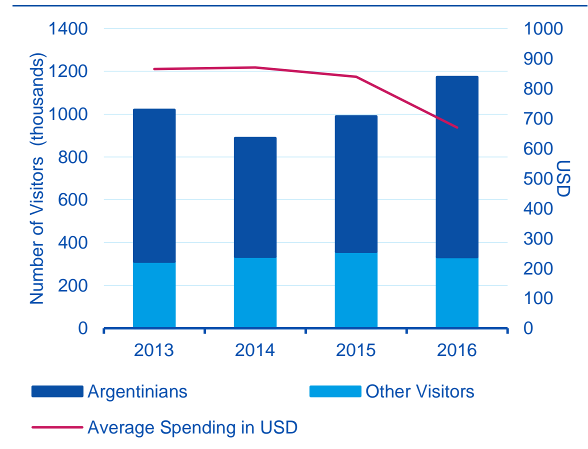
The fall in FDI is strongly connected with the completion of the Montes del Plata works, which required an investment of USD 2,000 million, and the fact that there is no other "mega project" in the pipeline requiring high levels of capital inflows.

Figure 5.3
Current Account and Foreign Direct Investment



Source: Central Bank of Uruguay and BBVA Research

Figure 5.4
Tourist revenue and average spending in 1Q



Source: Ministry of Tourism of Uruguay and BBVA Research

Nonetheless, FDI still remains at historically high levels (Figure 5.3) and even though such a “mega project” is lacking, there are still a considerable number of investment projects which are causing these capitals to flow quite smoothly. The fact that Uruguay maintains its Investment Grade rating and its reputation as a stable country in comparison with other countries in the region makes it an attractive target for investors.

6 Inflation still high. Any changes?

Three facts show us that the price increases show no signs of slowing. First, inflation reached 10.60% YoY in March, a figure last reached in November 2003, i.e. 147 months before. Second, cumulative inflation of 5.64% in the first 4 months of the year is even higher than the 4.09% registered in the same period of 2002, when it reached 25.94% YoY in December. Although inflation slowed slightly in April, to 10.47% YoY and 0.47% MoM below the monthly average of 1.69% of 1Q16, core inflation (10.42% YoY in April), which accounts for 71% of the price increase built up over the last 12 months, remains high (Figure 6.1).

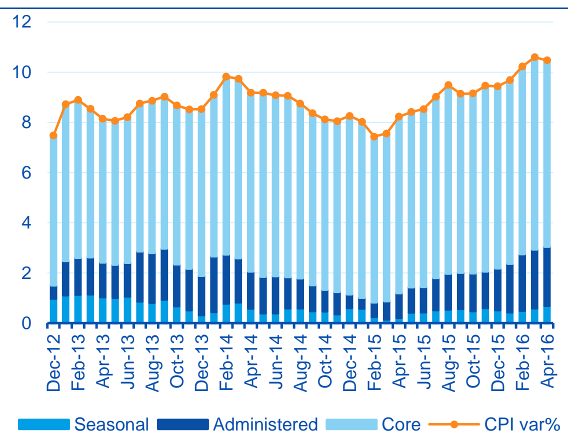
Unlike the case in previous reports, however, some progress has evidently been made in reducing inflation inertia and wage indexing by better adjustment of real wages to rates of productivity growth. In 2015, real wages rose by only 0.39%, markedly below the annual average growth of 4.1% during the 2004 – 2014 period; while in 2016 it will be close to zero, and curb demand. This is mainly due to the moderate deterioration in the labour market and the maturing of salary agreements according to the new decreasing nominal adjustments system[2].

On the other hand, the constraint in public service tariffs and fuel prices used to curb price increases in previous years would no longer be applied as the government would now be focused on its priority of fiscal equilibrium, and, in particular, the contribution made by revenues from public enterprises. This new strategy, which entails accepting an initial increase in inflation in order to align relative prices, becomes evident if we observe the 12-month accumulated variation in administered prices: in April 2016, they rose 9.6% YoY, while in April of the previous year they had only risen by 6.9% YoY (Figure 6.2).

After several years, therefore, we see a combination of a commitment by, –and a number of signs from Public Companies, with a fiscal policy of greater control, a non-expansionary revenue policy, and a Central Bank with a more contractive tone through monetary policy and macroprudential measures. In the mid term, inflation inertia should be kept at bay by this set of political, salary, fiscal and monetary measures. However, given that part of last year's devaluation is being processed, we assume that once again the Central Bank will not be able to make inflation converge at the target range for the next two years, as according to our estimates inflation will be 9.2% in 2016 and 8.7% in 2017.

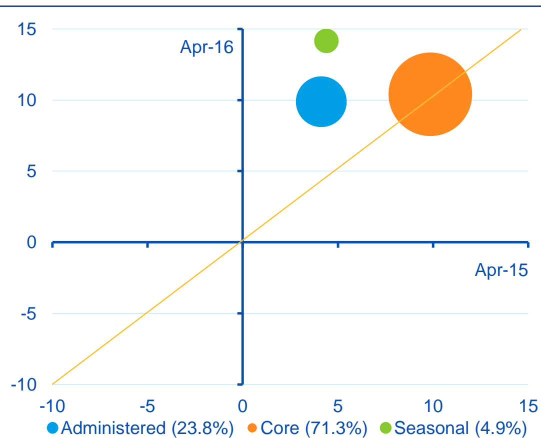
2: The 2H15 Uruguay Economic Outlook report provides an overview of the new wage negotiations scheme. At the date of publication of this report, 2/3 of total wage negotiations had been signed.

Figure 6.1
Incidents and CPI (chge. % YoY)



Source: National Statistics Institute (INE) and BBVA Research

Figure 6.2
Compared inflation 2016 vs. 2015 by components (chge % YoY)



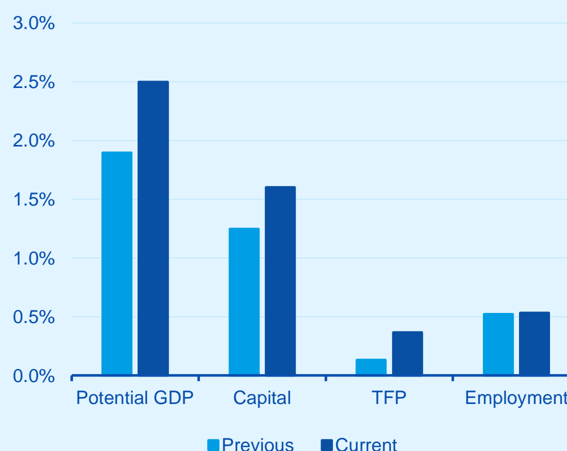
The size of the circle indicates the weighting in CPI
Source: Haver and BBVA Research

Box 1. Upward revision of Argentina's potential GDP following the turn-around in economic policies

Potential GDP is a theoretical concept defining the maximum level of production that a country can reach without causing inflationary pressures using the available factors of production (labour and stock of capital) and the existing technology (summarised as "Total Factor Productivity", which can be understood as the efficiency with which the capital and labour factors are combined). Therefore investment in fixed capital, demographic trends and technological innovation, closely linked to structural reforms, are some of the factors explaining how an economy's potential GDP evolves. In this brief note, we comment on the results of re-estimating Argentina's potential long-term GDP (over the period 2016-24) following the change of government last December and the new government's switch of policy direction.

Our latest estimates of Argentina's potential GDP for the period 2016-2024 give average annual growth of 2.5%, as against the average growth of 1.9% which we had estimated in May 2015 (Figure R.1.1) when our base scenario assumed continuation of the previous government's policies. This increase in projected potential GDP is basically due to a greater contribution from the capital factor - 1.5 pp as opposed to 1.25 pp in our previous estimate - and increased Total Factor Productivity, which contributes 0.37 pp in the new estimate compared with a meagre 0.13 pp in the previous one. Meanwhile the contribution of the labour factor remains almost unchanged at 0.53 pp (previously 0.52 pp).

Figure R.1.1
Annual growth of potential GDP between 2016 and 2024 (%)



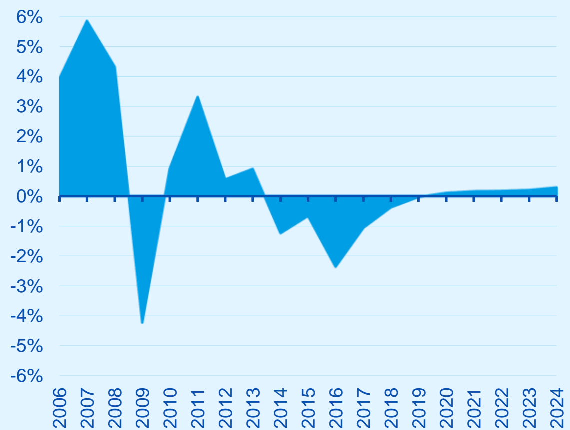
Source: BBVA Research

Why this increased contribution from the capital factor? On the one hand, the new government's switch to policies aimed at achieving greater stability, both macroeconomic (lower inflation, reduction of the fiscal deficit) and institutional (regularisation of the official statistics and of INDEC), less state intervention in the economy (end of exchange controls, elimination of para-tariff barriers, removal of export taxes), the return to international financial markets (settlement with holdouts, ICSID, IMF Article 4), an increase in international trade (reduction of para-tariff barriers, launch of trade treaties, elimination of export taxes) and the development of the financial system (indexed loans, end of regulated interest rates) drove private investment by both residents and non-residents, which will increase the stock of capital in the economy. On the other, the national government has announced an ambitious infrastructure plan to modernise ports, roads, railways, etc., which will also increase the stock of capital. Lastly, we also expect less capital impairment than in the past ten years, returning to historical averages, since we expect newer and more modern plant and equipment to have a lower rate of obsolescence.

As for Total Factor Productivity, its increased contribution is partly the result of the improved and more stable macroeconomic and business environment, with less state intervention, which will encourage greater efficiency in the use of resources, and also partly of changes in labour legislation, adapting it to more modern technologies and practices, introducing greater flexibility (wage negotiation by company and linked to productivity) and reducing taxes on labour.

GDP as observed generally differs from potential GDP: the difference between the two is referred to as the "output gap", which is an important concept for policy makers seeking to stabilise their economies. In expansionary phases, economic activity is above its potential for a time, leading to a positive output gap, associated with inflationary pressures and requiring more restrictive macroeconomic policies. In recessions, the converse occurs: economic activity falls below its potential level and the output gap is negative; this is characteristic of periods of adjustment to activity leading to downward pressure on inflation and calling for expansionary macroeconomic policies. As can be seen in Figure R.1.2, Argentina currently has a negative output gap. This is important for the anti-inflationary policy pursued by the present government, since the downward pressures will help disinflation. The recovery of growth from 2017 on will slowly but surely close this gap, which will turn positive from 2020 on, remaining very small however and not generating significant inflationary pressure.

Figure R.1.2
Annual growth of potential GDP between 2016 and 2024 (%)



Source: BBVA Research

In summary, the concept of potential GDP underlines the need for countries to push for structural and political reforms on the supply side so as to raise the potential level of output and its growth through increases in productivity. In this regard, a historical correlation can be observed between a country's Index of Structural Reforms and the contribution of TFP to its potential growth. In the case of Argentina, the main reforms need to be aimed at increasing investment in physical capital (especially infrastructure) and human capital (better quality education and health). At the same time there is a need to promote more saving to finance these investments, and to reduce the excessive weight of the informal economy, which discourages businesses and households from undertaking either type of investment. Our base scenario assumes that part of this work will be carried out in the next few years, but that the structural reforms will not be enough to allow Argentina's potential GDP to show really dynamic growth. This would require additional reforms which have yet to be announced and which it is to be hoped the government will undertake once it has completed the initial task of normalising the macroeconomy. In other words, let us hope that after first taking care of urgent matters, the government will then turn to the important ones.

7 The Central Bank, more aggressive

The Central Bank decided to deal with double-digit inflation figures above the target range by adopting a more restrictive stance in its monetary policy. In its latest meeting on 7 April, the Monetary Policy Committee announced that it was lowering the target range for growth in the money supply from a range of 7-9% year-on-year to 4%-6% year-on-year for the April-June 2016 quarter.

In early March, the monetary authority emphasised the more aggressive stance by increasing regulatory bank reserves, from 23% to 28% for sight deposits in domestic currency for terms of up to 30 days, and for 26% to 28% for those in foreign currency for terms of up to 180 days. This allows the Central Bank to withdraw USD 700 million from the money supply, heightening the monetary contraction.

It is still too early to assess what impact this might have on inflation, but what is certain is that this measure has implied a cost for banks in terms of return, as they are obliged to allocate a higher resources of funds to non-remunerated assets, in this case reserves. In our opinion, the authorities should look into ways of mitigating this cost, such as, for example, accepting Central Bank or government debt instruments for the integration gap created with the new regulation.

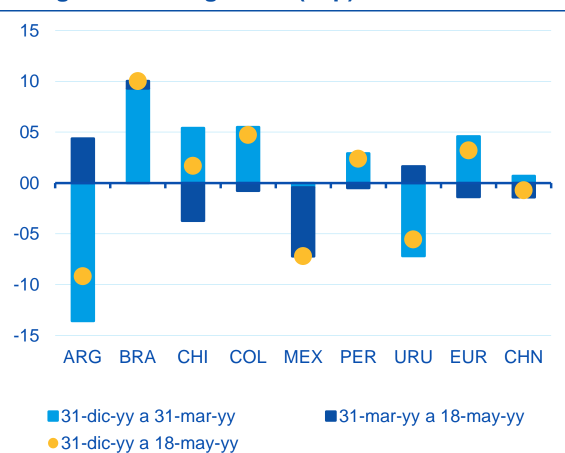
8 Uruguay's more competitive position will be maintained towards 2017

Over the first three months of the year, the Uruguayan peso slipped 8.3%. By the end of 1Q16, however, and once international volatility had calmed, the trend was reversed due to the dollar's greater weakness and the lower level of liquidity at local level, prompting a light appreciation. The peso's recovery against the dollar did not imply that it became less competitive against its major regional partners, however, as because of the specific circumstances in each country, local currencies strengthened in both Argentina and Brazil. From March up to mid-May, the Argentinian peso appreciated by an average of 4.6%, the real 4.9% and the Uruguayan peso by an average of 2.0%. Importantly, this is a temporary foreign exchange effect because volatility in both the Argentinian peso and the real is triggered by transitory questions rather than macroeconomic fundamentals (Figure 8.1).

During the rest of 2016, the exchange rate in Uruguay will continue to devalue, until it reaches $U35.2 per dollar, a loss of 18.4% of the peso's value against the dollar. Markets will keep a close watch on the timing of the Fed's –interest rate hike, although it should be slower than is estimated, and also fears about growth in China, which will continue to weigh on the local currency. In 2017, global markets will have already digested the Fed's adjustment, and the situation on regional markets will tend to stabilise, bringing down volatility. In this scenario, the dollar will reach $U37.1 per dollar at the end of next year.

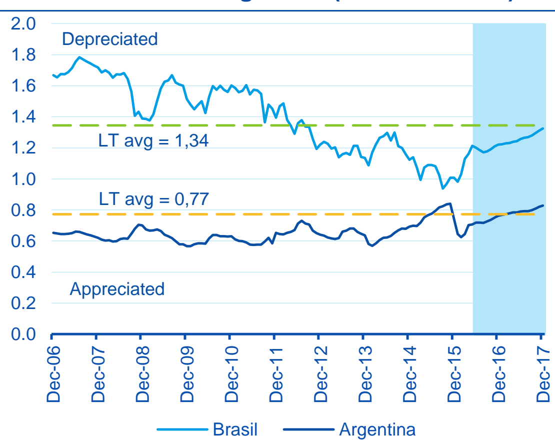
In the specific case of Uruguay, however, the dollar's performance in Brazil and Argentina is also crucial in order not to lose the gains made in competitiveness in recent months. The lower depreciation looking forward coupled with relatively high inflation rates of its trading partners creates a multilateral real exchange rate trend, a key indicator of Uruguay's competitiveness, showing significant improvement until it moves slightly above the long-term average at the end of 2017, returning to the end of 2009 level.

Figure 8.1
Change in Exchange Rate (eop)



(-) implies depreciation against the dollar
Source: Central Bank of Uruguay, National Statistics Institute (INE) and BBVA Research

Figure 8.2
Bilateral Real Exchange Rate (base Dec-01=1)



Source: Haver and BBVA Research

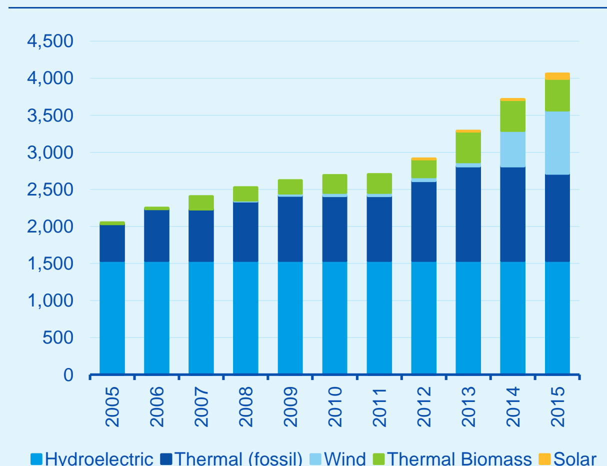
Box 2. Successful transformation of energy matrix

In recent years, Uruguay has made important progress in the direction of an energy matrix diversification policy, with renewable energies playing a dominant role. In 2015, in fact, 92.8% of its electricity stemmed from renewable sources, and only 7.2% was produced using fossil fuels.

This change has been made mainly through changes in installed capacity, which has been increased twofold over the last decade, from 2,049 MW in 2005 to 4,049 MW in 2015. Importantly, this growth has been focused on renewable energies. With hydroelectric power fixed at 1,538 MW (38% of the total), renewable energy sources increased to a total of 71% of installed power (including hydroelectric), while only 29% is still of a non-renewable origin (thermal-fossil fuel).

First, biomass-fuelled thermal energy, which was already used in 2005, became more significant through the installation of 2 pulp mills which reuse industrial waste (biomass) to produce a good deal of their own energy. Second, wind energy, which has reported the strongest growth in recent years, largely due to the subsidies granted for both public (joint ventures) and private investments – in wind farms. Lastly, solar energy began to contribute a significant amount of the total installed power once again in 2014. (Figure R.2.1).

Figure R.2.1
Installed Power in MW



Source: Ministry of the Economy and Finance and BBVA Research

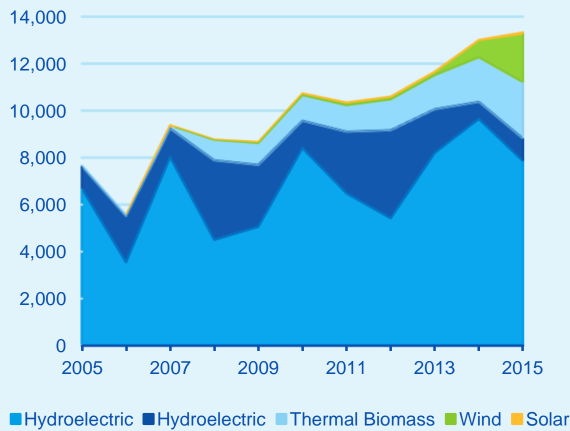
This shift in the energy matrix began to be consolidated once the private sector - which received (and which still receives) tax breaks - began to play a more significant role. In 2009, companies specialised in generation of renewable energies were declared exempt from payment of Tax on Income from Economic Activities (*Impuesto a las Rentas de Actividades Económicas*). In general terms, companies which applied for this tax break no longer paid most of this tax (almost 90%) but with the passing of time the reduction gradually grows less (ending up with 40% in 2020). This tax regime was instrumental in driving growth in wind energy.

Sustainable evolution of electricity matrix by generation source

In 2015, weather conditions were such that most electricity supply could be provided by hydroelectricity (58.9%), followed by biomass-fuelled thermal (18.0%), and, lastly, wind energy (15.5%). (Figure R.2.3) This situation is markedly different from the way the primary matrix was a decade before.

In 2005, 87% of Uruguayan energy produced was hydroelectric, and 12.5% of the total was thermal using fossil fuels, while only 0.3% was biomass-fuelled thermal. The main advantage of hydroelectricity is that once the dam construction costs are dealt with, the variable costs are usually low, no matter how much energy is generated. However, this kind of generation proves highly sensitive to changes in weather conditions. In other words, appropriate levels of water reserves need to be available, which is not always the case, and if not then it is necessary to resort to other alternative generation sources, as can be observed in the dips in the series in figure R.2.2.

Figure R.2.2
Participation in different electrical generation sources

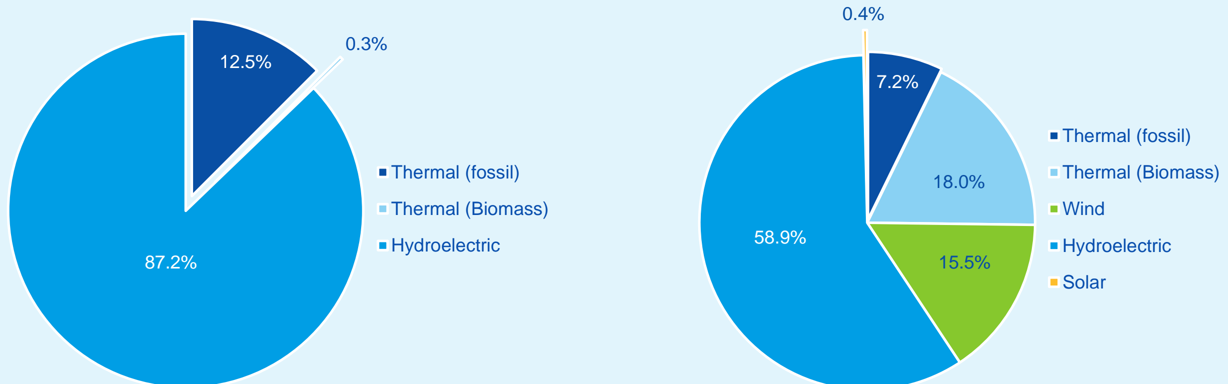


Source: Ministry of the Economy and Finance and BBVA Research

In Uruguay's case, in low hydroelectricity periods, fossil-fuel thermal generation was used, substantially increasing generation costs, particularly in years of high oil prices (Uruguay lacked this resource so had to import it).

Over the years, with the help of the incentives granted to investments in the energy sector, Uruguay has managed to diversify its generation sources, underpinned in particular by the most efficient generation sources. Hence, by 2015, hydroelectric energy is still the most important energy source, but it now represents a lower share of total generation. Fossil-fuelled thermal generation, meanwhile, has paled in significance and has made way for other renewable energy sources such as wind energy, biomass-fuelled thermal and solar energy.

Figure R.2.3
Comparison of energy matrix 2005 vs. 2015



Source: Ministry of the Economy and Finance and BBVA Research

Fiscal impact of changes in electrical generation sources

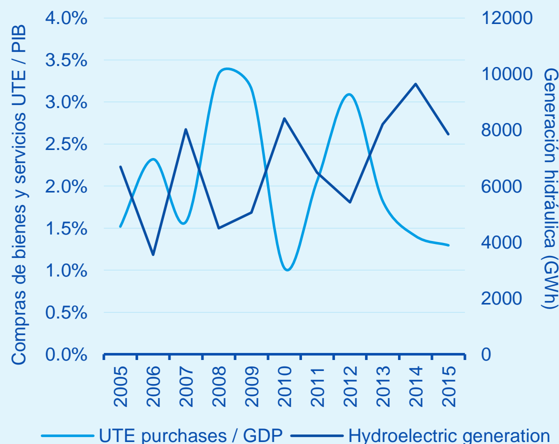
Through the state-owned ANCAP, Uruguay imports all the oil it uses. The oil is either refined and then sold to service stations, to be subsequently sold to the public, or it is sold to companies which use it as a commodity, for example, UTE, the state utility company. This means UTE had to incur higher costs when it had to import oil through ANCAP to flesh out the energy supply with thermal production sources.

Another problem Uruguay had to face with this scheme was that at the same time as the oil “super cycle” which launched halfway through the past decade, it faced low water reserve (hydroelectricity) periods, so it was necessary to complement thermal generation running up higher costs by importing oil from abroad.

This was taking place during the same period in which the government had to contain prices, given that inflation was outside the target range and was becoming one of the main destabilising factors of the Uruguayan economy. Administered prices (one of which was electricity tariffs) was one of the policies used to ensure that inflation did not grow even more sharply.

Figure R.2.4 below shows the correlation between low hydroelectricity, and, hence, low energy generation, based on dam utilisation, and necessary oil acquisitions by UTE, the state energy company, to complete supply and so meet growing demand. In recent years, not only has Uruguay achieved maximum hydroelectric generation levels, but it has also reduced its oil usage through diversifying its generation sources.

Figure R.2.4
Correlation between hydroelectric generation and UTE oil acquisitions



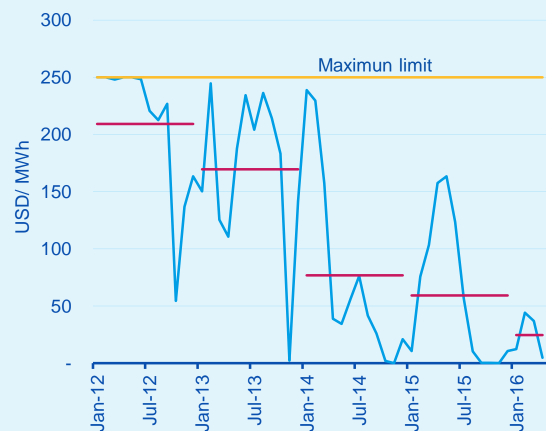
Source: UTE, Ministry of the Economy and Finance and BBVA Research

The change in the energy matrix in recent years, coupled with the heavy slump in the international oil price, has released pressure on UTE's revenues and on the public accounts, and particularly on electricity tariffs and inflation.

Beyond the volatility in spot electricity price per se, as we can see in R.2.5 the spot price has fallen significantly in recent years. In fact, the spot price will depend on the generation mix according to the source in question.

In periods in which solely hydroelectric energy is used, the price will be very low given that its variable cost is close to zero. When thermal (fossil) sources are used, however, the price is set by the generator with the least yield and therefore the highest variable costs, on top of the oil price.

Figure R.2.5
Electricity Price USD/MWh



Source: Ministry of the Economy and Finance and BBVA Research

Final conclusions

Uruguay's successful transformation of its energy matrix has had important impacts on its economy:

- First, an improvement in the environmental impact of electrical generation due to the shift towards the use of renewable energies.
- Greater diversification of electrical generation sources means less uncertainty and dependency on having benign weather conditions for hydroelectric generation.
- This diversity also reduces the country's dependency on imported oil, making generation more predictable and giving energy prices greater stability. This new matrix improves one of the problems which we pinpointed as a component of the structural current account deficit, the **energy balance**, which we analysed in "*Sustainability of the current account*" in *Uruguay Economic Outlook 2H 2013.*
- Companies' costs tend to fall (due to lower energy prices), making them more competitive.

9 Tables

Table 9.1
Macroeconomic forecast

	2013	2014	2015	2016f	2017f
GDP (% y/y)	4.6	3.2	1.0	0.7	1.5
Inflation (% y/y, eop)	8.5	8.3	9.4	9.2	8.7
Inflation (% y/y, average)	8.6	8.9	8.7	9.7	7.7
Exchange rate (vs. USD, average)	21.3	24.1	29.7	35.2	37.1
Exchange rate (vs. USD, eop)	20.4	23.2	27.3	33.5	36.2
Interest Rate (%, average)	17.7	21.5	21.4	24.3	22.8
Public Consumption (%y/y)	5.5	3.0	0.0	0.1	1.5
Fiscal Balance (% GDP)	4.9	2.5	2.6	0.0	1.0
Current Account (% GDP)	4.8	0.0	-7.7	2.0	4.0
GDP (% y/y)	-2.4	-3.5	-3.5	-3.5	-3.4
Inflation (% y/y, eop)	-5.0	-4.6	-3.6	-3.3	-2.7

Source: BBVA Research

Table 9.2
Macroeconomic forecast

	GDP (% y/y)	Inflation (% y/y, avg)	Exchange Rate (vs. USD, avg))	Interes Rate (%, avg)
T1 14	3.3	9.6	22.0	22.0
T2 14	3.7	9.1	22.9	21.9
T3 14	3.7	8.7	23.7	21.0
T4 14	2.4	8.1	24.2	21.2
T1 15	4.2	7.7	24.8	21.2
T2 15	-0.5	8.4	26.5	21.2
T3 15	0.5	9.2	28.3	20.6
T4 15	-0.1	9.3	29.5	22.8
T1 16	-0.1	10.2	31.5	23.0
T2 16	0.9	10.4	33.0	25.7
T3 16	0.5	9.5	34.2	24.6
T4 16	1.5	8.7	34.7	23.8
T1 17	1.4	7.1	35.5	22.0
T2 17	1.6	7.2	36.0	22.3
T3 17	1.8	7.9	36.5	23.0
T4 17	1.3	8.5	37.0	23.8

Source: BBVA Research

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