ECONOMIC OUTLOOK

URUGUAY

SECOND HALF 2016

- The global economic scenario continues to point to a slow recovery. GDP growth will improve slightly from the second half of 2016, but global risks remain high.
- Inflection point in Latin America. GDP growth will go from -1.2% in 2016 to 1.5% in 2017. We are starting to see the first signs of an upturn in activity in some countries in the region, but recovery will be gradual in 2017 and still below the potential growth in many countries.
- Uruguay will grow by just 0.5% in 2016, but expectations for 2017 are improving thanks to a positive contribution from external demand. In turn, private consumption will start to revive as purchasing power continues to improve thanks to slowing inflation.
- Inflation is starting to ease thanks to reduced pressures from the exchange rate and from demand, but will once again exceed the target range. Prices will increase by 9.2% in 2016, with a slight easing to 8.7% in 2017 as restrictive monetary policy is maintained and wage increases slow.
- We see the US dollar ending 2016 at 28.40 pesos and 2017 at 30.70 pesos. The peso's appreciation since the end of the first quarter of 2016 has basically been due to the strengthening of the Brazilian real, lower expectations of a rate hike by the Federal Reserve following Brexit and the lack of demand from major players such as banks and pension funds.

BBVA | RESEARCH

GLOBAL

SLOW RECOVERY IN GROWTH

GLOBAL FACTORS

Positive data, but risks still high

POSITIVE FACTORS

- Global trade is recovering
- Central banks are supporting growth
- Relative calm in financial markets and capital inflows to emerging ones
- Activity improving in China and emerging countries

BUT THE RISKS ARE HIGH

- Systemic risk in China
- Brexit and other risks in Europe
- Uncertainty about policies in the US
- **Geopolitics:** Middle East, Russia

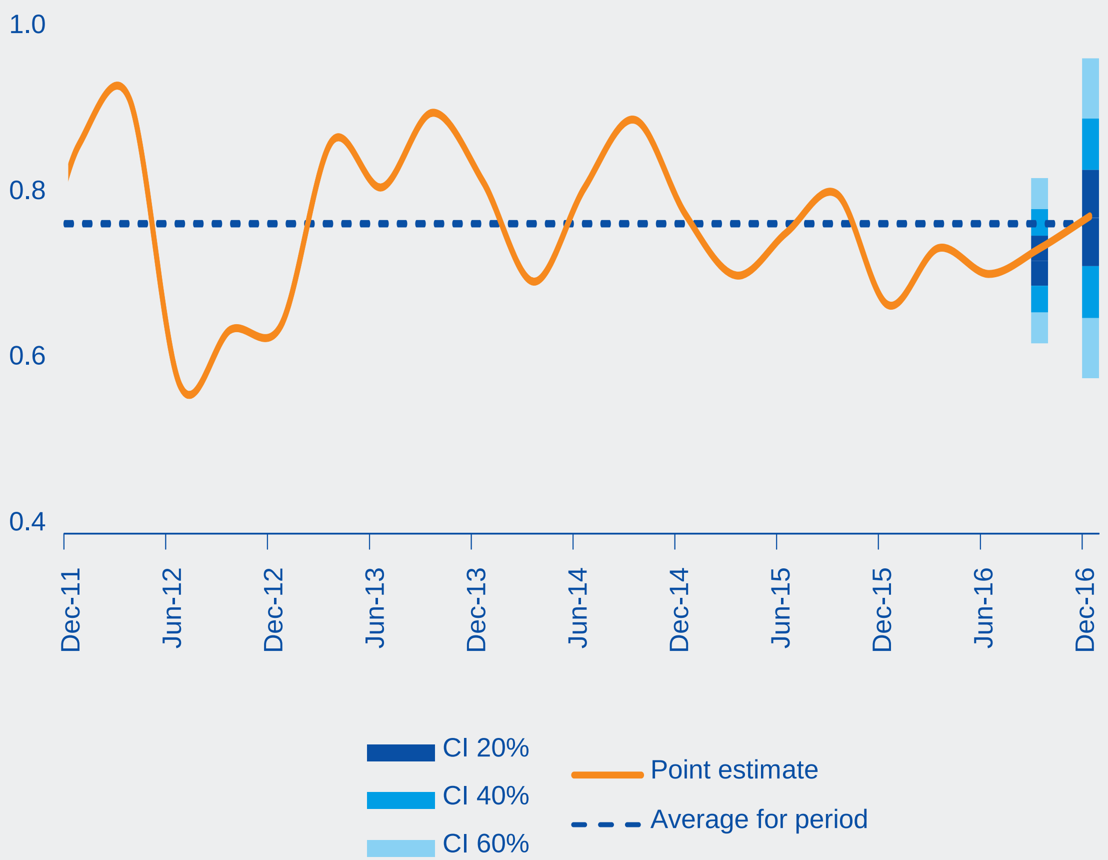
WORLD GROWTH

The data show a slight improvement in stable world growth in the second half of the year

- Retail sales suggest a strong boost to global consumption
- Confidence data are somewhat more optimistic, showing recovery in many countries, but data on activity are not yet conclusive
- We have revised our world growth forecast slightly downwards to 3.0% for 2016 while retaining our outlook for a slight improvement to 3.2% in 2017

WORLD GROWTH (% QUARTERLY, ANNUALISED)

Forecasts based on BBVA-GAIN (% QoQ)



Source: BBVA Research

WORLD GROWTH

Factors affecting recovery

Central banks and low interest rates

Low interest rates are here to stay, due to cyclical and structural problems

Expansive monetary policies in the developed countries are nearing their limits

Coordination of the various different policies

Growing calls for **fiscal and structural policies to complement monetary policy**

The US and Germany have room for **expansive fiscal measures**

Other countries have scope to modify the **composition of public expenditure**

Global trade

Fall in global activity leading to reduced trade…

... but the correlation between trade and global GDP growth is less clear than it was before the crisis

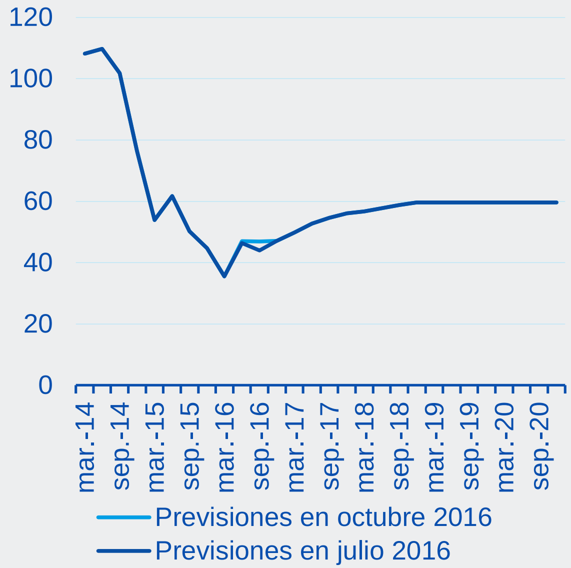
1. Contraction of value chains (China)
2. Less investment globally
3. Protectionism

Slow recovery of trade

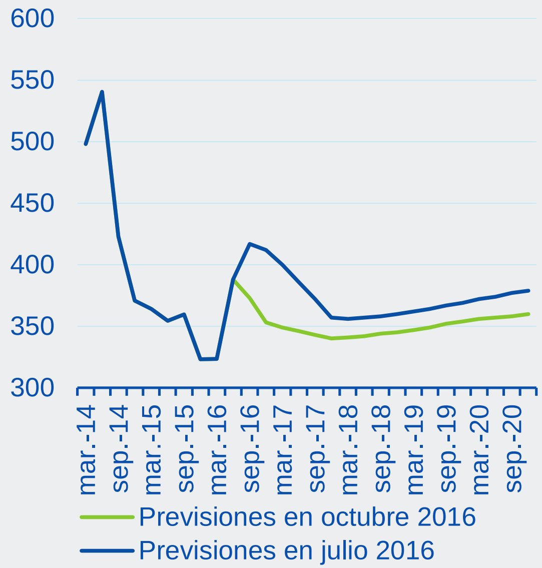
COMMODITIES

Oil and copper in line with very gradual recovery. Soybeans affected by increased supply

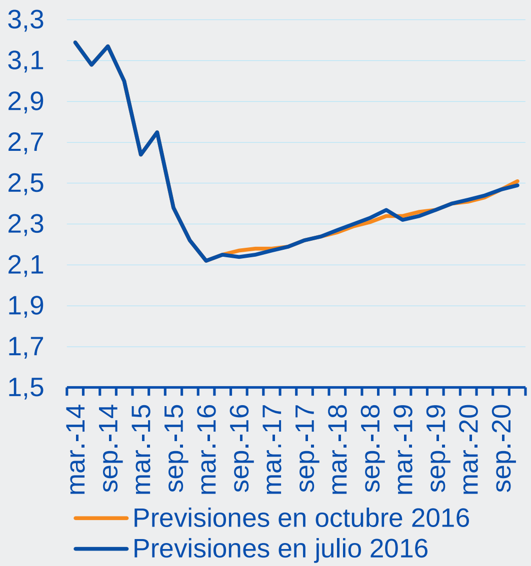
BRENT CRUDE
(US$ per barrel)



SOYBEANS
(US$ per metric ton)



COPPER
(US$ per lb.)



- Oil and copper prices will recover gradually as the current oversupply is absorbed
- The price of soybeans is adjusted downwards due to the upward surprise in world harvests, especially in the US and Brazil

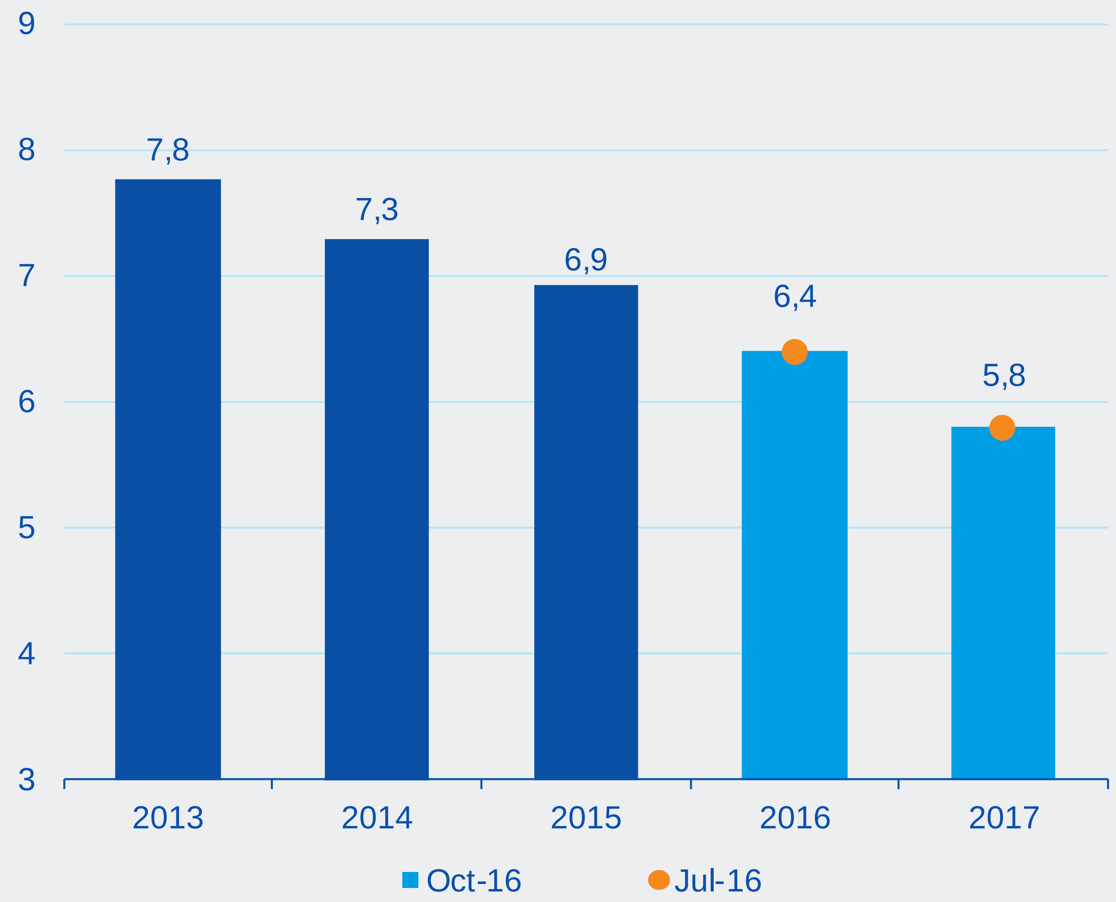
Source: BBVA Research and Bloomberg

CHINA

Baseline scenario still incorporates gradual adjustment. Slight upward revision in 2016

- **Domestic demand strengthened** by new monetary and fiscal stimulus
- The authorities have **postponed any additional monetary measures** with a view to curbing the real estate bubble, while continuing to move ahead with macroprudential measures
- Risks remain in the medium term:
  1. Indebtedness of private companies and lack of reforms in public ones
  2. Real estate market
  3. Capital outflows and currency depreciation
  4. Shadow banking

CHINA: GDP GROWTH
(%)



Source: BBVA Research

UNITED STATES

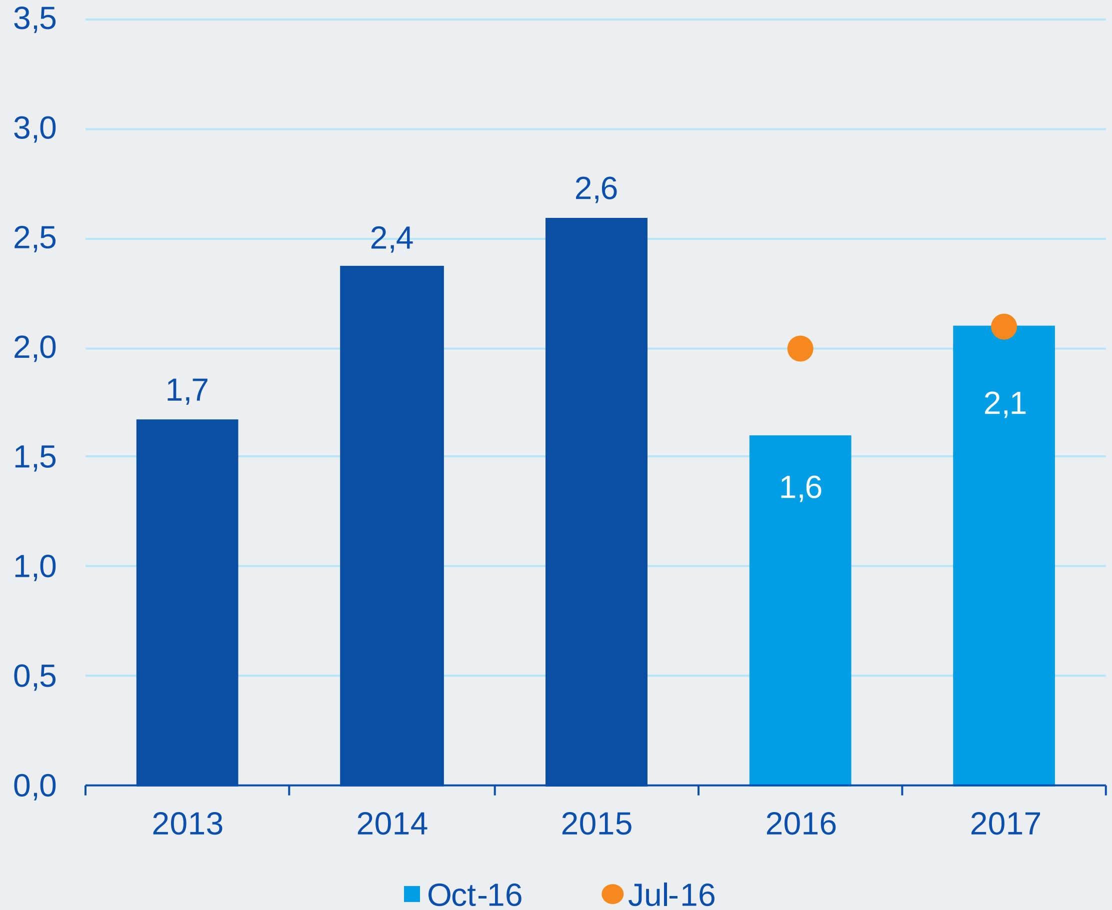
Growth for 2016 revised downwards

- Revised downwards due to:

  1. indicators suggesting **insufficiently strong growth** in 2H16 following the weak first half
  2. persistently **low productivity**

- **US Federal Reserve**: we expect an interest rate increase in December 2016 and two in 2017, up to 1.25%
- **Uncertainty about the policies** that the new president Trump will implement from 2017 on

UNITED STATES GDP GROWTH
(%)



Source: BBVA Research

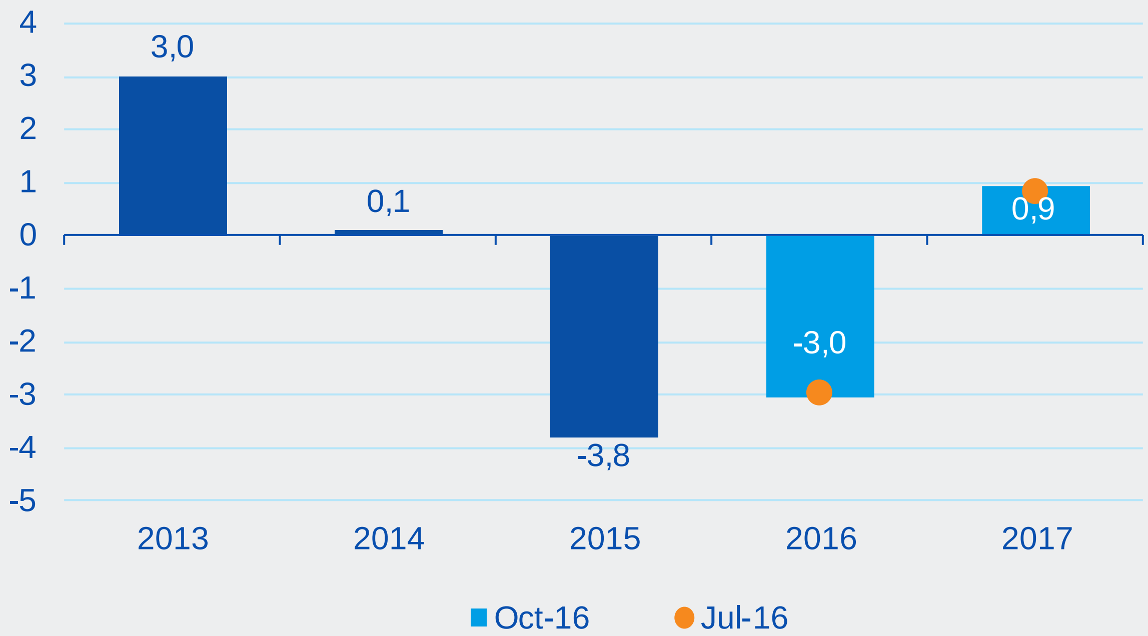
LATAM

Towards a gradual recovery of growth

BRAZIL

Renewed growth in 2017

BRAZIL: GDP GROWTH
(%)



- Reduced political uncertainty and increased confidence
- It now looks more likely that the proposed fiscal reforms will be approved by Congress, and this could nudge growth upwards in 2017
- Risks:
  - Solvency of the public sector
  - Corporate sector exposed to impairment due to its indebtedness, high interest rates and weak demand

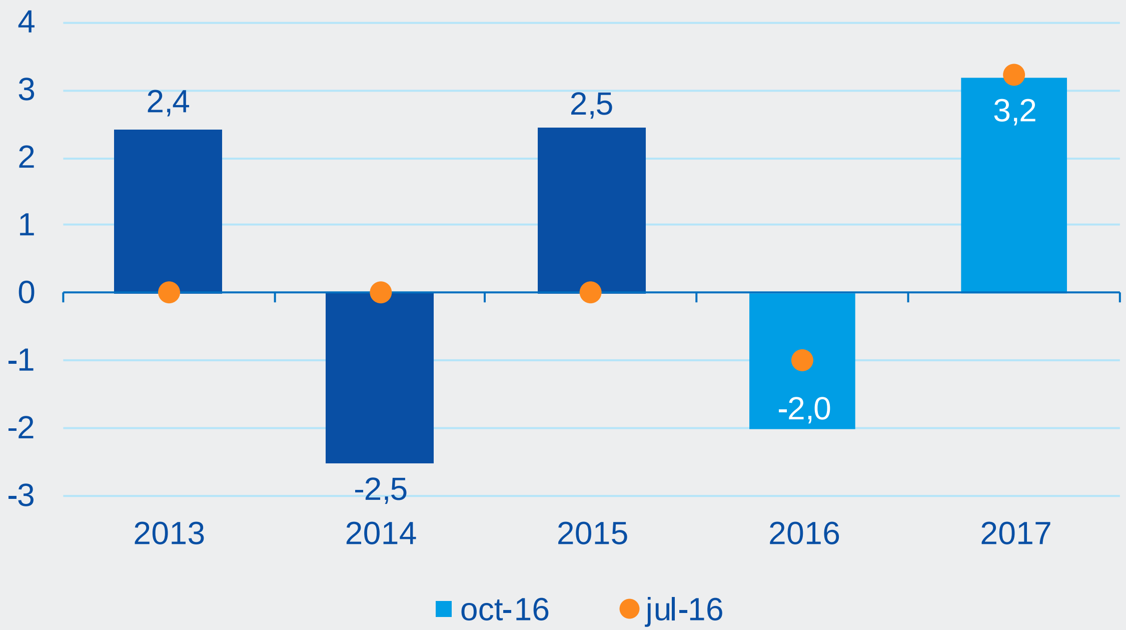
Source: BBVA Research

ARGENTINA

The economy has contracted more than expected in 2016, but will grow by 3.2% in 2017

- The economy seems to have touched bottom in 3Q16, which would mean an average fall in GDP of 2% for 2016. In 2017, a strong boost from investment and a moderate one from consumption should produce growth of 3.2%
- Inflation slowed sharply in 3Q16 to a monthly average core inflation rate of around 1.6%. The Central Bank will hold positive real rates high until the gap between expectations and its objectives is closed.
- Substantial inflows of currency due to public and private sector debt issues exert downward pressure on the peso. We estimate 15.70 pesos to the dollar for year-end 2016 and 17.60 pesos to the dollar for year-end 2017

ARGENTINA: GDP GROWTH
(%)



Source: BBVA Research

URUGUAY

SECOND HALF 2016

GDP 2016

“Saved” by electricity, though it will grow by just 0.5%

By supply sector:

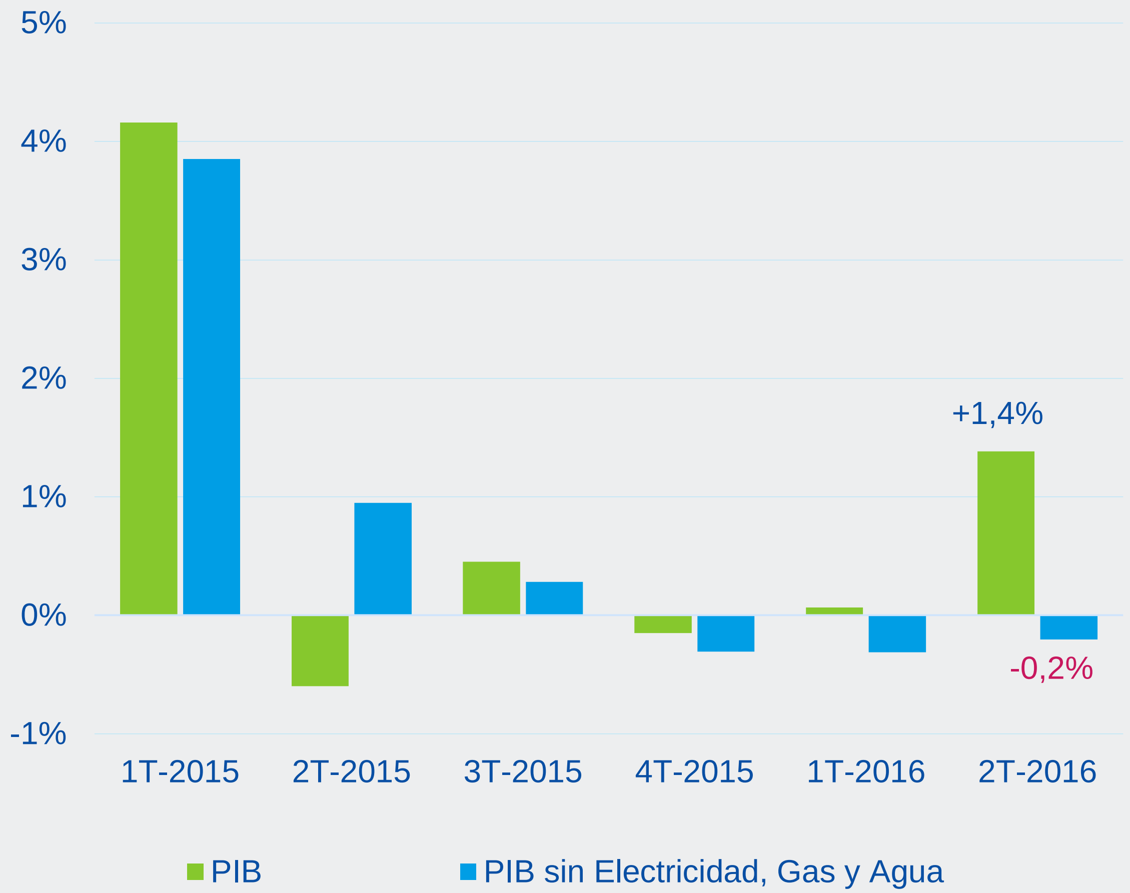
- The significant increase in generation of low-cost electricity was made possible by the large role played by hydroelectric power stations.

By expenditure item:

- Strong boost from investment, public and private, linked to renewable energy projects (wind turbines)

Although the economy is relatively sluggish, prospects are improving, staving off the risk of recession. The easing of inflation, mainly due to reduced exchange rate pressure, has increased households’ purchasing power, and this has translated into higher levels of confidence

QUARTERLY GDP WITH AND WITHOUT THE ELECTRICITY SECTOR
CHGE. % REAL YoY

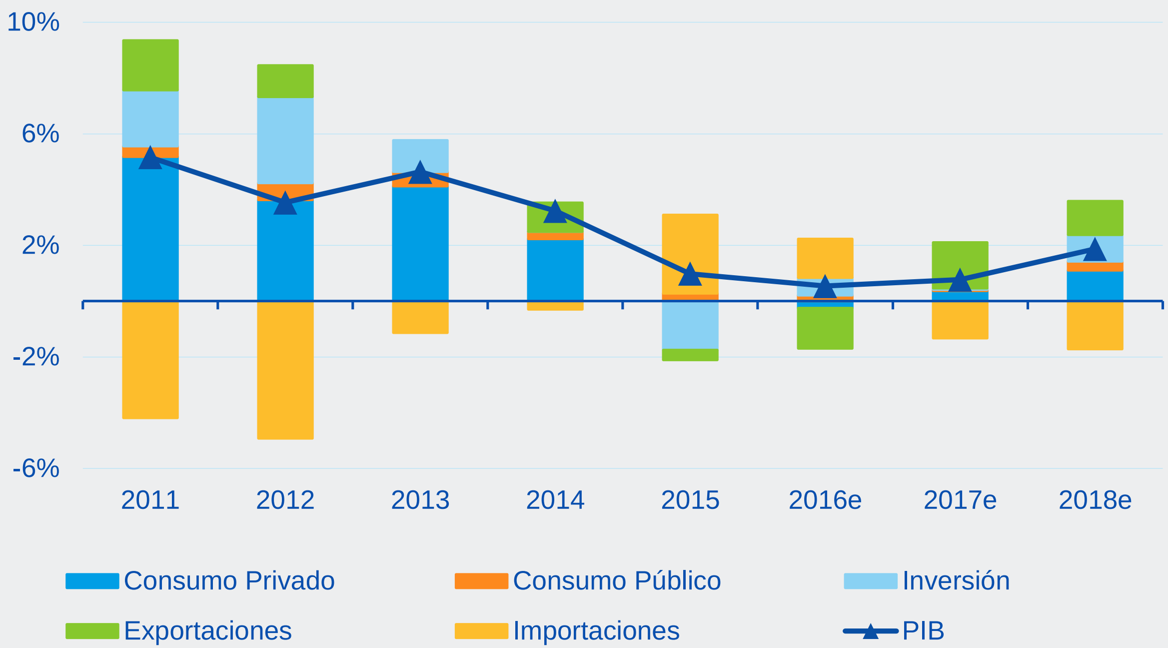


Source: BBVA Research based on BCU (Central Bank of Uruguay) data

GROWTH IN 2017

The external sector will start to make a positive contribution to GDP, in contrast to domestic demand which will remain lacklustre in 2017

CONTRIBUTIONS TO GROWTH
CHANGES % REAL YoY



Growth in 2017 around 0.8%

- Improvements in the regional context thanks to the recovery of growth in Brazil and Argentina will lead, albeit gradually, to increased exports
- Improvements in private consumption will be gradual, as lower inflation and modest increases in real wages at least partly offset increased unemployment
- We do not expect investment to start picking up until early 2018 with construction of the third cellulose plant, which will require private sector investment of US$4 billion and public investment (in infrastructure) of US$1 billion

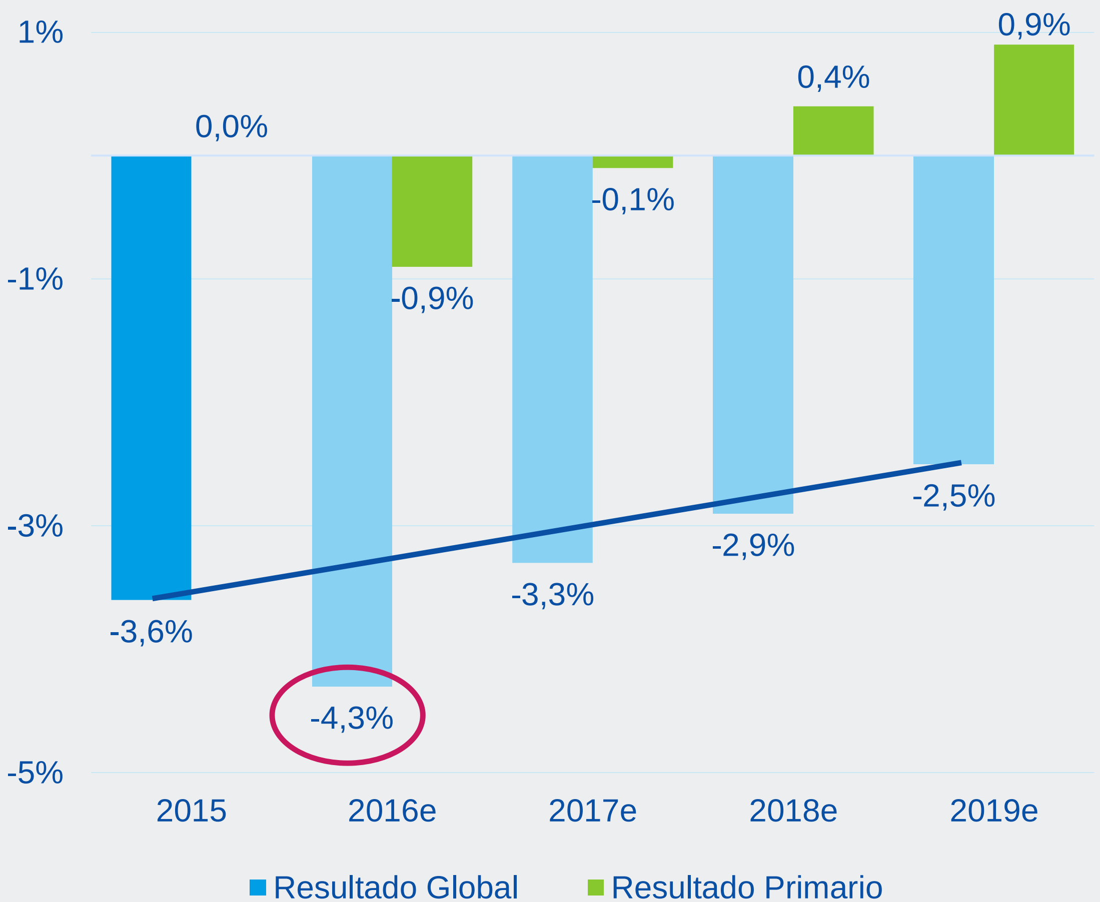
Source: BBVA Research based on BCU data

FISCAL

The government's fiscal forecasts have been revised in view of the more adverse environment

- In June the balance of the budgetary execution was struck (known as **Rendering of Accounts**) for 2015 and the official forecasts were revised
- **The government increased its projection of the fiscal deficit for 2016 to 4.3% of GDP**
- With fiscal adjustment however the objective of reducing it to 2.5% of GDP by 2019 is maintained

CHANGES IN THE FISCAL RESULT PROJECTED BY THE GOVERNMENT
(% OF GDP)



Source: BBVA Research

The government proposed fiscal adjustment to correct the imbalance and safeguard the country's investment grade rating

The main thrust of the fiscal adjustment aims to reduce the deficit by 1% of GDP every year from 2017

REVENUE:

- VAT reduced by 2 pp for purchases with debit cards
- IRAE (corporation tax): changes to calculation (2016)
- IRPF (personal income tax) increased rates (from January 2017)

+0.7% of GDP

EXPENDITURE:

- Central government (deferred expenditure)
- Public companies (cut-backs in investment)
- Transfer from Caja Militar (military pension fund)

+0.3% of GDP

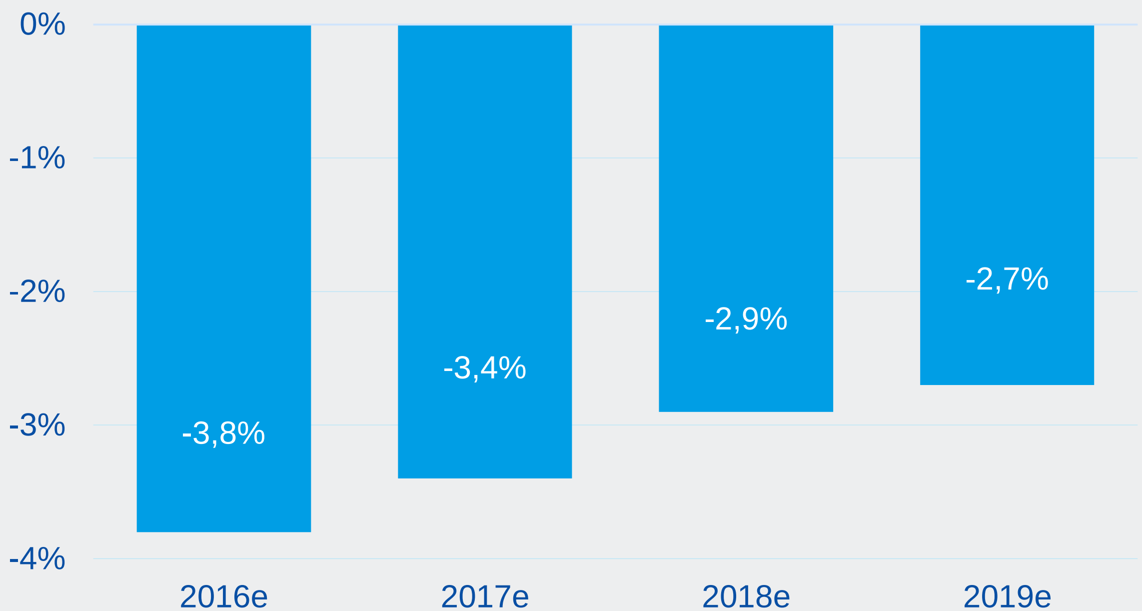
- Corporation Tax (IRAE): January 2016
- Personal Income Tax (IRFP): January 2017

FISCAL ADJUSTMENT

As presented it is not enough to attain the budgetary target of a deficit of 2.5% in 2019

- For 2016 we estimate a deficit of 3.8% of GDP. The result for the 12 months to September (-3.5%), which includes the effect of the cancellation of ANCAP's debt to PDVSA (ANCAP being Uruguay's and PDVSA Venezuela's state-owned oil company)
- The main fiscal adjustment is taking place by means of tariffs. These have ceased to be a tool for controlling inflation and started to better reflect public companies' costs
- For 2017 personal income tax rates will increase, directly affecting higher income consumers.
- Little improvement in the deficit in 2017 (to 3.4% of GDP). The tax reform will increase revenues from direct taxation, but it will discourage consumption and have a negative impact on VAT revenue

BBVA's FISCAL DEFICIT FORECAST
% OF GDP



Source: BBVA Research

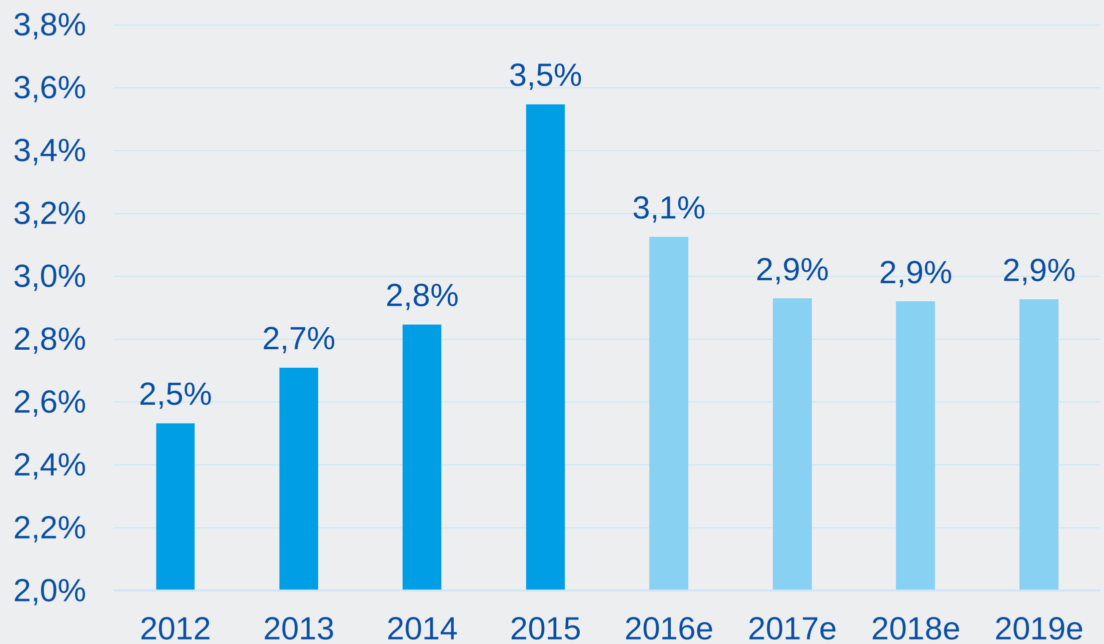
FISCAL VULNERABILITY

Reducing fiscal vulnerability is proving costly

- Uruguay has a substantial financial burden, which is almost entirely responsible for the fiscal deficit
- The policy of financing the deficit in advance allows it to protect against unexpected shocks, but it also generates a cost, which is rolled up in the interest charge
- Contingent credit lines with World Bank, Development Bank of Latin America, IDB and FLAR (Latin American Reserve Fund) total 4.2% of GDP. Available for any eventuality, they also generate cost, albeit limited

The downward rigidity of primary spending, in a context of low growth, limits the chances of obtaining a primary surplus big enough to bring down levels of indebtedness

CONSOLIDATED PUBLIC SECTOR INTEREST
% OF GDP

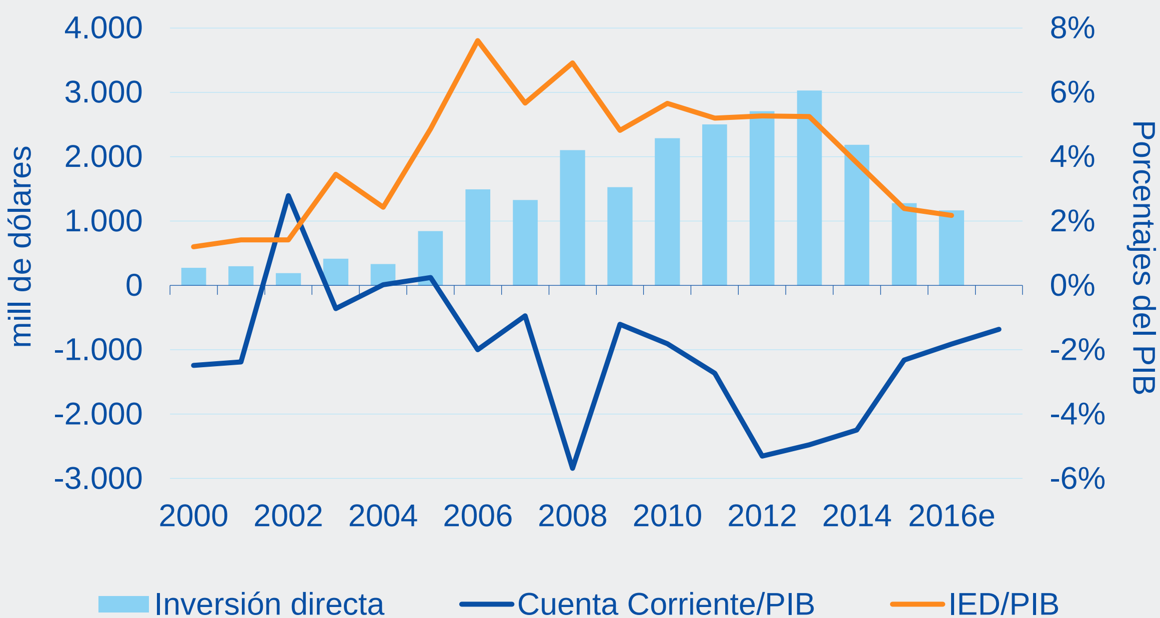


Source: BBVA Research

EXTERNAL ACCOUNTS

Significant improvement…

CURRENT ACCOUNT AND FDI
% OF GDP



- Substantial improvement in the balance of trade: imports have fallen by more than exports, both in volumes and in price
- In 2017 we expect a significant improvement in the tourist season, which will have a positive effect on the current account, bringing it to -1.4% of GDP
- FDI continues to finance the deficit, although in the absence of major investment projects it has been slowing
- We see the current account starting to deteriorate gradually from 2018 as a result of the construction of the third cellulose plant

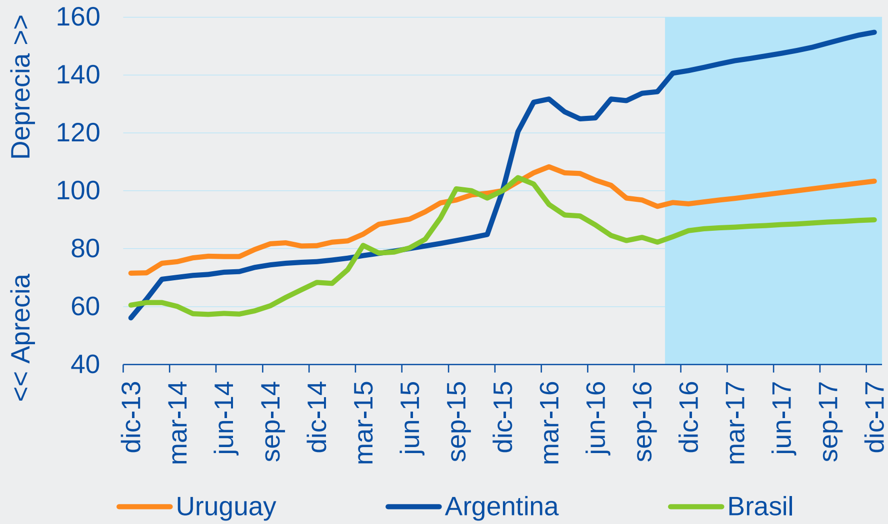
Source: BBVA Research and the Uruguayan Central Bank

EXCHANGE RATE

The peso is appreciating… in step with the real

EXCHANGE RATES

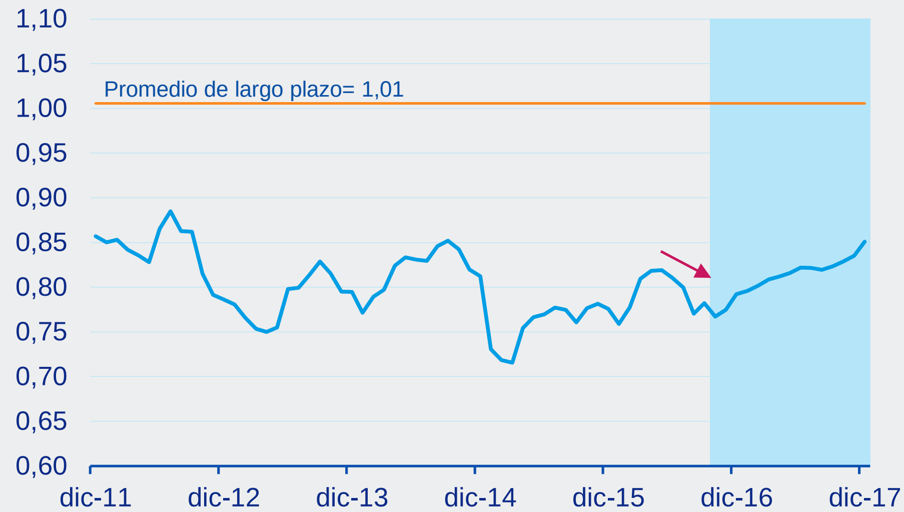
Base 100 = DEC 2015



- The peso seems unable to break free from trends in Brazil's currency, whether rising or falling

REAL MULTILATERAL EXCHANGE RATE

BASE DEC 2001 = 1



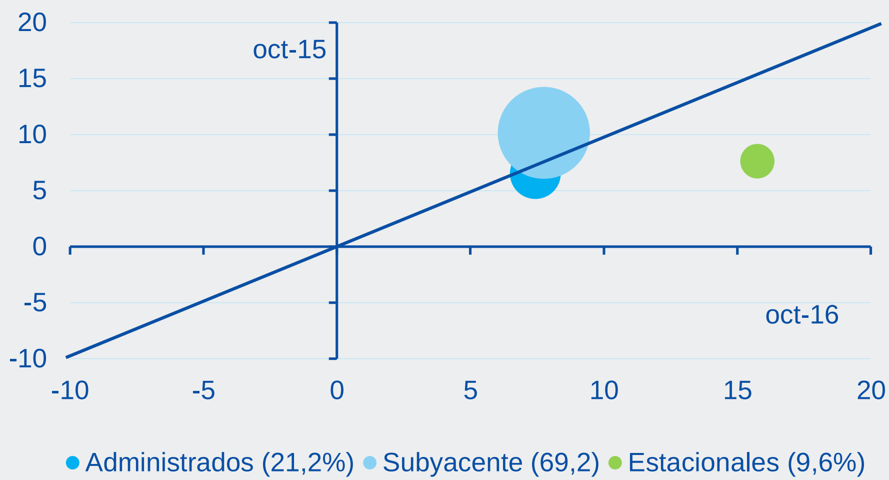
- … following the recent appreciation, the real rate of exchange will continue to make gains in competitiveness in 2017 due to the real appreciation of Argentina's currency

Source: BBVA Research and Haver

PRICES

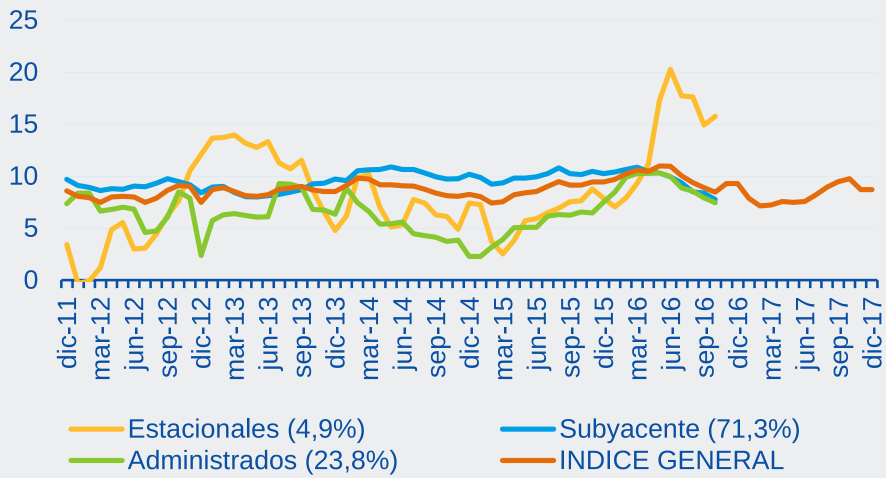
Prices are increasing more slowly, but inflation is still above the Central Bank's target range, reaching 9.2% in 2016

CPI BY COMPONENTS
CHGE. % YoY



- In October 2016, core inflation slowed to 7.7% YoY from its peak of 10.9% in March. In October 2015 it accounted for 77% of the year-on-year increase, but in October it represented just 63%

CPI BY COMPONENTS
CHGE. % YoY



- Administered prices for their part continue to recover ground lost in 2014, showing the importance attached to the fiscal balance and the abandonment of tariffs as a tool for countering inflation

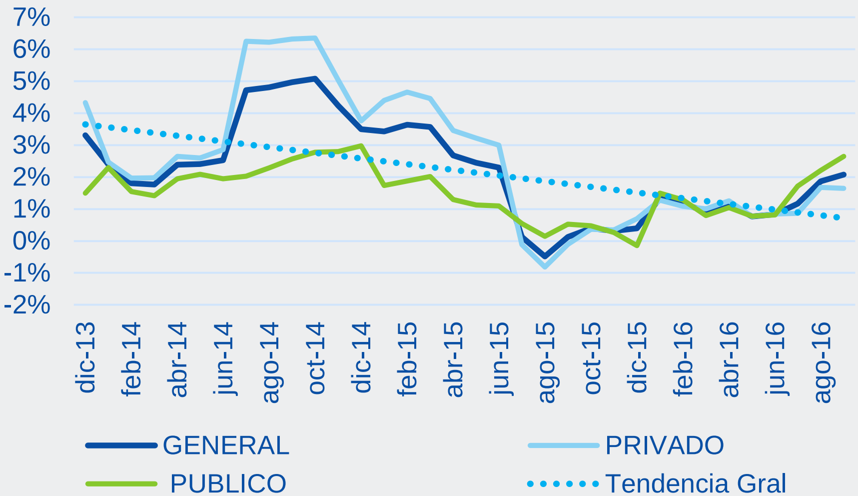
Source: BBVA Research and INE (National Statistics Institute)

WAGES AND MONETARY POLICY

Contained real wage increases and a contractive monetary policy will contribute to inflation's easing to 8.7% in 2017

EVOLUTION OF REAL WAGES

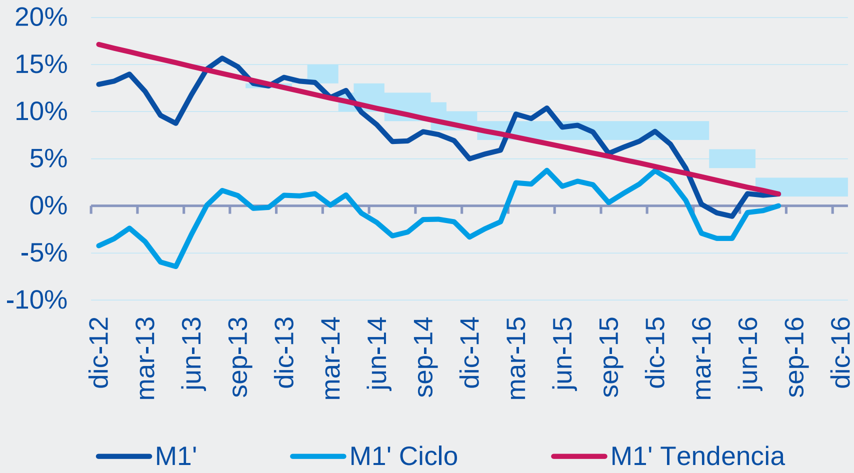
CHGE. % YoY



- Moderation in growth of real wages due to weak activity and the coming into force of new agreements on setting declining nominal wage increases

MONETARY POLICY

Broad M1, target range



- The Central Bank reinforces and conforms to its tough image. Increased likelihood of macroprudential measures to dampen the peso’s appreciation

Source: BBVA Research and INE (National Statistics Institute)

Forecasts

Uruguay	2013	2014	2015	2016e	2017e
GDP (% YoY)	4.6	3.2	1.0	0.5	0.8
Inflation (% YoY, eop)	8.5	8.3	9.4	9.3	8.7
Inflation (% YoY, eop)	8.6	8.9	8.7	9.8	8.2
Exchange rate (per USD, eop)	21.3	24.1	29.7	28.4	30.7
Exchange rate (per US$, average)	20.4	23.2	27.3	30.2	29.6
Asset interest rate (%, average)	17.7	21.5	21.4	22.8	23.1
Private Consumption (% YoY)	5.5	3.0	0.0	-0.3	0.5
Public Consumption (% YoY)	4.9	2.5	2.6	2.0	0.5
Investment (% YoY)	4.8	0.0	-7.7	3.0	0.2
Tax Revenue (% GDP)	-2.4	-3.5	-3.5	-3.8	-3.4
Current Account (% GDP)	-5.0	-4.5	-2.3	-1.8	-1.4

Source: BBVA Research

ECONOMIC OUTLOOK

URUGUAY

SECOND HALF 2016