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URUGUAY Economic Outlook

The economy is recovering despite greater global uncertainty

MAY 2017

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Main messages

- World growth continues to improve, accompanied by a certain clarification of US policies. Overall, global risk remain a concern.
- The downturn in Latin America ends. Growth is expected to increase from -1.4% in 2016 to 1.1% in 2017 and 1.8% in 2018. Growth will still be below the potential for the region, closer to 3%.
- Uruguay returns to growth, 1.9% in 2017 and 3% in 2018, with a strong impulse from investment.
- The fiscal balance is improving, although at a slower rate than expected.
- Inflation will remain outside the target range, reaching 8% in 2017 and 7.9% in 2018.
- The Fx rate will end 2017 at $31.1, avoiding a deterioration in competitiveness vis a vis its main regional partners.

Global environment

Growth has consolidated but there are still risks

Positive global dynamics

The main trends continue…

- Recovery of industrial activity and international trade confirmed
- Financial markets stable
- Headline inflation continues to rise, but core inflation holds steady

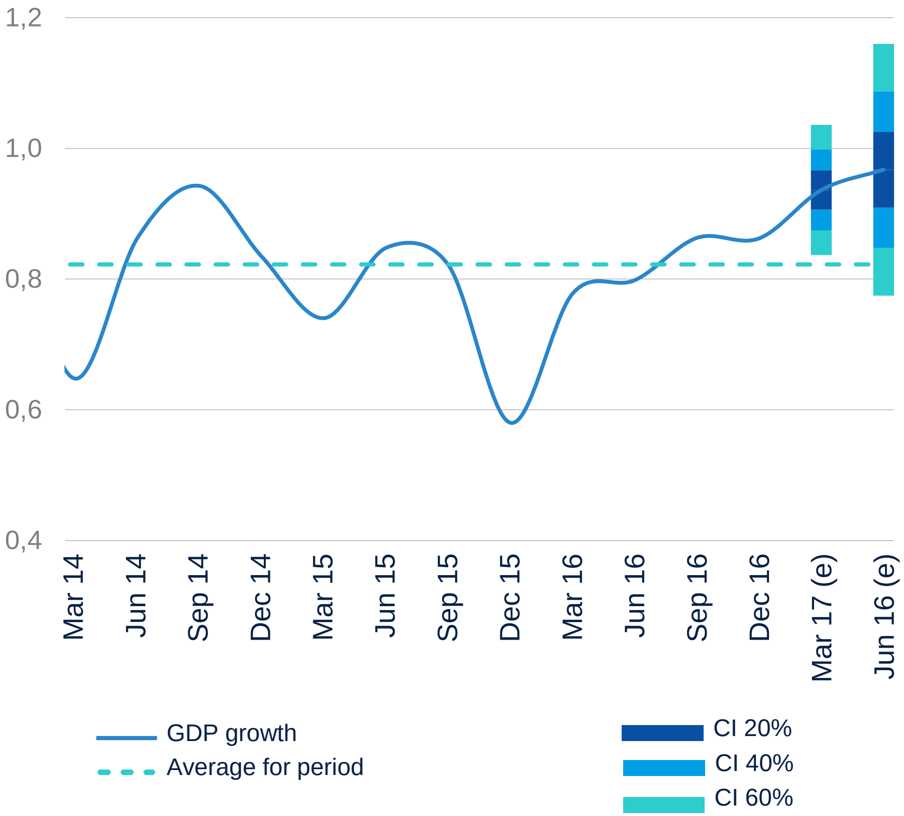
…and the probability of the baseline scenario increases

- Substantial stimulus to the US economy seems less likely…
- …but so do more protectionist scenarios
- Central banks move towards normalisation

The world's economy has been accelerating since early 2017

Growth of gross world product (GWP)

Forecasts based on BBVA-GAIN (% QoQ)

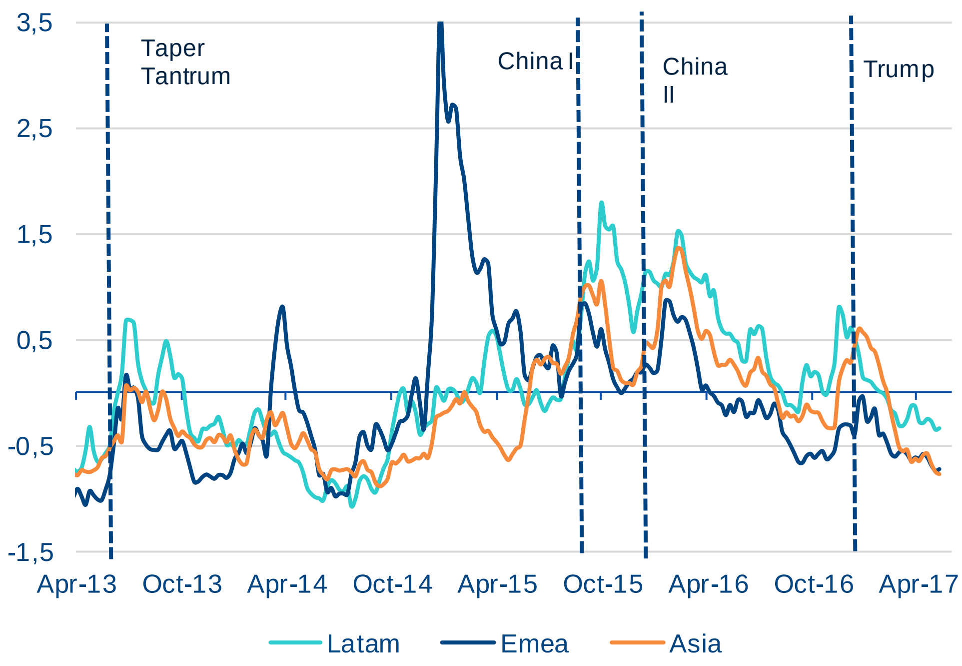


- Confidence indicators are at very high levels, although real indicators only partially reflect the improvement
- China and advanced economies show signs of strength. However, other emerging economies are performing more erratically

Source: BBVA Research

Financial stresses remain low

BBVA financial stress index
(normalised index)



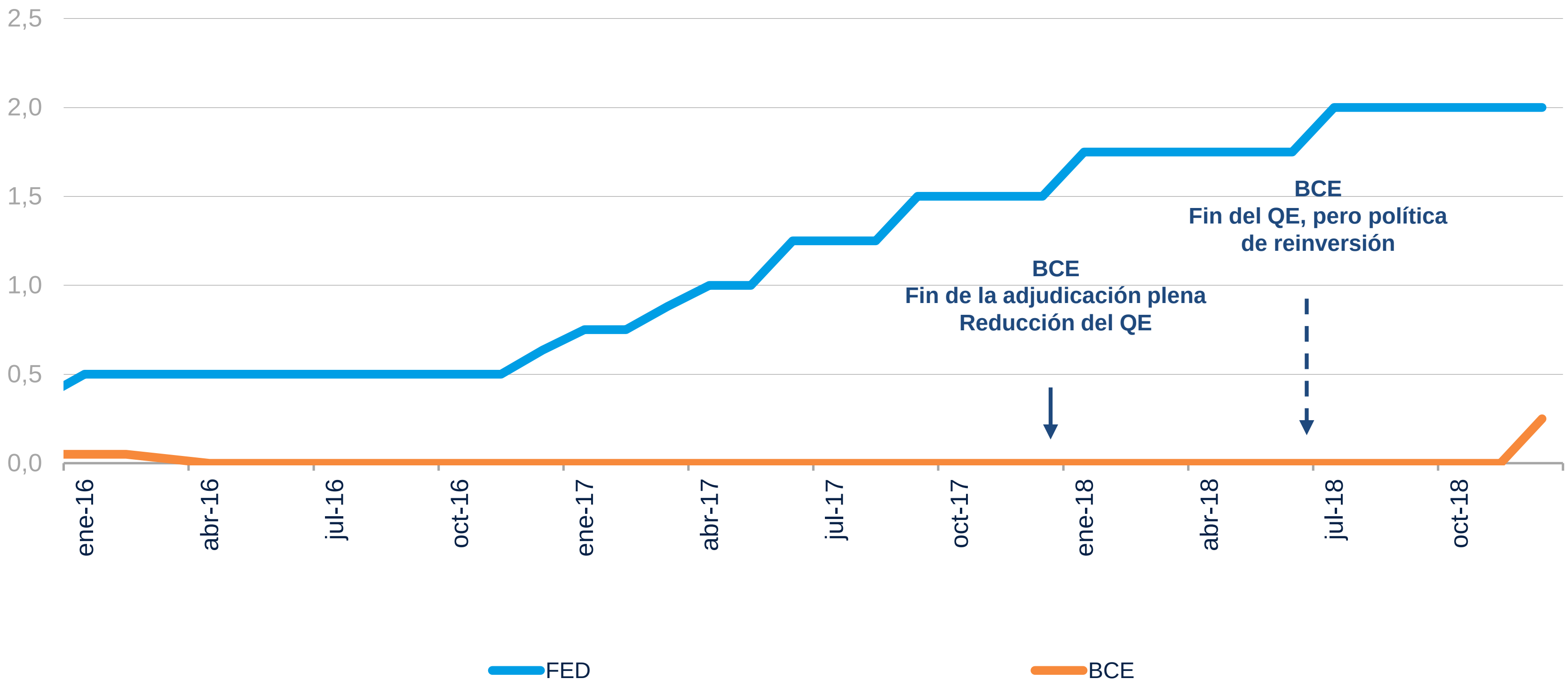
- Volatility has fallen, despite uncertainty about economic policy
- Monetary and fiscal stimulus measures mask a certain underlying unease
- Europe has been the exception, with sovereign spreads rising somewhat, although the tensions have eased after the French elections

Source: BBVA Research

Central banks move towards normalisation of their policies

US Federal Reserve and European Central Bank (ECB) interest rates

(bps)

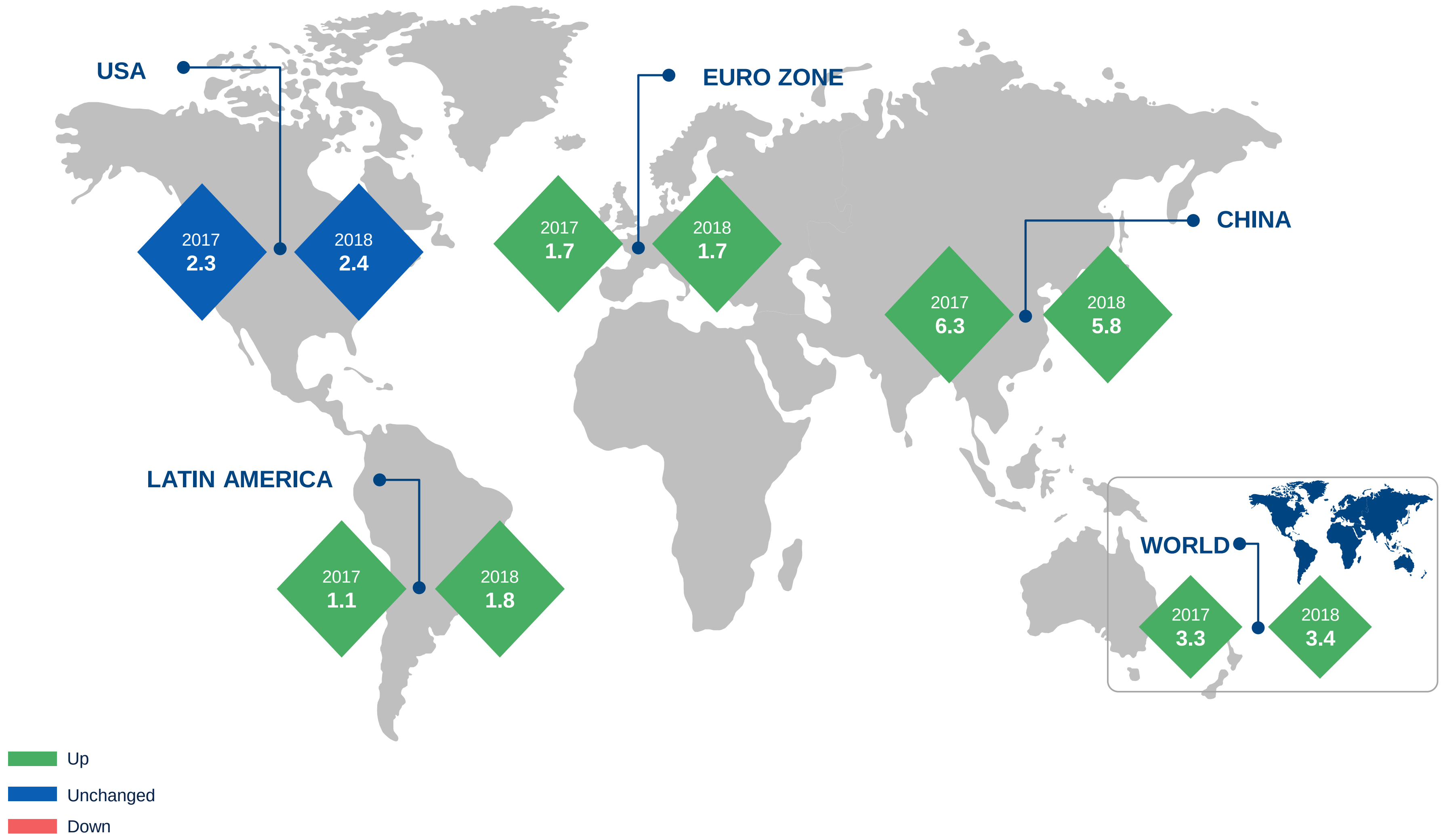


Source: BBVA Research, FED and ECB

The Federal Reserve continues to raise its monetary policy rate, although it remains cautious as far as the economic scenario is concerned

The ECB is increasingly discussing exit guidelines for monetary policy

World growth revised upwards…

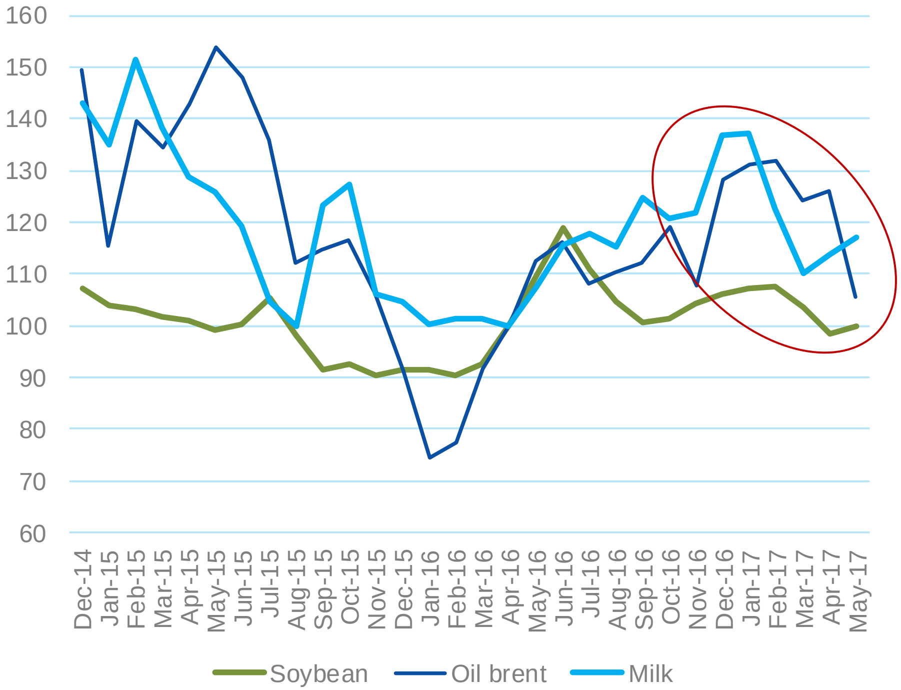


Source: BBVA Research. Latin America comprises: Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

We continue to see commodity prices gently converging to their long-term equilibrium

Favourable exchange rates

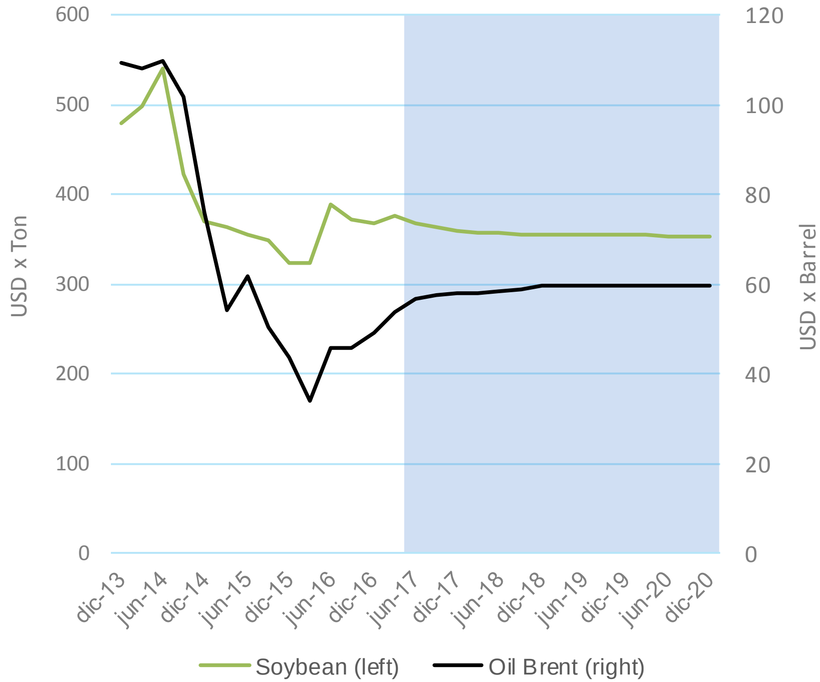
(Apr 16 = 100)



Source: BBVA Research and Haver

Markets close to their long-term equilibrium

(Quarterly averages)



Source: BBVA Research and Haver

Oil prices continue to be supported by the OPEC agreement on production quotas and lower inventories in the US. Prices may end up below our forecast of US$57 a barrel despite demand from China remaining firm.

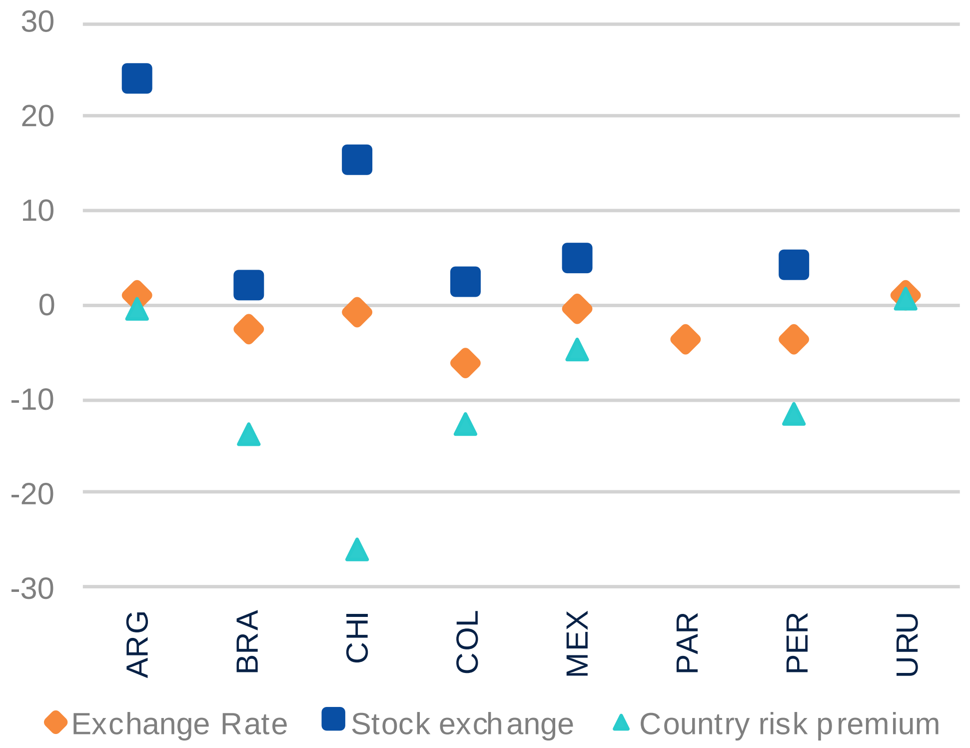
The price of soy beans returned to its 2015 level, with stocks gradually recovering thanks to good harvests in the southern hemisphere.

Similar growth levels in terms of supply and demand have resulted in a gradual downward adjustment to farm prices

The recovery seen in Latin America's financial markets has continued, including in Mexico

- The prices of key financial assets and exchange rates continue to record significant gains this year, due to a number of factors:
  - Less concern regarding the effects of US policy
  - The perception that the Fed will gradually increase interest rates
  - Faster growth worldwide
  - Higher raw material prices
  - Economic activity recovering in a number of countries

Financial asset prices: percentage change since US elections*

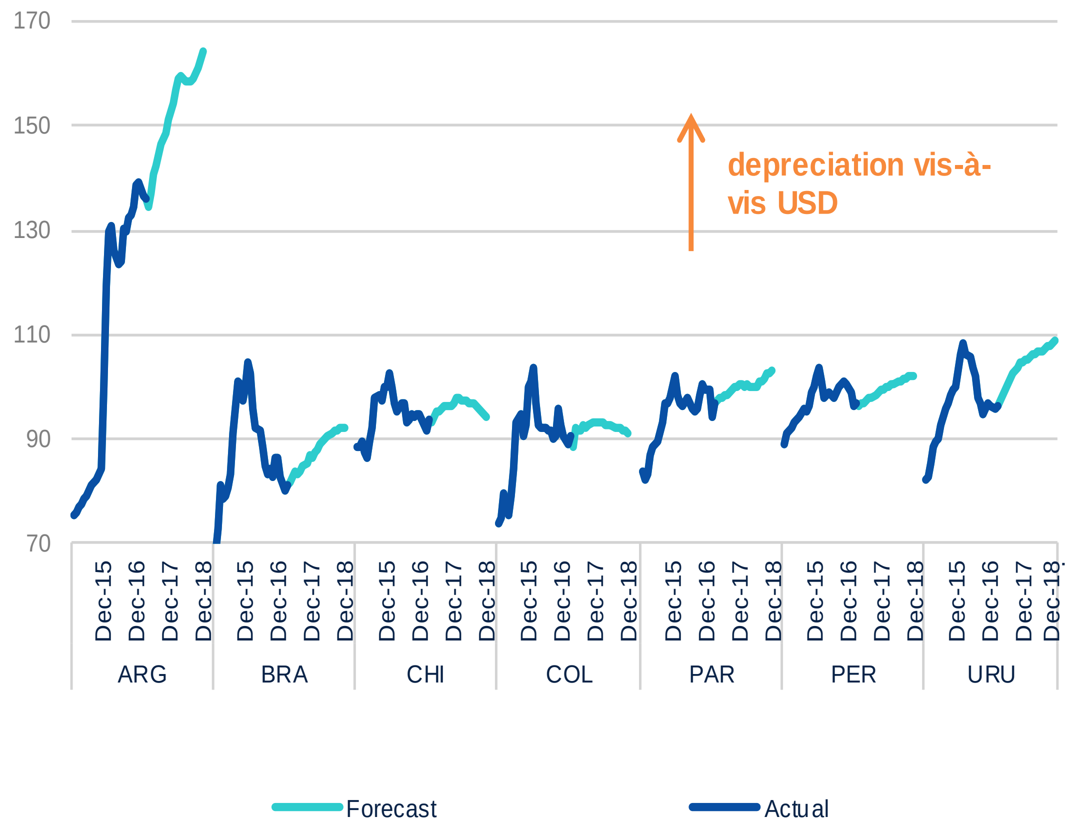


Source: BBVA Research, Haver Analytics and DataStream *Changes between 7 November and 14 April. Exchange rate: domestic currency / dollar. In this case, an increase indicates depreciation. Country risk premium: EMBI.

Certain stability with limited exchange rate depreciations moving forward

- Exchange rate appreciation in most countries since January. Marked recovery in Mexico
- We expect to see a moderate depreciation of exchange rates moving forward to the extent that there will be a relaxation of the monetary policy in South America, in contrast to the Fed's higher interest rates
- Some margin for continues appreciation in Mexico in the short run. FX forecasted to appreciate in Chile and Colombia in 2018

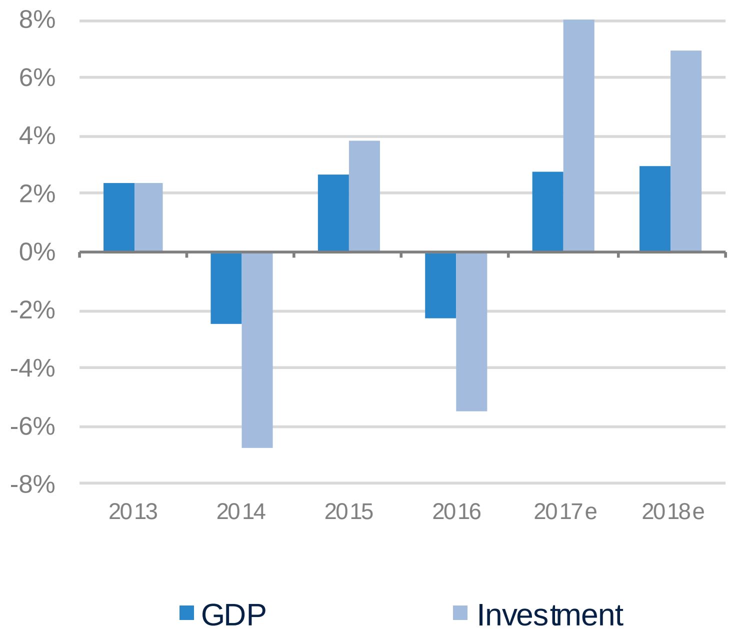
Exchange rate against the dollar



Source: BBVA Research and Haver

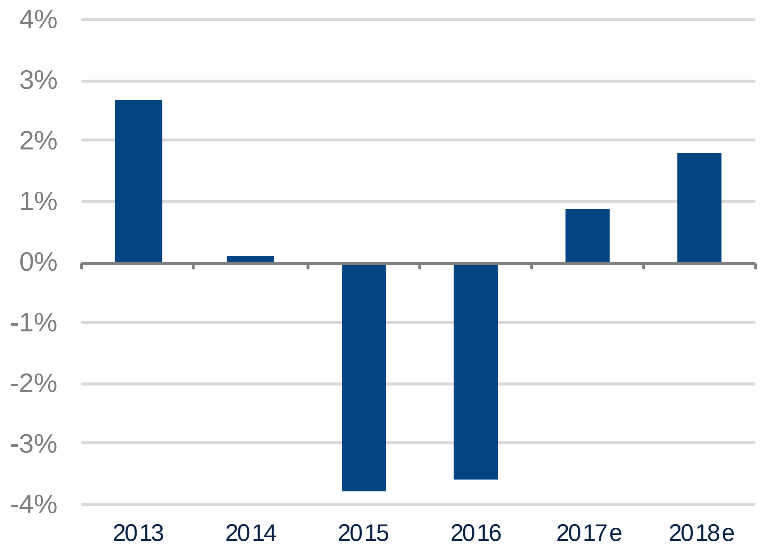
Uruguayan external demand boosted by economic recovery in Mercosur partners

Argentina's growth driven by investment
Change %



Source: BBVA Research

Brazil returns to growth in 2017
change %



Source: BBVA Research

- **Argentina experiencing a U-shaped recovery led by investment growth**
- **Inflation easing off more slowly than forecasted.**
- **In the case of Brazil, we forecast growth of 0.9% this year and 1.8% in 2018**
- **The failure to pass social security reforms could put growth at risk**

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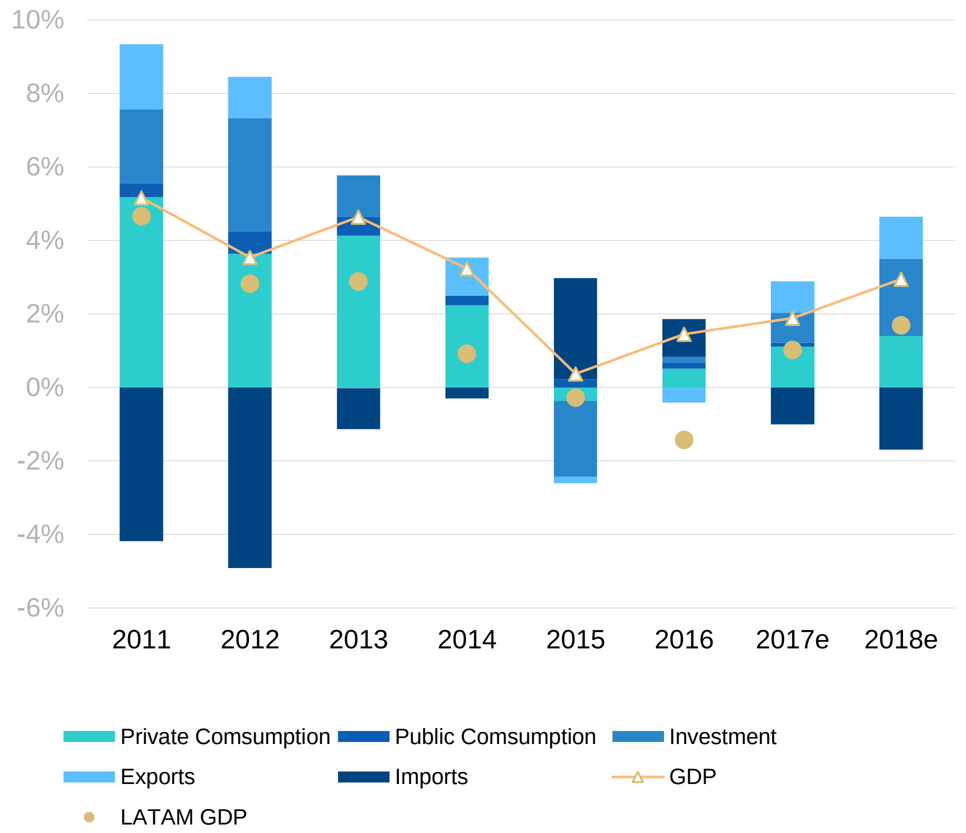
URUGUAY

A need to consolidate fiscal accounts

ECONOMIC ACTIVITY: 2017 growth to reach 1.9%

- In 2016, Uruguay emerged from a period of stagnation to grow 1.5%.
- Strong contribution to growth from the external sector through the marked fall in imports. Private consumer spending began to show signs of recovery (+0.7%).
- In 2017, growth will be led by domestic demand, in particular by private consumer spending, which will continue to improve (+1.5%) in view of higher real wages and credit expansion.
- Paper pulp mill investment will be key to driving growth in 2018, although it is likely that its start up will be delayed a few months.
- Increased exports, particularly in the service sector, will moderate the weakening of the trade balance caused by higher imports as economic growth recovers

GDP, by expenditure component
(contribution to growth, %)

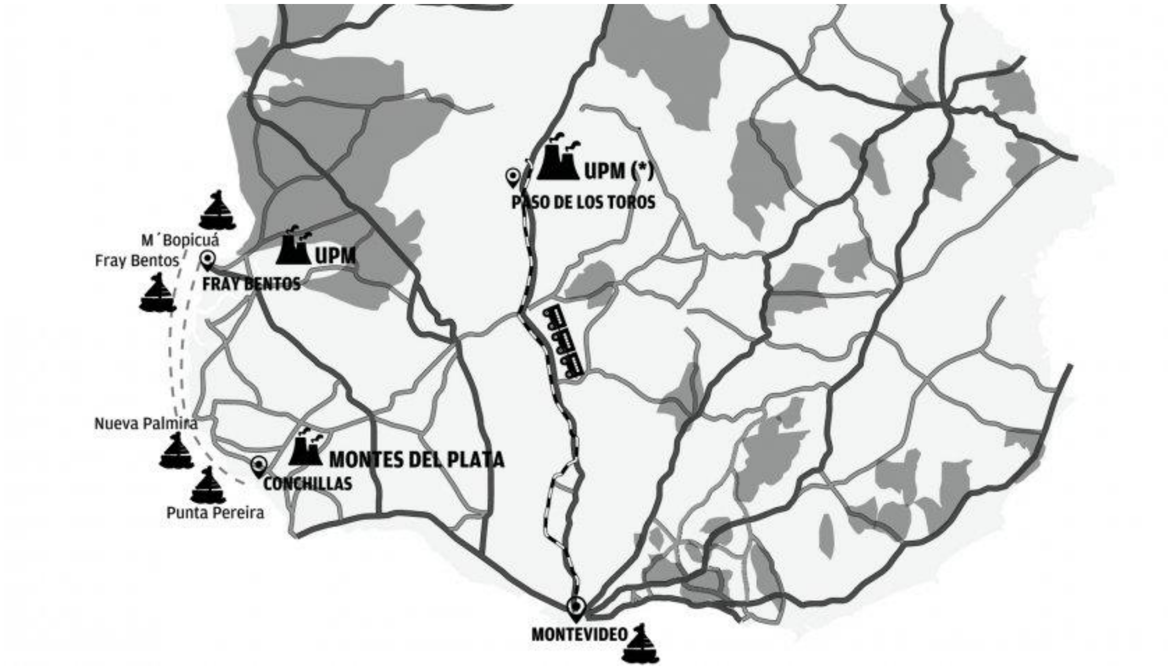


Source: BBVA Research

ECONOMIC ACTIVITY: Investment will be key to ensuring a rate of growth close to the potential level

- From 2018 onward, Uruguay will record levels of growth of around 3% (potential growth). However, in order to do so, it is essential that both UPM paper mill project and the necessary public investment in infrastructure be implemented
- As well as this mega-project which should begin in 2018, there are also several lesser projects which are nonetheless relevant to stimulating investment, both public and private.

Infrastructure required to build the third pulp mill



Private UPM investment = US$4 billion

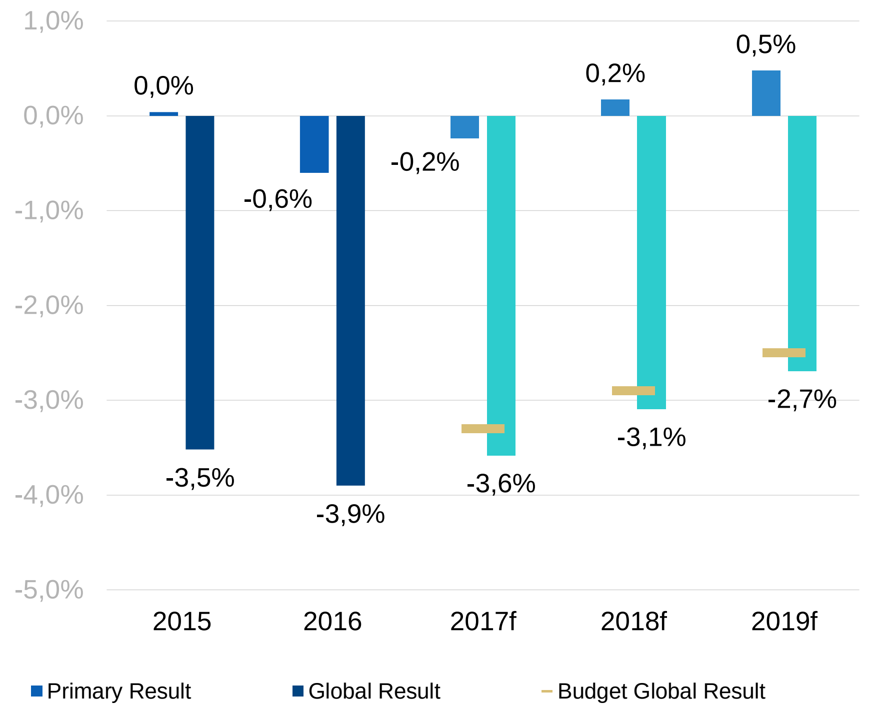
Investment in infrastructure (public) = US$1 billion

Source: BBVA Research

FISCAL SECTOR: Fiscal consolidation required

- Higher current expenditure (on health) raised the 2016 primary deficit to 0.6% of GDP, with an overall fiscal deficit of 3.9% of GDP, its highest level in almost three decades.
- The government has maintained its fiscal targets, with the aim of reducing the deficit to 2.5% by the end of its term in 2019.
- The first stage of tax adjustments was undertaken in 2016 with the alterations to the calculation of the corporate income tax, with the second phase coming in during 2017 with the increase in the personal income tax rate.
- As well as revenue hikes, the deferral or expenditure and the reduction in investment by public companies will help to reduce the deficit
- The Uruguayan government initially expected that these measures would lead to a 1 percentage point reduction of the deficit in 2017

BBVA fiscal result forecasts vs. budgeted figures
(as % of GDP)

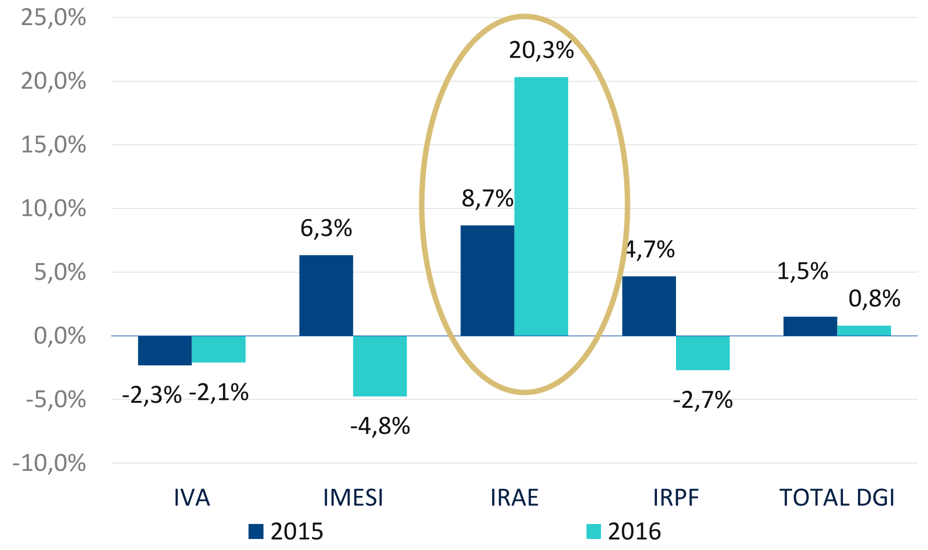


Source: BBVA Research

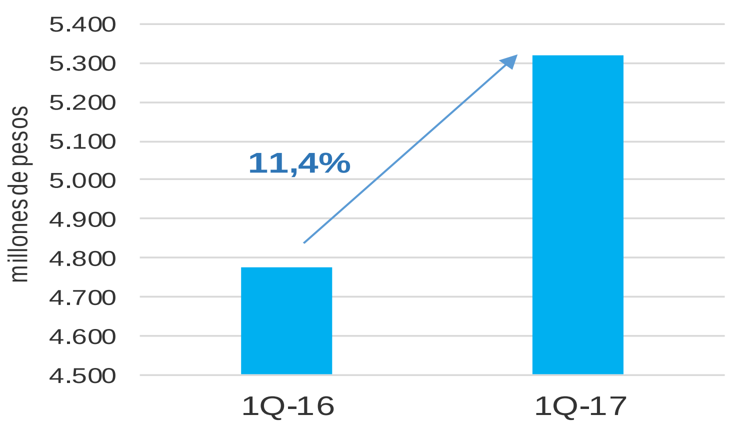
FISCAL SECTOR: Increasing tax revenues

- For 2017 we estimate a slight improvement in the primary deficit to 0.2% of GDP while the overall figure will reach 3.6% of GDP based on the assumption that the Government will at least be able to maintain a constant primary expenditure / GDP ratio.
- Tax revenue are expected to increase due to higher personal income tax rates, although the improvement will be limited by the adverse impact of the measure on consumer spending.
- The impossibility of reducing primary spending in a context of low growth limits the chances of obtaining a primary surplus big enough to bring down levels of indebtedness In 2016, primary spending reached 30% of GDP.
- In 2018, an additional improvement driven by greater economic growth and efficiency gains in spending will practically balance the primary deficit, maintaining the gradual reduction in the global deficit.

Total DGI revenue collection in real terms
(% variation YoY)



Income tax revenue in real terms
Millions of pesos in real terms (at 2005 prices)

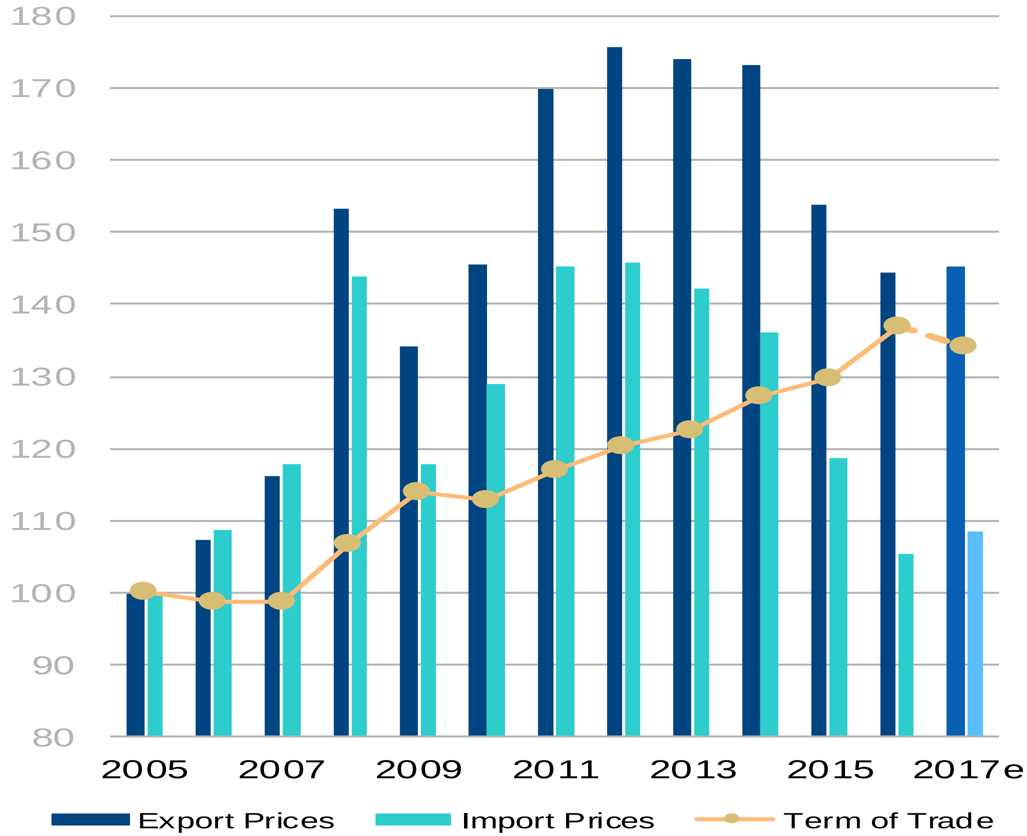


Source: BBVA Research

EXTERNAL SECTOR: Gains from terms-of-trade improved the trade balance in 2016

- In 2016, the terms-of-trade improved 5.7% due to a fall in import costs, driven by the contraction in the price of oil.
- With this improvement and the sharper fall in imports compared to exports, Uruguay recorded a trade surplus of USD 1.042 billion in 2016.
- Nevertheless, for 2017 we forecast stronger import price growth (mainly due to higher oil prices) which will result in a fall of 2% in the terms of trade.
- Stronger import growth due to economic recovery will also erode the trade surplus to a deficit of USD 726 million in 2017

Terms of trade
(2005 index base = 100)

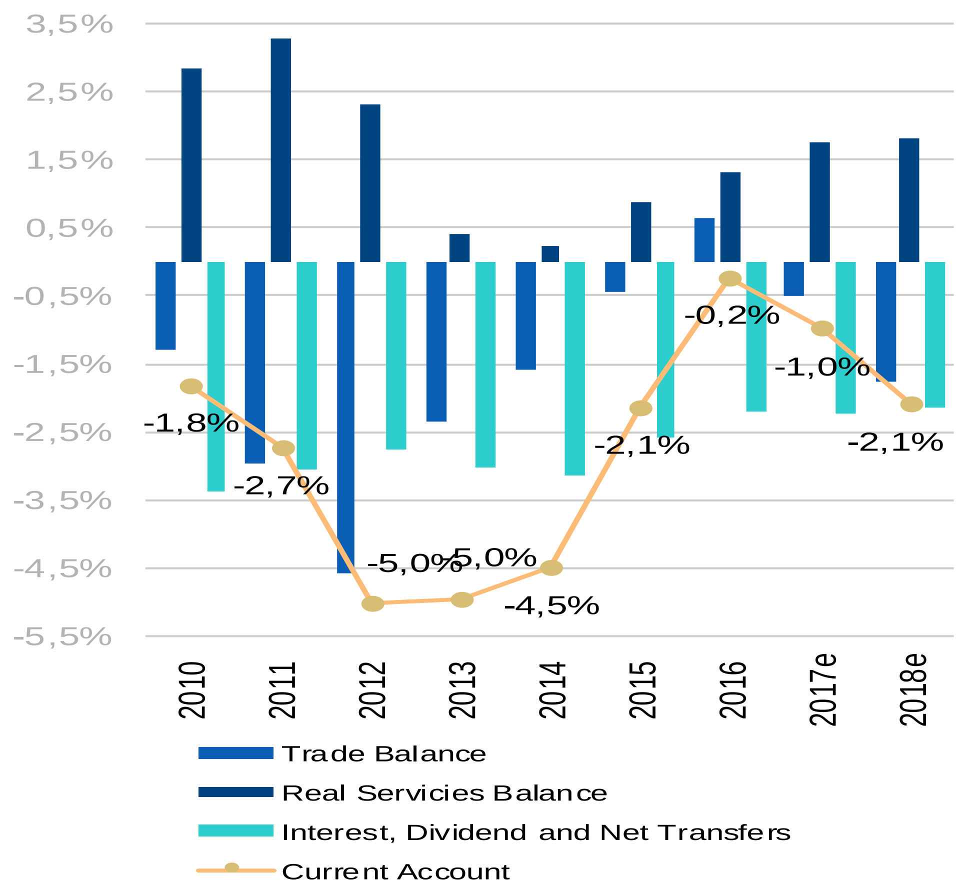


Source: BBVA Research

EXTERNAL SECTOR: Substantial – albeit temporary – improvement in external accounts

- The current account deficit fell to -0.2% of GDP in 2016 as a result of a surplus in both goods and real services balances.
- Tourism revenues grew by 1.2% of GDP in 2016 and considering actual data from the first quarter of 2017, we expect a further improvement in the real services balance.
- In 2017 we expect to see a slight fall in the current account due to the reduction in the goods trade balance
- In 2018 the current account will reach a deficit of 2.1% due to increased imports of capital goods for the third pulp mill although it will be fully financed through FDI inflows.

External sector: the current account and its components
As a percentage of the GDP

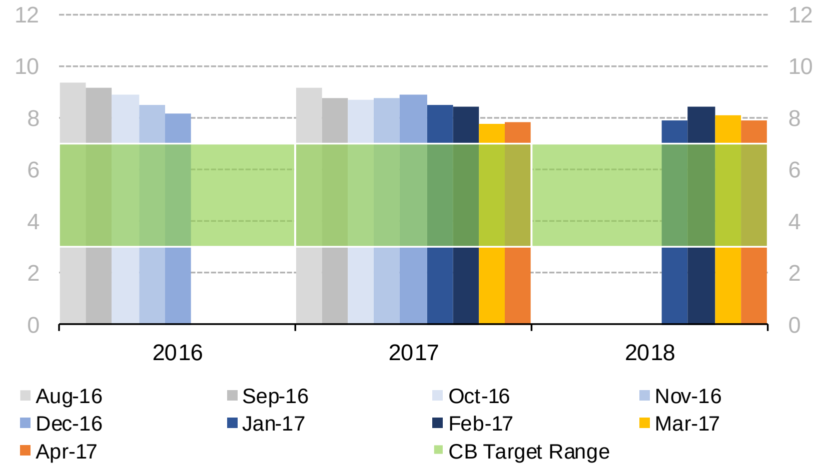


Source: BBVA Research

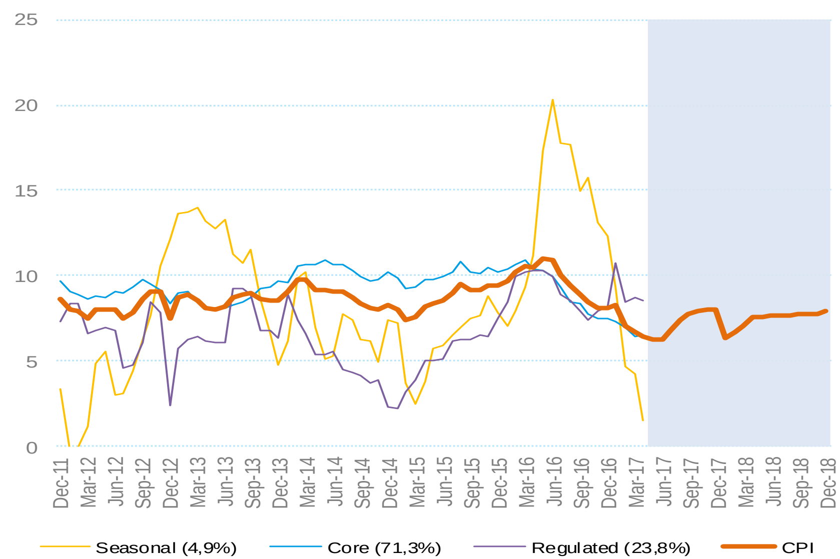
Inflation will slow down but remain outside the target range

- Inflation slowed down by 1% in 2016, mainly as a result of FX appreciation.
- Average core inflation stood at 7.5% YoY in 4Q16 and continued to fall slowly throughout 2017 to 6.8% YoY in April.
- Despite the contractionary bias of monetary policy, consensus inflation forecasts continue to be above the BCU's target range for 2017-18
- We estimate that once base effects disappear, inflation will rise to 8% due to:
- Higher peso depreciation rate
- Sluggish consolidation of the fiscal deficit
- Wage agreements that include deferred corrective clauses for past inflation

Inflation forecasts based on BCU survey
YoY variation, %



Consumer price components
YoY variation, %

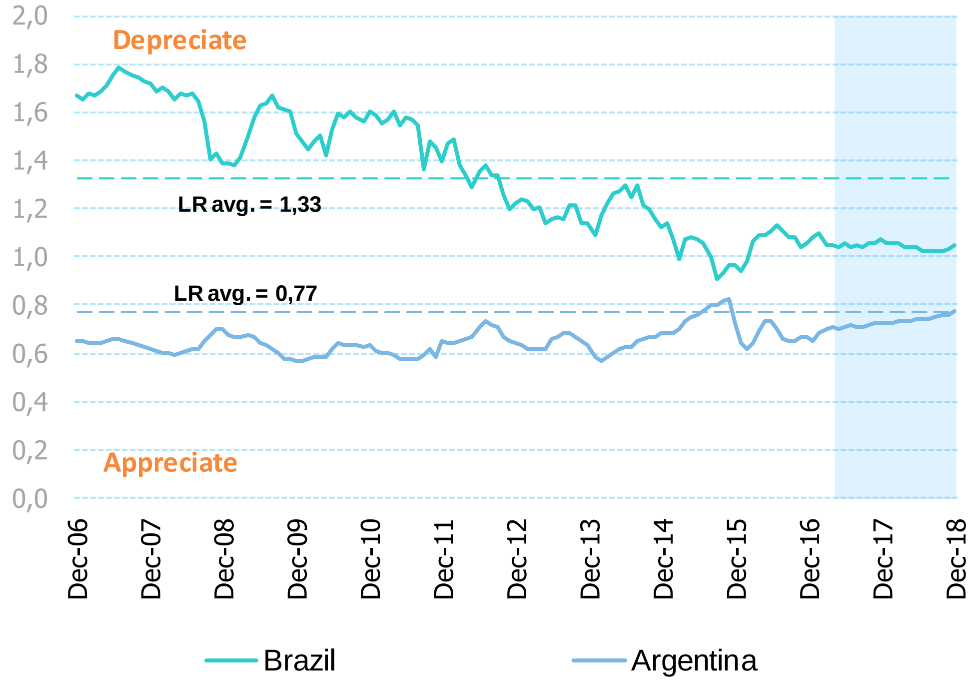


Source: National Statistics Institute (INE) and BBVA Research

With the help of Argentina, real appreciation of the Uruguayan peso will be reduced by 8% in 2017

- Despite a slight improvement in 2016, Uruguay's real multilateral exchange rate is still 20% appreciated compared to historical averages
- Over the coming two years, Uruguayan competitiveness will improve, at a stronger rate compared to Argentina than to Brazil
- While the Brazilian real and Argentinian peso will depreciate at a rate below inflation, the Uruguayan peso is expected to depreciate at a stronger pace than inflation.

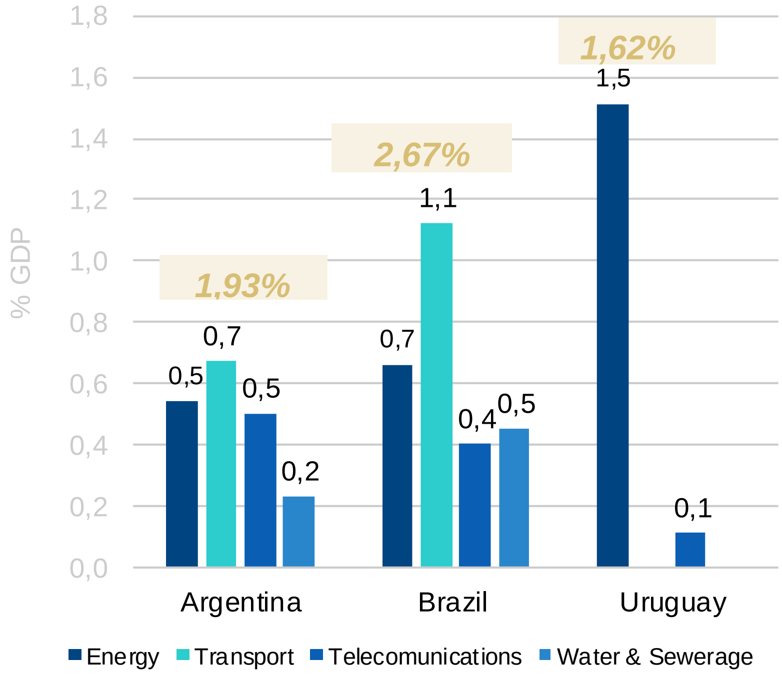
Real bilateral exchange rate with Argentina and Brazil
December 2001 index base = 1



Source: BBVA Research, Haver, BCU, INE

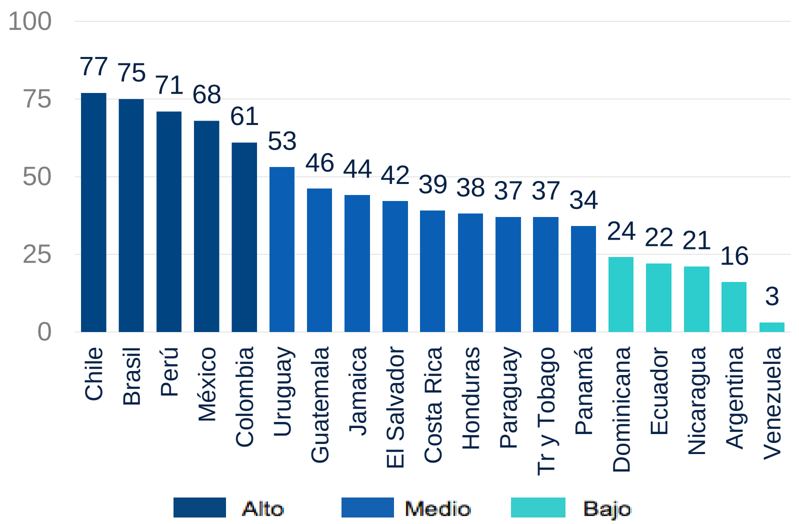
As far as competitiveness is concerned, there is room for improvement through investment in transport infrastructure

Investment in infrastructure by sector, 2013
(% of GDP)



Source: BBVA Research based on World Bank figures

Level of development in Latin American countries in terms of public-private partnerships, 2014



The Infrascope measures the capacity of a country to attract private investment in infrastructure through public-private partnerships (PPP). It takes six variables into consideration in order to reach its total figure.

Source: BBVA Research based on The Economist and IDB figures

- **Uruguay concentrates practically all its infrastructure investment in the (renewable) energy sector.**
- **Uruguay occupies sixth place out of 19 countries in terms of its capacity to attract private investment in infrastructure due to the regulatory framework and institutional strength, although there is still room for improvement as far as management capacity is concerned.**

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Main messages

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- The downturn in Latin America ends. Growth is expected to increase from -1.4% in 2016 to 1.1% in 2017 and 1.8% in 2018. Growth will still be below the potential for the region, closer to 3%.
- Uruguay returns to growth, 1.9% in 2017 and 3% in 2018, with a strong impulse from investment.
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- The Fx rate will end 2017 at $31.1, avoiding a deterioration in competitiveness vis a vis its main regional partners.

ANNEX:

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Macroeconomic forecasts

Uruguay

	2013	2014	2015	2016	2017f	2018f
GDP (% y/y)	4,6	3,2	0,4	1,5	1,9	3,0
Inflation (% y/y, eop)	8,5	8,3	9,4	8,1	8,0	7,9
Inflation (% y/y, average)	8,6	8,9	8,7	9,6	7,5	7,2
Exchange Rate (vs. USD, eop)	21,3	24,1	29,7	28,8	31,1	32,3
Exchange Rate (vs. USD, average)	20,4	23,2	27,3	30,1	29,7	31,7
Loan Interest Rate (%, average)	17,7	21,5	21,4	24,3	22,6	21,8
Private Consumption (% y/y)	5,5	3,0	-0,5	0,7	1,5	1,9
Government Consumption (% y/y)	4,9	2,5	2,2	1,6	1,0	0,0
Investment (% y/y)	4,8	0,0	-9,0	0,7	4,0	10,0
Fiscal Balance (% GDP)	-2,4	-3,5	-3,5	-3,9	-3,6	-3,1
Current Account (% GDP)	-5,0	-4,5	-2,1	-0,2	-0,9	-2,1

Source: BBVA Research

f = forecast