BBVA | Research

Uruguay Economic Outlook

Recovery under way

November 2017

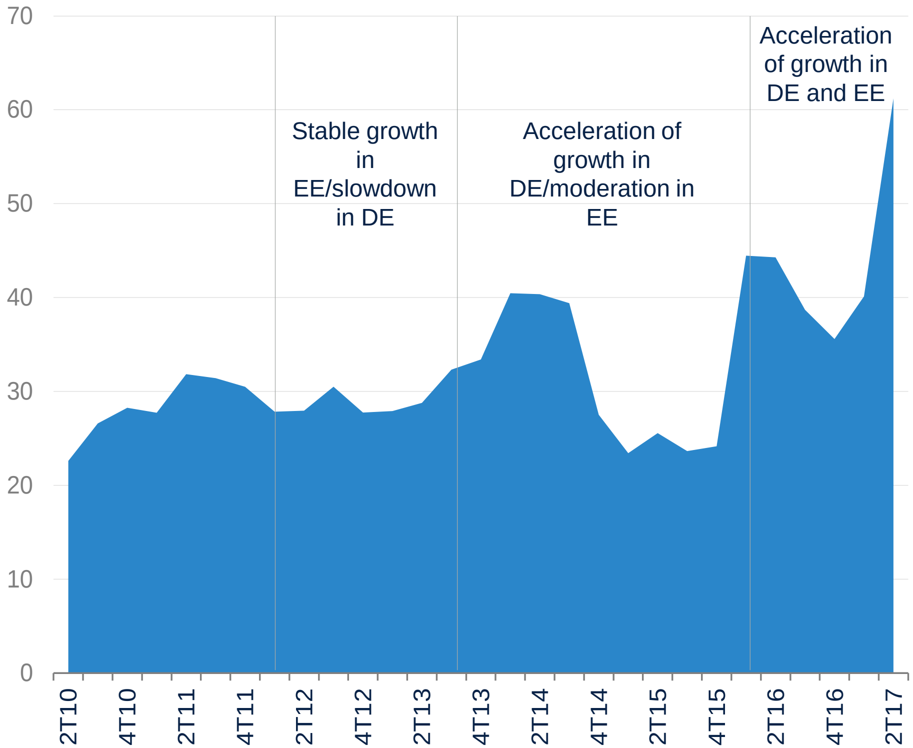
Contents

01

GLOBAL: The positive global environment is consolidating, with downward risks

Recovery: regions more in step than before

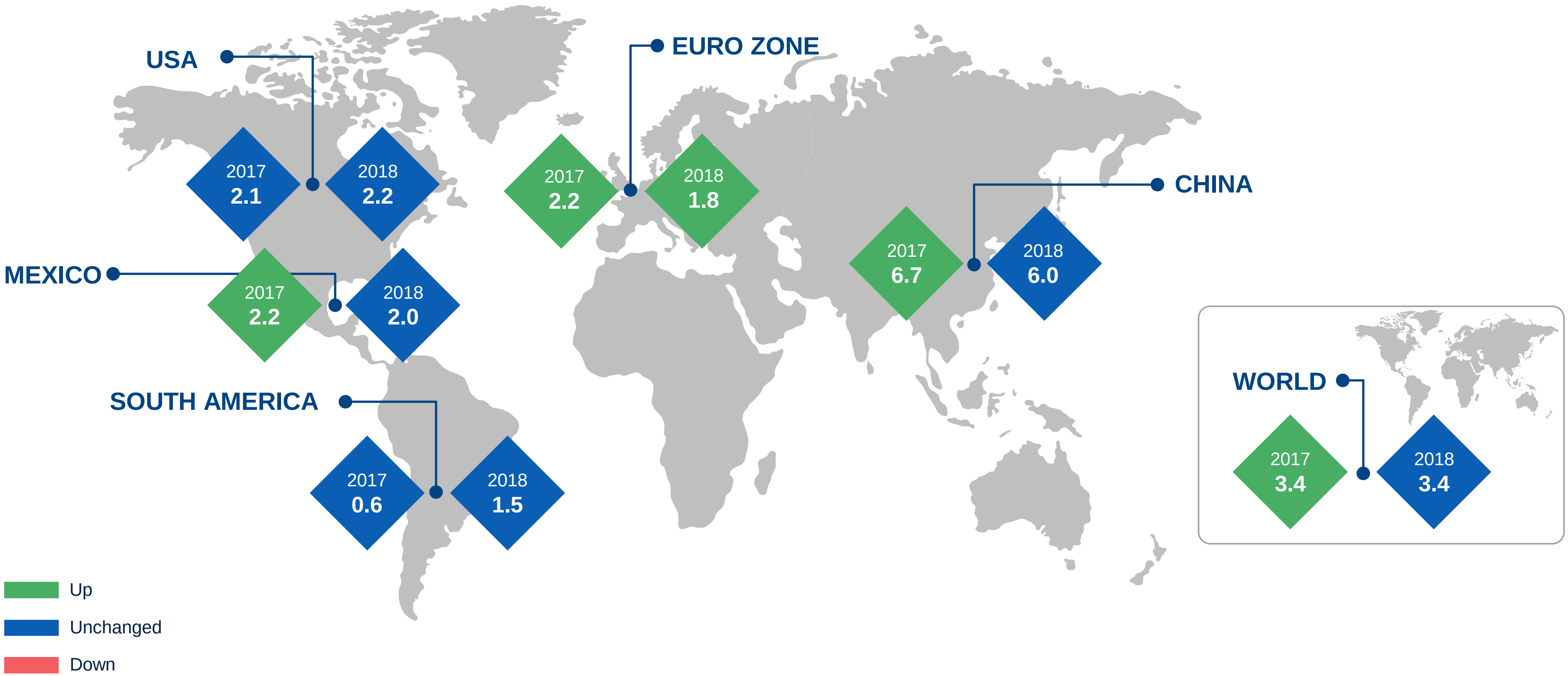
Index of synchronisation of growth between developed and emerging economies (DE & EE)



- **Developed economies:**
  - Strong uptick in the US
  - Positive surprise in Europe
- **Emerging economies:**
  - Slight slowdown in China, although less than expected. China continues to underpin the rest of Asia
  - Recovery in Russia and Brazil, which are no longer holding back world growth.
  - Growth is gaining traction in Latin America
- Greater support for growth from economic policies

The **synchronisation index** is the result of inverting the standard deviation of quarterly growth observed in the different countries. The index therefore associates less growth volatility among countries with a higher degree of synchronisation worldwide.
Source: National sources, Markit Economics and BBVA Research

Upward revision of growth in Europe and China
Positive bias in South America



Source: BBVA Research

Central banks are moving towards a very gradual normalisation process

FED

Balance sheet normalisation from October and next rate hike in December, with two more in 2018

Scaling back of bond purchasing in 2018, but no rate hikes are expected until mid 2019

ECB

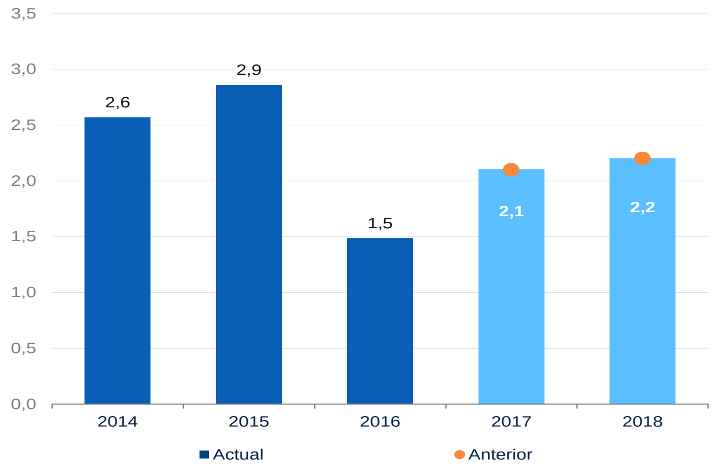
Great uncertainty:

- In the **United States** due to slowing inflation and the expected changes in the FOMC in 2018
- In the **euro zone**, bias towards more gradual tapering (euro strength) and a delay to the rate hike cycle (low inflation)

BBVA Research

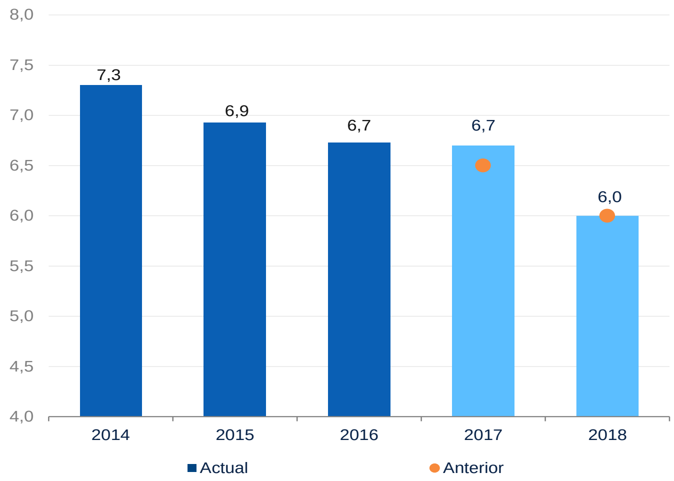
US: sustained growth despite political uncertainty and natural disasters, while China improves in the short term

USA: GDP growth
(YoY, %)



- We are maintaining our growth forecasts for 2017-2018, since the hurricanes will have only a moderate impact on activity
- Among outstanding issues are:
  - tax reform yet to be clarified
  - Uncertainty about the economic policy

China: GDP growth
(YoY, %)

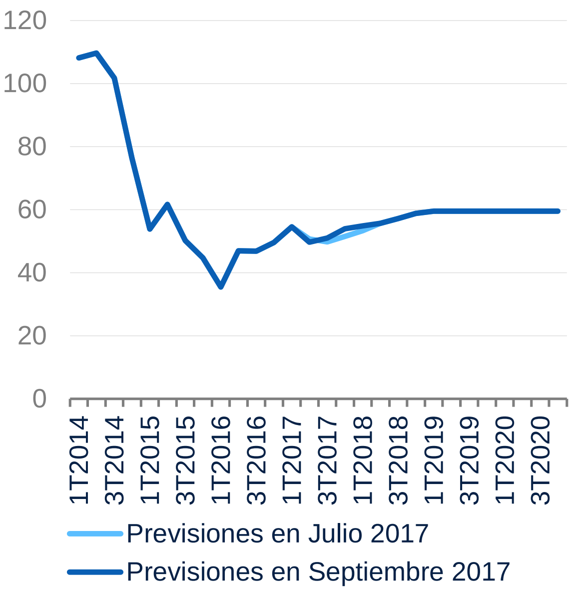


- Slight upward revision of growth for 2017 in view of improved performance in 1H17
- Slowdown in 2018 due to reduced support from economic policies and the appreciation of the currency

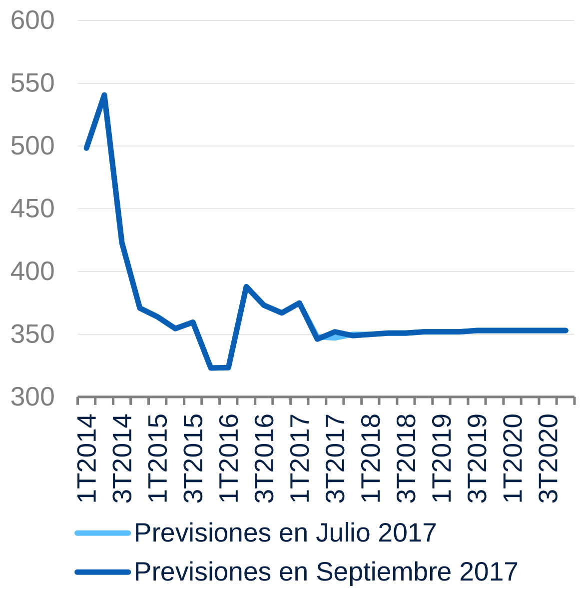
Source: BBVA Research and the BEA (US Bureau of Economic Analysis)

Oil and soybean prices on the way to their new equilibrium. Temporary increase in the price of copper

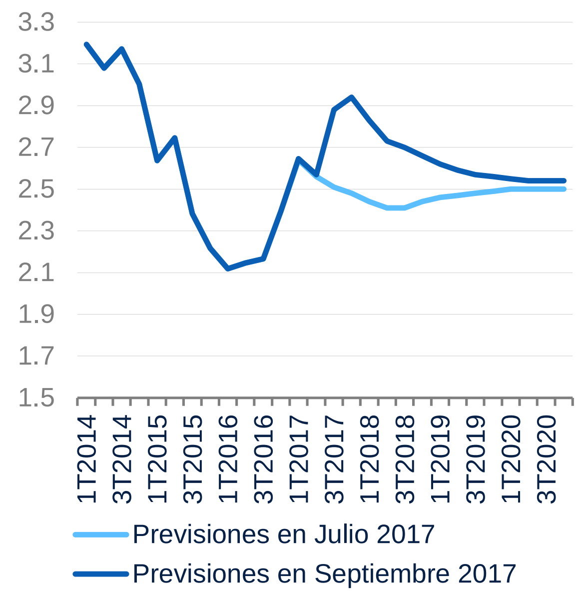
BRENT CRUDE
(US$ per barrel)



SOYBEANS
(US$ per metric ton)



COPPER
(US$ per lb.)

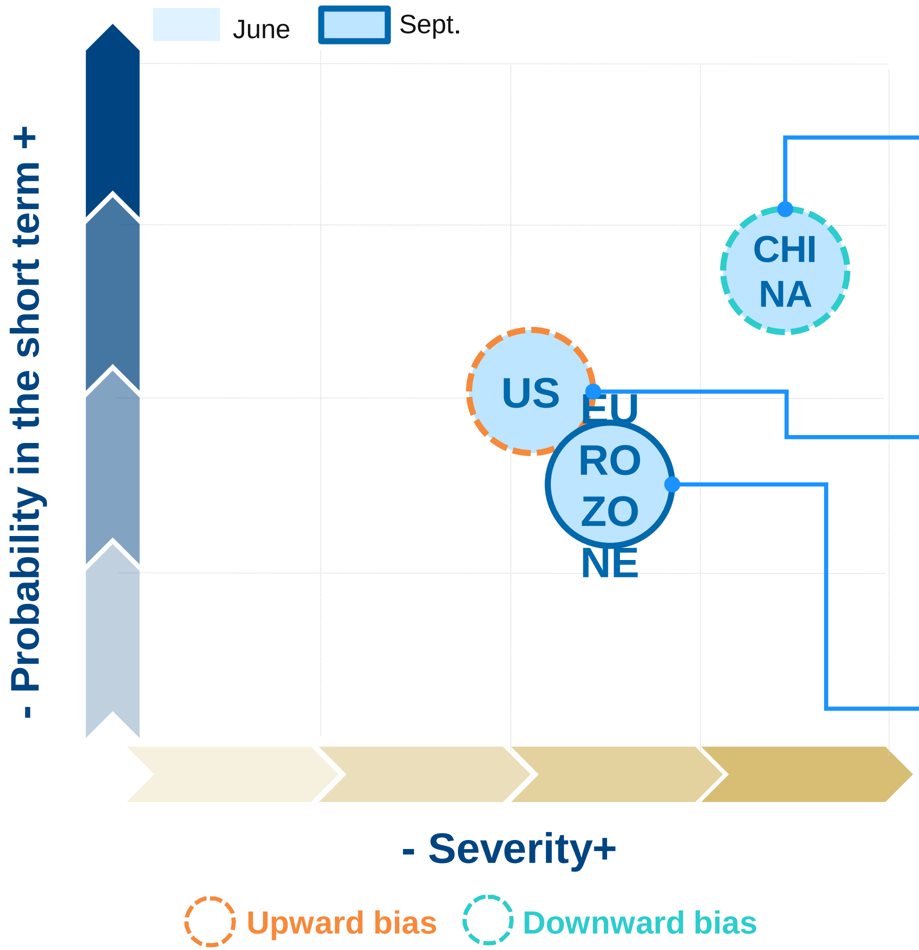


Source: BBVA Research and Bloomberg

Prices of oil and soybeans still look set, as they did a few months ago, to gradually approach their long-term equilibrium levels. We continue to expect to see Brent crude at US$60 per barrel

The price of copper increased significantly, driven by financial factors, which should gradually abate going forward. We are holding our long-term equilibrium price unchanged

Global risks: rebalancing from China to the US in the short term



- Very high risk of deleveraging, but more contained in the short term (more gradual economic slowdown and authorities' strategy)
- Need for reform of state companies
- Management of soft landing

- Political controversy and risk of cyclical slowdown
- Risk of financial instability: signs of overvaluation of certain assets
- Fed exit risk: low, but great uncertainty regarding rate hike strategy.

- Political and banking concerns: More contained except in Spain
- ECB exit risk; very gradual, starting with tapering in 2018.

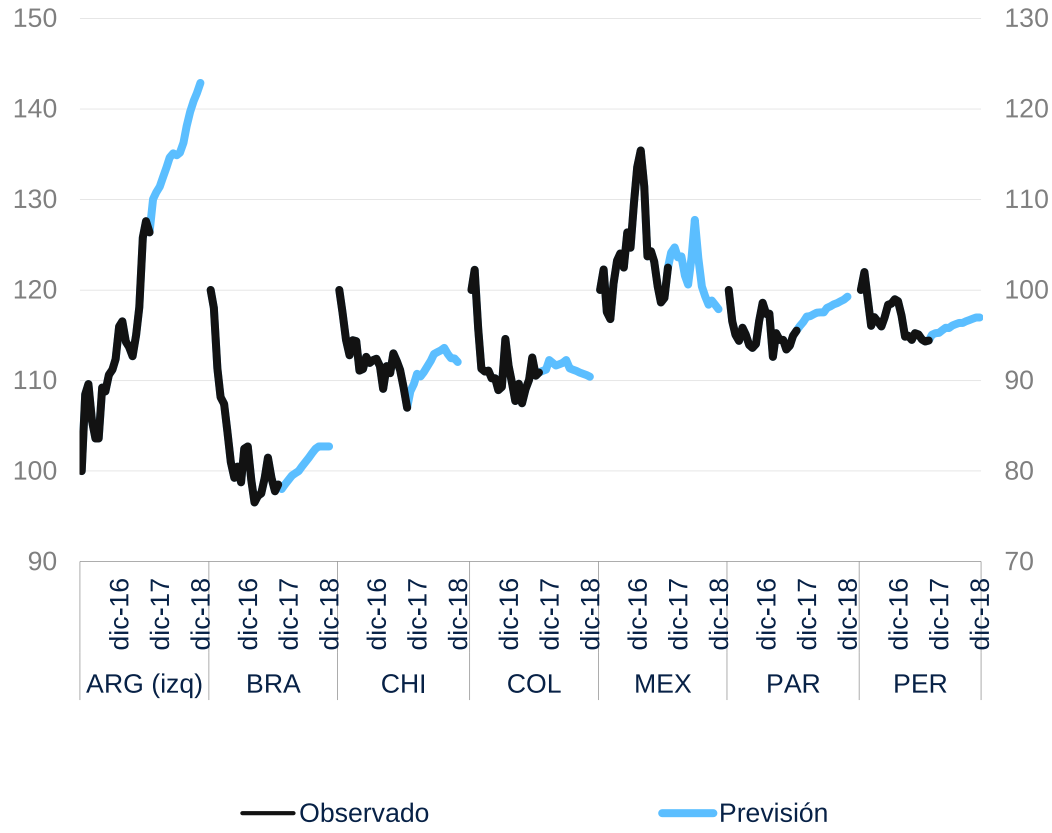
**Other risks: Geopolitical (North Korea); Protectionism (China/US)

Limited currency depreciation in 2018…

- Currencies have appreciated or held steady in the past three months, implying appreciation in real terms in all countries.
- We continue to expect moderate currency depreciation going forward, consistent with a divergence between the reduction in interest rates in South America and the increases on the part of the Fed.
- The Mexican peso could appreciate in 2018 if the risks relating to the renegotiation of NAFTA and the elections do not materialise.

Exchange rate against the dollar

(Dec 2016 index = 100)

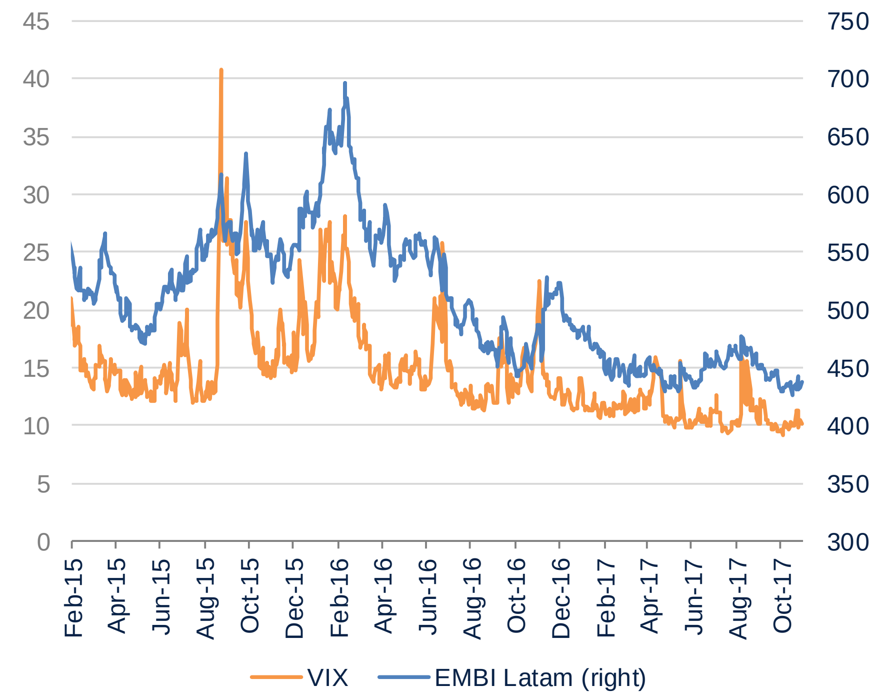


Source: BBVA Research and Haver

… in an environment in which volatility remains unusually low, with risks of reversing rapidly

- Volatility at all-time low, despite the persistent economic, political and geopolitical uncertainty.
- Risk of market complacency, in a context of increasing interest rates in the US.

Implied volatility in developed markets and risk premium in Latin America



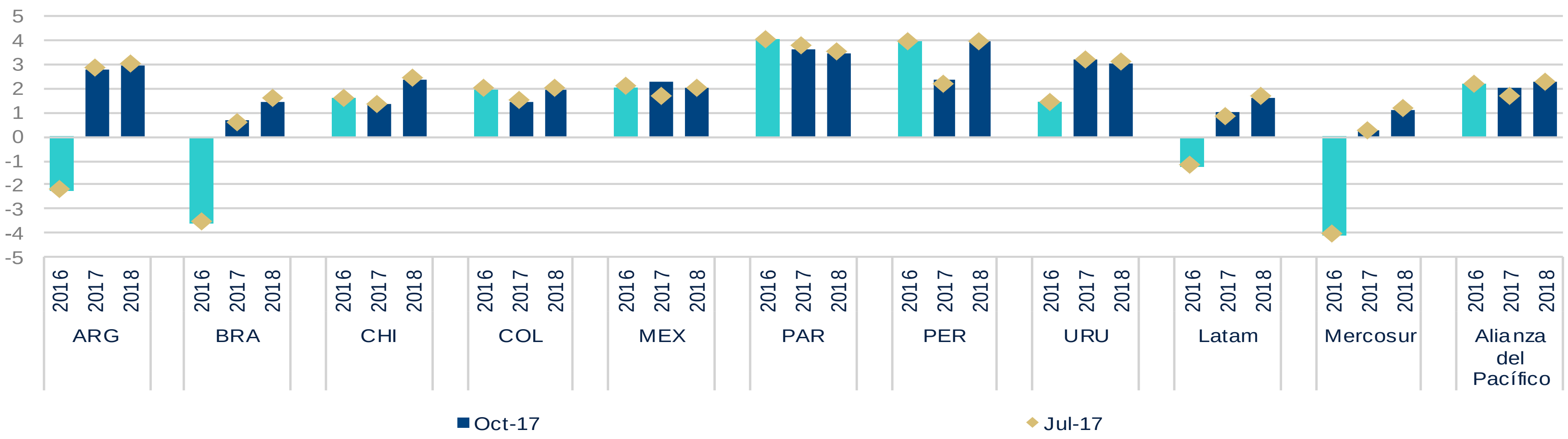
Source: BBVA Research, Haver Analytics and DataStream

After five years of slowdown, Latin America has started growing again, but growth will be slow in 2017 and 2018

We have revised our 2017 growth forecast for Latin America upwards (to 1.1%) while holding it unchanged for 2018 (at 1.6%) based on improvements in the external sector and domestic investment

Latin American countries: GDP growth

(%)



Source: BBVA Research

Recent data show growth consolidating in Argentina and activity picking up speed in Brazil, Chile and Peru in the past few months

Mexico's economic activity surprised positively in the first half of the year, but has been showing signs of slowing in the second half

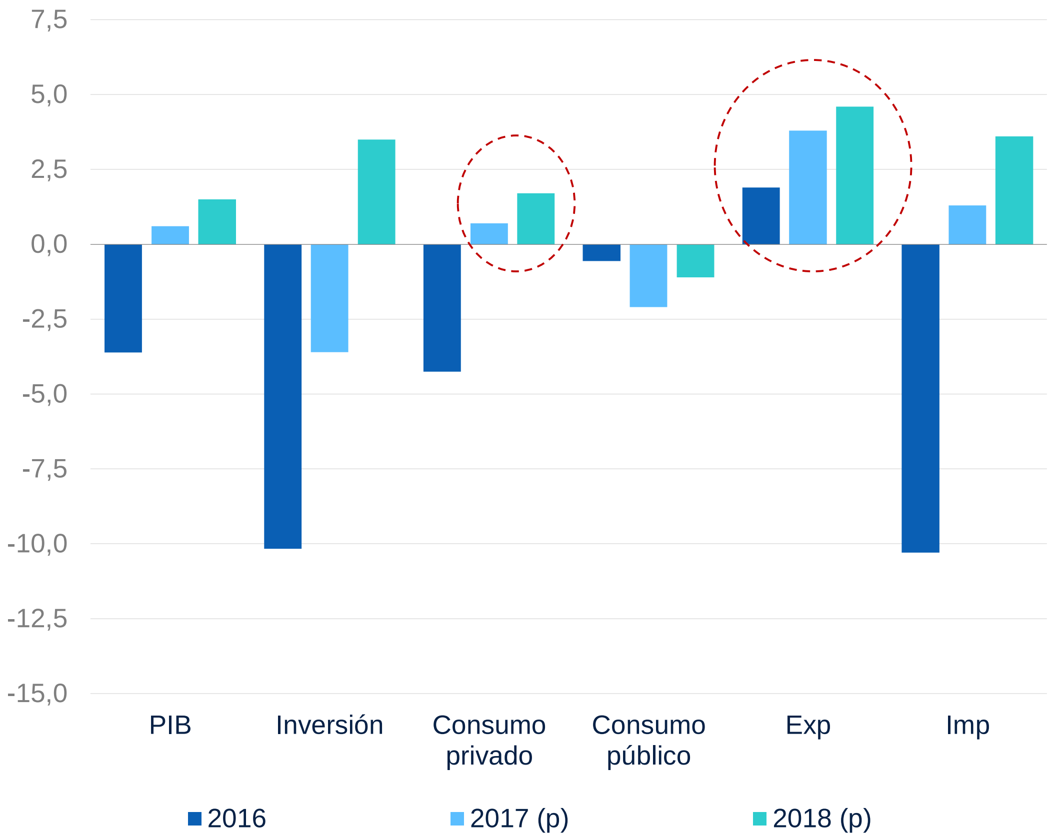
We have revised our 2017 growth forecast for Mexico and Peru upwards in view of the strength shown by domestic demand in the first half of the year

Brazil: cyclical recovery following the recession. GDP should grow by 0.6% in 2017 and 1.5% in 2018

- The fiscal situation and the political noise preclude greater optimism regarding growth. Even so, recent data suggest that the recovery could be stronger than expected.
- The economic recovery is being led by private consumption and exports. Low inflation, looser monetary policy and the gradual improvement in the labour market will underpin private consumption. Improved terms of trade, a more favourable exchange rate and increased global demand will continue to stimulate exports.
- Inflation, currently at 2.5%, will reach 3.2% in 2017 and 4.3% in 2018. These relatively low levels create a margin for a more accommodative monetary policy: the SELIC rate should soon approach 7.0%.

Brazil: Growth of GDP and its components*

(%)



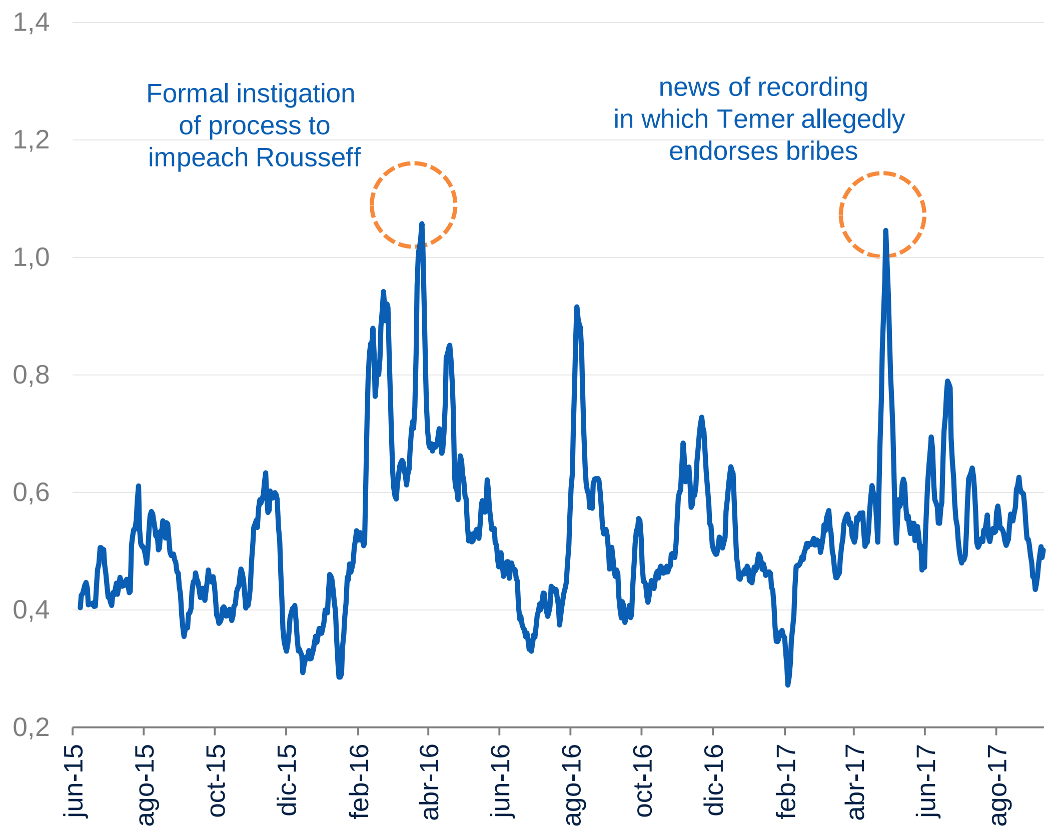
* (p): projected. Source: BBVA Research and IBGE (Brazilian Institute of Geography & Statistics)

A structural recovery of the Brazilian economy seems unlikely in the short term, mainly because of the political situation

- The recent signs of congressional support for President Temer increase the probability of his completing his term of office which expires at the end of 2018. Even so, only 3% of the population approve of the current government.
- It will be difficult to get approval before 2019 of an ambitious reform of the social security system (which is essential for ensuring the country's fiscal solvency) or other reforms needed to boost its potential GDP (currently around 2%).
- Whichever government emerges from the elections of 18 October could have enough support to be able to pass the necessary reforms. However, great uncertainty remains as to the next government's profile.

BBVA Research index of political tensions in Brazil*

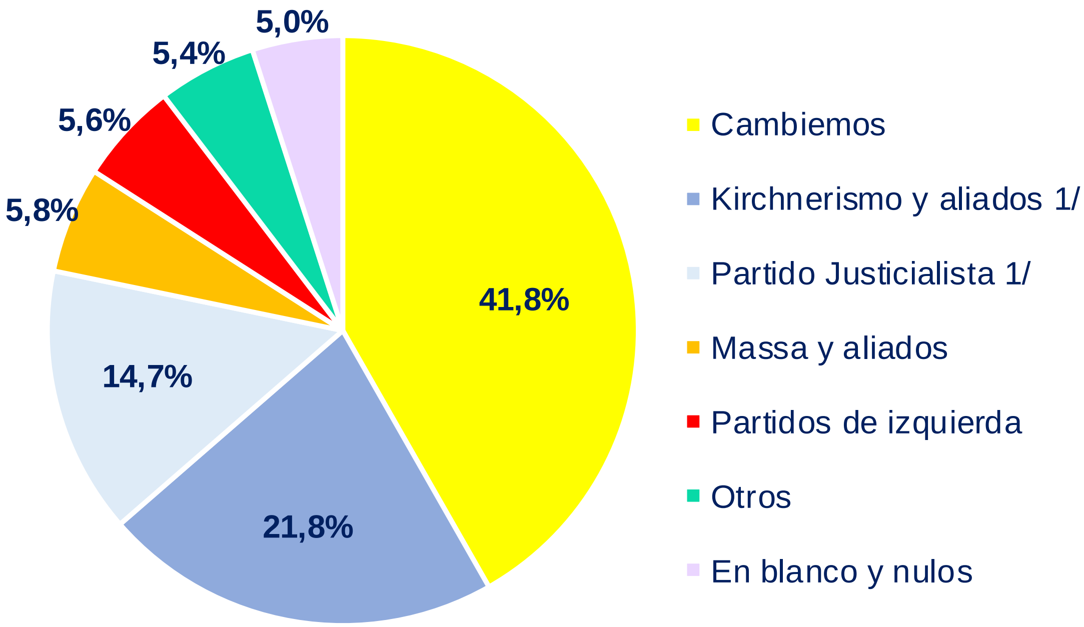
(moving average of the past seven days)



Source: BBVA Research

Argentina: government's sweeping victory in the elections calms fears of a return to populism

Provisional results of the elections to the lower house, October 2017



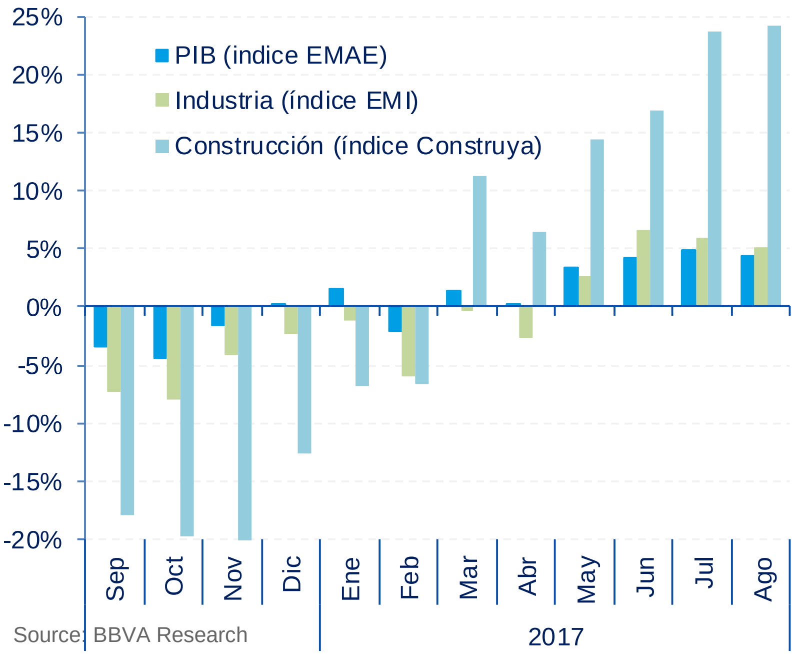
Source: Ministry of the Interior, "La Nación" daily newspaper and BBVA Research

- Government strengthens its position in Congress although it will still be necessary to negotiate agreements with opposition parties
- The government has quickly embarked on structural reforms (social security, tax, labour) vital for driving investment, boosting productivity and achieving long-term economic success.
- The risk premium will continue to fall to the extent that the policies succeed in meeting the targets for reducing inflation and the deficit

The improvement in economic activity in Argentina is consolidating, but inflation is falling more slowly than hoped

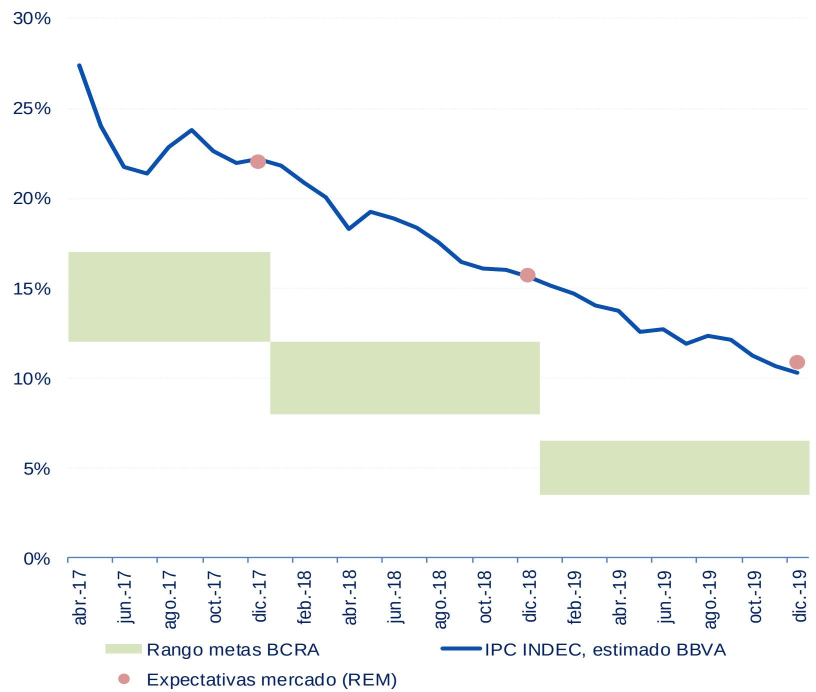
- Growth is firming up and spreading to more sectors. Growth will be close to 3% in 2018, for the second year in a row, driven mainly by investment.
- Inflation remains outside the target range , with some stagnation in core inflation, leading the BCRA to toughen its monetary policy even further.
- The slow fiscal consolidation (-1% of GDP p.a.) and the external financing of the deficit exert upward pressure on the peso and reinforce the need for structural reforms to improve competitiveness

Activity indicators (chge. % YoY)



Source: Indec (National Statistics Institute) and BBVA Research

National CPI, central bank targets and expectations (chge. % YoY)



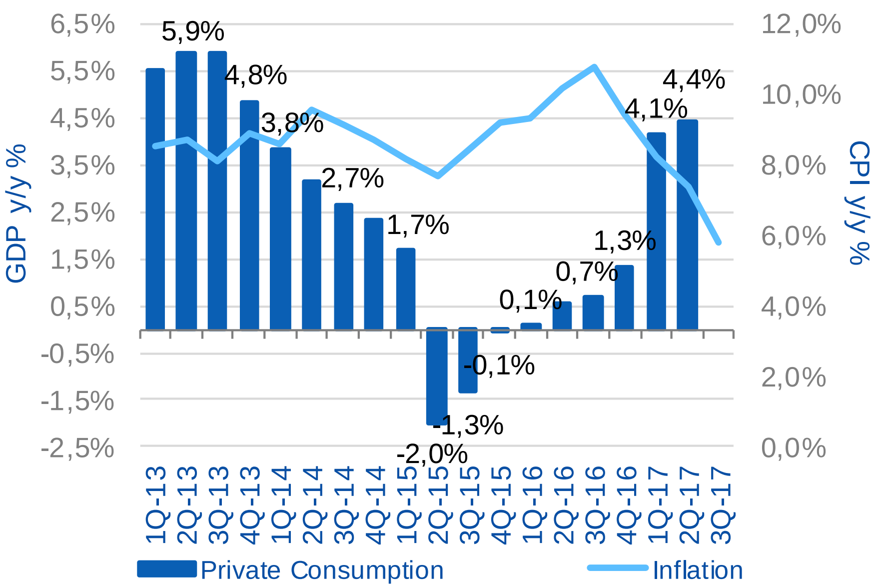
Source: Indec, BCRA (central bank) and BBVA Research

02

URUGUAY: Recovery under way, but imbalances persist

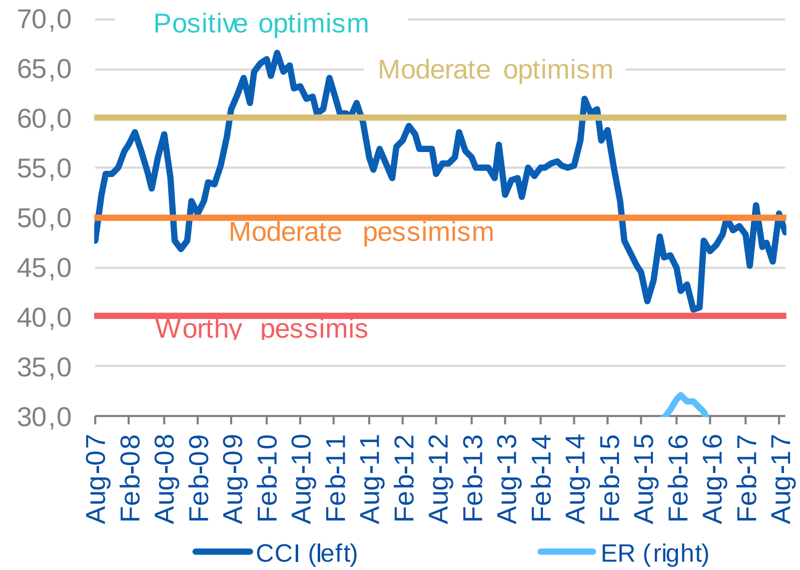
The economy continues to recover thanks to the dynamism of private consumption

Private Consumption and Inflation
(Changes %, YoY)



Source: BBVA Research based on data from BCU (Central Bank of Uruguay) and INE (National Statistics Institute)

Consumer Confidence and Exchange Rate
(Index and UYU/USD)



Source: BBVA Research based on data from the Department of Economy of the UCA (universidad Católica de Argentina) and the BCU

Private consumption has been growing since 2016, but in the first two quarters of this year it showed year-on-year changes in excess of 4%, in line with a falling glide path of inflation

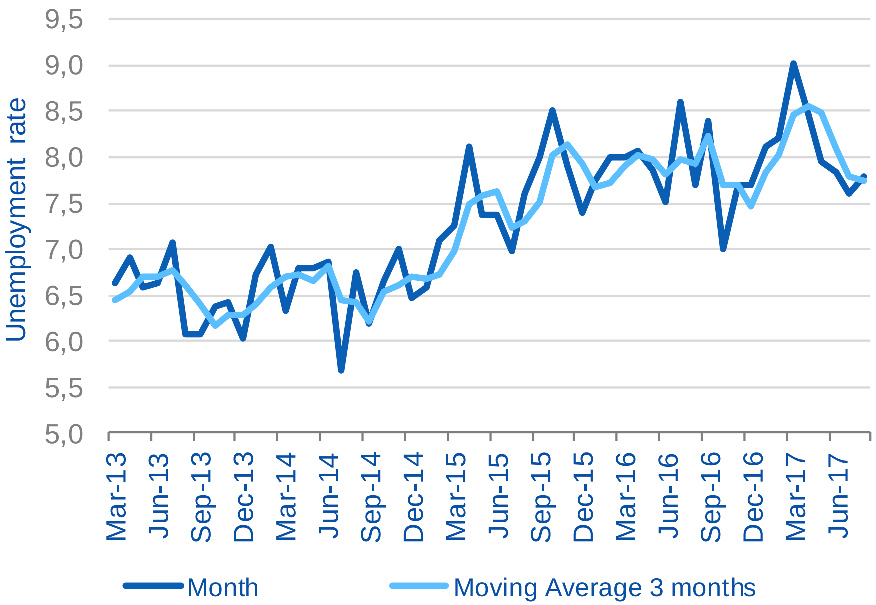
High volatility in the ICC (index of construction costs), which has fallen back into the moderately pessimistic zone, although ever closer to the neutral zone. A relatively strong peso in the coming months will lead to some additional improvement in some of the ICC sub-indices such as purchases of consumer durables

BBVA | Research

Labour Market: no signs of significant recovery in jobs, but real wages continue to improve

Unemployment Rate, whole country

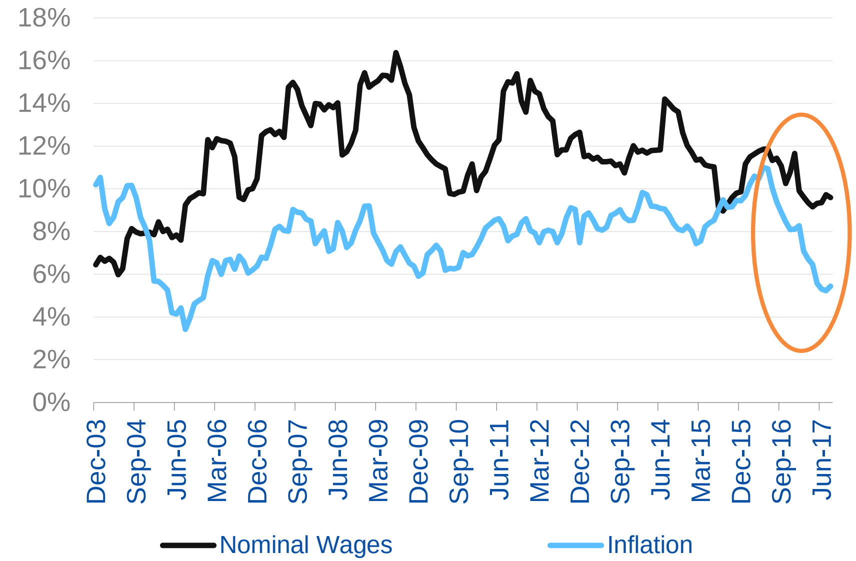
(% of EAP)



Source: BBVA Research based on INE data

Nominal Wages and Inflation

(Change % YoY)



Source: BBVA Research based on INE data

High volatility in the monthly unemployment rate, with a rising trend in the past few years. The economy's low capacity for job creation in a context of moderate economic growth makes it difficult to return to the lows of 6% in the unemployment rate in the short term

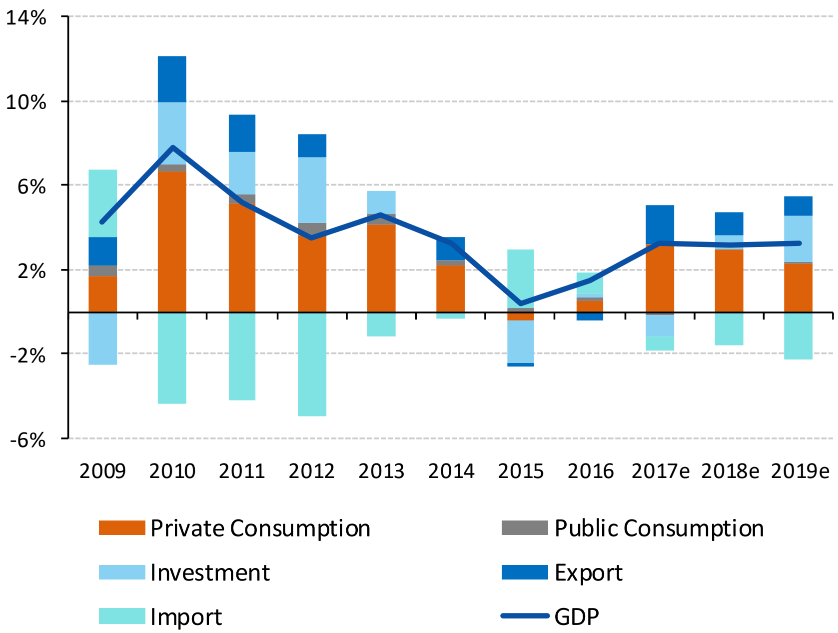
The increase in real wages in 2017 is due to the slowing of inflation. As inflation stabilises, real wages will grow at a slower pace, since nominal increases are limited by wage council agreements

Growth driven by consumption, but with increasing contribution from investment

We estimate GDP growth for the next few years close to the potential GDP growth of 3%

Contributions to Economic Growth

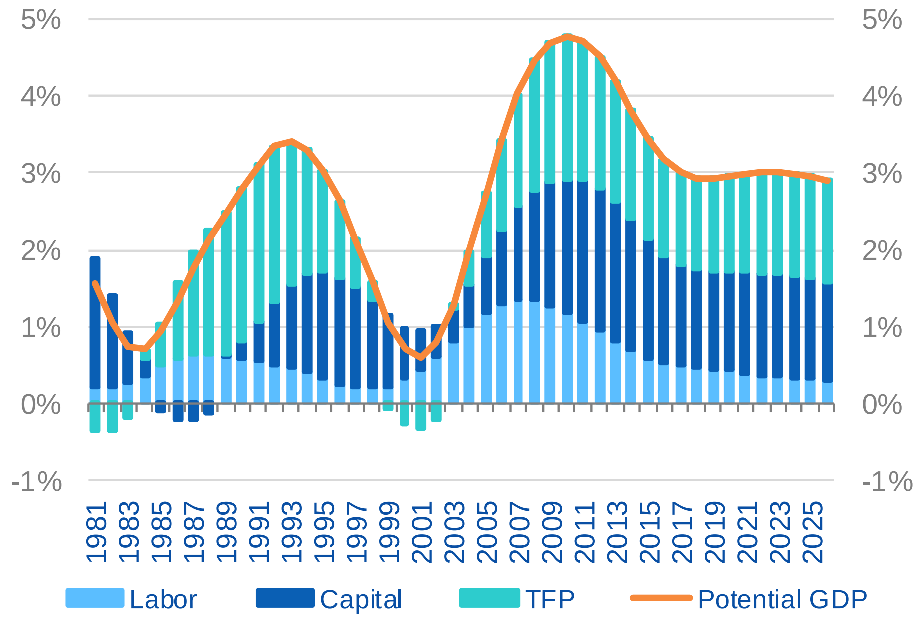
(%)



Source: BBVA Research based on INE data

Potential GDP Growth

(Change % YoY)



Source: BBVA Research

Our estimates of potential GDP are calculated on conservative assumptions about the improvement in total factor productivity

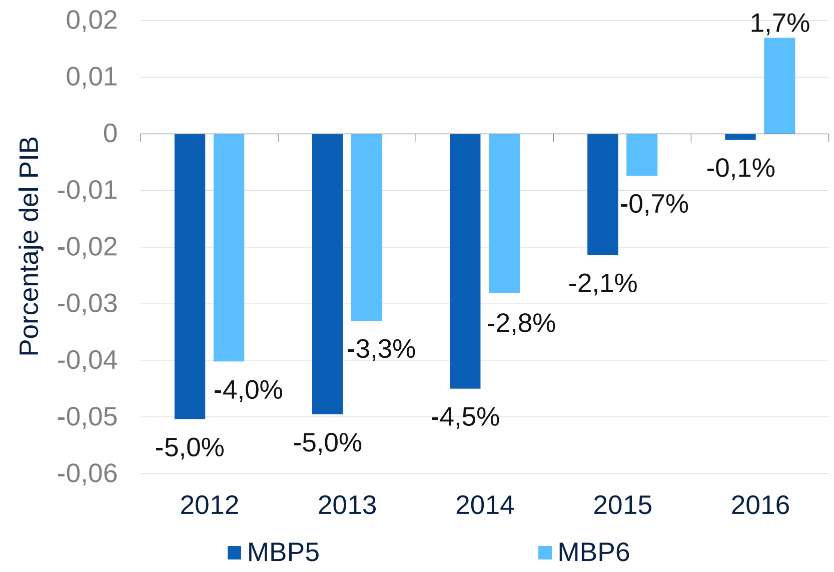
The greater contribution to growth will come from the capital factor, since labour's contribution is falling due to the low rate of growth in the EAP

Adjustments to the results of the external accounts due to change of method and greater statistical coverage

Main changes in current account

- The Balance of Trade figures now specify the import of goods for transformation carried out by many companies in free zones, which was not previously counted
- In the case of Services the classification has been expanded and the improvements made to the previously somewhat nebulous measurement of certain services
- The Primary Revenues account is now broken down to make the external accounts consistent with the domestic ones
- Lastly Secondary Revenues now include transfers

Current account result
(% of GDP)



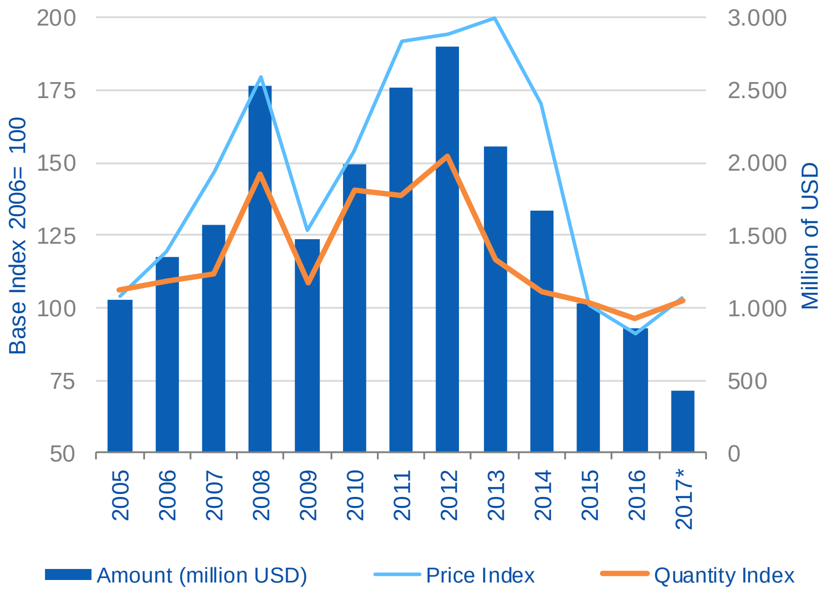
Source: BBVA Research based on BCU data

The results obtained with the new method show a smaller current account deficit, basically due to better trading results thanks in turn to a wider export base

Lower oil imports and a recovery in tourism revenues brought about structural improvements

Oil: Amount, prices and quantities

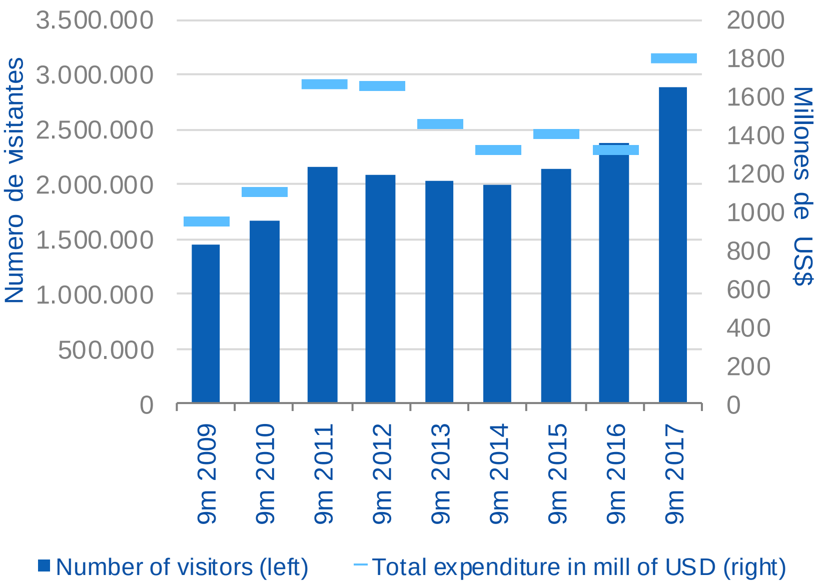
Amount in US$ millions; prices and quantities in indices



Source: BBVA Research based on BCU data

Inbound Tourism: record Jan.-Sept. ’17

Number of visitors and spending in US$ millions



Source: BBVA Research based on data from the Uruguay Ministry of Tourism

Reduced dependence on oil thanks to the change in the energy model, but also lower prices made it possible to reduce the total volume of imports

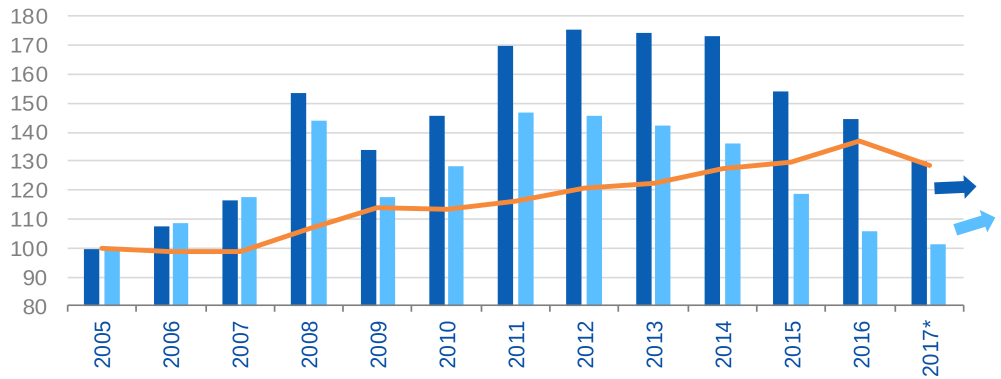
Tourist arrivals set a new record in the period January to September 2017, bringing in more than US$1.8 billion, which played a decisive part in the improvement in the current account

BBVA | Research

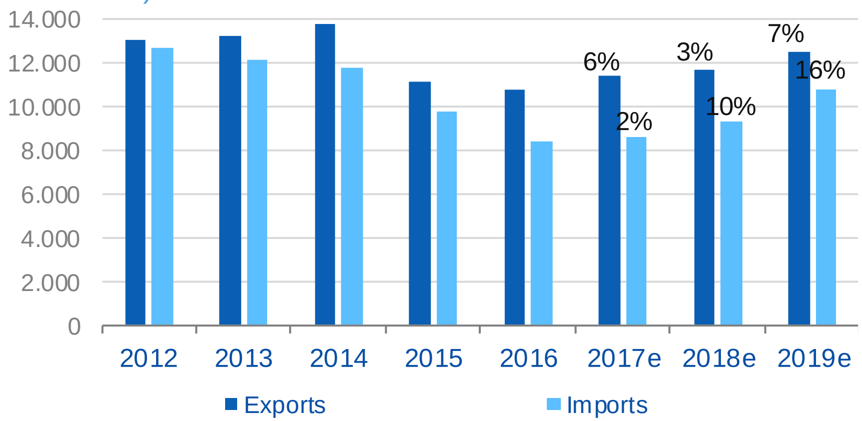
In 2018 the balance of trade surplus will shrink

We foresee slight deterioration in the Terms of Trade

Export and Import Prices and Terms of Trade
(Base 2005 = 100)



Balance of Trade in Goods (FOB-FOB)
(US$ millions)

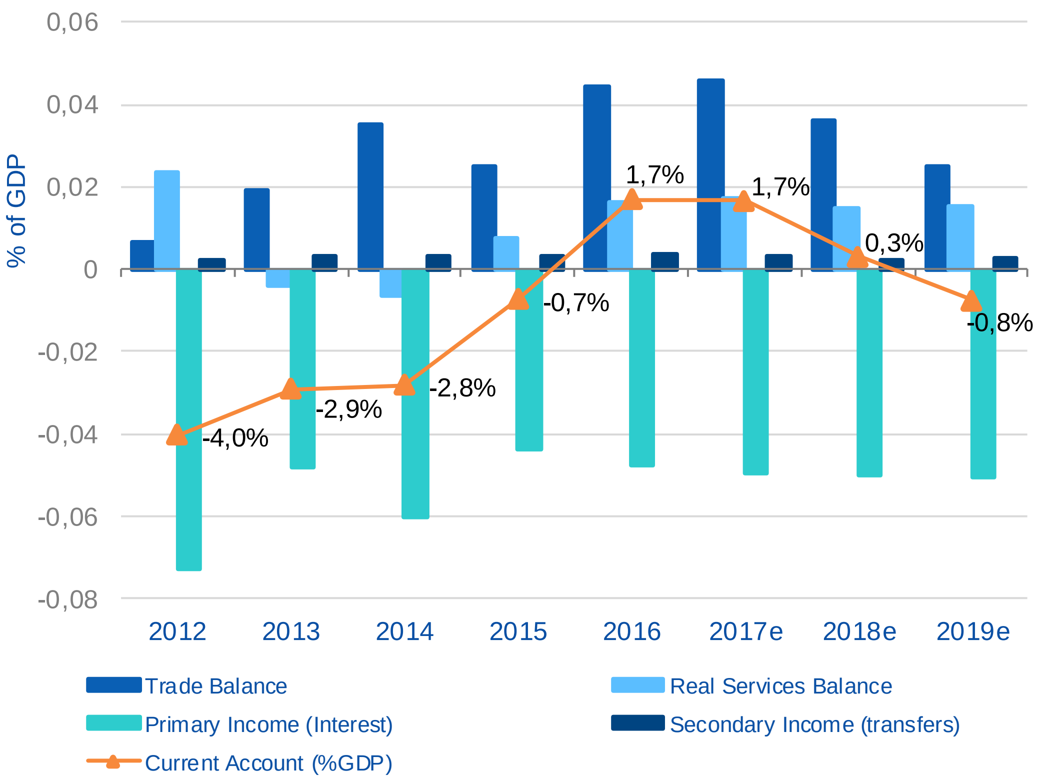


Source: BBVA Research based on BCU data

- We expect a certain recovery in the price of oil, stability in agricultural commodities and marginal increases in meat and dairy products
- We continue with our baseline scenario of rising imports due to increased growth and the purchase of capital goods for the pulp mill from 2018
- Exports will grow at a more limited pace but with an additional increase once the pulp mill is completed.

The current account remains in surplus in 2017 but we estimate it will start to deteriorate from 2018

Current account result (MBP6)
(% of GDP)



Source: BBVA Research based on BCU data

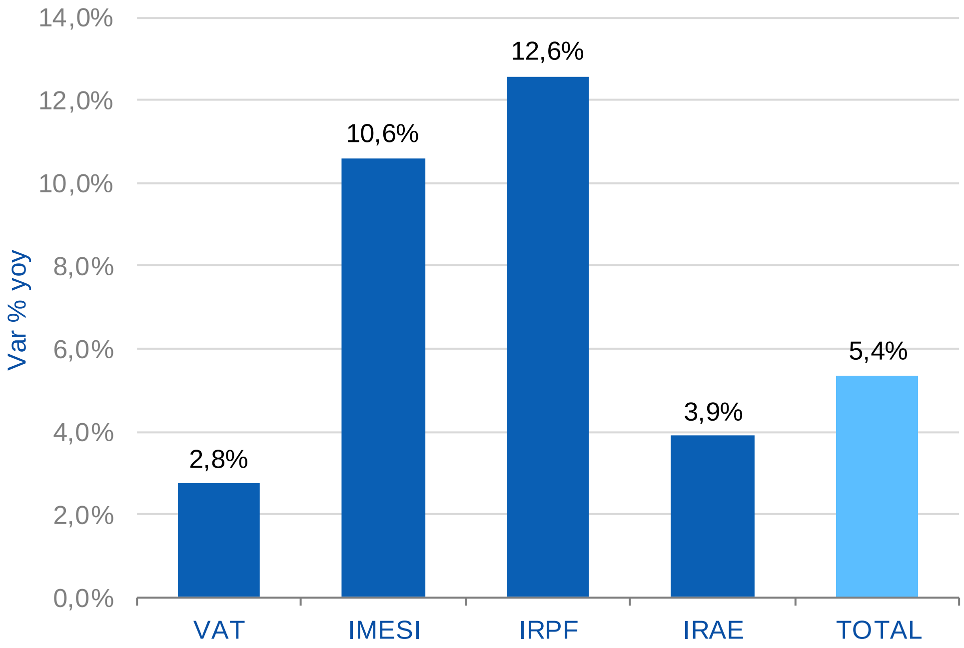
The increase in imports will cut the trade surplus

- The balance of trade for goods will continue to be positive, although the surplus will be reduced by increased imports
- Tourism will make a significant contribution, particularly if there are no major currency upsets in the region
- The current account deficit will be financed partly by FDI (UPM is financing the new pulp mill itself)

Fiscal Consolidation: going the right way, but more slowly than expected

Tax revenues in real terms

(Change % YoY, Jan-Sept.)



VAT: Value Added Tax
IMESI: Tax on Specific Goods
IRPF: Personal Income Tax
IRAE: Corporation Tax

Source: BBVA Research based on MEF (Ministry of Economy & Finance) data

The government is maintaining its objective of reducing the public sector deficit to 2.5% of GDP in 2019

The adjustments made to IRAE and IRPF have improved tax revenues in real terms

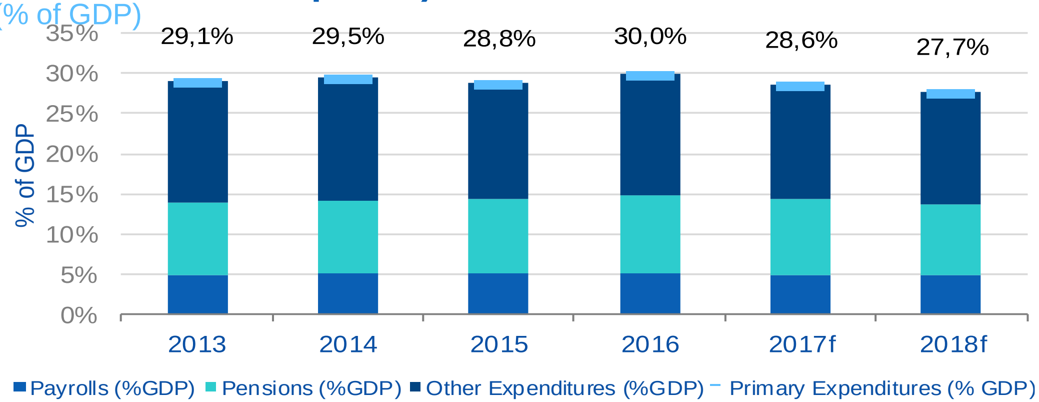
Revenue from VAT and IMESI increase in line with private consumption

We continue to foresee a total deficit of 3.5% of GDP for 2017 and of 3.1% in 2018

To come anywhere near the 2019 target will require extra effort on the part of the government to reduce the ratio of primary expenditure to GDP

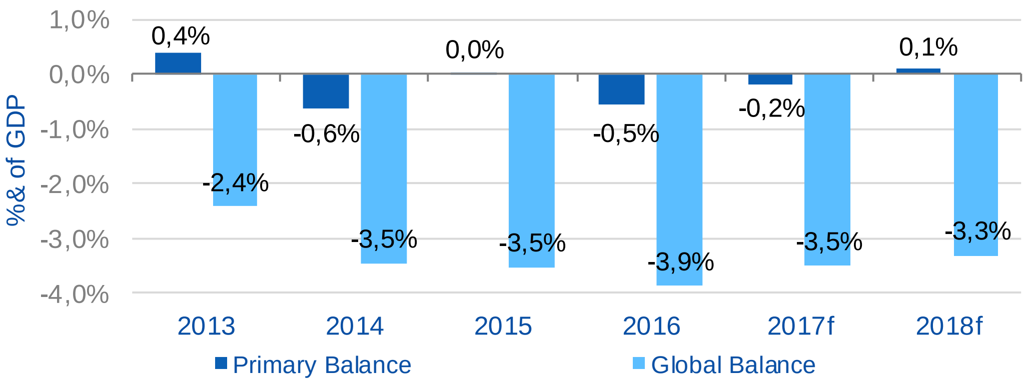
Primary Expenditure of the Public Sector (not including state-owned enterprises)

(% of GDP)



Result of the Public Sector

(% of GDP)

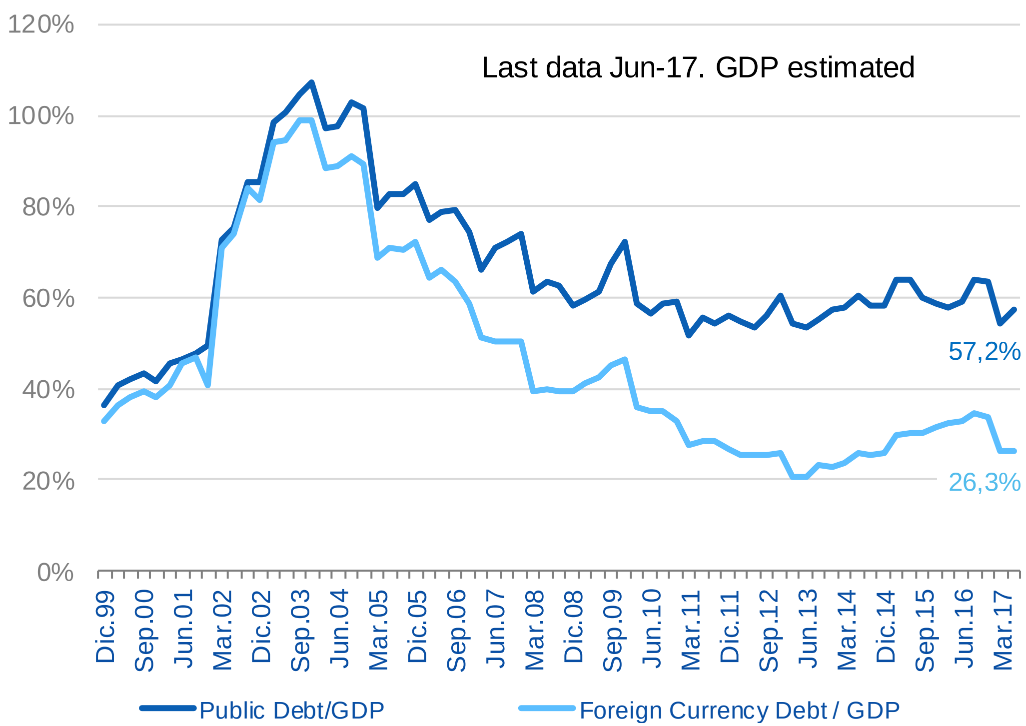


Source: BBVA Research based on MEF data

- Postponing certain items of expenditure as the last government did or reducing capital expenditure of state-owned enterprises served to reduce spending as a percentage of GDP in 2017, but going forward the focus should be on more structural reforms to increase the efficiency of the public sector
- The latest official data to September showed a cumulative 12-month deficit on the order of 3.6% of GDP, in line with our forecast for the year

This year the government resumed the process of dedollarisation of its debt, carrying out successful issues in pesos

Gross Debt of the Public Sector
(% of GDP)



Source: BBVA Research based on data from BCU and MEF

The public debt/GDP ratio is still moving within a contained range

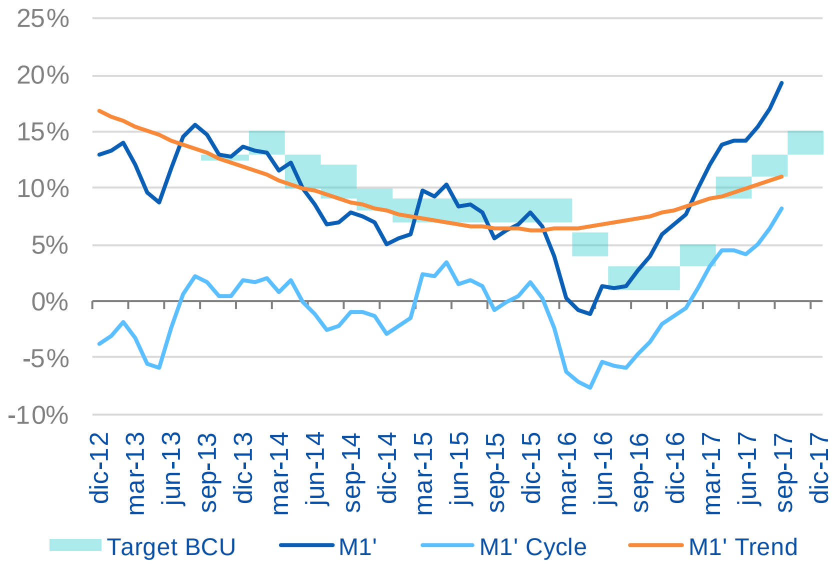
- The debt in dollars is approximately 46% of total public debt
- The increase of GDP in dollars has led to an improvement in the ratio of debt to GDP, despite the fact that debt increased by some US$ 1.97 billion in the first half of this year.
- Rating agencies confirmed investment grade for Uruguayan debt

BBVA | Research

Contractive bias of monetary policy eases

Aggregate change in M1+ and targets

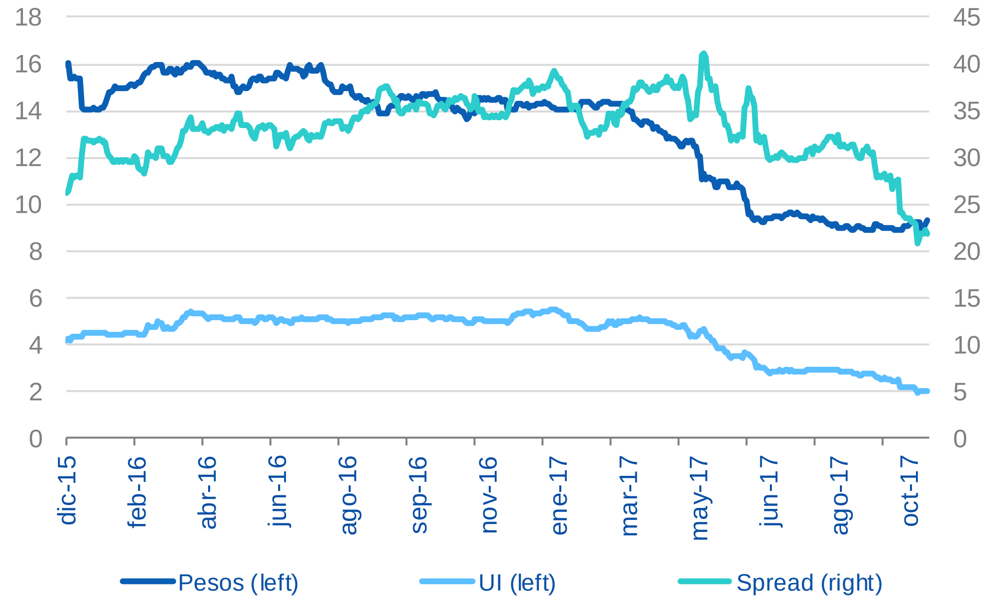
(%)



Source: BBVA Research based on BCU data

Inflationary Expectations

Spread % yield curve at 1 year, pesos and indexed units of account at 1 year



Source: BBVA Research based on BEVSA (Uruguay Electronic Stock Exchange) data

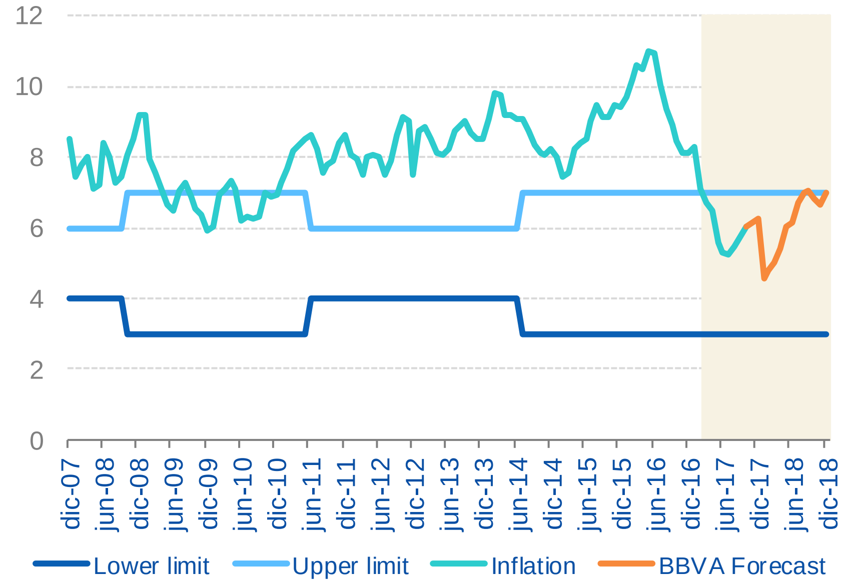
The BCU meets the increased demand for pesos, increasing the targets from 1Q17 in line with the fall in inflation

The spread between instruments in pesos and those in indexed units of account has narrowed significantly, indicating a decline in inflationary expectations

The CPI will end the year within the BCU’s target range

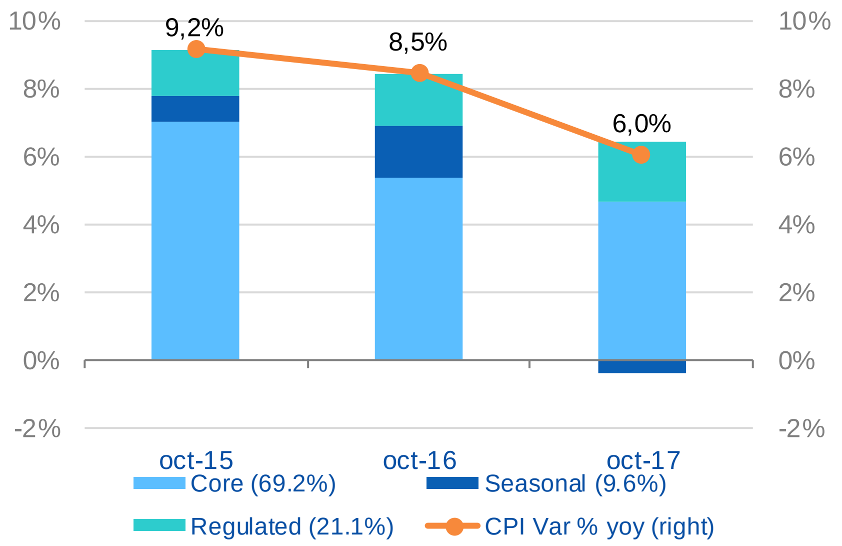
We have revised inflation for 2017 down to 6.3% and for 2018 to 7.0% in view of the stable exchange rate and the seasonal adjustment of electricity tariffs

Inflation within target range
(%)



Source: BBVA Research based on data from the INE and BCU

Consumer Price Index
Chge. YoY, general level and contributions



Source: BBVA Research based on INE data

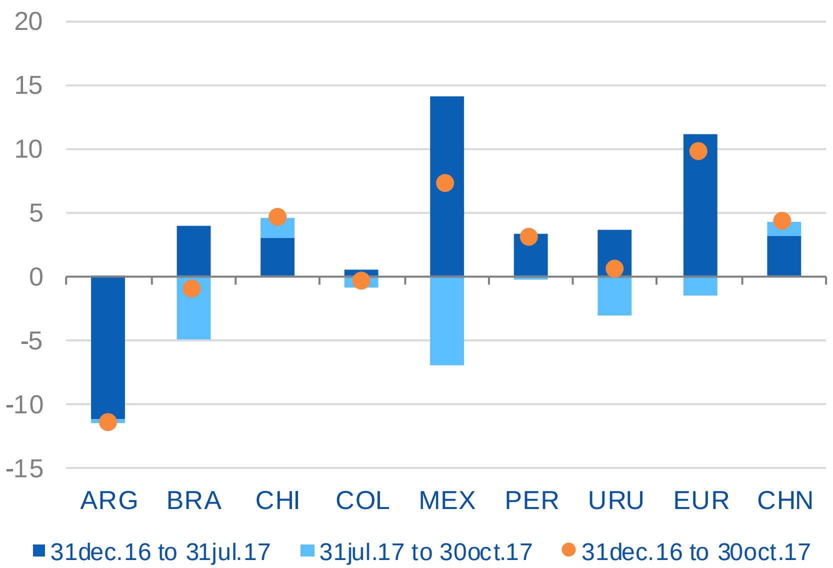
Since Dec. ’07 the CPI has been in the target range in just 21 months out of 118, or 17.8% of the time

Apart from seasonal factors and the reduced use of price controls to contain inflation, the decline in core inflation also reflects more structural factors

Regional currencies have appreciated somewhat in the year, but in the past quarter the dollar has regained ground

Trends in trading partners' currencies

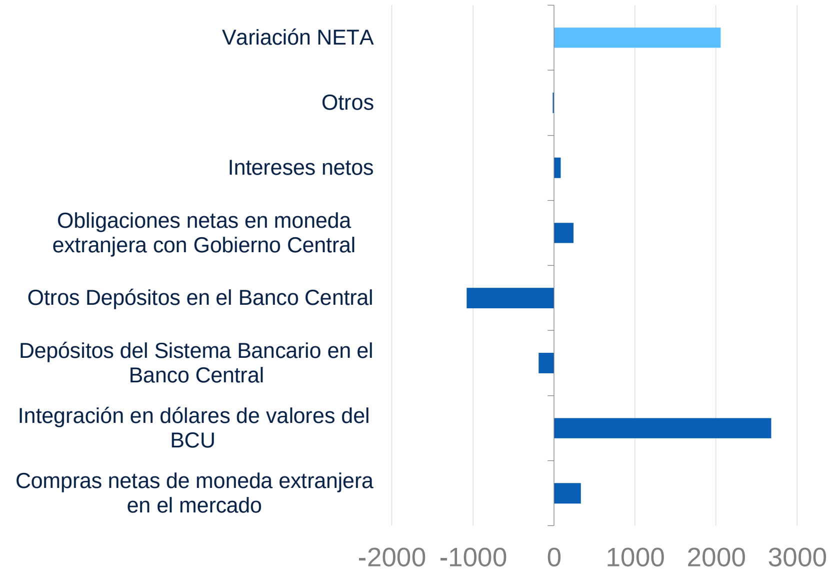
(%)



(-) implies depreciation against the dollar
Source: Haver, BBVA Research

Reserve Assets

Factors behind the cumulative change in 2017 (US$ millions)



Source: BCU

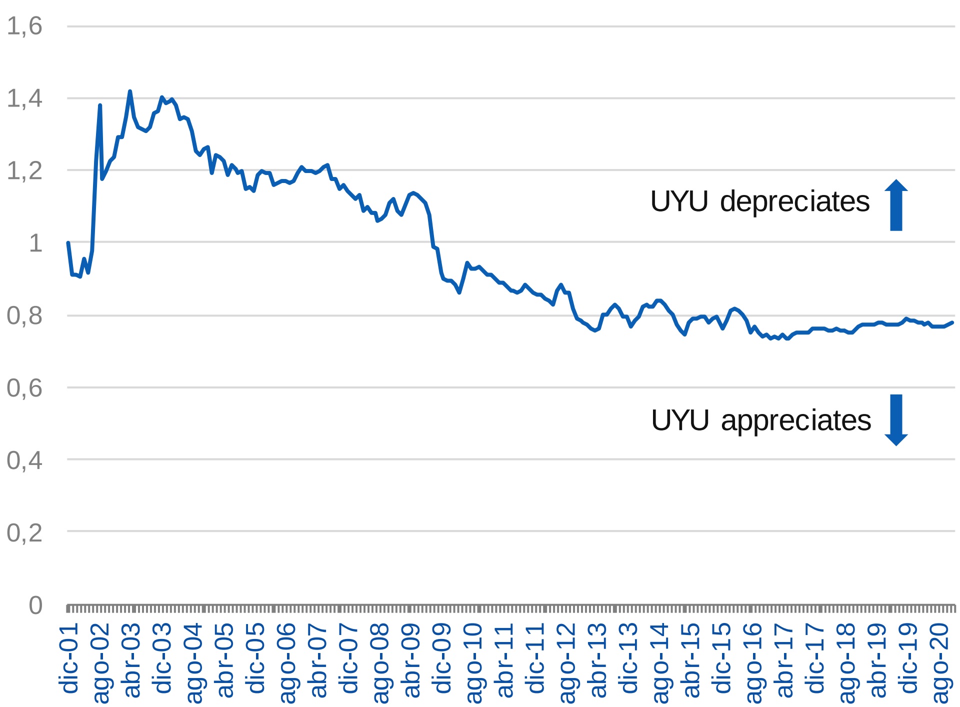
The Uruguayan peso shows a similar but more moderate trend, since the BCU gives priority to reducing volatility

The build-up of foreign currency reserves thanks to additions in dollars reflects the appetite for Uruguayan sovereign assets

We are maintaining our exchange rate forecasts in an environment of gradual interest rate increases by the Fed

Multilateral real exchange rate

Base Dec-01 = 1



The dollar will reach UYU29.50 at the end of 2017 and UYU31.40 at the end of 2018

The exchange rate of the Uruguayan peso will also be affected by the weakening of the Brazilian real and Argentine peso

In terms of the multilateral real exchange rate, the UYU will depreciate by around 3% between the end of 2016 and the end of 2018

Source: BBVA Research based on data from HAVER

BBVA Research

URUGUAY

Macroeconomic forecasts	2015	2016	2017e	2018e
GDP (% YoY)	0.4	1.5	3.2	3.1
Inflation (% YoY, EOP)	9.4	8.1	6.3	7.0
Inflation (% YoY, average)	8.7	9.6	6.2	6.1
Exchange rate (vs. USD, EOP)	29.7	28.8	29.5	31.4
Exchange rate (vs. US$, average)	27.3	30.1	28.7	30.5
Lending interest rate (%, average)	21.4	22.3	21.5	21.8
Private Consumption (% YoY)	-0.5	0.7	4.3	4
Public Consumption (% YoY)	2.2	1.6	-1.5	-1.0
Investment (% YoY)	-9.0	0.7	-5.0	3.5
Tax Revenue (% GDP)	-3.5	-3.9	-3.5	-3.1
Current Account (% GDP)	-0.7	1.7	1.7	0.3

Source: BBVA Research

BBVA Research

This report has been produced by the Argentina Division

Chief Economist
Gloria Sorensen
gsorensen@bbva.com

Adriana Haring
aharing@bbva.com

Juan Manuel Manias
juan.manias@bbva.com

BBVA Research

Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Long-Term Global Modelling and Analysis
Julián Cubero
juan.cubero@bbva.com

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

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

International Coordination
Olga Cerqueira
olga.cerqueira@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain and Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Middle East, Asia and Geopolitical
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

BBVA Research – BBVA Banco Francés, Reconquista 199, 1ª planta C1003ABC - Buenos Aires, Argentina Tel. (+54) 11 4346 4000 - Fax (+54) 11 4346 4416

bbvaresearch@bbva.com - www.bbvaresearch.com