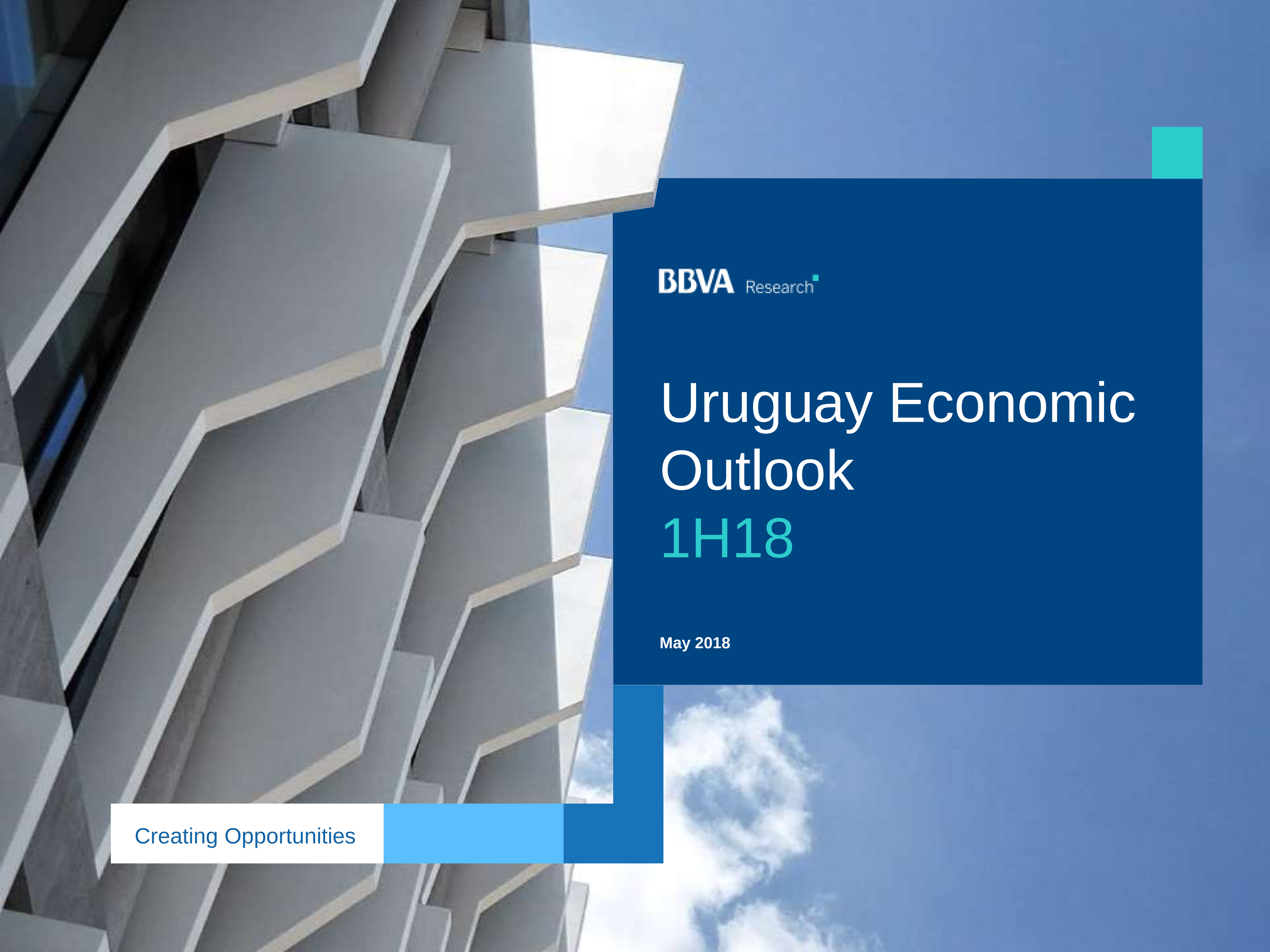


BBVA Research

# Uruguay Economic Outlook
## 1H18

**May 2018**

Creating Opportunities

## Contents

# Key messages

- Global growth remains robust, but uncertainty is increasing. US protectionist measures pose a risk
- The region's recovery holds firm amid external turbulence, but the strengthening of the USD increases the risk for Latin American assets
- Downward revision of growth in Uruguay due to the effect of the drought on the agricultural and livestock sector and hydroelectric generation. Private consumption slows due to slacker pace of increase in real wages
- No changes in fiscal forecasts, but now more important than ever to rise to the challenge of reducing non-forecast primary expenditure in order to attain the fiscal target of -2.5% of GDP in 2019
- Despite the good performance of exports, the external accounts will deteriorate, basically due to increased imports reflecting greater dynamism of investment
- The Uruguayan peso remains strong despite higher regional volatility, while inflation will hold steady at levels close to the upper limit of the central bank's target range

# 01

## Global environment

Growth rate holds firm,
but risks of protectionism intensify

# Robust global growth, but greater uncertainty

01

### The pace of global growth continues...

...thanks to the recovery in investment and trade

02

### Economic policies are extending the cyclical recovery

The US fiscal stimulus could provide support to other regions

03

### Greater financial volatility

The unusual environment of low volatility has been left behind

04

### Normalisation of central banks' monetary policy,

somewhat faster than expected in the case of the US Federal Reserve, while the ECB has already taken the first steps

05

### Uncertain effect of US protectionist measures

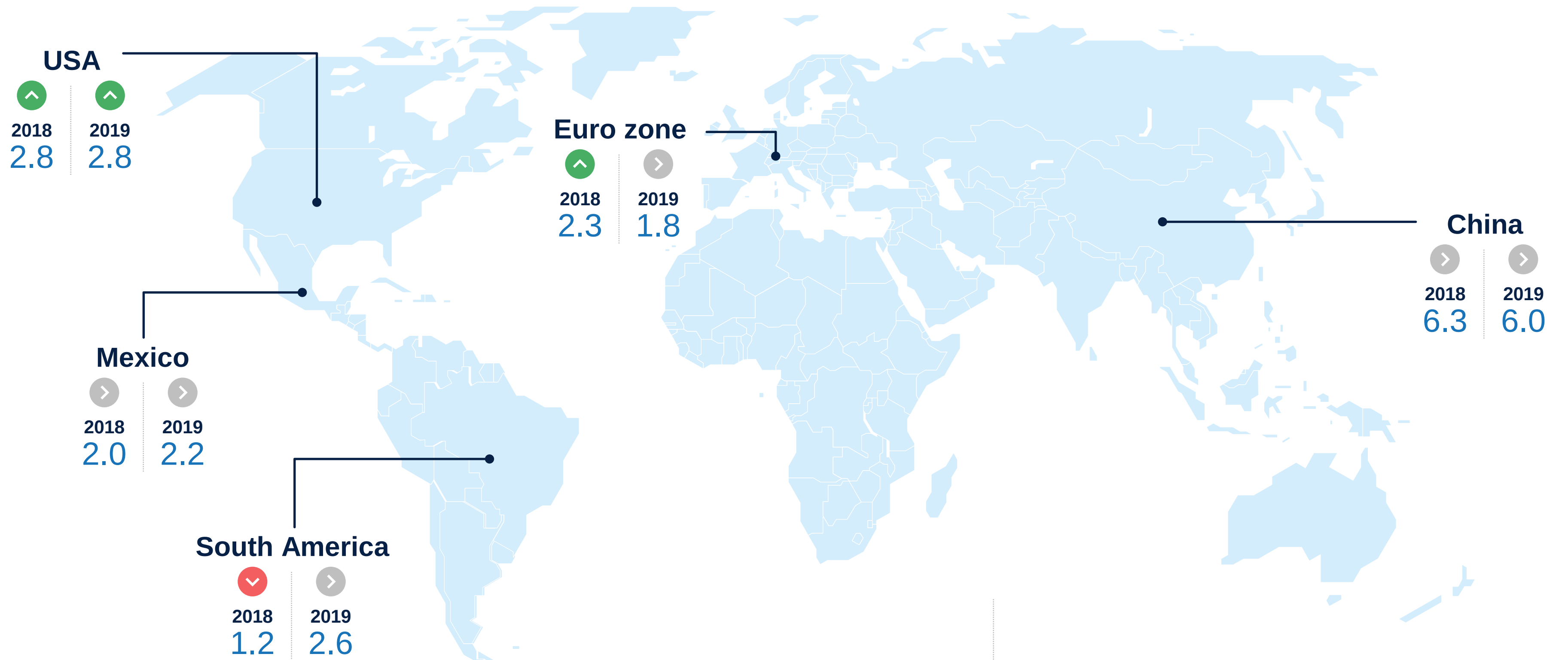
The direct effect of those already approved is not significant, but more aggressive measures may be in store

06

### Global risks

Increasing in the short term due to possible escalation of protectionism and toughening of global financial conditions

# Revised upwards in the USA and downwards in South America



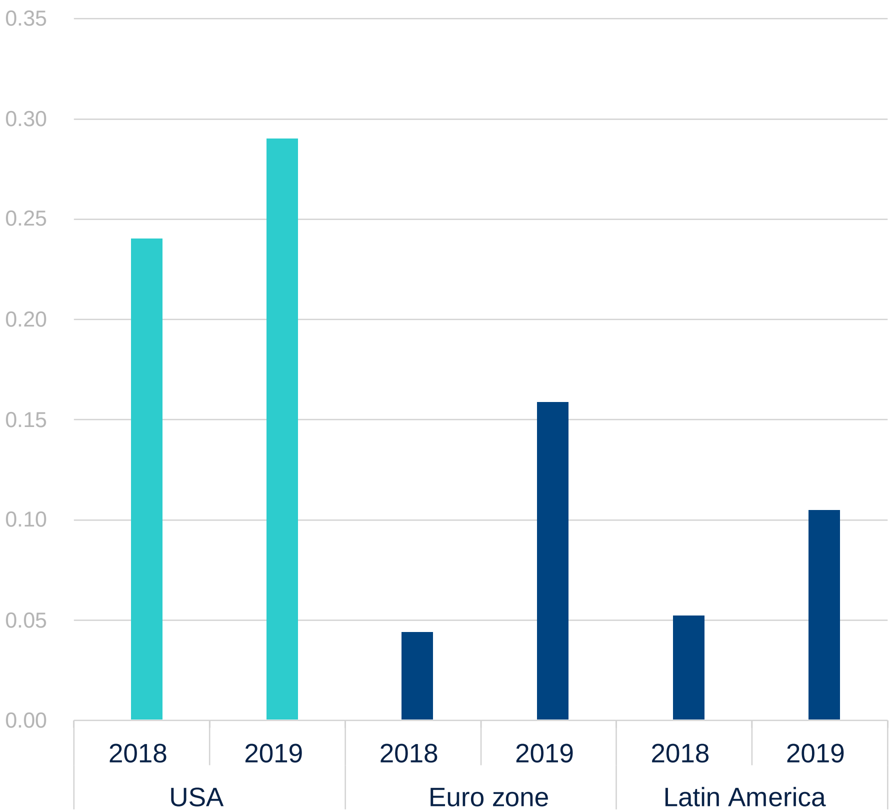


Up
Unchanged
Down

Source: BBVA Research

# Higher growth in the US could provide support for progress in other regions

### Impact of the US fiscal stimulus on growth
(pp)



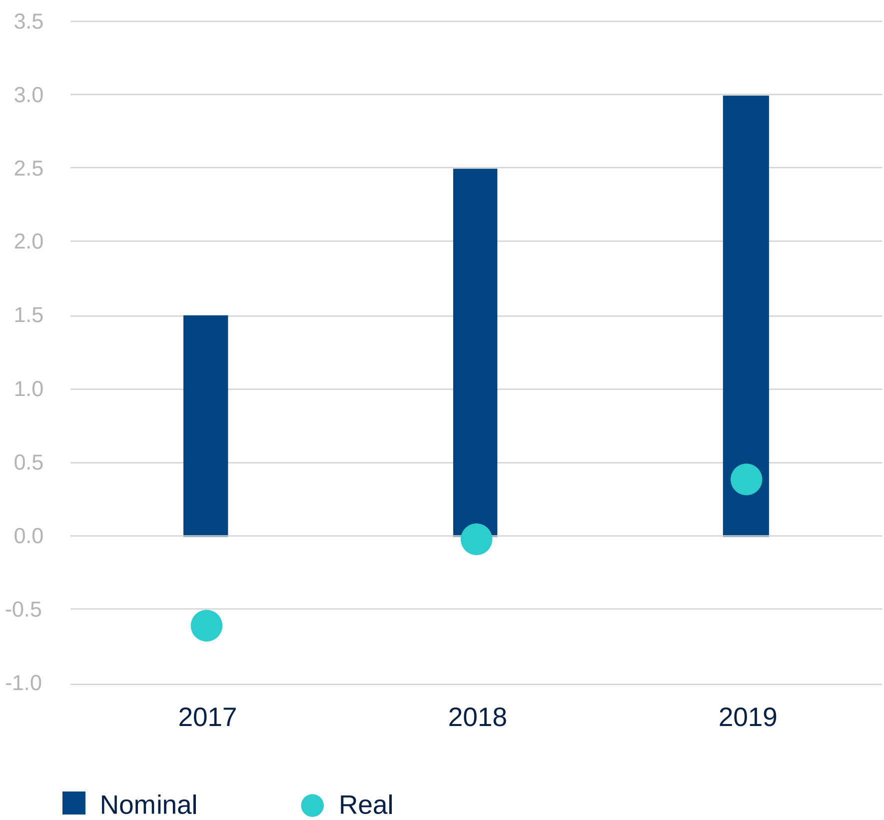

Source: BBVA Research

- Moderate effect of the new fiscal stimulus in the short term in an economy at full employment and in the absence of measures to support a significant increase in potential growth
- The most significant effect should be observed in 2019, especially in the euro zone
- Such support should offset some headwinds in other areas (political uncertainty in Latin America and increasing global volatility)

# US Federal Reserve rate hikes are picking up pace in light of greater economic dynamism

## USA: Federal Funds Rate

(%)




Source: BBVA Research

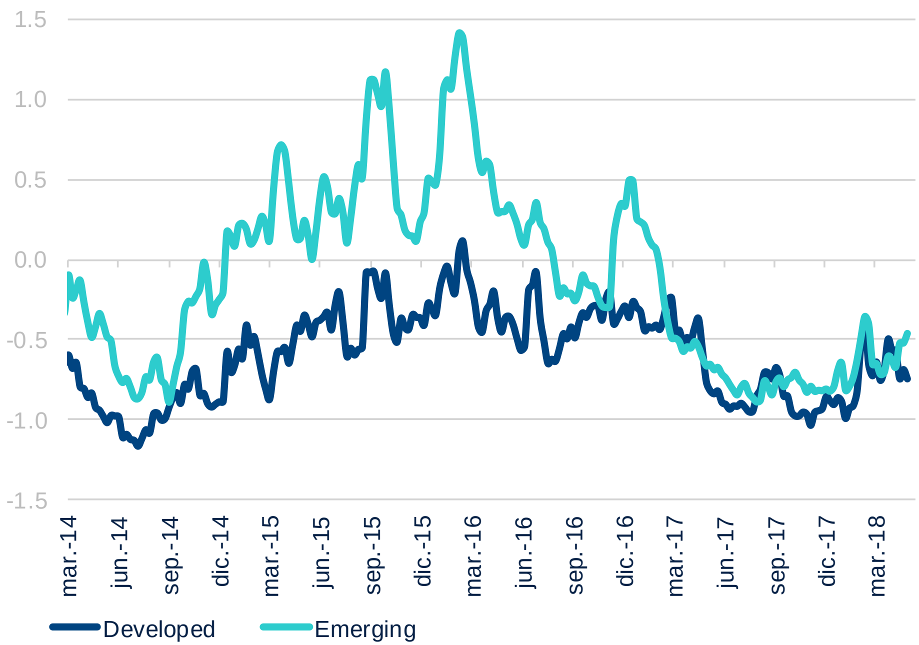
- The Federal Reserve will raise rates by 75 bps more this year and another 50 bps in 2019
- Monetary conditions will remain loose, with real interest rates close to zero

# Financial tensions are starting to reflect a less complacent environment, as investors grow more cautious

- Central banks will reduce their balance sheets, interest rates are gradually rising and volatility shocks may become more frequent and persistent
- Fears of an uptick in inflation (US) and the announcement of protectionist measures have led to an increase in volatility and a reassessment of emerging market risk which weakens inflows and leads in turn to currency depreciation, increased risk premiums and falling stock markets

## BBVA financial stress indicator

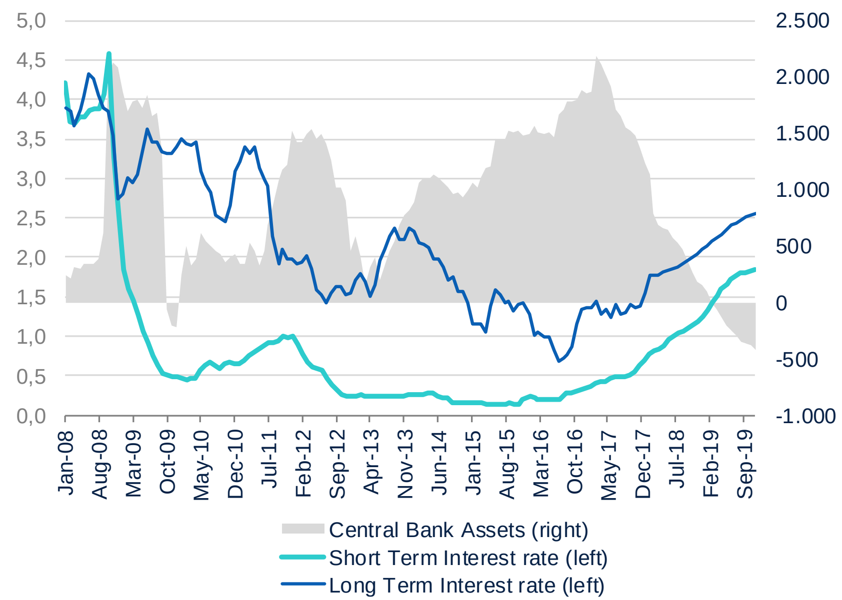
(%)




Source: BBVA Research based on Bloomberg

## Global financial conditions*

(% and change in US$ billions)



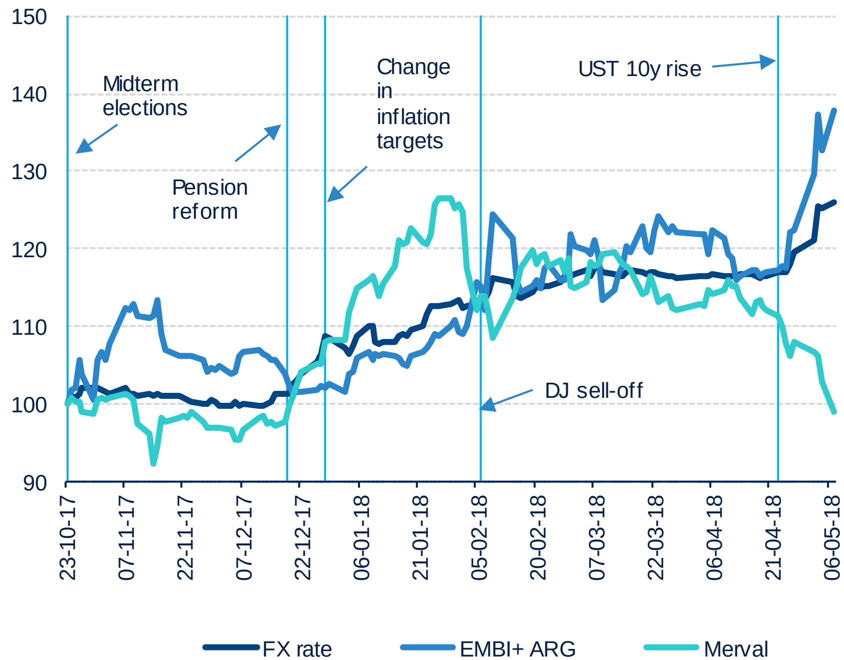

(*) Short- and long-term interest rates, average yield of German and US bonds over 3 months and 10 years. Includes assets on the balance sheets of the Fed, ECB, BoE and the BoJ

Source: BBVA Research, Fed, ECB, BoE and BoJ

# Particularly affecting the countries most exposed to external financing, such as Argentina

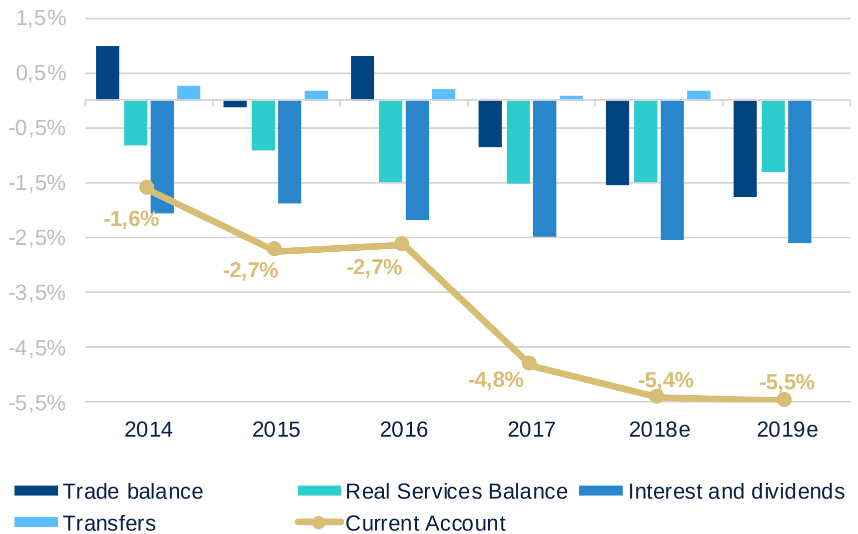
- Country risk, which had fallen by more than 100 bps in 2017, has increased by more than 90 bps so far in 2018, which together with the increase in the ten-year US Treasury rate makes financing the fiscal deficit significantly more expensive
- The rapid deterioration in the current account deficit raises doubts as to the sustainability of external debt, which will depend crucially on meeting the fiscal targets and boosting FDI to levels similar to those of the region as a whole

## Market indicators
(base Oct. 2017 = 100)




Source: BBVA Research and Haver

## Argentina's current account
(% of GDP)

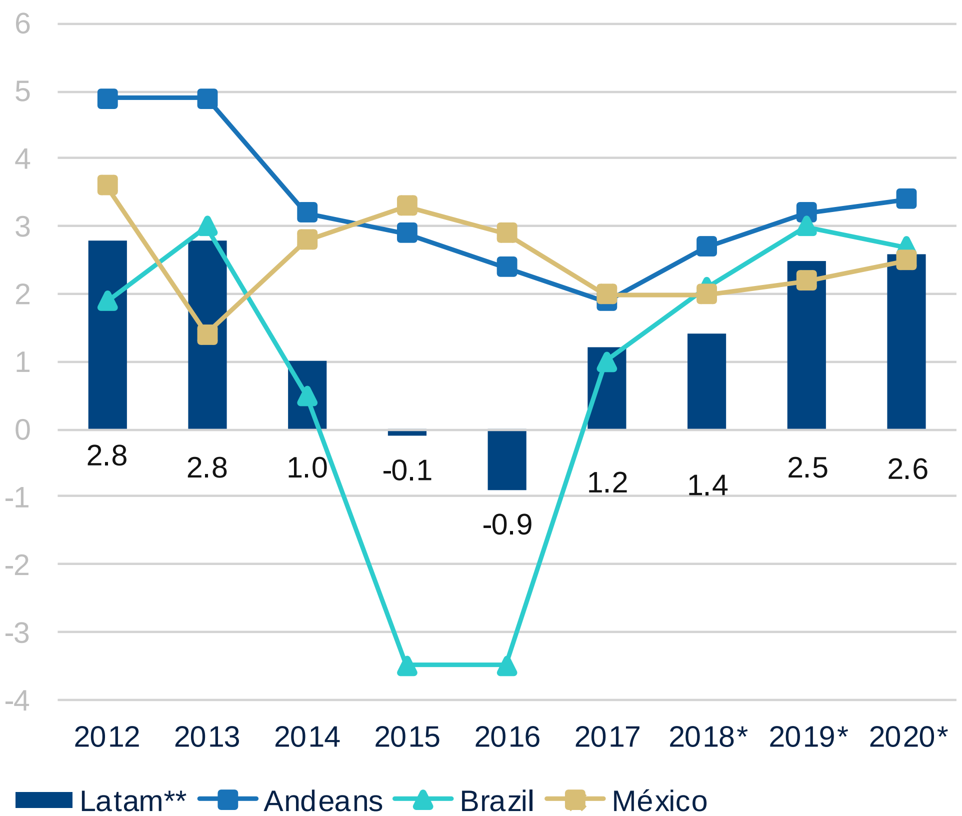



Source: INDEC (National Statistics Institute) and BBVA Research

# Confidence continues to improve in Latin America, underpinning growth, in spite of some negative external shocks

## Latin America: GDP growth

(% YoY)



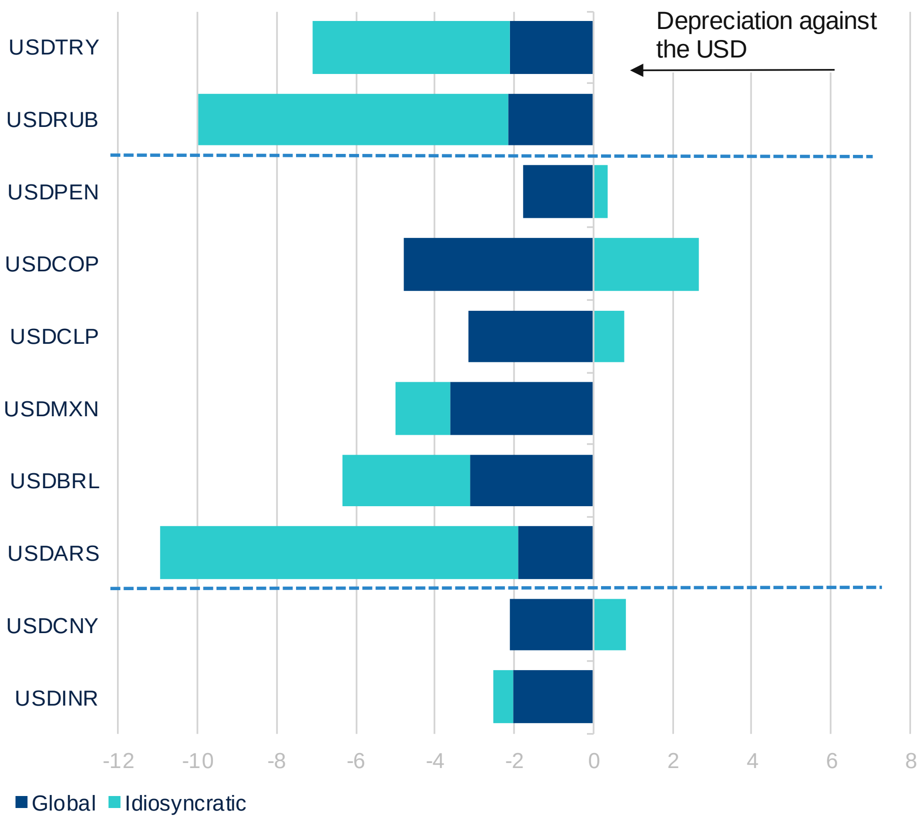

(*) Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela.
Source: BBVA Research

- The increase in growth in 2018 and 2019 will continue to be supported by two factors:
  - The external sector: with increased world growth and higher commodity prices
  - A boost from investment, both private and public
- Growth will be lower than in other emerging regions such as Asia or Eastern Europe

# The expected depreciation of currencies in 2018 and 2019 in the majority of countries in the region has accelerated

## Exchange rates against the dollar

(Chg. % from 1 April to now)




Source: BBVA Research

- Depreciation of currencies going forward, in a context of:
  - Federal Reserve interest rate hikes and end of the cycle of cuts in Latin America
  - Moderation of commodity prices
- The exception is Argentina, where greater inflationary pressure and the bigger external deficit will make depreciation faster than in the rest of the region
- The Mexican peso could appreciate if the risks associated with the NAFTA negotiations and the elections do not materialise

# Greater external risks, except for China…

### 01

Protectionism and impact on global trade flows

### 02

Pace of exit from the Fed's stimulus measures (aggressive rate hikes in response to temporary increase in inflation)

### 03

Leveraging and sharp slowdown in China

## …while domestic risks remain, with considerable disparities among countries

### 04

Political noise: increased risk in Peru, Brazil, Colombia and Mexico; decreased risk in Chile and Argentina

### 05

Delays in private and public investment Increasing risk in Peru and Argentina from higher currency volatility and fiscal adjustment

### 06

Failure to push ahead with reforms and boost productivity

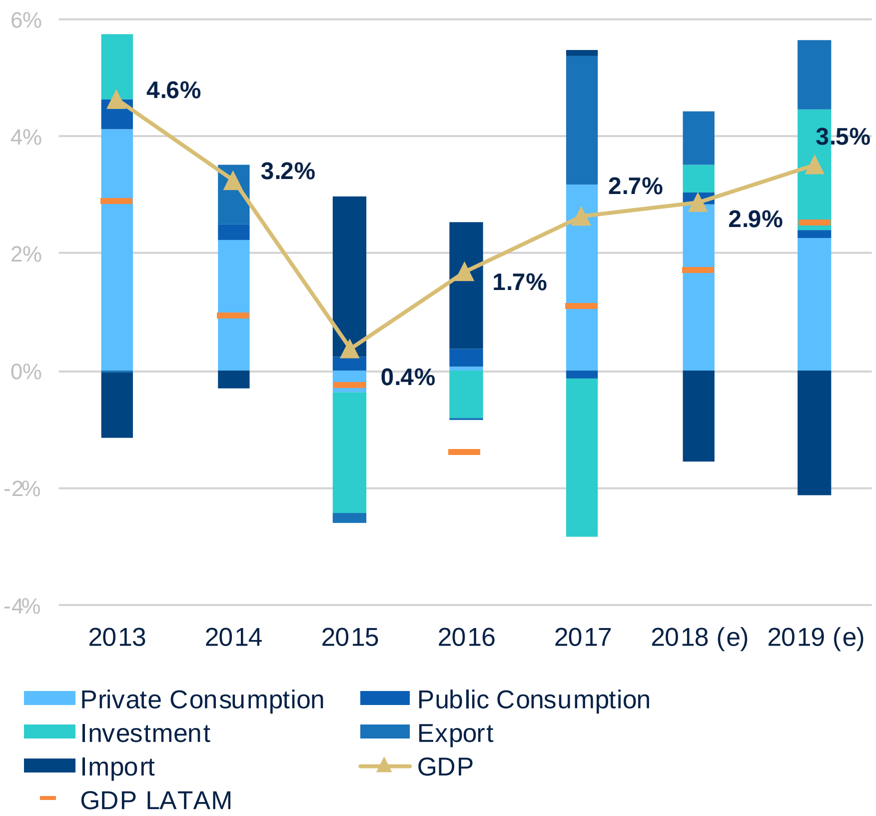
# 02

## Uruguay

Growth slows, but investment expected to pick up

# Uruguay has completed 15 years of uninterrupted growth, and in the past ten years it has grown by more than the average for Latin America

## GDP by expenditure component
(effects in %)




Source: BBVA Research and Uruguayan Central Bank

- GDP grew by 2.7% in 2017, driven by private consumption (+4.4% YoY) and exports (+7.6% YoY), but with a poor performance from investment (-13.8% YoY)
- Activity in 2018 (+2.9%) will again be driven by private consumption, which will continue to grow, albeit at a slower pace than in 2017, and we will start to discern a recovery in investment in infrastructure
- For 2019, we still think growth in investment will be driven by the construction of the country's third cellulose plant, taking growth to 3.5%

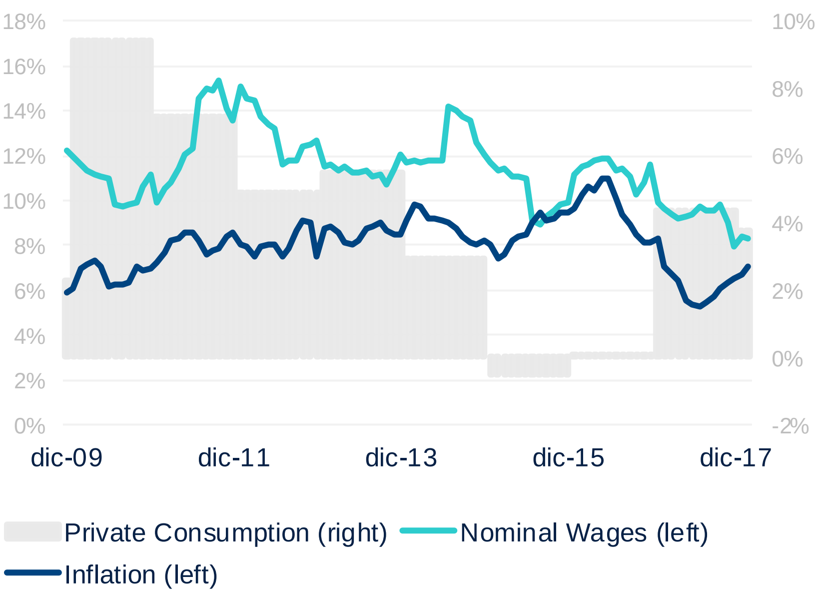
# What is behind the slowdown in private consumption?

- Lower growth in real wages in 2018: given the (decreasing) nominal growth guidelines for wages and relatively stable inflation

- Consumer confidence remains stuck at the 'moderate pessimism' level due to the deterioration in employment and lower growth in real wages
- Confidence in March was at 47.2 (down by -2.7% relative to February)

## Nominal Wages, Inflation and Private Consumption

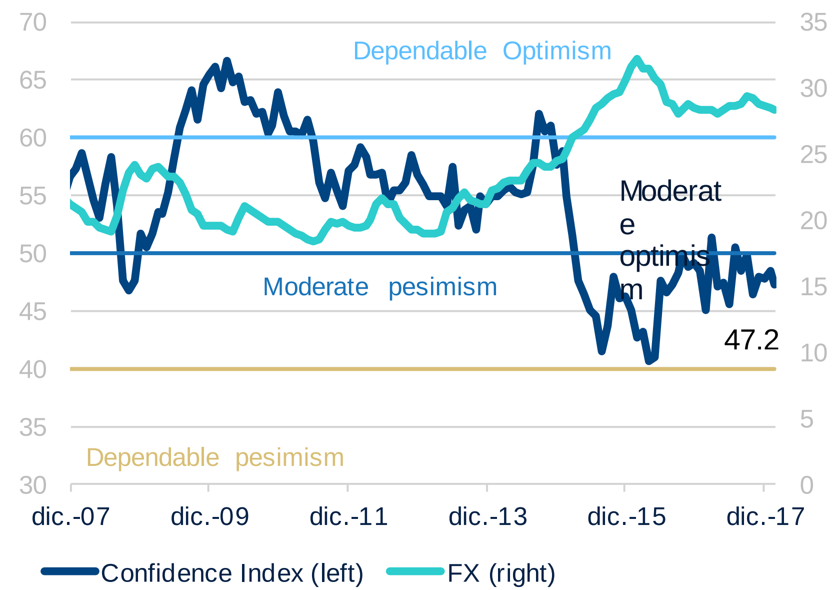
(Changes %, YoY)




Source: BBVA Research, Uruguayan Central Bank and INE (National Statistics Institute)

## Consumer Confidence and Exchange Rate

(CCI and UYU/ USD)



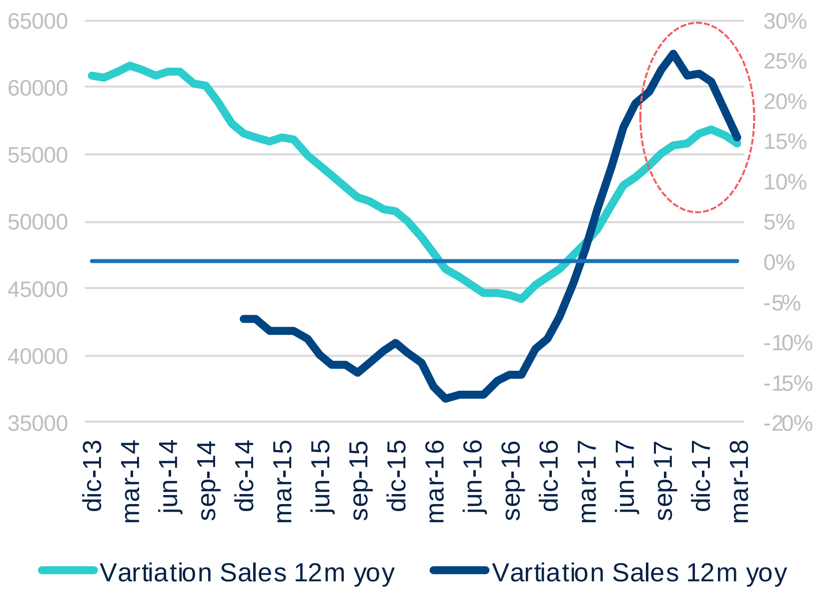

Source: BBVA Research, Teams

# First signs of slowdown in private consumption

- Sales of motor vehicles (including pick-ups, vans and heavy trucks) have started to slow, both in unit terms over the past twelve months and in twelve-month year-on-year terms

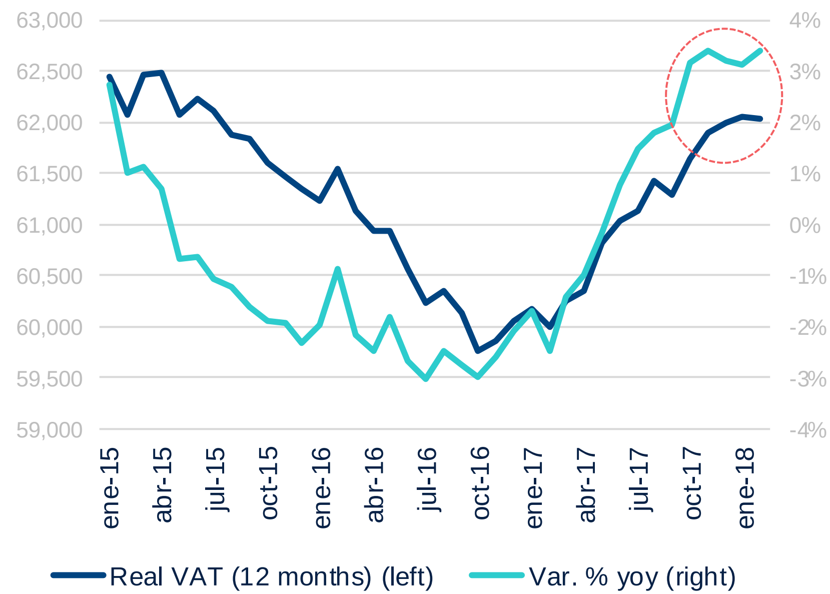
- VAT revenues, which are closely related to the level of activity and consumption, are starting to stagnate after several months of significant recovery

## Vehicles sales
(In units and Changes % YoY)




Source: BBVA Research and Ascoma (vehicle dealers association)

## VAT revenues in real terms
(Change % YoY)




Source: BBVA Research, Uruguayan Central Bank and Ministry of Economics and Finance (MEF)

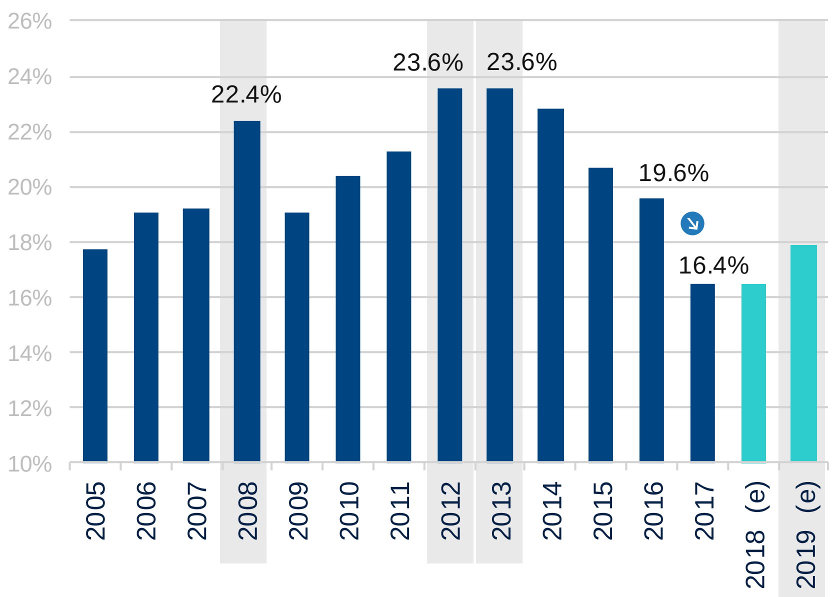
# Improvement in levels of employment requires investment to be boosted in order to attain sustainable growth

- The peaks in investment were reached in the years when the cellulose plants were built. Following the sharp fall of 2017, our baseline scenario assumes an increase in investment in 2019 with the construction of the third cellulose plant (the second by UPM) and the related necessary infrastructure

- In March the unemployment rate was 8.5% of the EAP (9.3% in February). Although monthly data are highly volatile, the trend is one of growing unemployment. This is closely linked to the low level of investment, particularly in construction, which is very labour-intensive

## Contribution of investment to GDP (constant)

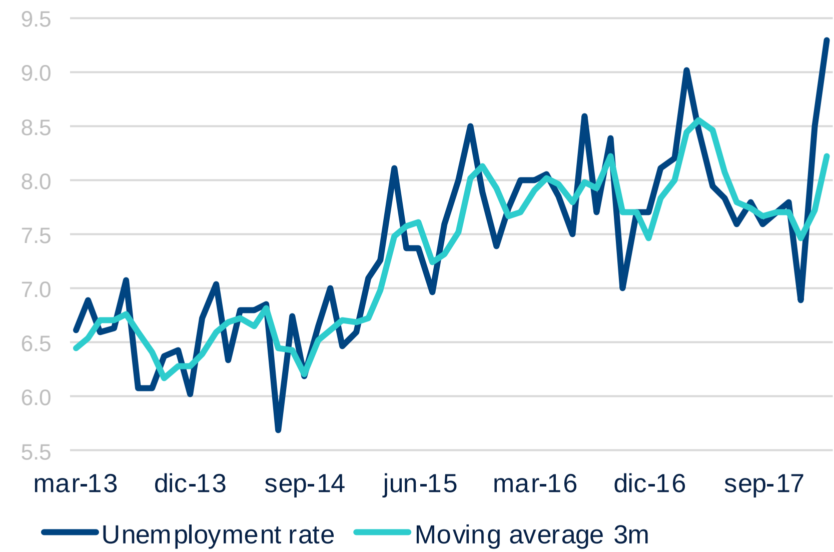
(% of GDP)




Source: BBVA Research, Uruguayan Central Bank and INE (National Statistics Institute)

## Monthly unemployment and 3-month moving average

(Rate in %)




Source: BBVA Research, INE

# Balance of indicators for 2018: Mixed signals, with a predominance of negative ones

## 01 Tourists

After reaching a record in 2017, the tourist industry continues to perform well: the number of visitors increased by 10.7% in 1Q18, although spending in dollars grew by only 1.1%, with average spending per person down by 8.3% YoY

## 02 ANCAP (state-owned oil, alcohol and cement company)

Industry is bound to show improvement relative to 2017 due to the reopening of the refinery after nine months of technical stoppage for five-year maintenance

## 03 Climate I

The agricultural sector was affected first by the drought ("la Niña") and more recently by excessive rains. Lower crop yields (mainly soya beans), but livestock and dairy sectors also affected

## 04 Climate II

The drought also leads to lower generation of hydroelectric power, this and wind power being the highest value added sources. The need to have recourse to thermal power generation to meet demand will affect the level of activity

## 05 Labour market

Unemployment data, although highly volatile in the short term and markedly seasonal, show a growing trend. With a given nominal wage guideline, real wages will not grow as they did last year thanks to the decline in inflation

## 06 VAT in real terms

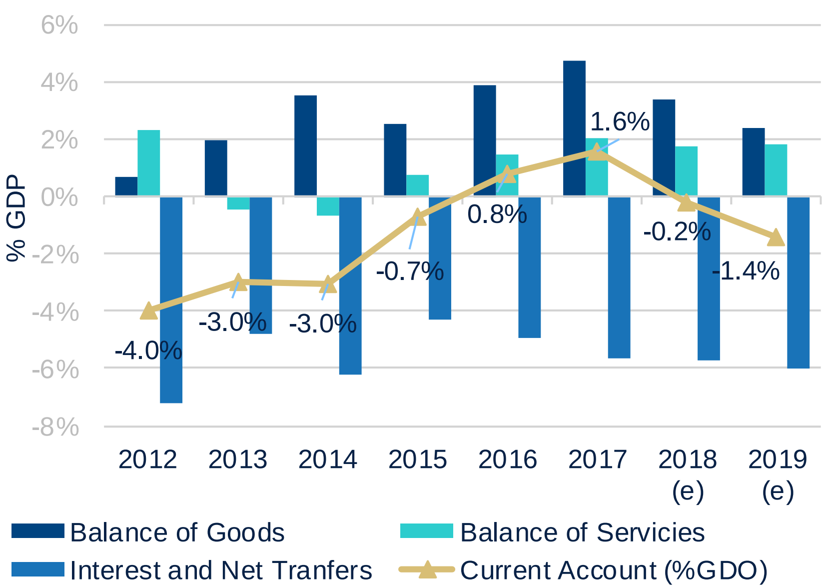
After growing by 3.2% in real terms during 2017, VAT revenues in 1Q18, also in real terms, fell by 1.1% relative to the same quarter of 2017

# The external surplus fades while we wait for FDI to arrive

- The deterioration in the balance of trade in goods will come from an increase in imports, due not just to increased activity but also to the capital goods needed to construct the third cellulose plant, leading to a current account deficit of 1.4% of GDP in 2019
- Exports will also suffer in 2018 as a result of the water shortages which reduce crop yields and affect the livestock and diary industries

## Current account and components

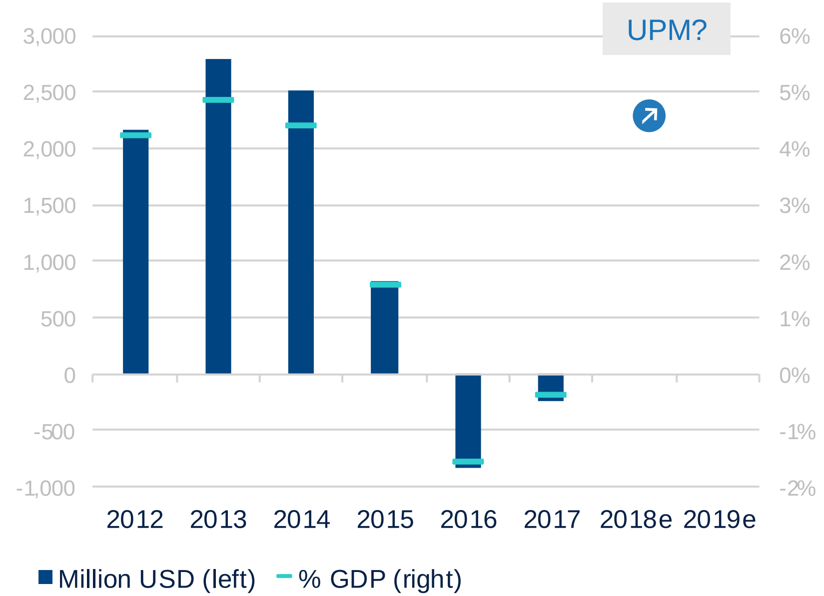
(% of GDP)




Source: BBVA Research, Uruguayan Central Bank

## Foreign Direct Investment

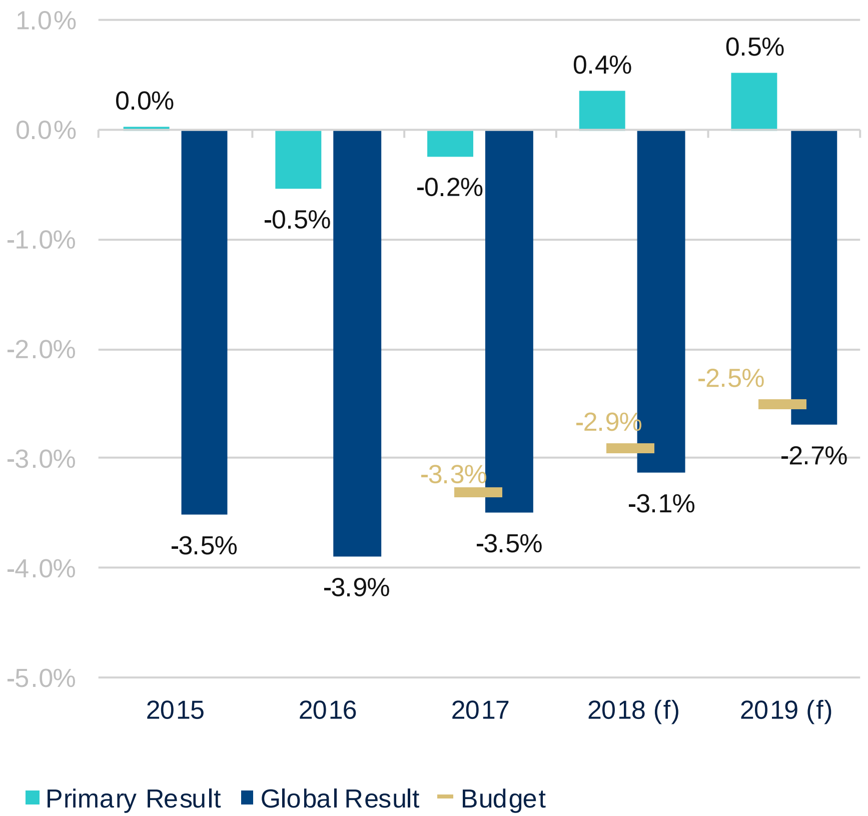
(In US$ millions and as % of GDP)




Source: BBVA Research, Uruguayan Central Bank

# No surprises on the fiscal front: consolidation at a slower pace than expected by the government

## Overall and Primary Fiscal Result
(% of GDP)



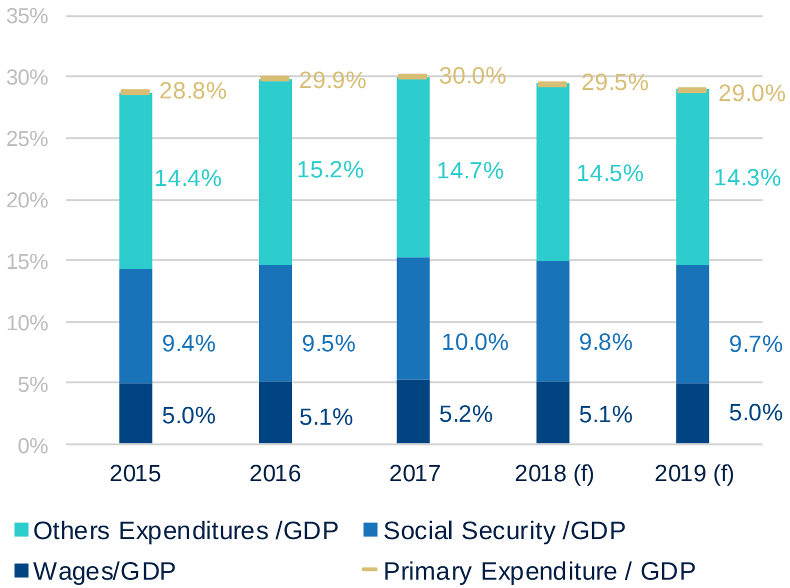

(f) Forecast.
Source: BBVA Research, MEF

- The result ended 2017 at 0.2 pp above the budget, but better than 2016, in line with our forecasts.
- Revenues improved thanks to the adjustments made to certain taxes although this is still not seen in VAT, which is directly linked to consumption and activity.
- We still see the overall result at the end of 2019 being a couple of tenths of a percentage point above the budgeted deficit

# To attain the target for 2019, the government will have to make an effort that involves not just containment but savings on spending

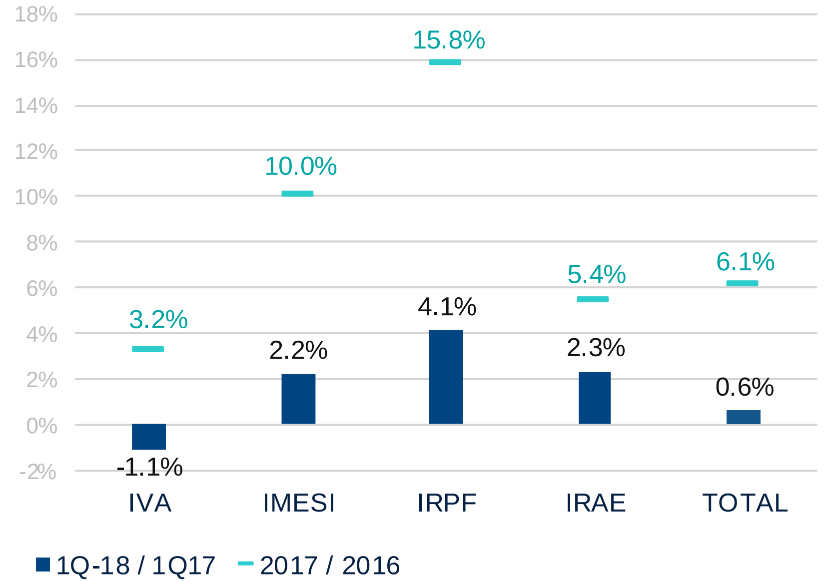
- The government has carried out the fiscal consolidation since 2016 basically on the revenues side (adjustments to business and personal income tax mainly) but it needs also to contain primary spending, half of which corresponds to pensions and wages, which are downwardly inflexible.
- Only with a fiscal effort involving savings of 1.2% of GDP in spending in 2018/2019 (from the 30% reached in 2017) will it be able to attain the 2019 fiscal target. In this regard it is important that the system of decreasing nominal wage negotiations be implemented.

## Components of Public Spending
(% of GDP)




(f) Forecast.
Source: BBVA Research, Uruguayan Central Bank and Ministry of Economics and Finance (MEF)

## Tax revenues: 2017 and 1Q 2018
(In real terms, chg. YoY)




Source: BBVA Research, MEF and INE

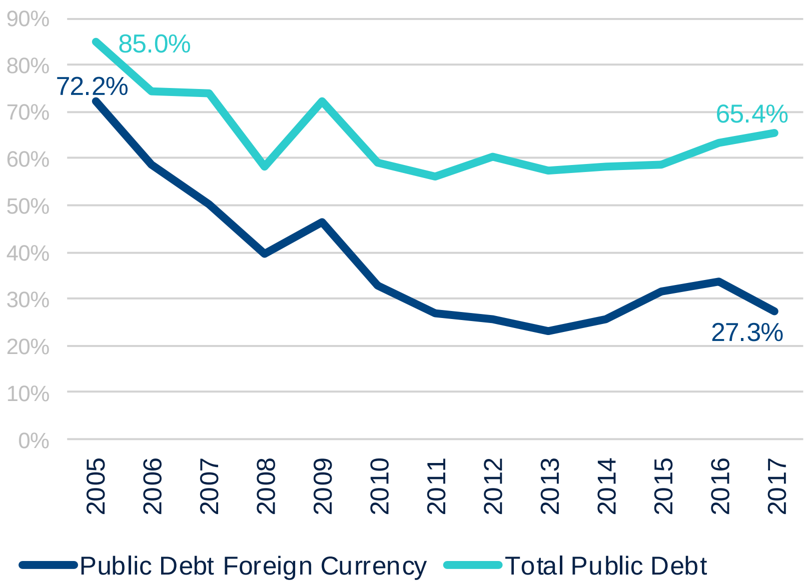
# Uruguay managed a successful bond issue maturing in 2055 before the sharp increase in volatility and global uncertainty

- Uruguay continues to manage its public debt well and took the opportunity to issue international bonds in dollars to finance the fiscal imbalance but also to extend the maturity profile

- The US$1.75 billion issue, the biggest in the country's history, saw demand amply exceeding supply at a rate of 5.03%.

## Uruguay's Public Debt by Currency

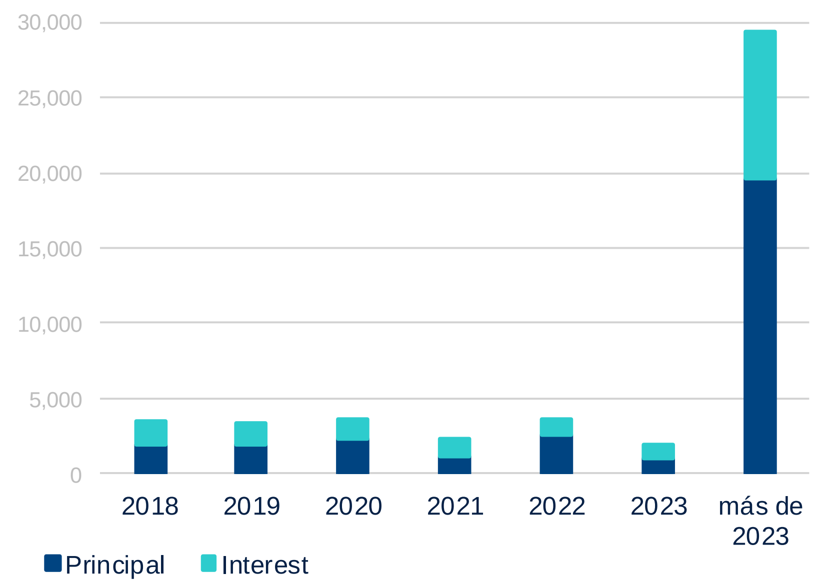
(Changes %, YoY)




Source: BBVA Research, Uruguayan Central Bank

## Maturity profile of public debt

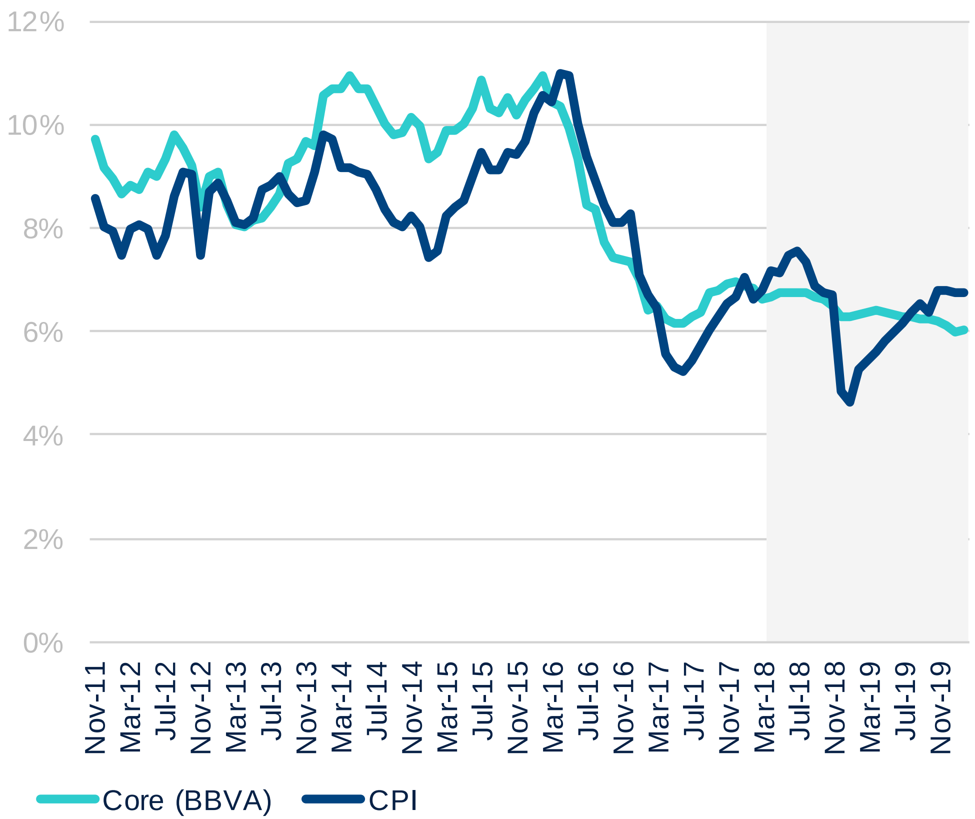
(In US$ millions)




Source: BBVA Research, Uruguayan Central Bank

# Inflation will remain in the upper part of the central bank's target range

## Inflation: headline and core
(change % YoY)



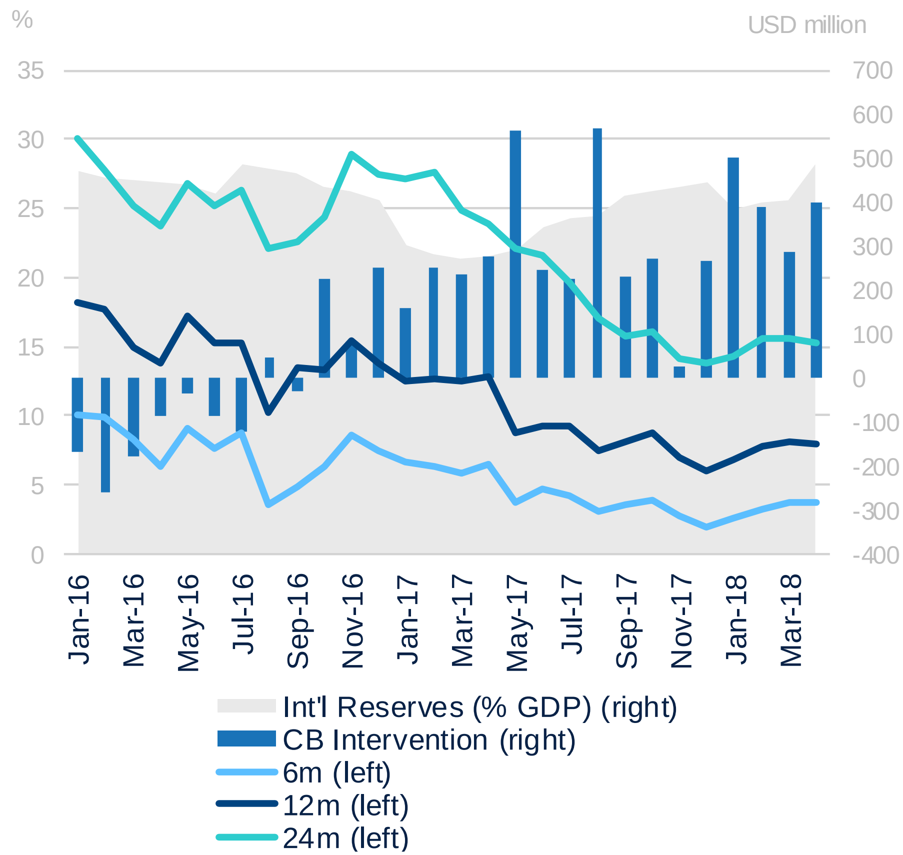

Source: BBVA Research, INE

- Core inflation has stabilised at around 6.8% YoY
- Containment of wage momentum, with agreements extended to three years with average annual nominal increases of 7.5%, 7.0% and 6.0%.
- Monetary policy is sticking to its commitment, while still going along with the preference for pesos of the past few months
- Inflation will reach 6.7% this year and 6.8% next year

# The peso remains attractive despite the Central Bank's intervention

## Reserves and Expectations of devaluation

(% of GDP)




Source: BBVA Research, Uruguayan Central Bank

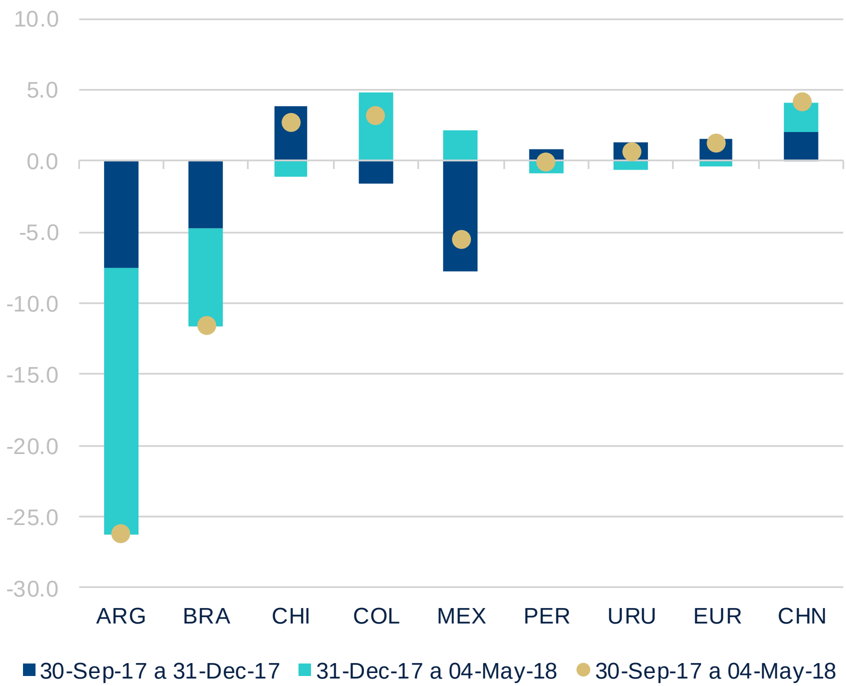
- So far this year the Uruguayan Central Bank has bought US$1.6 billion to relieve pressure on the exchange rate
- The accumulation of reserves (29% of GDP) reinforces expectations of lesser devaluation
- Reduced external vulnerability to structural changes and policy of pre-financing are reflected in the exchange rate
- We estimate the exchange rate at UYU 30.50 to the US dollar at year-end 2018 and 32.60 at the end of next year

# Slight deterioration in competitiveness

- The strengthening of the dollar against the region's currencies affected Uruguay's main trading partners more seriously, due to Argentina's external vulnerability and Brazil's political uncertainty.
- The Uruguayan peso's path of appreciation in real terms in the next two years is determined by the stability of inflation and the exchange rate

## Changes in the Nominal Exchange Rate

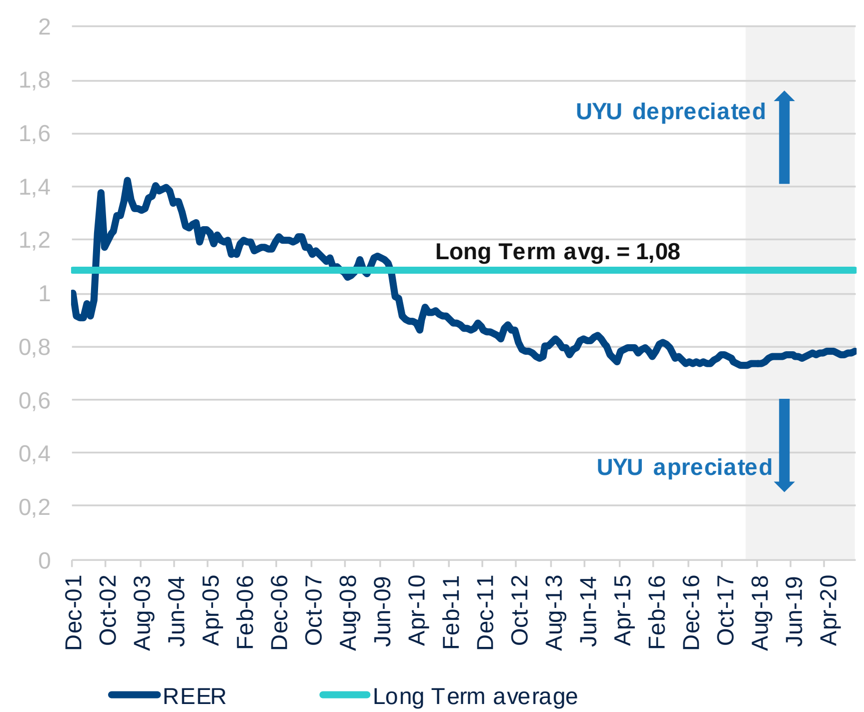
(%, (-) show depreciation against dollar)




Source: BBVA Research and Haver

## Real Multilateral Exchange Rate

(Dec. 2001 = 100)




Source: BBVA Research and Haver

# Uruguay

| | 2016 | 2017 | 2018 (f) | 2019 (f) |
|---|---|---|---|---|
| GDP (% YoY) | 1.7 | 2.7 | 2.9 | 3.5 |
| Inflation (% YoY, EOP) | 8.1 | 6.6 | 6.7 | 6.8 |
| Inflation (% YoY, average) | 9.6 | 6.2 | 7.0 | 5.8 |
| Exchange rate (vs. USD, EOP) | 28.8 | 30.9 | 30.5 | 32.6 |
| Exchange rate (vs. US$, average) | 30.1 | 29.4 | 29.3 | 31.6 |
| Asset interest rates (%, average) | 24.3 | 22.6 | 21.8 | 22.2 |
| Private Consumption (% YoY) | 0.1 | 4.4 | 3.8 | 3.0 |
| Public Consumption (% YoY) | 2.9 | -1.3 | 2.0 | 1.5 |
| Investment (% YoY) | -3.9 | -13.8 | 3.0 | 12.5 |
| Fiscal Balance (% GDP) | -3.9 | -3.6 | -3.1 | -2.7 |
| Current Account (% GDP) | 0.8 | 1.6 | -0.2 | -1.4 |

(f) Forecast.
Source: BBVA Research