BBVA Research

Uruguay Economic Outlook

May 2019

Creating Opportunities

Key messages

- Global growth slows down and domestic problems grow in the region. By 2019, Latin America will see a growth of 1.7%, and then 2.3% by 2020 (previously 2.1% and 2.4%).

- Uruguay will grow 0.8% this year due to poor consumption performance and stagnant investment. In the external sector, the recovery of the agricultural sector will be compensated by a weak tourist season.

- The consolidation of the fiscal balance will become a key issue in the agenda of the next administration. The fiscal deficit will reach 3.1% of GDP this year, including income from the "Cincuentones" effect, as observed in 2018. By 2020 it will reach 2.9%, with a minimum effect from extraordinary revenues.

- The Uruguayan peso’s accelerated depreciation since the end of 1Q19, led us to raise our exchange rate forecast to $ 36.2 per dollar for Dec-19 (previously $ 35.6/USD). The BCU (Uruguayan Central Bank) responded with stronger interventions and regulatory changes in response to the increase in inflation expectations.

- In spite of tight monetary policy and the decreasing nominal wage increase scheme, inflation will reach 8.0% this year and 6.8% in 2020 as a result of the accelerating depreciation in the exchange rate.

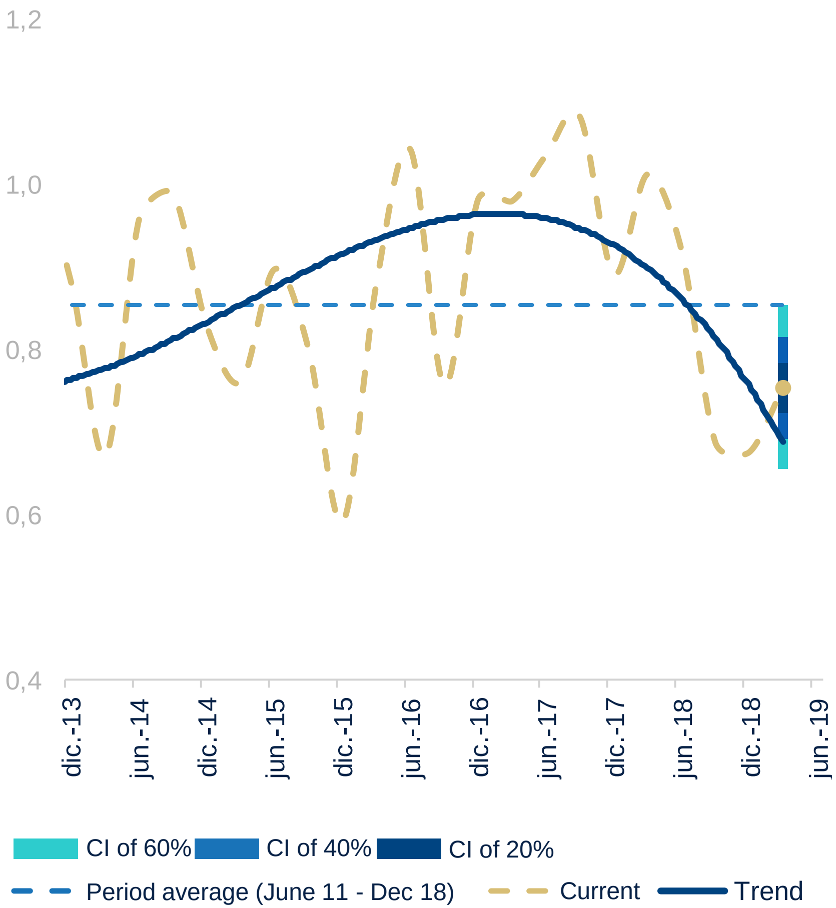
- We expect a recovery in exchange rate competitiveness in the next two years and, if the improvements in infrastructure are achieved, increases in non-exchange rate competitiveness will also be achieved.

01

International context

GDP has moderated more than expected

Evolution of global GDP
(Forecasts based on BBVA-GAIN, % QoQ)



(e) Estimate.
Source: BBVA Research

- Global growth has slowed due to China's structural moderation, high uncertainty in Europe, protectionism, and the cyclical slowdown in the US.
- A slight rebound in the short term is possible, but the activity's dynamism would remain less than in recent quarters.

Action by central banks and an absence of “accidents” would enable the slowdown in world growth to be mild

More signs of global slowdown

New stimulus policies

Assumption based on the evolution of the global environment, without "accidents"

01
Protectionism:
a US-China agreement remains probable, despite the delay.

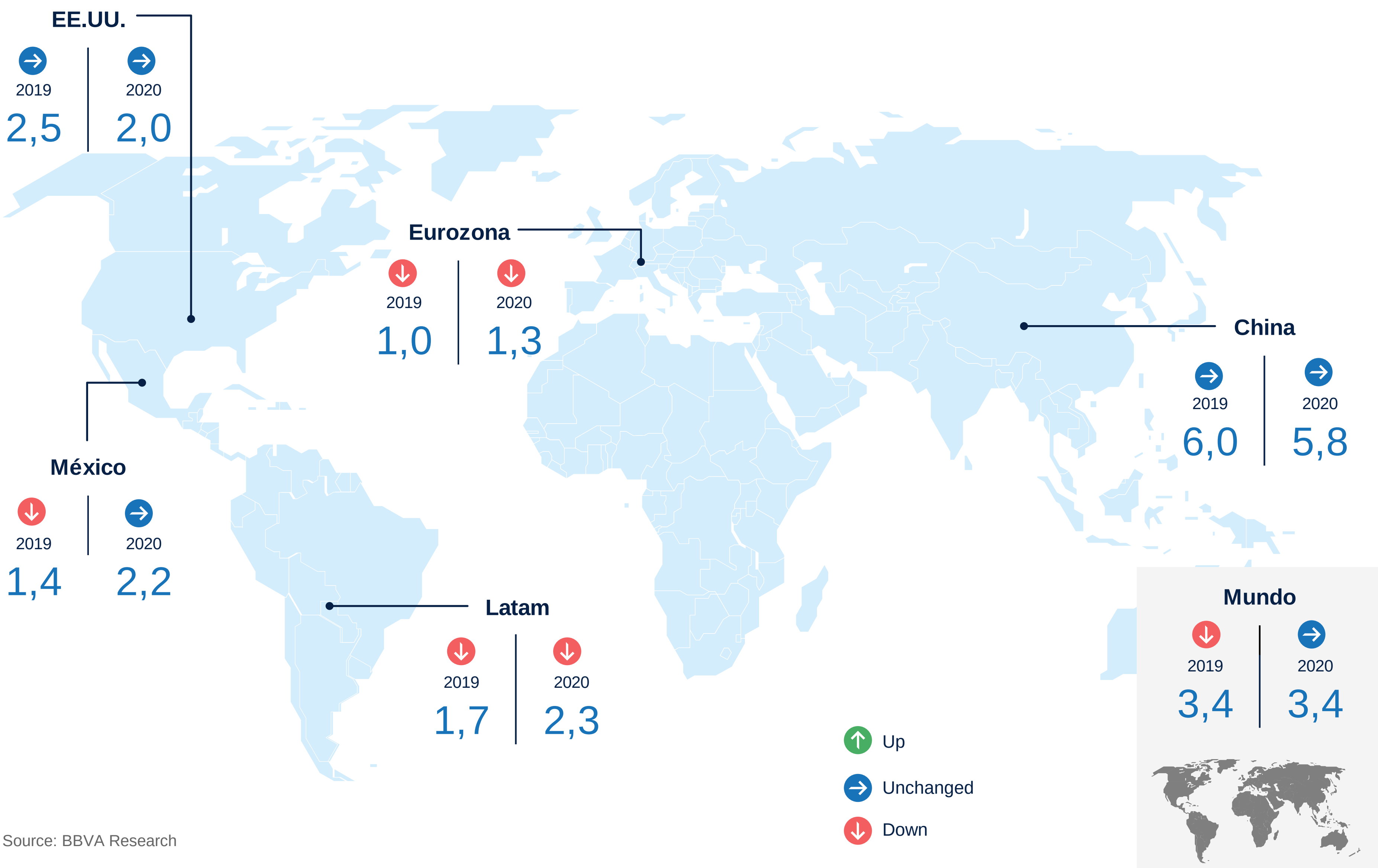
02
Brexit:
greater uncertainty over a longer period

03
Financial markets:
volatility limited by action from central banks

04
Oil
price moderation after recent upturn

Global growth gradually softens

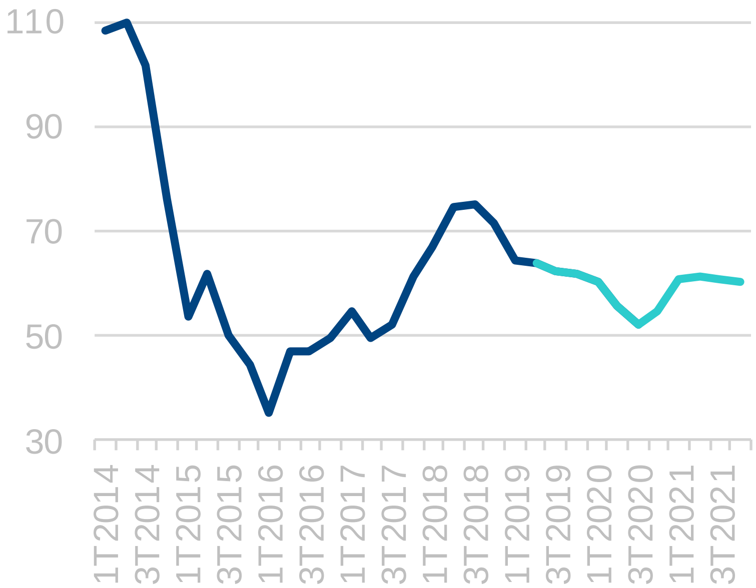
Without “accidents,” global growth will gradually slow



Source: BBVA Research

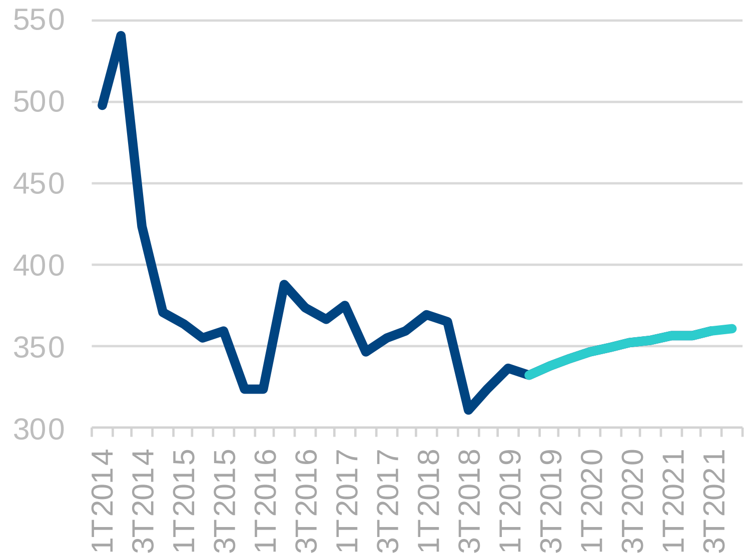
Oil: supply adjustments provided support for prices in 1Q19, which, nonetheless, are expected to correct downward

Oil: Brent prices
(Dollars per barrel, end of period)



Source: BBVA Research and Haver

Soy beans
(Dollars per ton)



Source: BBVA Research and Haver

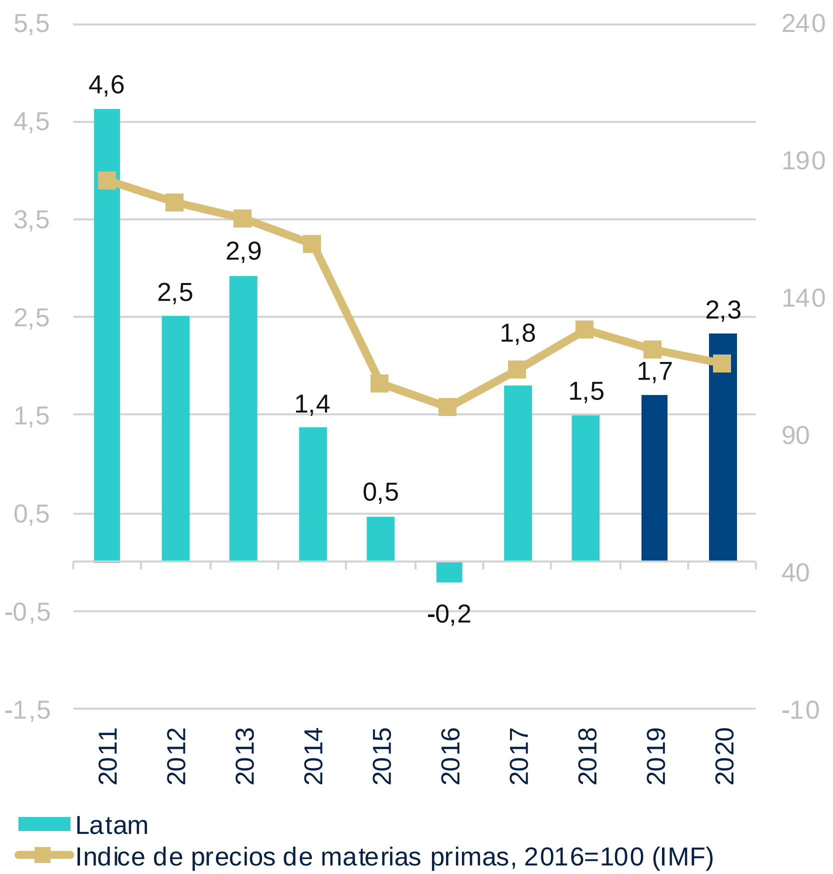
The outlook still calls for lower oil prices in the second half of 2019 and 2020, in line with the expected slowdown in demand and the expansion of supply in the USA.

High volatility in the price of soybeans due to the US-China trade conflict.
The outbreak of swine flu in China and expectations of bumper crops introduce a downward bias to our forecasts

Latin America: growth remains below 2% in 2019 and recovery has been postponed to 2020

GDP growth in Latin America and raw material price (*)

(% YoY)

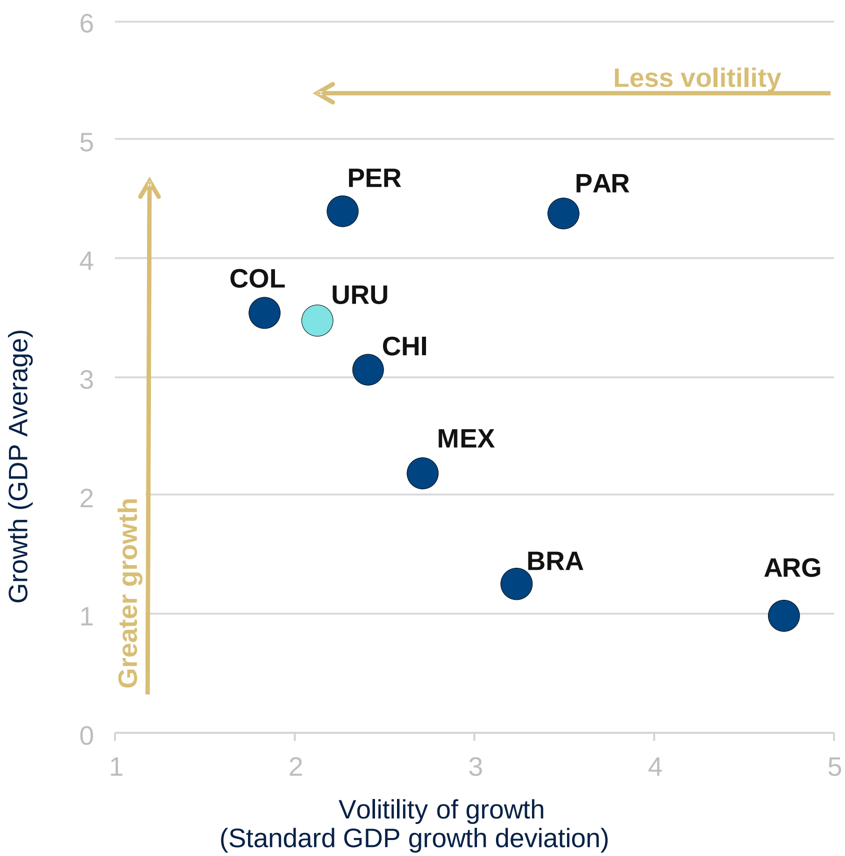


(*) Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru and Uruguay.
Source: BBVA Research

- Regional growth is revised downwards, from 2.1% to 1.7% in 2019 and from 2.4% to 2.3% in 2020
- The slowdown in global growth, as well as lower raw materials prices are resulting in growth in the region remaining below that seen in 2010-13
- Reduced reformist momentum in a majority of countries has limited productivity gains and thus helps explain the lack of dynamism in economic activity

Countries with greater stable growth: Peru, Colombia, Chile, and Uruguay

Latin America: Average GDP growth and volatility in the last decade (2009-2018)
(%)

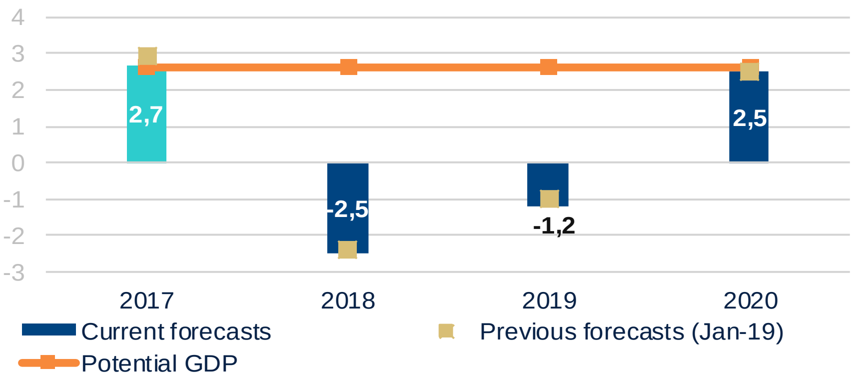


Source: BBVA Research

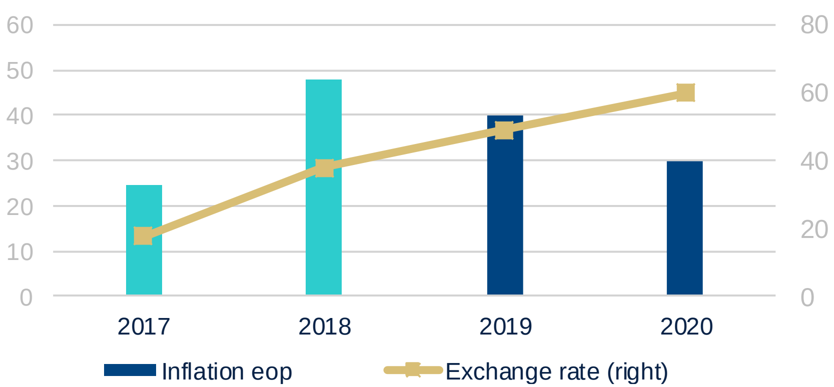
- The countries with the highest growth have generally also been able to improve the well-being of their citizens in the last decade through greater growth stability
- Countries such as Peru, Colombia, Chile and Uruguay have been able to grow in an increasingly stable way in part due to more prudent and more consistent macroeconomic policies
- They may also have benefited - given their greater dependence on raw materials - from China's strength and relative stability compared to the US.
- Even so, it is striking that some of the countries with the greatest productive diversity have exhibited greater volatility

Argentina: focused on stabilising the exchange rate and reducing (persistent) inflation

Argentina: GDP growth and potential
(% YoY)



Argentina: Inflation and exchange rate
(%, end of period)

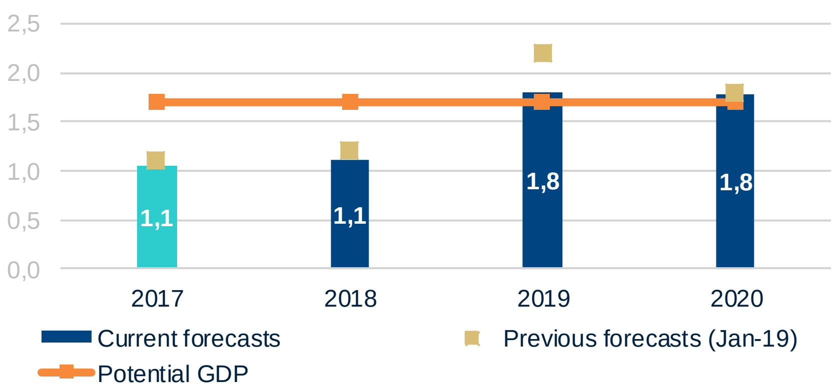


Source: BBVA Research

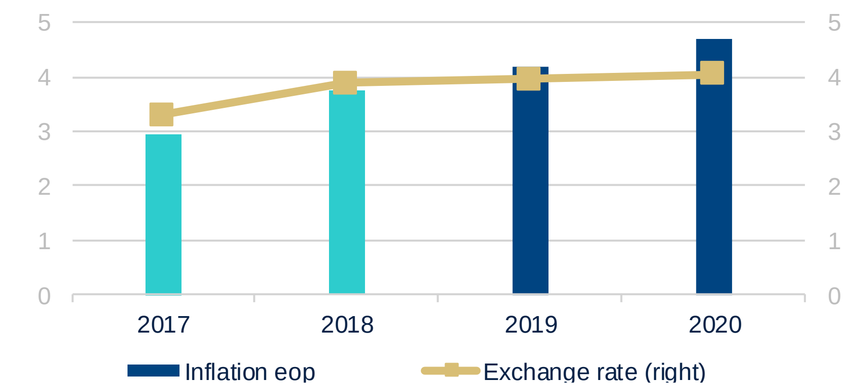
- Downward revision in the growth estimate, from -1.0 to -1.2% in 2019, mainly due to a more contractionary monetary policy
- Primary fiscal balance in 2019 and surpluses from 2020
- Upward revision in inflation in 2019, from 31% to 40%, due to greater inertia and regulated price pressure
- The exchange rate forecast of ARS 49 per USD will remain for the end of 2019, but volatility will remain high during the electoral process
- By 2020, Argentina will need to return to global financial markets and we estimate that its debt-to-GDP ratio will decrease from 85% in 2018 to 83% in 2019 and 75% in 2020

Brazil: A slowdown in recovery

Brazil: GDP growth and potential
(% YoY)



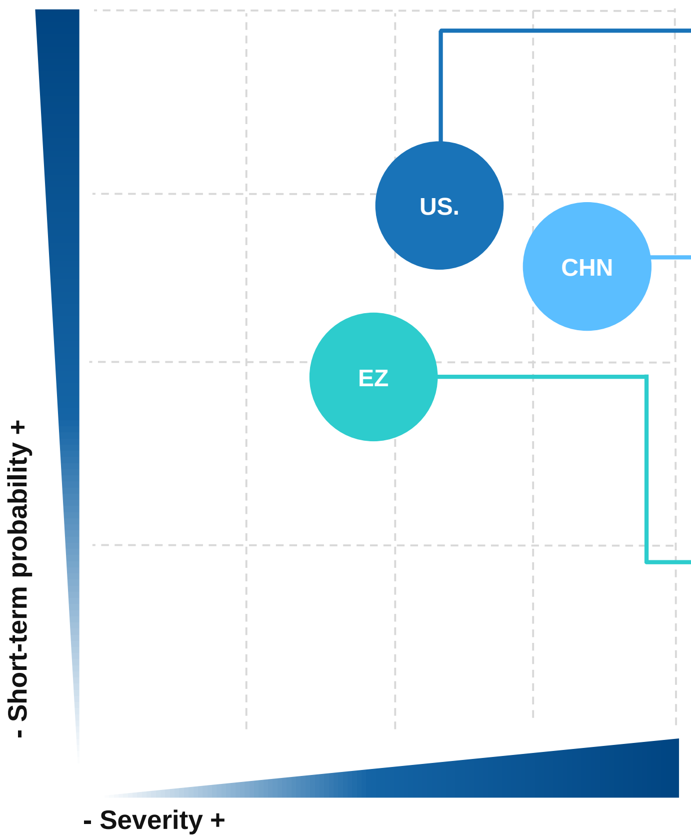
Brazil: Inflation and exchange rate
(%, end of period)



Source: BBVA Research

- The GDP forecast for 2019 was revised downwards from 2.2% to 1.8%, mainly due to the weakness shown by incoming data; the forecast for 2020 has not changed
- Recent developments in the local situation support the view that progress in the adoption of economic reforms (including social security reforms) will be slow and limited
- This, along with moderation in world growth will limit the country's ability to grow in the coming years
- Lower internal growth and the more accommodative stance of central banks around the world indicate that no interest rate increases are likely to occur until 2020

Global risks: fear of an economic recession in the US and the Eurozone continues despite greater support from central banks



- **Economic recession: high**
- **Protectionism: high**
- **Fed out: significantly lower than three months ago**

- **Disorderly deleveraging: relatively greater than three months ago**
- **Protectionism: high**

- **Economic recession: growing**
  - Brexit:
  - Italy:
  - Increase of eurosceptic forces in Parliament
- **Protectionism: growing**
- **ECB exit risk: significantly lower than three months ago**

Source: BBVA Research

Financial vulnerabilities may amplify the severity of risks

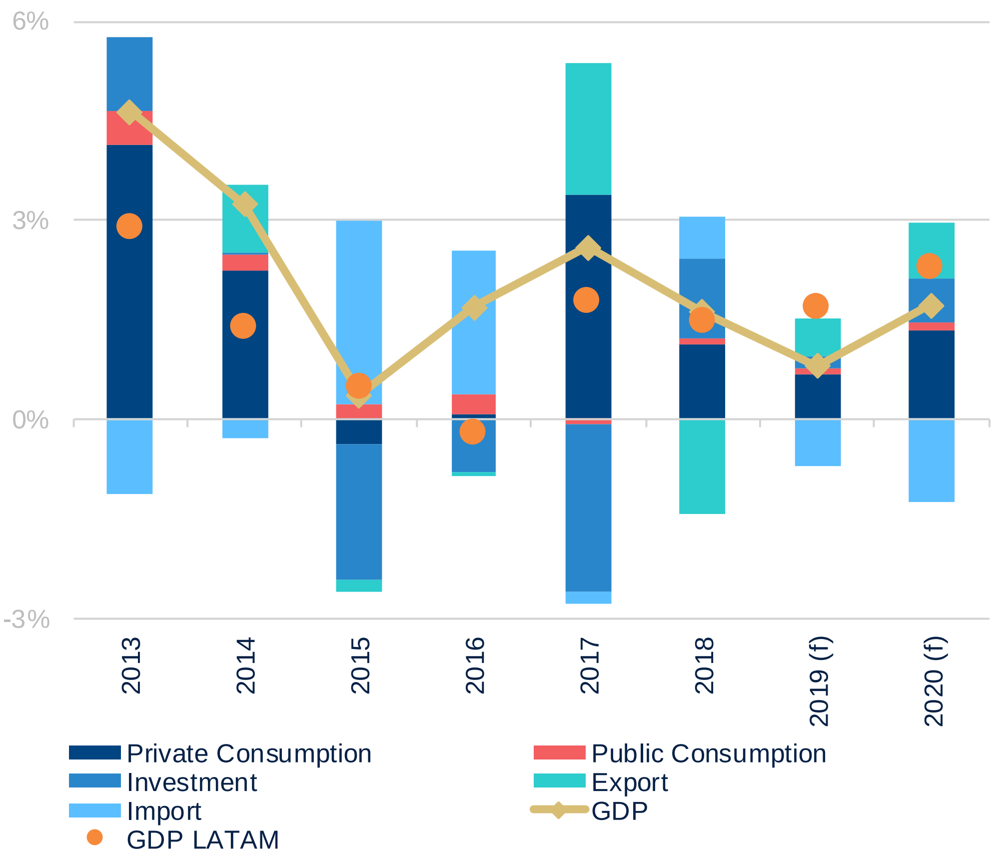
02

Uruguay is focused on elections, with necessary structural reforms taking a back seat.

Due to practically stagnated economic activity, we revised our growth forecast down for 2019 to 0.8% and to 1.7% for 2020

Contributions to economic growth

(%)

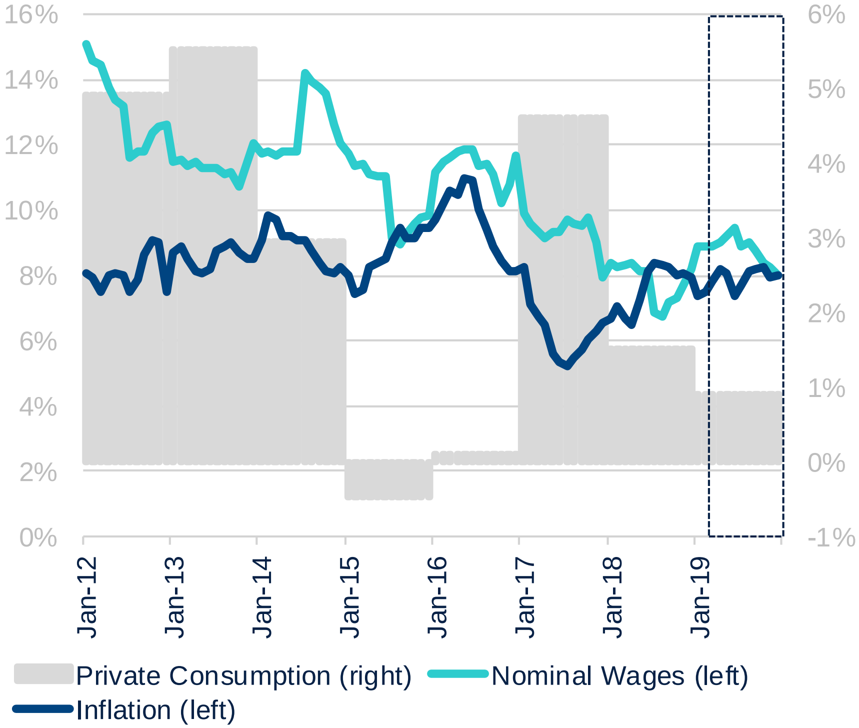


Source: BBVA Research and BCU

- Sluggish private consumption : in a context of higher inflation and a pattern of decreasing nominal wage increases, purchasing power has deteriorated, adding to unemployment levels that remain relatively high.
- Investment will contribute little to growth in 2019, the only highlight is the construction of new railway line that already has the necessary financing and should start in 2H19
- The beginning of the construction of the 3rd pulp mill is expected to mobilize investment and employment. Construction is expected to start in 2020 after the agreement between the National Government and the company on labour conditions
- A lacklustre tourism season (1Q19) will probably erode any slight growth of exports of goods, resulting in the negative contribution of the external sector.

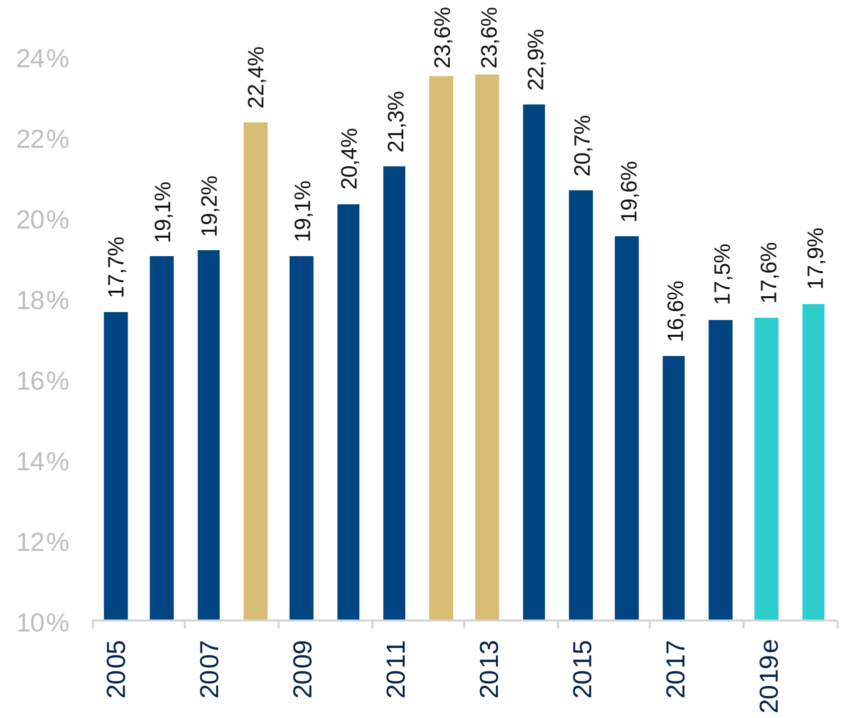
Little dynamism in consumption and private investment in 2019

Private Consumption, Salaries, and Inflation
(% change YoY)



Source: BBVA Research INE and BCU

Evolution of investment levels
(% of GDP)

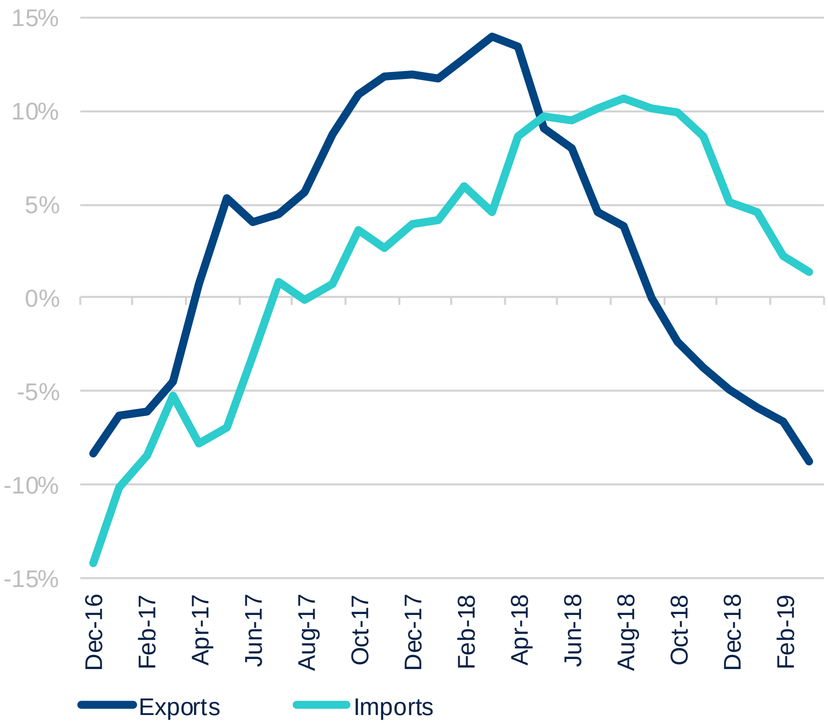


Source: BBVA Research and BCU

With real wages that will not show any increase, private consumption is expected to grow at low rates in 2019 (+ 0.9% y/y) The ratios of investment to GDP are at minimum levels (in 2018 rebounding somewhat due to public investment). This year we foresee a marginal growth in investment (the Railway and other minor projects) but there will be a strong impulse when work on the pulp mill finally begins.

The trade balance remains in surplus as exports recover slightly despite the regional context and other external risks

Exports and imports, last 12 months
(% change YoY)



Source: BBVA Research INE and BCU

Balance of trade
(In US$ millions)

Source: BBVA Research Uruguay XXI and BCU

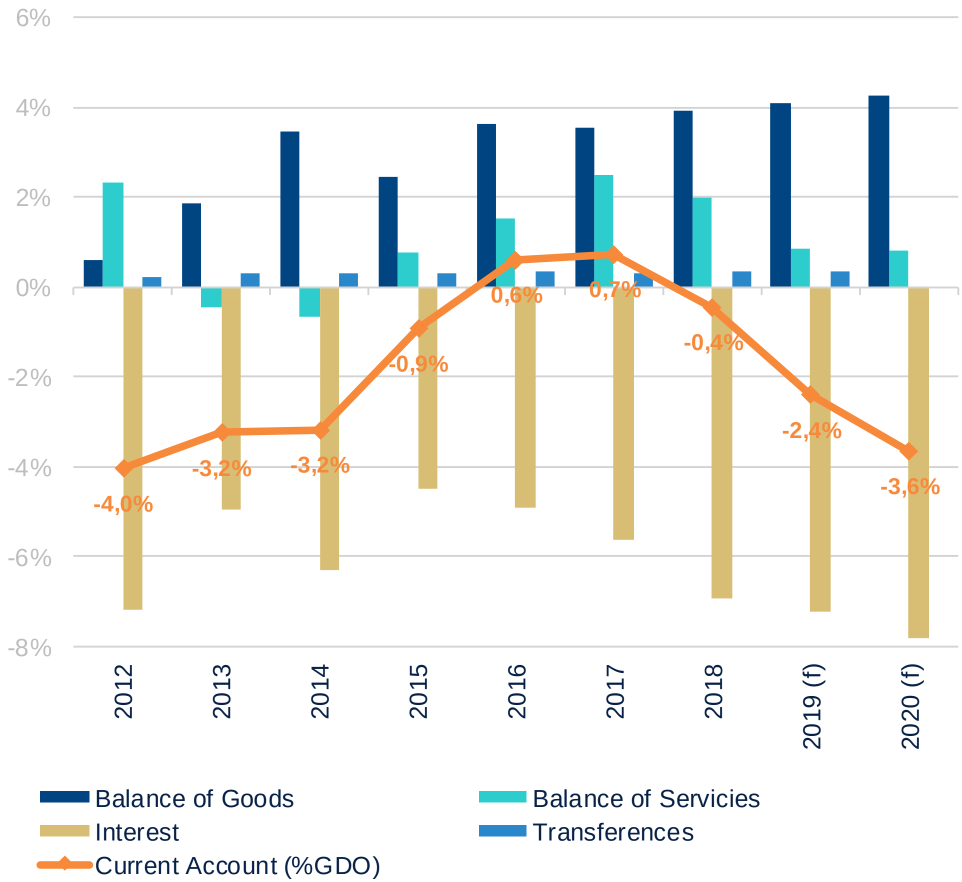
Exports will grow slightly in 2019, driven by the recovery of the agricultural sector after the drought of 2018.
Negative impact on soy prices due to lower demand in China as a result of swine flu is expected to affect exports.

The commercial battle between the US and China is adding a great deal of volatility to commodity prices

Deterioration of current account due to the drop in tourism

Current account and main components

(% of GDP)



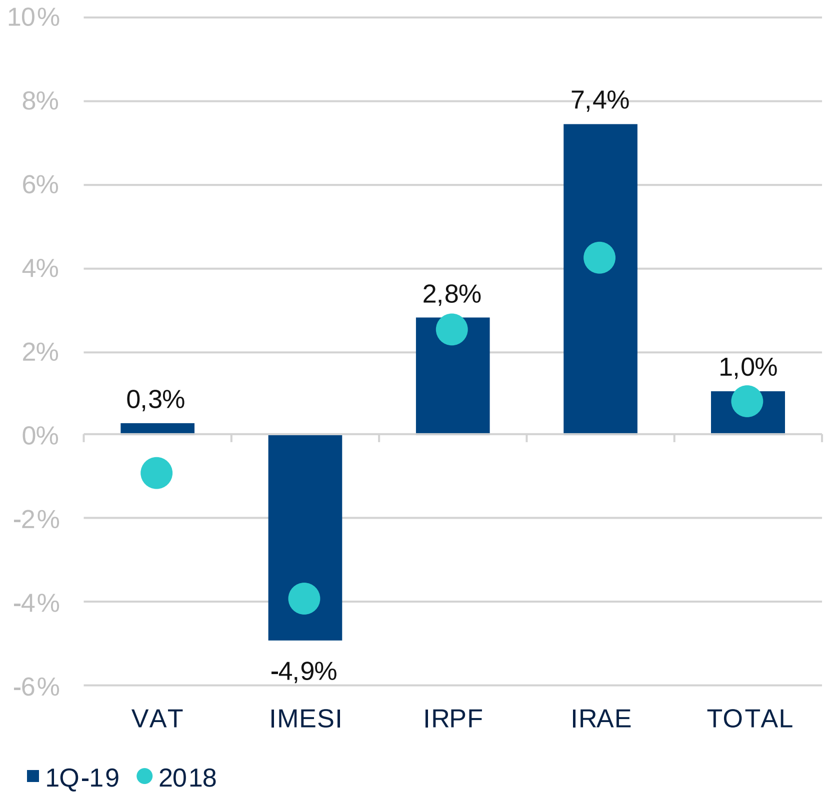
- Higher current account deficit in 2019 (up to -1.9% of GDP) mainly due to the deterioration of the Real Services (Tourism) account, where we are assuming a drop of almost 25% in incoming tourism and a slight increase in outgoing tourism
- The trade surplus in goods (Fob/Fob) will be slightly higher than in 2018
- To the extent that the beginning of the works of the third pulp mill is palpable, the current account result will have two stages: i) increase in imports as building begins and ii) increase in exports after the paper mil begins operating.
- However, this greater initial trade deficit would be totally financed by the FDI of the same company which reduces external vulnerabilities.

Source: BBVA Research and BCU

Tax collection evolve in line with the economic cycle

Tax collection in real terms

(% change YoY)



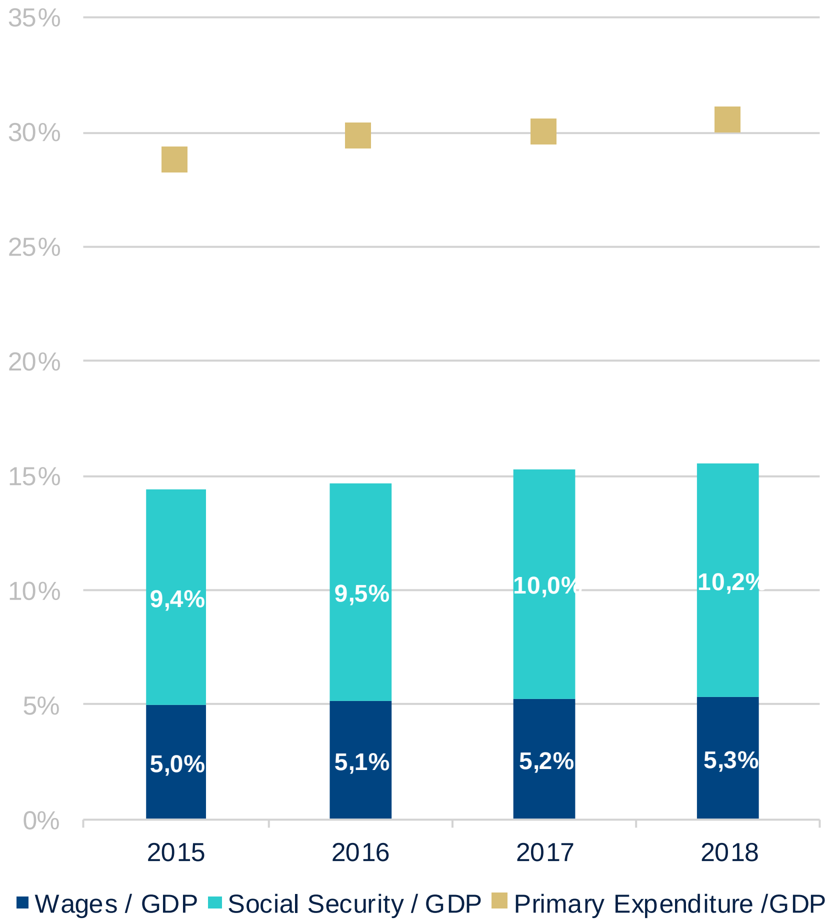
VAT = Value Added Tax; IMESI = Internal Specific Tax; IRPF = Personal Income Tax; IRAE = Income Tax on Economic Activities

Source: BBVA Research and MEF

- After discounting the effect of inflation, tax collection has grown 1% in 1Q-19, at the same rate as in 2018.
- Taxes associated with consumption are the worst performers. In real terms, VAT for 1Q-19 is practically at the levels of 1Q-18 while the IMESI is almost 5% below the same period 2018
- Only taxes related to income have grown during 2018 and in 1Q-19 after the hike in rates or the tax base

The composition of public expenditure raises the need for a pension reform

Current expenditure of the Central Government
(% of GDP)



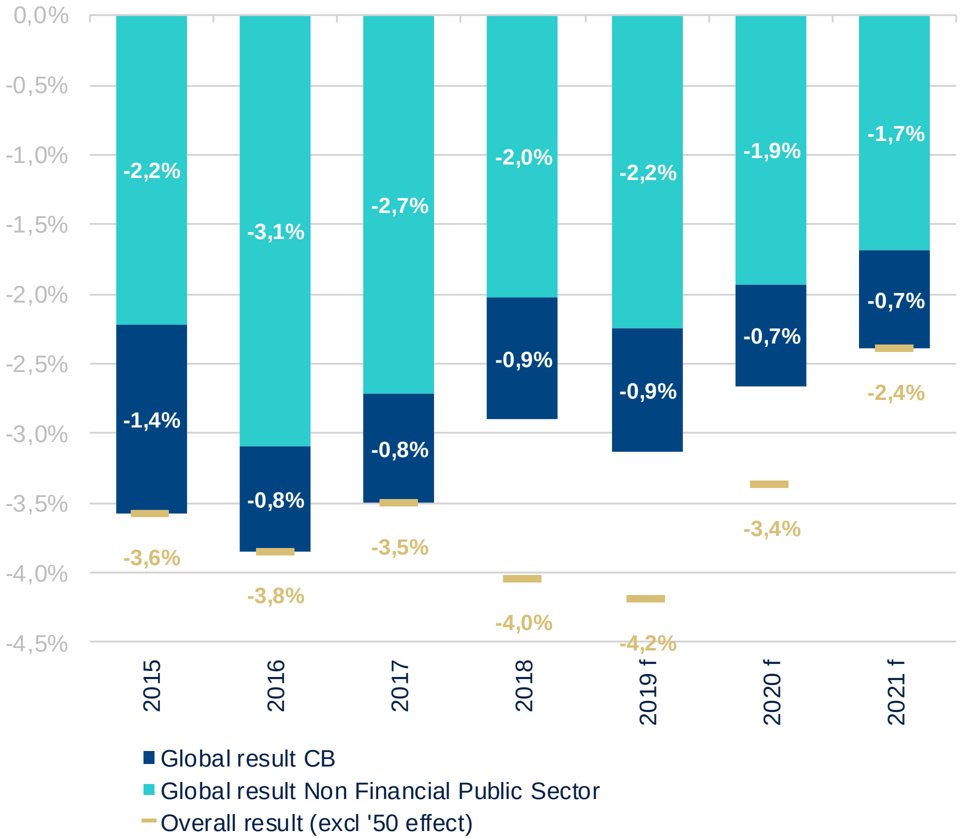
- Current public sector spending as a percentage of GDP, far from falling, shows a growing trend in recent years. In 2018 it stood at 30.6% of GDP.
- Cause for concern stems from the fact that half of spending corresponds to salaries and social security payments that show little downward flexibility and are indexed to past inflation.
- This situation raises the need for a pension reform in order to reduce the inertia of public spending.
- However, and despite the recognition of this problem, there is consensus that this will be a task for the next administration

Source: BBVA Research and MEF

Transitory improvement of the fiscal result allows postponement of the necessary reforms to reduce spending

Result of the Public Sector

(as a % of GDP)



Source: BBVA Research and MEF

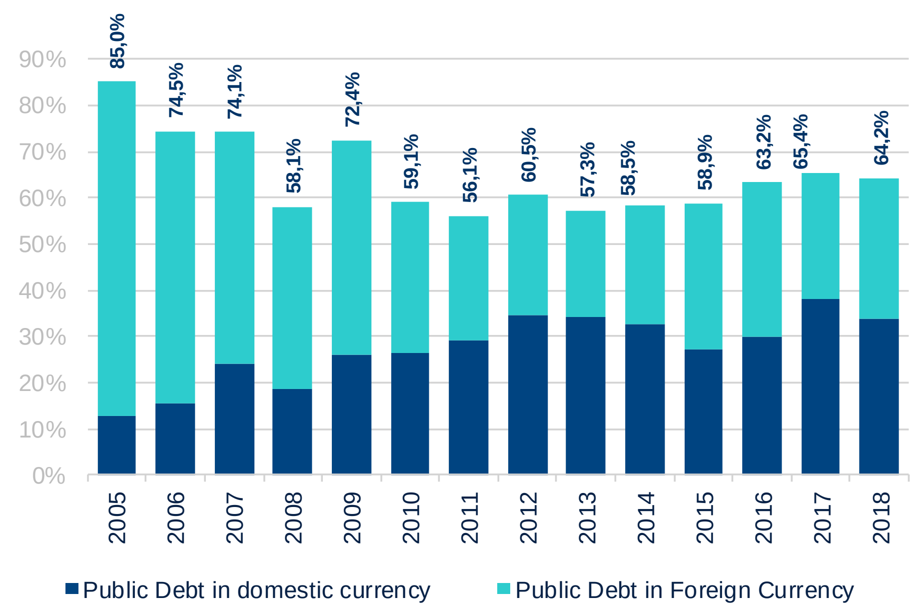
"Cincuentones" refers to individuals over 50 years old (as of 01/04/2016) who were affected by the 1996 pension reform and are therefore allowed to transfer the balance of their accounts in the private pension system (AFAPs) to the public system (Banco de Prevision Social, BPS)

- The government closed the consolidated fiscal result for 2018 at -2.9% of GDP, which includes extraordinary income from the "**Cincuentones**1/" Trust. Without these revenues, the deficit would have reached 4% of GDP.
- By 2019 we expect the consolidated deficit to be approximately 3.1% of GDP (excluding the Trust, it could climb to 4.2% of GDP). By 2020 the deficit will reach 2.6% of GDP (3.4% without considering extraordinary income).
- Our estimates are based on a scenario of lower economic growth that would limit the increase in tax revenues and a level of primary spending that is difficult to reduce given the high share of salaries and social security payments that are indexed.
- Given that adjustments via fiscal revenues have already been made and it is impossible to continue increasing the tax pressure, pension reform that allows greater savings on the expenditure side becomes increasingly necessary

Consistent debt management policies have reduced vulnerability

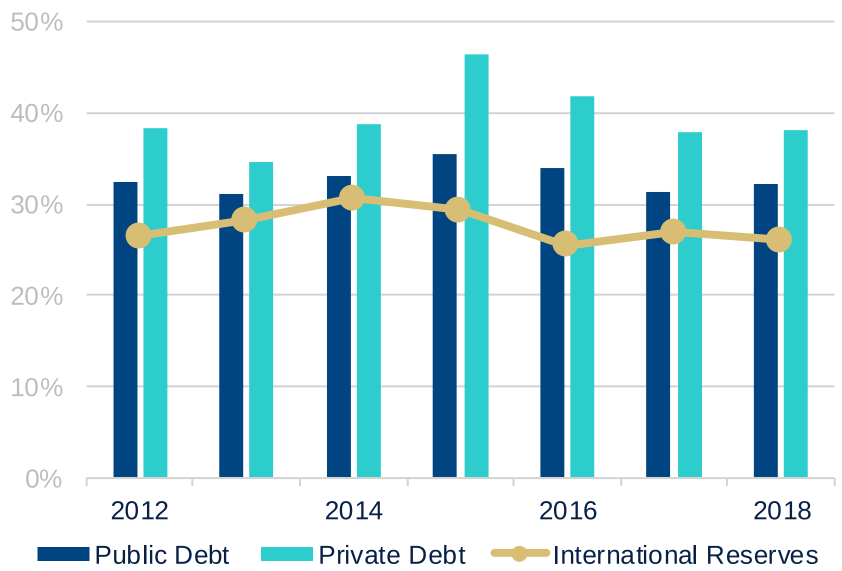
Uruguay has a high level of International Reserves (26% of GDP) which cover a large part of the external public debt

Public Debt in Foreign and Domestic Currency
(as a % of GDP)



Source: BBVA Research and BCU

External Private / Public Debt and International Reservces
(as a % of GDP)



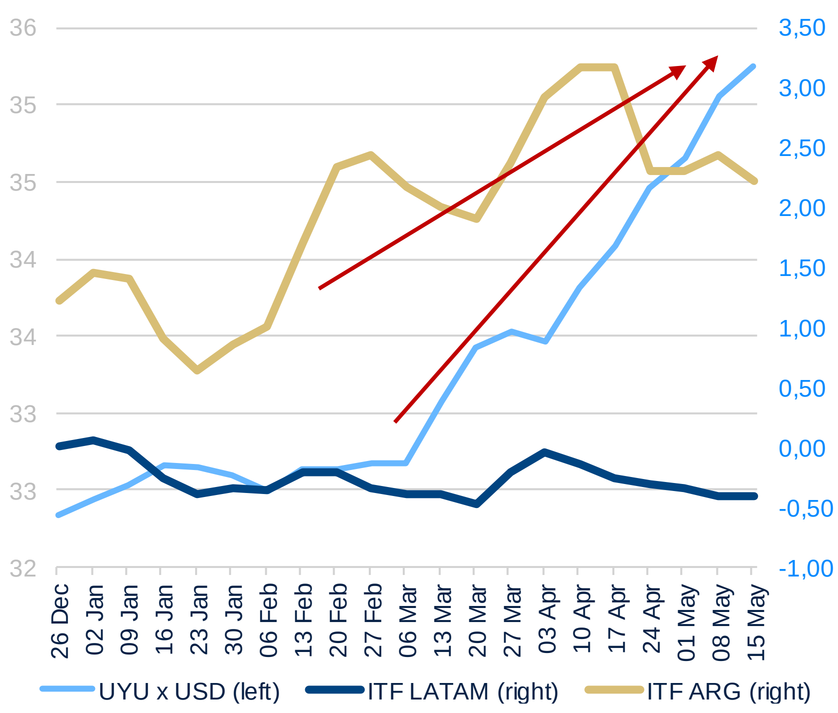
Source: BBVA Research, Uruguay XXI and BCU

Uruguayan public debt closed 2018 at 64.2% of GDP, although it has been relatively stable in recent years, the trend continues towards de-dollarization, in order to reduce exchange rate risk. Bond issues in both Units Indexed to the CPI (UI) and in Pension Units (UP) indexed by the variation of the Average Salary Index cater to this need; but these issues in UP are also attractive to meet the investment demand of the private pension funds to cover the cyclical effect, since increasing pension liabilities also increases the yield of these bonds

The peso, among the most depreciated in 2019...

Financial Tension and Exchange Rate index

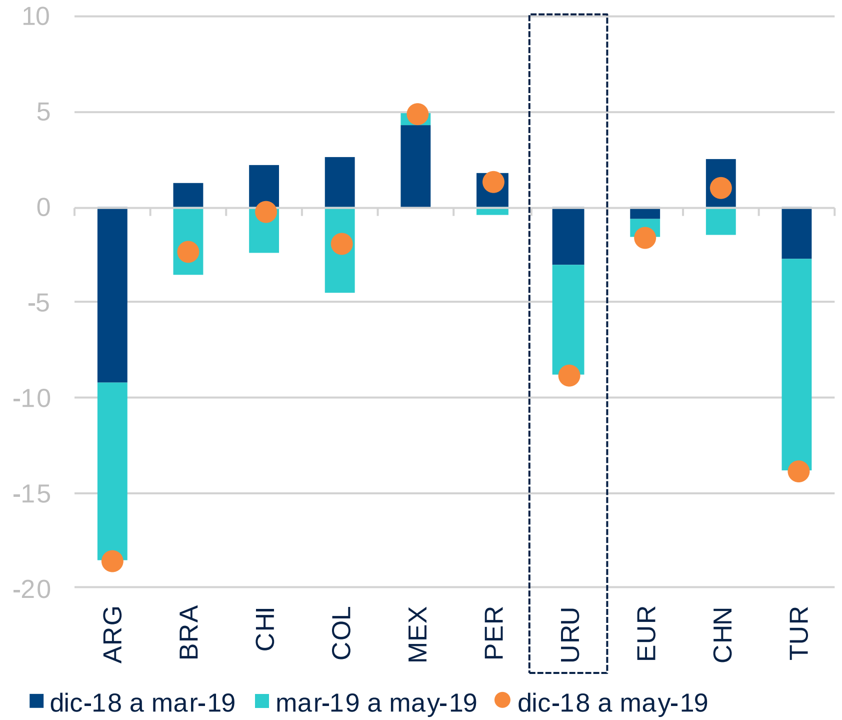
(Financial tension index: TC in $ for USD)



Source: BBVA Research and BCU

Currency vs. USD

(Var% average monthly exchange rate)



(-) implies depreciation against the dollar

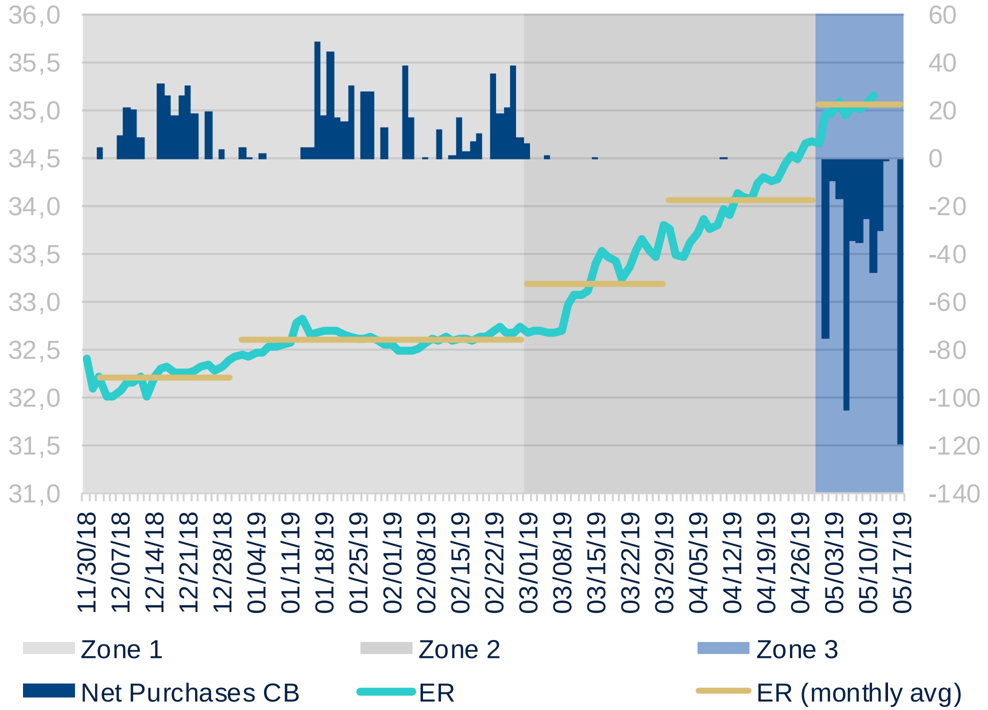
Source: BBVA Research and BCU

The combination of the recent global strengthening of the USD and the increase in financial tensions in the region, especially in Argentina, accelerated the depreciation of the peso since the end of February.

...activate change in Central Bank policy mix

The BCU unveiled "intervention by zones"

(TC in $ x USD, interventions in millions of USD)



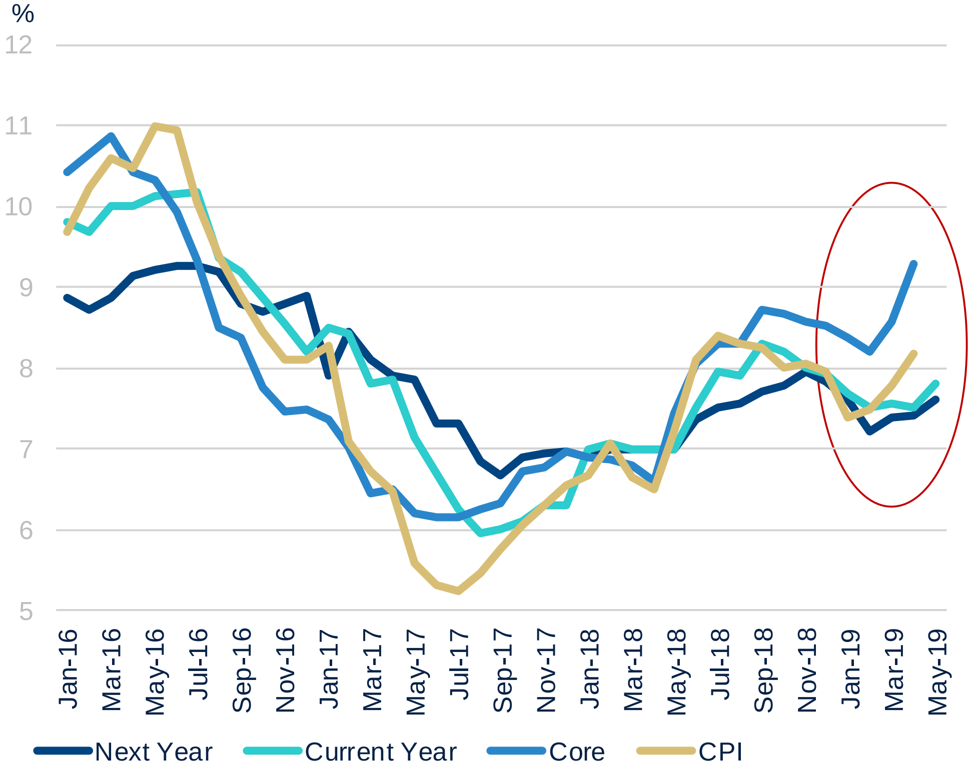
Source: BCU and BBVA Research

- The evolution of the exchange rate and the effect on inflation expectations defined three "stages" of BCU intervention
  - Zone 1: the BCU tried to avoid appreciation of the peso during January and February when a preference for the domestic currency that increased M1 + growth to 10.4% y/y was verified. Inflation expectations were slightly down.
  - Zone 2: in March a period of depreciation of the peso began in line with the external context: the BCU allowed the peso to depreciate.
  - Zone 3: in May, inflation expectations increased (from 7.4% to 7.6% for 12 m), the BCU perceived an excessive depreciation of the peso and began to sell in a very relevant way on the market, accumulating sales of USD 503 million through May 17
- Due to this acceleration in the exchange rate, we raise our estimate to $ 36.2 per dollar for December-19 and $ 39.5 for December-20.

The greater depreciation of the peso impacts on prices

Inflation and inflation expectations

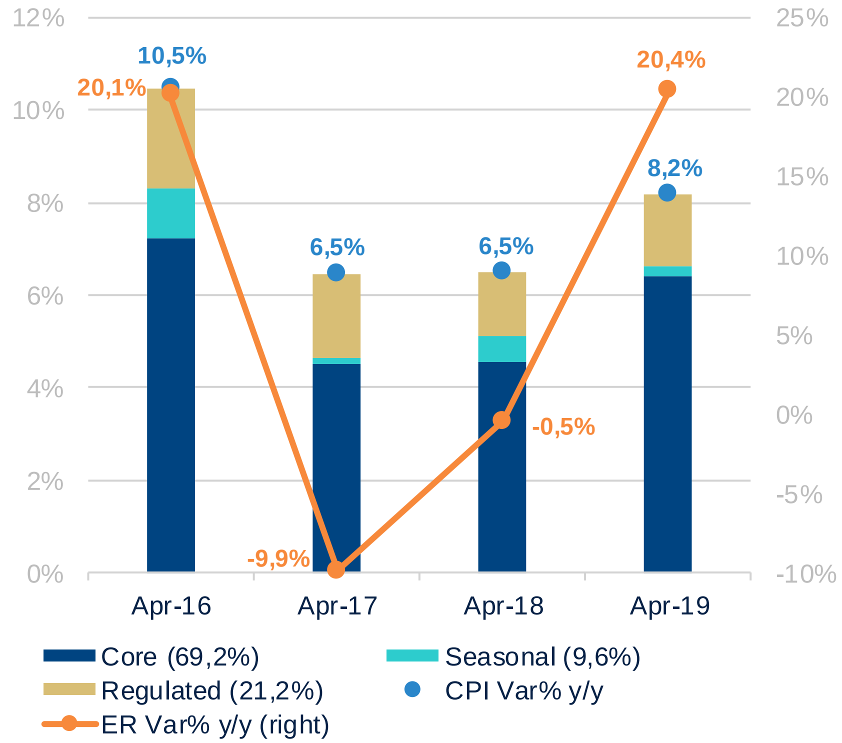
(Var% y/y)



Source: INE and BBVA Research

IPC by component and depreciation

(Var% y/y and contribution in pp)



Source: BBVA Research and BCU

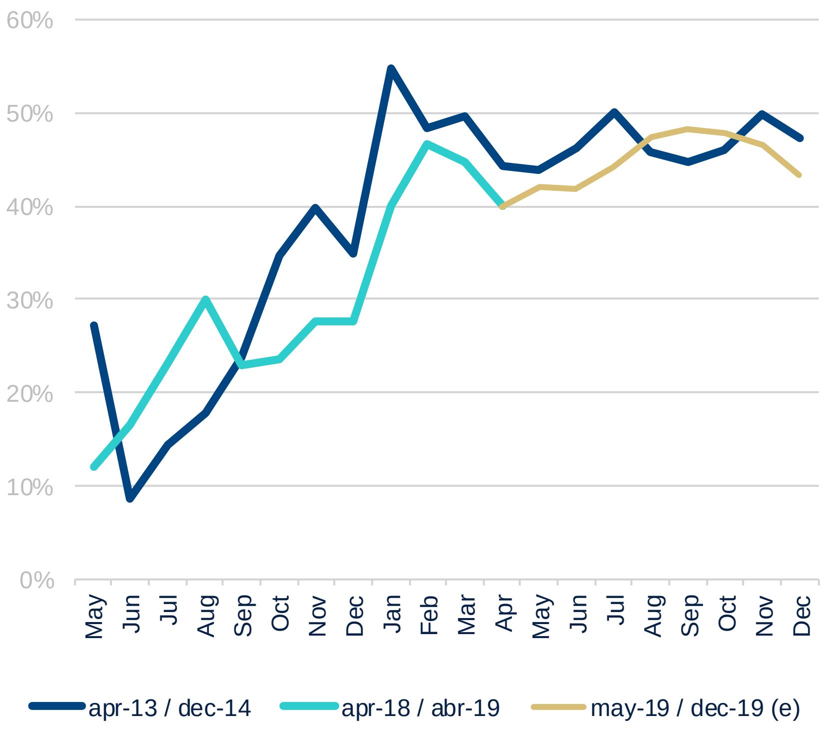
Monetary policy remains tight, and the increase in salaries within the official guidelines, but the exchange rate accelerated its rate of depreciation.

Pass through to prices increased in April and also raised inflation expectations

Core inflation also rose and is returning to levels of historical inflation regimes above 8% per year

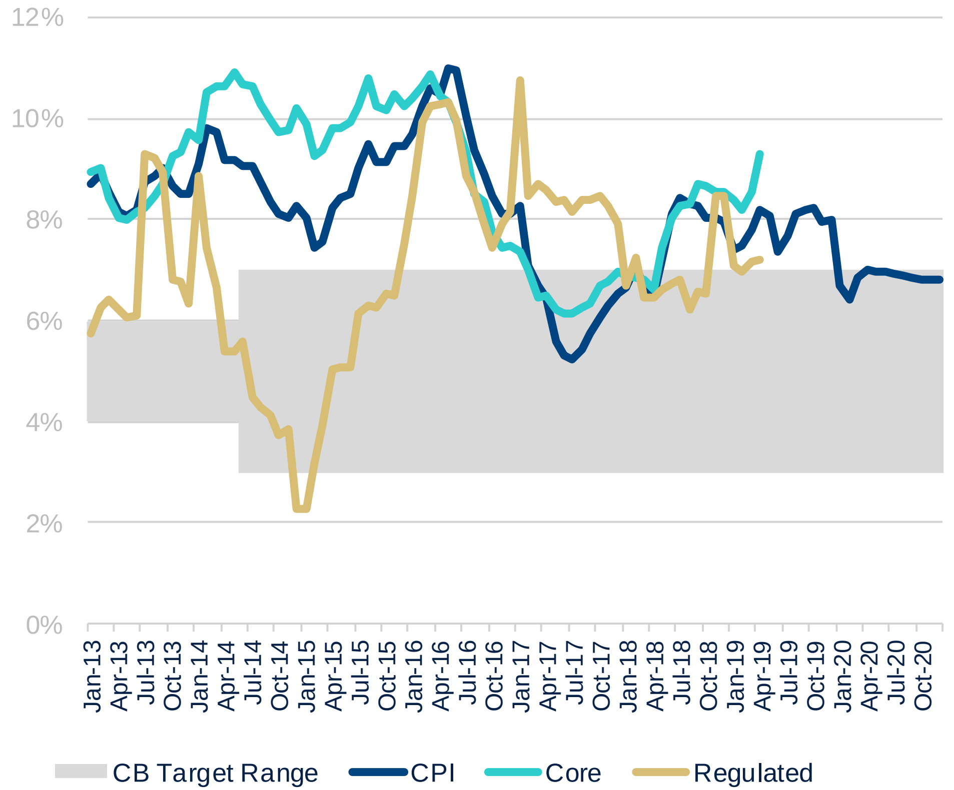
Inflation will remain high for two more years

Depreciation and prices, how was it before?
(12-Month cumulative inflation/depreciation ratio)



Source: INE and BBVA Research

Inflation, headline, core and regulated
(% change YoY)



Source: BBVA Research and BCU

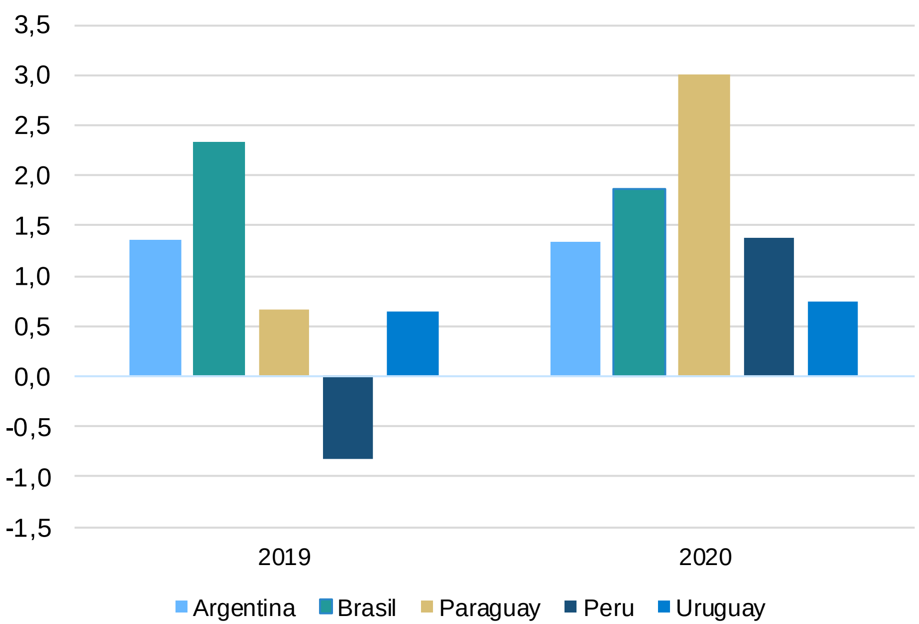
Since Dec-07, inflation has been within the target band of the BCU for only 27 months of the 137 months, i.e. only 20%.
We assume pass through to domestic prices that does not accelerate in the rest of the year in line with previous experiences

We are raising our inflation forecasts for 2019 to 8.0% and 6.8% for 2020 assuming the continuity of moderately contractionary domestic policies and the stabilization of international financial volatility

Slight deterioration in competitiveness

Depreciation and inflation

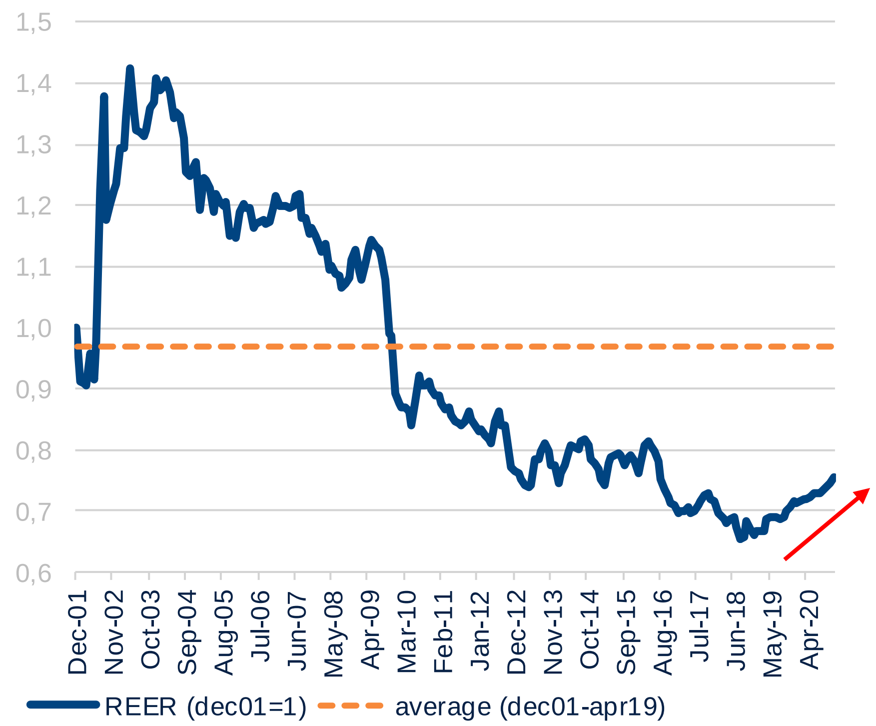
(Annual cumulative inflation/depreciation ratio)



Source: INE, Haver and BBVA Research

At the end, cheaper or more expensive?

(%)



Source: INJE, HAVER, BCU and BBVA Research

The main regional partners will see real appreciation of their currencies this year and the next since inflation will exceed depreciation, while in Uruguay relatively low pass through will allow recovery of foreign exchange competitiveness in the short term

Tables

Uruguay

	2017	2018	2019 (f)	2020 (f)
GDP (% YoY)	2.6	1.6	0.8	1.7
Inflation (YoY %, eop)	6.6	8.0	8.0	6.8
Inflation (% YoY, average)	6.2	7.6	7.9	6.8
Exchange rate (vs. USD, EOP)	28.9	32.2	36.2	39.5
Exchange rate (vs. US$, average)	28.6	30.7	34.5	38.0
Lending rates in pesos (%, average)	21.2	19.9	21.3	20.6
Private consumption (% YoY)	4.6	1.5	0.9	1.8
Public consumption (% YoY)	-0.7	0.8	1.5	1.5
Investment (% YoY)	-13.0	-13.8	1.0	1.0
Consolidated Fiscal Result (% GDP)	-3.5	-2.9	-3.1	-2.7
Current account (% GDP)	0.7	-0.6	-1.9	-2.4

(*) (p) Forecasts.
Source: BBVA Research