Economic Outlook

Uruguay

First Half 2013

Economic Analysis

- **Sluggish domestic consumption, delays to large investment projects and weak contribution from foreign trade** will limit growth for 2013 at just 3.7%, with a slight upturn in 2014 (3.9%) thanks to higher exports.
- **Inflation is the main macroeconomic imbalance.** It will remain high over the next two years, at 8% at the end of 2013 and 7% at the end of 2014. This means the Central Bank will again miss its inflation target for the period. The Monetary Policy Rate will remain at 9.25% for the rest of the year, but we expect a 175 bp cut in 2014, closing the year at 7.5%.
- **The twin deficits will be reduced as the factors that affected them in 2012,** related to the need to meet energy demand, will be reversed. However, competitiveness problems will persist and will make the external imbalance more vulnerable to changes in global conditions.
- **We forecast a current-account deficit of 3.6% for 2013, with a slight improvement in 2014 to 3.4%.** Meanwhile, the public sector deficit will hit 2.3% of GDP in 2013 and will improve to 2.1% of GDP in 2014 due to strict spending cuts.

Index

Closing date: May 16, 2013

1. Summary

Figures for 2012 confirmed the slowdown in the Uruguayan economy, which grew at 3.9% last year. Domestic demand continued to be the main driver for growth, although a slowdown should be expected this year. On the private consumption front, confidence is being affected by greater uncertainty in the job market, with lower wage increases likely from this year on. Large investment projects have also been delayed, which will have a knock-on effect on the domestic demand in 2013. **We expect growth to slow mildly in 2013 to 3.7%. It should recover thanks to foreign demand to 3.9% in 2014.** The following years should see some stability at around potential growth (4%).

The main macroeconomic imbalance continue to be inflation, it will remain above the Central Bank's target. Prices will rise by 8% this year and 7% in 2014. Slowing consumption and a stronger peso will slow down pressure on prices. Furthermore, monetary authorities will keep the Monetary Policy Rate unchanged at 9.25% for the rest of the year, thus leaving the real rate in positive territory. The stronger currency is clearly a limit to monetary policy. We see the use of unorthodox or macroprudential tools as highly likely.

The surprise current account deficit for 2012 (5.3% of GDP) was due to specific factors linked mainly to the need to import higher quantities of oil and energy. This situation will not be repeated in 2013, so the current-account deficit should improve. Nonetheless, tourism will continue to perform poorly unless the currency loses value and exchange controls imposed by Argentina are reversed. These now make outbound tourism increase and inbound decrease, thus limiting the improvement in the external balance. **We therefore expect a current-account deficit of 3.6% of GDP for 2013 and 3.4% of GDP for 2014, following some recovery in competitiveness and higher exports.**

The major fiscal deterioration in 2012 (deficit of 2.6% of GDP) was also due to specific factors linked to the buying of energy by state-owned enterprises and the need to control their tariffs to avoid higher inflation. The government absorbed these increases, with the resulting higher deficit. We again expect that once these temporary factors recede, the government should be able to improve its balance, though this will be determined by lower tax receipts (due to lower output) and the impossibility of lowering spending on payroll and benefit payments, especially before an election year. **We therefore forecast the fiscal deficit hitting 2.3% in 2013 and, thanks to a slight upswing in output, 2.1% in 2014.**

The currency continues to strengthen despite major foreign-currency purchases by the Central Bank (BCU). We expect the Uruguayan Peso to hit 19.05 by December 2013, meaning competitiveness problems will remain. We could see some nominal depreciation in the exchange rate in early 2014 due to the need to bring the peso into line with other currencies in the region. Nonetheless, this will be conditioned by the inflow of capital, which will act in the opposite direction.

2. A more varied global scenario

Global growth continues its steady recovery, but the very different prospects for the leading economies are putting the brakes on the improvement in GDP in 2013 and 2014. Quarterly global GDP growth, estimated at 0.7% by BBVA Research at the start of 2013, will have been slightly over 0.6% in the last quarter of 2012, but available indicators point to growing disparity in activity, particularly between the most developed economies, with the euro zone once more lagging behind the U.S. and even Japan. In turn, emerging economies will continue to underpin global growth. Overall, the **rate of global growth in 2013 is expected to be 3.3%, only 0.1 points above the figure estimated for 2012** (Chart 1). In 2014, the rate will be close to 4%, although the risks continue to have a downward bias.

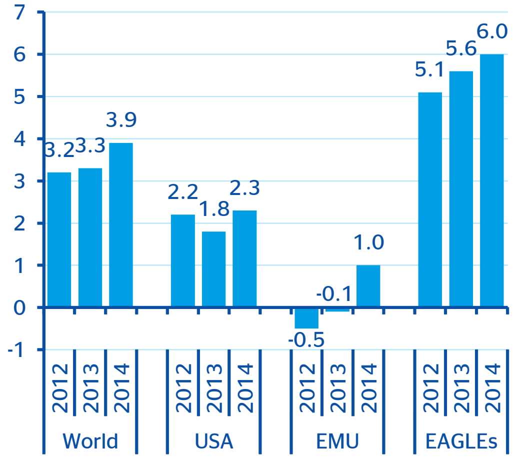
In the euro zone the recovery has been delayed until 2014, despite the role of the ECB as a firewall for financial tensions, aided by the boost provided to banking union. The ECB has been surprisingly effective as a guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the ruling by the Portuguese Constitutional Court. As a result, the markets and financial tensions have only reacted to these events to a limited extent (Chart 2). On the negative side, economic indicators show a **general cyclical weakness beyond the European periphery,** which justifies the ECB's recent interest-rate cut. This is a positive measure, although **it is unlikely in itself to reduce financial** fragmentation, which is already having less impact on sovereign issuers and even large corporations, but continues to affect households and companies due to the **uneven operation of the banking channel.** The conditions of credit supply in the area as a whole continue to tighten while demand for credit is falling in peripheral countries. Something more is needed than the extension of the liquidity facility for banks at least until mid-2014; measures currently being studied have to be implemented to boost finance for business, with the participation of institutions such as the European Investment Bank.

In this context, our scenario includes a downward revision of euro zone growth. We estimate GDP will fall by 0.1% in 2013 and rise by 1% in 2014, 0.4 and 0.3 points, respectively, below the forecasts in our January publication. In any event, the risks continue to have a downward bias. A key point is that Germany must not remain the only source of growth in the area thanks to its easy access to finance, high level of competitiveness and greater exposure to the best performing sources of global demand.

One additional consequence of the weakness of the European cycle is the growing debate on the appropriate level of fiscal consolidation to achieve a credible schedule for cutting the deficit without leading to such short-term deterioration in growth that it makes the adjustment effort a waste of time. The European Commission's support for the postponement of the public deficit targets in some European countries is in line with the idea of stressing the quality and composition of the fiscal adjustment and emphasizing structural reforms above short-term objectives. **What is Europe missing?** More determined progress towards banking union, shifting the debate on deficit targets to structural measures, and a firmer commitment to reform in peripheral countries.

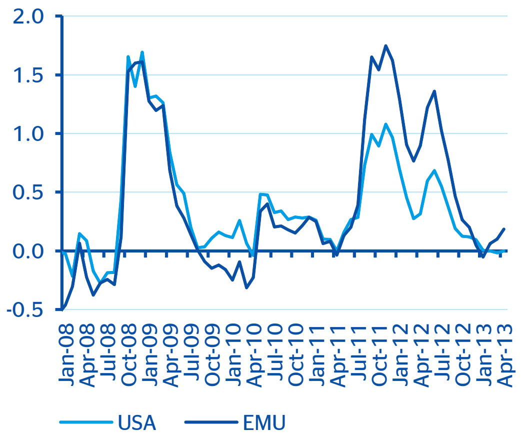
In the U.S., the strength of private demand is sustaining growth prospects despite the brake of fiscal adjustment. Uncertainty regarding fiscal policy in the short-term has receded in terms of scenarios that included the closure of government offices (although credible long-term fiscal consolidation measures have still not been taken). The elimination of some tax breaks and expenditure cuts coming into force have not triggered alarms in the financial markets (Chart 2), nor do they appear finally to have provided a substantial brake on private expenditure, thanks to **monetary expansion, which is maintaining very favorable financing conditions** and contributing to the improvement of income and wealth. Thus it is reasonable to maintain growth prospects for 2013 at 1.8%, despite the downward surprise of public-sector demand in the GDP figures for the last two quarters.

Chart 1
GDP growth



The EAGLEs are the emerging countries that will contribute most to growth over the next 10 years. They are: China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research

Chart 2
BBVA Financial Stress Indicator



Source: BBVA Research

The Chinese economy lost steam in the first quarter of 2013, with a negative surprise of weak investment, despite the greater strength of foreign demand and growth remaining in line with the government's target of 7.5% for 2013. The measures implemented to limit domestic financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a greater weight of consumption continues. With inflation also lower than expected, there is less pressure on tightening monetary conditions, so authorities have room for maneuver, given their commitment to sustainable growth for achieving the announced growth target. That is why our growth forecast for China remains unaltered at 8% for 2013 and 2014.

The path of sustained monetary expansion, which the Central Bank of Japan has now joined, involves challenging problems. The idea that investors looking for returns will move to more risky assets may lead to valuations in some markets that are a long way from their long-term fundamentals, which could lead to disordered adjustments when the stimuli are withdrawn. This risk is growing because of the lack of coordination between central banks with quantitative expansion policies, each focusing on its respective domestic anchored inflation targets and sustainable growth. In the case of emerging economies, although for now they are supporting the major capital inflows well, it is essential to remain vigilant regarding the domestic excesses this could generate.

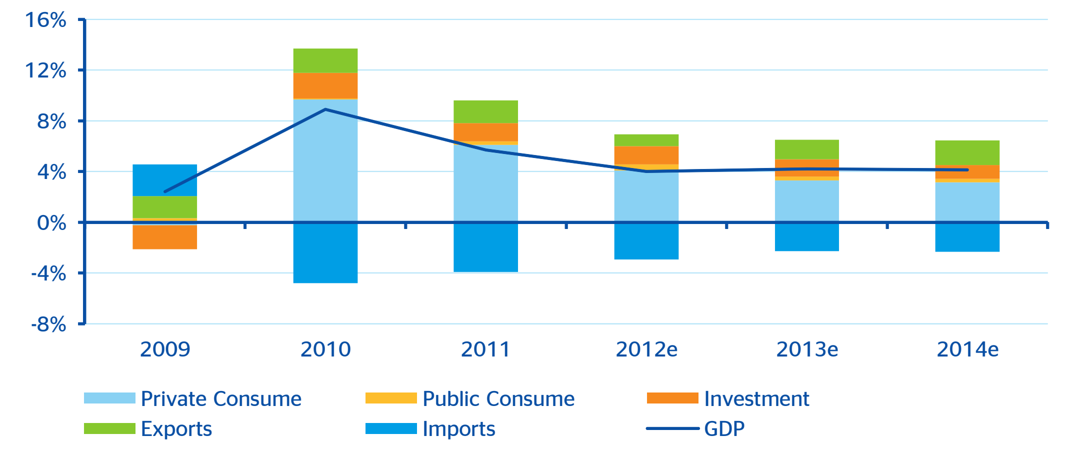
3 Uruguay: favoring growth over inflation

3.1. Slower economic growth

The Uruguayan economy expanded 3.9% in 2012, slightly below our forecast of 4%, rounding off a decade of uninterrupted growth. Nevertheless, this figure demonstrates a slowing economy in comparison to recent years where Uruguay saw average output grow over 6% according to information from the Central Bank of Uruguay (BCU). At the end of last year, the BCU revised Uruguay's growth figures upward from 2009 on. The correction for 2011 was particularly significant, up from 5.7% to 6.5% for the year, with a statistical carry-over into 2012, which thus determines lower actual growth last year.

Domestic demand continued to be the main driving force for economic output and, despite a slight slowdown, we forecast it will continue to boost growth in 2013. This trend is in line with the fact that after several years of recovery in the levels of jobs and real wages after the 2002 crisis, much of the deferred demand has already materialized and consumption growth is more likely to be in line with potential GDP.

Chart 3
Uruguay GDP: Contribution to growth



Source: BCU and BBVA Research

Partial indicators for 1Q13 point in the same direction, suggesting output growth will slow this year. On the consumer front, the consumer confidence index has posted falls for three months in a row, dropping from highs to show “moderate optimism”, with a significantly lower willingness to purchase durable goods due to higher unemployment expectations. In fact, in 1Q13 unemployment increased in comparison to the same period for 2012 (6.5% vs. 5.7%) and average wage increases are expected to be around 3.5% in real terms for this year, somewhat below the figures seen in previous years (4/4.5%). This will lead to a slowdown domestic consumption growth.

In the same vein, the delay in starting large investment projects in the pipeline means we are not as optimistic for private investment growth this year as we were before, and this could lead to lower GDP growth.

Export performance will be limited by the slow global recovery. Here, the main focus of concern continues to be Europe, in addition to a possible slowdown in growth in China (although only temporary), preventing a better performance of exports to these areas. The restrictions imposed by both Argentina and Brazil on imports point in the same direction.

We are reviewing our output forecast for 2013 downward to 3.7% (from 4.2%), and it will start to pick up in 2014 (3.9%) with higher exports due to the launch of Montes del Plata. From then on, potential GDP growth, as explained in the box, should come in around 4%.

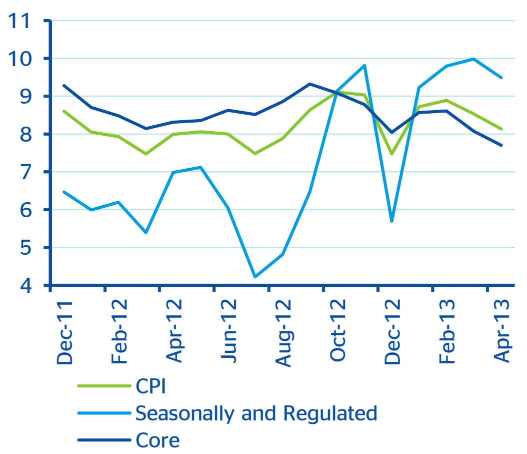
3.2. Inflation continues to be the main focus for concern

Prices increased by 7.5% in 2012, according to figures from the National Institute of Statistics (INE). This change included the deflationary effect in December (-0.7% m/m) of the “Your savings are worth double” plan (that cut electricity rates for customers who had reduced their consumption during the period) and of the agreement on supermarket prices. If the 0.7% m/m rise December 2011 would have been repeated in December 2012, inflation would have reached 9% y/y for 2012, just above our forecast of 8.7% in our last Uruguay Outlook of November 2012.

In the first four months of 2013, aggregate inflation hit 4.0 (April: 8.1% y/y) with increases to Food (4.4%), Education (7.9%) and Housing (11%) standing out due to the “rebound effect” of canceling the electricity tariff reduction in December.

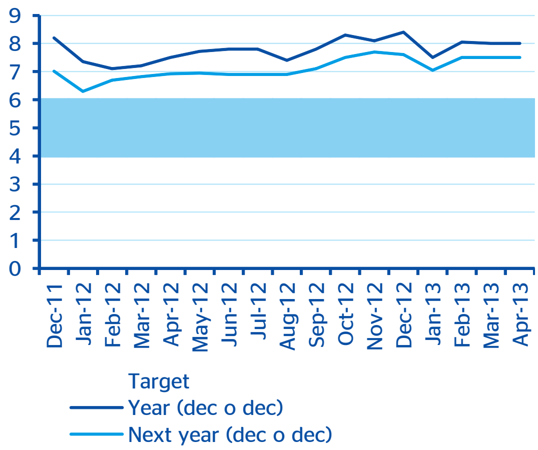
We expect a slowdown in price increases for the rest of the year due to lower consumption, lower real wage increases in comparison to last year and the stronger peso making imports cheaper. This trend should be supported by core inflation slowing to below 8% (Chart 4).

Chart 4
Inflation: Headline, core and administered prices (var. % y/y)



Source: INE and BBVA Research

Chart 5
Annual inflation target and forecasts (%)



Source: BCU and BBVA Research

Despite the lower price momentum, we forecast that inflation will again come in above the target range, at 8% y/y for the close of 2013 and then drop back slightly to 7% in 2014 thanks to the BCU keeping the real interest rate slightly positive and GDP converging to its potential level.

Wage inertia remains the main factor driving prices and has left its mark in the form of an implicit indexation of the economy. It is worth noting that the average annual real salary increase in the last five years hit 4.5% and we expect to see an increase of around 3.5% in 2013 and 2014.

In light of the lax monetary policy (see below), and since fiscal policy requires an expansive bias for its social equity targets, agents are pessimistic on inflation converging toward the target range, as can be seen in their inflation expectations (Chart 5), which are clearly outside the target range.

By looking at the period from December 2007, when the inflation target system was introduced, to March 2013, we see that only in 14 out of the 65 months, i.e. 22% of the period, has the BCU met its target. We can conclude that given current output levels, agents accept the current high but stable inflation, seeing 10% as the psychological threshold to act as a trigger for adjusting pension benefits.

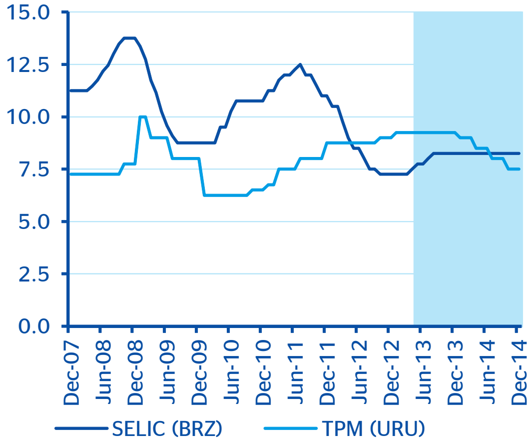
The BCU has maintained its decision-making framework in the light of the perception of this "comfort level for agents", as shown by the choices made in recent months. At its December 2012 meeting, the Monetary Policy Committee (COPOM) increased the Monetary Policy Rate by just 25 bps to 9.25%, left the rate unchanged at its March meeting and increased marginal reserves in April by 5 pp (the reserve rate going from 20% to 25% for domestic currency deposits and from 40% to 45% for foreign currency deposits, and leaving the remuneration structure for reserve requirements unchanged).

In assessing these facts, we see the same diagnosis as in our previous report: too high a burden for monetary policy, so unorthodox or macroprudential measures need to be used in the face of lax fiscal policy. Implementation of this policy mix is due to the limited effect of Monetary Policy Rate changes and the stronger currency. In this way, output again wins another round against prices. This is why we forecast no changes for the Monetary Policy Rate in the rest of the year, leaving the real interest rate in slightly positive terrain. The positive policy-rate spread against inflation (albeit not enough to make forecasts converge with the target) will act to contain demand somewhat. Supported by a stronger peso, this should moderate inflation.

Monetary policy could receive support from Brazil, which has already started to increase the Selic rate, marginally relaxing exchange restrictions with the Real and thus freeing up space for an adjustment in the Monetary Policy Rate (Chart 6). Nonetheless, we consider that this rate is unlikely to rise, given the major weighting output had in decisions taken by the COPOM in Uruguay.

Chart 6

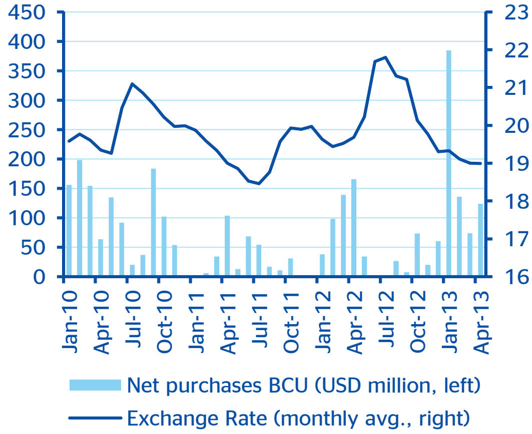
Interest Rates: Selic (Brazil) and MPR (Uruguay)



Source: BCU and BBVA Research

Chart 7

BCU intervention and Nominal Exchange Rate



Source: INE and BBVA Research

This preference for the output target was also reflected on the foreign-exchange market. The stronger peso, stoked by the country's investment grade rating, a high Monetary Policy Rate and international monetary liquidity, put equally intense pressure on the BCU, which attempted to maintain (with scant success) exchange rate competitiveness with interventions on the FX market purchasing currencies at record levels, taking advantage of good market uptake for issues used for sterilization. In the first four months of the year, net purchases hit USD 718.0 million, surpassing the total for last year (USD 662.1 million) while yields on Monetary Regulation Bills (LRM) show no signs of saturation in terms of demand (Chart 7).

As a result of these operations, reserve assets increased in 2012 by USD 3,287 million, accounting for 6.6% of GDP. At the start of this year, the BCU continued to purchase foreign currency on the markets and reserve assets continued to increase by around USD 400 million to a total of USD 14 billion in mid-April this year.

Box 1. Uruguay's potential GDP

This box calculates Uruguay's potential GDP. The idea behind this analysis is to assess what the core sources of growth in Uruguay have been on the supply side of the economy, and to attempt to predict what growth level Uruguay could expect in the future if all output factors are fully utilized. Potential GDP is a "non-observable" variable defined as the maximum GDP level an economy can achieve without creating inflationary pressure, where the 2 factors of production, capital stock (K) and labor force (L), are fully utilized. It is therefore a measurement of the economy's "sustainable growth".

Technically, potential GDP is estimated by using a production function (usually of the Cobb-Douglas kind; see the next equation) that links the level of output Y with capital stock K and labor force L, to which we add the effect of a variable A summing up "Total Factor Productivity" (TFP). This TPF aims to capture the part of growth that is not due to either capital stock increases or amount of labor in an economy, but rather to the more efficient use of productive factors. Thus increases in the TFP are considered to be increases in the economy's "aggregate efficiency".

$$Y_t = AK_t^{\alpha} * L_t^{\beta}$$

Potential output is defined as the GDP level an economy can achieve when i) the unemployment rate is at its "natural" level; ii) the use of installed capacity is at its "normal" level; and iii) productivity is at its "long-term trend level".

As this potential output level can be estimated for any time (t), it is a very powerful tool for calculating the "output gap", i.e. for knowing at any time "t" whether the current output (actually achieved by the economy) is above potential GDP for that period, which will generate inflationary pressure given the economy is "overheated"; or below potential GDP, meaning there is considerable idle capacity.

Historical experience

Average growth of potential GDP has been positive since the 1980s. We have divided the selected period into decades to make it easier to analyze. In the four decades selected, the highest contribution came from the capital factor, and there was also a good increase in factor productivity, as measured by TFP.

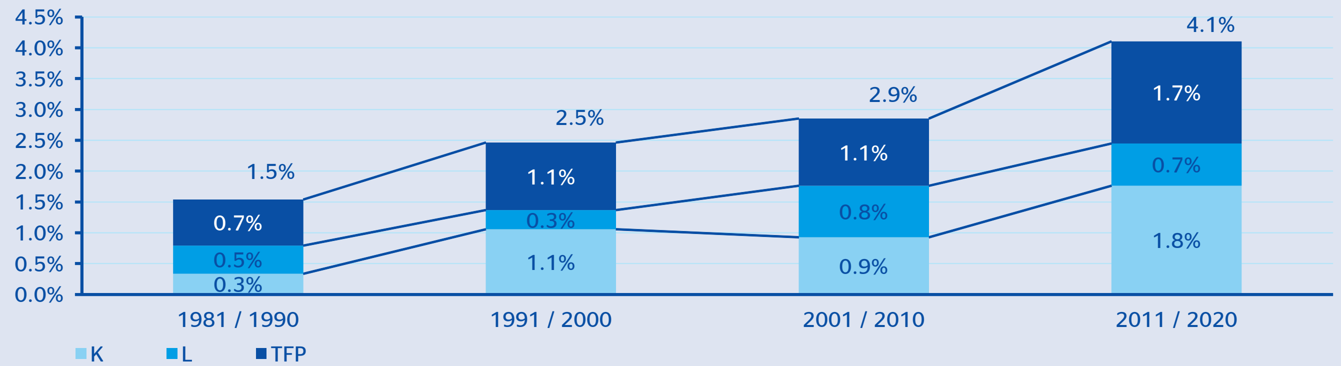
In the 1980s, potential GDP hit an average of 1.5%, with low contributions from both capital and labor; meaning that TFP took the honors in terms of contribution to potential growth. In the 1990s, a higher contribution from capital made up for the slightly lower contribution from labor, while productivity improved by 0.4 pp. This combination of factors saw potential GDP increase 1.0 pp on average in comparison with the previous decade, to 2.5%.

The third period includes the last major crisis in Uruguay (2002). In this decade the contribution of capital to potential GDP decreased in comparison with the previous decade, while the contribution of labor increased thanks to structural unemployment falling from 17% in 2002 to an average level of 6% in recent years. As a result, potential GDP grew by 2.9% on average for the decade.

Nevertheless, it is in the last period when we estimate a major increase in the growth of potential GDP, rising to 4.1% on average for the current decade. In this period, the contribution from capital would reach a maximum thanks to the boost from both public and private sector investment, and TFP growth rates also hit values above those up to the previous decade. In contrast, the contribution from labor will see a minimal decline in this period.

The following chart shows the average performance per decade for potential GDP in Uruguay and how the contributions from the factors of production and productivity have varied.

Chart 8
Potential GDP in Uruguay and contributions (decade averages)



Source: BBVA Research

Over the full period it can be seen that it is the labor factor that places the biggest restriction on potential GDP growth. Although the demographics of Uruguay show high life expectancy, there is a very low birth rate, leading to a low population growth rate. The population of working age in Uruguay only increased an average of 0.56% from 2005-2010, while for Latin America as a whole, the increase was 1.64% over the same period.

The effect FDI has on the labor factor through a process of "learning by doing" means labor becomes more productive (raising TFP) and the potential growth rate increases.

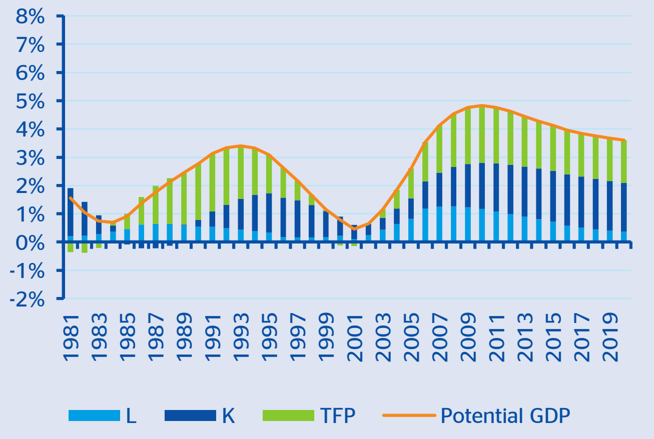
High global liquidity, Uruguay being rated as investment grade and its highly valued institutional stability, all lead us to believe that the capital factor should continue to contribute to potential growth. In the case of the labor factor, the labor force supply is the most important restriction; it can also only be resolved in the medium and long term, since apart from immigration programs, it is biological variables that determine its variations. The contribution of the TFP thus needs to be improved, and it is here that the government should make its biggest effort in view of the need to modernize aspects of the labor market. The authorities will need to take measures aimed at improving efficiency and eliminating distortions such as rigid labor union statutes, reducing bureaucracy, speeding up the legal system and increasing innovation. All these are aspects where Uruguay does not have a high international standing.

GDP expansion and contraction cycle

If we examine the present real and potential output gap, the economy appears to be functioning above its potential level. This impression is backed up by persistently high inflation. Estimated convergence at values of around 4% in our model involves a more restrictive monetary policy than in previous years, so as to keep the real rate in positive terrain to restrain demand. A similar turn toward a less accommodative position should guide fiscal policy.

Chart 9

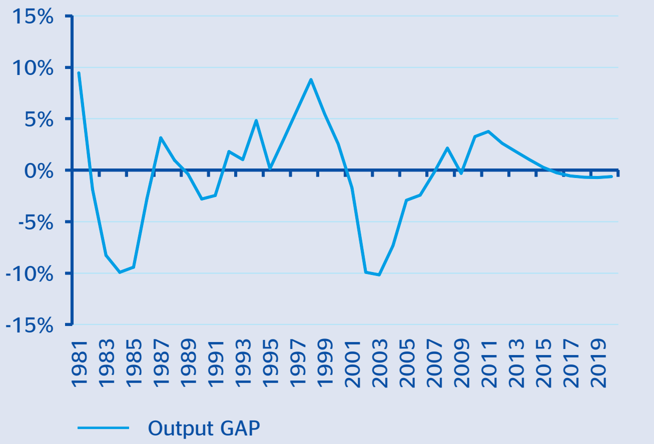
Potential GDP growth and factor contribution



Source: BBVA Research

Chart 10

Observed and potential output gap



Source: BBVA Research

3.3. The sharp deterioration of the current account will partially reverse in 2013

The current-account deficit hit USD 2,625 million in 2012 (in 4Q12 alone the deficit was USD 950 million), equivalent to 5.3% of GDP, above our forecast of 3.8% y/y. This major deterioration can be entirely explained by the trade and services balance, since transfers and wages saw a slight improvement.

The higher trade deficit was basically due to the large amounts of oil that needed to be imported to supply electricity production (thermal generation) in the face of lower hydro generation (as a result of the drought); as well as re-stocking of oil reserves by the state oil company ANCAP and the higher demand for raw materials and capital goods by ongoing investment projects.

As a result, while exports grew 7% y/y in constant dollar terms, imports grew double that (14% y/y) in 2012. Furthermore, the poor result in services was due to the combination of a decline in revenue from inbound tourism (-6.3% y/y) and higher outbound tourism (+19.2% y/y), in both instances favored by a stronger exchange rate in real terms; in the case of tourism from Argentina (traditionally over 50% of revenue in Uruguay), this was further affected by the currency restrictions implemented by the Argentine government.

For 2013 we see a calmer climate with a more normal rainy season allowing for better (and cheaper) energy supplies, meaning that big oil imports like those in 2012 will not be required. Nevertheless, other factors that contributed, albeit to a lesser extent, to the worsening of the current account in 2012 will remain in place throughout 2013. Indeed, in the first months of the year there was a decrease in tourism revenue as a result not only of the persistently strong currency but also thanks to the ongoing currency restrictions implemented in Argentina. Moreover, data that include the period from December 2012 to February 2013 show that tourism revenue in dollar terms declined around 12% in comparison to the previous period, according to information supplied by the Minister for Tourism. Data from the Ministry of Tourism for the 1Q13 show an 11.8% fall of tourism revenue in dollar terms in comparison with 1Q12. Also, the number of Argentine tourists fell 4.2% y/y, those of Brazilian visitants decreased by 15.6% y/y while those of other nationalities increased by 14% y/y. However, given the importance of the first two in the total, specially the Argentine ones, the total visitants to Uruguay in 1Q13 decreased by 2.4% y/y.

Competitiveness will also continue to decline this year as we will see the real multilateral exchange rate continuing to strengthen by around 5% y/y (Chart 9), making it difficult to sell Uruguayan goods overseas and driving up imports.

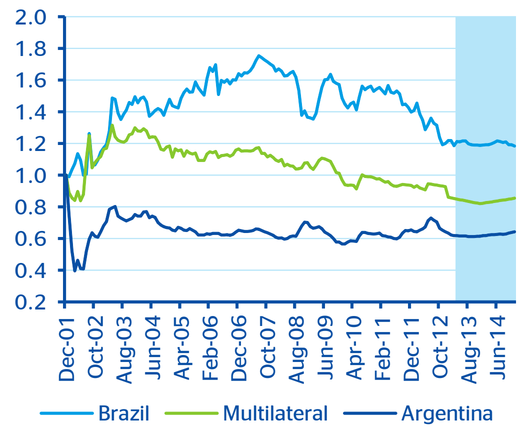
Furthermore, the loss of competitiveness has been of increasing concern in Uruguay in recent years, favored by major capital inflows, and underlines the low structural domestic savings rate. In addition, the lack of a manufacturing industry producing basic supply goods (such as oil and capital goods) means Uruguay depends on increasing imports to maintain a high growth rate. In other words, to maintain average growth of 6% a year, which Uruguay recorded over the last decade, imports needed to significantly increase. This has led to successive large trade deficits, the main determinant of current-account deficits. Uruguay will therefore continue to post negative balances in its external balance while growth, as forecast, continues to converge to potential growth in the coming years.

In fact, as shown in Chart 11, Uruguay continues to be valued higher in real terms than its trading partners (Multilateral Real Exchange Rate = MRER), this situation is particularly clear in the case of Argentina (Bilateral Real Exchange Rate = BRER). In recent years, we can see how the competitiveness gains Uruguay made over Brazil (BRER) in the first half of the last decade have been reversed.

We forecast the current-account deficit will come in at around 3.8% of GDP, which is a substantial improvement over 2012, although above our earlier forecast (3.3% of GDP). However, this improvement only means that the one-off factors inherent to the energy deficit seen last year will not occur again; the problems related to competitiveness will still impact the external accounts this year. We forecast a slight improvement in competitiveness at the start of 2014 as the predicted interest-rate cuts and doubts surrounding the sustainability of foreign deficits under current parameters start to correct the appreciation in the currency. In this scenario and with more dynamic growth in exports as soon as output from Montes del Plata, which should be working by then, can be exported, the current account deficit would drop to 3.4% of GDP.

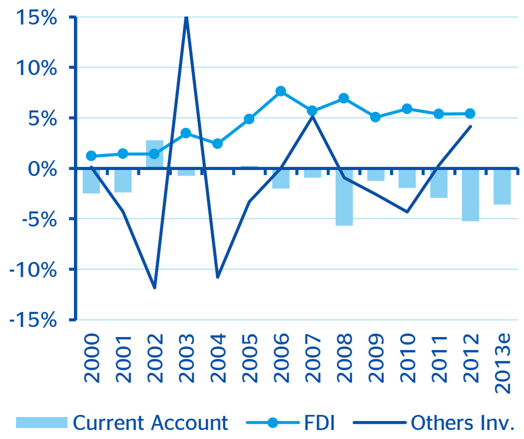
It is important to note that Uruguay's successive external deficits can be fully financed by increasing foreign direct investment (FDI). Indeed, FDI in 2012 hit a record USD 2.7 billion, equivalent to 5.2% of GDP. However, the constant dependence on external saving adds some vulnerability in the event of a sudden change to the international situation. Consequently, it would be good for Uruguay to increase its domestic savings rate, which has dropped in recent years to 12.3% of GDP in 2012.

Chart 11
Multilateral and Bilateral Exchange Rate with Argentina and Brazil (December 2001 = 1)



Source: BBVA Research

Chart 12
Current account, FDI and other investments (% of GDP)



Source: BBVA Research

With regard to the rest of the capital account, in addition to FDI the flow of portfolio investment is also important. Last year, it came in at around USD 1,650 million (41% of total investments). Almost all of this can be attributed to the public financial sector (Chart 12). Indeed, since being rated at investment grade Uruguay has attracted more short-term capital in Monetary Regulation Bills (LRM) from the Central Bank and, more recently with the implementation of the "Frozen Funds System" (Régimen de Fondos Inmovilizados) regulating these operations, non-resident demand has shifted toward central government bonds.

An inherent risk factor here is whether given the delay in starting work on large projects in the pipeline and with Montes del Plata being finished, FDI will continue at these levels or perhaps decline until work on pending projects starts.

3.4. Higher fiscal imbalance due to temporary and structural factors

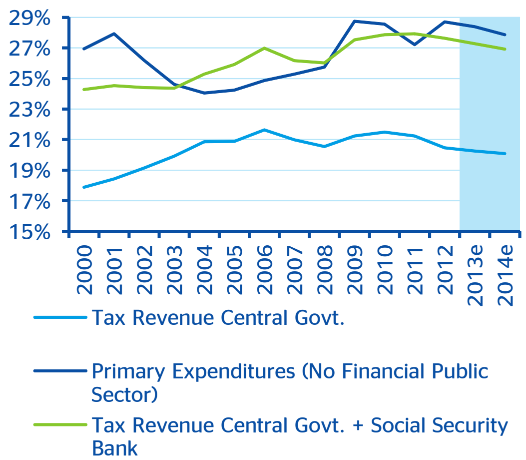
Uruguay's public balances in 2012 worsened due to both temporary and structural questions. The primary budget surplus was wiped out last year (after having hit 2% of GDP in 2011), while the interest repayment burden in GDP terms fell back slightly to 2.6% of GDP in 2012. As a result, the overall public sector deficit closed at 2.6% of GDP, compared with 0.9% of GDP in 2011, in line with our forecasts.

The economic slowdown brought with it lower revenue growth from VAT, IMESI and IRAE taxes (+10% y/y vs. +15% y/y in 2011). In turn, primary spending increased from 27.2% of GDP in 2011 to 28.7% of GDP in 2012. This higher spending was due to higher wage and pension benefit payments that basically resulted from statutory indexation mechanisms.

Transfers are increasing due to both structural and temporary factors. Since 2007, transfers have increased by almost 4 points of GDP, mainly as a result of higher social benefits for the population as a whole. The healthcare system was reformed, one objective being to introduce universal healthcare, incorporating an increasing number of retired people and pensioners. Welfare benefits were also introduced for the poorest members of society.

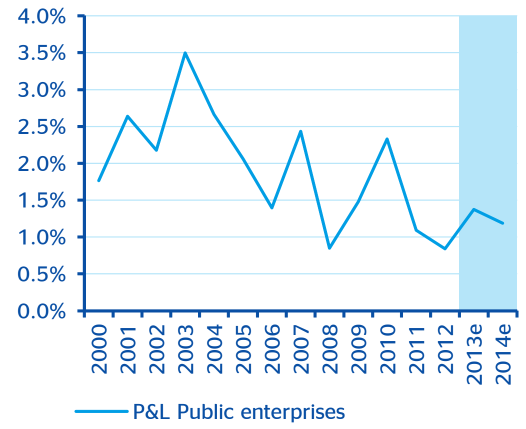
In addition, transfers increased in 2012 due to payments made by the government, above all to end the dispute with foreign financial institutions as a result of Banco Comercial being liquidated (0.25% of GDP) and linked to the closure of PLUNA (0.1% of GDP). Also key was the extra fiscal cost arising from the need to supply electricity demand with thermal generation, since the lack of rain affected the normal operation of hydroelectric plants. This higher spending in 2012 contrasts with the reduction in 2011, although the 2011 figure was determined by a substantial reduction in investments (Chart 13).

Chart 13
Primary expenditure and tax revenue with and without BPS (% of GDP)



Source: BBVA Research and Ministry of Economy and Finance of Uruguay

Chart 14
Earnings from state-owned enterprises (% of GDP)



Source: BBVA Research and Ministry of Economy and Finance of Uruguay

We expect an improvement in the fiscal balance this year, given the fact that most discretional spending in 2012 will not recur. In particular, a better climate is expected that will allow energy demand to be covered without needing to bring thermal plants onstream. Nonetheless, the increase in current spending (wages and pension benefits) will continue this year, albeit less so thanks to lower real wage growth in the public sector, forecast to come in around 3% y/y. This will combine with lower tax revenues due to flagging output. As a result, our estimate points to 2013 closing with a deficit of 2.3% of GDP, a slight improvement over 2012.

Despite seeing an improvement in public balances, the government's planned overall deficit target of 1.4% of GDP will not be achieved. In addition, with inflation within its current range, the government could continue to apply unorthodox measures to further control administered prices (state-owned enterprise tariffs) so as to avoid a steeper rise in inflation. It is thus clear that the aim of fiscal policy is to meet the government's social objectives such as growth and improved wealth distribution. We continue to believe that 2014 will see another, albeit limited, drop in the deficit, coming in at 2.1% of GDP, since there will be no slowdown in current spending, given it is an election year, while output will gradually converge to its potential level (4%).

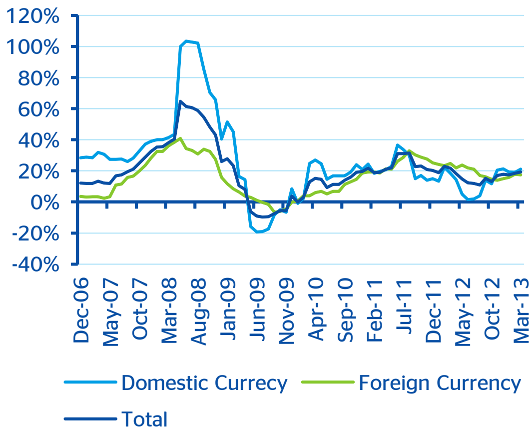
Good debt management continues without restrictions on external borrowing. In fact, Uruguay still has unpaid credit lines with the CAF for USD 400 million, the Latin American Reserve Fund (FLAR) for USD 470 million and with the World Bank for USD 520 million that could be used by the government.

With the aim of reducing the risks inherent in refinancing debt and making it cheaper, in January the government paid off loans for USD 520 million it had with the IDB with maturities in 2024 and whose interest rate was higher than the current government borrowing cost. This operation meant a saving of USD 40 million at present values. In March this year, a new loan for USD 550 million was agreed with the IDB that replaced the loans canceled in January.

3.5. Private credit growth slows

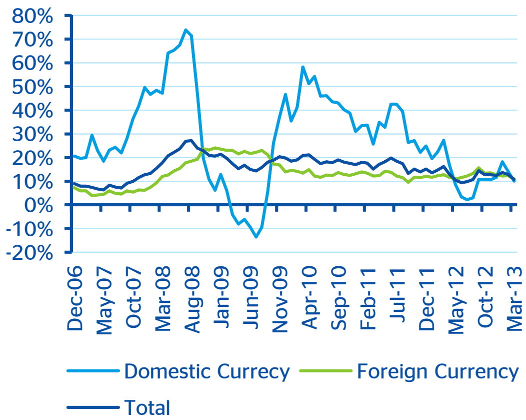
Lending to the private sector stabilized at an average growth rate of around 18% y/y over the last six months (Chart 15). The factors behind this slowdown are higher marginal reserve requirements and greater household prudence when taking out loans in light of the prospects for lower growth. Meanwhile, deposits from the non-financial resident private sector, accounting for 42% of liabilities in the financial system, recorded an average growth rate of 13% over the same period (Chart 16). Deposits showed no major signs of de-dollarization, with the domestic currency maintaining an average share of 25%.

Chart 15
Private-sector credit, y/y % change



Source: BBVA Research and Ministry of Economy and Finance of Uruguay

Chart 16
Private-sector deposits, y/y % change



Source: BBVA Research and Ministry of Economy and Finance of Uruguay

To weigh up briefly the economy's strengths and weaknesses, we again highlight high liquidity and solvency as strengths; while still among the areas for improvement are the risk of a currency mismatch in the face of a run on deposits or a sudden devaluation.

5. Tables

Table 1
Macroeconomic Forecast Annual

	2010	2011	2012	2013	2014
GDP (% y/y)	8.9	6.5	3.9	3.7	3.9
Inflation (% y/y, average)	6.7	8.1	8.1	8.2	6.9
Exchange Rate (vs. USD, average)	20.0	19.3	20.2	19.1	19.7
Interest Rate (%, average)	6.3	7.0	8.8	9.3	8.3
Private Consumption (% y/y)	13.7	8.9	6.5	5.4	3.0
Government Consumption (% y/y)	1.0	3.6	5.4	3.0	1.0
Investment (% y/y)	8.1	11.4	14.2	6.0	4.0
Fiscal Balance (% GDP)	-1.2	-0.9	-2.8	-2.3	-2.1
Current Account (% GDP)	-1.9	-2.9	-5.3	-3.6	-3.4

Source: BBVA Research

Table 2
Macroeconomic Forecast Quarterly

	GDP (% y/y)	Inflation (% y/y, average)	Exchange Rate (vs. USD, average)	Interest Rate (%, average)
Q1 11	7.5	7.7	19.6	7.00
Q2 11	6.3	8.5	18.7	7.50
Q3 11	8.8	7.9	18.8	8.00
Q4 11	3.8	8.3	19.9	8.25
Q1 12	4.4	7.8	19.5	8.75
Q2 12	3.7	8.0	20.4	8.75
Q3 12	2.9	8.0	21.4	8.75
Q4 12	4.8	8.5	19.7	9.00
Q1 13	2.9	8.7	19.1	9.25
Q2 13	3.6	8.3	19.1	9.25
Q3 13	3.4	8.6	19.1	9.25
Q4 13	4.7	7.3	19.0	9.25
Q1 14	4.7	6.7	19.2	9.00
Q2 14	4.0	6.9	19.5	8.50
Q3 14	3.6	6.9	19.8	8.00
Q4 14	3.3	7.0	20.1	7.50

Source: BBVA Research

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