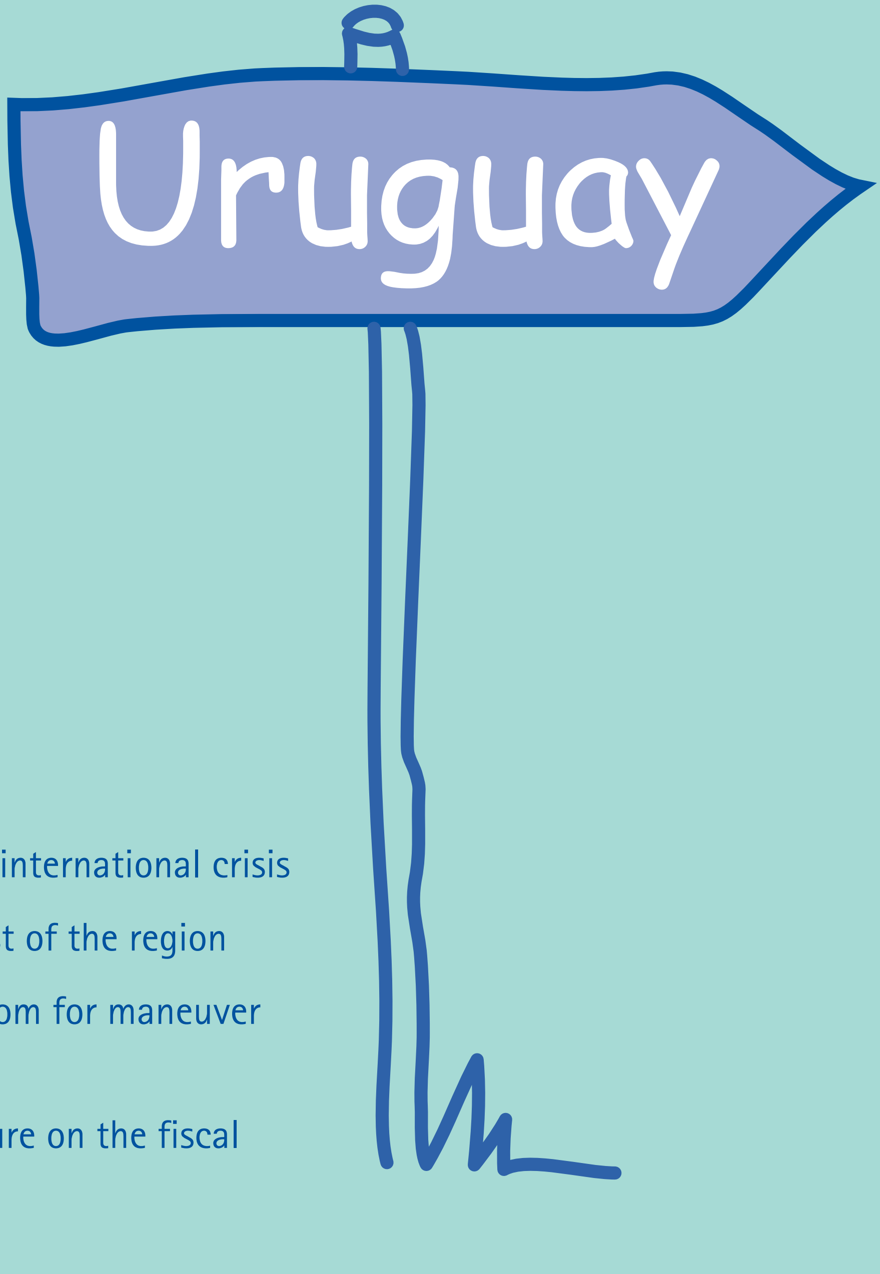
Uruguay Watch

Economic Research Department

Year 2009



Uruguay well-positioned in the international crisis

Growth falls less than in the rest of the region

Slowing inflation widens the room for maneuver for the Central Bank

The falling oil price eases pressure on the fiscal balance

Index

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Editorial

A crisis of global scope such as the current one has specific impacts on the economies of Latin America. Uruguay will not be immune to the slump in foreign demand or the abrupt adjustment in export prices. Domestic spending will also be affected by the greater uncertainty as a result of the postponement of investment projects and the contraction of spending on consumer durables.

However, the economy is currently better prepared to deal with financial volatility than in previous crises. Over recent years, the quality of economic policies has improved, with the Central Bank implementing inflation targets and establishing a floating exchange rate system that partially cushioned the crisis at the end of 2008.

But the resurgence of inflationary pressures in 2008 prevented a swift relaxation of monetary policy, which would have mitigated the contraction in economic activity. Although the Central Bank subsequently reduced its intervention rate by 200 bps, the lack of an anchor to dampen inflationary expectations limits the capacity of monetary authorities to compensate for the fall in internal demand by introducing more expansive monetary policies.

In a similar way, the capacity to apply countercyclical policies is restricted by the need to prevent further deterioration in fiscal solvency against the background of uncertainty in which the sources of international finance could be limited. Given that the debt/GDP ratios are still high, long term fiscal sustainability requires restrictions on the budget deficit at a time of low GDP growth and the end of the cycle of appreciation of the Uruguayan peso.

The restructuring of the public accounts and financial system in the wake of the 2002 crisis has substantially reduced the fragility of the economy and improved its ability to cope with external shocks, as shown by our Index of Financial Vulnerability (see Box). The most important progress made in this respect has been the reduction in short-term foreign debt through a government policy to extend the maturity profile of debt and increase domestic issuance with inflation index-linked instruments.

But progress is slow. Uruguay is still vulnerable to exchange-rate volatility due to the balance-sheet effect in both the private and public sectors. Public debt is still high (around 54% of GDP), and more than 70% is denominated in foreign currency. Lending in dollars to companies in non-tradable sectors exposes the private sector to credit restrictions at a time when there is a depreciation in the domestic currency.

There will be presidential elections in October 2009, so we do not rule out some volatility in interest and exchange rates in the second half of the year. However, the candidates of the main parties elected in the general elections in June have given signs that they do not plan to implement major economic policy changes and will try to consolidate the progress made in the last political cycle.

The new soundness of the Uruguayan economy will enable a return to the path of sustained growth as international financial conditions recover.

Executive Summary

After 18 quarters of unbroken growth, the Uruguayan economy suffered an abrupt check as the international crisis deepened. The economy contracted in the first quarter of 2009, when investment was halted as a result of lower foreign demand and a fall in domestic confidence. However, the upturn in international conditions and rising commodity prices in the second half of the year will mitigate the impact of the crisis, and as a result GDP will fall by only 0.8% in 2009, and grow by 1.4% in 2010.

Concerns about inflationary pressure have been significantly reduced after the fall in international commodity prices and the slowdown in economic activity. Unlike previous years, the increase in consumer prices will be below the upper target band set by the Central Bank of Uruguay for 2009. The downward revision of inflationary expectations will allow the government to relax monetary policy gradually and begin to adjust energy and transport charges, which had been frozen to avoid extra inflationary pressure.

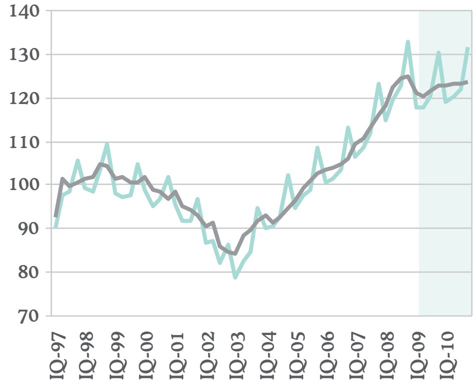
This policy will be maintained for the rest of the year. It will help improve the results of the state-owned companies ANCAP and UTE, which have also benefited from the fall in oil prices and the recovery from the drought that affected the country in 2008. However, this will not be enough to prevent a deterioration in fiscal solvency. Tax revenues will reflect the slowdown in activity, but spending on payroll and social security will grow more due to the wage increases granted in 2008. As a result, the consolidated deficit of the public sector will increase to 2.5% of GDP in 2009. This amount can be financed through the domestic and multilateral markets. In fact, the placements of government debt, taken as a precautionary measure, cover the financing needs of the public sector until mid-2010.

The fall in the oil price compared from 2008 levels will not only ease the fiscal accounts, but also the trade deficit, and restrict imports more than the slowdown in economic activity. Uruguayan exports of meat, dairy products and grain are inelastic to demand and will be relatively less affected than the exports of other countries, so the current account deficit will fall to 0.2% of GDP.

The exchange rate depreciated less than that of other currencies in the region in 4Q08 after the bankruptcy of Lehman Brothers. The speedy recovery in the Brazilian real so far in 2009 has left the competitiveness of the Uruguayan peso close to pre-crisis levels and its equilibrium values. We expect that the currency will remain stable for the rest of the year, in line with the expected trend for the Brazilian real and the inflation differentials.

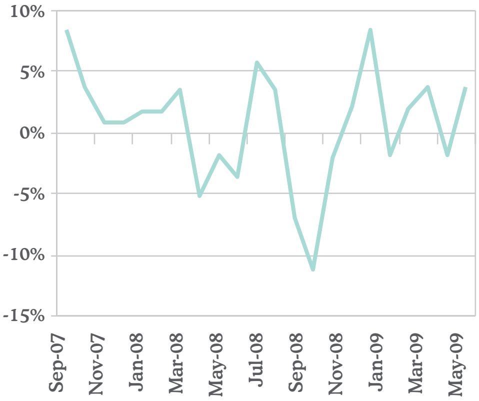
Thanks to the sound local banking system, the impact of the international crisis through the financial channel was relatively limited. The country risk has returned to pre-crisis levels and the interest rates on Central Bank of Uruguay bills are approaching their earlier range. The Central Bank has once more bought reserves and expanded the monetary base. The level of lending has still not recovered, but no deterioration in default levels has been noted, and they remain at a minimum. Although some vulnerability in the banking sector remains through currency mismatch, mainly in corporate lending, the risk is limited because of the relatively restricted movement of foreign exchange rate.

Graph 1.
GDP
Original and seasonally-adjusted IVF index of output



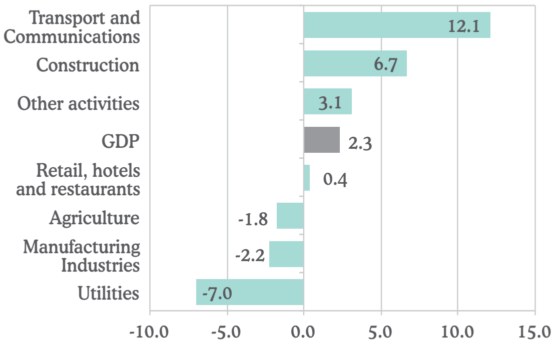
Source: BBVA, using Central Bank of Uruguay (BCU) data and own estimates

Graph 2.
Consumer Confidence Index
Monthly change



Source: BBVA using data from Grupo Equipos

Graph 3.
GDP by activity
YoY change, first quarter



Source: BBVA, using Central Bank of Uruguay data

1. The Macroeconomic Context

Economic activity slows

The Uruguayan economy grew by 8.9% in 2008, rounding off a total of six consecutive years of strong growth. However, the deepening international crisis in October last year, together with domestic factors such as the drought, have had a major impact on the levels of activity in recent months. The fall in international demand significantly affected Uruguay's foreign trade, and at the same time there was a major contraction in internal demand. Economic activity fell by around 2.9% in seasonally-adjusted terms in the first quarter of 2009 (Index of the Physical volume of output, Chart 1) compared with the fourth quarter of 2008, which in turn had already registered a marked slowdown, with a rise of only 0.8% on the previous quarter.

Uncertainty relating to the size and duration of the international recession, combined with greater expectations of devaluation, renewed memories of the 2002 crisis and produced a swift fall in consumer confidence. Households increased their savings as a precautionary measure and delayed the purchase of consumer durables. Sales of automobiles (ACAU figures), for example, fell by 23% in the first quarter of 2009.

Companies were affected by the simultaneous collapse of export prices and the deterioration of domestic confidence. This produced a major adjustment in inventories, and industrial production contracted sharply. Although this process was reflected in most countries in the region, in the case of Uruguay it was aggravated by the rapid devaluation of the peso. This had an impact on the balance sheets of companies with dollar liabilities.

Apart from the external shocks, the Uruguayan economy was also affected by a domestic problem: the major drought that devastated the region towards the end of 2008 and the start of 2009. Agricultural activity fell by 1.8% year-on-year in 1Q09, as a result of reduced livestock numbers and a drop in dairy production. The drought also had a negative effect on the generation of hydraulic energy, and domestic demand had to be met with imports from Brazil (output of electricity, gas and water fell by 7% year-on-year). The most dynamic sectors were Transport and Communications (mainly cellular telephony) and Construction, as a result of the impact of public works (Chart 3).

The economy still showed signs of recession in the second quarter: the index of industrial production for April-May registered a year-on-year fall of around 7.3%, sharpening the fall in the first quarter (-3.5% year-on-year). Imports continued to drop, although part of the contraction can be explained by the fall in the oil price.

However, the financial indicators such as country risk clearly improved during this period, as did international grain prices. Consumer expectations (Chart 2) were also more upbeat as a result of the improvement in the international situation and slowing inflation. In June the consumer confidence index was 17% above the minimum levels registered last November. The moderate increase in unemployment and rises in real wages will act as a basis for a recovery in private consumption in the second half of the year. As a result, the year will close with private consumption falling by only 1%, while public consumption will make a positive contribution to growth.

Investment will also contract due to the lack of finance for projects developed by international corporations, while residential construction will be affected by the reduction in tourist flows at a global and regional level.

In 2009 economic activity will fall by 0.8% as a result of lower domestic demand. Foreign demand will have a positive effect on GDP of 1%, due to the contraction of imports, which will exceed the fall in exports with a less elastic demand (Table 1).

Next year, the recovery of the world economy will boost GDP to a growth of close to 1.4%. Private consumption will increase once more and investment will begin to find finance, while foreign demand will only contribute 0.3% to GDP growth, given the greater dynamism of imports.

A number of investment plans that had been announced in Uruguay, such as Portucel's USD 2.5 billion cellulose plant and the plant to be constructed by the Chilean Empresas Copec through Celulosa Arauco, have been postponed by the international crisis. These projects, together with other smaller ones, may be restarted in the coming years as foreign demand and commodity prices recover.

Household income barely affected by unemployment

The economic slowdown had a negative impact on the unemployment rate in the first quarter of the year. Average unemployment in this period was 7.5% of the active labor force for the country as a whole, while in Montevideo unemployment was slightly higher, at 7.8% (Chart 5). These figures are slightly above those for the fourth quarter last year, although they are not significantly different from the 2008 average. In April, the labor situation worsened again (8.3%), but the unemployment rates are still notably lower than those at the end of the last decade and the start of this one, when with the 2002 crisis they reached levels of 17%.

Everything suggests that the drop in economic activity expected for the coming months will continue to have a negative impact on unemployment, which will reach an annual average of 8.6% this year compared with 7.6% in 2008. However, given that negative growth is only expected in 2009, we expect an improvement next year and a return to levels of under 8%.

However, the wage levels agreed at the end of 2008, when inflation was still rising, will prevent a significant deterioration in the playroll. In 2009, workers' income will increase close to 7% in real terms. This will mitigate the effects of rising unemployment and represent a stimulus to consumption when confidence returns.

Inflation within reasonable parameters

The general CPI increased by 9.2% over 2008, reaching one of the highest levels in recent years since the 2002 crisis. As in many emerging countries, inflation accelerated in 2008 due to the upward pressure of agricultural commodity prices and a positive excess demand, after 6 years of strong GDP growth.

Table 1.

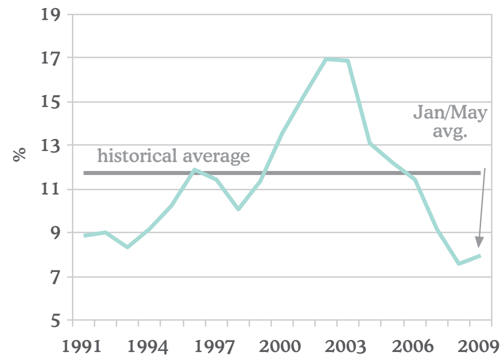
Year-on-year %	2007	2008	2009 f	2010 f
Private Consumption	7.7%	8.8%	-1.0%	1.0%
Public Consumption	5.0%	8.6%	1.0%	1.0%
Investment	6.3%	25.0%	-5.8%	1.5%
Domestic demand	7.2%	11.9%	-1.9%	1.1%
Exports	8.2%	10.5%	-3.0%	5.6%
Imports	6.7%	19.9%	-5.7%	4.3%
Trade balance	0.4%	-3.0%	1.0%	0.3%
GDP, UYU million (2005 prices)	444,774	478,495	521,073	516,729
y/y	7.6%	8.9%	-0.8%	1.4%

Source: BBVA using BCU data

Graph 4.
Index of the Physical Volume of Manufacturing Output (except Refining)
(% change)

Source: BBVA using INE data

Graph 5.
Unemployment rate in towns of 5,000 or more inhabitants

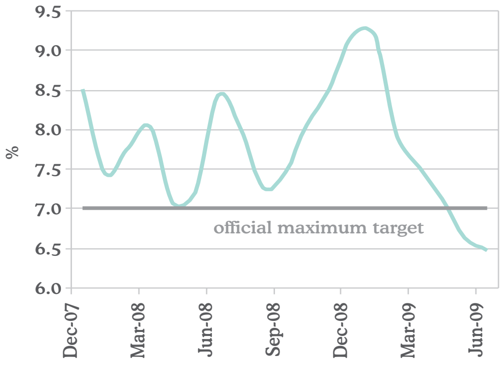


Source: BBVA using INE data

Graph 6.

CPI rate

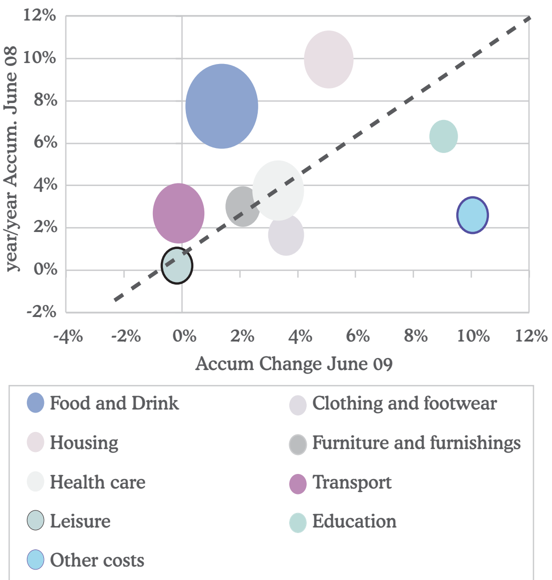
Accumulated, last 12 months



Source: BBVA using INE data

Graph7.

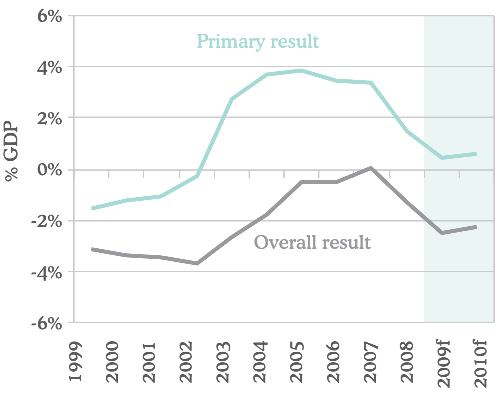
Price changes by items



Source: BBVA, using INE data

Graph 8.

Public accounts



Source: BBVA, using Economy Ministry data and own estimates

Apart from tightening monetary policy, the government implemented price agreements in 2008 for consumer goods, such as those covering meat depots and supermarkets, and contained the administered prices charged for public services and mutual and collective health provision, as well as the prices regulated by the municipal authorities of Montevideo.

Nevertheless, inflation remained above the maximum target set by the Central Bank of Uruguay until the end of 2008. As a result, the Bank increased its intervention rate in January 2009, even though the international crisis had already hit the country (Chart 6).

The fall in commodity prices and the slowdown in activity have moderated inflationary pressures this year. If we measure accumulated inflation to June 2009, the rise was only 2.8%, compared with a rise of 5.4% in the same period in 2008.

As can be seen in Chart 7, in which the size of each circle gives an idea of the weight of each item in the CPI, the accumulated variation in 2009 has been greater in those items of least weight. Those items with more weight, such as Food and Beverages, Health Care and Housing, which are above the target, posted smaller increases than in the same period the previous year. There was even a fall in Transport.

A significant part of the public rates may be controlled, thanks to the international fall in the oil price. This allows increases in regulated fuel prices (ANCAP) and electrical energy (UTE) to be contained. The health care fees for people not included in the National Health Fund were also left unchanged in the initial months of the year, and the loss was compensated through the general revenues. In Montevideo there were also reductions in taxi fees dependent on the municipal authorities, and the subsidy for public transport tickets was maintained.

But from June the government took advantage of lower inflation and the greater room for maneuver given by the appreciation of the peso to increase some of the charges. This will have an impact in the second half of the year. Another possible source of increased inflation could be wages and the way they are determined. Current wage levels have been set at a time when prices were rising. Now, with falling inflation, the increase in real wages could have an impact on consumer goods once confidence returns.

Our forecasts for 2009 indicate that inflation will end at around 6.8% year-on-year in December, with a bigger rise in the second half of the year than the accumulated rate for January to June, due to the rates increases and a recovery in domestic demand. For 2010 prices will increase by 7% as growth picks up.

Significant deterioration in the public accounts

After the 2002 crisis and the “friendly” renegotiation of its foreign debt, Uruguay began a process of restructuring its public accounts. However, in 2008 the combination of a rise in the price of oil and drought at home combined to negatively impact the fiscal balance. Although the primary balance remained in positive territory (1.4% of GDP), the overall balance entered the negative zone (-1.3% of GDP), as can be seen in Chart 8 and Table 2.

The rise in the price of oil increased costs for the state-owned company ANCAP (Administración Nacional de Combustibles Alcohol y Portland), while the drought put pressure on the expenditure of another state-owned company, UTE (Administración Nacional de Usinas y Transmisiones Eléctricas), as it had to replace its hydroelectric production with thermal, which is more expensive.

These costs could have been transferred to prices and would not then have greatly affected the results of the state-owned companies, but the government prioritized the aim of containing inflation. Had tariffs been increased, inflation may have easily exceeded 10%, and this would have triggered automatic adjustments affecting wages and pensions.

The fall in commodity prices meant a relief for Uruguay's fiscal accounts, as it reduced the cost of generating electrical power. In addition, tax revenues were not affected by the impact of falling export prices as the tax system in the country does not include export duties, and export activity is concentrated in private hands. However, tax revenues slowed notably as the economy entered a more recessive phase.

Nevertheless, the new reality has not led to an adjustment of spending, as the government is maintaining investment plans in health and education (for example, the Ceibal plan to provide all schoolchildren in public schools in the country with laptops) that were approved before the crisis. Moreover, wage increases in the public sector at the end of 2008 have reduced the scope to contain current spending, where wages and pensions represent 57% of the total. In addition, the recent rise in the oil price could affect the fiscal balance in the second half of the year.

The accumulated figures for January to May 2009 show that consolidated income of central government and the Social Insurance Bank (Banco de Previsión Social, BPS) increased by 15% year-on-year, while expenditure increased by 19%. The improved results of state-owned companies was not sufficient to compensate for the combined deterioration in the results of the local authorities and the BSE, so the primary balance of the public sector fell by nearly 30% year-on-year, in nominal terms. Increased interest payments, mainly by the central government, also led to a substantial fall in the overall result, which turned from a surplus of UYU 1,653 million in the January-May period in 2008 to a deficit of UYU 2,282 million in the same period this year.

One of the alternatives the government can consider as inflation slows would be to increase the prices of public services even more in the second half of the year. In fact, the government increased some charges in May and June, including ANCAP, mutual society fees, taxis and gas, though these increases were insufficient to compensate for rising spending. In addition, the recent increases in the oil price and the lack of rain could affect the fiscal balance in the second half of the year.

This is why we expect that the primary result will fall to 0.4% of GDP, while the overall result of the public sector will be around -2.5%. For 2010, taking into account the impact of increased activity on tax revenues and an average oil price at low levels, we estimate that the primary result will recover slightly to 0.6% of GDP, while the overall result will reach -2.3% of GDP.

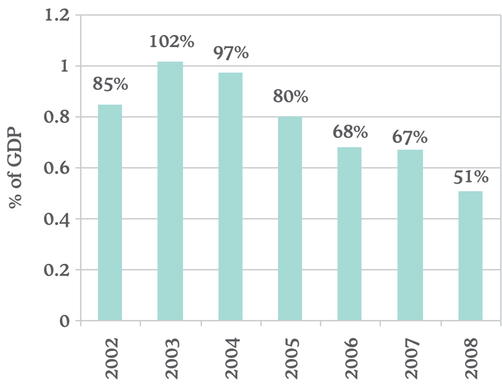
Table 2.

Overall Consolidated Result (as % GDP)	2007	2008	2009f	2010f
Primary result	3.4%	1.4%	0.4%	0.6%
Overall result	0.0%	-1.3%	-2.5%	-2.3%

Source: BBVA, using Economy Ministry and Central Bank data and own estimates

Graph 9.

Gross Public Sector Debt / GDP



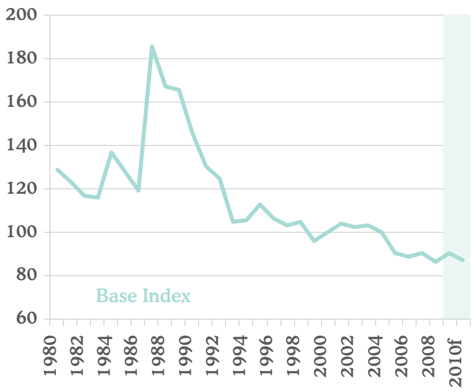
Source: BBVA, using Central Bank of Uruguay data

Table 3.
Central government financing

Millions of dollars	2009	2010
USES	1,284	1,567
Interest payments	860	901
Amortizations	357	615
Loans	222	225
Bonds	135	390
Other	76	51
SOURCES	1,284	1,567
Primary budget surplus	280	300
Multilateral payments	960	700
Issues on the local market	120	250
Other	40	0
Use of Reserves (*)	-116	317

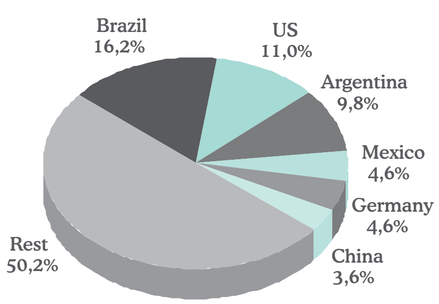
(*) A positive value indicates a change in International Reserves
Source: Economy Ministry

Graph 10.
Terms of Trade



Source: Cepal and own estimates

Graph 11.
Main destinations of exports



Source: BBVA, using Uruguay XXI data

Uruguay will not have financing problems in the short term

After the "friendly" restructuring of its debt, Uruguay not only managed to reduce it in terms of GDP, as can be seen in Chart 9, but also extended its terms and eased short-term pressure (Table 3).

Nevertheless, in the first quarter of 2009, the overall public sector debt stood at USD 17,238 million, or some USD 695 million above that in December 2008, due to the precautionary increase in the lines for multilateral credit bodies. Of the total debt, 77% is in the hands of central government, 18% is the Central Bank of Uruguay, 5% is owed by state-owned companies and the rest by local government.

Against an international background of uncertainty, it is highly likely that foreign finance will be limited. Even so, the level of liquid assets in the overall public sector (net of interbank deposits) would be enough to cover government financing, both in terms of deficits and capital amortization, from now to the end of next year, in a situation in which sources of external finance have been completely closed.

The Terms of Trade improve for Uruguay

The rally in commodity prices in 2008 did not favor Uruguay, as it did other countries in the region, despite the fact that its economy is also an exporter of agricultural products. This is because it is a major oil consumer. The Terms of Trade fell by 4.4% in 2009 (CEPAL figures), as import prices rose 13%, boosted mainly by oil, while export prices only increased by 8%.

Conversely, in 2009 there was a slight improvement, boosted mainly by the fall in the price of oil. However, this year the recovery in the oil price (Chart 10) will once more deteriorate the Terms of Trade.

Commodity prices represent nearly 60% of Uruguayan exports, the most important of which include meat (24%), agricultural products (rice) and flour-milling (20%), dairy products (7%) and wood, pulp and paper (6.9%).

Agricultural prices will fall around 15% on average in 2009, according to our forecasts. Meat and the dairy products with least weight in Uruguayan exports will register lower falls in magnitude (FAPRI figures), so in general in 2009 there will be a fall in the price of exports of just over 10% year-on-year and 3% year-on-year in 2010.

In the case of import prices, those causing most effect are intermediate goods, where oil has a weight of nearly 20%, and the remaining intermediate goods 36.6%. Although the oil price will remain at its current value to the end of the year, there will be a significant fall on average (-41% year-on-year) in 2009, according to forecasts by the BBVA Group ERD, and a recovery in 2010 to 13%.

Despite diversification, the trade balance is in deficit

In recent years, Uruguay's foreign trade has been extremely buoyant. Argentina's trade dependence meant that after the 2002 crisis, Uruguay turned more to Brazil and other extra-regional countries, thus diversifying its trade.

As can be seen from Chart 11, 50% of exports from the country were concentrated in only 6 countries, with the most important being Brazil (16.2%), and with the United States in second place (11%). Ten years before, Brazil and Argentina alone accounted for half of Uruguay's exports.

The countries that are the source of Uruguay's imports (Chart 12) are more concentrated: nearly 80% of imports come from only 6 countries, while Brazil and Argentina alone account for 45% of the total.

After the 2002 crisis, in which the sharp adjustment in imports led to a practically neutral balance, the improved level of activity boosted an increase in domestic demand. Since Uruguay has an imports/GDP elasticity of more than 2 in expansionary phases, purchases from abroad rose significantly.

This situation was exacerbated by the effects of the energy crisis, which led to a greater import of oil, just when prices were highest, because of the drought making hydroelectric production impossible. the result was a record deficit of USD 2,974 million.

Improved trade balance in 2009

With the crisis intensifying at the end of 2008, both exports and imports began to slow. The fall in exports was boosted by the drop in supply of products derived from the agricultural sector as a result of the drought. Imports were cut by the significant increase in the price of oil.

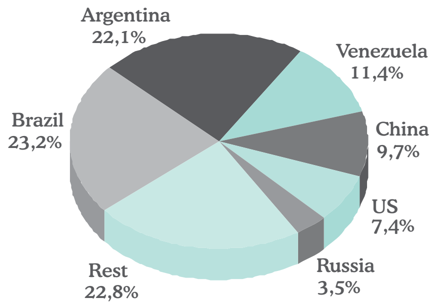
The reduction in exports slowed in the second quarter of 2009 (Chart 13). Measured in year-on-year terms, the accumulated figure for January to April fell by 17%. The preliminary figure from the Uruguay XXI institute for May show a slight year-on-year increase.

In contrast, the fall in imports has speeded up (Chart 14). After falling by 25% year-on-year in the first four months of the year (according to provisional figures for May), imports fell by 45% year-on-year. However, these figures do not necessarily reflect a sharper decline in activity, as they are affected by the fall in the price of oil. Oil imports in the first few months of the year remained at similar levels in terms of amounts to those of the same period last year (Chart 15). What explains the significant drop in nominal imports is the sharp fall in prices from the peak of the second quarter of 2008. Imports not including oil fell, but to a lesser extent, both in terms of prices and in amounts.

With the expected improvement in the global situation towards the second half of the year and in activity in Brazil, a recovery in exports can be expected, although for 2009 as a whole they will be below the figures for 2008 (-13% year-on-year), basically because of the fall in prices. The significant fall in import prices, together with the fall in the amounts imported, which fell more than would be suggested by the import/GDP elasticity of recessive periods, will result in an improvement to the trade balance, although it will continue to be in deficit, at nearly USD 1,764 million.

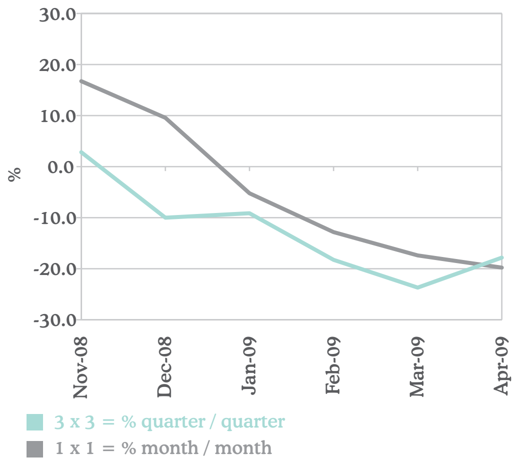
Next year we expect exports to recover some of the lost ground, to the extent that the main destinations of Uruguayan exports begin to

Graph 12.
Sources of imports



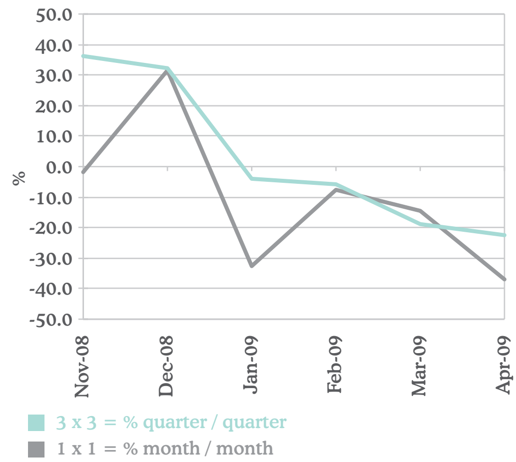
Source: BBVA, using Uruguay XXI data

Graph 13.
Exports (Change %)



Source: BBVA, using CBU data

Graph 14.
Imports (Change %)



Source: BBVA, using CBU data

Graph 15.
Oil imports
Base 100 Index =1Q 06

Source: BBVA using CBU and Bloomberg

Table 4.

Balance of payments (% GDP)	2007	2008	IQ-09
Current Account	-0.90%	-3.80%	1.10%
Trade Balance	0.70%	-2.30%	1.60%
Current revenues and Transfers	-1.60%	-1.50%	-0.40%
Capital and Financial Account	6.00%	10.10%	1.10%
Errors and omissions	-2.60%	0.50%	-0.40%
Balance of payments	2.60%	6.90%	1.90%

Source: BBVA using Central Bank of Uruguay data

Graph 16.
Current account balance (% GDP)

Source: BBVA, using Central Bank of Uruguay and Cepal data and own estimates

recover, and approach their historical trend. Export prices will fall again, although less than in 2009. With a renewed growth of imports, in 2010 the trade balance will show a slight increase to USD 1,802 million.

Improved current-account deficit

Given the Uruguayan financial market's position as a haven, with the deepening international crisis there has been a increased inflow of capital through the financial account. This has not only financed the current account deficit but also the increase in the Central Bank of Uruguay's reserve assets. This is because a greater risk aversion in Argentina led to an increase of transfers to Uruguay (mainly via deposits), due to its reputation for property rights.

The current account ended 2008 with a deficit of 3.8% of GDP, nearly three points more than the previous year (-0.9% GDP in 2007). The worsening current account deficit was mainly the result of the fall in the trade balance, and to a lesser extent the increase of income from investment (Table 4).

Tourism generated net foreign currency income of USD 685 million in 2008, 20% more than in 2007. Of the increase of tourists visiting Uruguay, 64% is the result of more tourists from Argentina and Brazil.

Conversely, the current account was in surplus in the first quarter of 2009, nearly tripling the figure achieved in the same period the previous year. Although it is true that the first quarters of the year are seasonally positive for tourism, which had a significant impact this year, the improvement was boosted by a major adjustment in imports (-19.7% year-on-year), and with a fall of exports of only 7.5% in year-on-year terms.

In the first quarter, there was an increase in the financial account of the public sector in long-term debt with multilateral bodies by the central government through the placement of precautionary debt. The movement was in the opposite direction in the private sector: private banks increased their placements abroad, although they continued to increase deposits of capital related to FDI.

The entry of financial capital will probably be reestablished over coming months, so despite its trade deficits, Uruguay could continue to accumulate reserve assets as it has done until now.

For 2009 we expect a substantial improvement in the current account balance, mainly due to the adjustment in the trade balance and to a lesser extent to tourism (Chart 16). This is why our forecasts give a current account deficit of only 0.2% of GDP for this year, while for next year it is expected to reach -0.7%.

2. Monetary and Exchange Policy

Inflation slows and the Central Bank relaxes its reference rate

The objectives of the Central Bank of Uruguay (BCU) are price stability and the regulation and supervision of the system of payments and the financial system. Until March 2007 monetary policy was implemented through quantitative targets, but from October 2007, the Central Bank began to use the short-term reference rate (MPR) as an instrument, together with other fine-tuned instruments that enable the market rate to be aligned with the intervention rate.

In recent years the accumulated 12-monthly rate of inflation has remained constantly above the upper level of the target band established by the monetary authority (Chart 17). Because of this, and despite the slowdown in the Uruguayan economy towards the end of 2008, the Central Bank raised the monetary policy rate (MPR) to 10% in January last, taking into account the increased inflationary expectations and the risks that the CPI could exceed the 10% threshold. An inflation of more than 10% would trigger four-monthly wage adjustments in the public sector under Law 16.903. Under Article 67 of the Constitution pensions would also have to adjust to the changes in the average wage index (IMS). These increases could impact prices again as a secondary effect, given the importance of the sectors affected.

However, in recent months inflation has begun to converge towards the middle of the band (3% to 7%), which has enabled the Central Bank to reduce its intervention rate by 100 bps in meetings of the Monetary Policy Committee (COPOM) in March and June. In the June meeting the Central Bank reduced the MPR to 8%, given the new situation resulting from the fall in activity. It suggested that this fall in the rate would not imply changing the restrictive nature of monetary policy, as the real rates remain positive. The Central Bank justified this wariness by the fact that most of the reduction in inflation in the first half of the year is due to the fall in seasonal and administered prices rather than a fall in core inflation.

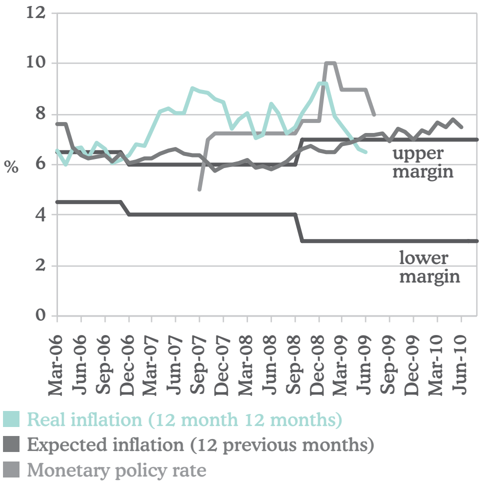
Despite the bias made clear by COPOM, the medium-term expectations are still above the upper level of the target band, indicating that they are still not fully anchored. We expect that for the rest of the year, the Central Bank will maintain is slightly restrictive bias in monetary policy, and make minor cuts to the intervention rate as inflationary pressures reduce. Stability in the exchange rate will allow the Central Bank to gradually relax its monetary conditions.

The real interest rate is in line with long-term equilibrium

After the overshooting of 2002, the Uruguayan peso appreciated steadily, and this was sharpened towards mid-2007. In the last 2008 it once more depreciated significantly due to the exit of capital caused by the worsening international crisis.

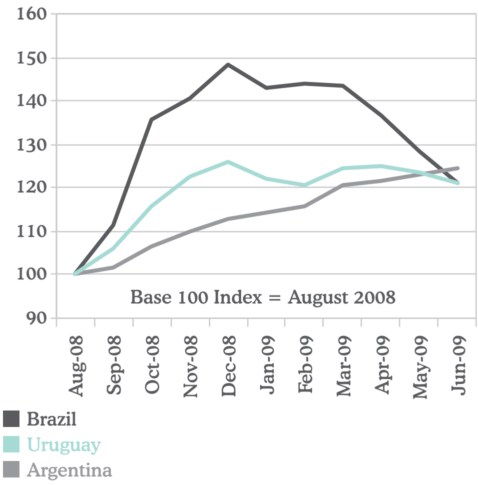
Comparing the exchange rates of June 2009 with those of August 2008, both the Brazilian real and the Uruguayan peso lost 21% with respect to the U.S. dollar (Chart 18). However, in the case of Uruguay, the depreciation and later recovery was more moderate than in Brazil.

Graph 17.
Inflation and Monetary Policy



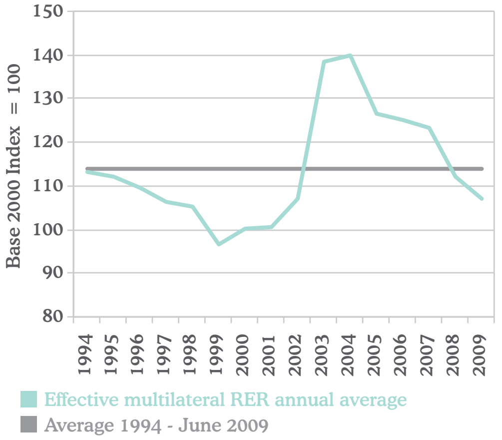
Source: BBVA, using Central bank of Uruguay and INE data

Graph 18.
Relative exchange rate parity



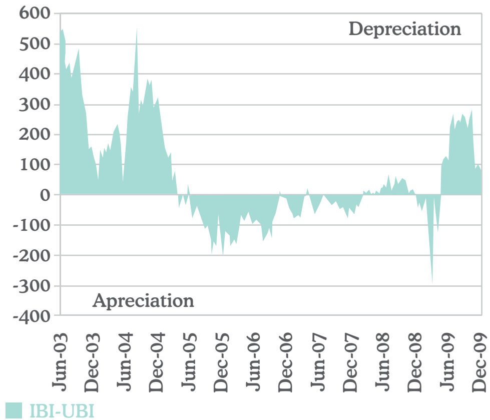
Source: BBVA, using Bloomberg data

Graph 19.
Effective Multilateral Real Exchange Rate



Source: BBVA using Central Bank of Uruguay data

Graph 20.
TCR Expectations



Source: BBVA, using República AFAP data

The Argentinean currency depreciated by 24% in the same period, increasing its rate of devaluation in recent months for domestic reasons.

This crisis did not have a significant effect on the competitiveness of the Uruguayan peso against its main MERCOSUR trading partners.

From a medium-term perspective, the real multilateral exchange rate (Chart 19) remained relatively weak between 2003 and 2007. Currently it is slightly above the average for the last fifteen years. This is not as big a depreciation as that registered before the 2002 crisis. Other indicators calculated by the IMF, such as the equilibrium real exchange rate and the sustainability of the current account, suggest that there are no important divergences in exchange-rate parity with respect to long-term equilibrium.

The markets expect a real depreciation of the Uruguayan peso, looking at the yield of indexed and dollar Uruguayan bonds relative to U.S. bonds. This expectation is included in the indicator measuring the spread between the Indexed Bond Index (IBI) and the Uruguayan Bond Index (UBI)[1]. If the IBI is greater than the UBI expectations are for a depreciation in the real exchange rate (Chart 20).

The exchange rate will remain stable, with a slight depreciation to the end of the year

Without greater pressure on the trade competitiveness side, the exchange rate will be mainly affected by the financial situation. In a slow recovery of the global economy, it is likely that the recent rally of emerging currencies will not be sustained over time. Risk aversion could once more increase and lead to a strengthening of the U.S. dollar against the currencies of developing countries. In this situation, we estimate that the nominal exchange rate will close 2009 at UYU 24.35 to the U.S. dollar, or a devaluation rate of 3.8% in the second half of the year.

This exchange rate is consistent with a scenario in which the Brazilian real gains to BRL 1.88 / USD at the end of the year, and the real bilateral exchange rate between both countries remains constant. In qualitative terms, no special events affecting Uruguay are assumed, whether political or economic in nature, to add volatility to the value of the currency.

Our estimates do not differ significantly from the implicit parity calculated according to the different rates paid by securities denominated in Uruguayan currency and those denominated in a foreign currency.

Based on the index of yield rates of Treasury bills denominated in the national currency (ITLUP) and the Uruguay curve in 180-day dollars, both calculated by the Electronic Securities Exchange, the exchange rate at the end of the year will be UYU 24.4 per USD.

[1] Both indices, IBI and UBI, are constructed by República AFAP. The UBI is a country risk indicator that captures the spread between the average yield of Uruguayan sovereign bonds and that of U.S. Treasury bonds. The IBI reflects the spread in the yield between securities issued in inflation-indexed units (UI) and TIPS (Treasury Inflation Protected Securities) issued by the U.S. government.

3. The Financial System

A highly dollar-based system with a major foreign presence

Although there are institutions in Uruguay that operate as offshore entities, the source of information for this report are the statistics of the Central Bank of Uruguay, which only includes entities operating under its regulatory powers (onshore) and that are authorized to grant loans in Uruguay. The financial system includes 13 banking institutions, of which 2 are state-owned (Banco de la República Oriental de Uruguay has 39% of the assets of the banking system). There is only one private banking institution owned by residents.

The main activity in the system is traditional financial intermediation, with little exposure to public risk (6% of credit), and with abundant liquidity mitigating any potential risk of deposit flight.

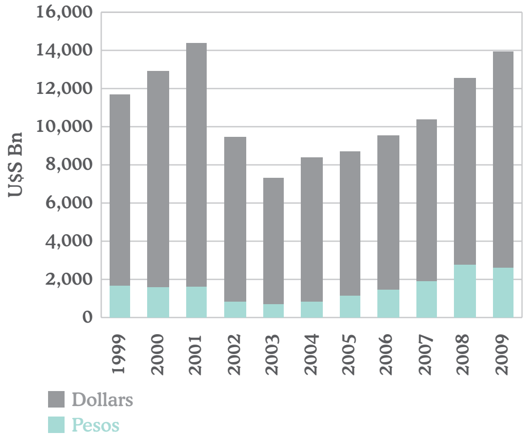
Deposits in the private sector (75% of liabilities) are key to the financing structure of the system (Chart 21). Of the total of these deposits, 83% are denominated in foreign currency (Chart 23), of which 23% belong to non-residents. After the 2002 crisis, the participation of non-residents fell sharply, from a maximum of 43% to 23% in 2009. The crisis in Argentina was the main influence in this trend, as it transferred the lack of trust to the Uruguayan system via entities operating in both markets.

The main structural weakness is the dollar denomination of its portfolios and the corresponding currency mismatch. Although in the wake of the 2002 crisis the government introduced the use of indexed instruments to create incentives to de-dollarize the system, progress is slow and 53% of the loans are still denominated in dollars. This phenomenon generates a structural type of risk if there is a pronounced devaluation if a large number of these lenders receive their incomes in the national currency.

Although most of those asking for loans are households that want to finance consumption, with 35% of the total, the lending to this sector has a low level of dollarization (5%), while in manufacturing industry (20% of lending) the rate of dollarization is 96%. This feature significantly mitigates the currency mismatch in the active portfolio of the financial system, given that part of the manufacturing industry is focused on export, and in addition they are short-term bonds of typically 90 days, thus reducing the exchange rate risk (Chart 22).

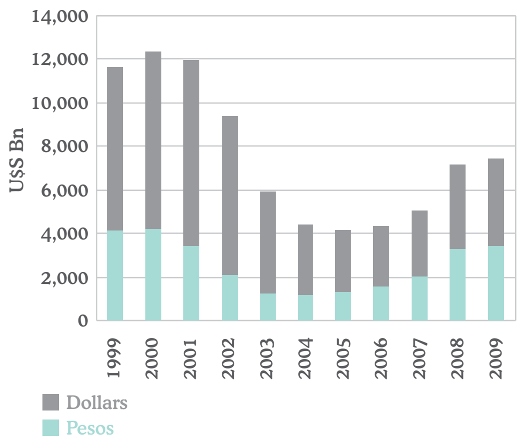
The mortgage loan market collapsed in the 2002 crisis. From then on the vast majority of lending is through Indexed Units, with private banking having a significant participation in the business. This line of assets has a special feature in terms of the real exchange rate (RER). Given that most of the deposits financing the operations are denominated in USD, the liabilities are adjusted by the nominal exchange rate (NER), while since the assets are composed of indexed units they are corrected for inflation. In this way, starting with a situation of equilibrium, an appreciation in the RER will increase the need for financing for each indexed unit lent, generating a mismatch and increasing the risk of exposure to the RER. This means that there a strong incentive for banks to develop this business is if the difference between the inflation rate and the devaluation rate is positive.

Graph 21.
Average deposits, non-financial sector



Source: BBVA, using Central Bank of Uruguay data

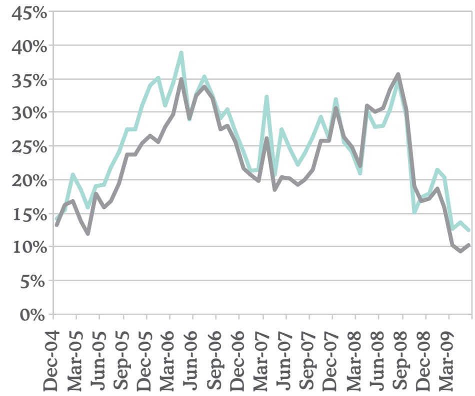
Graph 22.
Average loans to non-financial private sector



Source: BBVA, using Central Bank of Uruguay data

Graph 23.

Monetary aggregates, year/year change (%)



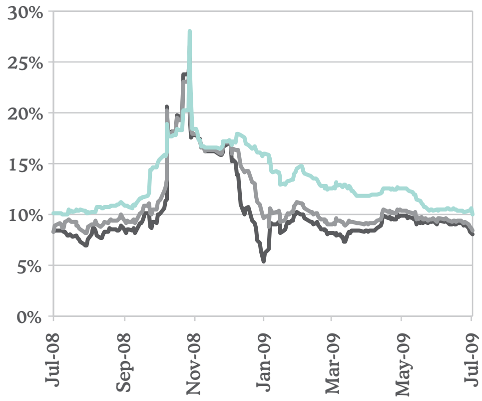
M 1 + CA

M 2 + Savings & Loans

Source: BBVA using Central Bank of Uruguay data

Graph 24.

Interest rates for Monetary Regulation Bills in UYU



30 d

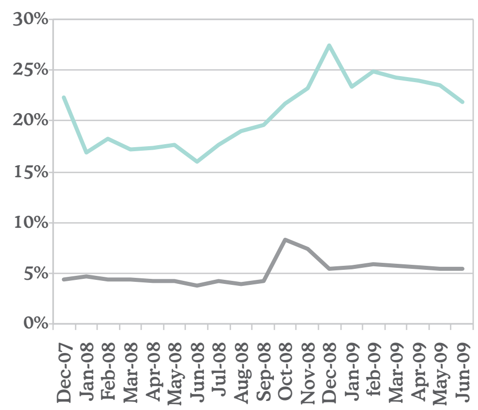
60 d

180 d

Source: BBVA, using BEVSA data

Graph 25.

Transaction rates in pesos



Lending

Borrowing

Source: BBVA using Central Bank of Uruguay data

In order to reduce the mismatch generated by mortgage portfolios in the balance sheets of entities because of its long duration, the National Housing Agency is currently trying to implement a "mortgage-backed securities" project that will form part of the menu of investments of the Pension Savings Fund Managers, following regulation by the Central Bank of Uruguay. These instruments will have the special feature of a double guarantee, one from the issuing bank and the other as the mortgage on the property.

Entry of capital presents a dilemma for the Central Bank of Uruguay

The Uruguayan economy is a small, streamlined open economy with a significant flow of foreign capital compared with its GDP. In addition, the capital movements are affected by the effect of non-resident investors, mainly Argentineans, who value the Uruguayan financial system as a haven in the crisis, generating entry of significant capital that makes management to maintain the desired levels of exchange rates and prices.

The prolonged growth in GDP enjoyed by Uruguay after the 2002 crisis was accompanied by a process of monetization of the economy. In recent years, the Central Bank has been a net buyer of reserves to moderate the appreciation of the exchange rate. This monetary expansion caused by foreign factors was partially sterilized by the monetary authority through the placement of Monetary Regulation Bills.

The process was then reversed after the bankruptcy of Lehman Brothers last September and the major flight of capital led the Central Bank of Uruguay to intervene actively in the market by selling reserves to prevent a major depreciation of the exchange rate. As a result, the rate of growth of monetary aggregates has shown a major slowdown since 2008 (Chart 23).

Interest rate adjustments lag behind

The severe restrictions to liquidity imposed by the Central Bank of Uruguay's intervention strategy in the currency markets to reduce the volatility of the exchange rate resulted in a significant increase in interbank rates in the last quarter of 2008. The Central Bank acted by providing liquidity through short-term or fine-tuned instruments, but even so the spread between the Average Market Rate (AMR) and the RER widened to more than 20 pp. The rate of the Central Bank's Monetary Regulation Bills reached highs during this period (Chart 24). In February this year, the rates began to move down, and in July reached pre-crisis levels. This showed a positive time structure without major spreads for the longer maturities.

Despite the fall in the risk premium and the relaxation of the Central Bank's intervention rate, the active rates in pesos have only shown a minimal fall. From February there was a fall in the corporate lending segment of barely 105 basis points. In the case of private banking, individuals have still not reversed the upward trend beginning in mid-2008, showing both the lack of sensitivity of the RER and the low degree of competition in the market. As the passive rates behaved more in line with monetary policy expectations, particularly falling in

[2] The AMR includes rates of the following short-term transactions: Interbank call, draft call, day deposit certificates issued by the Central Bank of Uruguay, repos.

the more short-term deposits, there has been a notable increase in the intermediation margin (Chart 25). This is due in part to the high level of participation of credit cards in consumer lending and negative passive rates in real terms.

Conversely, the rates for lending transactions in USD fell in line with the downward trend in country risk towards pre-crisis levels, while deposits in USD were also remunerated by increasingly lower rates of close to zero in line with the international scenario (Chart 26). As a result, the net interest income in USD, in relation to U.S. inflation, also registered high values.

The downward adjustment in interest rates can be expected to continue for the rest of the year as the risk premium is established and the expectations of devaluation are reduced.

Increased preference for liquidity and foreign currency

Total deposits as a percentage of GDP have registered a falling trend since the high of 71% reached in 2003 in the wake of the fall in GDP and the devaluation. At the end of 2008 total average deposits measured in dollars were 43% of GDP, below the figure of 47% in 2007.

In the first five months of the year new deposits increased by 7.9%, with a real positive increase compared with accumulated annual inflation of 2.8%.

The structure of deposits presents a strong concentration of new demand deposits. This trend strengthened after the crisis, and reached 77% for the first five months of this year.

The dollarization of deposits was falling slightly in recent years, but began to increase again and reached a level of 83% in the private sector.

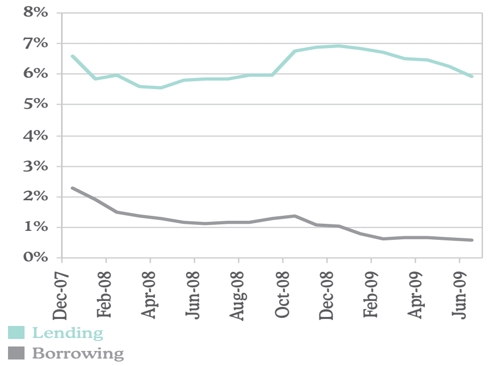
Lending reflects the fall in activity

The demand for credit by companies, mainly denominated in dollars, fell significantly as a result of the increase in the exchange rate in the months before the crisis and to the deterioration of the economy. Lending to the private sector registered a notable slowdown since mid-2008, which became particularly steep in the last quarter of the year. Between December 2008 and June 2009 it fell -5.3% (a fall of 9.2% in domestic-currency lending and 2.1% in foreign-currency lending). The exposure to non-residents has fallen significantly since the worsening of the international crisis (Chart 27).

The trend would appear to have reached bottom in April, with slightly positive increases which could be the start of a slight recovery (Chart 28), but it is unlikely that it will return to the high levels of mid-2008 in a sluggish international situation. The public sector contributed significantly to this growth through the syndicated loan by a group of private banks to UTE for the interconnection of energy with Brazil.

Household lending continues sluggish and mortgage loans are contracting, as decisions on real estate purchases are postponed due to the uncertainty of future income, although they still represent a burden for families (Chart 29).

Graph 26.
Transaction rates in USD

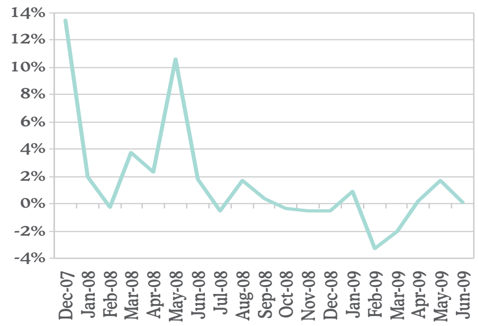


Source: BBVA using Uruguay Central Bank data

Graph 27.
Loans to private sector, yoy % change

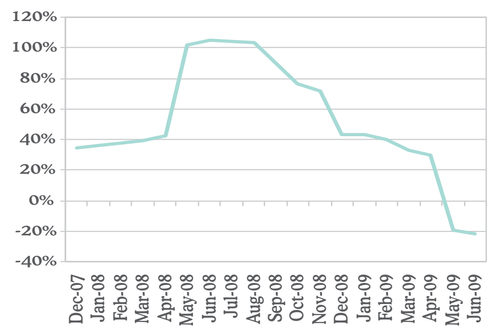
Source: BBVA using Central Bank of Uruguay data

Graph 28.
Loans to resident private sector
monthly change (%)



Source: BBVA using Central Bank of Uruguay data

Graph 29.
Loans to the household sector
Year-on-year % change



Source: BBVA using Central Bank of Uruguay data

As a result, the Uruguayan financial system has significantly increased its liquidity, which was already high before the crisis. The 30-day liquidity ratio increased from 63.7% in June 2008 to 71.9% in March 2009.

Without alternative sources of domestic finance

Outside the financial system, the private sector has few agents that can supply resources. The funds of the private pension system are mainly invested in public assets and the local capital market is not well developed.

Since 1995 Uruguay has a mixed pension system, made up of a intergenerational solidarity branch and another of individual savings administered by the Social Insurance Bank (BPS) and the Pension Savings Fund Administrators (AFAP), respectively.

The administered fund amounted to UYU 89,418.28 million pesos in June, or 12% of GDP, an increase of 15.8% year-on-year. Broken down by currencies, the assets denominated in pesos amounted to 73.1% (with equal percentages in Uruguayan pesos and index bonds), and 26.9% in foreign currency. Broken down by instrument, most of the pension fund is invested in Treasury bills (58.6%) and Monetary Regulation Bills issued by the Central Bank of Uruguay (20.4%).

The assets of the savings fund have not been immune to the 2008 crisis. Evidence of this is the negative yield of the system for a rolling year, but the trend is towards positive ground due to the increase in bond prices and the appreciation of the local currency.

This investment structure gives rise to two challenges: first, to design restraining mechanisms to prevent the propagation of public risk to the pension system; and second, to increase the volume of resources destined for the productive sector.

The capital market, as a financing agent, is small in size. It operates via two entities: the Montevideo Securities Market and the Uruguay Electronic Securities Market. In their vast majority the transactions use securities in the public sector or Central Bank of Uruguay instruments such as bills, notes or deposit certificates. The volume of stock market capitalization is around 1% of GDP. This shows the lack of importance for companies to finance themselves through the issue of shares or debt instruments.

Little impact on the solvency of the financial system

Defaults at all-time low levels. In March 2009 the rate of bad debts stood at 1.1%. The fact that in June 2008 the figure was also 1.1% makes clear that the quality of the portfolio and the prudence of the entities that were able to weather the crisis without increasing bad debt levels.

Looking at the solvency indicator we can see a slight worsening, with a fall from 17.8% in December 2007 to 15.4% in December 2008. Despite this, the system is sound, with capital levels that double those required by regulations. In addition, it is worth pointing out that like in Spain, the system has statistical forecasts that act as an automatic stabilizer and give it an countercyclical character.

Box: External Vulnerability Index

The degree of openness of the Uruguayan economy, both commercial and financial, generates a high level of sensitivity to the external sector behavior in the remaining economic variables.

The External Vulnerability Index[3] (EVI) gives us a tool to detect the degree of stress to which relations with the rest of the world are subject and to evaluate the potential vulnerability of the Uruguayan economy. The symmetry with the Uruguay Bond Index (UBI), which measures the spread of a basket of Uruguayan bonds with a risk-free bond, allows us to validate the EVI results.

The index gives values within a range of -10 to 10, with the negative values being those that demonstrate the lowest foreign vulnerability and the positive value of 10 meaning that the economy does not meet its obligations with the rest of the world.

Vulnerability to an external shock has fallen substantially in the last 6 years. From maximum values of 6 reached in 2003, the economy has improved to negative values of -2 in 2008 (Chart 1).

The variable determinant in the changing trend of the index after 2005, when it changed from neutral to favorable figure, was the performance of foreign debt, as a percentage of GDP, in the last 8 quarters. This line of the indicator was markedly positive in the two years of crisis 2002-2003. It became neutral in 2004, and moved to a positive contribution from 2005 as a clear effect of the new debt profile after the «friendly» exchange. The short-term debt coverage with reserves was sufficient in this period.

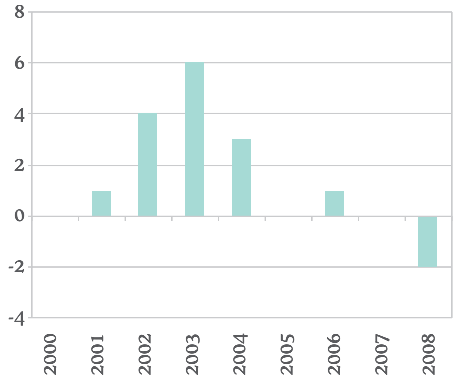
The divergence of the real exchange rate with respect to the average during the period shows the difficulty that may confront the economy if there are major devaluations, as it takes away the capacity for payment when the national currency devalues. Since 2008 this variable has played a positive role as a result of the appreciation of the peso.

Both the current account as a percentage of GDP and the growth in exports above the average had a slightly negative impact on the index because of the structural deficit of the trade balance.

Uruguay's main trading partners in the region, Argentina and Brazil, have also substantially reduced their vulnerability to external risk since the 2002 crisis, boosted by the international cycle and the increase in commodity prices. The post-crisis cycle of economic improvement in Uruguay was more gradual than in the case of Argentina, as the restructuring of Uruguayan debt did not include a capital reduction (Chart 3).

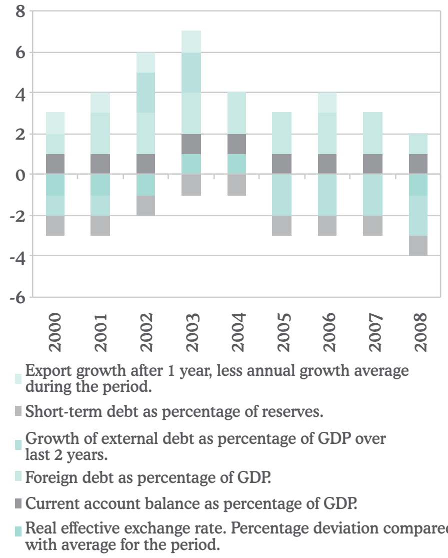
Based on the EVI, we can conclude that the foreign sector does not represent a problem for the Uruguayan economy in the medium term, as it has been able to capitalize the lessons of the 2002 crisis, limiting debt issues and preventing a major appreciation of the peso.

Graph 1.
External Vulnerability Index



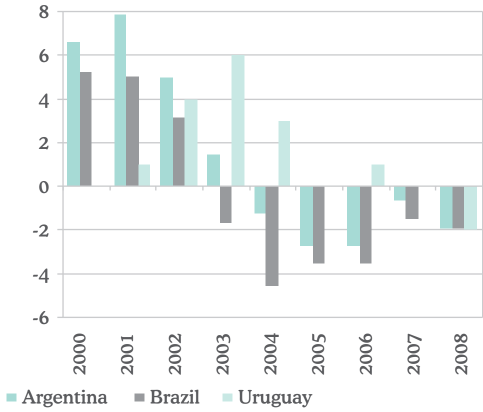
Source: BBVA, with Central Bank of Uruguay and INE data and own estimates

Graph 2.
Contribution to the External Vulnerability Index (EVI)



Source: BBVA, using Central Bank of Uruguay and INE data and own calculations

Graph 3.
External Vulnerability Index (EVI)



Source: BBVA, with Central Bank of Uruguay and INE data

[3] The index is constructed using the following variables: the deviation of the real exchange rate form the average in the period under observation; the current account expressed as a percentage of GDP; external debt as a percentage of GDP; growth of foreign debt as a percentage of GDP in the last two years; short-term debt as a percentage of reserves and the difference in annual growth of exports and the average for the period.
These variables are assigned a value according to their behavior in previous crises in developing countries. This valuation is then weighted equally, except if the variable measuring the growth of short-term foreign debt takes extreme values, in which case its weight in calculating the index is doubled.

URUGUAY: BASIC ECONOMIC INDICATORS	2007	2008	2009(f)	2010(f)
Activity				
Nominal GDP (UYU millions)	569,261.1	674,277.9	739,964	812,048
Nominal GDP (USD millions)	24,338.0	32,439.8	31,056	32,514
Real GDP (% change)	7.6	8.9	-0.8	1.4
Unemployment (annual average %)	9.2	7.6	8.6	7.8
Prices				
CPI (yoy %, end of year)	8.5	9.2	6.8	7.0
PPI for national products (% change, end of year)	256.3	272.8	6.7	5.2
Public and Private sector wages (% change, end of year)	12.9	13.9	15.0	7.8
Foreign sector				
Exports (USD million)	4,514	5,959	5,178	5,327
Imports (USD millions)	5,589	8,933	6,943	7,129
Trade balance (USD million)	-1,074	-2,974	-1,764	-1,802
Current Account Balance (USD million)	-80.5	-1,119.0	-70	-209
Nominal exchange rate (UYU/USD, end of period)	21.61	24.11	23.30	26.65
Exchange rate (UYU/USD average)	23.39	20.79	23.83	24.98
Effective real overall exchange rate (Base index 2000=100) 1/	119.29	110.47	112.66	-
Effective real regional exchange rate (Base index 2000=100) 1/	108.39	94.15	101.80	-
Private external debt (USD million, end of period) 2/	1,119.8	1,273.0	1,216.1	-
Financial sector				
Private sector deposits (USD million, end of year) 3/	10,613.7	12,795.5	14,020.0	-
Private sector deposits Annual % change	12.7	20.6	-	-
Private sector loans (USD million, end of year) 3/	5,612.6	7,022.2	6,650.3	-
Private sector loans Annual % change	31.2	25.1	-	-
Policy interest rate 4/	7.25	7.75	7.00	7.50
Central Bank reserve assets (USD million) 5/	1,700	1,900	2,000	2,200
Public Sector				
Primary reserves (UYU million)	19,375	9,693	3,063	4,940
Primary fiscal balance (UYU million)	58	-8,925	-18,459	-18,409
Total public debt (USD million, end of period) 6/	16,319	16,543	17,238	-
Foreign-currency public debt (USD million) 6/	11,323	11,542	12,171	-
Foreign public debt (USD million) 6/	11,065	10,736	10,993	-

RISK INDICATORS (%)	2007	2008(f)	2009(f)	2010(f)
Current account /GDP	-0.3	-3.4	-0.2	-0.6
Trade balance / GDP	-4.4	-9.2	-5.7	-5.5
Exports / GDP	18.5	18.4	16.7	16.4
Imports / GDP	23.0	27.5	22.4	21.9
Primary fiscal result / GDP	3.4	1.4	0.4	0.6
Overall fiscal result / GDP	0.0	-1.3	-2.5	-2.3
Public debt / GDP	67.1	51.0	55.5	-
Foreign public debt / PBI	45.5	33.1	35.4	-

Notes:

1/ Effective exchange rate published by the Central Bank of Uruguay. The year 2009 corresponds to June.
2/ Gross private sector foreign debt. The year 2009 corresponds to the first quarter.
3/ Private sector deposits and loans. The year 2009 corresponds to June.
4/ Central Bank of Uruguay monetary policy rate
5/ Net reserve assets, without adjustment for public and financial sectors.
6/ The debt for 2009 corresponds to the first quarter.

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Closing date: July 2009

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