BBVA Research

Uruguay

Economic Outlook

Second Quarter of 2010

Economic Analysis

- Dynamic domestic demand will be the main driving force of the economy in 2010, for which we forecast growth of 5.8%.
- Inflationary pressures will tend to moderate over the rest of the year, but expectations are slightly above the new Central Bank target for 2011.
- The fiscal balance will improve over the next three years in response to the program of spending restrictions proposed by the government, with fiscal policy moving towards more neutral ground.
- Monetary policy faces the dilemma of maintaining a commitment with the inflation target while avoiding upward pressure on the exchange rate.

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Closing date: June 2nd 2010

1. Challenges for global recovery

In recent quarters, the cyclical situation has improved considerably due to the upturn in emerging economies and in the U.S. World trade is growing at a rate of 7% and our forecasts suggest there will be 4.2% growth in the world economy in 2010. However, over the past few months doubts remain regarding the EMU's capacity to tackle the problem of high debt levels in some countries. These doubts have led to an increase in sovereign spreads and a new period of financial instability. The severe fiscal adjustments in European countries will have an impact on the region's growth in 2010 and could have repercussions in the rest of the world, especially if there is contagion in financial systems. The timing and the scope of these adverse impacts will crucially depend on the effectiveness of the announcements that the European Council made on 9 May regarding the agreed rescue packages and the ECB's exceptional measures. In spite of these measures, uncertainties still lurk on three fronts: i) the rescue package implementation process over the coming months; ii) the credibility of the additional fiscal consolidation in some EMU countries; and iii) the commitment of core EMU countries to the rescue packages in the medium term.

While economic recovery has been widespread at the start of 2010, its intensity varies widely between countries. This is due to the varying degrees of use of fiscal and monetary policies. These policies have been particularly effective in driving the economic cycle in China and the U.S. At the same time, emerging economies are benefiting from a stronger domestic demand and the recovery in this region seems to be much more consolidated. However, in developed economies, as the expansionary policies ease, there are doubts regarding the sustainability of the recovery beyond 2010.

The Fed is expected to push interest rates up gradually. The first rises are predicted for the start of 2011, with rates slightly above 1% by the end of that year. The differences in the economic fundamentals in the U.S. and the EMU will lead to different monetary policy exit strategies in the two regions. Although economic growth could be slow from 2010 onwards, the risk of a reversal of the current trend is limited in the U.S. and inflationary pressure is still at a very early stage. In contrast, in the EMU, as well as a much more fragile financial situation, the cyclical improvement seems to be uncertain and there are no indications of inflationary pressure. As regards monetary policies in emerging economies, there is no doubt that they need to be toughened. Given the cyclical discrepancies in this region, the exit strategies will vary from country to country. If monetary policy is not made stricter and other measures are not implemented in time, imbalances could be generated in the medium term.

At times of greater risk aversion, financial markets tend to be more forward-looking. Financial markets are efficient when it comes to detecting inconsistencies in macroeconomic policies that usually go unnoticed in times of economic boom. In spite of the substantial rescue package agreed in Europe, significant risk premiums will persist on the sovereign debt market in some European countries in the midst of uncertainties regarding fiscal consolidation processes. The growing contagion has been clear proof of the fragility of the current situation. Economic history is full of examples of "unfounded contagions" from country to country in times of crisis. In these cases, geographical proximity or cyclical similarities are more important than differences in terms of fundamentals. In fact, the current contagion situation is not completely justified by either the financial channel spurred by the breakout of the crisis in Greece or by any similarity in terms of fundamentals. Even though this may be cause for debate, there is a compelling need for some countries to increase their credibility in order to resist pressure from international investors.

There is growing concern over the long-term consequences of increases in public debt. This will inevitably lead to upward pressure on real interest rates and high risk premiums for a long time. Even if the recent contagion gradually fades, there will be growing discrimination between countries depending on the credibility of their fiscal situation.

There are two main types of uncertainty arising from the financial sector. First, the slow restructuring of the financial industry, especially in Europe, could result in a creditless recovery. This is an increasing concern, because past experience and empirical evidence show the importance of the credit channel in the early stages of economic recovery. There is also uncertainty over the regulatory reform that is already underway. The most likely result is a significant increase in capital and liquidity requirements, which could limit banks' lending capacity over the coming years.

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2 .Uruguay grows above its potential again, with good fundamentals

After managing to elude the recession that had been on the horizon since the middle of last year and achieving a rate of GDP growth of 2.9% in 2009, this year Uruguay will grow by 5.8%. On the supply side, the drought that ravaged the country in 2008 and 2009 has now receded, leading to a forecast improvement in the agricultural sector (particularly in beef, corn and soy) and a return to normal in hydroelectric generation.

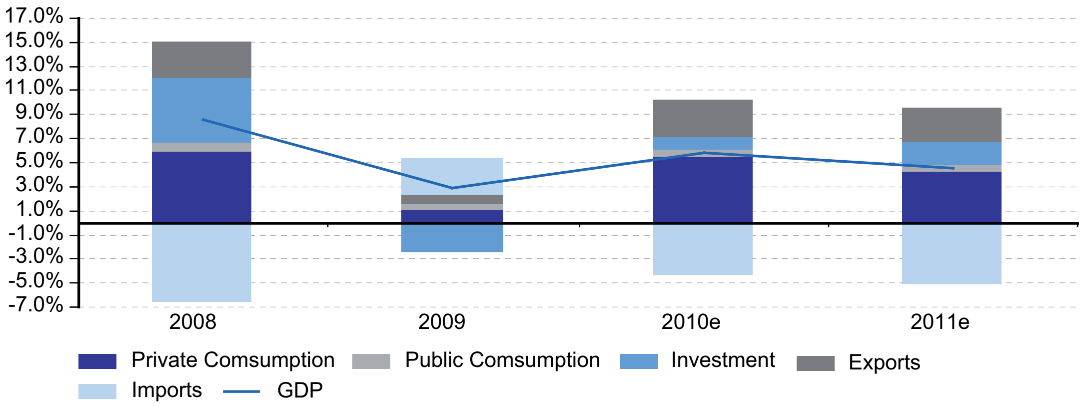
On the demand side we expect a significant growth in exports, given the buoyant economies of Uruguay's main trading partners. However, private consumption will be the main driving force of the economy, thanks to the improvement in confidence and employment (up 2% y/y in 2010) and a growth in real wages in the private sector of around 4%.

Uruguay continues to be a good environment for business. The new government has strengthened this message to attract foreign investors, so we forecast that investment will grow at rates above GDP in the next two years. The announcements of committed investments over the coming years are focused on the cellulose pulp, electricity and auto parts sectors.

Public spending will grow at a slower rate, in line with the budget presented by the new government for the 2010-2014 period, which aims to regularize the fiscal accounts and lower the burden of public debt. Without the need to carry out a counter-cyclical policy this year, or subsidize electricity tariffs as in 2009, the government aims to moderate increases in real public sector wages and pensions, to limit public spending as a proportion of GDP.

Chart 1

Uruguay: Contributions to GDP (% yoy)



Source: BBVA Research

In a context of greater growth, new fiscal forecasts point to an increase in the primary surplus to 1.7% of GDP for 2010, with an operational deficit of 1.3% of GDP due to the greater burden of interest (3% GDP). From now on, we expect the public accounts to consolidate their improvement as a less expansive spending policy is executed according to government proposals, limiting the fiscal deficit to under 0.5% of GDP.

Since last year, the government has been executing a financing policy to ensure the provision of funds. It has issued USD 500 million in debt as well as having access to funds from multilateral institutions of USD 320 million, which are more than sufficient to cover the gap in the public sector accounts this year. The government plans to continue with the same policy of preventive debt in 2010. It will focus on achieving an optimum combination between multilateral and private debt aimed to reduce the financial burden.

Table 1

Central Government Flow of Funds (USD Million)

	2009	2010	2011
Uses		**1,817**	**2,081**
Interest Payments		979	984
Amortizations		669	1,048
Loans		229	274
Bonds		440	774
Others		168	49
Sources		**1,817**	**2,081**
Primary Surplus		350	450
Multilaterals Disbursements		320	261
Issuances		500	1,300
Others		149	0
Use of Assets*	-928	498	70
Central Government Account	1,509	1,011	941

*Positive indicates a reduction in reserves
Source: Debt Management Unit, Uruguay

The need for more imports of capital goods and supplies as a result of the robust growth expected in 2010 and boosted by relatively cheaper imported consumer goods (with a better exchange rate) will lead to a negative balance of trade. This in turn involves current account deficits of the order of 1.6% for 2010 and an increase in future years. Thanks to Uruguay's financial stability, it has had a significant and growing flow of FDI in recent years. This has been sufficient to finance the whole current account deficit.

3. Deterioration in the international and regional scenario would impact recovery

As Uruguay is a small and open economy, it is not immune to international financial shocks and in fact shows a great sensitivity to changes in regional economic conditions. If the recent risk aversion arising from increased sovereign risk in Europe continues, a global slowdown combined with more restrictive monetary policies in China could lead to a lower demand for Uruguayan exports, boosted by reduced growth in Argentina and Brazil. The negative effect on the foreign balance would be increased if at the same time there was a major correction in commodity prices, although this appears rather unlikely at the moment.

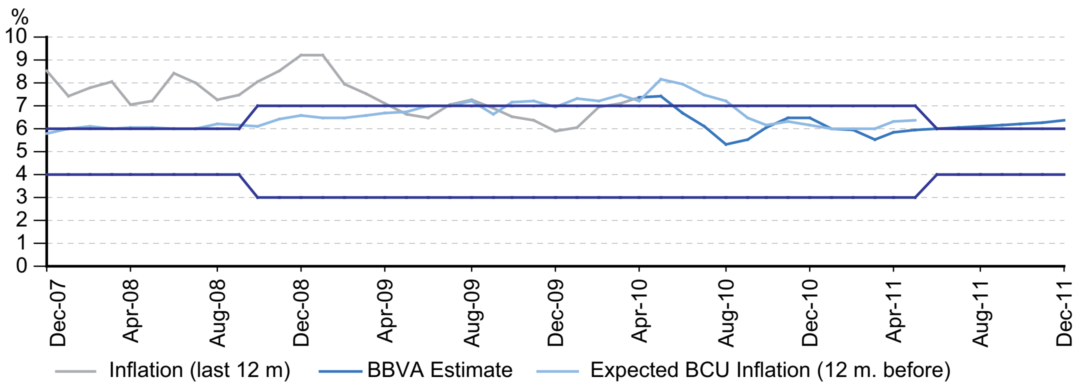
In this scenario on the foreign front, the Uruguayan economy would register lower than expected rates of growth, and the fiscal position would also deteriorate due to a reduction in tax revenues and the upward impact of social benefit payments on primary expenditure. The initial effect of a fall in oil prices that benefits the results of public importing companies is balanced by future quarters of lower performance of the central government balance.

Although Uruguay has progressed in improving the profile of its debt maturities and reduced the share of public debt in dollars, it is still vulnerable to exchange rate volatility, which could trigger a situation of extreme risk aversion and capital flight if the international crisis deepens. It is therefore important to continue to progress in reducing the ratios of gross debt to GDP (69% in December 2009) by more ambitious fiscal targets that reduce financing costs. Given the sensitivity of the results in the public sector to climatic factors affecting energy generation, it would also be a good idea to create an anti-cyclical fund to ease the fiscal deterioration in years of drought.

4. The Central Bank's dilemma: between the exchange rate and inflation

Inflation remained within the Uruguayan Central Bank targets in 2009 (5.9% to December), but in the 1st quarter of 2010 prices accelerated, in particular in some regulated items, which led to a 7.1% year-on-year increase in the CPI . The increase in core inflation due to the general level of prices indicates that the phenomenon is not due to seasonal factors and reflects a significant recovery of domestic demand. In addition, in 2010 prices of imported products will not contribute to a reduction in inflation, given the moderate nominal appreciation in the Uruguayan peso. We estimate that CPI growth in 2010 will be 6.5%, as the recent increases will be mitigated by the slowdown in administered prices for the rest of the year, at under the 7% threshold of the Central Bank's target band.

Chart 2
Inflation

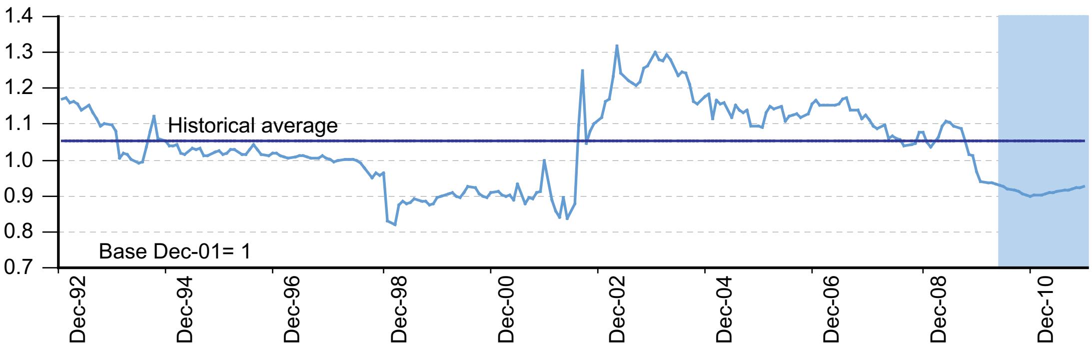


Source: BBVA Research and BCU

However, inflationary expectations for the next 12 months are not well anchored, and above the target range that the Central Bank reduced to 4-6% for mid-2011. The monetary policy rate (MPR) was revised down by 175 pp in December 2009, and it remained in slightly negative territory in real terms in the early part of the year. Given the basically neutral character of the fiscal policy forecasts, the need to withdraw stimuli for demand and move towards a less expansive monetary policy will require a gradual increase in the monetary policy rate to 7% by the end of the year, which would leave the MPR above inflationary expectations.

This will test the Central Bank's commitment to the policy of inflation targets, as the rise in interest rates would boost upward pressure on exchange rates generated by the favorable perspectives of the Uruguayan economy. Competitiveness has been affected in recent years due to the increased strength of the Uruguayan peso. In a context of greater inflation than that in most of its trading partners, this has led to an appreciation in the real multilateral exchange rate of 16% in the last 12 months to April.

Chart 3
Multilateral Exchange Rate



Source: BBVA Research

Due to the high level of dollarization of the Uruguayan economy and the negative impact on the financial system of exchange rate volatility, the Central Bank has taken measures such as reducing the monetary policy rate and reserve requirements at the end of last year, as well as actively intervening in the foreign exchange markets to prevent the local currency from rising. In accumulated terms to May, the Central Bank made net purchases of foreign currencies of around USD 800 million. These were sterilized with the issue of Monetary Regulation Bills. These transactions have led to an increase in the reserves of bills of around USD 1 billion and an increase in the Central Bank's quasi-fiscal deficit, due to the spread between the MPR and the rate of return on the reserves acquired.

The Central Bank's role in the foreign exchange market and the need for sterilization will be reduced as the government's improved fiscal situation allows it to recover its leading role in foreign currency purchases to meet its maturities as they fall due. Although the contagion of the European crisis is only moderate, it will reduce capital inflow to emerging economies and ease upward pressure on currencies. This will allow the Central Bank to concentrate on complying with inflationary targets.

5. Tables

Table 1

Macroeconomic Forecast Annual

	2009	2010	2011
GDP (% y/y)	2.9	5.8	4.5
Inflation (% y/y, average)	7.1	6.5	5.9
Exchange Rate (vs. USD, average)	22.5	19.3	19.7
Interest Rate (%, average)	8.7	6.6	7.2
Private Consumption (% y/y)	1.5	7.9	6.1
Government Consumption (% y/y)	5.2	5.9	4.8
Investment (% y/y)	-4.0	8.9	9.6
Fiscal Balance (% GDP)	-1.7	-1.3	-0.4
Current Account (% GDP)	0.8	-1.7	-2.3

Source: BBVA Research

Table 2

Macroeconomic Forecast Quarterly

	GDP (% y/y)	Inflation (% y/y, average)	Exchange Rate (vs. USD, average)	Interest Rate (%, average)
Q1 09	2.9	8.2	23.5	9.7
Q2 09	1.0	6.7	23.7	9.0
Q3 09	2.8	7.1	22.7	8.0
Q4 09	4.5	6.3	20.3	8.0
Q1 10	8.3	6.7	19.6	6.3
Q2 10	7.1	7.4	19.2	6.3
Q3 10	4.4	5.8	19.1	6.8
Q4 10	3.4	6.4	19.0	7.0
Q1 11	3.9	5.8	19.2	7.2
Q2 11	4.4	5.7	19.5	7.3
Q3 11	4.6	6.0	19.8	7.3
Q4 11	5.1	6.3	20.2	7.3

Source: BBVA Research

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