Economic Analysis

Uruguay Economic Outlook. First half 2019

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- **Global growth slows and domestic problems rise in the region. Latin America is now expected to experience growth of 1.7% for 2019 and 2.3% for 2020 respectively (previously forecast at 2.1% and 2.4%)**
- **Uruguay's growth for this year will be 0.8% due to poor consumption figures and stagnant investment. In the external sector, recovery in the agricultural sector will be offset by a weak tourist season**
- **Fiscal consolidation will become a key factor in the agenda of the next administration. The fiscal deficit will reach 3.1% of the GDP this year, which will also include extraordinary income from the "Cincuentones[1]" effect, although extra revenues will be smaller than those observed in 2018**
- **The depreciation of the Uruguayan peso accelerated at the end of 1Q19. We therefore raised our exchange rate estimate from UYU 35.6 to the dollar to UYU 36.2 to the dollar for December 2019**
- **Despite tight monetary policy and decreasing nominal wage increases, inflation will reach 8.0% this year and 6.8% in 2020 due to a weaker exchange rate**

Uruguay is expected to grow 0.8% in 2019 and 1.7% the following year. These figures imply a relative stagnation of economic activity which began to slow down in 2018, when the economy grew by 1.6% according to official figures.

The contribution of domestic demand to growth will be around 1% this year, as private consumption will be sluggish in the context of the lack of growth of real wages and investment growth will be weak depending greatly on when works on the 3rd pulp begin which will probably go ahead towards the end of 2020.

The complicated economic environment in the region, with downward growth revisions in Argentina and Brazil, means the external sector will not provide a major boost to GDP either this year. In 1Q19, the Tourism sector suffered the consequences of the poor performance of the Argentine economy and the loss of competitiveness of the Uruguayan economy with respect to Argentina, which made Uruguay more expensive in real terms for Argentine tourists after the strong depreciation of 2018. Export growth in 2019 will come mainly from the agricultural sector, which is recovering from the poor harvest that it suffered last year due to the drought.

Additionally, once the agreement with the third paper mill (UPM) is formally signed, the likelihood of which the Government itself has recently reaffirmed, import levels will grow significantly in view of the need to purchase capital goods for the plant. This will lead to a deterioration of the current account in 2020-21 which will later be compensated by higher paper and pulp exports starting in 2020. We expect a current account deficit of 0.6% GDP in 2019, increasing to 1.9% in 2020 for the reasons stated above. However, this larger external deficit will be mostly financed through greater direct foreign investment; essentially funding provided by the Finnish company for the construction of the pulp mill.

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

In fiscal matters, we still haven't seen see the much-awaited consolidation as the reduction in the deficit has only been a transitory event. In 2018 the consolidated fiscal result reached -2.9% of GDP but this takes into account extraordinary income of 1.1% of GDP corresponding to the Trust Fund income created from transfers by so-called "Cincuentones" from the private social security scheme to that of BPS (Banco de Previsión Social — the state-owned social security institute). However; this revenue inflow, which will continue—albeit at a slower pace—in 2019, will in future mean higher pension payments and reverse the positive effect recorded on public accounts in at least 2018 and 2019. In fact, we expect the consolidated deficit to rise to 3.1% of GDP by 2019 and 2.7% of GDP by 2020 (including Trust Fund income). The "Cincuentones" operation also implies an improvement in the Uruguayan public debt ratios as much of these revenues are also debt securities previously held by AFAPs (Administradoras de Fondos de Ahorro Previsional — Pension Fund Management Companies) and now transferred to the Banco de Previsión Social.

A more permanent improvement in public accounts will probably require a reform of the pension system that could improve income to the social security system permanently and reduce spending on pensions from the current levels. A structural reform of this size, however, requires strong political consensus and will probably be difficult to implement by the current administration in an electoral year.

High exchange rate volatility is a phenomenon that concerns not only Uruguay, but the region as a whole, where Argentina and Brazil in particular have suffered from depreciation of their currencies and the Uruguayan peso has felt certain contagion from this effect. The Uruguayan Central Bank has explicitly confirmed its determination to limit volatility and avoid excessive depreciation of the peso compared to fundamentals, aiming to do so through strong sales in the FX market and making it easier for local currency bondholders to choose the currency in which they wished to be paid.

We do not expect depreciation of the Uruguayan peso to accelerate in the coming months, however there remains the risk of contagion if electoral volatility in Argentina continues to put pressure on the exchange rate. Currently, we expect the exchange rate to end at around UYU 36.2 to the dollar with some upward bias depending on how the dollar performs in the region, reaching UYU 39.5 to the dollar by the end of 2020.

Inflation in 2019 is estimated to reach 8.0% y/y and will again exceed the top band of the Central Bank target range (from 3% to 7%). In 2020, CPI increases are expected to be around 6.8% y/y assuming the continuity of the tight monetary policy and the adjustment of nominal wages in a decreasing trend within the government guidelines for the current round of the multi-year collective bargaining agreements.

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