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Uruguay Economic Outlook

2023

Growth to be limited in 2023 as drought impacts heavily on the external sector

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Activity

Gross domestic product grew by 4.9% in 2022 on the back of strong investment momentum (UPM2) and solid external trade performance in the first half of the year. However, activity fell in the second half of the year due to the severe drought that affected agricultural output and exports, and due to the completion of the UPM2 project. This led Uruguay to enter recession at the end of 2022, leaving a negative carry-over of 1% for 2023.

In 1Q23 Uruguay pulled out of the technical recession by growing 0.9% y/y s.a., above expectations, due to the good tourism season and a less intense effect of the drought on farming and electricity generation. Although the activity indicators for 2Q23 give mixed signals, it will not be a good quarter because the drought will continue to impact primary activities and because the low rainfall will reduce growth while requiring energy imports from Brazil.

For this year we estimate a 2% growth, driven by private consumption from a recovery of real wages and services exports (tourism). The start-up of the pulp mill and its first exports will only partially offset the drop in export of goods. By 2024, activity will have expanded by 2.3%, driven by the dynamization of domestic consumption, the recovery of the agricultural sector and the strong contribution of cellulose exports. We are waiting for further clarifications on the recent announcements of investments in a hydrogen plant to factor them into our estimates.

Unemployment and wages

In 2022, there were 40,000 more jobs than in 2021, and the level of employed population ended above pre-pandemic figures. In 2023, the unemployment rate will be 8.3%, in a context of a slowdown in activity and the completion of the UPM2 project. The job improvement in more dynamic sectors such as tourism and commerce will not offset the fall in sectors that are stagnant. Regarding wages, we expect that the 10th round of wage negotiations will achieve a nominal increase slightly above inflation (between 2.0% and 2.5%).

External sector

Our scenario of commodity price correction, greater global uncertainty and lower global growth, will affect Uruguay's exports. The prices of the key commodities for Uruguay reached highs in 2022 and are proving to be persistent, although this year they will correct downward (but will remain high in historical terms). Hence, we expect a 10% y/y drop in the exports of goods. This will be partially offset by higher pulp exports as the new mill starts up.

The current account had a deficit of 3.2% of GDP in 2022 due to the impact of the drought and a lackluster tourism season. This year the tourism season was better than expected, but imports will have the impact of the higher energy purchases required due to the low rainfall. Hence, we expect a current account deficit of 3.3% of GDP this year, improving slightly to -2.9% of GDP in 2024 once the drought fully dissipate.

Fiscal sector

The overall public sector deficit closed in 2022 at 3.2% of GDP, but excluding the extraordinary revenues from social security trust, it would have reached 3.4%, improving 0.7 pp with respect to 2021 and exceeding the target of -3.5% established in the last financial report. This makes three consecutive years of compliance with the target.

As of April 2023, the overall consolidated result reached -3.6% of GDP, deteriorating with respect to 2022, due to a drop in revenues and an increase in primary expenditure (salaries and pensions, transfers, etc.). Several factors make us doubt that the fiscal target for 2023 will be met. First, the drought will affect activity and revenues, and will raise the cost of electricity generation for public companies. Also, the need to increase the supply of drinking water may require greater investments by the state-owned company Obras Sanitarias del Estado. Finally, the expected increase in real wages will reverse the real decline in expenditure on salaries and pensions that occurred in 2022.

Our forecast of a consolidated deficit of 3.1% of GDP for 2023 is above the target of -2.7%, but it will probably be more flexible in view of the fiscal report to be submitted to Congress as a result of the unexpected event of the drought. For 2024, we estimate an improvement in the fiscal result up to -2.9% of GDP.

Inflation and monetary policy

Inflation will reach 7.5% this year and 6.2% next year. In the first 5 months of this year, the CPI has increased 4.3%, surpassing the 5.4% of the same period last year, which captured the effect of the increase in raw materials due to the war in Ukraine, which impacted baked goods and fuels. Although monthly CPI variations have decelerated from 1.6% in January to -0.1% in May, core inflation, which reflects the inertia of the inflationary process, shows signs of a more sluggish slowdown than the general level. Thus, the annualized monthly average of core inflation for the last quarter reached 5.2%, below the 6.8% reported by the CPI.

The central bank of Uruguay (BCU) has taken note of the signs of a slowdown and has been the first central bank in the region to lower its monetary policy rate. At the last meeting in April, it cut its rate by 0.25 pp, bringing it down to 11.25% after reaching a high of 11.5% (it started from 4.5% in Sep-20, when it was negative in real terms to mitigate the effects of the pandemic). Inflation expectations for the next 24 months stand at 6.7%, above the target range, and do not show a downward trend. This leads us to estimate that the BCU will pause until at least Q3 and then resume rate cuts, as inflation expectations converge to a range of 3-6%, and end the year at 10.25%.

Exchange rate

The expectation of the Fed completing its upward path and the appetite for emerging assets have boosted regional currencies. Also, macroeconomic fundamentals contribute to the strength of the peso, as the price of commodities at historically high levels, the high FDI inflows to complete the UPM2 project, the *Ferrocarril Central* del Uruguay railroad project and other private projects, in addition to the low perception of sovereign risk (the lowest in the region), which made Uruguayan assets more attractive. In the same vein, monetary policy supports the peso. However, although the BCU's stance in the fight against inflation has led to a high interest rate with respect to the yield of foreign currency assets, there are no short-term capital inflows. Most exchange operations are carried out between non-financial domestic agents who sell USD for operational reasons or because it is better to invest in pesos. Adjusting for domestic inflation and that of trading partners, the real exchange rate has shown a slight appreciation in the first part of the year as a consequence of the accelerated nominal depreciation in Argentina, which in the global aggregate has resulted in an appreciation of the Uruguayan peso of around 12% in real terms.

We assume that the BCU will maintain its exchange rate policy of not intervening beyond market operations aimed at containing volatility. In this scenario, we expect a slight acceleration of the FX rate in the remainder of the year due to the cut in exports because of the drought to reach UYU/USD 39.7 by Dec-23 and 42.3 by Dec-24.

Conclusions

The slowdown in activity in 2023 and the deterioration of fiscal accounts do not imply a worsening in Uruguay's risk perception, which remains at the lowest in the region. In this sense, Standard & Poor's and Fitch raised the country's rating above the investment grade threshold due to the improvements in compliance with tax rule objectives and the approval of the social security reform. The recent announcement of the investment in a green hydrogen plant, which would be the largest investment received by the country, adds another milestone in the consolidation of Uruguay as an investment recipient and benchmark in the transition to renewable energies. We remain optimistic about Uruguay, which continues to revalue its strong institutional framework and to give clear signs of a medium and long-term economic course based on a sustainable macroeconomy.

Table 1. **URUGUAY: MACROECONOMIC FORECASTS**

	2020	2021	2022	2023f	2024f
GDP (% y/y)	-6.3	5.3	4.9	**2.0**	**2.3**
Inflation (% y/y, EOP)	9.4	8.0	8.3	**7.5**	**6.2**
Inflation (% y/y, average)	9.8	7.7	9.1	**7.2**	**5.8**
Exchange rate (vs. USD, EOP)	42.4	44.3	38.9	**39.7**	**42.3**
Exchange rate (vs. USD, average)	42.0	43.6	41.2	**39.1**	**41.1**
Private consumption (% y/y)	-6.8	2.9	6.0	**3.0**	**2.8**
Public consumption (% y/y)	-7.1	8.4	1.6	**1.0**	**1.0**
Investment (% y/y)	7.7	18.3	5.2	**2.5**	**0.0**
Unemployment rate (% EOP end)	10.6	7.0	7.9	**8.3**	**8.2**
Overall fiscal balance (% GDP)	-5.8	-3.9	-3.4	**-3.1**	**-3.0**
Current account (% GDP)	-0.7	-2.5	-3.2	**-3.2**	**-2.8**

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