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Economic Outlook

Uruguay

Second Half 2012
Economic Analysis

- **In 2012, growth is expected to slow in line with estimates and should close at 3.8%.** In 2013, GDP should continue to be fuelled by internal consumption and grow 3.9%.
- **This year, energy purchases by the Public Sector have a negative impact on the current account (-3.3% of GPD)** and also increase the fiscal deficit, which would reach 1.9% of GDP. In 2013, the current account would be expected to improve as the energy problem is not expected to be repeated. However, the fiscal result (-1,9% of GDP) would remain compromised by incipient growth in current expenses.
- **Inflation of 8.7% in 2012 and the dilemma of the strengthening Uruguayan peso, mean that unorthodox solutions must be found** to the lack of contraction in the fiscal balance and the inertia seen in real salaries.
- **The strengthening of the peso should slow in 2013,** but in order to improve competitiveness in the mid term measures need to be taken to boost productivity.

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Closing date: November 16, 2012

1. Summary

2Q-12 figures confirm the slowdown in economy activity as estimated (0.8% qoq). Internal demand should continue to fuel growth, with internal consumption benefiting from the increased wage bill, while improvement in capital stock continues due to the investment projects under way. In 2012, growth should see out the year at around 3.8%, showing a slight increase in 2013 (3,9%), taking advantage of the rise we expect to see in the Brazilian economy.

The higher current account deficit can be funded with Foreign Direct Investment. In 2012, the deficit would rise to 3.3%, as electricity imports due to drought and the restructuring of ANCAP oil stocks impact the trade balance. However, it would fall to 2% of GDP in 2013, when these temporary factors would disappear. Furthermore, the contribution of the tourism sector is showing signs of weakness, which could be heightened towards 2013 due to the weak global backdrop, the real appreciation of the peso and exchange restrictions in Argentina.

We expect fiscal result to deteriorate for 2012 (-1.9% of GDP). The drought had more of an impact than was initially expected, and this has spoilt the result of public companies, given that the higher costs were not transferred to prices to avert inflationary pressures. Excess energy costs (1.2% of GDP) was partly offset by the use of the surplus Energy Stabilization Fund. However, because of certain signs of growth in primary spending we are maintaining the deficit for 2013 on the same scale.

Without a more restrictive fiscal policy, more efforts are needed in monetary policy, probably prompting the Central Bank of Uruguay to take new increases in the policy rate, while also implementing price agreements and other non-standard measures. In 2013, with a more aggressive interest rate policy, inflation should slow to 7.8% yoy, though yet again it would be outside the target range of the Central Bank. With inflation and outlook, above the target range despite the Central Bank's more hawkish stance, questions will linger as to whether the current combination of policy instruments is ideal.

The tightening of monetary policy is expected to compound the loss of competitiveness in exports, particularly at regional level, prompting the Central Bank to continue intervening in the currency market and to take macro prudential measures, in an attempt to halt the strengthening of the peso.

In order to maintain high growth rates, Uruguay has to implement supply policies to improve productivity. Looking beyond changes in exchange rates, Uruguay will have to work on expanding the supply of capital and quality work, overcoming certain rigid aspects of the economy which are today preventing it from being dynamic in the mid term. It is essential to make reforms which can help to fund investment and to improve efficiency through innovation.

2. Global environment marked by the decisive measures taken by the ECB and the Fed

These key actions have clarified the global economic outlook

The world economy is expected to continue its soft recovery with a GDP growth rate of 3.5% in 2013 (3.2% in 2012). It is supported by lower risk aversion, following the influential decisions taken by central banks, especially the ECB. However, three factors could make this outlook deteriorate significantly: first and most worrying, troubles in Europe, if euro break-up fears that loomed during the first half of the year resurface; second, in the US, the still-hanging threat of the so-called fiscal cliff, i.e., a spending-cut and tax-hike package worth 4% of GDP due to come into effect in early 2013 that would push the US economy back into recession; third, a severe slowdown in the emerging economies, in particular in China and some commodity-oriented economies, if Chinese appetite for raw materials decreased.

Central bankers to the rescue; other policies should follow suit

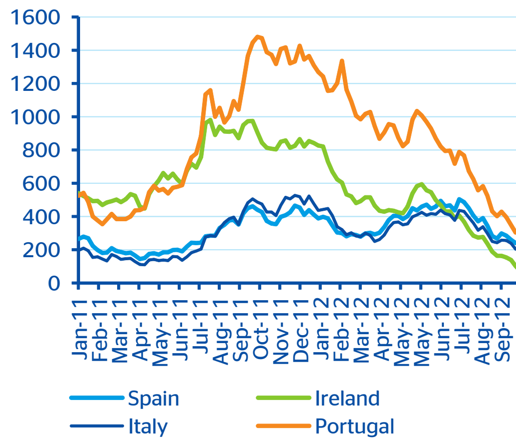
Against a backdrop of high uncertainty, over the past months authorities across the world – in particular central bankers in the eurozone and the US – have taken significant steps forward that have spared the world economy from a systemic event like the financial developments of late 2008. Both central banks have built a bridge to a new institutional environment in the case of Europe, and to a new fiscal pact in the US; these actions have paved the way for other policy makers to use their room for manoeuvre. However, the FED's actions are more open-ended than the ECB's due to different conditionality: strict fiscal fulfillment is compulsory in Europe, whereas labour market improvement is the objective in the US.

ECB: "... whatever it takes..."

The ECB took a decisive step to put an end to the debt crisis in Europe when it announced the new bond-purchase program (Outright Monetary Transactions, or OMT) in late July through which, under certain conditions, it could intervene in the secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached some agreements to reinforce the currency union: a broad roadmap towards a single banking supervision, far-reaching plans covering fiscal issues and growth-supporting measures. The rationale behind the ECB announcement is clear. Yields on some peripheral bonds are elevated because markets are partly pricing in eurozone break-up fears, compromising the ECB's mandate amid a severe financial fragmentation. The ECB move was more decisive than anticipated and dispelled market's fears about an euro break-up, alleviating tensions in financial markets (see Chart 1) in spite of recent adverse market events.

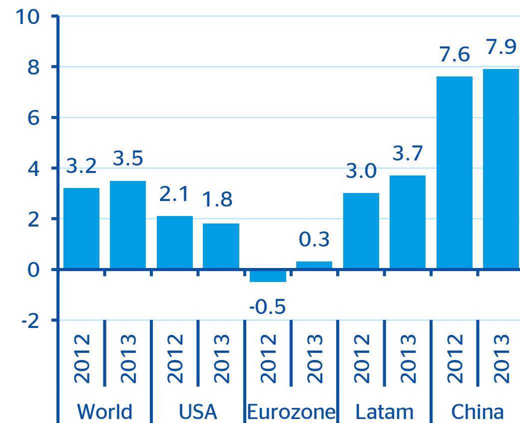
At the end of the process, the eurozone may eventually come up with a full package that will reinforce its governance. As we have long argued, it should comprise a banking union, a fiscal union and a lender of last resort to prevent fragmentation. Progress has been made on all of these fronts, though probably not enough to revert the current dynamic quickly. Yet, policy makers seem committed enough to the process and we think the worst of the crisis may, at last, be over. In the short term, the ECB's program and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations that countries such as Italy and Spain could face. In the long run, the key factors for the sustainability of the eurozone are the proper implementation of the banking and fiscal union.

Chart 1
Financial Stress Index for eurozone countries



Source: BBVA Research

Chart 2
GDP growth rate (%)



Source: BBVA Research and Haver

Fed: "… as long as needed…"

The US economy is still growing but at historically low rates and the unemployment remains high. This is the result of a still high indebtment that should keep on reducing, but also of the uncertainty regarding the resolution of the euro crisis and, from a domestic perspective, of the lack of agreements about how to reduce the high public debt while avoiding the automatic income and expense adjustment that is coming closer by the day (fiscal cliff). Against this backdrop, the Fed additionally eased the monetary policy in September. It announced that it intends to keep rates at its current low levels at least until mid-2015, a year over what was previously declared. But to support the improvement of the job market's expectation, it also announced a new round of quantitative easing (QE) through the purchase of mortgage backed securities (MBS) in an attempt to improve financial conditions for households. With this, the Fed is buying insurance against the "fiscal cliff," that in our baseline scenario we expect not to fully happen.

The potential effects of QE3 are not restricted to the US. As previous programmes showed, they prompt inflows to emerging economies, decreasing their risk premia and funding costs, boosting the availability of credit, their growth rates and also their inflation.

Central bankers' responses are not enough to bring the global economy back to a firm expansion

With the mentioned policy actions the world economy may have avoided decelerating to the slowest growth in the last 30 years (apart from the 2009 great recession) but the low growth environment continues. The advanced economies have been losing momentum since 2011 as one should expect given the current deleveraging environment. More recently the emerging economies have been hit too, though in some important cases, as Brazil and China, recent data shows that activity is stabilizing.

In our baseline scenario, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Growth in the eurozone, after a 0.5 decrease in 2012, is likely to gain momentum entering 2013 (+0.3%). In the US, growth will remain at around 2% in 2012 and 2013. The main downward revision in our current scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will remain close to 8% both years due to expected policy stimulus to compensate partially the current slowdown (Chart 2).

This scenario relies on three key assumptions. First, we assume that the recent wrangling over financial supervision does not substantially affect June's agreements, so the vicious link between sovereign and bank risk is broken and the monetary policy transmission, which in the eurozone is conducted mainly by banks, works again. Second, we assume that the mechanism in place to eliminate the "convertibility risks" is activated in full if needed. This will keep yields in peripheral economies contained, but substantial reductions will happen at the same time as Europe progresses in its new institutional arrangement and the commitments are fulfilled Finally, in this scenario, Greece will continue being part of the euro, which will, in turn, require further support from Europe by additional funding and/or a longer period to fulfill fiscal conditionality. Based on past experience, too many things could still go wrong, but policy makers tend to find solutions to Europe's problems when crunch time approaches.

3. Uruguay needs to look at its mid term productivity

Activity is slowing as expected, allaying fears of overheating

During the second quarter of 2012, the economy grew 0.8% qoq in a seasonally adjusted series (3.8% yoy), in line with our estimates, showing a slight slowdown compared with previous quarters. Internal demand continued to be the main factor underpinning activity, while exports made a lower contribution due to the deterioration in competitiveness and greater uncertainty internationally, and, in particular, at regional level. During this period, the lack of rain continued to have a negative impact on the Electricity, Gas and Water sector, which fell sharply due to having to use thermal power generation – with lower value added - to meet demand. Primary activities were also affected by weather problems, though not as seriously as in previous periods (See table 1).

Certain partial activity indicators and outlook suggest that growth in 3Q-12 would continue at about 1% qoq and would be maintained in the last quarter of the year. According to National Institute of Statistics data, manufacturing industry reported growth of 0.7% qoq. After 4 successive months with positive values, the Ceres leading indicator (ILS) also shows that growth continued in 3Q-12 and will very possibly continue in 4Q-12, while a poll by the Chamber of Commerce of Uruguay points to brighter outlook for the final months of the year.

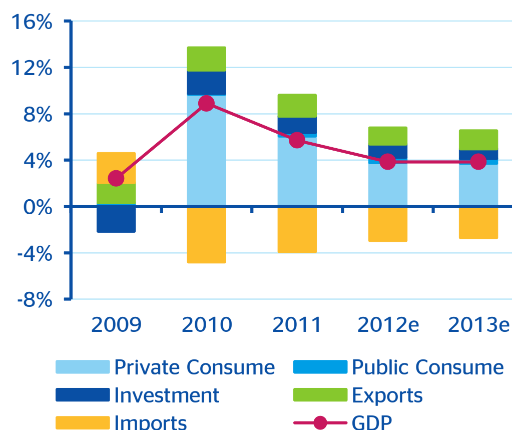
The growth pattern for the second half of the year should be similar to the pattern seen in the first half, implying a slowdown against 2011. Internal demand should continue to shore up growth albeit more slowly. The Central Bank's decision to increase the monetary policy rate to contain inflationary pressures also has this end. With consumer confidence still at optimistic levels and favourable conditions in the labour market (unemployment at all time lows and wages growing 4% p.a. in real terms), private consumption should continue to fuel internal demand. (See Chart 3).

Table 1
GDP Supply: breakdown by sectors

Economic activity	Var. % (q/q) s.a. IQ-12	IIQ-12
Primary activities	0.0%	-1.6%
Manufacturing industry	8.7%	3.8%
Supplies of Electricity, Gas and Water	-25.8%	-28.0%
Construction	4.2%	7.6%
Commerce, maintenance, restaurants and hotels	2.7%	-0.3%
Transport, storage and comunication	2.8%	1.3%
Others activities	2.0%	0.8%
Tax less subsidies	2.4%	0.4%
Gross domestic product	2.2%	0.8%

Source: BBVA Research using Central Bank of Uruguay data

Chart 3
GDP Demand: contributions to growth



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

Looking ahead to 2013, our estimates still point to growth being slightly above that registered this year (3.9%). Activity should continue to be fuelled by internal consumption, thanks to the expected wage improvements, and also through increased foreign demand in view of the better estimated performance for Argentina and Brazil. What is more, depending on the dates on which the major projects on portfolio will get under way, in 2013 growth could be driven by a higher than expected increase in investment.

It is important to highlight the role played by both public and private investment in Uruguay's growth in recent years, allowing the weight of Investment in GDP to rise from 15% in 2003 to the current 21%. From Botnia (2008) to Montes del Plata (2012/13), investment in cellulose pulp megaprojects has contributed to a high growth rate. The portfolio currently includes important mining and energy investment projects which have yet to be rolled out.

Major investments planned include the privately-owned Aratirí Mine, in the centre of Uruguay, which would need $3.0 billion dollars for its construction, and which could make Uruguay the world's eighth-ranked iron ore producer. The building of the Rocha Deep Water Port, which is needed to export future production in Aratirí, would also be taken advantage of to export timber and pulp. A new regasification plant in Punta de Sayago in the outskirts of Montevideo (with public investment of USD 400m) aims to diversify the country's energy matrix, ensuring the supply of natural gas. This project would be able to produce up to 10 million m3 of gas a day. In addition to this project, there are others which are intended to improve Uruguay's energy mix: two wind farms making up the Wind Farms Complex (owned by UTE, the national utilities company) located in Maldonado which could produce up to 1,000 megawatts a day. Although there is no start date for these projects, it is widely believed that they will get under way in 2013.

Marked deterioration in current account though still financed with FDI

In 2012, the current account deficit would reach 3.3% of GDP, i.e. 5 tenths higher than in 2011. During 2Q-12, deterioration was observed primarily in the trade balance, as the pace of growth in imports rose during that period from the purchase of electricity and the restructuring of oil stocks by ANCAP, the national refinery, while growth in exports slowed. During this period, exports of goods reported growth of 7.4% yoy, slowing sharply against 1Q-12 (13.8% yoy), while imports increased to 4.8% yoy (in 1Q-12 they reported growth of 3.5% yoy).

Figures released show a slight improvement in the 3Q-12 trade balance, given that even though imports continued to rise (13.6% yoy), exports increased 15.3% yoy.

It is important to note that growth in Uruguay's exports (12%) is underpinned by good commodities prices and the growing demand from China and the USA for these kinds of products (soya, beef). However, exports to Europe and Argentina in the first nine months of the year fell against the previous year's figures, due to the lower demand from Europe and restrictions on imports imposed by Argentina. Sales to Brazil grew by only 4% yoy in the first 9 months of the year, underlining the poor ferformance of the Brazilian economy in the year so far (See chart 5). Uruguayan imports, meanwhile, continue to grow (8%). Particularly important imports are purchases of material for the building of Montes del Plata over the last two years, and the oil and electricity imported this year due to the drought.

According to our estimates, the trade balance will end 2012 with a deficit of around USD 3.0 billion, and looking ahead to 2013, the deficit might fall slightly through not having to repeat the drought-induced energy imports of 2012 and also because of the higher external demand, particularly from the higher growths in Argentina and Brazil as against 2012.

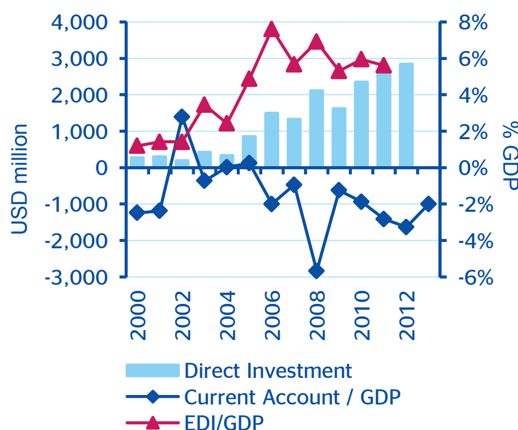
The current account estimate also implies a slight deterioration in the balance of real services, given that revenues from inbound tourism show certain signs of weakness - which we expect will be increased looking towards next season - while there are also signs of increases in outbound tourism. (See box)

The higher current account deficit, however, will be funded with Foreign Direct Investment. Over the last 12 months, FDI has amounted to USD 2.56 billion, accounting for 5.3% of GDP (See chart 4). While it is true that during 1Q-12, FDI fell 7.6% against 1Q-11, and those capital inflows have shown some volatility in recent years, the overall trend is of substantial growth. Major investment projects still remaining on portfolio would be expected to keep FDI levels healthy in the mid term.

Shorter term capitals, under Investment in portfolio, which had been negative on average since 2006, showed a positive inflow in 2011 of USD 1.98 billion, accounting for 45% of total capital inflows during this period. Revenue flows were maintained during 1H-12 (USD 615m), thanks to Uruguay's low level of risk, confirmed through its recovery of investment grade. In view of the high degree of international liquidity, short term flows are very likely to grow in importance, putting extra pressure on the exchange rate.

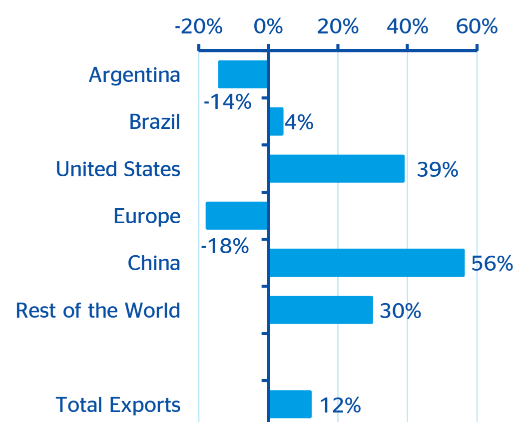
As the inflows of capital (both short and long term) to Uruguay comfortably exceed the amount necessary for financing the current account deficit, Reserve Assets have grown and now amount to a stock of approximately 13.0 billion dollars. Although these short term capitals are more volatile and can be quickly reversed when faced with an event which could expose Uruguay to a risk scenario, they would not complicate the financing of the current account as it would be comfortably covered solely by FDI.

Chart 4
Current Account and FDI (% of GDP)



Source: BBVA Research and Central Bank of Uruguay

Chart 5
Uruguay's accumulated exports to September by destination Chg yoy



Source: BBVA Research and Central Bank of Uruguay

Box 1. The global context, the strengthening of the Uruguayan peso and Argentinean restrictions should be detrimental to the next tourist season

Uruguay has been highlighted by the World Tourism Organization as it is a small country which has focused on continuously improving the quality of its services, thus managing to draw a large number of visitors and considerable foreign exchange revenue, bringing the net tourism balance to account for a positive 3.3% of GDP.

In 2011, spending on inbound tourism represented 4.6% of GDP. In the same year, Real Services (approximately 75% of which are covered by tourism) accounted for 27% of total Exports, clearly showing the importance of this industry for the country's economy.

During 1H-12, 1.6 million tourists entered Uruguay, a little over 1 million - 65.6% of the total - of which were Argentinean visitors. Although the total number of visitors entering Uruguay in this period was slightly less than was observed in the same period of 2011 (-1%), it is important to note that the number of Argentineans was comparatively higher (+9.8 pp) between periods. Indeed, during 1H-11, 0.9 million Argentineans entered Uruguay, accounting for 59.2% of total visitors.

The growth in Argentinean tourists towards Uruguay during 2012 could be due to the fact that restrictions on buying foreign currency for tourism were not yet applicable, and the fact that acquisitions were permitted abroad with credit cards at the official exchange rate, to some degree encouraging the outside tourism of Argentineans, because of the real appreciation of their currency.

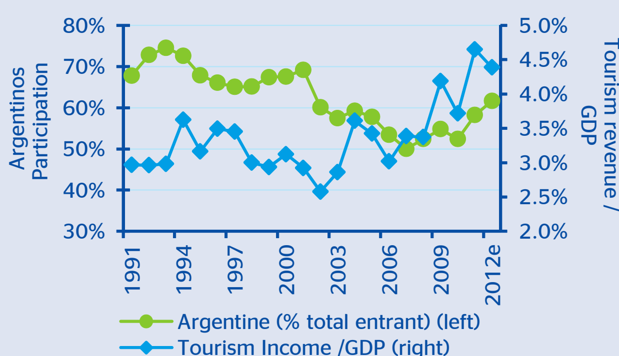
From the second half of the year on, and looking ahead to 2013, we expect that currency restrictions in Argentina will have a negative impact on demand for tourism services in Uruguay, particularly during 1Q-13, which is seasonally the best period for arrival of tourists in Uruguay.

The closure (bankruptcy) of Pluna (flagship airline) and the real appreciation of the Uruguayan peso would also be expected to have a negative impact on the number of visitors to the country.

However, the Uruguayan government is promoting certain measures geared towards offsetting the adverse effects of the Argentinean restrictions. One of these is the return of VAT (22%) on payments with credit or debit cards in tourism-related services (restaurants, car rental, etc.). Furthermore, 10.5% of payment of rentals for tourist purposes carried out with credit and debit cards by foreigners would be returned. The Uruguayan private sector is also promoting special offers to encourage tourism (particularly by Argentineans), offering discounts in hotel prices, and also accepting Argentinean pesos for paying for goods and services.

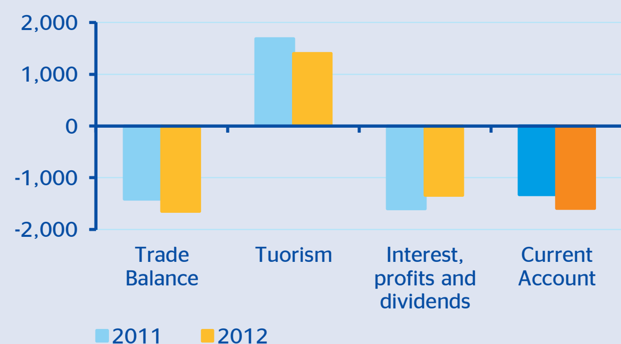
Opinions currently differ regarding how successful these measures will be and if, ultimately, they will be able to offset the unfavourable factors affecting the tourism sector. We expect the sector will be moderately hit during 2013, as Uruguay's measures will only partially help to offset the negative effects of Argentina's currency restrictions. However, it is important to note that Uruguay is proving increasingly popular as a destination for tourist from other countries from outside the region and throughout the entire year. This is an early sign of reducing the strong seasonality of 1Q and reducing the dependence on Argentinean tourists in the mid term. Nevertheless, with the current global backdrop of low growth in central countries and the relative devaluation of the Brazilian real against the Uruguayan peso, we do not expect that these factors these factors will outweigh the difficulties caused by Argentina's exchange restrictions.

Chart 6
Tourism Revenue (as % GDP) and Argentinean participation in total



Source: BBVA Research and Ministry of Tourism

Chart 7
Importance of Tourism in Current Account (USD mill.)



Source: BBVA Research and Central Bank of Uruguay

Warning signs for fiscal result

The impact of the drought in early 2012 was greater than was initially expected, and this has proved detrimental to the result of public companies, and naturally had an impact on the fiscal balance. The higher costs of using thermal power generation (to replace hydroelectricity) were absorbed by the public sector, given that if they had been transferred to prices it would have heightened inflation, which is already at worrying levels. According to the Government's estimates, the higher energy costs as a result of the drought amounted to 1.2% of GDP, partially offset by using the funds remaining in the Energy Stabilization Fund created in 2010 (equivalent to 0.3% of GDP).

In light of these circumstances, we lowered our estimated result of public companies and also adjusted the rate of growth in primary spending, as there has been a certain degree of slowdown in wage items and benefit payments, in particular, in recent months. In 2012, the fiscal balance in the national public sector would reach a deficit of 1.9% of GDP, 2 tenths above our previous estimate (and that of the National Budget, which stands at 1.7% of GDP). This estimate implies that the negative impact of the drought will not be felt during the latter part of the year, as has been the case, but it also entails higher current spending, arising in wages and transfers. Wage negotiations are under way, and if real wage increases are confirmed as in previous years (beginning with a level of 3% for 2013), the increase in spending in real terms would create further complications for the fiscal result, and therefore we expect 2013 to finish with a deficit of 1.9% of GDP, with no improvement that year.

In this regard, there is a certain concern about the high level of inertia of growth in spending, which has grown by almost 4 points of GDP since 2003 (see Chart 8). This pro-cyclical fiscal policy also adds pressure on inflation at a time when it should be helping to slow internal demand, overburdening the role of monetary policy.

Despite the fiscal deterioration, we do not believe Uruguay will have problems in covering the public sector's financing needs, as it has a pre-financing policy which enables it to offset the negative effects of international liquidity restrictions and increased risk aversion. It has currently covered its financing needs for the remainder of 2012 and the whole of 2013 using the issues made on the local market and also internationally (see Table 2). The government also has contingent credit facilities with international bodies amounting to over 2.0 billion dollars, and is negotiating lines with the IDB for another 550 million dollars.

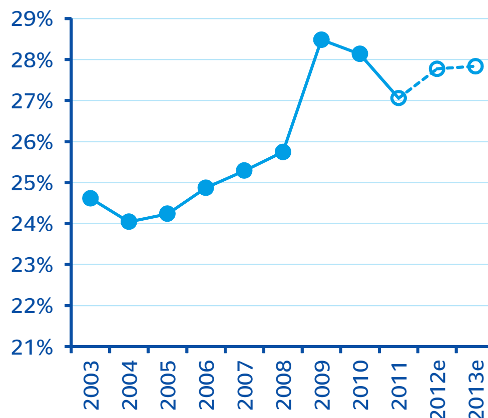
The positive perception which voluntary debt markets had of Uruguay was shown on 13 November 2012. On this occasion, USD 500 million of the Global Bond 2045 were issued at 4.125%, and were demanded by 120% of the total. The funds will be applied to the redemption of bonds maturing between 2013 and 2027. Continuing with its efforts to improve the debt maturity profile, the Ministry of Finance announced that it was intending to extend the issue of this bond by up to USD 1.50 billion in order to exchange for securities maturing between 2022 and 2036.

Table 2
Central government fund flows (USD mill.)

	2012	2013
Uses	2150	2012
Interest Payments	1227	1314
Amortizations	624	649
Loan	191	188
Bonds	432	461
Others	299	49
Sources	2150	2012
Primary Surplus	350	550
Multilateral Dusbursements	191	188
Issuances	1543	1200
Others	93	214
Use of Assets*	-27	-140

* Positive indicates a reduction in reserves
Source: BBVA, Uruguayan Ministry of Economy and Finance - Debt management unit

Chart 8
Primary Spending/GDP (in %)



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

Prices put the Central Bank under pressure

Inflation has gathered pace in recent months and shows no signs of subsiding, in view of the inertia shown in core inflation, in other words, discounting seasonal effects and prices managed, which are above the general level. Inflation is fuelled by three main factors: the strength of domestic demand, underpinned by real wage earnings in an adjusted labour market, the expansionary fiscal policy and increases in international commodity prices.

In the first 10 months of the year, accumulated inflation reached 7.8% (9.1% yoy). The three most important items in the basket, accounting for 49% of the total, are: Foods and Beverages which rose 10.5% yoy; the item of Home rental and maintenance which increased 11.6% yoy and Transport, up 6.3% yoy. Therefore, almost half of the basket (and which is also responsible for 55% of the 9.1% increase in CPI) is increased above the upper limit of the Uruguayan Central Bank's target range of 6%.

The prices performance in recent months prompted us to raise our inflation estimate for 2012 to 8.7% (formerly 7.5%), making another important deviation from the target range. For 2013, prices, measured by CPI, are expected to rise 7.8% (former 6.9%), slowing due to a more restrictive monetary policy.

The Uruguayan Central Bank responded to this scenario with a more aggressive attitude, but with little assistance from fiscal policy, it had to resort to unorthodox solutions. This shows that the burden on monetary policy has increased in light of the "policies mix" which is not ideal for reaching the target of reducing inflation.

On the one hand, the Central Bank surprisingly increased the Monetary Policy Rate (MPR) from 8.75% to 9% in the September meeting of the Monetary Policy Committee (COPOM), showing that this was its priority in fighting against inflation. Along the same lines, due to the persistent inflationary inertia, our estimates also include a further 50 bp increase in the Monetary Policy Rate in the next COPOM meeting, so as to reach a real positive rate in 2013. It is important to bear in mind the considerable impact of the strengthening in the exchange rate which could discourage the Central Bank from using this method and instead make greater use of unorthodox tools.

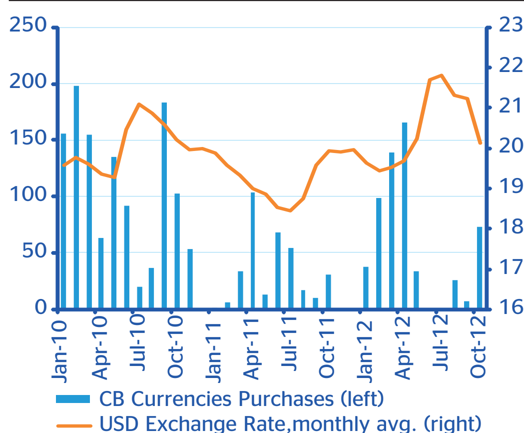
In addition to the increase in the policy rate, and noting the impact of outlook for the sharp increase in Foods and Beverages prices, the government reached an agreement with supermarkets to freeze (and even in some cases to cut by 10%) the prices of a basket of 200 products up to 31 December. The cost of the agreement will affect traders' and suppliers' margins, and there will not be official controls on prices. We believe there might be other measures of this kind, particularly in utilities and fuels, assuming the respective fiscal cost.

Different biases in monetary policy accentuate the strengthening of the exchange rate vs. Brazil

The upward adjustment of the policy rate (MPR) makes it more pressing to resolve the dilemma of monetary policy between exchange rate and inflation. In order for monetary policy to work on prices, a certain period of time is needed in order to reduce the strength of demand. In Uruguay, this "waiting period" is fairly long and is weakly transferred due to the low level of baking penetration and the strong level of liquidity in the financial system. The use of unorthodox instruments to keep prices in check highlights the government's reluctance to use an even more restrictive monetary policy in light of the strengthening of the exchange rate

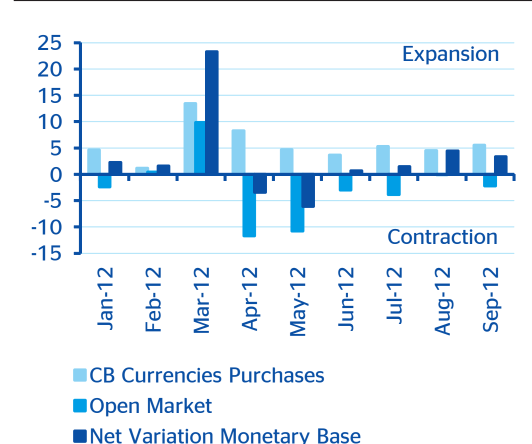
The peso, which had already appreciated before the surprising increase in the Policy Rate, became even stronger, thus making the economy less competitive, mainly with Brazil - which is going in the opposite direction, i.e. reducing the SELIC rate in order to stimulate the economy.

Chart 9
Exchange rate intervention and Nominal exchange rate ($/USD)



Source: Central Bank of Uruguay and BBVA Research

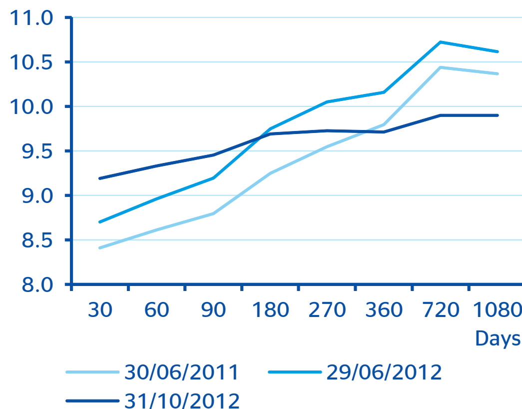
Chart 10
Monetization (millions of pesos)



Source: Central Bank of Uruguay and BBVA Research

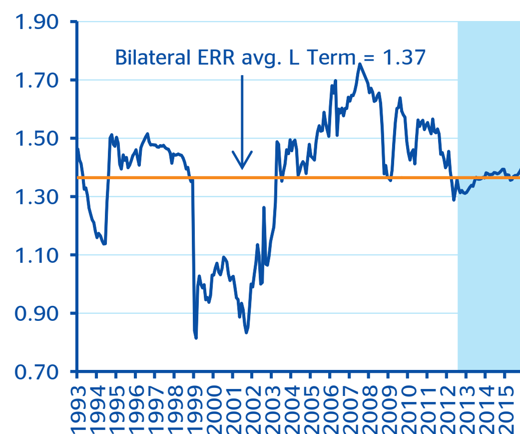
Over the course of the year, the Central Bank of Uruguay has continued to intervene in the currency market and has instrumented macroprudential measures in order to check the strengthening of the peso. In order to slow down the entry of capitals in the short term, in August it was decided to immobilize funds for increases in Non-Residents' positions in Bills in pesos of the Central Bank and to integrate in dollars for bills in pesos. Furthermore, from August onwards the Central Bank has resumed acquisitions on the currency market (Chart 9), accumulating USD 107.8 million until 31 October, albeit at a slower pace (average of USD 36 million per month vs. average of USD 95 million between January and May). Currency intervention brought about a 30% increase in international reserves from the end of 2011, which was partly neutralized by the placement of monetary regulation bills. According to our estimates, in the yearly aggregate figure 46% of the monetization from the foreign sector was absorbed through open market operations of the Central Bank (see chart 10). The cost has been moderate in quasi-fiscal terms, given that there has not been excessive growth in the MRB interest rates. The yield curve of Central Bank bills has flattened against one year ago. This shows that for the time being the sterilization is facing a demand which far from tiring, has even sacrificed yield in the long term, implying that there will not be any devaluation (Chart 11).

Chart 11
Bond Yield in Non-indexed Pesos



Source: BEVSA and BBVA Research

Chart 12
Real bilateral exchange rate with Brazil



Source: Central Bank of Uruguay, INE and BBVA Research

Despite these measures, there is cause for concern in the export industrial sector, due to the loss of competitiveness caused by the strengthening peso.

The most important comparison is with Brazil, Uruguay's most important trading partner and which accounts for 20% of exports. Last year, both countries adopted opposing monetary policies, the result of which has been for Uruguay to become relatively more expensive. While Brazil has implemented expansionary policies, lowering the interest rate (SELIC) in order to encourage activity and to prevent the Real from strengthening, in Uruguay the Central Bank has increased the Monetary Policy Rate mainly in order to control inflation, which is reaching worrying levels. Since early 2011, the Brazilian real has depreciated by 20% and inflation has risen 11%, while over the same period of time Uruguay devaluated only 6.7% but inflation amounted to 16% (Chart 12).

With current inflation levels, and given the signs given by the Central Bank in its last monetary policy committee meeting, it is seems unlikely that it will be able to adjust competitiveness levels and try to converge with Brazil's monetary policy. In our opinion, therefore, the real bilateral exchange rate will remain slightly stronger than the long term averages despite macroprudential policies being implemented.

4. Supply policies are required to improve competitiveness

In the mid term productivity is paramount

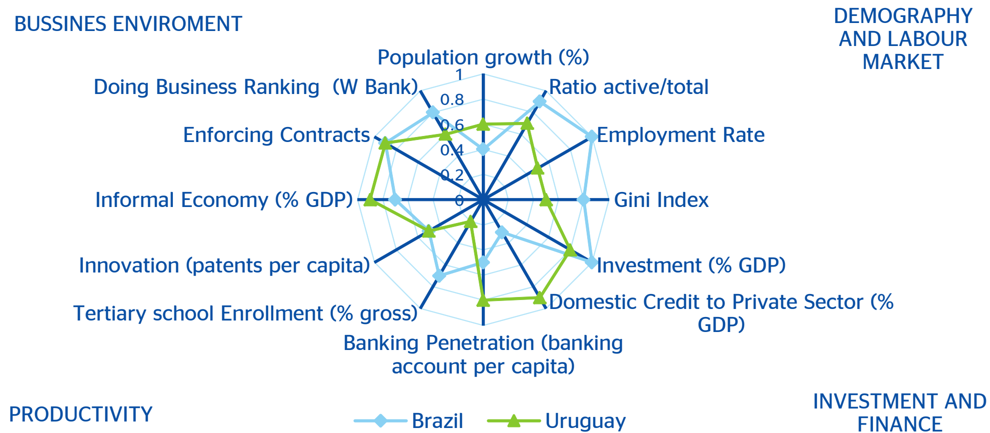
Overall, Uruguayan exports have become less competitive due to the real strengthening of the peso in a context of rising inflation and a nominal appreciation of the peso in view of a more restrictive monetary policy than its regional partners. The recent combination of these factors has raised concerns about the loss of the peso's competitiveness. However, the deeper problem concerning Uruguay's competitiveness is more difficult to solve given that more structural measures would need to be applied in the mid/long term.

From the standpoint of supply, a country's capacity to grow potentially depends on the growth in productive factors (capital and labour) and the efficiency with which they are combined. We

have divided these factors into four main pillars: demographics and job market, investment and saving, business climate and productivity.

In the chart below, we compare Uruguay and Brazil on the basis of 14 variables which fit into the aforesaid four pillars. Brazil has been chosen for comparison due to its importance and in order to see how Uruguay is positioned next to is largest trading partner. Each one of the parameters is measured from 0 (best) to 1 (worst) performance.

Chart 13
Growth Potential Radar. Comparison between Uruguay and Brazil. (being closer to the centre indicates a better position)



Source: BBVA Research

As far as the lab or supply is concerned (Demography and labour market), we see that Uruguay has a very low population growth. Compared with other emerging countries, it does not have a "demographic boom", i.e. it does not shown a rise in the number of people of working age as against the total population, given that it is one of the countries with highest life expectancy and lowest birth rates in Latin America. In order to improve the rate of growth in the labour supply, policies would be required to encourage immigration or to "repatriate" a large number of Uruguayans currently living abroad or other measures to encourage families to have more children. The high labour force, low unemployment levels and a fairer distribution of income in comparison with Brazil and other countries in the region, mean that in these areas of the labour market pillar, Uruguay has little room for improvement.

Turning now to the subject of capital stock, Uruguay has gradually increased levels of investment in terms of GDP (currently at 21%), but the ratio is still a long way behind Asian countries and other countries in the region, such as Chile. Furthermore, in recent years the Uruguayan growth model has largely been based on consumption, leading to a relatively low saving rate which is not sufficient to finance a substantial increase in investment, particularly in infrastructures - where there are important shortcomings. Here it would be necessary to apply policies geared towards encouraging saving, and also to promote the penetration of credit and financial inclusion through developing banking products and infrastructure.

In the third pillar - business climate - Uruguay is better positioned than Brazil, according to the Doing Business ranking (World Bank). Its macroeconomic stability, institutional strength and lack of corruption are some of the reasons for this position. However, there are certain negative factors which hinder productive companies, such as the inflexible labour market or the excessive amount of bureaucracy, increasing the number of procedures required for compliance of contracts. Measures geared towards expediting compliance with regulatory processes would bring about further improvement in business climate, thereby helping to increase productivity.

The last pillar concerns the efficiency with which available productive factors are used, a question which is essential in achieving a higher potential GDP. The high rates of informality observed in Uruguay, higher even than Brazil's, appear to indicate that productivity is low in broad sections of the economy, thus not allowing companies to grow and to take advantage of economies of scale.

Although Uruguay has high levels of education and equality, innovation is low, as is the case with other countries in the region. Greater training needs to be promoted in technology degrees so as to raise innovation levels, and so achieve a higher number of patents per capita.

In recent years, Uruguay has enjoyed hefty growth following on from the serious financial crisis in 2002. However, for this growth to be sustainable over time, beyond changes in the exchange rates, Uruguay will have to work on expanding the supply of capital and quality labour, overcoming some of the inflexibilities of its economy which are presently undermining its dynamic role in the mid term.

5. Tables

Table 3
Macroeconomic Forecast Annual

	2010	2011	2012	2013
GDP (% y/y)	8,9	5,7	3,8	3,9
Inflation (% y/y, average)	6,7	8,1	8,2	8,7
Exchange Rate (vs. USD, average)	20,0	19,3	20,5	20,4
Interest Rate (%, average)	6,3	7,0	8,8	9,3
Private Consumption (% y/y)	13,7	8,2	5,0	5,0
Government Consumption (% y/y)	0,8	3,0	5,0	4,0
Investment (% y/y)	10,1	7,0	5,5	4,0
Fiscal Balance (% GDP)	-1,1	-0,9	-1,9	-1,9
Current Account (% GDP)	-1,9	-2,8	-3,3	-2,0

Source: BBVA Research

Table 4
Macroeconomic Forecast Quarterly

	GDP (% y/y)	Inflation (% y/y, average)	Exchange Rate (vs. USD, average)	Interest Rate (%, average)
Q1 11	6.7	7.7	19.6	7.00
Q2 11	5.1	8.5	18.7	7.50
Q3 11	7.7	7.9	18.8	8.00
Q4 11	3.5	8.3	19.9	8.25
Q1 12	4.2	7.8	19.5	8.75
Q2 12	3.8	8.0	20.4	8.75
Q3 12	2.1	8.0	21.4	8.75
Q4 12	4.9	8.9	20.6	9.00
Q1 13	4.2	8.8	20.3	9.50
Q2 13	4.4	8.7	20.4	9.50
Q3 13	3.6	9.4	20.5	9.25
Q4 13	3.3	7.9	20.6	9.00

Source: BBVA Research

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