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Economic Outlook

Uruguay

Second Half 2013
Economic Analysis

- **We maintain our growth estimates at 3.7% and 3.9% for 2013 and 2014 despite the positive surprises in 1H13.** In 2H13, domestic demand will slow down due to an incipient deterioration in the labor market and lower investment levels.

- **The Central Bank shifts from an interest rate instrument towards monetary aggregates, but inflation remains above the target range.** We have raised our inflation forecast to 8.7% in 2013 (8.2% in 2014).

- **Fiscal policy remains lax despite the low level of domestic saving:** the overall budget balance will close the year with a deficit of 2.1% of GDP and 2.3% next year.

- **We keep our exchange rate forecast of $/USD 21.5 for 2013 and $/USD 23.6 for 2014,** insofar as the United States begins to reduce monetary stimuli and the US dollar appreciates further in Latam.

- **In 2013, the trade balance is improving due to lower oil import requirements,** although the current account deficit will remain high (3.6% of GDP in 2013 and 3.4% in 2014) due to tourism restrictions in Argentina.

Index

1. Summary 3

2. A slow global recovery with downward risks 4

3. Uruguay: Positive surprise in growth for 2Q-13 7

Box 1. The real estate business: a change in trend? 9

4. Upward trend in inflation which is difficult to manage 10

5. Changing instruments but not trends: inflation remains above target 11

6. Higher short term FX volatility due to changes in monetary policy 12

7. Fiscal policy… is it neutral? 13

8. Lower oil imports improve the trade balance 14

Box 2. Sustainability of the Current Account 15

9. Uruguay less vulnerable to external shocks than other countries in the region. 19

10. Tables 20

Closing date: November 4, 2013

1. Summary

Positive surprise in growth of 2Q-13 (+2.1% q/q s.a.) almost doubled our estimates. In year-on-year terms, GDP rose 5.6% in 2Q-13, accumulating growth of 4.8% y/y in the first half of the year. However, we are maintaining our growth estimates for 2013/2014. This year would close at 3.7% given that in 2H13 we expect an adjustment due to the slowdown in private consumption from a slight deterioration in the labor market, while looking ahead to next year we estimate an incipient improvement in foreign demand.

Inflation has gathered pace since mid 2013, and stood at 9.0% y/y at the end of 3Q13. Although the increase is led by regulated and seasonal prices, it is the rise in core inflation which marks the momentum in prices. In 2013, we estimate inflation of 8.7% (8.2% in 2014), assuming that the government will use some unorthodox instruments to prevent inflation reaching the psychological threshold of 10%.

Since July, the monetary authority decided to change its Monetary Policy instrument, and gave up interest rate intervention in favor of monetary aggregates. It also extended the programming horizon to 24 months and widened the target range of 3% to 7%. The M1 aggregate in question reported less expansive rates, validating the contractive stance declared by the Central Bank of Uruguay. Inflation expectations for the next 24 months showed only marginal variations from the time the new instrument was implemented insofar as there has been no firm attempt to reduce salary indexation mechanisms.

The nominal exchange rate remained more volatile in the short term although the Fed's e withdrawal of monetary stimuli in the mid term should lead the peso to fall in value against a stronger dollar.

Fiscal policy is not restrictive enough to generate a primary budget surplus which might enable a substantial improvement in fiscal solvency or provide significant to support monetary policy in its efforts to reduce inflation. We still estimate an overall deficit of 2.1% of GDP for 2013 with a slight deterioration for 2014 (2.3% of GDP).

In 2013, we expect the trade deficit to improve slightly, reaching USD 2.3 billion. With this result and a lower positive contribution from the tourism sector (above all from Argentinean tourism), the current account deficit should improve to not more than 3.6% of GDP. In 2014, the terms of trade will not be favorable for Uruguay while tourism should contribute a lower amount of foreign currency than in 2013 as restrictions in Argentina will continue. However, assuming no weather difficulties, the lower demand for oil should enable there to be a slight improvement in the deficit (3.4% of GDP).

This deficit is practically determined by the structural component which arises - as it does in most of the countries in the region - from sharp growth in investment but without an accompanying increase in savings (either private or public).

Vulnerability to an external shock is relatively low in Uruguay, above all if we compare it to the risk threshold for emerging markets.

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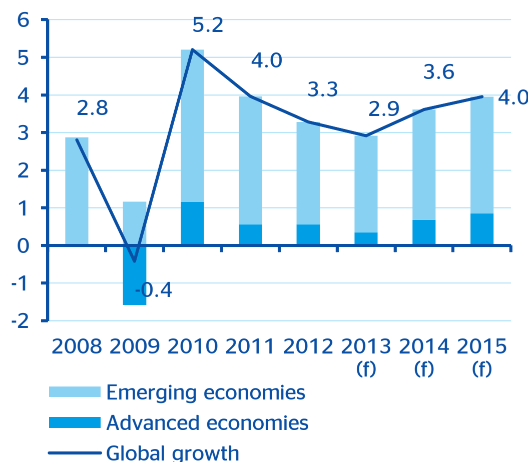
2. A slow global recovery with downward risks

The economic cycle is improving, above all in advanced economies, although strong recovery is still far off

Two general features have characterized the last quarter from the macroeconomic standpoint. First, the confidence indicators of economic agents and the volatility of the financial markets have continued to reflect the low level of possibility of tail risk events that could be disruptive for the global situation. Thus economic recovery is becoming consolidated and there is less risk of it derailing. However, there have also been events over the quarter that have contributed to a scenario of weak global recovery that is limited within a one or two-year horizon. They are events with a present impact (the partial closure of the US government) but also a future one (the more or less early exit from the exceptional liquidity support measures).

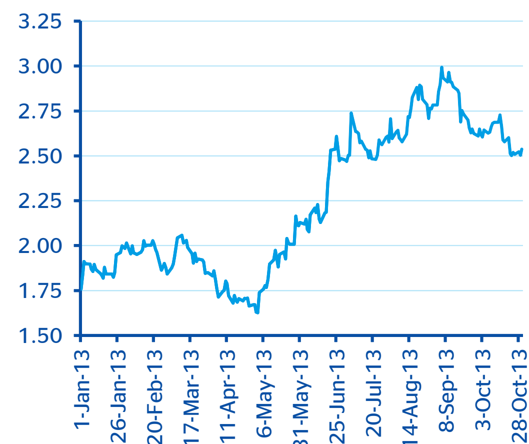
Overall, we have revised down by 0.2 pp the expected growth for the global economy in 2013 to 2.9% and in 2014 to 3.6%. The revision of 2013 growth is due to the worse figures recorded in the U.S., and the slowdown in some of the countries in developing Asia, which are also affected by financial turbulence in the wake of the Fed's announcement of an imminent cut in the rate of asset purchases in its quantitative easing program (the tapering of QE). Growth in 2014 has also been revised down to 3.6%. The emerging markets are behind this downward revision, (except for China, where we stick to our forecasts), although they will continue to be the biggest contributors to global growth (Chart 1). The higher rate of global growth in 2014 is backed by an acceleration of the economy in all geographical areas, except for Asia, where growth is expected to remain at the same levels.

Chart 1
World growth and contribution by regions



Source: BBVA Research and IMF

Chart 2
U.S.: yield on 10-year U.S. government debt



Source: BBVA Research and IMF

The tensions in the financial markets caused by the announcement of the Fed's tapering have eased, providing a boost not only in the U.S.

The Fed caused surprise when in September it decided not to start the process of reducing the rate of asset purchase in its quantitative easing (QE) program. Through this delay, it has reinforced the nature of the "data-dependent" program, and also heightened the effect of the uncertainty on the negotiation of the fiscal deficit and the debt ceiling.

The clarifications on the tapering process, which the Fed's members are preparing in the light of the unexpected reaction of the market to their first announcement and its delay until (possibly) the start of 2014, have reduced the risks of a derailment in the recovery. First, much of the rise in interest rates recorded since May has been reversed (Chart 2), and markets now do not anticipate interest rate hikes until 2015. Second, volatility and financial tensions have eased at global level, especially with regard to the emerging regions of Asia and Latin America, also affected by lower capital inflows. Thus, fears of a sudden stop in emerging markets have gradually eased, while emerging markets show some indications of a recovery in confidence, after the halt in the middle of the year.

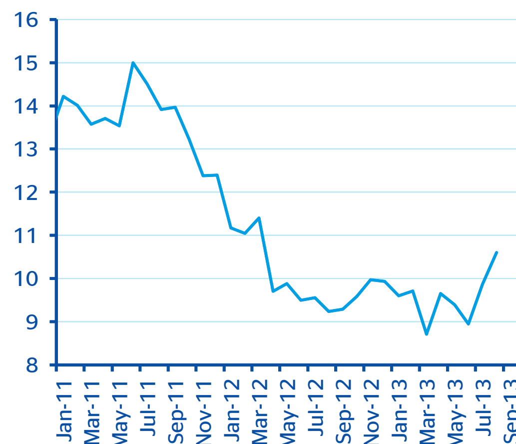
In any event, the tapering will eventually arrive, and change the global scenario of liquidity injections that favored indiscriminate flows towards emerging markets. The impact of tapering once it is effectively underway, will probably be a greater discrimination in flows toward emerging markets according to the fundamentals of each of them.

China once more stimulates its growth, but in a more limited fashion

Uncertainties at the start of the year in China about the possibility of a sharp adjustment to its economy have also evaporated, at least in the short term: it has maintained its high rate of growth, and the most recent data (third quarter) point towards stronger growth in GDP (Chart 3). The better than expected figures in 2013 mean that the annual growth outlook has been revised upward slightly from 7.6% to 7.7%. Even so, doubts remain about the sustainability of growth in the medium and long term, as the recent upturn in growth has been the result of the improvement in foreign demand, but also of one-off tax policy and public spending measures with a renewed use of credit.

Chart 3

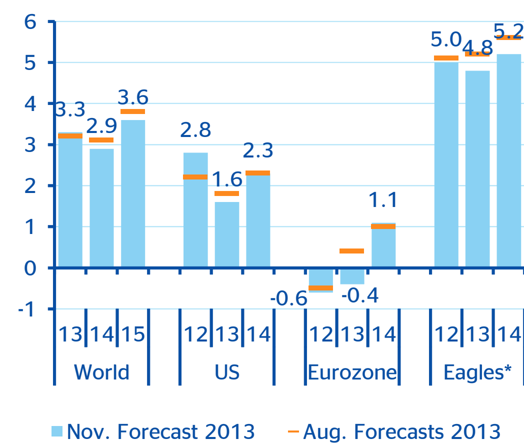
China: Industrial output (% y/y)



Source: BBVA Research and Haver

Chart 4

GDP growth estimates (%)



* The EAGLEs are the emerging countries that will contribute most to global GDP over the next 10 years. The group is made up of China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.

Source: BBVA Research and IMF

The perception on Europe improves and the most extreme risks are dissipated. The reforms geared toward better governance continue and growth returns

In Europe the forecasts have been confirmed and the economic situation has continued to improve, to the point that the Eurozone emerged from the recession with growth of 0.3% in the second quarter of 2013, after 6 quarters of recession. A positive reading may be made of the data in two aspects, given that the recent upturn is largely underpinned by improved domestic demand and the improvement in activity has also reached the periphery, helping to eliminate the systemic risks so typical of the preceding quarters. The recovery in activity has been helped by a reduction in financial tensions in the area and by an easing (de facto) of the more short-term fiscal consolidation targets, implicitly tolerated by the European authorities.

GDP growth in this part of the year formed part of our scenario, and no additional element has appeared to make us change our forecast of a weak recovery. In 2013 Europe's GDP will fall by 0.4% and grow by 1.1% in 2014. The weak recovery is consistent with the deleveraging process underway in the private sector in some economies in the area and the financial fragmentation that is still in place, which affects the capacity of bank credit supply. The next few months will be decisive in progress toward banking union, with the entry into operation of a single supervisor, the ECB, and the definition of the mechanisms for bank resolution, whose implementation model is still under discussion.

The fiscal agreement in the U.S. has been another "sticking plaster" that does not address long-term fiscal sustainability and does not avoid a contractive impact in the short term

The fiscal agreement reached on October 16 in the US simply postpones the current situation, as it only takes into account that the Government will have financing until January, while the new debt ceiling will be reached in February. Intense negotiations are drawing near on cuts in discretionary expenditure and increases in taxation. The U.S. thus once more has to address an uncertain process that it has already passed through in these months on previous occasions, and this will surely have negative consequences. Most likely is that the partial closure of government for 16 days has had a relatively marginal direct effect on the GDP for the quarter, perhaps a few tenths of a pp. However, the threat of this process continuing may have an additional impact. In any event, the situation in which economic policies push in opposing directions will continue, with a lax monetary policy that will continue to be lax for a long period, and an unnecessarily contractive fiscal policy in the short term. Thus the U.S. public deficit will have fallen without market pressure (the opposite of in Europe) from 6.8% in 2012 to 4% in 2013, which can be considered a drain of 1.3 percentage points of GDP growth in 2013. And the long-term challenges for the fiscal sustainability of the U.S. economy have not been tackled. In any event, in our central scenario, a lower fiscal burden in 2014 and continued recovery should enable growth in the US, from our estimate of 1.6% for 2013, to 2.3% in 2014 (Chart 4).

Risks in the forecast: downward bias but a priori with less probability and lower impact

Fewer risks to the aforementioned central scenario. This does not prevent the balance of risks from continuing to be downward, given that a variety of factors are still in place that could move in this direction. First of all, it is worth mentioning the possibility that the exit QE process announced by the Fed may be disorderly, giving rise to an excessive increase in interest rates (in the US, and in other countries). Financial conditions that are too tight for the rest of the world could abort a global recovery if it is not especially dynamic, particularly in the Eurozone.

Second, it is worth identifying as a risk factor the possible adjustment in growth in China and in other emerging markets. This could be the result of idiosyncratic factors, but also of dilemmas which have to be addressed by domestic policies in a less favorable global financial environment.

Lastly, the resurgence of the euro crisis remains a globally relevant risk. The authorities have to support the positive perception of the markets with decisive progress to strengthen monetary union, in particular banking union. However, there are number of elements which could lead to a shift in perception, ranging from a check in the necessary reforms to unexpected results in the review of bank balance sheets and stress tests to risk scenarios, needed for the setting up of the single banking supervisor, the ECB. Lastly, as has been shown by past experience, disagreements on the definition of policies that strengthen the euro area, in this case bank resolution mechanisms, may produce tensions and volatility in the financial markets.

3. Uruguay: Positive surprise in growth for 2Q-13

Uruguay's GDP for 2Q-13 rose 2.1% q/q, seasonally adjusted, and was twice our estimate. In year-on-year terms, GDP rose 5.6% in 2Q-13, accumulating growth of 4.8% y/y in the first half of the year. The services sectors, primarily Electricity, Transport and Communications and Trade, Restaurants and Hotels, stood out due to their good performance.

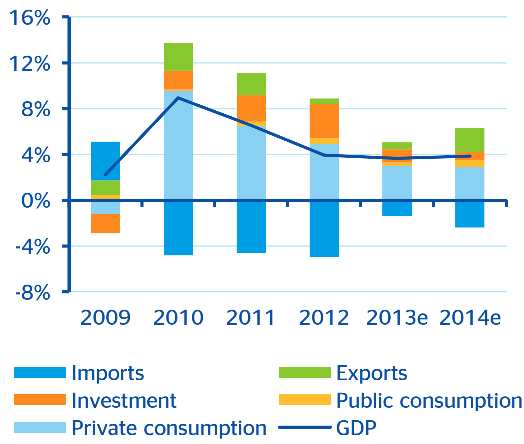
From the standpoint of demand, consumption is losing momentum, albeit at a rate lower than expected, thereby converging at similar growth rates as those reached by GDP, while investment is slowing down (see chart), evidencing the completion of the construction stage of the Montes del Plata plant (a company which cultivates forests for pulp production and export), and also the lower investments of Argentinean residents in the real estate sector (See below).

The contribution of foreign demand to growth was slightly positive due to the contribution made by soy exports. Imports have slowed, largely due to the lower necessities of importing oil due to the lack of weather problems and the slowdown in domestic demand. (See Chart 5).

We are not expecting to change our growth estimates for 2013/2014. This year would close at 3.7% given that in 2H13 we expect an adjustment due to the slowdown in private consumption from an incipient deterioration in the labor market (slight growth in unemployment and lower wage increases in real terms). Furthermore, higher inflation levels will have a negative impact on consumer confidence. On the foreign demand side, no significant recovery would be observed due to higher controls on imports in Argentina and weak growth in Brazil.

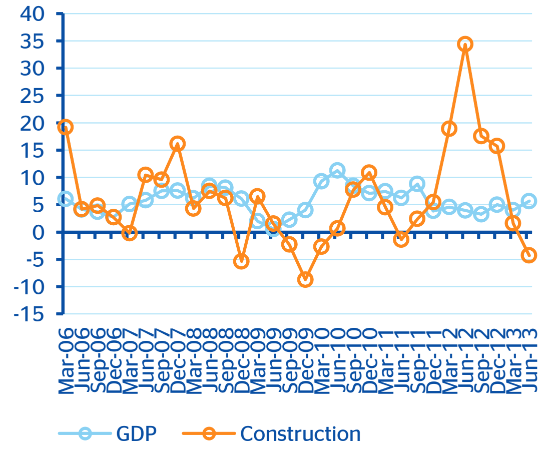
Looking ahead to 2014, our estimates still point to growth in the region of 3.9%, near to its potential and slightly above this year. We expect the tourism season to remain weak (largely due to stronger FX restrictions in Argentina), but Montes del Plata will begin to operate and thus create stronger growth in exports. Also, some of the (smaller scale) investment projects which the government currently has on portfolio and which amount to a total of USD 2.0 bn, should materialize in 2014. These projects have to be completed in the short term - otherwise they would forego their tax benefits, thereby ensuring an investment floor for the next two years.

Chart 5
Contribution to GDP



Source: Uruguay Central Bank and BBVA Francés.

Chart 6
GDP and Construction GDP (chg. change y/y)

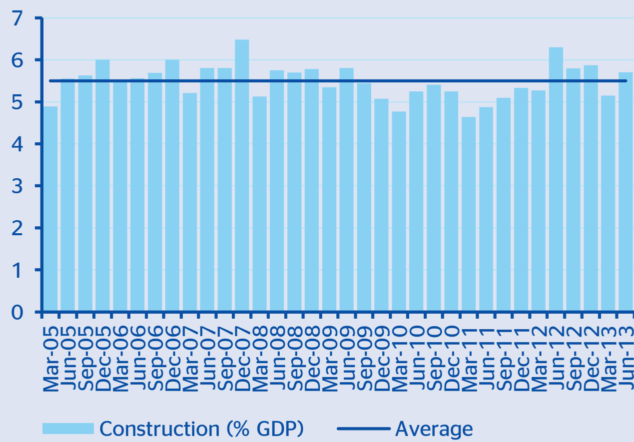


Source: Uruguay Central Bank and BBVA Francés.

Box 1. The real estate business: a change in trend?

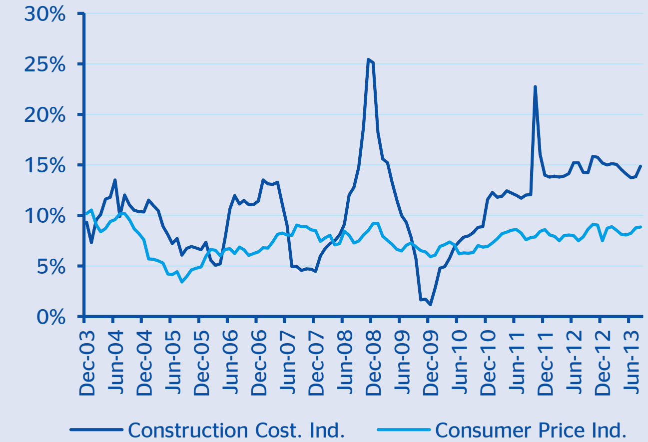
Construction represents approximately 6% of GDP (see chart 7) and in the first half of last year it reported a surprisingly buoyant performance, taking advantage of the construction of Montes del Plata and a growing flow of investors, especially from Argentina, who sought to maintain the value of their savings in upscale construction projects. Following record growth of 34.2% y/y in 2Q12, the sector plunged downwards, marking -4.3% y/y in 3Q13, given the completion of the construction stage of Montes del Plata, the reduction in investments by non-residents (due to stricter exchange controls in Argentina) and the higher construction prices in Uruguay, which, in a scenario of peso appreciation, showed a trend of the Construction Cost Index which had always been above CPI since the end of 2010. (See Chart 8).

Chart 7
Contribution to GDP



Source: Uruguay Central Bank and BBVA Francés

Chart 8
Consumer Price Indices and Cost of Construction (chg% y/y)



Source: National Statistics Institute and BBVA Francés.

The sharp halt in residential construction was notorious because part of the real estate market is designed for investors, mostly from Argentina, thus creating pockets of high value assets in the most exclusive parts of the country. Due to the imposition of foreign exchange controls in Argentina, practically all the flow which financed these developments in areas such as the seaside resort Punta del Este, or, to a lesser extent, the Montevideo coast, was cut off.

In light of this special feature of the real estate market and construction in Uruguay, Law 18.795[1] on "Access to Social Interest Housing" (VIS) was enacted in 2013 to provide an incentive for housing development in underprivileged areas. While no projects have yet been completed pursuant to this law, preliminary results appear to be optimistic, given that the National Housing Agency has received projects to build 7,115 units over the last two years, in excess of the 6,000 planned by the government for the five-year period; and 3,454 of which are already being constructed.

Although it is too early to venture that in the short term the activity created by the VIS will offset the observed fall in the other upscale residential projects, we do perceive an incipient change of trend in the construction and real estate business, which is now geared directly towards the final users (owners) rather than towards investors. A priori, this new scheme would offer a less volatile horizon and one that is more sustainable for the sector, which has a high demand whose main priority is the acquisition of their own homes.

In light of the new business architecture introduced by this law and the initial results, it is feasible to think that the real estate and the construction market is at a turning point. There is no doubt that a number of years will be required in order for this new user-centered scheme to be implemented in order to reach the necessary critical mass to offset the traditional model; but once it is reached it will be an ideal vehicle to channel savings, creating new opportunities for the group of agents involved with the sector, ranging from construction companies to banks, and so satisfy a demand which has been overlooked for years.

1: Law 18.795 stipulates tax exemption for real estate developers in order to ensure an attractive rate of return for the sale of the property or rental if the constructor decides to retain ownership.

4. Upward trend in inflation which is difficult to manage

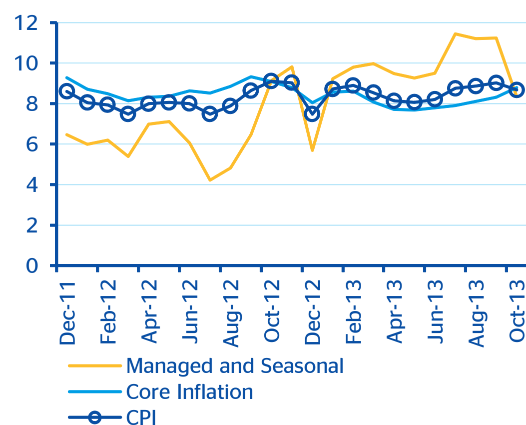
In October, inflation reached 8.7% year-on-year, a cumulative figure of 9.1% over the first ten months of the year, while for the same period of last year the figure was 9.1% y/y and 7.9% cumulative. The items which have the most impact on this rise in inflation are Foods and Beverages, with an impact of 2.4 pp in the accumulated yearly figure, followed by Housing with 2.1 pp., these two items recording price increases of 9.8% and 9.2% y/y respectively. Transport, which registered an average increase of only 0.57% per month over the twelve preceding months, rose 3.1% m/m in September and 1.1% in October due to the increase in fuel prices in mid September and the effect they had on public transport and taxi fares (See Chart 6).

The increase in prices with high seasonal sensitivity (such as fruits and vegetables) together with regulated prices (those determined by public companies, state agencies or which have a strong tax component) was significantly higher than the increase in the rest of prices since January 2013 (See Chart 9). Although core inflation[2] has remained below the headline level in 2013, indicating a certain degree of restraint in price momentum, it is important to note that since May this component has increased every month, thereby confirming concerns about the growing pace of inflation.

In view of the recent pattern of core inflation and the expected lag in the effects of Monetary Policy, we have raised our inflation estimate for 2013 to 8.7% (formerly 8.2%). This new estimate includes the effect of the fall in energy prices prompted by the application of the "Your saving is worth twice" which we expect the state electricity company to implement in Dec-13 . This plan, which provides a discount on electricity rates in view of the saving in energy compared with the previous year, has been announced as a marketing strategy by the state company but it also has an impact on CPI (as occurred in Dec-12), which is used to adjust wage agreements and government debt contracts. This may create a legal vulnerability for the government due to it being an interested party in these contracts but also "responsible" for a fall in prices. The other point is the role played by salary indexation in shaping inflation expectations.

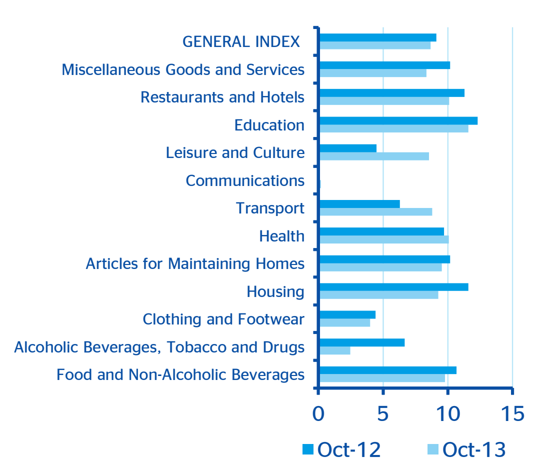
Looking ahead to 2014, we estimate inflation to slow slightly to 8.2% (formerly 7.6%) based on the Central Bank of Uruguay continuing with the contractive stance in monetary policy and on fewer increases being verified in wages in real terms and also in our estimates.

Chart 9
Inflation (chg% y/y)



Source: National Statistics Institute and BBVA Francés

Chart 10
Inflation by items (% change y/y)



Source: National Statistics Institute and BBVA Francés

2: According to own calculations. Core inflation is calculated by excluding prices with a strong seasonal component and those regulated or with a significant fiscal component from CPI.

5. Changing instruments but not trends: inflation remains above target

Beginning in July, the Monetary Policy Committee (COPOM) decided to change its monetary policy instrument from the fixing of interest rates (monetary policy rate, TPM) and focusing instead on targeting monetary aggregates[3]. It also announced that it was extending the relevant horizon of monetary policy to 24 months, and widening the target range from July 2014 on from the current 4%-6% to the former range of 3%-7%. It also stressed that the Central Bank will have less room for maneuver with the new instrument, given that important role played by the public's preferences in determining the demand for money. The Central Bank of Uruguay (BCU) considers this "opaqueness" in the final determination of inflation to be an advantage. The BCU also values the greater flexibility of the instrument and the volatility it adds to short term interest rates, making carry trade more expensive because of the increase in the risk premium due to the added uncertainty.

A brief assessment of the performance of the previous monetary policy which targeted the interest rate (TPM) comes up short, given that it failed to drive inflation towards the center of the target range defined by the monetary authority during the entire period, either through the interest rate instrument and even with the additional use of unorthodox measures. Nor did it have an effect on lowering agents' inflation expectations.

Although the limited success of using the monetary policy rate to control inflation may be due - a priori - to the lack of transmission of monetary policy through the usual channels of lending rates, due to the low credit penetration in Uruguay, two important factors have to be taken into account in this particular case. First, the main driver for the momentum in prices is salary indexation, which has registered very significant increases in real terms in recent years, so that the increase in inflation becomes less important in consumer decisions as it is offset with higher income, particularly in individuals who are unwilling to undertake debt. Second, the strong perception by agents that the Central Bank of Uruguay was in a relatively comfortable position while inflation remained below the 10% psychological threshold, without feeling the need to converge towards the lower target range. The appreciation of the peso also restricted a higher increase in the policy rate in order to avoid capital inflows which might erode the already deteriorated level of Uruguay exchange rate competitiveness.

The average market interest rate (TMM), which stood in the region of 9% in early July, responded to the change of instruments with a very high volatility. Initially explained by the idea of a strongly expansive bias monetary policy by the Central bank to help in the depreciation of the peso, it fell to 2% but after 10 days the market ran out of liquidity, raising the interbank lending rate to 35% in one day. Although the new instrument requires a learning process, the new set up of the Monetary Regulation Bills market[4] has revealed a certain degree of rigidity, determining interest rates which reflect an extra risk premium on top of the lack of experience in adjusting to the new system. This design problem was the booster for the rate increase since it left the market maker banks in a dire shortage of pesos. The volatility of interest rates would be expected to subside insofar as the Central Bank's capacity to manage the new policy and its timing improve.

The increase in interest rate was verified in the Monetary Regulation Bills (MRB) auctions where the Central Bank of Uruguay allowed rates to reach 15%; these higher rates were partially transferred to loans granted to the business segment which are already within the limit determined by the Lending Rate Ceiling of 18%; consumer lending rates have not risen yet. Then the market processed part of this volatility and the curve recovered slightly. (See Chart 12).

3: The indicator of reference is Extended M1 (M1 Ampliado) (M1'). This refers to currency in circulation, sight accounts and sight deposits. It is monitored through 3-month monthly moving averages, comparing the year-on-year variation with the target established by COPOM. The monetary authority has announced that it is committed to a contractive stance, reaching growth of 8% by Jul-15, which is the horizon for evaluating the policy. This target is consistent with our calculation of potential GDP of 4% plus 4% of inflation.

4: The reform of the money market consists of designating primary agents or market makers, with the obligation of offering in all tranches, and the rest of the banks which have to operate in the secondary market.

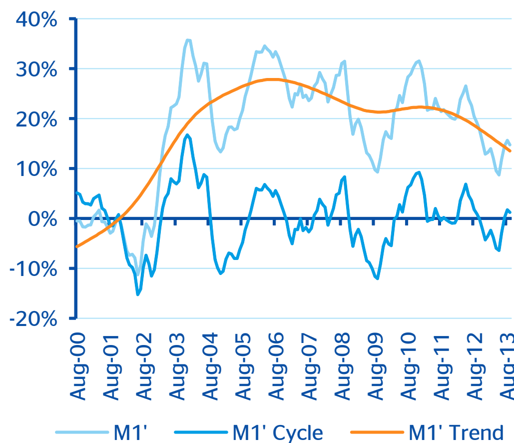
In its last meeting, the COPOM insisted once again on the contractive stance of monetary policy, and set a year on year growth target of 15%-17% for M1 for the last quarter of the year. Although the year-on-year variation suggests greater expansion, the monetary authority stated that the contractive bias is maintained taking into account seasonal factors.

At first, we can see compliance with the contractive monetary policy to a certain extent (in fact, it is less expansive). This is due to the fact that, upon analyzing the breakdown into trend and cycle of the evolution performed by the M1 COPOM (see chart 11), a marked trend slowdown is evidenced. Reaffirming the contractive stance, on September 19 the Central Bank of Uruguay increased the Marginal Lending Facility rate - or Lombard rate - for financial brokers, from 20% to 30% per annum.

Although it is still early to analyze the performance of the new instrument, given the necessary learning process engaged on both by authorities and financial agents, one priority is to construct and publish the partial monitoring indicators, and their respective targets, with a higher frequency than at present, in order to reduce volatility in the shaping of expectations.

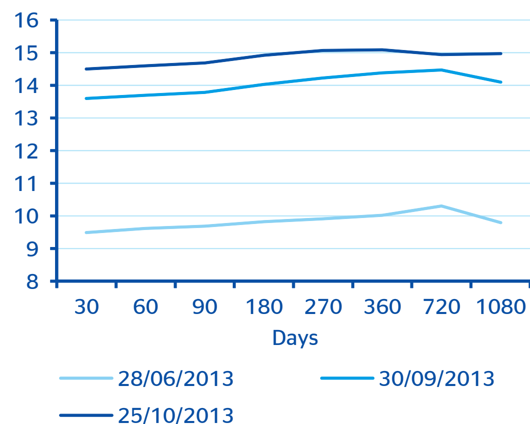
Lastly, it is crucial to note that on top of the necessary good performance of the selected Monetary Policy instrument, in order for inflation to converge towards the center of the target range it is necessary to dampen the momentum in salary indexation, for which purpose it is essential to shift negotiations towards more decentralized scenarios with productivity growth as the main driver. Furthermore, the Central Bank of Uruguay has to demonstrate that it is committed to complying with the inflation target, even at other costs, with the aim of removing the psychological 10% threshold.

Chart 11
M1'. Cycle Trend Breakdown



Source: Uruguay Central Bank and BBVA Francés

Chart 12
Monetary Regulation Bill Yield in Pesos



Source: BEVSA and BBVA Francés Research

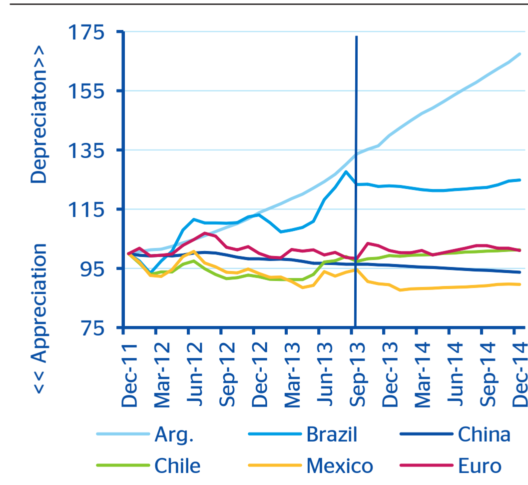
6. Higher short term FX volatility due to changes in monetary policy

After reaching a high in late May, the Uruguayan peso began to lose value against the dollar. This trend was initially due to the imposition of reserve requirements on the purchase of public securities by non-residents, implemented by the government to contain capital inflows and also to the FED's announcement of a possible start of tapering of QE3 and thus the strengthening of the dollar against the majority of emerging currencies, particularly the Brazilian real.

The Central Bank of Uruguay took advantage of this new scenario and withdrew from the foreign exchange market until the date of this report, suspending purchases of hard currency in the FX market. It is important to note that until June 6, in other words in the first half of the year (date of the last intervention), it had accumulated net purchases of USD 873 million, markedly higher than the USD 662 million accumulated during the whole of 2012.

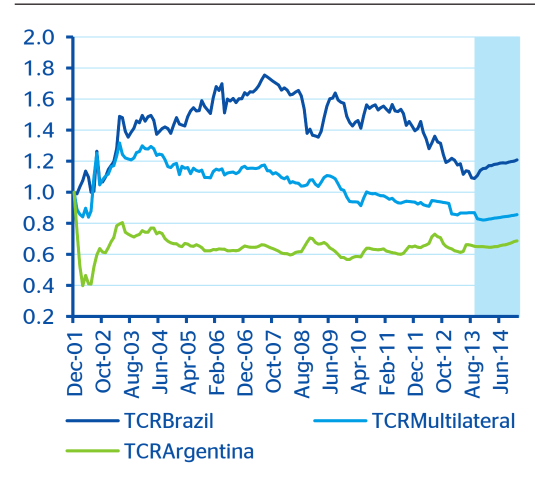
The price of the Uruguayan peso will undoubtedly depend to a large extent on what happens with the US dollar in the region, mainly in Brazil. We maintain our estimated exchange rate of $ 21.50 per USD for 2013 year end. Currently, the Uruguayan peso is slightly more depreciated but seasonally it tends to appreciate towards the end of the year (due to the tourism season, which while it will not be one of the best years, will still ensure there is an inflow of foreign exchange), leading to a devaluation of 11.5% over the full year. In 2014, we expect the peso to depreciate 9.7%, reaching a level of $ 23.6/USD as QE3 tapering becomes effective, prompting a greater appreciation of the dollar in Latin America. This would allow Uruguay to recover some of the competitiveness it has lost against its regional partners in recent years (see chart 14).

Chart 13
Interest rates: Uruguay and Region
Base Indices Dec-11= 100



Source: Haver and Research BBVA Francés

Chart 14
Real exchange rates of Uruguay
Base Indices Dec-01=1



Source: Haver and Research BBVA Francés

7. Fiscal policy… is it neutral?

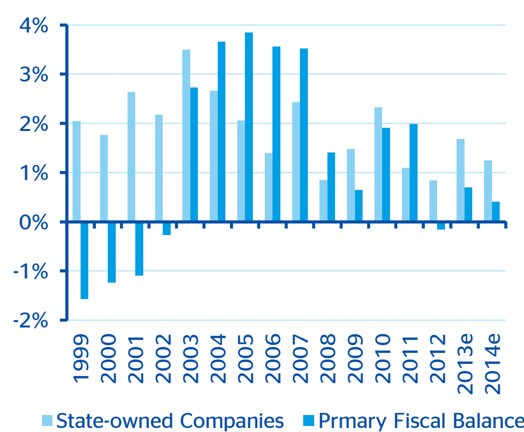
The normalization of weather conditions allowed for an improvement in state owned utilities´ profits, achieving an important contribution to fiscal results. Over the first eight months of the year, Uruguay once again achieved a primary surplus, which, according to our estimates, will be maintained until year end. However, unlike the post-2002 crisis period, this primary result falls below the interest payments on public debt. Despite the prudent debt management policies Uruguay has applied, which have reduced the weight of interest burden to 2.8% of GDP, fiscal policy is not restrictive enough to be generate a high primary budget surplus which could support a substantial improvement in fiscal solvency and help monetary policy in its effort to reduce inflation. (See Chart 15).

Thus, the improvement in the fiscal deficit which we estimate for 2013 (-2.1% of GDP vs. -2.8% in 2012) is largely due to transitory factors associated with the impact of the end of the drought on state owned energy companies. Our forecast includes extraordinary financial income at the start of the year from an advance payment by the ANCAP refinery, enabling a gain of 0.4% of GDP, and also the contributions of USD 100 and USD 50 million to the Energy Stabilization Fund (FEE), which were possible thanks to the improvement in state-owned companies' results this year. For 2014, the deficit will increase slightly, as indicated in our forecasts, to 2.3% of

GDP. Although it is an election year, we do not expect growth in spending to increase, but for revenues to slowdown along with private consumption.

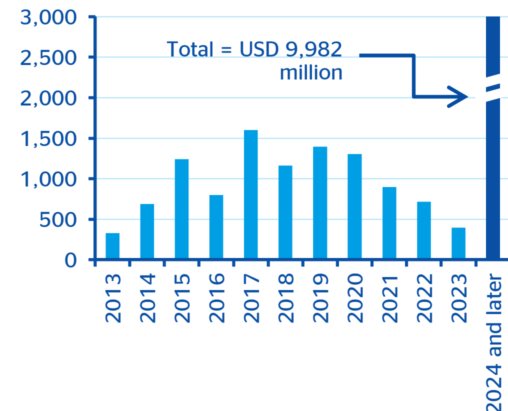
It is important to note the sound management of public debt in Uruguay, which has allowed a significant improvement in the debt profile, taking advantage of liquidity and low international interest rates, and also shifting financing towards a higher proportion of pesos vs a vs dollars. This lowers vulnerability to a worsening of the international economic scenario which could put upward pressure on the exchange rate (See chart 16). This policy also enabled the government to keep its financing needs covered in advance for a period of at least two years. According to the Central Bank of Uruguay, at June 2013 the gross debt of the Global Public Sector amounted to USD 30.877 billion (56% of GDP), the largest proportion being accounted for by the non-financial Public Sector while approximately 30% of the total is Central Bank debt.

Chart 15
Primary Fiscal Balance and Contribution of State-Owned Companies As % of GDP



Source: Research BBVA Francés and MEF

Chart 16
Central Government Debt Maturities Profile Millions of US dollars



Source: BBVA Francés Research. and Central Bank of Uruguay

8. Lower oil imports improve the trade balance

In 2013, the terms of trade will improve for Uruguay given that the fall in import prices (-4%) will be higher than the fall in export prices (-1.5%). In spite of slowing growth in both export and import volumes, there will be a reduction in the trade deficit of around USD 400 million. Exports will amount to USD 8.777 billion, while imports will stand at USD 11.090 billion, thus generating a trade deficit of USD 2.3 billion in 2013. With this result and a lower contribution from the tourism sector, the current account will improve but only up to 3.6% of GDP compared with 5.3% in 2012.

For 2014, the terms of trade will not be favorable for Uruguay, as we expect there to be a fall in export prices prompted by the fall in agricultural prices while import prices will be dominated by a slight rise in crude oil prices. Tourism will contribute a lower amount of foreign currency than in 2013 because of stronger FX restrictions in Argentina, with no evidence of a significant reduction in the appreciation of the Uruguayan peso which might attract tourism from other countries in the region, as shown in chart 12. However, there will possibly be a slight improvement in the current account (3.4% of GDP) given that in addition to being a "normal" year in terms of weather, the negative performance in the "external balance" of Montes del Plata will be reversed, since the import of capital goods will fall as the plant construction is finished and the first pulp exports get under way towards the end of the year.

Box 2. Sustainability of the Current Account

Blame it on Investment...

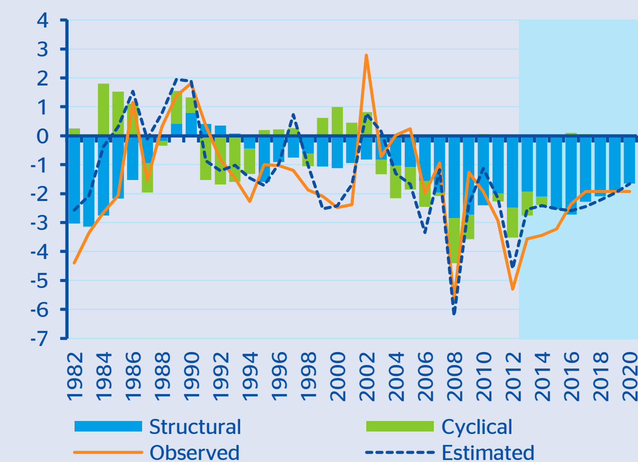
The "boom" in commodity demand which started at the end of the last decade triggered a sharp rise in prices, benefiting the raw material producing countries. However, most of the countries in Latin America which produce and export these commodities (the most important of which include soy, copper, oil) have benefited from this situation, although they have not managed to improve their external balances significantly, underlining the fact that many of these countries have a structural current account deficit.

Given that Uruguay is also affected by this situation, the question is how sustainable its current account deficit might be in the event of a "Sudden Stop" in capital inflows. In a context of gradual tapering of QE3, which we expect in the relatively short term, and in which commodities no longer have such high prices as they have had in recent months, Uruguay's external sector could become more vulnerable to a Balance of Payments crisis.

Historically, Uruguay has increased its current account deficit in periods of high growth. In the decade following the 2002 crisis, it has achieved high rates of **growth in GDP** which have coexisted with high current account deficits. As it is a small and open economy, high growth rates fuel a sustained increase in domestic absorption, which is associated with higher import levels.

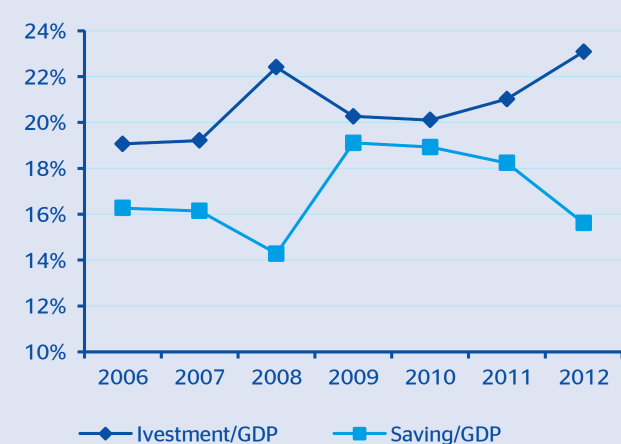
The model we have used to estimate Uruguay's structural current account forecasts that the current account deficit for coming years will be around 3% of GDP, in line with our forecasts. The deficit will be almost wholly determined by the structural component, which is dominant in practically the whole series (see chart 17).

Chart 17
Cyclical Current Account vs. Structural: breakdown. Percentage of GDP



Source: Research BBVA Francés and Central Bank of Uruguay

Chart 18
Savings and Investment
Percentage of GDP



Source: Research BBVA Francés and Central Bank of Uruguay

Uruguay's structural current account deficit, in common with many countries in the region, arises from the imbalance between savings and investment which has increased in recent years (See charts 18 and 20). Growing investment needs were and are financed with foreign savings - given that domestic savings are not sufficient - prompting a deficit in the current account.

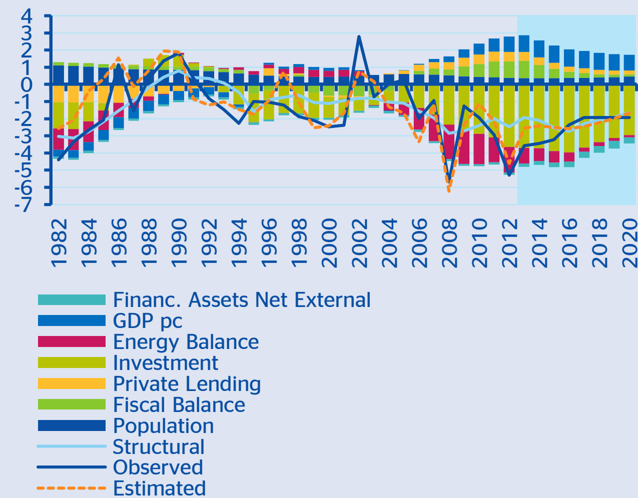
In fact, Uruguay managed to increase its **investment** rate to over 23% of GDP, mainly due to the strong inflow of capitals under the form of FDI which were used for the construction of mega-projects such as the former Botnia (now, UPM) or, more recently, and nearing the end of its construction - Montes del Plata, both of which are pulp production plants, without the low level of domestic saving being an impediment. In fact, the dynamic private consumption rates shown by Uruguay in recent years (much higher than real growth in GDP) and the accumulation of negative fiscal results have brought about a deterioration in the country's gross saving rate, leading to the need to access "foreign savings" to finance increasing levels of investment, prompting a current account deficit. This important increase in investment, which occurred from the mid 1990s, however, should be seen as a future gain in productivity and it will therefore enable higher growth in exports in the mid term, reversing the external deficit. However, the dependence on foreign savings implies a risk in terms of sustainability since a sudden stop in capital flows towards emerging countries, would

require an abrupt fall in investment ratios. It is necessary to increase domestic savings through public policies which offer an incentive to postpone present consumption.

However, there are other determining factors which help to explain the structural deficit, albeit to a lesser extent (See chart 19). An important part of Uruguayan imports is determined by oil and energy. In this regard, Uruguay's energy supply is heavily based on hydroelectricity, implying that large oil imports are needed to supply domestic demand, particularly in drought periods. The **energy balance** is clearly another determining factor for the structural deficit in Uruguay.

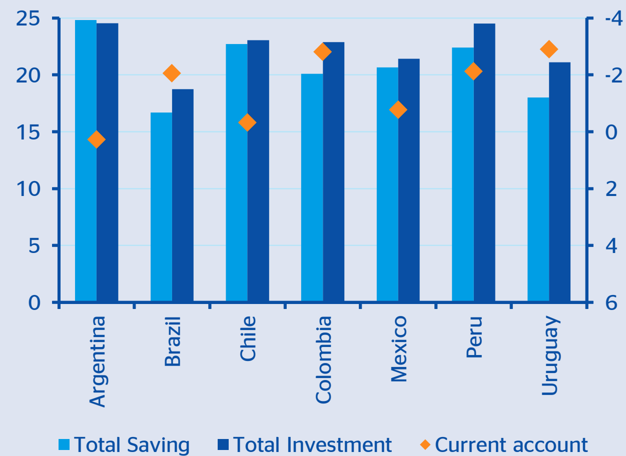
One positive contribution to the current account is given by the relatively high **GDP per capita** recorded by Uruguay (there is no catch-up effect), and, to a lesser degree, demographic variables. The demographic growth rate is low in Uruguay and dependency ratios (persons older than 65 or younger than 14 over the total population between 14 and 65 years) are also moderate. This has a positive impact on household saving capacity since it increases the ratio of working to non-working family members.

Chart 19
Cyclical Current Account: breakdown. Percentage of GDP



Source: Research BBVA Francés and Central Bank of Uruguay

Chart 20
Comparison with Latam. Percentage of GDP

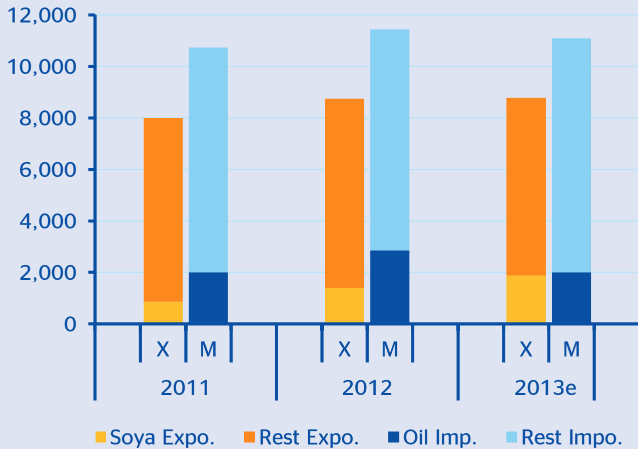


Source: BBVA Francés Research. and Central Bank of Uruguay

Uruguay did not benefit from the boom in commodity prices

The considerable increases in commodity prices and a scenario of low international interest rates enabled countries to restructure their fiscal balances. However, unlike most of the countries in the region, Uruguay did not significantly benefit from raw materials prices, given its dependence on imported oil and its late positioning as a soy exporter. In fact, the sustained increase in export prices was offset by the import prices, leaving the terms of trade virtually stable in the later period, while they rose considerably in other countries in the Region (See chart 22).

Chart 21
Share of oil in Imports and soy in Exports (US million Dollars)



Source: Research BBVA Francés and Central Bank of Uruguay

Chart 22
Terms of trade. Base Indices 2005= 100

Source: Cepal

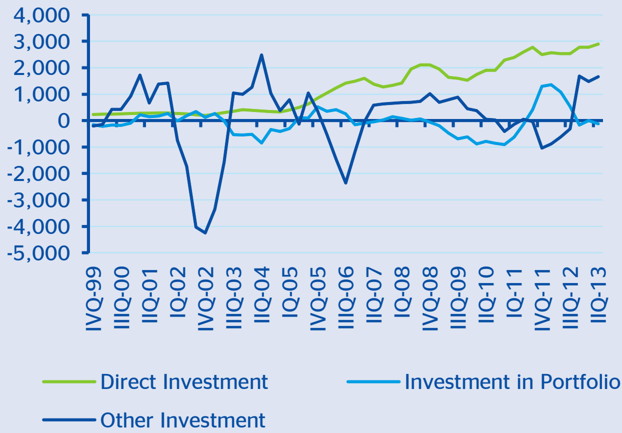
However, Uruguay is vulnerable to a correction in commodity prices, affecting both the external and the fiscal balance. On the export side, a fall in soy prices has a negative impact bearing in mind the 21.6% soy share in total exports. On the other hand, if oil prices rise (20% of imports), complications for Uruguay are greater, given this country's high level of dependence on this commodity, particularly in "dry" years when they have to replace hydro energy with other imported energy sources . Furthermore, a rise in energy prices and the need to import oil would affect not only the trade balance but also, as in 2012, the fiscal accounts given that the Government would not allow the international price hike to be fully transferred to domestic consumer prices in order to prevent an additional spike in inflation, leading to negative results for state-owned utilities. For the coming years, our forecasts for soy prices (downward) and for oil prices (slightly upward) will also have a negative impact on the external and fiscal balances, which could become even more significant in the event of adverse weather conditions which would affect not only the soy harvest but would also require higher oil imports to supply the local energy demand. This situation also compounds the problem of the lack of public savings which is also one of the causes of the current account deficit and which has deteriorated in recent years (See chart 15).

Sustainability of current account

The current account deficit is sustainable provided there are no problems in financing it regularly. In Uruguay's case, the external deficit has been financed with Foreign Direct Investment, which amounts to over 5 % of GDP, comfortably in excess of the imbalance which has to be financed (See charts 23 and 24). Only around 30% of total FDI is directed towards residential Construction, and the remaining 70% is used for productive investment, thereby ensuring higher production in the future so as to be able to balance the current higher external debt levels.

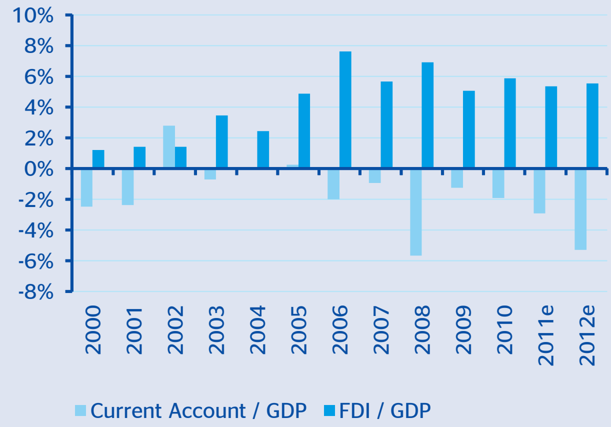
In recent years, Uruguay has benefited from an international environment of high liquidity and, thanks to a very stable and friendly business climate – including an Investment Grade rating, has received strong capital inflows. Therefore, the most likely scenario is that in the event of an external shock, Uruguay will be one of the countries which will suffer least from sudden capital outflows given that short term portfolio flows account for a low proportion of external financing. At the same time, Uruguay has taken advantage of this favorable international scenario to increase its level of international reserves to almost 30% of GDP, which, together with ready access to contingent financing lines from multilateral agencies, allows Uruguay to temporarily finance foreign imbalances in the event of a sudden stop in capital flows.

Chart 23
Breakdown of capital flows to Uruguay. Millions of US dollars



Source: Research BBVA Francés and Central Bank of Uruguay

Chart 24
Current Account and FDI in terms of GDP



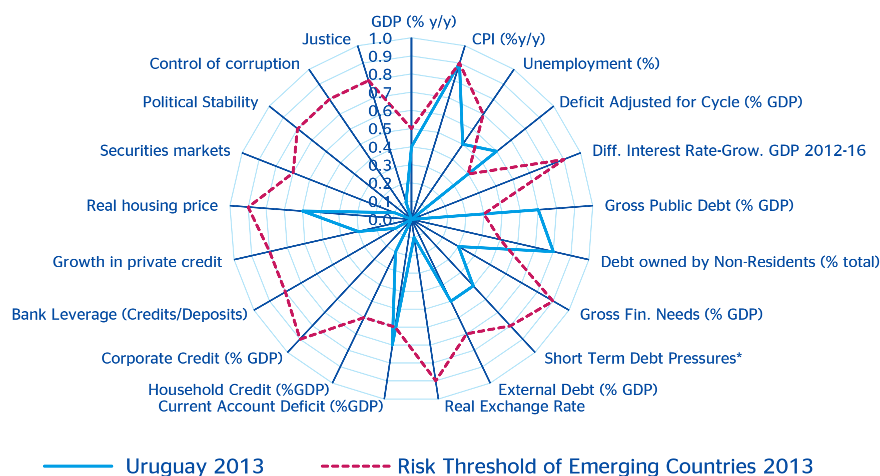
Source: Cepal

9. Uruguay less vulnerable to external shocks than other countries in the region.

Vulnerability to an external shock is relatively low in Uruguay, above all if we compare it to the risk threshold for emerging markets

The vulnerability radar (Chart 25) shows offers a static representation of how vulnerable a country can be in different dimensions, and allows us to compare it with other countries or as in this case with a risk threshold. In other words, for each variable or set of Uruguay's variables we compare the country's results to the average of the countries in the sample, in this case with emerging countries. The internal positions (close to 0) show a low vulnerability level, while those closer to 1 show a higher level of vulnerability.

Chart 25
Uruguay: Vulnerability Radar



Source: Research BBVA Frances

Vulnerability Dimensions: what is good and what is bad...

In the **Macroeconomics** area, which includes variables such as GDP, inflation and unemployment, Uruguay obtains a low degree of vulnerability because the fundamentals are solid enough so that an external shock will not result in excessive costs in social and economic terms. This is evidenced by growth in GDP of above 3% and a low unemployment rate. However, while Inflation is still below 10% per annum, its proximity to this "risk threshold" signals a red flag given that in the event of an external shock, the capacity of Uruguay to conduct an countercyclical monetary policy would be limited by this factor.

As far as **fiscal vulnerability** is concerned, Uruguay has made important progress in prudential debt management, not only by extending debt maturity, but also by changing the currency composition to achieve a lower degree of debt dollarization. Although it has shown an important improvement in recent years, debt levels are still a cause for concern: with gross public debt to GDP around 56%, above the risk threshold (43% of GDP). Furthermore, in structural terms

Uruguay has a primary fiscal deficit of 1.1% of GDP and maintains a high level of structural expenditures (wages and pension benefits which represent 31% of total spending), which makes it difficult to reduce the fiscal imbalance and raises doubts about the possibility of carrying out countercyclical policies in the event of a sudden contraction of external finance.

Although financing problems do not represent a problem for Uruguay, given that the central government financial needs are covered for a period of at least two years, the fact that an important part of the debt is owned by non-residents (foreign deposits in Uruguayan banks are calculated to amount to around USD 4.8 billion), it does make Uruguay more vulnerable than other emerging markets to a sudden stop in terms of **liquidity**. Short term debt is not a problem (due to the transactions concluded to lengthen the terms of public debt) while the Central Bank's intervention policy in the exchange market in order to prevent a greater appreciation of the peso enabled a heavy accumulation of international reserve assets which allow Uruguay to a cope with a temporary reduction of short term financing without a major disruption.

The main cause of concern in terms of **external vulnerability,** as seen in the box, is the high current account deficit, even though it can be financed with FDI.

Private sector balances in Uruguay do not show vulnerability problems in comparison with emerging countries because household and business debt levels have not reached critical levels, while banking leverage is not excessive given the low level of banking penetration. However, the balance sheet effect might be heightened in the event of a sudden devaluation due to the mismatch of currencies in terms of debt and company income.

Lastly, the three variables taken into account when considering institutional quality - Political Stability, Control of Corruption and Justice - show Uruguay to be much better positioned than the rest of emerging markets, and it is these virtues which, for example, have enabled it to reach Investment Grade status once again in 2012. This means that in a scenario of international turbulence, the flight of investors would be limited by a smaller loss of confidence and a lower spike in legal uncertainty.

10. Tables

Table 1
Macroeconomic Forecast Annual

	2010	2011	2012	2013	2014
GDP (% y/y)	8.9	6.5	3.9	3.7	3.9
Inflation (% y/y, average)	6.7	8.1	8.1	8.5	7.9
Exchange Rate (vs. USD, average)	20.0	19.2	20.2	20.5	22.6
Interest Rate (%, average)	21.1	19.0	18.6	16.7	17.1
Private Consumption (% y/y)	13.7	8.9	6.5	5.4	4.0
Government Consumption (% y/y)	1.0	3.6	5.4	4.0	2.5
Investment (% y/y)	8.1	11.4	14.2	5.0	3.0
Fiscal Balance (% GDP)	-1.2	-0.9	-2.8	-2.1	-2.3
Current Account (% GDP)	-1.9	-2.9	-5.3	-3.6	-3.4

Source: BBVA Research

Table 2
Macroeconomic Forecast Quarterly

	GDP (% y/y)	Inflation (% y/y, average)	Exchange Rate (vs. USD, average)	Interest Rate (%, average)
Q1 11	7.5	7.7	19.6	7.00
Q2 11	6.3	8.5	18.7	7.50
Q3 11	8.8	7.9	18.8	8.00
Q4 11	3.8	8.3	19.8	8.25
Q1 12	4.4	7.8	19.5	19.3
Q2 12	3.7	8.0	20.3	16.9
Q3 12	2.9	8.0	21.4	18.2
Q4 12	4.8	8.5	19.7	20.7
Q1 13	4.0	8.7	19.1	17.2
Q2 13	5.6	8.1	19.5	15.1
Q3 13	3.5	8.9	21.6	17.7
Q4 13	1.6	8.4	21.7	17.4
Q1 14	2.5	7.6	21.8	16.9
Q2 14	2.0	8.2	22.3	17.5
Q3 14	3.9	8.2	22.9	16.8
Q4 14	7.1	7.7	23.4	17.4

Source: BBVA Research

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