BBVA Research

Uruguay

Economic Outlook

December 2010

Economic Analysis

- An improved international environment, reflected in higher exports and a strong increase in investment and consumption, leading us to revise upwards our 2010 growth forecast from 6.3% to 8.8%.
- The inflation is close to the upper band of the Central Bank target range, but its monetary policy continues to be accommodative.
- Uruguay has not escaped the regional trend for upward pressure on exchange rates and this has intensified the Central Bank's interventions, though these are partially sterilized by the issue of inflation-linked bills.
- Economic growth and more efficient spending have contributed to increased fiscal solvency, although this year the improvement is mostly due to the earnings of government-owned companies recovering from transitory factors.
- The financial sector is robust, but higher economic growth has not yet been reflected in a significant increase in lending, as much of the investment is financed from external sources.
- Any renewed contraction in developed countries would only have a moderate impact on Uruguay due to the importance of oil imports and the public sector's pre-funding strategy.

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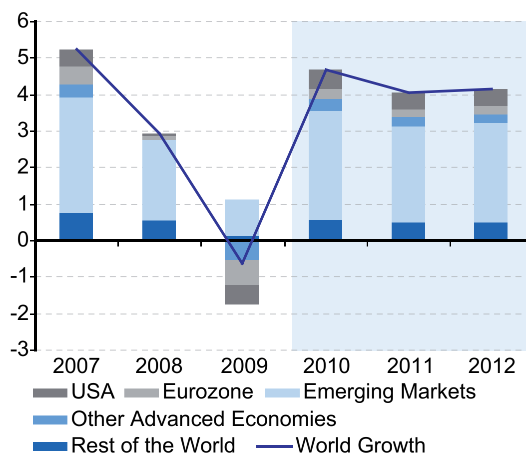
Closing date: 30 November 2010

1. Global outlook: slow north, fast south

The global economy keeps growing strongly, mostly in emerging countries, whereas cyclical and financial concerns dominate advanced economies
Global growth continues to be strong, and is expected to reach 4.7% in 2010, and 4.1% in 2011 (Chart 1), mostly unchanged with respect to our forecast three months ago. This encouraging performance is mostly due to strong outturns in emerging economies, which have been less affected by the financial crisis, as their banking sector was in very good shape, and have thus recovered rapidly. In contrast, renewed cyclical concerns in the US have joined financial concerns still dominating Europe, where macroeconomic and financial adjustments are still underway. Thus, in line with our expected scenario, the outlook for the next two years continues to highlight the growth gaps between the advanced north and the emerging south (Chart 2) even if the latter also embarks on a controlled slowdown to ameliorate the risk of overheating.

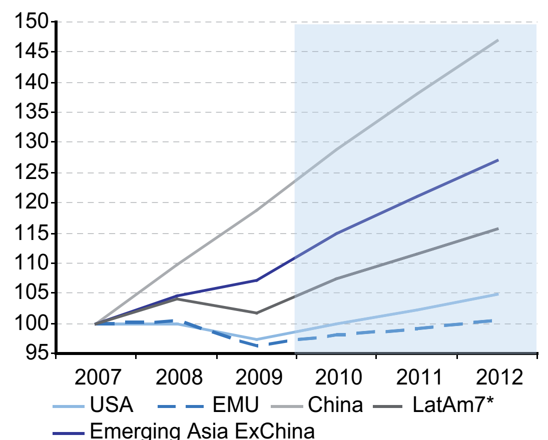
But there are also significant policy differences inside each of these groups. In the US, monetary expansion is set intensifying in relative terms with respect to Europe (and most other countries), and has thus been reflected in a depreciation of the dollar against the euro and complicating Europe's recovery. In emerging economies, a strong asymmetry in exchange rate policy between Asia and Latin America continues, forcing the latter to bear (together with the euro) a significant part of the exchange rate appreciation derived from renewed monetary easing in the US.

Chart 1
Global GDP growth and contributions



Source: BBVA Research

Chart 2
GDP level (2007=100)



* Argentina, Brazil, Chile, Colombia, Mexico, Peru y Venezuela
Source: BBVA Research and Datastream

Growth in the US will remain low given ongoing household deleveraging, but a double dip scenario is very unlikely
Over the last quarter, relatively weak indicators of economic activity in the US have raised the specter among market participants of a possible relapse into a recession –a double dip in economic activity–. The weakness observed in some key sectors that had benefited directly from fiscal support through incentives for purchases (durable goods and housing) is a strong signal that the recovery in private sector demand is still not self-sustaining. This weakness is a consequence of an ongoing household deleveraging process and a weak labor market, which will continue to push households to save more than what was observed since the second half of the 1990s. Even though this is to be welcomed in the process of rebalancing growth in the US, it increases cyclical concerns since consumption (one of the pillars of recovery in past recessions) will remain muted and will be only partially compensated by stronger investment in equipment by firms and exports.

Recent concerns about the health of the housing sector are, in our view, excessive and the possibility of a relapse into further significant real estate price drops is very small, given that prices have declined by about 30%. There are certainly elements of concern, such as elevated house inventory levels and the potential impact of an unexpected further supply of housing from new foreclosures, which may come either from increased delinquencies or due to owners walking away from increasingly negative housing equity. But there are also elements of support, such as the huge gains in housing affordability since the crisis started and the demographic trends that should help prop up demand going forward. It is true that if house prices continue to decline, it might have a non-negligible impact on consumption,

but at least the banking system seems in a relatively good shape to withstand a moderate shock to prices. All in all, the scenario of further significant price drops is highly unlikely. Instead, a period of relatively stable house prices seems more likely, while past excesses are finally reabsorbed.

Overall, the drags on consumption will be partially compensated by recovering private investment as sales improve and regulatory uncertainties diminish. This will imply an exit from the crisis in the US at a pace much lower than in previous cycles (Chart 3), as we have been forecasting for a long time. While the probability of a double dip in the US is low, in any case, the lack of strength of domestic demand will induce the US more and more to press the rest of the world (especially countries with a current account surplus and high domestic saving rates) to increase their demand and contribute to the necessary global rebalancing. The renewed monetary expansion in the US can be interpreted in this context as one way to force part of this adjustment onto the rest of the world.

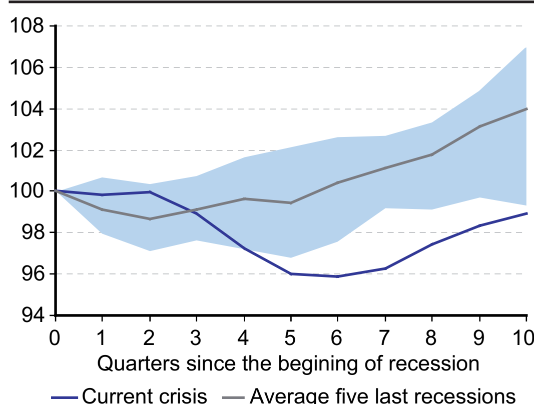
The main source of concern continues to be financial tensions in Europe. Whilst systemic risk reduced substantially between July and October following the performance of "stress testing" and progress on fiscal consolidation in the countries involved, resulting in a partial reopening of debt markets, in November there was a major outbreak of renewed financial tension that ended in an agreement of an aid package for Ireland

The Irish rescue package has failed to calm the markets and peripheral sovereign spreads remain in very high levels, showing the skepticism of the markets regarding the solvency of the involved countries and regarding crisis resolution mechanism at European level. Henceforth, further advances in fiscal consolidation in the affected countries remains crucial to sustain confidence, and will not have a large negative impact on growth beyond the short-term, as financial market stress in Europe is still the main source of risk for the region (Chart 4) especially given the link between sovereign concerns and risks to the financial sector, given their national and cross-border exposure.

In addition, the strengthening of the euro since mid-June, though it was partially compensated by the euro depreciation during the Irish crisis, means an added challenge given that best performing economies had been supported by external demand. This makes it more imperative to tackle decisively in the short run the sources of macroeconomic vulnerability in the region, namely fiscal sustainability and external imbalances, as well as avoiding further delays in restructuring the weak part of banking systems. The key is to continue rebuilding confidence to reduce market tensions and rebuild the autonomous strength of private sector demand. In addition, to sustain growth in the long run, it will be crucial to undertake much needed structural and institutional reforms, the latter especially geared towards preventing and resolving future fiscal imbalances.

Chart 3

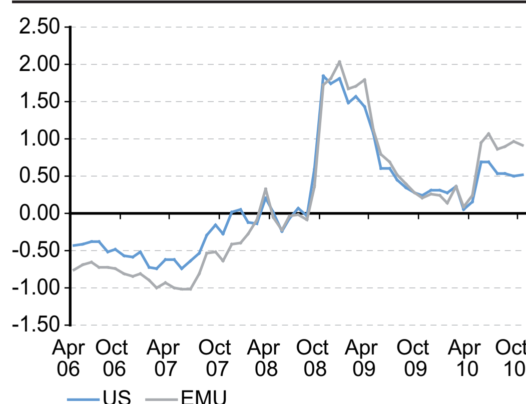
US GDP: current cycle vs. previous recessions. Beginning of each recession=100



* Shaded area: range of GDP during last 5 recessions
Source: NBER and BBVA Research

Chart 4

Financial Stress index



Source: BBVA Research

Monetary policy in advanced economies will be lax for a long time, adding pressure to exchange rates worldwide

Prospects of very low growth and subdued inflationary pressures in advanced economies will translate into low interest rates for a prolonged period in the three most important advanced areas (US, Europe and Japan). However, against the backdrop of renewed cyclical concerns and the much-reduced scope for further fiscal stimulus, markets were focused on the US embarking into a new bout of unconventional monetary easing (so-called Quantitative Easing 2, or QE2). The expectation of this further increase in liquidity lowered the exchange rate of the dollar across the board, including vis-à-vis the euro. Going forward, given that most of QE2 has been already priced in by markets, euro-dollar exchange rates will depend more on relative growth prospects (which favor the US vis-à-vis EMU) but also on the relative perception of monetary policy in both areas and the evolution of investment flows. At the same time, we expect appreciation pressures on emerging economies to continue due to increased global liquidity, stronger macroeconomic fundamentals and positive return differentials favoring renewed capital inflows.

Emerging markets face increasing policy dilemmas from strong growth, abundant global liquidity and neighbors' foreign exchange interventions

Emerging economies continue to grow strongly, with emerging Asia leading the world recovery, as discussed below. In both Asia and Latin America, private domestic demand is taking over policy-induced stimulus as the source of the recovery. Going forward, growth in Asia will slow down because of a reduction in momentum from the ending of the global inventory cycle, weaker external demand and a withdrawal of policy stimulus, thus reducing the risk of overheating. But the region will continue to contribute the most to global growth.

Both Asia and Latin America confront increasing monetary and exchange-rate policy dilemmas, between cooling strong domestic demand and preventing strong capital inflows and preserving competitiveness in foreign markets. Some countries have started introducing administrative measures to discourage strong capital inflows and some others have slowed their rate of monetary tightening.

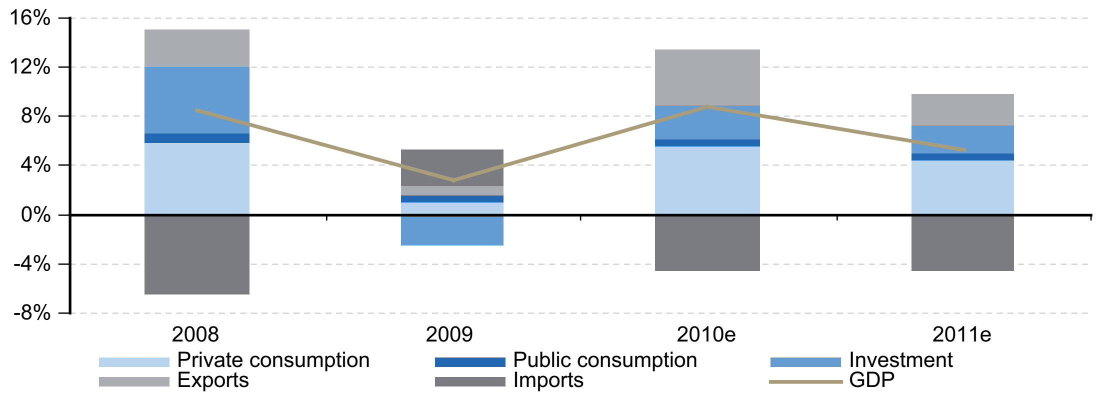
Given the relative inflexibility of exchange rates in China (and, to a lesser extent, in the rest of emerging Asia), Latin America is facing a significant part of the adjustment, to the point that further exchange-rate appreciations will start to be a problem for growth. Thus, many countries in the region are weighing further exchange rate interventions although experience shows that their effectiveness if rather limited, contributing mostly to slow down the rise in exchange rates, but not prevent them. The risk is that increased intervention in foreign exchange markets ends up sliding into retaliatory trade measures. This highlights the importance of increased exchange rate flexibility in Asia (China, in particular) as a way to provide more policy space to the rest of the world.

2. The international cycle and new investments are favorable to growth in Uruguay

After the strong dynamism of activity in the first half of the year, with a GDP increase of 9.6% compared to the same period in 2009, growth slowed in the second half of the year as many of the sectors which grew rapidly in the first half reached their pre-crisis levels. The energy sector is a clear example of this.

However, this will not stop 2010 growth from reaching 8.8%, above our previous forecast of 6.3%. Another clear example of this deceleration can be found in the industrial sector, where the meat processing industry, the biggest in the country, was also affected by the scarcity of beef products following the drought. Exports, in turn, will maintain the positive performance of the first half of the year, sustained by high commodity prices.

Chart 5
Uruguay: Contributions to GDP (changes %)



Source: BBVA Research

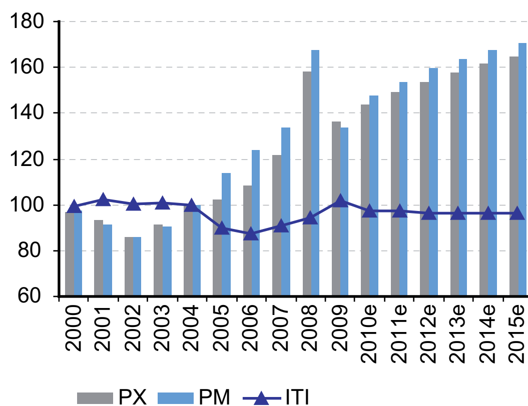
Everything points to the economy growing by 5.3% in 2011, due in part to a drag effect of around 2.6% and also the expected increase in real wages (3-4%) which, in a context of historically low unemployment levels for Uruguay, will continue to drive domestic demand. In the future, GDP will converge to its potential growth level, which is currently calculated to be around 4%.

3. Incipient changes in the pattern of exports will prevent major deterioration in the external sector

Continued high prices for most agricultural commodities, particularly soybean, are helping to make a significant change in the composition of exports by driving investment in agriculture, mostly involving capital from Argentina. So far this year, soybean exports have for the first time exceeded frozen food exports, traditionally Uruguay's main export product.

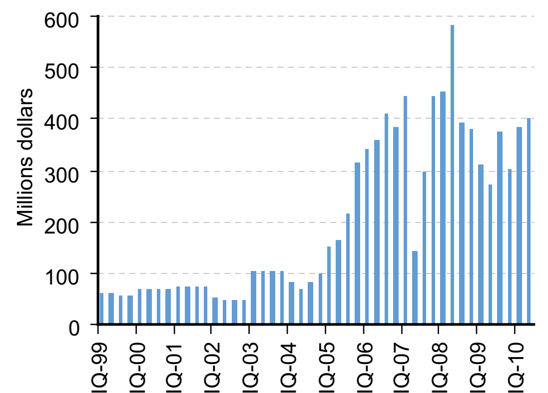
However, given Uruguay's major dependence on oil imports, and the very high price of this commodity, the trade balance has only improved to a limited extent. In fact, the current account surplus for the first half of the year was only made possible by real services, particularly tourism.

Chart 6
Evolution of the terms of trade



Source: BBVA Research, based on CIU data and own estimates

Chart 7
Foreign direct investment



Source: BBVA Research based on BCU

We forecast that the current account will be in balance by the year end. This is because the seasonal decline in tourism combined with the high level of imports (particularly oil) will lead to a trade deficit of around USD 2 billion as export growth (21%) does not keep pace with imports (24%).

Our 2011 forecast is for a slowdown in export volumes, given that another surge in agricultural production similar to the one this year is unlikely, and a slight fall in their prices; imports, on the other hand, will continue to outpace exports, in line with historical income elasticity. The increased trade balance deficit will result in a moderate deterioration in the current account balance (-0.4% of GDP). This can easily be financed by the large capital inflows, in particular foreign direct investment (FDI), which has increased significantly (see Chart 7).

In this situation of high export prices and positive flows from tourism, the performance of domestic demand is still not a significant threat to the sustainability of the foreign balance; however, careful attention must be paid to the performance of the Brazilian currency as, to a large extent, this controls Uruguayan competitiveness.

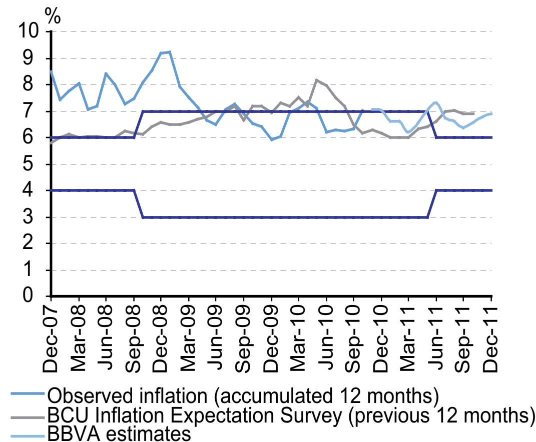
4. The strength of domestic demand puts pressure on inflation

Consumer prices have resisted falling from levels close to the higher end of the target band established by the monetary authority. As a result, inflation will be 7.0% at the end of 2010 and 6.9% at the end of 2011. The 2011 figure is outside the Central Bank's target range of 4-6% from June 2011 (Chart 8).

Inflationary pressures are mainly being generated by the growth in domestic demand, high commodity prices and, to a lesser extent, reduced supplies of meat and meat products as a result of the drought, which resulted in prices in the sector being 17.3% higher y/y in October 2010.

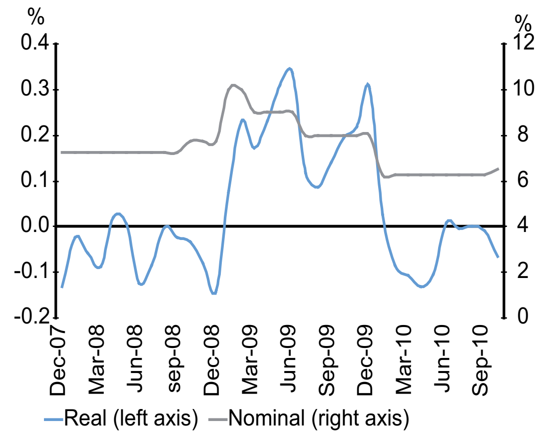
The Monetary Policy Committee (COPOM) sent out a weak signal at its last meeting on September 23 by increasing the Monetary Policy Rate only 25 bps to 6.50%. This left the rate slightly negative in real terms (Chart 9). The monetary policy rate has been slightly negative since the start of the year, whilst the M2 monetary aggregate increased at a rate of 30% year-on-year to September 2010, significantly in excess of economic growth.

Chart 8
Inflation



Source: BBVA Research and BCU

Chart 9
Monetary Policy Rate



Source: BBVA Research and BCU

Assuming a more restrictive monetary policy next year with the reference interest rate tending towards neutral, we expect that a range of unorthodox measures will be used to contain prices, given that the credit channel has little scope to affect demand further. The economic authorities will basically operate on administered prices such as energy, fuel and public transport prices and mutual medical fees. The government has also decided to extend the removal of value added tax (IVA) on certain products (mainly food) in order to reduce pressure from international prices.

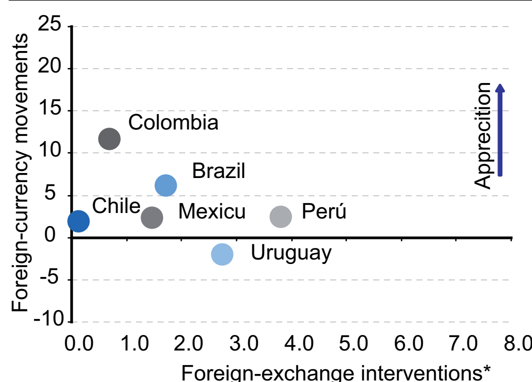
5. Monetary policy faces the classic dilemma, but with no obvious spot fires

The exchange rate has fallen slightly following the policy reversal and the “verbal” intervention in the middle of the year. However, over recent months the general weakness of the dollar has forced Uruguay’s Central Bank (BCU) to step up currency purchases again in order to sustain the exchange rate. However, we estimate that the U.S. dollar will be trading at 19.9 pesos at the end of 2010. Upward pressure will continue on the currencies of emerging markets, and central bank measures will only manage to slow the rate of this appreciation.

This year, the Central Bank of Uruguay has accumulated purchases of around USD 1.2 billion, making it one of the countries with the highest levels of foreign-exchange intervention in GDP terms in the region (Chart 10). Unlike other countries such as Brazil, it has been successful in preventing the appreciation of the peso in real terms. Nevertheless, this policy will have a high cost if the foreign exchange intervention is completely sterilized (Chart 11) due to a significant spread between the return on foreign reserves and the rates on the treasury bills issued to pay for the purchase of dollars. The stock of central bank indexed monetary-policy bills increased by 32.9% in the first three quarters of the year, resulting in a cost amounting to 0.4% of GDP; this may develop into a risk factor over the medium-longer term, although there is currently an appetite for such instruments on international markets.

Chart 10

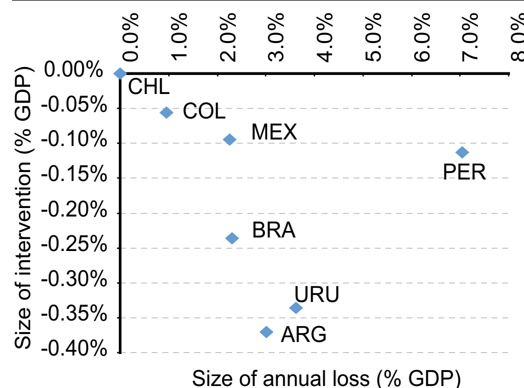
Foreign-currency movements vs. Foreign-exchange interventions*



* Foreign-exchange interventions: net purchases of foreign reserves between Jan 10 - Sep 10 (% GDP).
**Foreign currency movements: appreciation/depreciation in the real effective exchange rate between Jan 08 -Sep 10
Source: BBVA Research

Chart 11

Size of intervention vs. Size of annual loss



* Purchases of dollars: accumulated since Jan 2010 (million USD).
**Rate spread: spread between rates of return that central banks earn from their foreign reserves (FED rate: 0.5%) and the cost they must pay for interest on the debt they issue.
Source: BBVA Research y BCUI

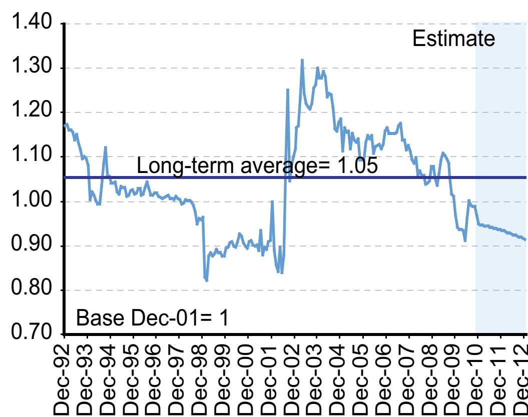
In an attempt to contain these costs, an effort has been made to carry out some of the intervention by other agents such as Banco de la República Oriental de Uruguay (BROU) instead of the Central Bank. An example is debt in assets (mortgage loan portfolio) amounting to USD 400 million which the Ministry of Finance has with BROU. This has been converted from USD into indexed units (UIs). As a result of this swap, the BROU will have to buy an equivalent amount of foreign currency on the markets for the rest of the year to offset its foreign currency position. This is significant because it amounts to about one third of the accumulated total intervention in the year. The operation will meet the dual strategic objectives of lowering the percentage of public debt held in dollars and supporting the exchange rate with less impact on the money supply.

To date, the government has concentrated its efforts to contain excess foreign currency supply on operations in the foreign-exchange markets. Uruguay does not tax capital inflows and it is very unlikely that it will decide to introduce such measures, given the respect it has always had for economic freedoms. However, this option cannot be ruled out completely if such action is taken by the majority of emerging countries. After all, such measures were explicitly accepted at the G20 meeting in Seoul dealing with the validity of using such instruments in countries under pressure from capital inflows - as is Uruguay's case.

Although the current consensus, even in Chambers of Commerce, is that there is no great concern about exchange rate appreciation at the moment, as Brazil's currency has also appreciated considerably, the country's competitiveness against its other partners has deteriorated and our forecasts point to the Real Multilateral Exchange Rate returning by 2012 to the average level seen in the 1990s.

Chart 12

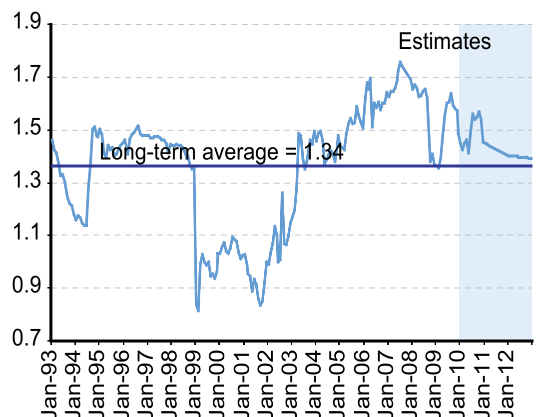
Real bilateral exchange rate with Uruguay



Source: BBVA Research

Chart 13

Real bilateral exchange rate with Brazil



Source: BBVA Research and BCU

6. In the short term, the fiscal situation provides some room for maneuver to contain inflation

The improvement in the fiscal situation is mostly due to the performance of government-owned companies, particularly UTE, as the return to normal weather enabled hydroelectric power production to be restarted, thus eliminating the high costs of replacement thermal generation. As a result, the company has returned to profit set up the counter-cyclical Energy Stabilization Fund, which will offset any losses resulting from future droughts. ANCAP's results have also improved as oil stocks were built up during the months when oil prices fell to levels considered sufficient.

Although tax revenues have continued to grow due to the increase in economic activity, a policy of greater rationalization of spending will stop expenditure increasing at rates considerably in excess of revenues. Our forecasts are based on the assumption that this trend will continue. As a result, the operational deficit will stand at around 0.5% of GDP in 2010 and will reach similar levels in 2011, with no funding problems, as the government has brought forward the issue of bonds to take advantage of favorable market conditions.

According to the 2010-2014 budget, fiscal policy aims to reduce all risks related to public-sector finance, including exchange-rate risk. As a result there will not only be a reduction in public debt ratios, but the government will increasingly use securities denominated in peso indexed units (IUs) instead of dollar debt, with the proportion of debt in the domestic currency increasing from 30% in 2009 to 45% in 2014.

Public finances face some risks over the medium term. First, the difficult negotiations in the Wage Committees may result in real wages increasing by more than productivity. Second, government-owned companies may suffer the effects of further droughts if the La Niña effect is confirmed and the government decides to offset inflation by putting off adjustments to energy and other administered prices. Although rationalization of public spending is underway, there is no anti-cyclical fiscal policy other than the recently established Stabilization Fund to offset any imbalances in periods when conditions are not as favorable as they are at present.

Table 1

Overall consolidated result (as % GDP)

	2009	2010e	2011e
Primary result	0.6%	2.2%	1.8%
Overall result	-1.7%	-0.5%	-0.1%

Source: BBVA based on Ministry of Finance and BCU data

7. Still room for an extension to financial intermediation

Strong capitalization, taken together with relevant statistical forecasts, suggests that Uruguay's financial situation is extremely solvent, with capitalization ratios double those under regulatory requirements. Delinquency rates at 1.3% in the second half of the year confirm that credit has been well managed, with the corporate sector performing better than households, where there are some signs of a slowdown in growth at the end of the first half of 2010.

However, there is still a great deal of room for financial intermediation to expand. Deposits amounted to around 42% of GDP in 2010, a slight fall on the figure of 46% in 2009, due to strong GDP growth. Bank balance sheets contain some potential liability problems in the event of being stressed, as they contain a high degree of current account deposits and a rate of dollarization of 77%.

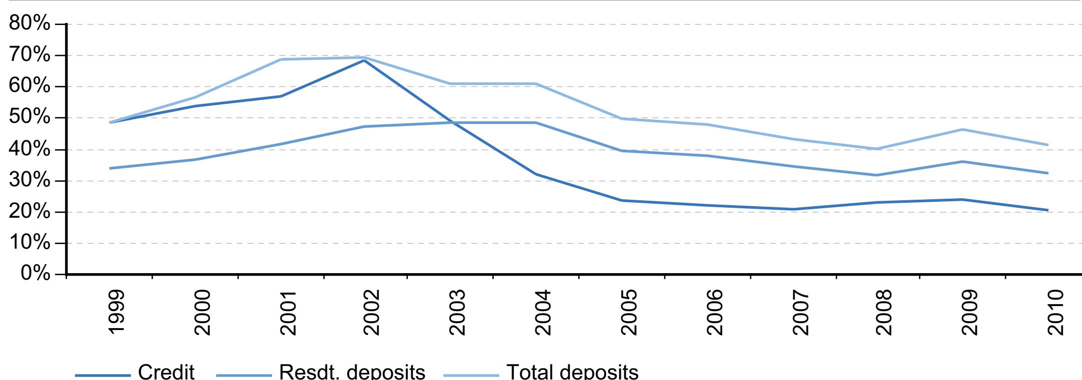
Lending increased by 16.7% year-on-year, with the largest increase being in the household sector where there was a 20.0% increase, mainly in mortgage lending and credit cards. Despite work on many investment projects, corporate lending has not increased to the same extent due the projects being financed by foreign parent companies or institutions. Consumer finance in Uruguay is strongly supported by the "parabanking" system, which competes directly with the banks. This channel is used by the public through habit and because it is easy to access in technical terms.

Over the coming months a great deal of political debate will focus on banking secrecy, because of the need for Uruguay to be removed from the OECD's "gray list" of tax havens. Under a current bill that has already been approved in part by the Senate, income tax would be charged on the interest from deposits of residents abroad and banking secrecy would be made more flexible.

Assuming the maturity of Uruguay's lawmakers, we assume that they will end up with a legal system which enables its highly valued banking secrecy to be maintained in a way that is compatible with the standards required by the international financial system. The qualitative improvement in the system is certain to outweigh the costs resulting from the impact of the legislation involved.

Chart 14

Credit and deposits as % of GDP



Source: BBVA Research

8. Further setbacks in the developed world would only have a moderate effect on Uruguay

Any return to recession in the global economy would impact on Uruguay's economy through both trade and financial channels. However, we expect any impact to be limited in both cases. In terms of the balance of trade, a fall in commodity prices might actually be beneficial for Uruguay, given the importance of oil imports in the total. In fact, in the 2009 crisis there was a paradoxical improvement in the terms of trade, as export prices fell by 8% and import prices by 16%. This situation should be repeated in the event of any further global recession, as there have been no structural changes to Uruguay's foreign trade to affect the above analysis. As a result, the slowdown in growth required to prevent a major deterioration in the current account would be quite moderate.

In terms of the financial channel, any increase in risk aversion internationally would probably lead to a reduction in capital inflows and reduced pressure on the exchange rate. However, if this is not prolonged, it would not result in any major problems for funding the public sector, given the pre-funding system it has introduced. Furthermore, given the stability of its macroeconomic policy and the robustness of its institutions, Uruguay would have no difficulties in accessing credit from international bodies in the event of a more lasting deterioration in voluntary funding.

9. Tables

Table 2

Macroeconomic Forecast Annual

	2009	2010e	2011e
GDP (% y/y)	2.9	8.8	5.3
Inflation (% y/y, average)	7.1	6.7	6.6
Exchange Rate (vs. USD, average)	22.5	20.0	20.0
Interest Rate (%, average)	8.7	6.3	7.1
Private Consumption (% y/y)	1.5	8.0	6.5
Government Consumption (% y/y)	5.2	5.0	5.0
Investment (% y/y)	-10.7	13.8	11.0
Fiscal Balance (% GDP)	-1.7	-0.5	-0.1
Current Account (% GDP)	0.8	-0.2	-0.5

Source: BBVA Research

Table 3

Macroeconomic Forecast Quarterly

	GDP (% y/y)	Inflation (% y/y, average)	Exchange Rate (vs. USD, average)	Interest Rate (%, average)
Q1 09	2.6	8.2	23.5	9.7
Q2 09	1.1	6.7	23.7	9.0
Q3 09	2.8	7.1	22.7	8.0
Q4 09	4.7	6.3	20.3	8.0
Q1 10	8.8	6.7	19.6	6.3
Q2 10	10.4	6.9	19.6	6.3
Q3 10	8.2	6.3	20.8	6.3
Q4 10	7.8	6.9	20.1	6.5
Q1 11	7.9	6.5	19.9	6.8
Q2 11	4.9	7.0	19.9	7.0
Q3 11	4.6	6.4	20.0	7.3
Q4 11	4.1	6.7	20.0	7.3

Source: BBVA Research

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