Country report

URUGUAY

Summary

Uruguay's economy grew rapidly in 2010, fuelled by both domestic and external demand. There is now some overheating risk, as inflation has increased above target in early 2011, while unemployment has reached historically low levels. Further monetary tightening is therefore likely. Public debt is still quite high, but has decreased as a percentage of GDP. Former guerrilla fighter José Mujica has continued the government's investment-friendly policies and the country continues to attract large inflows of FDI. However, Uruguay's dependence on agricultural exports and Argentina remains a weakness. In 2010 Uruguay posted a small current account deficit. Foreign reserves have grown in recent years, while external debt has gone down. A significant part of credit is denominated in USD, but liquidity and capital ratios within the banking sector are high.

Things to watch:

- Prices of agricultural commodities, Uruguay's most important export products.
- Economic sentiment in Uruguay's large neighbours Argentina and Brazil.
- Inflation, as the economy is running close to full capacity.

Author: **Herwin Loman**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-31105
H.Loman@rn.rabobank.nl

Uruguay

National facts	
Type of government	Constitutional republic
Capital	Montevideo
Surface area (thousand sq km)	176
Population (millions)	3.3
Main religions	Roman Catholic (47%)
	Atheist/agnostic (17%)
Main ethnic groups	White (88%)
	Mestizo (8%)
	Black (4%)
Head of State (president)	Jose Mujica Cordano
Head of Government (PM)	Jose Mujica Cordano
Monetary unit	Peso (UYU)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	41	0.07
Nominal GDP at PPP	48	0.06
Export value of goods and services	10	0.06
IMF quotum (in mln SDR)	307	0.14
Economic structure	*2010*	*5-year av.*
Real GDP growth	8.3	6.0
Agriculture (% of GDP)	9	9
Industry (% of GDP)	23	23
Services (% of GDP)	68	68
Standards of living	*USD*	*% world av.*
Nominal GDP per head	12192	124
Nominal GDP per head at PPP	14269	122
Real GDP per head	7013	88

Social and governance indicators	rank / total
Human Development Index (rank)	52 / 169
Ease of doing business (rank)	124 / 183
Economic freedom index (rank)	33 / 179
Corruption perceptions index (rank)	24 / 178
Press freedom index (rank)	37 / 178
Gini index (income distribution)	47.06
Population below $1 per day (PPP)	0.02

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Brazil	20	Argentina	20
China	11	Brazil	16
Argentina	5	China	10
Venezuela	5	US	9
Main export products (%)			
Meat & products			19
Processed rice			6
Wool & products			3
Hides & skins			3
Main import products (%)			
Intermediate goods			60
Consumer goods			24
Capital goods			17
Openness of the economy			
Export value of G&S (% of GDP)			25
Import value of G&S (% of GDP)			23
Inward FDI (% of GDP)			4.1

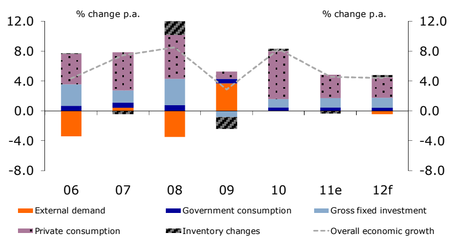
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Uruguay was one of the fastest growing countries in Latin America in 2010. The economy grew by 8.5%, driven by both external and domestic demand. It was not the first year the country experienced a favorable economic development: the country managed to grow by 2.9% in crisis year 2009, while the annual average real GDP growth rate was 6% in the past 5 years. Thus, the country has been able to recover vigorously from the financial crisis it experienced in the beginning of this century, when Argentineans massively took away their savings at Uruguayan banks and Uruguay's government was forced to restructure its debt. Growth is likely to slow down to roughly 4-5%, as unemployment has reached historic lows. In the past years, the country attracted a lot of foreign direct investment. A large part of this investment went into the important agricultural sector, with productivity and production in this sector increasing rapidly as a result. There is also a lot of attention among investors for the paper and pulp sector, with Finnish company Stora Enso and the Chilean firm Aruaco announcing a USD 1.9bn investment in a pulp mill in April 2011 for instance. Once finished, this mill is likely to add 2% to GDP annually, and, as it will produce for the world market, the mill will also help to diversify Uruguay's export base. Moreover, foreign companies have also done a significant amount of investment in facilities which use Uruguay as an export hub for the Mercosur countries, which is a favorable development, as it helps to make the economy less reliant on agriculture. Uruguay has relatively strong institutions. After Chile, it is the South American country with the best ranking on the Corruption Perceptions Index, and also scores well on other social and governance indicators, except on the Ease of doing business index.

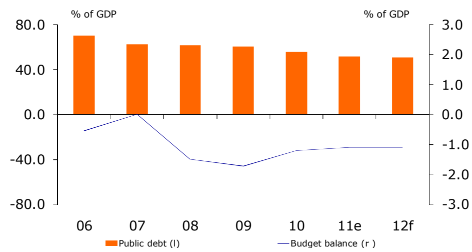
However, the country is vulnerable due to the small size of its economy and its dependence on exports of agricultural products and tourism. Furthermore, Uruguay is still dependent on Argentina, which is a weakness, given the unpredictable and unsustainable economic policy mix its southern neighbor is implementing. This is demonstrated by the fact that the import restrictions Argentina implemented in early 2011 are likely to reduce Uruguay's earnings from exports to Argentina by 20%. However, the overall dependence on Argentina has been reduced significantly, with Argentina now accounting for a much smaller percentage of good exports than a decade ago. Moreover, Argentineans now account for 21% of all deposits within the banking sector, down from 46% in 2001. The dollarization rate of the banking sector has also gone down, but is still high, with 81% of deposits and 51% of credits denominated in foreign currency in October 2010. This remains a weakness, just like the low profitability of the private banks in Uruguay. However, the banking sector is well capitalized and also enjoys good liquidity, while the number of non-performing loans is low. Moreover, as a percentage of GDP, the banking sector is now much smaller than during Uruguay's financial crisis in the first years of this century, which reduces the potential impact on the economy of problems in the financial sector.

Chart 1: Growth performance



Source: EIU

Chart 2: Fiscal position



Source: EIU

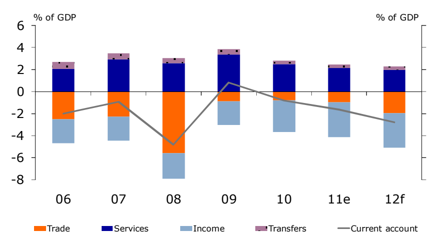
Political and social situation

Uruguay's political stability is high. Since 1 March 2010, José Mujica has been Uruguay's president. He is leading the Frente Amplio, a broad coalition consisting of 21 parties ranging from the center-left to the radical left. The Frente Amplio has been in power since 2005, when it became the first left-wing government in Uruguay's history. José Mujica succeeded the very popular Tabaré Vázquez as president in 2010, as Uruguay's constitution does not allow an immediate re-election of the president. When former guerilla fighter Mujica took power there were fears within the business community that he would implement radical policies. However, he has continued Uruguay's successful economic policies. However, it will be hard for him to deliver on his promises of reform of the civil service and the education system, due to opposition from some of his coalition partners and the trade unions. The main opposition party, the Partido Nacional, is weak and divided, but relations between the coalition and the opposition are relatively good. The next general election is scheduled for October 2014. Thanks to its relatively high standard of living and good education and health, Uruguay has the highest score within Latin America on UNDP's Human Development Index. Income inequality is less extreme than in most other Latin American countries, but is still high. Internationally, Uruguay's most important partners are its large neighbours Brazil and Argentina. José Mujica has a close relationship with both the presidents of both countries, even as Argentina's unpredictable policies sometimes cause some difficulties. A long standing dispute with Argentina over a Uruguayan paper and pulp mill was resolved in December 2010, at least at the central government level. Relations with other Latin American countries are generally pragmatic.

Economic policy

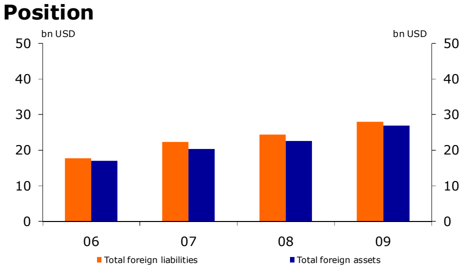
Uruguay's government has investor friendly policies, as it aims to attract more foreign direct investment, in particular in productive sectors which create employment. The government is trying to boost the attractiveness of Uruguay by improving the weak infrastructure through public-private partnerships. In particular the electricity, railroad and port sectors have been targeted. Just like in neighboring Brazil, public investment has traditionally been low in Uruguay. At the same time, Uruguay is spending a relatively high amount on social policies. Like many other emerging markets, Uruguay has been confronted with rising inflation. Inflation increased to 7.3% year-on-year (yoy) in January 2011 and 7.7% yoy in February 2011, thus breaking the central bank's 3-7% inflation target. For some time the central bank kept the benchmark interest rates at 6.5%, as it seemed unwilling to let the peso appreciate further, as Uruguay already experienced a real appreciation of 13.4% yoy in 2010. However, in March 2011 the central bank hiked its main policy rate with 100bp to 7.5% citing the increase of the inflation rate. This increase was partially a result of higher food prices. However, as we already mentioned, it also reflects a tight labor market. Furthermore, credit has been growing rapidly recently with nominal year-on-year growth at 21% in January 2011. Moreover, fiscal policy has also played a role, as public spending had increased by 20% year-on-year in January 2011. However, a rather conservative budget rule was approved in December 2010. Just like in the past years, Uruguay will post a small budget deficit in 2011. Thanks to the high growth rate of the past years, government debt has decreased as a percentage of GDP from 70% in 2006 to 56% in 2010. Nonetheless, this debt ratio is still rather high. What is more, government debt is predominantly denominated in foreign currency. However, the maturity profile of the debt is good. The average maturity of government debt is more than twelve years, which is very long. As a result, in the coming years only 5% of the total debt will be maturing per year. Furthermore, almost all loans have fixed interest rates. Besides, the government has large cash reserves. As a result, overall sovereign risk is moderate. Both Moody's and Fitch have upgraded Uruguay's sovereign rating in the past year, leaving the country close to (re)obtaining investment grade.

Chart 3: Current account



Source: EIU

Chart 4: International Investment Position



Source: EIU

Balance of Payments

Primarily thanks to its tourism industry, Uruguay has a surplus on the services account, which helps to cover a deficit on the income account. Mostly due to a deteriorating balance on the trade account, Uruguay's current account deficit is likely to increase in the coming years. However, we consider the fact that Uruguay has been able to attract large inflows of foreign direct investment (FDI) an important risk mitigant. In 2010, the country received foreign direct investment inflows equal to 4.1% of GDP. Inflows are projected to continue to exceed the current account deficit, even as the latter increases. Important threats to Uruguay's balance of payment position are a sharp fall of agricultural commodity prices and/or economic problems in its large neighbors Argentina and Brazil.

External position

Uruguay's external position has improved in recent years. Firstly, foreign reserve levels have gone up strongly, except for a small reduction in 2010. As a result they were equal to almost 10 months of imports or three times the debt service in 2010, which means that Uruguay has a relatively good liquidity ratios. Secondly, the foreign debt to GDP ratio has also gone down rapidly, from 51% of GDP in 2006 to 31% of GDP in 2010. Almost all foreign debt is public debt. Thirdly, the International Investment Position (IIP) of Uruguay has also improved recently. The IIP has not only become less negative, but the risk profile of the foreign assets and liabilities has also become better. Thanks to the large FDI inflows, the share of FDI stock in total liabilities has gone up from 15% in 2005 to 33% in 2009. At the same time, the liquidity of Uruguay's foreign assets has improved, with foreign reserves accounting for 30% of total foreign assets in 2009, against 18% of total foreign assets in 2005.

Rabobank

Uruguay

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	4.3	7.5	8.5	2.9	8.3	4.6	4.4
Consumer prices (average % change pa)	6.4	8.1	7.9	7.1	6.7	7.7	6.9
Current account balance (% of GDP)	-2.0	-0.9	-4.8	0.8	-0.8	-1.6	-2.8
Total foreign exchange reserves (mln USD)	3085	4114	6353	8029	7732	8200	9000
Economic growth							
GDP (% real change pa)	4.3	7.5	8.5	2.9	8.3	4.6	4.4
Gross fixed investment (% real change pa)	17.4	8.9	18.7	-4.0	5.8	6.5	7.2
Private consumption (real % change pa)	5.8	7.2	8.4	1.5	9.2	4.6	3.8
Government consumption (% real change pa)	6.7	6.5	6.8	5.2	4.0	4.5	4.0
Exports of G&S (% real change pa)	3.2	7.4	10.1	2.5	10.7	5.3	5.8
Imports of G&S (% real change pa)	15.3	5.7	21.0	-8.6	10.3	5.5	6.9
Economic policy							
Budget balance (% of GDP)	-0.5	0.0	-1.5	-1.7	-1.2	-1.1	-1.1
Public debt (% of GDP)	70	62	62	60	56	52	51
Money market interest rate (%)	1.6	4.1	9.8	8.6	8.1	8.7	9.4
M2 growth (% change pa)	22	31	17	15	31	19	17
Consumer prices (average % change pa)	6.4	8.1	7.9	7.1	6.7	7.7	6.9
Exchange rate LCU to USD (average)	24.1	23.5	20.9	22.6	20.1	19.2	19.2
Recorded unemployment (%)	10.9	9.2	7.6	7.3	6.5	7.1	6.9
Balance of payments (mln USD)							
Current account balance	-392	-220	-1503	259	-332	-790	-1490
Trade balance	-499	-545	-1730	-275	-318	-470	-1040
Export value of goods	4400	5100	7077	6389	7959	9820	10290
Import value of goods	4899	5645	8807	6664	8277	10290	11330
Services balance	409	703	804	1071	1033	1040	1070
Income balance	-428	-516	-727	-679	-1168	-1520	-1700
Transfer balance	126	137	150	142	121	150	170
Net direct investment flows	1495	1240	1839	1244	1646	1940	2220
Net portfolio investment flows	1686	1151	-574	-738	-625	-30	-300
Net debt flows	66	1106	-209	2159	-363	480	600
Other capital flows (negative is flight)	-2843	-2245	2686	-1246	-620	-1140	-220
Change in international reserves	12	1031	2239	1678	-294	460	800
External position (mln USD)							
Total foreign debt	10107	11488	11049	13228	12863	13340	13940
Short-term debt	739	908	817	1125	1262	1150	1280
Total debt service due, incl. short-term debt	3727	1966	2391	1982	2591	2940	2630
Total foreign exchange reserves	3085	4114	6353	8029	7732	8200	9000
International investment position	-712	-2029	-1750	-961	n.a.	n.a.	n.a.
Total assets	17013	20324	22602	26927	n.a.	n.a.	n.a.
Total liabilities	17725	22353	24352	27888	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-2.5	-2.3	-5.5	-0.9	-0.8	-1.0	-1.9
Current account balance (% of GDP)	-2.0	-0.9	-4.8	0.8	-0.8	-1.6	-2.8
Inward FDI (% of GDP)	7.5	5.6	5.9	4.0	4.1	4.0	4.1
Foreign debt (% of GDP)	51	48	35	42	31	28	26
Foreign debt (% of XGSIT)	151	144	108	143	118	102	101
International investment position (% of GDP)	-3.6	-8.5	-5.6	-3.0	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	56	25	23	21	24	23	19
Interest service ratio incl. arrears (% of XGSIT)	11	9	6	6	5	4	4
FX-reserves import cover (months)	6.3	7.3	7.5	12.4	9.7	8.4	8.3
FX-reserves debt service cover (%)	83	209	266	405	298	279	342
Liquidity ratio	140	176	157	226	213	192	186

Source: EIU