

Investment Risks in Uruguay By Patti Mohr

In the wake of the 2008-2009 global financial crisis, global investors are revising their strategies. Previously attractive locations now carry more risk and fewer returns. Meanwhile, the developing world has continued to grow despite the global downturn of growth. And some advisors suggest that it is now less risky to acquire debt in emerging markets than it is to buy U.S. debt.¹

One area investors are examining is Latin America, where the impact of the financial crisis appears to have been shallow and short. Many countries in the region are now positioned for positive growth. Uruguay is an attractive destination for savings because its economy promises returns on both financial and capital investments. Inflows of capital are moving into Uruguay from several sources: private equity firms looking for undervalued real estate; companies seeking homes for their production of environmentally-hazardous paper and pulp materials; and bond and currency investors.

Uruguay was not highly leveraged before the crisis hit, so its economy was able to rebound quickly from the global credit crunch. Furthermore, over the past several years, it has improved its investment climate considerably by curbing inflation, strengthening its currency and reforming bank regulations.

National Production

Uruguay is a small country with a correspondingly small economy. It is similar in size to Kenya, Latvia and Costa Rica. In broader terms, its economy is less than one-four-hundredth—or 0.23 percent—that of the U.S. GDP.²

2008	GDP	GDP PPP
Dollar amount	\$32 billion	\$42.5 billion
Rank	81/186	84/176

Source: World Bank, WDI database, Sept. & October 2009

¹ “Investment climate shifting back to emerging markets.” June 26, 2008. Financial Adviser.

² World Bank, WDI

Per Capita: On GNP per capita basis, Uruguay produces \$8,260 per person. That figure increases considerably when domestic prices are taken into account because the cost of living in Uruguay is less expensive than it is in the United States. Therefore, when GNI per capita is converted into U.S. dollars (using the purchasing-power-parity exchange rate method), annual output rises to \$12,540 per person. Consumers have more bang-for-the-buck in the domestic Uruguayan economy.

	GNI per Capita (Atlas method)	GNI per Capita (PPP)
Dollar Amount	\$8,260	\$12,540
Rank	80/210 countries	84/210 countries

Source: World Bank, Oct. 2009

National Income: In contrast to many developing countries, the statistical estimate of Uruguay's national welfare declines when national income is taken into account. Its GNI, gross national income (as adjusted for exchange rate differences using the Atlas method), was \$27.5 billion in 2008. This suggests two things: Foreign investors are receiving more annual income from their assets in Uruguay than Uruguayan savers are receiving from their foreign investments; and Uruguay has fewer nationals sending remittances back home from work abroad. Both of these assumptions can be corroborated using international data on financial flows.

Remittances: Uruguay's population is half that of Paraguay yet it receives remittances worth only a fifth of the value of those flowing into Paraguay. (See table next page.) It receives less in remittances from its two other neighbors, Argentina and Brazil. However, on a proportionate basis, it is less than those countries with a much higher populations. A separate set of data shows that \$188 million flowed into the country in 2008 via transfers while \$37 million moved out.³

	2008 Remittances	Population (domestic)

³ IMF IFS

Uruguay	\$103 million	3.3 million
Argentina	\$691 million	40 million
Paraguay	\$503 million	6.2 million
Brazil	\$5,088 million	191 million

Source: World Bank, WDI, 2009

Income: Meanwhile, that same year \$1,381 million of income moved out of the country while some \$754 moved into it.⁴ This shows the amount of earnings Uruguayan holdings paid out to foreign investors. It also reflects the fact that Uruguay is a destination for international investors. The primary vehicle for incoming savings is foreign direct investments.

Foreign Investments: Over the past decade, FDI remained in positive territory. Even during the bleakest year, 2002, FDI was \$194 million. That figure climbed to \$2.2 billion in 2008, largely because Uruguay has opened its doors to European and Japanese firms seeking a base to produce pulp and paper. The policy is noteworthy because it has created trouble with its neighbors. Argentina, in particular, has raised concerns that the mills produce environmental hazards for the geographic region. Argentina has legally challenged the projects.⁵ But after the International Court of Justice ruled against that case in 2006, foreign firms moved forward with those projects. It looks like those capital investments will only continue to grow. In fact, early this year, a Portuguese pulp and paper firm announced plans to move forward with construction of plant, now estimated to be worth \$4 billion.⁶

Infrastructure: As pulp and paper projects moved into the country, the country moved itself forward in terms of national infrastructure. In 2008, the government announced plans to construct new ports, highways and railways that would facilitate trade, especially that of agricultural goods and products like soya and beef.⁷

⁴ IMF IFS

⁵ "Uruguay Magnetizes FDI." Sept. 2008. LatinFinance.

⁶ "Regions: Americas, Latest Investments." Feb.1, 2009. FT Business. Foreign Direct Investments.

⁷ "Uruguay Magnetizes FDI." Sept. 2008. LatinFinance.

The emphasis on infrastructure could help address one of Uruguay's—not to mention the entire region's—greatest obstacle to expanding trade. High logistical costs of transporting goods impede trade and stymie economic growth throughout the region. Though Latin American exporters are geographically closer to the United States—the world's largest market—than Asian exporters, the advantage of being close is obliterated by its “poorly maintained roads, congested airports and ports, and inefficient custom services, increased shipping time and added costs,” according to a 2008 report by the Inter-American Development Bank.⁸ The impediment of poorly constructed and managed ports is especially harmful for perishable items, such as food.

Agri-Flipping: Real estate investments in crop land are booming across Latin America as large multinationals look toward the region for growth opportunities. Paris-based Pergam Finance, for example, recently invested in cropland in Argentina and Uruguay via a joint-venture with an Argentina family.⁹ And New-York based Falcon Real Estate Investment has an agricultural sub-fund that is seeking up to \$250 million for land investments in Brazil, Argentina and Uruguay.¹⁰

Private equity firms are getting in on the game in what is being described as a magnified version of a house “flipping” real estate strategy. Here's how it works: Firms like Louis Dreyfus Commodities line up private financing for projects; they purchase large plots of land; then they increase the value of the land by developing infrastructure such as roads, water and electricity; and after a few years into the project, they resell—or “flip”—the land by way of putting the project up for an initial public offering.¹¹ The flipping strategy can perhaps explain why a U.S. investment firm recently acquired a New Zealand firm's stake in a dairy agribusiness.

Investment (foreign and domestic): Thanks mainly to increased government spending on infrastructure, capital investments are on the rise. Overall, gross capital

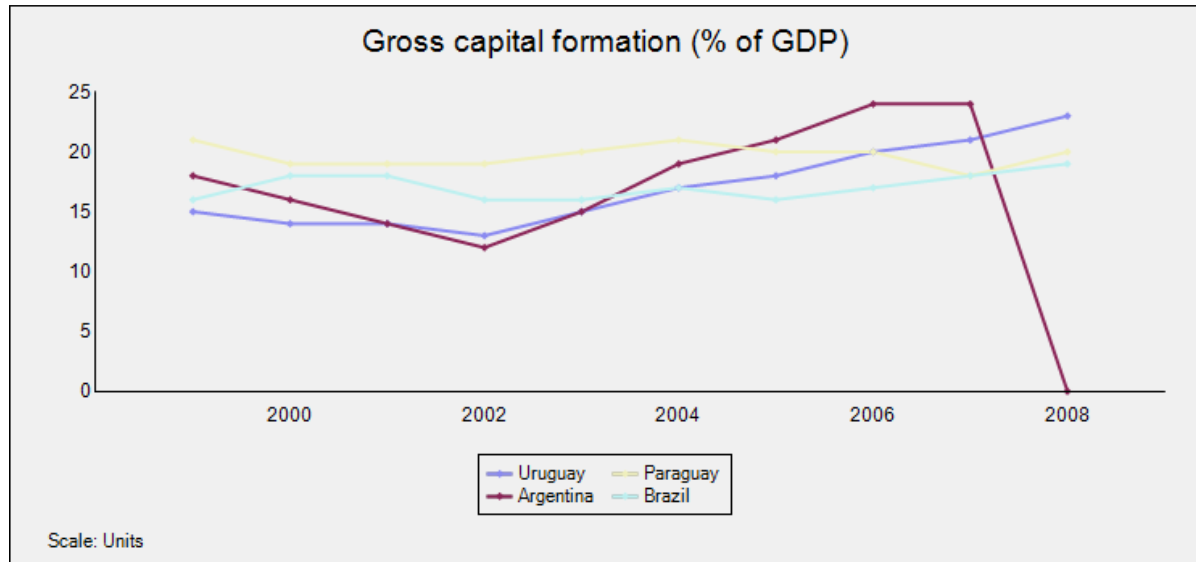
⁸ “Poor logistics hindering Latin American economy; Improving the area's ports would drastically boost trade prospects.” Oct. 1, 2008. Lloyd's List.

⁹ “Bargain Farmland Sought; New Global Players.” National Post's Financial Post & FP Investing (Canada). July 7, 2008.

¹⁰ “LatAm Private Equity: Eye on the Prize.” June 2009. Latin Finance.

¹¹ “Flipping crops.” Sept. 2008. Latin Finance.

formation in Uruguay by public and private entities has steadily grown and has outpaced similar investment in neighboring countries. (See chart below.)



Source: World Bank, WDI, 2009

Specific data shows that annual gross capital formation expanded threefold in less than a decade. It grew from 31 billion pesos per year in 2001 to 99 billion pesos in 2008.¹² Needless to say, this expansion has helped increase Uruguay's annual output. It is interesting that capital formation in Uruguay is larger than they are in other regional economies when it is measured as a percent of GDP.

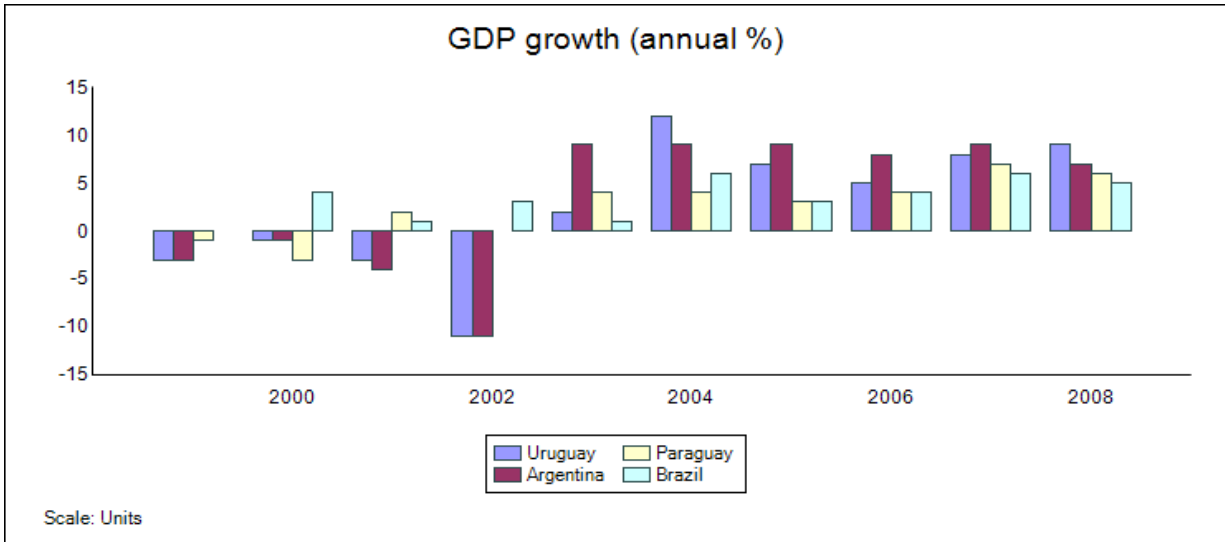
Measures of Growth

Economic growth rates are relatively strong. However, they appear fluctuate more from year to year than they do in other countries, suggesting there is no normal rate of long-term growth. In some years 2 to 3 percent growth seems the norm, while other periods suggest that 8 percent is the average. They have generally remained in positive territory, at times increasing to high levels. GDP growth reached a peak of 8.9 percent in 2008.

¹² IMF IFS, 2009

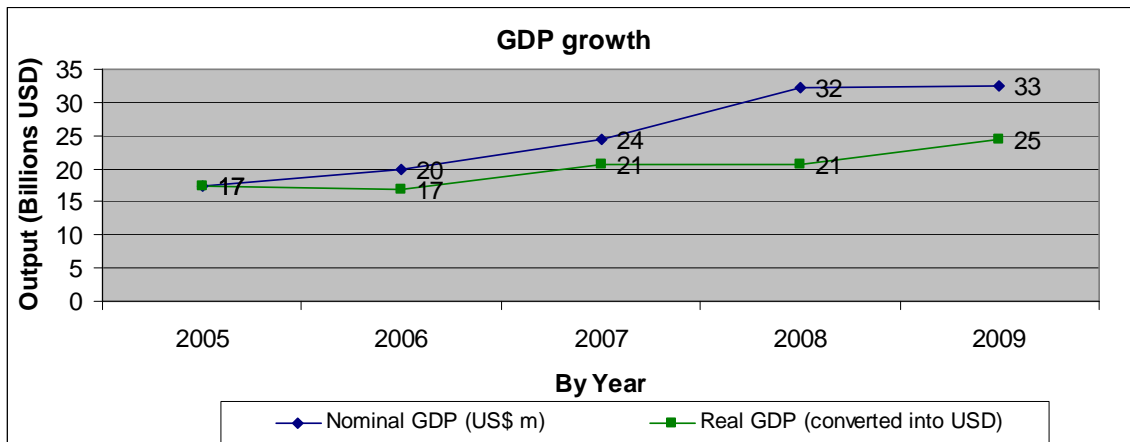
That level fell sharply to an expected 0.5 percent for this year, but growth should expand next year by 3 percent.¹³

Table: Country Comparison



Source: World Bank, WDI, 2009

It is worth pointing out that reported rates of growth also vary widely by source. This reflects differences of methods in valuating domestic prices and the worth of the currency. In nominal terms based on U.S. dollar values, GDP has increased at a steady pace over the past several years. (See the blue line in the chart below.) Yet, when consumer prices are taken into account, growth looks much more moderate.



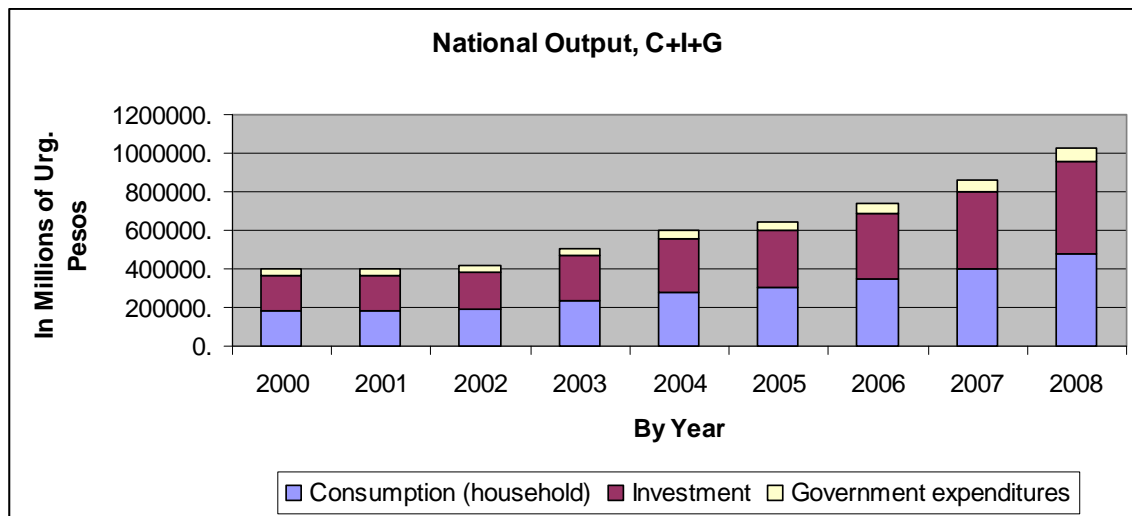
Source: EIU, 2009

¹³ EIU. Nov. 12, 2009
(http://portal.eiu.com.mutex.gmu.edu/index.asp?layout=displayIssueArticle&issue_id=1105016295&article_id=1515016336)

It is also notable that the fluctuations in GDP look less striking when output is not converted into U.S. dollars. In peso terms, GDP growth rates over the past five years have varied only moderately (except for the last year of global downturn): 6.6, 4.6, 7.6, 8.9, and 0.5.¹⁴ This could suggest that there is a greater risk of currency revaluations than in variability of the domestic economy.

Accounting for Growth

Data covering the last decade suggest that capital investments are the primary driver behind economic growth. This information makes sense considering the rise of gross capital formation discussed earlier. In the chart below, investment is defined as gross capital formation minus the expected value of inventories.



Source: IMF IFS, 2008

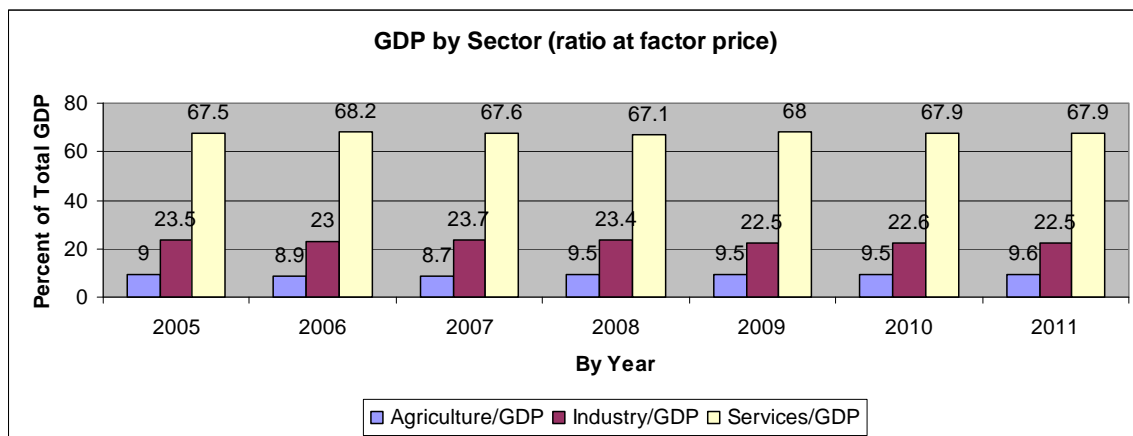
Household consumption accounts for the next largest share of the increase in GDP. However, much of that increase is due to valuation changes. Although inflation fell to one percent in 2005, the annual rate hovered between 8 to 10 percent between 2006 and 2008. The rapid increase in consumer prices appears to be the norm for the region.

¹⁴ EIU, Nov. 12, 2009

Inflationary pressures have hit Argentina—Uruguay’s neighbor, especially hard. Inflation rates there climbed to 19 percent in 2008.¹⁵

The good news for Uruguay is that unemployment rates are falling and the overall labor force is growing. In 2005, unemployment reached 12.2 percent. The latest figure shows that it has fallen to 7.9 percent this year, and that is expected to decline more next year.¹⁶ As unemployment falls, domestic consumption should rise. However, that is not to say that Uruguay is a fitting location for firms seeking to a base to sell products. Uruguay has a price competitiveness advantage compared to most developed countries, including the United States. This means that unless a firm is willing to significantly trim its market price, it should not put up the capital to set up a manufacturing base or headquarters in Uruguay.

Services Sector: Although many writers describe Uruguay as an agrarian economy, it is the services sector that accounts for the largest share—68 percent—of the country’s GDP. The sector also has reported steady growth over the past several years.



	2005	2006	2007	2008	2009
Ratios, GDP at factor cost (%)					
Agriculture/GDP	9	8.9	8.7	9.5	9.5

¹⁵ World Bank, WDI, 2009

¹⁶ EIU, 2009

Industry/GDP	23.5	23	23.7	23.4	22.5
Services/GDP	67.5	68.2	67.6	67.1	68
Origin of GDP (% real change)					
Agriculture	4.6	3.1	-5.2	5.8	2
Industry	8.7	3.8	11.2	8	-0.9
Manufacturing	10.1	7.9	7	17.3	1
Services	3.2	4.3	7.7	9.8	0.9

Source: EIU 2009

Agriculture is, nevertheless, an important sector in the economy. And, as mentioned previously, the industry is drawing the attention and capital of foreign investments. Production of beef and soy are strongest.

External Risks

Uruguay's economy is closely tied with that of its two neighbors, Brazil and Argentina. It is, thus, vulnerable to external pressures and shocks of those economic giants. The Uruguay public knows this full well. In 2001-2002, a banking crisis in Argentina quickly spilled across the border. Uruguay's banks had long served savers in both countries. So as financial institutions in Argentina started collapsing at the end of 2001 and the government responded by freezing that country's bank accounts, Uruguay's banks went down too. Argentinean depositors rushed into Uruguay banks to withdraw their cash. In total, more than \$3.6 billion left the country in 2002.

Uruguay faced a sharp currency depreciation, large capital outflows, a spike in inflation, and the economy contracted by 11 percent.¹⁷ The Uruguayan peso lost half its value from one year to the next: from 14.7 pesos: \$1 in 2001 to 27.2 pesos: \$1 in 2002.¹⁸ Inflation jumped to 17 percent—not as bad as Argentina's spike to 31 percent, but well above the 4 percent rate of inflation in the previous year.¹⁹ Reserves shrank to less than

¹⁷ World Bank, WDI, 2009

¹⁸ IMF IFS

¹⁹ World Bank, WDI

a third of what they had been in 2001—from \$3 billion to \$769 million—as the central bank expended reserves to try to hold up the value of the peso.

Reforms and Recovery: Uruguay learned its lesson. It needed to insulate itself from sudden financial crises of its neighbors. Since 2002, Uruguay has restructured its debt into longer-term maturities and implemented banking reforms. Specifically, Uruguay aligned its banking standards to international benchmarks, made changes to loan classification system and raised liquidity requirements. According to the IMF, the Uruguay financial system “now generally conforms to high standards while also embracing innovative elements such as dynamic provisioning.”²⁰

The government has also worked hard to put its fiscal house in order. It reduced its budget deficit and built back up its reserves to provide a buffer against external shocks. Reserves now stand at \$6.4 billion—more than twice of what they were before the 2002 crisis.²¹ The exchange rate is more flexible, and the banking system is stronger and better regulated. According to the International Monetary Fund, these changes along with a low private debt level “helped to dampen the impact” of the recent global recession.²²

Uruguay is also participating in a deferred drawdown option (DDO) that the World Bank is offering to countries practicing good macroeconomics. The DDO acts as an insurance policy for countries experiencing crisis because it allows them to draw upon a long-term credit line to finance government spending over a three-year period.

According to a separate IMF study, the region as a whole was able to survive the global economic crisis because countries had implemented solid fiscal and macroeconomic reforms in the past decade. The agency estimates that those changes enabled the region to save itself from losing 4 percentage points of GDP during the crisis.²³

²⁰ <http://www.imf.org.mutex.gmu.edu/external/pubs/cat/longres.cfm?sk=23251.0>

²¹ IMF IFS

²² IMF Public Information Notice, Nov. 2009 (<http://www.imf.org/external/np/sec/pn/2009/pn09127.htm>)

²³ IMF Regional Economic Outlook, pg. 35
(<http://www.imf.org/external/pubs/ft/reo/2009/WHD/eng/wreo1009.pdf>)

Monetary Policy: Inflation has been a central concern over the past several years, and the central bank has been focused on easing inflationary pressures. The monetary base has quadrupled since 2001. The currency never recovered from its devaluation in 2002, but it has not depreciated further.

Interest rates spiked somewhat in 2008, in response to the global credit crunch. But it now appears that the bank will ease monetary policy because inflation is within target range. Before 2008, interest rates remained relatively low. The Discount Rate was at 10 percent; the Money Market Rate ranged between 1.3 percent and 4 percent; the Treasury bill rate hovered around 4.5 percent; and the overnight Deposit rate averaged 2 percent.²⁴ This suggests that investors have confidence in the Uruguay peso. The risk premium is low.

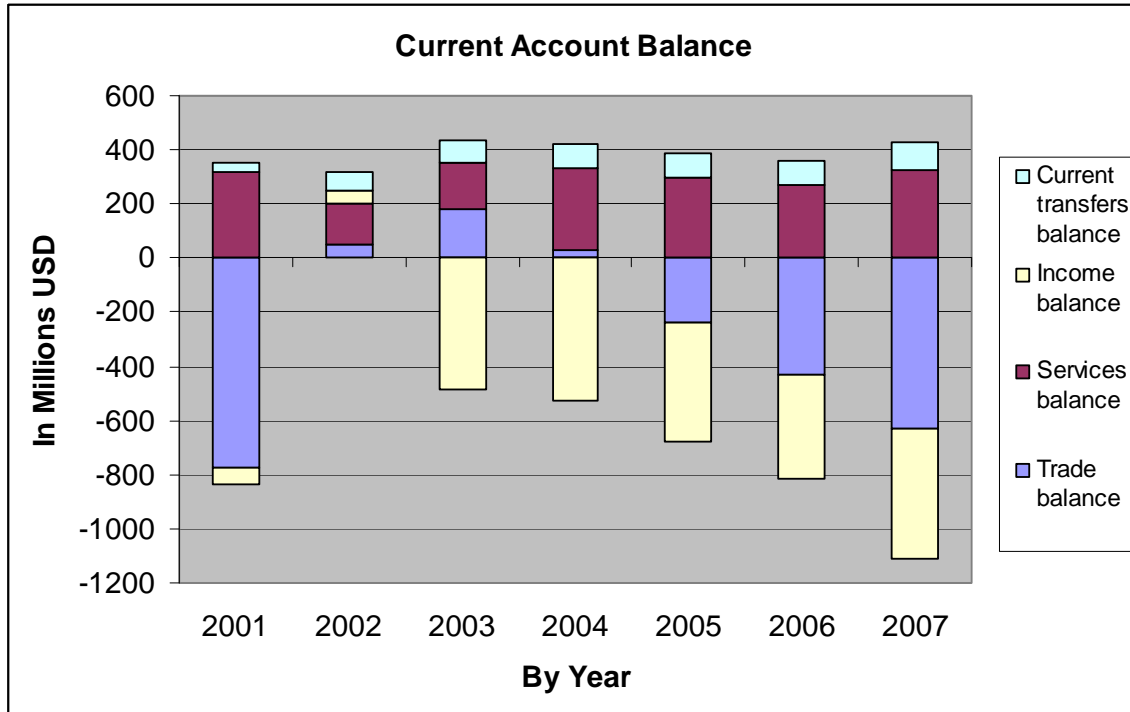
Current Account Deficit: Uruguay maintains a current account deficit. In 2007, the CAB deficit was \$688 million—a worsening of its \$452 million deficit in 2006. Uruguay imports roughly \$633 million more worth of goods than it exports. Part of that loss is offset by a net surplus of \$326 million in trade in services.

The CA deficit is not a cause for concern, however, because it is easily financed by foreigner savers.²⁵ Furthermore, medium and long-term debt inflows are strong as are inward direct investments. Together, they bring in an average of \$1 billion a year. Reserves are plentiful enough to buffer speculative attacks on the currency.

The current account deficit is not necessarily a sign of weakness. Besides, some things are heading in the right direction. The government has reduced its fiscal deficit from a high of 4 percent of GDP in 2003 to 1 percent of GDP in 2007. The fiscal deficit is therefore manageable.

²⁴ IMF IFS

²⁵ IMF <http://www.imf.org/external/np/sec/pn/2009/pn09127.htm>



	2001	2002	2003	2004	2005	2006	2007
Current-account balance	-488	322	-56	-103	-287	-452	-688

Source: EIU 2009

Trade: Expanding Exports

GDP growth is reliant primarily upon its export sales of beef and tourism for its growth, and Brazil is a key factor in the equation because it is Uruguay's largest export market. What is important is that Uruguay is expanding its trade relations with its neighbors and with developing countries around the world. As a member of the MERCOSUR customs union—the largest trade bloc in South America, Uruguay offers foreign investors access to a regional market of 38 million people and that produces \$2 trillion per year.²⁶

The bloc includes Argentina, Brazil and Paraguay—Uruguay's most significant trading partners. In recent years, MERCOSUR is working to further expanded trade opportunities for its members by negotiating a trilateral preferential trade agreement with India and the Southern African Customs Union. It is also in talks with the European

²⁶ "FDI Trends: Spotlight on Argentina, Platform for business." Foreign Direct Investment. April 1, 2009

Union to expand trade. MERCOSUR's role is significant because trade among developing nations is expanding at a much more rapid pace than trade among developed nations. Acceleration of this South-South trade, as it is called, is a major reason why FDI is rising in emerging economies. FDI has reportedly tripled in South-South trading countries the past decade.²⁷

Conclusion

Uruguay appears poised to attract additional foreign investors in the years to come. The country's next president ran his campaign promising an investment-friendly environment that has closer relations with Brazil than with Venezuela. The campaign ended last month when the former guerrilla fighter and leftist won the presidential run-off election.²⁸

Overall the investment climate has improved. Still, it appears that it is a select class of foreign investors who are invested in the country. Pulp and paper manufacturers make up the largest share of capital inflows, and those investments come at an environmental and diplomatic cost. It is too soon to know whether the private equity interest in agricultural real estate will produce sustainable returns or end in a bust. One good sign is that the currency has weathered the storms of external shocks and appears stable enough to bring savings into the country.

²⁷ "Developing world's opportunities in recession." Nov. 6, 2008. Chinadaily.com.cn.

²⁸ "Ex-Guerrilla Fighter Mujica to Rule Uruguay." Nov. 30, 2009. NYT
<http://www.nytimes.com/reuters/2009/11/30/world/international-uk-uruguay-election.html>