MOODY'S INVESTORS SERVICE

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Update

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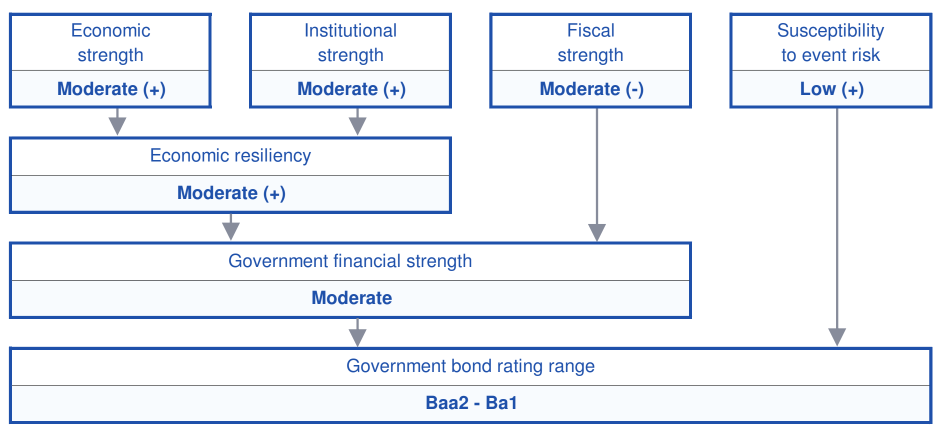
Government of Uruguay – Baa2 stable

Regular update

Summary

The credit profile of Uruguay is supported by moderate economic and fiscal strength. Uruguay has relatively high income levels and a growth potential of about 3%. Although growth likely weakened last year to near 2%, we expect GDP growth to be higher in 2019-20. Lower-than-potential growth and significant expenditure rigidity limit the authorities' ability to meet fiscal deficit targets. While debt metrics have deteriorated in recent years, we expect that the debt trend will be relatively stable over the next two years.

Exhibit 1
Uruguay's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» A favorable debt maturity profile and moderate government financing needs

» Large government financial buffers

» Strong institutions and strong commitment to arrest the increase of debt metrics

Credit challenges

» Structural rigidities in the composition of government spending

» Relatively high share of foreign-currency-denominated government debt

» Modest medium-term growth prospects compared to above-potential growth in 2004-13 period

Rating outlook

Uruguay's stable outlook reflects our expectation that debt metrics will remain relatively stable as the authorities implement their fiscal consolidation program, supported by a recovering macroeconomic environment. These improving credit conditions are balanced by continued challenges stemming from a relatively rigid public expenditure structure and the level of dollarization that exists in the economy.

Factors that could lead to an upgrade

Upward credit pressure could result from (1) a significant strengthening of the government balance sheet through a reduction in the sovereign's debt and interest burdens, (2) a reduction in vulnerability through a significant decrease in the share of foreign-currency government debt and (3) a reduction in structural rigidities in the economy such that potential growth increased.

Factors that could lead to a downgrade

Downward credit pressure could result from (1) fiscal measures or outcomes falling significantly short of achieving the authorities' fiscal targets, leading to a continued increase in debt ratios and a deteriorating medium-term fiscal profile, (2) a weakening in institutional strength and policy responsiveness, particularly to any renewed fiscal challenges, or (3) a sustained and material erosion in external and financial buffers.

Key indicators

Exhibit 2

Uruguay	2013	2014	2015	2016	2017	2018E	2019F	2020F
Real GDP (% change)	4.6	3.2	0.4	1.7	2.7	2.0	2.4	3.0
Inflation (CPI, % change, Dec/Dec)	8.5	8.3	9.4	8.1	6.6	8.0	7.3	6.8
Gen. gov. financial balance/GDP (%)	-1.5	-2.3	-2.8	-3.7	-3.0	-3.1	-3.0	-2.9
Gen. gov. primary balance/GDP (%)	0.9	0.0	-0.5	-1.0	-0.3	-0.4	-0.1	0.0
Gen. gov. debt/GDP (%)	38.9	39.7	47.7	47.1	47.7	49.2	49.2	49.1
Gen. gov. debt/revenues (%)	139.1	143.8	175.7	169.5	164.5	170.8	170.3	170.3
Gen. gov. interest payment/revenues (%)	8.5	8.2	8.5	9.6	9.3	9.5	9.8	10.2
Current account balance/GDP (%)	-3.6	-3.2	-1.0	0.8	1.5	0.6	0.3	0.5
External debt/CA receipts (%)[1]	193.1	212.0	264.3	254.1	234.7	233.7	270.2	238.9
External vulnerability indicator (EVI) [2]	104.2	91.3	84.9	108.8	107.4	88.8	98.7	98.8

[1] Current Account Receipts
[2] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves

Source: Moody's Investors Service

Detailed credit considerations

Uruguay's credit profile incorporates our "Moderate (+)" **economic strength** assessment on a global basis reflecting moderate potential growth and a relatively high income per capita, counterbalanced by the small scale of the economy, which at $61 billion in 2018 is smaller than the 'Baa' median of about $200 billion. We estimate the economy grew about 2.0% in real terms in 2018 and will expand on average 2.7% in 2019-20. The final score for economic strength diverges from the indicative "Moderate" because we consider that the implied GDP growth volatility, which covers the 2008-17 period, overstates the potential volatility that the economy will display over the coming years.

Our final score for Uruguay's **institutional strength** of "Moderate (+)" is below the indicative score of "High." This assessment balances Uruguay's strong institutional framework, which reinforces policy predictability, with still-evolving capabilities to effectively and credibly conduct these policies. The authorities have faced challenges to meet policy goals, as exemplified by stubbornly high inflation rates that remained above the official target range, although in early 2017 inflation fell within the target band for the first time since 2010. Despite this temporary reversal, inflation climbed to 8.0% in December 2018. Current institutional arrangements guiding fiscal policy have not provided a strong anchor for overall fiscal policy, which has led to a deterioration in the structural deficit and a pro-cyclical policy stance.

Uruguay's “Moderate (-)” **fiscal strength** assessment balances its moderate government debt burden, very strong liability management practices and fiscal reserve assets, with lingering vulnerabilities from an elevated proportion of foreign-currency debt. Debt ratios are in line with ‘Baa’ medians despite weaker-than-peers' debt affordability as measured by the interest payment-to-revenue ratio. While the share of foreign-currency-denominated debt decreased to 49% in 2017, this share once again exceeded 50% in 2018 and we expect it to stay around 53% in 2019-20 following the depreciation of the peso. While Uruguay is exposed to exchange rate risk due to the level of government debt dollarization, this risk is mitigated by the government's financial assets, which are mostly denominated in foreign currency and provide 12 months of debt service coverage.

We assess Uruguay's **susceptibility to event risk** as “Low (+),” driven by banking sector risk. The banking sector's risk is assessed as “Low (+),” implying higher risk than the indicative of “Low,” to reflect the relatively high level of financial dollarization in the system. Additionally, this assessment reflects the system’s relatively large size for a Latin American economy, with assets equivalent to 65% of GDP in 2017, and a baseline credit assessment of ba1, which informs the risk assessment of potential contingent liabilities materializing on the government’s balance sheet.

Uruguay's government liquidity risk assessment is “Low (-),” balancing the government's relatively low gross borrowing requirements – favored by a long maturity profile – against a relatively high share of external debt in total government debt.

External vulnerability risk is assessed as “Very Low (+),” from an indicative of “Low,” to reflect the country's large external buffers that partially mitigate exchange rate risks stemming from the country's high degree of financial dollarization. Uruguay's external position has strengthened in recent years, with the current account in surplus since 2016, although this reflects a decrease in overall investment in the country. Meanwhile, foreign exchange reserves provide full coverage of external debt amortization payments, an improvement from a decade ago.

Political risk is “Very Low.” We consider that the risk of political events developing in a manner that could compromise the economic, institutional or fiscal features of Uruguay's credit profile to be very low.

Recent developments

Inflation ended 2018 above the target range

Annual inflation was 8% as of December 2018, well above the upper limit of the central bank's target range of 3%-7% but lower than the highest point of 8.4% in July. Increases in the prices of foodstuffs due to a drought that affected the country in the early months of 2018, as well as the depreciation of the peso, influenced higher inflation last year. We expect inflation to decrease to between 7.0%-7.5% in 2019, and for it to fall back in the target range in 2020.

Lower inflation within the target would help to anchor inflation expectations. Although authorities have put in place wage negotiation mechanisms that no longer incorporate past inflation, expectations about future inflation can still influence wage dynamics. De-linking wages from inflation, i.e. removing an element of inflation inertia in Uruguay, could lead to a structurally lower level of inflation in future years. Additionally, because pension spending – which represents about 30% of total spending for the central government – is linked to the average nominal wage growth, future wage growth will continue to be a key determinant of expenditure dynamics and fiscal consolidation.

Fiscal deficit remained relatively stable excluding “Cincuentones” transfers

As of November 2018, the ministry of finance publishes the fiscal accounts incorporating the effect of the Law 19.590, also known as the “Cincuentones” Law, which allows people 50 years old or older who were affected by the 1996 pension reform to transfer the balance of their accounts in the private pension system (AFAPs) to the public one (Banco de Prevision Social, BPS). Starting last November, AFAPs began making transfers into a trust and the government recorded these transfers above-the-line following IMF accounting methodology.

In the case of Uruguay for the purpose of our analysis we use fiscal data at the consolidated central government level, which includes the BPS. However, we will not incorporate Cincuentones-related transfers into our government revenue estimates as these will always be held in the trust and are earmarked to cover a portion of the Cincuentones' future pensions.[1]

Excluding these transfers, government revenue grew 9.8% (2.2% in real terms) during January-November coming to UYU488 billion – including the transfers revenue grew 14.4% (6.8% in real terms). In the same period expenditures grew 10.7% (3.1% in real terms) to UY536 billion. The fastest growing expenditure items were investments, which increased 20.9% in nominal terms (representing 4.6% of total spending), and interest payments, which increased 16.1% in nominal terms (accounting for 8.3% of total spending) – the increase in interest payments reflects the depreciation of the peso as over half of the government debt is denominated in foreign currency.

On a 12-month rolling basis, the government deficit came to 3.2% of GDP last November compared to 3.0% in November 2017. We estimate the annual deficit was over 3.0% of GDP in 2018 and will remain relatively stable in 2019-20. The latter means the central government deficit will come above the 2.5% of GDP target set by the authorities in the mid-year budget review. A higher central government deficit also implies the deficit reduction target at the consolidated public sector level – the one that authorities focus on – is unlikely to be met in 2019-20.

Moderate economic growth in 2018-20, with weak underlying dynamics

GDP expanded on average 2.3% in real terms during the first three quarters of 2018, broadly in line with our expectation of 2.0% for the full year. Economic performance mainly reflected the re-opening of ANCAP's (Ba2 stable) refinery, which had been offline for most of 2017. Gross fixed capital formation remains relatively weak, expanding 1.2% during the first three quarters of 2018, extending a trend seen since 2014-15. Overall, Uruguay is facing structural constraints in terms of investment and employment that will weigh on medium-term growth prospects if left unaddressed.

We forecast growth to accelerate in 2019 and 2020. We expect to see a rebound in agricultural output in 2019 that would boost exports as well, following the severe drought experienced by Uruguay in early 2018. Additionally, although we expect authorities to continue pursuing expenditure restraint in the context of fiscal consolidation, execution of public investment will accelerate this year, as well as some PPP projects that will begin their construction phase in 2019. Downside risks to our forecasts stem from (1) still-weak, albeit recovering, private investment and a weak labor market, and (2) potential adverse external conditions, for example the impact of Argentina's recession on Uruguay's tourism sector. In 2020, we see some potential upside risk to our growth forecast if the proposed construction of a third pulp mill in the country led by Finland's UPM (Baa2 positive) begins.

Rating methodology and scorecard factors

Rating factors grid - Uruguay

Rating factors	Sub-factor weighting	Indicator	Indicative factor score	Final factor score
Factor 1: Economic strength			M	M+
Growth Dynamics	**50%**			
Average real GDP growth (2013-2022F)		2.6		
Volatility in real GDP growth (standard deviation, 2008-2017)		2.3		
WEF Global Competitiveness index (2017)		4.2		
Scale of the economy	**25%**			
Nominal GDP (US$ billion, 2017)		59.2		
National income	**25%**			
GDP per capita (PPP, US$, 2017)		22,374		
Automatic adjustments	**[-3; 0]**	Scores applied		
Credit boom		0		
Factor 2: Institutional strength			H	M+
Institutional framework and effectiveness	**75%**			
Worldwide Government Effectiveness index (2017)		0.4		
Worldwide Rule of Law index (2017)		0.6		
Worldwide Control of Corruption index (2017)		1.3		
Policy credibility and effectiveness	**25%**			
Inflation level (%, 2013-2022F)		7.7		
Inflation volatility (standard deviation, 2008-2017)		1.1		
Automatic adjustments	**[-3; 0]**	Scores applied		
Track record of default		-2		
Economic Resiliency (F1xF2)			**H-**	**M+**
Factor 3: Fiscal strength			M-	M-
Debt burden	**50%**			
General government debt/GDP (2017)		47.7		
General government debt/revenue (2017)		164.5		
Debt affordability	**50%**			
General government interest payments/revenue (2017)		9.3		
General government interest payments/GDP (2017)		2.7		
Automatic adjustments	**[-6; +4]**	Scores applied		
Debt trend (2014-2019F)		0		
Foreign currency debt/general government debt (2017)		-4		
Other non-financial public sector debt/GDP (2017)		0		
Public sector assets/general government debt (2017)		0		
Government financial strength (F1xF2xF3)			**M+**	**M**
Factor 4: Susceptibility to event risk	**Max. function**		L	L+
Political risk			VL	VL
Worldwide voice & accountability index (2017)		1.2		
Government liquidity risk			L-	L-
Gross borrowing requirements/GDP		5.6		
Non-resident share of general government debt (%)		56.0		
Market-Implied Ratings		Baa2		
Banking sector risk			L	L+
Average baseline credit assessment (BCA)		ba1		
Total domestic bank assets/GDP		65		
Banking system loan-to-deposit ratio		90		
External vulnerability risk			L	VL+
(Current account balance + FDI Inflows)/GDP		0.0		
External vulnerability indicator (EVI)		98.7		
Net international investment position/GDP		-27.8		
Government bond rating range (F1xF2xF3xF4)			**Baa1 - Baa3**	**Baa2 - Ba1**
Assigned foreign currency government bond rating		**Baa2**		

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range. For more information please see our Sovereign Bond Rating Methodology.

Footnotes: **(1) Indicative factor score:** rating sub-factors combine with the automatic adjustments to produce an Indicative factor score for every rating factor, as detailed in Moody's Sovereign Bond Methodology. **(2) Final factor score:** where additional analytical considerations exist, Indicative factor scores are augmented to produce a Final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Bond Methodology; details on country-specific considerations are provided in Moody's research. **(3) Rating range:** Factors 1: Economic strength, and Factor 2: Institutional strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3: Fiscal strength (FS), following a non-linear pattern where FS has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's susceptibility to event risk, is a constraint which can only lower the preliminary government financial strength rating range as given by combining the first three factors. **(4) 15 Ranking categories:** VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL- **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

» **Credit Analysis**: Government of Uruguay, 26 July 2018

» **Country Statistics**: Uruguay, Government of, 29 November 2018

» **Outlook:** Sovereigns – Latin America & Caribbean: 2019 outlook stable as growth, debt structures still favorable; political risks rising, 9 January 2019

» **Rating Methodology**: Sovereign Bond Ratings, 27 November 2018

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 The "cincuentones" transfers will only positively contribute to the fiscal position while the transfers from the AFAPs take place. The AFAPs will continue to make these transfers to the trust over the next three years. The trust will invest these funds over the subsequent three years and after the seventh year the trust will provide one twentieth of the accumulated capital plus earnings generated to the "cincuentones" over a period of 20 year. Additionally, the "cincuentones" effect will create a future liability for the BPS that will be negative for fiscal performance because public pension outlays will enlarge without a matching revenue source, unless there is a push for reforms after the elections later this year.

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