FITCH AFFIRMS URUGUAY AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-New York-05 October 2016: Fitch Ratings has affirmed Uruguay's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BBB-' with a Stable Outlook. The issue ratings on Uruguay's senior unsecured Foreign- and Local-Currency bonds have also been affirmed at 'BBB-'. The Country Ceiling has been affirmed at 'BBB+' and the Short-Term Foreign- and Local-Currency IDRs at 'F3'.

KEY RATING DRIVERS

Uruguay's ratings are supported by strong structural features in terms of social and institutional development, established external liquidity buffers, and low fiscal financing risks. These factors are balanced by persistently high inflation, high public debt, and a rigid spending profile lifting fiscal deficits above targets in recent years, which narrow the scope for counter-cyclical policies.

Growth has continued to stagnate in 2016 as external headwinds have coincided with waning consumption and contracting investment. Real GDP growth of 0.7% year-over-year in the first half of 2016 captured a boost to hydroelectric production from favourable rainfall; however, all other key sectors posted contractions and unemployment has continued to rise. Fitch projects growth of 0.3% in 2016 and a modest increase to 0.7% in 2017, as the boost from a more favourable external environment is restrained by an income tax hike.

Medium-term growth prospects have improved with the announcement of a new megaproject in the pulp sector, representing a USD4 billion investment that is expected to begin in 2018, and requiring another USD1 billion in related public infrastructure that could begin sooner. Broader public investment will provide limited support to growth after falling considerably since 2014 amid fiscal constraints, but authorities expect the slow progress on Public Private Partnerships projects (PPPs) to gain speed in the coming year. The government intends to pursue new trade agreements, but other structural reform priorities (e.g. education) have not materialised into concrete proposals thus far.

Inflation moderated to 9.4% in August after six months in double-digits, but remains one of the highest among investment-grade peers. High inflation has complicated on-going sector-level wage negotiations. Official guidelines calling for ex post inflation adjustments to correct against real wage losses (but no longer to ensure real gains) have mostly been followed, but more contracts are adopting shorter-than-recommended horizons for the correctives. Amid pressure from unions, the authorities relaxed the guidelines in August by allowing wage hikes 1.0pp - 1.5pp above prior guidance.

The external position continues to improve, facilitated by a flexible exchange rate and naturally hedged terms of trade (Uruguay is an agricultural exporter and a fuel importer). The current account deficit (CAD) fell to 1.4% of GDP in the four quarters through 2016Q2 from 4.5% in 2014. Foreign direct investment inflows have fallen by half since 2014 but fully fund the lower CAD.

The peso has appreciated since March after sizeable depreciation and intervention by the central bank in the prior eight months. International reserves have stabilised in nominal terms well below their earlier peaks, but coverage and external liquidity metrics remain among the strongest in the 'BBB' category given the concomitant fall in imports and non-resident holdings of local debt instruments.

Structural factors have driven further deterioration of public finances in 2016. Revenues have been resilient to the economic downturn, and have even risen as a share of GDP due to changes in calculation of corporate income taxes. However, this has not been enough to offset inertial growth in social spending (namely the growing deficit in the public healthcare fund) and higher interest costs due to past peso depreciation. Fitch project the central government deficit will reach 3.6% of GDP in 2016, up from 2.8% in 2015 and 1.5% on average in 2010-14.

To correct the fiscal trajectory in line with the targets in the 2015 - 2019 budget, the authorities recently unveiled a package of consolidation measures worth 0.9% of GDP (mostly taxes, and some spending cuts). The measures only partially offset sizeable upward revisions in projected healthcare and interest costs, and as a result the 2019 central government deficit goal was raised to 2.5% of GDP from 1.9%. The headline goal of a 2.5% deficit by 2019 at the public sector level was reaffirmed, and achieving it will now rely more on the central bank's falling quasi-fiscal deficit, following some recent improvement in public companies' finances.

In Fitch's view, the proposed fiscal adjustment, while relatively modest, improves the credibility of the consolidation goal. Fitch expects that broad consensus for the adjustment in the legislature will support its smooth approval, highlighting mature institutions. Nevertheless, the authorities' commitment to consolidation could be further tested should sluggish growth and current spending pressures persist. Scope to use investment spending as an adjustment variable is limited, as it has already been cut to decade-low levels that are among the lowest in the 'BBB' category. Fiscal credibility has been weakened by frequent overshooting of deficit targets, even in years of strong growth, and hikes to legal caps on annual rises in net debt.

The fiscal adjustment could help arrest the deterioration in public debt dynamics. Fitch projects general government debt will remain stable around 57% of GDP in 2016, as a high deficit is offset by a proposed cancelation of recapitalisation bonds held by the central bank, and that gradual reduction in the deficit could help it stabilise around 62% of GDP by 2018. Uruguay's public debt level is high relative to the 'BBB' median of 40%, and is especially vulnerable to peso depreciation given that a high share (around 50%) is denominated in foreign currency. Prudent debt management continues to mitigate financing risks, supported by liquid assets currently covering 18 months of debt service and multilateral credit lines.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Uruguay a score equivalent to a rating of 'BBB' on the Long-Term Foreign-Currency IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

--Macro: -1 notch, to reflect a weak track record of compliance with inflation and fiscal targets, and narrow scope for counter-cyclical policies due to high levels of inflation, indexation, dollarisation, and public debt.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a Long-Term Foreign-Currency IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main risk factors that, individually or collectively, could trigger a negative rating action are:

--Failure to achieve fiscal consolidation and stabilise the general government debt burden;
--Deterioration in growth prospects;
--Erosion of external liquidity buffers.

Conversely, the main factors that could lead to a positive rating action are:
--Fiscal consolidation consistent with a declining public debt trajectory;
--Evidence of investments or productivity gains that lift medium-term growth prospects;
--A track record of lower inflation and improved anchoring of inflation expectations.

KEY ASSUMPTIONS

--Fitch assumes that construction of a new pulp mill project will take place as scheduled beginning in 2018, supporting growth during the construction phase and once production begins.

--Fitch assumes that after contracting in 2016, Brazil's economy will recovery in 2017-2018, supporting economic activity in Uruguay.

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Applicable Criteria
Country Ceilings (pub. 16 Aug 2016)
https://www.fitchratings.com/site/re/885997
Sovereign Rating Criteria (pub. 18 Jul 2016)
https://www.fitchratings.com/site/re/885219