S&P Global Ratings

RatingsDirect®

Research Update:

Uruguay 'BBB/A-2' Ratings Affirmed; Outlook Remains Stable

April 30, 2020

PRIMARY CREDIT ANALYST

Constanza M Perez Aquino
Buenos Aires
(54) 114-891-2167
constanza.perez.aquino@spglobal.com

SECONDARY CONTACTS

Manuel Orozco
Sao Paulo
(55) 11-3039-4819
manuel.orozco@spglobal.com

Joydeep Mukherji
New York
(1) 212-438-7351
joydeep.mukherji@spglobal.com

Overview

- The impact of the COVID-19 pandemic and the global economic downturn in 2020 will hurt the Uruguayan economy and increase the country's already high fiscal deficit.
- However, we expect ongoing investment projects and fiscal correction will improve the economic outlook for Uruguay once the pandemic subsides.
- We are affirming our 'BBB/A-2' sovereign credit ratings on Uruguay.
- The stable outlook balances short-term economic and fiscal setbacks with an expected recovery in GDP growth, sustained by investment, along with a solid external position and well-established institutions.

Rating Action

On April 30, 2020, S&P Global Ratings affirmed its 'BBB' long-term and 'A-2' short-term foreign and local currency sovereign credit ratings on Uruguay. The outlook on the long-term ratings remains stable.

The transfer and convertibility assessment remains 'A-'.

Outlook

The stable outlook reflects our view that the social and economic impact of the COVID-19 pandemic, including the downturn in global economic growth, will result in increased government borrowing and a higher debt burden for Uruguay this year. However, we expect economic recovery and corrective fiscal policy will contribute to reversing the near-term deterioration in the sovereign's fiscal and debt profile, limiting the long-term negative impact on its financial profile.

Downside scenario

We could lower the ratings on Uruguay over the next two years if lower-than-expected long-term growth prospects, which depend partly on advancing important investment projects, limit the government's ability to correct fiscal deficits and reverse the near-term erosion in public finances. In this scenario, the already high general government deficit and net general government debt burden could continue to rise beyond our expectations. Moreover, a sustained weaker long-term growth trajectory could dampen Uruguay's per capita income, weakening its economic resilience and leading to a lower rating.

Upside scenario

A sustained decline in inflation, along with further deepening of local capital markets, could facilitate the government's ongoing efforts to increase the share of local currency in its debt stock. Falling exposure to foreign currency-denominated debt could reduce the impact of exchange rate fluctuations on the sovereign's balance sheet. The resulting improvement in debt dynamics, along with continued GDP growth, could lead to a higher rating over the next two years. We could also raise the ratings if a combination of good GDP growth and greater-than-expected fiscal consolidation measures narrows the fiscal deficit and decreases the government's debt burden.

Rationale

Our ratings on Uruguay are supported by its track record of moderate and predictable economic policies and its well-established institutions, which have underpinned consistent economic growth for over 15 years. The ratings also benefit from Uruguay's strong external position and reflect the sovereign's per capita GDP of US$16,000 in 2019, one of the highest in Latin America.

Uruguay's persistently high--and increasing--fiscal deficits and debt burden are constraints on the sovereign ratings, as are its relatively high inflation and still high dollarization in the financial system.

Institutional and economic profile: Building political consensus within the governing coalition will be key to advancing needed measures

- We project real GDP to contract 3% in 2020 and rebound 5% in 2021, supported by infrastructure investments over coming years.
- We expect broad political consensus following the election of President Luis Lacalle Pou, which will be key to implementing needed structural measures.
- Uruguay's strong checks and balances and low perceived corruption, which sustain investor confidence in the country, continue to support economic policies.

Uruguay has been growing consistently for over 15 years. However, growth has recently decelerated, to 1.3% in 2015-2019 from 4.9% on average in 2010-2014. Deceleration in consumption, in part due to unemployment levels and persistently high inflation, as well as lower public and private investment, explain the recent stagnation.

We expect real GDP to contract 3% in 2020, following a sharp fall in consumption because of the pandemic and weak global and regional demand. We estimate a 5% rebound in GDP in 2021 and average growth of 2.8% over 2022-2023 as consumption resumes and planned investment projects ramp up. These planned investments, including a US$800 million public-private partnership railroad and an investment by Finland-based forest and paper company UPM-Kymmene Corp. for US$3 billion, will support a recovery in GDP growth over the coming couple of years. Our base case incorporates the assumption that projects will continue, albeit with some delays due to supply-chain disruptions as well as likely lower productivity stemming from the application of health protocols.

President Lacalle Pou, from center-right Partido Nacional, was elected in the November 2019 run-off elections with the support of a political coalition, and his administration took office on March 1, 2020. This follows 15 years of the center-left Frente Amplio coalition government. We believe Uruguay's broad political consensus and its stable and well-established institutions have anchored--and will continue to anchor--economic stability. Partido Nacional does not hold a majority in either chamber of Congress. Hence, maintaining support across various parties to implement measures to encourage GDP growth, address weaknesses in public finances, and contain inflation will be key.

The new government is currently in the process of delineating the five-year budget bill for 2021-2026 and has expressed commitment to reducing fiscal imbalances and restoring fiscal credibility. The administration took office with a plan to contain government spending through nonrenewal of public employment vacancies, cuts in administrative infrastructure, and measures to improve efficiency and governance of public-sector companies. However, the pandemic has refocused priorities to the short term and will result in high social and health spending outlays.

The Uruguayan authorities have responded promptly to the pandemic. There is no countrywide lockdown, although social distancing measures are promoted and movement restrictions are in place. Fiscal and monetary authorities announced measures focused on the more vulnerable sectors and on providing support to small businesses. Measures to inject liquidity into the financial sector were also introduced.

The administration submitted the Law of Urgent Consideration to Congress on April 23, 2020, with over 500 articles covering different areas. It includes the creation of a fiscal rule as well as a committee to recommend reforms to the social security system. While we believe this signals commitment to addressing structural weaknesses in public finances, we expect fiscal consolidation will be only gradual, given likely high unemployment following this year's economic slump will limit the ability of the government to make significant adjustments in 2021.

Uruguay continues to have a strong democracy and ranks high in global institutional quality rankings. Institutional strength sustains investor confidence in the country despite adverse economic and political events in neighboring Argentina and Brazil. Uruguay is a largely middle-class society with a relatively strong social contract that emphasizes consensus and social cohesion. The country ranks high in international scores for governance and has the best ranking, indicating the least corruption, in Latin America and across global emerging markets in Transparency International's 2019 Corruption Perceptions Index. The Economist Intelligence Unit ranked Uruguay first in Latin American in its Democracy Index.

Flexibility and performance profile: A higher fiscal deficit and currency depreciation will further increase debt, although with favorable funding terms

- We expect the general government (GG) deficit will peak in 2020 and push net GG debt to 70% of GDP.
- We expect the current account deficit (CAD) to remain below 2% of GDP in the next two years, sustaining Uruguay's balanced external position.
- Inflation is likely to be 9.0% in 2020 and to remain above 7% in the next couple of years.

We expect the GG deficit will peak in 2020 as revenue suffers from the economic contraction and spending rises to address the social and economic impact of the pandemic. We believe the GG deficit could expand to 6.2% of GDP in 2020 (or 7.2% excluding one-off revenue from the pension system), then fall to an average 3.7% of GDP over 2021-2023 (3.9% excluding one-off revenue) as economic growth resumes and pandemic-related spending slowly subsides. Our definition of the GG includes the central bank and excludes public-sector enterprises.

In late 2017, Congress approved changes to the social security system wherein certain groups of future retirees in private pension plans were able to return to the public-sector pension system. This resulted in one-off revenue for the government over 2018-2021. While this revenue lowers the GG deficit, it does not change the government's financing needs, because the funds that it receives due to the shift are deposited in a ring-fenced trust.

Our base case assumes net GG debt will jump to 71.1% of GDP in 2020 due to the expected increase in the fiscal deficit along with foreign currency depreciation (50% of Uruguay's debt is denominated in foreign currency). We estimate an increase in net GG debt of about 6.1% over 2021-2023 with net GG debt remaining close to 68% on average. We expect the Central Bank of Uruguay's debt, typically issued for open-market operations in response to changes in the foreign currency market, to remain at about 10% of GDP over this period. We also expect GG interest payments to average 7.7% of GG revenue between 2020 and 2023.

While debt is set to increase in 2020, additional funding sources will mostly be long term and with favorable terms. Uruguay has accumulated ample external liquidity in the past to manage potential financing disruptions. Liquidity buffers include contingent credit lines with multilateral institutions (Inter-American Development Bank, CAF, and FLAR), for about 4% of GDP, some of which have already been called upon and disbursed to finance measures in response to the COVID-19 pandemic, as well as government liquid assets, for about 2% of GDP as of December 2019. As in the past, we expect the government to continue to meet its overall financing needs mainly through local and international bond issuance.

Effective debt management has significantly reduced the risks embedded in Uruguay's debt profile. This is reflected in the central government's debt management milestones, which show that average maturities have continued to increase and are now about 14 years, from eight years in 2005. About 95% of the central government debt is at a fixed rate, compared with 78% 14 years ago, and bonds compose 92% of central government debt, while loans make up 8%. External market debt accounts for 78% of debt, while local market debt is about 22%.

International bond issuances over the recent past have boosted liquidity and extended maturities. Also, in January 2020, the government held a special tender for treasury notes in inflation and nominal wage index units with an exchange offer in conjunction with the central bank, issuing $952 million equivalent in treasury notes. The government has continued with its prefinancing policy to cover debt service payments for the subsequent 12 months. The strategy of prefunding amortization payments by holding substantial liquid assets provides insulation against Uruguay's external vulnerabilities but also has a fiscal cost.

The accumulated inflation rate reached 9.2% in March, and inflation expectations over the next 12 months remain above the central bank target range of 3%-7%. We estimate a 9% inflation rate for 2020 as a result of depreciation of the Uruguayan peso and pass-through effects to the tradable sector, counterbalanced by falling demand due to the recession.

High inflation and still high dollarization continue to limit Uruguay's monetary policy flexibility. They also pose risks to the financial sector, should there be potential sudden spikes in the exchange rate. Over 50% of resident loans are denominated in dollars, while more than 70% of resident deposits are denominated in dollars.

Despite the high dollarization, the Uruguayan banking system has remained relatively healthy and resilient. We classify it in group '6' of our Banking Industry Country Risk Assessment, or BICRA (see "Banking Industry Country Risk Assessment: Uruguay," published Aug. 14, 2019). BICRAs are grouped on a scale from '1' to '10', ranging from what we view as the lowest-risk banking systems, or group '1', to the highest risk, or group '10'.

We expect government-owned Banco de la Republica Oriental del Uruguay, the country's largest bank, with 45% of total assets, to have an active role in the implementation of response measures to COVID-19. While we expect pressure on banks' asset quality to surge with nonperforming loans (NPLs) increasing in 2020, we consider capital adequacy and liquidity levels to be relatively strong. Asset-quality metrics in the financial system (consisting of private and public banks) have remained stable over the past years, with NPLs accounting for 3.0% of total loans in 2019, from 3.2% in 2018. Nonresident deposits accounted for 10.5% in 2019, slightly up compared with 2018.

Uruguay's external sector has remained balanced despite unfavorable regional and global conditions. We expect a moderate deficit in 2020, with decreases in exports from lower global demand compensated by lower imports. We believe the CAD could widen but remain below 2% of GDP, with expected higher imports due to the execution of infrastructure projects, including the construction of a second pulp mill by UPM. In 2023, the beginning of production of a cellulose plant could provide a boost for exports.

Gross external financial needs should remain below 100% of current account receipts (CAR) plus usable reserves in 2020, then trend down to 91% of GDP by 2023. Given Uruguay's still narrow and shallow domestic capital markets, the sovereign depends on external debt. While we expect higher external funding from multilateral institutions in 2020, we expect Uruguay to continue financing half of its central government deficit abroad over 2021-2023, and thus narrow net external debt should be about 38% of CAR over that period.

Key Statistics

Table 1

Uruguay--Selected Indicators

	2013	2014	2015	2016	2017	2018	2019	2020f	2021f	2022f	2023f
Economic indicators (%)											
Nominal GDP (bil. LC)	1,178.33	1,330.51	1,455.85	1,589.20	1,707.11	1,831.13	1,975.92	2,089.14	2,369.09	2,618.08	2,885.16
Nominal GDP (bil. $)	57.53	57.24	53.27	52.69	59.53	59.60	56.05	51.37	54.03	59.33	64.10
GDP per capita (000s $)	17.0	16.8	15.5	15.3	17.2	17.2	16.1	14.8	15.5	16.9	18.2
Real GDP growth	4.6	3.2	0.4	1.7	2.6	1.6	0.2	(3.0)	5.0	2.8	2.8
Real GDP per capita growth	4.3	2.9	(0.4)	1.3	2.2	1.5	(0.1)	(3.3)	4.7	2.5	2.5
Real investment growth	3.8	2.4	(9.2)	(1.6)	(15.7)	(2.7)	1.4	1.0	16.0	18.0	10.0
Investment/GDP	22.5	21.2	19.7	17.8	15.2	16.5	16.2	18.0	19.5	21.8	22.7
Savings/GDP	18.9	18.0	18.8	18.4	15.9	16.6	16.9	16.9	18.4	20.9	24.6
Exports/GDP	23.4	23.5	22.5	21.4	21.4	21.0	21.7	21.7	21.7	21.7	21.7
Real exports growth	(0.1)	3.5	(0.6)	(0.2)	6.9	(4.8)	1.2	(3.0)	5.0	2.8	2.8

Table 1

Uruguay--Selected Indicators (cont.)

	2013	2014	2015	2016	2017	2018	2019	2020f	2021f	2022f	2023f
Unemployment rate	6.5	6.6	7.5	7.8	7.9	8.3	9.1	13.1	9.6	9.1	8.6
External indicators (%)											
Current account balance/GDP	(3.6)	(3.2)	(0.9)	0.6	0.7	0.1	0.7	(1.1)	(1.1)	(0.9)	1.9
Current account balance/CARs	(10.6)	(9.3)	(3.0)	2.0	2.4	0.3	2.3	(3.6)	(3.4)	(2.7)	5.8
CARs/GDP	34.3	34.0	31.2	29.7	30.0	30.7	32.3	29.8	32.5	32.5	33.5
Trade balance/GDP	1.9	3.5	2.5	3.6	4.0	4.1	5.2	4.7	4.4	4.3	7.0
Net FDI/GDP	(4.9)	(4.4)	(1.5)	2.1	3.8	1.9	0.8	1.4	2.5	3.1	3.1
Net portfolio equity inflow/GDP	(3.1)	(0.6)	1.9	3.9	(3.2)	(2.7)	2.1	0.0	0.0	0.0	0.0
Gross external financing needs/CARs plus usable reserves	99.3	97.4	95.1	100.6	98.9	88.3	86.2	98.7	99.7	98.0	88.0
Narrow net external debt/CARs	31.3	32.6	36.0	35.3	25.3	25.3	33.1	48.9	38.4	34.0	21.2
Narrow net external debt/CAPs	28.3	29.8	35.0	36.0	25.9	25.3	33.9	47.2	37.1	33.2	22.5
Net external liabilities/CARs	88.3	98.0	108.6	114.7	98.4	93.3	83.4	113.3	95.8	96.0	85.9
Net external liabilities/CAPs	79.8	89.6	105.4	117.0	100.8	93.5	85.4	109.4	92.7	93.5	91.2
Short-term external debt by remaining maturity/CARs	34.3	39.0	48.0	50.9	39.1	37.7	33.6	41.3	37.4	34.1	30.6
Usable reserves/CAPs (months)	5.0	5.7	6.9	5.9	4.7	6.7	6.4	5.4	4.8	4.6	5.3
Usable reserves (mil. $)	10,170	9,754	7,508	6,844	10,183	9,465	7,150	7,246	7,623	8,969	12,175
Fiscal indicators (general government; %)											
Balance/GDP	(2.3)	(2.9)	(3.5)	(2.4)	(3.5)	(2.8)	(3.2)	(6.2)	(3.8)	(3.7)	(3.4)
Change in net debt/GDP	9.7	5.1	6.1	3.2	8.5	6.5	8.2	12.0	5.7	6.4	6.1
Primary balance/GDP	0.3	(0.2)	(0.1)	0.7	(0.4)	0.5	(0.5)	(3.1)	(0.9)	(0.7)	(0.5)
Revenue/GDP	35.0	35.3	35.9	36.1	38.1	39.6	39.6	37.6	38.8	39.0	38.8
Expenditures/GDP	37.3	38.2	39.4	38.5	41.6	42.4	42.8	43.8	42.7	42.7	42.2
Interest/revenues	7.4	7.6	9.4	8.7	8.2	8.2	6.8	8.2	7.6	7.5	7.5

Table 1

Uruguay--Selected Indicators (cont.)

	2013	2014	2015	2016	2017	2018	2019	2020f	2021f	2022f	2023f
Debt/GDP	56.0	56.5	59.9	57.7	61.6	64.1	66.7	75.9	72.6	72.0	71.4
Debt/revenues	159.8	159.9	166.9	159.6	161.9	161.7	168.3	201.8	186.9	184.6	184.3
Net debt/GDP	51.1	50.3	52.0	50.9	55.9	58.6	62.5	71.1	68.4	68.3	68.1
Liquid assets/GDP	4.9	6.2	7.9	6.8	5.7	5.4	4.2	4.8	4.1	3.6	3.3
Monetary indicators (%)											
CPI growth	8.6	8.9	8.7	9.6	6.2	7.6	7.9	9.0	8.0	7.5	7.2
GDP deflator growth	8.2	9.4	9.0	7.3	4.7	5.6	7.7	9.0	8.0	7.5	7.2
Exchange rate, year-end (LC/$)	21.39	24.33	29.87	29.26	28.76	32.39	37.34	44.00	43.69	44.57	45.46
Banks' claims on resident non-gov't sector growth	24.9	18.0	22.3	1.2	0.5	11.6	10.7	8.0	10.1	12.0	12.0
Banks' claims on resident non-gov't sector/GDP	26.7	27.9	31.2	28.9	27.0	28.1	28.9	29.5	28.6	29.0	29.5
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	75.3	77.7	80.9	77.3	73.3	73.6	76.2	76.2	76.2	76.2	76.2
Real effective exchange rate growth	6.0	(3.9)	0.6	0.9	6.1	1.5	(3.2)	N/A	N/A	N/A	N/A

Definitions: Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. e--Estimate. f--Forecast. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Uruguay--Ratings Score Snapshot

Key rating factors	Score	Explanation
Institutional assessment	3	Stable democracy, predictable policies, free press, and peaceful changes of government. No external threats. Largely middle-class society with consensus on key economic policies. Policymaking during the past 10 years has remained generally effective. Strong institutional checks and balances, low perception of corruption, and respect for the rule of law.

Table 2

Uruguay--Ratings Score Snapshot (cont.)

Key rating factors	Score	Explanation
Economic assessment	3	Based on GDP per capita (US$) and growth trends as per Selected Indicators in table 1.
External assessment	2	Based on narrow net external debt and gross external financing needs/(CAR + usable reserves) as per Selected Indicators in table 1.
Fiscal assessment: flexibility and performance	5	Based on the change in net general government debt (% of GDP) as per Selected Indicators in table 1.
Fiscal assessment: debt burden	4	Based on net general government debt (% of GDP) and general government interest expenditure (% of general government revenue) as per Selected Indicators in table 1. Over 40% of gross government debt is denominated in foreign currency.
Monetary assessment	5	The Uruguayan peso is a free-floating currency with central bank intervention in foreign-exchange markets. CPI as per Selected Indicators in table 1. The central bank has a track record of independence and has the ability to act as lender of last resort for the financial system. Resident deposits/loans in foreign currency account for more than 50% of the total.
Indicative rating	bbb	As per table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	0	
Final rating		
Foreign currency	BBB	
Notches of uplift	0	
Local currency	BBB	Default risks do not apply differently to foreign currency and local currency debt.

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating, the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Risk Indicators, April 24, 2020 (An interactive version is also available at https://www.spratings.com/sri/.)
- COVID-19 Deals A Larger, Longer Hit To Global GDP, April 16, 2020

- Sovereign Ratings History, April 7, 2020
- Sovereign Ratings List, April 7, 2020
- Sovereign Ratings Score Snapshot, April 1, 2020
- Sovereign Debt 2020: Global Borrowing To Increase To $8.1 Trillion Amid Favorable Financing Conditions, Feb. 20, 2020
- Global Sovereign Rating Trends 2020: Sovereign Debt Buildup Continues, Jan. 29, 2020

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed	
Uruguay	
Sovereign Credit Rating	BBB/Stable/A-2
Transfer & Convertibility Assessment	
Local Currency	A-
Uruguay	
Senior Unsecured	BBB
Short-Term Debt	A-2