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Rating Action Commentary

Fitch Affirms Uruguay's Rating at 'BBB-'; Outlook Negative

Thu 08 Oct, 2020 - 16:33 ET

Fitch Ratings - New York - 08 Oct 2020: Fitch Ratings has affirmed Uruguay's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB-' with a Negative Outlook.

KEY RATING DRIVERS

The Negative Outlook reflects deterioration in growth and public finances that has been compounded by the coronavirus shock, and risks to government plans to arrest these trends. Deft management of the pandemic has underscored Uruguay's institutional strengths and helped its economy fare better than peers. However, Uruguay has faced sluggish growth and a recession that predates the crisis, despite ramp-up in a large pulp mill project (UPM), reflecting structural issues which are likely to persist. High public debt-to-GDP is projected to rise sharply and diverge further from the peer median in 2020 despite a smaller fiscal expansion, given the high starting point of the fiscal deficit and a dollarized debt stock sensitive to exchange-rate swings. The Lacalle Pou administration aims for a swift fiscal consolidation after 2020, but this could be difficult to achieve in the absence of the high growth rates expected in its new five-year budget, given downside domestic and external economic risks.

The ratings are also supported by robust external liquidity, prudent debt management practices, and stable (albeit low) economic growth. These strengths are counterbalanced by high inflation and dollarization and low financial intermediation that narrow scope for counter-cyclical policies, although the authorities have laid out plans to tackle these issues in the coming years.

Fitch projects Uruguay's economy will contract by 4.6% in 2020, a moderate decline relative to peers that reflects its successful containment of the pandemic and a less severe lockdown, the ramp-up in the UPM project, and the outsized weight of telecom activity in GDP data (the 2Q20 contraction of 11% yoy was 16% net of this). Growth rates could be subject to change in new 2016-base GDP data set for release in December as these are likely to re-weight telecom and include new activities, also resulting in higher nominal GDP.

Fitch projects growth to rebound 2.8% in 2021 and 2.0% in 2022, below the authorities' baseline given a greater drag from real wage losses and fiscal austerity, risks to exports and tourism (the pandemic, record-strong exchange rate relative to neighbors, and Argentine capital controls), and a smaller contribution from UPM (negative in 2021-2022 as project outlays decline, and positive in 2023-2024 as exports begin).

The government expects a surge in exports and private investment to offset the drag from fiscal austerity, delivering strong job gains and a large current account surplus, although it is unclear if its agenda to address cost competitiveness issues will be potent enough to

deliver these results. Its budget and Urgent Consideration Law (LUC) reform package passed in mid-2020 express a goal for but no clear path toward a more competitive exchange rate and reduction in high utility rates (though the latter will be set more transparently). The authorities plan to seek new trade agreements, although a key EU-Mercosur deal faces an impasse. Recent enhancements in the tax incentives scheme for investments offer an upside, but fiscal constraints prevent a larger impulse. Plans to leverage Uruguay's relative stability to court investment and migration from Argentina also offers an upside, despite risks from this neighbor.

Fitch projects the central government and social security (CG+BPS) deficit will rise to 7.3% of GDP in 2020 from 4.3% in 2019 (net of "cincuentones" pension transfers), a smaller rise than in peers but above the official projection of 6.6%. This reflects the shock to revenues and spending increases related to the pandemic, partially offset by extraordinary dividends from the state-owned commercial bank (BROU).

The five-year budget aims to reduce the CG+BPS deficit to 3.8% of GDP in 2021 and 2.7% by 2024 by containing spending growth below high expected GDP growth. The plan centers on a 4.8% cut in real primary spending in 2021 - mostly in opex, investment and wages, but also reflecting phase-out of all pandemic transfers - followed by increases averaging 2.3% in 2022-2024. Fitch projects a slower fall in the deficit to 5.2% of GDP in 2021 and 4.8% in 2022 as lower GDP growth results in a smaller reduction in spending/GDP. These projections assume opex and investment budget cuts in 2021 are achieved, but these could face implementation risk as seen by a smaller-than-expected impact of a March decree for a 15% cut to these outlays in 2020. Fitch expects pension pressures to ease amid a real decline in wages (to which benefits are indexed) but that these outlays will exceed budget estimates, as has already occurred in 2020. Pressure for restitution in public and private real wages, which the government has pledged after 2021, and political factors could make austerity more difficult further into the five-year term.

Strong access to global markets and multilaterals supports the sovereign's flexibility to finance large deficits. It met its higher 2020 funding needs by tapping USD800 million of USD2.2 billion in preexisting multilateral credit lines, allowing it to wait for a fall in yields to issue global bonds. It has also secured two large multilateral budget support loans totaling USD750 million (1.5% of GDP) that will help reduce market issuance needs, although market yields remain low.

Fitch projects general government debt (including non-marketable debt owed to the central bank, and netting out "cincuentones" fund holdings) to surge to 76% of GDP in 2020 from 63% in 2019, diverging further from the also-rising 'BBB' median of 53%, and rise past 80% in the coming years. This assumes an improvement in the primary fiscal balance smaller than the 2.5pp-3.0pp-of-GDP Fitch estimates is needed to stabilize debt, relative to the precrisis level of -1.9%. An especially large stock of foreign-currency debt (40% of GDP) make the projection highly sensitive to the exchange rate, which Fitch projects will be stable in real terms.

The authorities have unveiled three new fiscal rules to improve the credibility and counter-cyclicality of fiscal policy. A structural balance will be the key fiscal target, but could be difficult to develop as an anchor given its calculation is based on the difficult-to-estimate output gap. Real primary spending growth will be capped at 2.3%, although this is in line with the 2015-2019 average and exempts payments on Public Private

Partnership projects - the budget item that will grow the most. A cap on annual net borrowing could be more binding, given this would pose a limitation to the actual deficit and require measures to offset the impact of any growth underperformance.

The authorities have also laid out plans to reduce persistently high and above-target inflation, which stood at 9.9% in September after having crossed into double-digits earlier in 2020. The central bank (BCU) has switched its policy target to an interest rate from monetary aggregates, emphasized a clearer focus on control of inflation versus other objectives, and reduced the target band from 3%-7% to 3%-6% by 2022. High dollarization, shallow financial depth and prevalent indexation present challenges reducing inflation. Real wage declines agreed to between unions and the government in 2020-2021 offer an opportunity for wage-price inertia to contribute to rather than hinder a disinflationary process, although the pledge for recovery in these wage losses after 2021 may pose some challenge later on. These monetary- and wage-policy announcements have already contributed to a sizeable fall in inflation expectations.

The BCU set its initial policy rate at 4.5% in September, which is negative in real terms and ratifies an expansionary policy stance to support liquidity conditions during the pandemic. This has supported a moderate increase in credit growth, which has been complemented by a government guarantee program (SiGA) that has supported 1%-of-GDP in new credits so far. While disinflation will likely require hikes in the policy rate eventually, the recent reduction in the long end of the peso curve could prove more lasting, with positive effects for sovereign debt dynamics and ability to issue peso debt in both local and global bond markets.

External finances remain sound. Fitch expects the current account surplus to turn into a modest deficit of 0.3% in 2020 and 1.4% in 2021 on the UPM-led investment cycle, funded by corresponding FDI inflows. This should contribute to stability in Uruguay's strong net external creditor position around 24% of GDP. The sovereign is a net external debtor but its liquidity position is strong, supported by BCU reserves that have risen in 2020 to around USD16.5 billion.

ESG: Uruguay has an ESG Relevance Score (RS) of 5 for Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in Fitch's proprietary Sovereign Rating Model. Uruguay has a high WBGI ranking (81st percentile), balancing high scores for all pillars, particularly for political stability, control of corruption and voice and accountability.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--Public Finances: Failure to achieve a substantial fiscal adjustment and stabilization of debt/GDP;

--Macro: Evidence of a weak economic recovery and/or post-recovery trend growth, due to domestic or external challenges or lack of progress on structural reforms to improve competitiveness issues and growth potential.

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--Public Finances: Confidence in fiscal consolidation consistent with stabilization of debt/GDP;

--Macro: A strong recovery in economic growth, supported by improved prospects for private investment and exports;

--Macro: Evidence of progress in a sustained reduction in inflation and inflation expectations, de-dollarization, and financial deepening that improve policy flexibility.

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 (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final Long-Term Foreign Currency IDR by applying its QO, relative to rated peers, as follows:

--Macro: -1 notch, to reflect constraints to policy flexibility posed by high dollarization and indexation, shallow financial market depth not fully captured in the SRM, and structurally high inflation and public debt. A poor track record of compliance with inflation and fiscal targets weighs on policy credibility, reflecting institutional shortcomings not captured in the strong governance indicators that feed into the SRM, although the government is focused on efforts to improve this.

Fitch has removed the -1 notch previously assigned in Public Finances. This had partially reflected Fitch's expectation of a sharp rise in debt-to-GDP in 2020 and the sensitivity of the debt stock to exchange-rate, which has now materialized and contributed to the fall in the SRM output.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC 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.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [<https://www.fitchratings.com/site/re/10111579>].

KEY ASSUMPTIONS

As of its latest Global Economic Outlook (GEO) in September, Fitch projects global real GDP to grow 5.2% in 2021 after contracting 4.4% in 2020, and key trading partner Brazil to grow 3.2% in 2021 after contracting 5.8% in 2020.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Uruguay has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's Sovereign Rating Model (SRM) and is therefore highly relevant to the rating and a key rating driver with a high weight.

Uruguay has an ESG Relevance Score of 5 for Rule of Law, Institutional and Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in the SRM and are therefore highly relevant to the rating and a key rating driver with a high weight.

Uruguay has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for the Uruguay, as for all sovereigns.

Uruguay has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3' - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed

by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.