FitchRatings

Fitch Affirms Uruguay at 'BBB-'; Outlook Negative

Fitch Ratings - New York - 27 June 2019: Fitch Ratings has affirmed Uruguay's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB-' with a Negative Rating Outlook.

A full list of rating actions is at the end of this rating action commentary.

Key Rating Drivers

The Negative Rating Outlook reflects growth underperformance and fiscal deterioration, which are lifting the government debt burden. Fitch projects Uruguay will see the largest increase in debt/GDP in the 'BBB' category in the five years through 2019, constraining policy space to manage shocks. Growth has fallen to one of the lowest levels in the 'BBB' category, although it has remained relatively resilient to shocks from neighbouring economies. The scope, nature and timing of potential measures to address these negative fiscal and macroeconomic trends remain uncertain, but could become clearer after the October 2019 elections.

Uruguay's ratings are supported by strong social and institutional development, high external liquidity and solvency metrics, and long-dated public debt and liquidity buffers. These factors are balanced by weak public finances, reflected in a poor track record in meeting fiscal targets, a large stock of foreign-currency debt rendering the sovereign balance sheet sensitive to exchange rate shocks, and persistently high inflation.

Upcoming general elections in October are poised to be competitive, following three terms and fifteen years of government under the center-left Frente Amplio. Broad policy continuity is likely in any outcome, but the elections will be important for prospects for fiscal adjustment to arrest rising public debt and structural reforms to boost a weak economy.

Growth slowed to 1.6% in 2018 from 2.6% in 2017, and to -0.2% in first-quarter 2019. Private sector activity has been contracting as a whole, as public utilities and telecom services (which has an outsized impact in GDP series) have propped up growth. External headwinds have explained part of the slowdown, namely the hit to Uruguay's tourism sector from Argentina's currency crisis and recession. On the internal front, a weak labor market and low confidence have weighed on consumption, and structural issues have continued to weigh on investment (which has contracted around 30% cumulatively since 2014).

Fitch expects growth to slow to 0.5% in 2019 as a whole, and rise to 1.5% in 2020 and 2.5% in 2021 on ramp-up in construction activity of a large pulp plant and related railway infrastructure, as well as a pipeline of other PPP projects. Growth net of the pulp megaproject is likely to remain subdued, however, given low investment in recent years. Business groups and surveys point to high local production costs (salaries, utility rates, taxes) as a key factor weighing on investment appetite. Economic reactivation has been a key theme in the 2019 election campaign, but the outlook for reforms is unclear and concrete proposals have been limited so far.

The fiscal position has weakened beyond Fitch's prior projections, net of a transitory statistical impact of the cincuentones law allowing persons in their 50s and recent retirees to bring their private pension funds into the public system (booked as revenue in accordance with IMF data standards). The central government deficit rose to 3.7% of GDP in 2018 from 2.9% of GDP net of the cincuentones impact and a 0.3 percentage point (pp) transfer from an energy fund, but fell to 2.1% with these effects. Fitch expects it to reach 4.3% in 2019. The fiscal slippage mainly reflects structural spending pressures that have continued to far exceed budget projections, and some cyclical impact on tax collections from weak growth. Fitch projects the public sector deficit will reach 5.4% of GDP in 2019, above the 2.8% target.

Fitch projects general government debt will reach 64.3% of GDP at the end of 2019, up from 59.6% at end-2018 and compared with the historic 'BBB' median of 36%. Fitch's debt figures consolidate out holdings of central government bonds by the new cincuentones fund (1% of GDP at end-2018) and include bonds issued to the central bank (BCU) for recapitalisation (8.2% of GDP). Debt forecasts are sensitive to exchange rate assumptions, possible cancelation of recapitalization bonds and the size of further cincuentones transfers in the next three years.

Fitch estimates a fiscal adjustment of around 2.5% of GDP could stabilise debt/GDP, but the outlook for this is likely to remain unclear and plans vague until after the elections. Candidates have advocated for budget austerity, and the opposition has detailed a particularly ambitious set of cuts it hopes to achieve, but a rigid spending profile could make a spending-focused adjustment strategy challenging and slow. There is broad consensus around the need for social security reform, but this will take time to negotiate and at best is likely to contain further upward pressure on the deficit rather than contribute to reduction. There is narrow appetite for tax hikes to reduce the deficit more quickly given a weak economic backdrop, and candidates have focused instead on lifting revenues by fostering stronger economic growth.

Long-dated debt and liquidity buffers help mitigate financing risks in the context of relatively high reliance on external funding. Maturities averaging 2.8% of GDP in 2019-2021 are low, and cash holdings and contingent credit lines cover debt service for over a year. The authorities have made progress in deepening local funding, recently via issuance of wage-indexed bonds.

Inflation stood at 7.7% as of May, above the target range (5%±2pp) and the highest among investment-grade sovereigns. Fitch expects it to remain stable by year-end, balancing weak domestic demand with pass-through pressure from recent peso depreciation. The BCU has recently dialled back the contractionary bias of monetary policy despite above-target inflation, given a weak growth backdrop. A major round of wage negotiations concluded last year in which sector-level councils largely adopted official guidelines establishing nominal wage increases on a declining path rather than real increases (ie reducing backward-looking indexation to inflation), which could help moderate inertial inflation pressures going forward.

External finances remain sound. The current account balance shifted back into deficit in 2018 (0.6% of GDP). Fitch expects it will rise but remain moderate at 2.0% of GDP in 2019 as the full impact of Argentina's currency crisis on tourism inflows is felt, and rise further in the following years as construction of the pulp plant progresses (financed by corresponding FDI). The large stock of FX reserves provides ample coverage of current external liabilities and imports, and has offered scope for the BCU to intervene in FX markets in recent months to manage the depreciation of the peso.

Derivation Summary

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 LT FC IDR by applying its QO, relative to rated peers, as follows:
--Macro: -1 notch, to reflect a relatively poor track record of compliance with inflation and fiscal targets, which weighs on policy credibility and narrows counter-cyclical policy scope, despite relatively strong governance indicators that feed into the SRM;
--Public Finances: -1 notch, to reflect a highly rigid expenditure profile dominated by heavily indexed and constitutionally protected social entitlements, with a low share of capital spending. This poses challenges to fiscal consolidation goals. A large stock of foreign-currency debt makes Uruguay's debt metrics sensitive to exchange-rate risk.

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 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 the criteria that are not fully quantifiable and/or not fully reflected in the SRM.

Key Assumptions

--Fitch assumes that construction of a new pulp mill project will begin as soon as 2020, following initiation of related infrastructure investments in 2019, supporting growth during the construction phase and once production begins;
--Fitch projects Argentina's economy will contract -1.7% in 2019 and grow 1.5% in 2020, and that Brazil's economy will grow 1.0% in 2019 and 2.2% in 2020.

RATING SENSITIVITIES

The main risk factors that, individually or collectively, could trigger a downgrade are:
--Failure to reduce fiscal deficits and/or improve the trajectory of government debt-to-GDP;
--Persistently weak economic growth;
--Sustained erosion of central bank international reserves.

The Rating Outlook is Negative. Consequently, Fitch does not currently anticipate developments with a high likelihood of leading to a positive rating change. However, the main factors that, individually or collectively, could lead to a stabilization of the Outlook are:
--Greater confidence in a fiscal consolidation path that would support stabilization of debt metrics in the medium term;
--A sustained reduction in inflation and better anchoring of inflation expectations;
--Evidence of investments or productivity gains that lift medium-term growth prospects.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
Uruguay	LT IDR BBB- Affirmed	BBB-
	ST IDR F3 Affirmed	F3
	LC LT IDR BBB- Affirmed	BBB-
	LC ST IDR F3 Affirmed	F3
	Country Ceiling BBB+ Affirmed	BBB+
senior unsecured	LT BBB- Affirmed	BBB-

Additional information is available on www.fitchratings.com

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Applicable Criteria

Country Ceilings Criteria (pub. 19 Jul 2018)
Sovereign Rating Criteria (pub. 26 May 2019)

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