FITCH AFFIRMS URUGUAY AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-New York-07 April 2017: 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, a strong external balance sheet, and fiscal financing buffers. These factors are balanced by a weak track record of compliance with inflation and fiscal targets, weighing on policy credibility, a relatively high and dollarized public debt burden, and budget rigidity.

Uruguay's key credit challenge continues to be structural deterioration in public finances, which gained pace in 2016. Inertial growth in social spending continues to drive the fiscal slippage, reflecting broadened coverage of the public health insurance fund (FONASA) and pressure on indexed pension benefits. Revenues have risen despite sluggish growth due to tariff adjustments that have boosted public utilities' tax and dividend contributions to the treasury, and modifications in the corporate tax calculation.

These factors lifted the central government deficit to 3.7% of GDP in 2016, above the government's prior forecasts and up from 2.8% in 2015. The rise in the global public sector deficit targeted by the government was smaller - 4% in 2016, up from 3.6% in 2015 - as lower central bank interest costs partly offset the slippage at the central government level.

The authorities have already enacted a fiscal adjustment package of 0.9pp of GDP to support their goal to lower the public sector deficit by 1.5pp of GDP to 2.5% by 2019, and economic recovery could provide additional fiscal relief. However, achieving the target is likely to require further efforts in Fitch's view, given existing inertia in social spending and political pressures for further hikes. The government has kept pledges to lift health and education spending, and factions in the ruling coalition are pushing for additional budget increases. How the authorities balance their spending promises and consolidation goals is not yet clear given narrower appetite for further tax hikes, and will be a challenge in this year's budgeting exercise.

General government debt was stable in 2016 at 57.3% of GDP, above the 'BBB' median of 41%, as borrowing to finance the deficit was offset by exchange rate appreciation and some asset drawdown. (Fitch's figures include 8.5pp in illiquid bonds issued to the central bank for recapitalisation, which do not entail debt service). Fitch forecasts debt will reach 62.1% of GDP by 2018, and a still high share of foreign-currency debt makes these projections sensitive to exchange rate risk. Risks from relative reliance on external funding sources are presently mitigated by favourable market access, a pre-financing policy, and contingent credit lines.

Uruguay's economy grew a modest 1.5% in 2016, up from a downward-revised 0.4% in 2015, but beat prior expectations as the shock to confidence in Q1 from peso depreciation and a jump in inflation dissipated later in the year as these trends reverted. Fitch expects growth will reach 2.1% in 2017, as a return to positive (albeit lacklustre) growth in Brazil and Argentina creates some tailwinds, already visible in the tourism sector. Tax hikes could restrain the pick-up in consumption some, although consumer confidence has been resilient to these measures so far.

Uruguay's medium-term growth prospects hinge upon its ability to leverage its relative human-capital and institutional strengths, given local production costs are not a relative advantage (labour, energy, taxes). A large pulp project could provide a major boost, although its execution and timing are not yet certain amid ongoing negotiations around the tax and labour regimes and infrastructure needs. Fitch expects broader growth to be subdued in the coming years given the recent ebb in investment. The administration is aiming to advance infrastructure projects (some via the PPP law), trade agreements, and financial inclusion. Efforts to improve education - a key pledge - have been limited to higher budget allocations so far, rather than concrete structural reforms.

Inflation has fallen rapidly to 6.7% in March from double-digit rates a year earlier, within the target range (5%+2pp) for the first time in seven years. A strong peso and base effects have driven disinflation in recent months, and expectations remain above target, so it is not yet clear how structural in nature this trend is. Structural challenges to improving inflation-targeting credibility persist, but the authorities are making efforts on this front. Wage guidelines for the private sector (but not the public sector) seek to scale back ex post inflation adjustment mechanisms, and have mostly been followed with some modest relaxation to ensure acceptance by resistant unions. Uruguay's five-year average inflation of 8.8% is the highest among investment-grade peers.

Uruguay's current account deficit fell to just 0.2% of GDP, from an average of nearly 4% in 2011-2016. Exports fell, but showed some resilience to price shocks and contractions in Brazil and Argentina due to a fairly diversified export base in terms of markets in soft agriculture products. Imports fell by a larger amount due to a cyclical ebb in investment, lower oil prices, and structural improvement in the energy balance from expansion of renewables. A new oil hedging program further mitigates Uruguay's vulnerability to oil price fluctuations.

Despite the improved current-account dynamics, international reserves have been falling due to capital outflows that do not pose a source of concern in Fitch's view. Argentina's tax amnesty has driven sizeable deposit outflows and reduced USD reserve requirements, but the central bank's "own" reserve position net of these USD liabilities has risen on FX market intervention. Non-residents have unwound positions in the local debt market to 6% of the total in February 2017, from 25% at end-2015, and local investor demand has kept this process orderly.

As the decline in FX reserves has corresponded to an even larger decline in liquid external liabilities, Uruguay's external liquidity ratio has risen to a record-high 300% in 2017. The negligible impact of Argentine deposit withdrawals on Uruguay's banking system highlights its resilience and represents a noteworthy contrast to the contagion-induced crisis of 2002.

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 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 weak track record of compliance with inflation and fiscal targets, which weighs on policy credibility and counter-cyclical policy scope.
--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. A still relatively large stock of foreign-currency debt (around half) exposes the fiscal balance and debt metrics to higher exchange rate risk, underscored in the context of greater currency flexibility.

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 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 that improves the government debt trajectory;
--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 after contracting in 2016, Brazil's economy will post positive growth 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