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Oriental Republic of Uruguay

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Oriental Republic of Uruguay

This report supplements our research update "Uruguay Outlook Revised To Negative On Risks Of A Weaker Economy; 'BBB/A-2' Ratings Affirmed," published on June 6, 2016. To provide the most current information, we may cite more recent data than that stated in the previous publication. These differences have been determined not to be sufficiently significant to affect the rating and our main conclusions.

Rationale

Sovereign Credit Rating
BBB/Negative/A-2

The ratings on the Oriental Republic of Uruguay reflect its stable political system, cohesive society, moderately prosperous economy, moderate fiscal flexibility and debt burden, and limited monetary flexibility. Although the country's stability continues to support the rating, the economic challenges facing Uruguay--external, monetary, and fiscal--have increased owing to regional and global factors. S&P Global Ratings expects real GDP to grow 0.7% this year and 1.5% in 2017, versus 1% in 2015; GDP per capita should average just below $17,000 between 2016-2019. The economies of two of Uruguay's main trading partners and sources of foreign direct investment (FDI)--Brazil and Argentina--are set to contract by 3.6% and 1%, respectively, in 2016, with growth in Brazil only expected to rebound slowly in the next two years. Although we believe that the Uruguayan economy's links with these countries are weaker than in the past, it will still suffer from the regional recession. In addition, lower trend growth in China (which buys 23% of Uruguay's exports) and weak global commodity prices also weigh on Uruguay's growth prospects. At the same time, inflation dynamics have worsened amid depreciation of the Uruguayan peso; we expect consumer confidence to remain weak in a context of inflation that remains close to 10%.

In our view, low economic growth has, and will continue to, hurt Uruguay's fiscal performance, including government tax collection. The general government deficit increased to 4.3% of GDP in 2015, and we expect it to remain at this higher level, around 4.5% of GDP this year, up from an average deficit of 2.4% in 2013-2014. (Unlike the government's definition of public sector, our definition of general government includes the central bank and excludes public-sector enterprises.) Although the government has begun to implement expenditure efficiency measures, particularly in public-sector enterprises, which partly led to a surplus in public-sector enterprise balances in 2015, we do not expect these measures to be sufficient to avoid a higher general government deficit in 2016. However, we assume that new fiscal measures the government currently is contemplating will be implemented later this year following the government's budget accountability process. We assume these measures will lead to a reduced deficit over the coming three years.

We expect that the change in general government debt will rise by close to 6% of GDP this year--boosted by depreciation of the Uruguayan peso since around 52% of general government debt is denominated in foreign currency--and gradually decline to below 3% by 2019. At the same time, we expect net general government debt to peak at 54% of GDP in 2016 and then decline to 49% by 2019, while we expect general government interest to average 7.4% of general government revenues between 2016-2019. We include central bank debt as part of our calculation of general government debt.

The country's flexible exchange rate and, to some extent, its natural trade hedge as both a commodity exporter and oil importer have helped to moderate the deterioration in the country's external liquidity and indebtedness, in our opinion. We expect Uruguay's gross external financing needs to average 109% of current account receipts (CARs) plus usable reserves in 2016-2018, and we expect external debt net of public- and financial-sector external assets to average 26% of CARs over this same period.

The current account deficit (CAD) fell to 3.6% of GDP in 2015 from 4.6% in the previous year. However, net FDI fell to 3% of GDP in 2015 from 3.8% in the previous year, no longer fully funding Uruguay's CAD (as it had during most years over the past decade). The 23% depreciation of the Uruguayan peso in 2015 supported the country's external competitiveness amid regional and global volatility. Yet, central bank intervention in the foreign exchange market to help smooth this depreciation partly led to the fall in international reserves, which reached $14.3 billion by March 2016 (excluding gold holdings) from $17.5 billion at the end of 2014. Despite the decline in reserves, the central government's liquid external assets and contingent funding lines help to limit external liquidity risks, in our opinion. Liquidity buffers include the central government's liquid assets and contingent credit lines from multilateral institutions worth close to 7.7% and 4.5% of GDP, respectively.

We believe that higher inflation and still-high dollarization continue to limit Uruguay's monetary policy flexibility. Year-over-year inflation exceeded 10% in the beginning of 2016, higher than the central bank's 3%-7% target and higher than inflation has been in over 10 years. The rise in inflation reflects a combination of the pass-through effect of significant currency depreciation and a hike in utility tariffs. By the end of 2016, we expect that inflation will remain close to 10%, and gradually decline thereafter, as the impact of recent currency depreciation is counterbalanced by contractionary monetary policy, a decelerating economy, and new wage-indexation guidelines, which should somewhat limit the impact of backward wage indexation.

The broad political consensus on the need for fiscal consolidation reflects Uruguay's stable and well-established institutions that anchor economic stability. We expect that the Administration of President Tabaré Vazquez of the Frente Amplio (FA) will continue to implement policies to facilitate growth, although the speed of this progress may be slower than originally expected. In particular, we expect the government to advance with its capital investment plans, somewhat counterbalancing its otherwise contractionary fiscal measures. We expect that the new budget adjustments in 2016 will broadly maintain the government's infrastructure plan, relying in part on the private sector for financing, some of which will come from public-private partnerships (PPPs).

Outlook

The negative outlook reflects our view that there is a greater than one-in-three likelihood that we could lower the ratings on Uruguay over the next two years. We could lower the ratings if economic growth disappoints beyond our current expectations, leading to lower per capita income, or if Uruguay's growth prospects deteriorate such that we expect its revenue base, policy flexibility, or debt burden to be weaker than our base-case scenario. This risk would be exacerbated by a failure to implement timely fiscal adjustment measures currently under debate, leading us to believe that fiscal deficits would continue to widen over the next two years, or if the measures passed are insufficient to revert deterioration. At the same time, if, contrary to our expectations, inflation continues to rise, eventually breaching 12%, new wage agreement clauses could be triggered, causing nominal wage increases that could lead to spiraling inflation levels and reflecting weaker effectiveness of monetary policy, and we could also lower the ratings.

On the other hand, the ratings could stabilize if, in line with our base-case scenario, the economy gradually strengthens, supporting per capita income and, thus, the country's revenue base, its fiscal and monetary policy flexibility, and its capacity to absorb growing debt levels. This, combined with the implementation of fiscal reform measures this year that keep Uruguay on track to reduce its deficit in order to meet its five-year budget goal in such a way that doesn't deteriorate growth, would support the rating.

Summary Statistics:

Table 1

Uruguay--Selected Indicators											
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016f**	**2017f**	**2018f**	**2019f**
ECONOMIC INDICATORS (%)											
Nominal GDP (bil. LC)	714.52	808.08	926.36	1,041.21	1,178.33	1,330.51	1,460.44	1,617.34	1,772.97	1,917.44	2,083.30
Nominal GDP (bil. $)	31.66	40.28	47.96	51.26	57.53	57.24	53.44	52.88	55.53	58.03	61.52
GDP per capita ($000s)	9.5	12.0	14.2	15.2	17.0	16.8	15.7	15.4	16.2	16.8	17.8
Real GDP growth	4.2	7.8	5.2	3.5	4.6	3.2	1.0	0.7	1.5	2.0	2.5
Real GDP per capita growth	3.9	7.4	4.8	3.2	4.3	2.9	0.7	0.4	1.2	1.7	2.2
Real investment growth	(5.8)	16.0	7.0	18.2	3.8	2.4	(8.2)	0.7	1.5	2.0	2.5
Investment/GDP	19.6	19.4	20.9	22.9	22.5	21.2	19.8	20.0	20.0	20.0	20.0
Savings/GDP	18.4	17.6	18.1	17.9	17.5	16.6	16.2	16.7	17.1	17.5	17.7
Exports/GDP	27.1	26.3	26.4	25.9	23.4	23.5	22.3	22.3	22.3	22.3	22.3
Real exports growth	4.5	7.2	5.8	3.6	(0.1)	3.5	(1.2)	0.7	1.5	2.0	2.5
Unemployment rate	7.7	7.2	6.3	6.5	6.5	6.6	7.5	7.8	8.0	8.4	6.0
EXTERNAL INDICATORS (%)											
Current account balance/GDP	(1.2)	(1.8)	(2.7)	(5.1)	(5.0)	(4.6)	(3.6)	(3.3)	(2.9)	(2.5)	(2.3)
Current account balance/CARs	(4.1)	(6.4)	(9.6)	(18.4)	(20.2)	(18.8)	(15.5)	(14.1)	(12.6)	(10.6)	(9.6)
Trade balance/GDP	(1.6)	(1.3)	(3.0)	(4.6)	(2.4)	(1.6)	(0.5)	(0.0)	0.3	0.6	0.7
Net FDI/GDP	4.8	5.8	5.2	5.0	5.3	3.8	3.0	3.1	3.0	3.0	3.0
Net portfolio equity inflow/GDP	(0.1)	(0.0)	0.0	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Gross external financing needs/CARs plus usable reserves	124.3	108.4	105.8	99.4	98.4	96.9	97.0	106.9	110.7	110.9	109.5
Narrow net external debt/CARs	23.8	8.6	(2.8)	8.1	5.3	3.7	7.3	20.5	25.8	28.0	28.5
Net external liabilities/CARs	30.6	29.2	40.7	59.4	68.1	79.8	92.5	106.1	107.9	104.8	99.5

Table 1

Uruguay--Selected Indicators (cont.)

	2009	2010	2011	2012	2013	2014	2015	2016f	2017f	2018f	2019f
Short-term external debt by remaining maturity/CARs	54.8	49.0	40.6	33.8	41.0	47.9	57.0	57.5	57.6	54.1	50.2
Reserves/CAPs (months)	3.2	4.9	4.6	5.4	6.4	7.3	8.1	6.4	5.7	5.3	5.0
FISCAL INDICATORS (%, General government)											
Balance/GDP	(1.2)	(1.3)	(0.7)	(2.1)	(1.8)	(3.0)	(4.3)	(4.5)	(3.9)	(3.2)	(2.9)
Change in debt/GDP	1.8	3.9	5.1	5.7	8.9	7.0	8.3	6.2	4.3	3.2	2.7
Primary balance/GDP	1.6	1.6	2.1	0.5	0.9	(0.2)	(0.7)	(1.5)	(1.2)	(0.5)	(0.5)
Revenue/GDP	35.8	36.6	36.8	36.6	38.0	37.5	36.8	35.9	36.4	37.3	38.1
Expenditures/GDP	37.0	37.9	37.5	38.6	39.8	40.5	41.1	40.5	40.2	40.6	41.1
Interest /revenues	7.8	8.1	7.7	6.9	7.1	7.6	9.6	8.4	7.4	7.3	6.3
Debt/GDP	58.3	55.4	53.5	53.3	56.0	56.6	59.8	60.3	59.2	58.0	56.1
Debt/Revenue	163.1	151.6	145.4	145.5	147.1	150.9	162.4	167.7	162.9	155.4	147.1
Net debt/GDP	48.7	49.5	45.3	45.6	49.7	49.0	50.3	53.8	53.2	52.3	50.6
Liquid assets/GDP	9.7	5.9	8.2	7.7	6.2	7.6	9.5	6.4	6.0	5.7	5.6
MONETARY INDICATORS (%)											
CPI growth	7.1	6.9	8.6	7.5	8.5	8.3	9.4	10.0	8.0	6.0	6.0
GDP deflator growth	7.7	4.9	9.0	8.6	8.2	9.4	8.7	10.0	8.0	6.0	6.0
Exchange rate, year-end (LC/$)	19.63	20.09	19.90	19.40	21.39	24.33	29.87	31.30	32.55	33.53	34.20
Banks' claims on resident non-gov't sector growth	(15.8)	20.8	18.9	15.0	24.9	18.0	22.4	13.0	11.5	9.3	7.2
Banks' claims on resident non-gov't sector/GDP	21.3	22.8	23.6	24.2	26.7	27.9	31.1	31.7	32.3	32.6	32.2
Foreign currency share of residents' bank deposits	71.5	69.1	67.4	67.1	69.1	72.5	75.8	75.8	75.8	75.8	75.8
Real effective exchange rate growth	2.7	11.9	2.0	3.1	6.6	(1.7)	3.8	N/A	N/A	N/A	N/A

Note: 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 other 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. 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. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. f--Forecast.

Institutional And Governance Effectiveness: Growing Policy Challenges Amid Stable And Well-Established Institutions

- Despite an external, economic, political, fiscal, and monetary context that presents more challenges to policymaking than that of the last decade, we expect Uruguay's stable and well-established institutions will continue to support governability.
- We expect that the Administration of President Tabaré Vazquez, of the FA, will make steady progress toward fiscal consolidation and continue to implement policies to facilitate growth, although the speed of this progress may be slower than initially expected.
- The country's cohesive civil society, evolving checks and balances, respect for the rule of law, and free flow of information also support our evaluation of Uruguay's institutional and governance effectiveness.

Although the new Vázquez Administration, in its first year in office, has made efforts to contain the external and domestic threats to growth and fiscal sustainability, we expect these challenges to continue through 2016. While the FA holds a simple majority in both houses of Congress, tensions within the coalition have slowed fiscal reform efforts. However, we believe there is a general consensus across political factions on the need to implement budgetary constraints given the more challenging economic conditions. We anticipate that new fiscal reform measures implemented this year, following the government's budget accountability process, will put it back on track to come close to meeting its five-year budget plan passed in December 2015. The government has also modified the wage-setting framework in order to limit de facto indexation adjustments for inflation. Over the remainder of the government's term in office, we expect that it will also prioritize the country's social development, through secondary education reforms, responding to growing demands from the country's electorate for improved education, health care, and security.

Uruguay continues to have a strong democracy and ranks highly in global institutional quality rankings. Institutional strength sustains investor confidence in the country despite adverse 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 highly 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 2015 Corruption Perceptions Index. The Economist Intelligence Unit ranked Uruguay first in Latin American in its Democracy Index. Additionally, Uruguay was the best-ranked country in Latin America for the Rule of Law Index, which indicates better rule of law implementation than Latin American peers, as published by The World Justice Report in 2015, and was ranked 22nd worldwide. Uruguay also ranks first in South America in Reporters without Borders' 2016 Press Freedom Index.

The new Administration has prioritized economic growth and trade, and we expect these to remain priorities throughout the government's term in office. Led by the president, the government is seeking to reform Mercosur (an economic and political agreement between Argentina, Brazil, Paraguay, Uruguay, and Venezuela) to allow for increased trade flexibility. In addition, discussions, in part led by Uruguay, are currently underway between Mercosur and the EU to sign a free-trade agreement. The government has also made progress on its infrastructure investment plans. In the beginning of 2016, it announced several highway construction and rehabilitation projects as a part of its PPP plans included in its five-year budget. We expect the government will also continue to prioritize reducing the country's external vulnerabilities by enhancing energy independence. Currently, Uruguay generates 95% of its electricity from renewable energy, and energy investment makes up over one-third of Uruguay's planned infrastructure investments over the next four years.

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Uruguay's stable political system provides an anchor for economic stability. The FA has managed to maintain its unity despite consistent internal tensions between different factions over economic and social policies. The opposition to the FA is divided largely between the two former dominant parties, the Colorados and the Blancos. The policy differences between the main political parties have narrowed over the last decade. Opposition to some of the government's economic policies has sometimes been stronger within the FA than from the external opposition parties, and all of them agree on the need to maintain macroeconomic stability.

Uruguay is similar to Chile in terms of per capita income (projected to be about US$13,195 in 2016), political stability, and level of development but very different in terms of greater social cohesion and a more even income distribution. For example, Uruguay's Gini coefficient (a measure of inequality, with zero being perfect equality and one being perfect inequality) fell to 0.38 from 0.45 eight years earlier, and it's the lowest in Latin America--Chile's is 0.52. The middle class, using World Bank definitions, accounts for more than 72% of the population. The poverty rate is less than 10%, and about 95% of the population has access to health insurance. Average life expectancy is nearly 80 years.

Uruguay faces no external or internal security threats. While the country has suffered in the past from trade frictions caused by protectionist measures, as well as currency controls, imposed by Argentina, we expect that Argentina's new administration and the opening of the Argentine economy will benefit the countries' bilateral relations.

Economic Analysis: Growth Slowdown Expected To Persist In 2016

- Despite a fall in expected GDP per capita in U.S. dollar terms to around $15,442 in 2016, Uruguay's income level still anchors Uruguay as the wealthiest economy in the region in per capita terms.
- However, we expect below-trend economic growth will persist over the next two years, with real GDP growing by 1.8%, on average, driven by an unfavorable external environment and tighter domestic consumption, which we believe will weaken Uruguay's economy.
- Nevertheless, we believe that unlike regional neighbors, still-substantial investment, predictable policies, and a diverse structure will prevent the economy from contracting.

The Uruguayan economy is underpinned by a higher income level than regional peers, which reflects over a decade of growth. Although we expect growth in 2016 to be lower than the country's historical average for the second consecutive year, we expect its diverse structure will somewhat insulate it from the regional economic downturn and prevent contraction. The main sectors of the economy are the manufacturing sector (13.4% of GDP in 2015); the commerce, restaurants, and hotel sector (13.1%); the construction sector (9.5%); and the primary sector (6.6%). Manufacturing drove growth in 2015, led by the Montes del Plata pulp and paper mill coming on stream. In 2016 and over the next two years, we expect that the country's growing middle class, along with a stable political system and predictable economic policies, should also sustain economic growth, albeit lower than in past years, above that of regional neighbors.

Although links with neighboring economies have weakened, helping to insulate Uruguay from economic contraction in Argentina and Brazil, we still believe that the regional economic downturn will contribute to lower growth in Uruguay in 2016 of 0.7%, on the back of 1% growth in 2015. We now expect the Brazilian economy to contract by 3.6% in 2016 and the Argentine economy to contract by 1%. However, direct links between Uruguay and these countries have diminished. Close to 19% of Uruguay's total exports go to Argentina and Brazil (5% to Argentina and 14% to Brazil), down from 41% in 2000. Nevertheless, Uruguay remains somewhat dependent on Argentina for services and financial inflows. Expenditures made by Argentine tourists represent over 60% of total tourist expenditures in Uruguay, while FDI flows from Argentina represent over 28% of total FDI. Starting in 2017, we expect that the Argentine economy will begin to recover and will grow by 3.1%, fueled by improved investor confidence and growing investment following the implementation of corrective political and economic adjustments. Economic growth in Argentina will depend, to a large extent, on the level of external financing by multilaterals and capital markets. We also expect the Brazilian economy to return to growth in 2017, growing by a mild 1%. Both of these developments should help growth in the Uruguayan economy pick up, though remain below average at 1.5% in 2017.

High levels of investment over the past decade contributed to productivity gains and continue to lead to growth. Total investment represented 20% of GDP over the past decade, benefiting many sectors of the economy. The introduction of new technology and management practices led to significant growth in soya and dairy output. At the same time, net FDI averaged close to 5% of GDP during the same period, which is one of the highest levels of FDI in the region. Nevertheless, investment has been declining in both nominal and real terms, reflecting economic downturns in many source markets. While we expect investment to remain steady in 2016, around 21% of GDP, which is lower than levels reached between 2012-2014, around 23% of GDP, we expect that investment will still be a source of growth in the economy over the next three years. According to the government, during the first quarter of 2016, US$795 million worth of investment projects were presented to the government, which is the highest value of projects presented in the first quarter since these statistics began to be measured nine years ago, and over 60% of these projects were from foreign companies, the bulk of which were for renewable energy projects.

The government has made some progress on PPP projects, which should continue over the next four years. The government of Uruguay plans to boost its infrastructure spending through 2019, principally on energy, roads, schools, hospitals, and housing projects. Nearly one-third of this spending will likely be financed through private funds and PPPs. As of the first quarter of 2016, the first two PPP contracts had already been awarded--a prison compound project for which construction has begun and is estimated to finish in the middle of 2017, and a highway project for which the contract was awarded in November 2015.

We expect the drop in consumer confidence and the uptick in unemployment will persist. Lower, though still steady, investment has reduced the demand for labor, and the unemployment rate has begun to rise, reaching 7.9% as of May 2016 from 6.2% in 2014. In addition, we expect that lower consumer confidence will continue to hurt private consumption. In 2015, private consumption growth was flat in nominal terms, and we expect this will restrain growth in 2016.

External Analysis: Exchange Rate Flexibility And Lower Oil Prices Have Helped To Moderate External Risks

- We estimate gross external financing needs at 107% of CARs plus usable reserves in 2016, and we expect narrow net external debt at 25.7% of CAR, on average, through 2019.
- We expect Uruguay's steady access to external liquidity to remain over the next three years.
- Buffers such as exchange rate flexibility will help Uruguay weather the riskier external environment, in our opinion, including lower export prices and the regional economic downturn.

Despite lower net FDI inflows, which no longer cover Uruguay's CAD, and a significant drop in central bank reserves, the country's flexible exchange rate and natural balance of payment hedges have helped to moderate the deterioration in the country's external liquidity and indebtedness. The Uruguayan peso depreciated by nearly 23% in 2015 following portfolio outflows, supporting the country's external competitiveness amid regional and global volatility. Nevertheless, although slowing in the latter part of the year, central bank intervention in foreign exchange markets to help smooth this depreciation partly led to the fall in international reserves, which reached $13.97 billion by April 2016 (excluding gold holdings), from $17.5 billion at the end of 2014. Yet, on the other hand, the improvement in the CAD prevented deterioration in the country's external liquidity. Despite Uruguay's main trade partners' economic slowdown in 2015, coupled with the fall in global commodity prices, the majority of the country's commodity exports are agricultural goods, while Uruguay is also an oil importer. Over 60% of the country's commodity exports are related to agriculture, which we expect to be more resilient than other commodities in the face of global economic slowdown, particularly from China, while agricultural and oil prices tend to move in conjunction, limiting the risks of significantly higher current account imbalances.

In 2015, Uruguay's CAD improved to 3.6% of GDP from 4.6% a year earlier, which was mostly caused by an improvement in the trade deficit to 0.5% of GDP from 1.6% in 2014. In 2016, we expect the current deficit to continue to shrink and reach 3.3% of GDP as energy prices remain low and economic slowdown will help shrink the external imbalance.

At the same time, the central government's liquid external assets and contingent funding lines help to limit external liquidity risks, in our opinion. Liquidity buffers include the central government's liquid assets (7.7% of GDP as of December 2015) and the Energy Stabilization Fund (fund assets reached around $300 million as of March 2016). Additionally, Uruguay continues to have contingent credit lines. These lines are worth close to 4.5% of GDP and include lines from the Inter-American Development Bank (US$800 million), World Bank (US$520 million), Fondo Latinoamericano de Reservas (US$597 million), and Corporación Andina de Fomento (CAF) (US$500 million). Moreover, we believe that Uruguay could quickly qualify for the International Monetary Fund's (IMF's) flexible credit line facility. As a result, we believe that Uruguay still has ample external liquidity to manage potential financing disruptions.

We expect that in 2016 FDI will recover somewhat, reflecting new investment projects beginning in the first quarter of 2016, though remain lower than historical levels, funding 94% of the CAD. FDI continued to decline in 2015 and funded around 83% of the CAD in 2015. FDI more than fully covered Uruguay's CAD for seven years after 2006, in part explaining the significant increase in international reserves during this period. Historically, the main FDI sources have come from Argentina (28%), Spain (17%), and Brazil (12%). Nevertheless, we expect FDI to remain above 3% of GDP over the next three years, gradually recovering as growth returns to some of Uruguay's main source markets, and be a source of growth for the country. We expect FDI to once again fully fund the country's CAD beginning in 2017, which should contribute to a recovery in the country's international reserves to US$15.8 billion (not including gold holdings) by 2019.

The bulk of the FDI in the last decade consists of new flows, not reinvested earnings of existing foreign enterprises. Just less than 20% of the flows have gone to primary and extractives, about 60% to manufacturing, and the remaining 15% to services. Substantial FDI from Argentina has helped transform the productivity of Uruguayan agriculture, introducing new technology and management practices that have boosted output and land prices. FDI inflows from Argentina declined over the past two years, and we expect them to remain low in 2016. However, such potential declines should be offset by increasing FDI in the oil and gas sector, as well as in various energy projects. In addition to continued investment in the renewable energy sector, offshore oil exploration has continued to advance over the past couple of years. Most recently, in March 2016, oil company Total began the first offshore drilling, which involved an investment of US$200 million. The government has also recently approved a third round of bidding for exploration--the terms will be similar to the previous two rounds.

Fiscal Analysis: The Deficit Is Expected To Grow In 2016 And Gradually Decline Thereafter Following Reform Measures

- We expect the change in general government debt to GDP to average 4.1% through 2019, while we expect net general government debt to average 52% of GDP and interest payments to remain around 7% of general government revenues.

- Nevertheless, the government's prudent debt management moderates financing risks, in our opinion.
- Around 56% of the central government's debt stock is denominated in foreign currency, though this is still lower than the 85% denominated in foreign currency a decade ago, reflecting the government's strategy to reduce dollarization.

Although we expect the government's deficit to continue to rise in 2016, in a context of lower economic growth, we anticipate that fiscal reform measures beginning this year will help the government come close to reaching its five-year budget goal. We expect that the general government balance will rise to 4.5% of GDP in 2016 following subdued revenue intake due to the economic slowdown and only moderate improvements in expenditure efficiency measures. This expected outturn follows two years of a growing general government and public-sector deficit. While the general government's primary balance deteriorated only moderately in 2015, reaching 0.7% of GDP from 0.2% in 2014, large interest payments made by the central bank, which we include in our calculation of general government statistics, of close to 1.2% of GDP following the institution's buyback of local currency bills for which it had to pay interest up front that would have accrued in subsequent years, contributed to the overall general government deficit of 4.3% of GDP in 2015. Nevertheless, this deterioration was somewhat offset by the overall positive contribution of public enterprises to the public-sector balance last year, following four consecutive years of negative public enterprise balances. Although we believe that most of this improvement was due to the completion of investment projects, such as the completion of Antel's fiber optic network, expenditure controls also contributed.

We expect that following the government's budget accountability process, and in light of the general consensus across parties on the need to implement budgetary constraints given the new economic context, it will implement a series of cost-cutting and revenue-boosting measures that will slowly lead to a reduced deficit. We believe that there is room in the government's operations for cost-efficiency measures, particularly at the public-enterprise level. However, we expect we will only see the full impact of these measures in the 2017 fiscal year. Yet we believe that these measures, along with a rebounding economy, will lead to a change in general government debt of 4.3% of GDP in 2017, from an increase of 6.2% of GDP in 2016.

In our opinion, the government does not have the fiscal space to undertake significant anticyclical fiscal measures, though we expect that its capital investment plans will move forward, somewhat counterbalancing otherwise contractionary measures. We expect that the new budget adjustments in 2016 will broadly maintain the government's infrastructure plan, relying in part on the private sector for financing. In its five-year budget plan, the government expects to execute over $12 billion in infrastructure projects, or over 2% of the country's GDP, primarily in energy, roadworks, social infrastructure, and housing projects. Around 11% of this infrastructure is expected to come from PPPs and another 19% from other private funds. As of the first quarter of 2016, the first two PPP contracts have already been awarded--a prison compound project for which construction has begun and is estimated to finish in the middle of 2017, and a highway project for which the contract was awarded in November 2015. Additionally, calls for tenders have been launched for a railway project and another road infrastructure project in the beginning of 2016, and timetables have been set for six additional projects during the remainder of 2016 through the end of 2017.

Despite growing fiscal deficits and exposure to exchange rate risk, Uruguay's debt burden remains moderate and financing risks are low, in our opinion. We project that net general government debt over GDP (which includes central bank debt issued for open-market operations) will increase to 53.8% in 2016, from 50.3% in 2015, given the expected general government deficit of 4.5% of GDP and given expected further currency depreciation. By 2019, we expect net general government debt to reach 50.6% of GDP as deficits consolidate, currency depreciation moderates, and growth begins to recover. The projections are subject to volatility due to sharp movements in the exchange rate as about 56% of the central government's debt is denominated in foreign currency.

We expect the government to meet its 2016 financing needs primarily through bond issuances and increasingly through multilateral financing sources. International bond issuances--most recently a $1.7 billion bond issued in October 2015--have helped to boost liquidity, but they have also led to an increase in the percentage of central government foreign currency debt to 55% as of year-end 2015 from 48% a year earlier. However, the average maturity of the central government's debt has continued to increase and now reaches about 14 years, from eight years over a decade ago. Additionally, about 94% of the debt is at a fixed rate, compared with 78% 10 years ago. Bonds compose 91% of central government debt, while 9% are loans. External market debt accounts for 74% of debt, while local market debt is about 26%. As of March 2016, the central government faces US$1.2 billion in debt service in 2016 (US$311 in amortizations and US$900 million in interest payments), equivalent to about 2.4% of GDP, increasing to 4.7% of GDP in 2017.

In our opinion, effective debt management has significantly reduced the risks from a sudden disruption in external markets or a spike in the exchange rate or interest rate. The government has undertaken liability management operations to improve the profile of sovereign debt, as well as to build reserves that provide cushion against external shocks. The government has also continued with its prefinancing policy to cover debt service payments for the following 12 months. The strategy of prefunding amortization payments by holding substantial levels of liquid assets provides insulation against Uruguay's external vulnerabilities but also imposes a fiscal cost. As of April 2016, the government's liquid assets and contingent credit lines represent close to 2.2x debt service over the next 12 months.

Central bank debt, much of it issued for open-market operations, reached close to 11% of GDP in 2015, down from 16% a year earlier, in part because the central bank bought back a significant amount of local currency monetary bills. These securities were mostly held by local pension funds and this decline helped limit the increase in the value of net general government debt in 2015.

In early 2016, the government voted to recapitalize the Administracion Nacional de Combustibles, Alcoholes y Portland (ANCAP), the state-owned oil company and the largest public-sector enterprise. S&P Global Ratings has a 'b-' stand-alone credit profile (SACP) on ANCAP, reflecting the company's weak liquidity and cash flow generation. The government has written off US$622 million of debt the company owed to the central government and guaranteed a US$250 million loan from CAF for the company. In total, support to the company reached about 3% of the general government debt stock, or 1.6% of GDP. We do not expect the government to have to make additional contributions to the company over the next couple of years following changes to the company's oversight and benefits from lower global oil prices. Besides this extraordinary support from the central government, in general public-sector enterprises do not depend on government financial support. In fact, in 2015, public-sector enterprises made a positive, though small, contribution to the overall public-sector balance for the first time in several years. In general, we estimate that public-sector enterprises pose a limited contingent liability to the sovereign.

We assess Uruguay's overall contingent liabilities as limited as well, based in part on our Banking Industry Country Risk Assessment (BICRA) on Uruguay at group '6'. Our BICRAs, which evaluate and compare global banking systems, are grouped on a scale from '1' to '10', ranging from what we view as the lowest-risk banking systems (group '1') to the highest-risk group (group '10'). Our contingent liability assessment also reflects other depository corporation assets, which account for 76% of GDP. About 2% of banking assets are to the central government, but this ratio increases to almost 18% when including central bank exposure (most of its reserves are at the central and in treasury notes).

Monetary Policy Analysis: Higher Inflation Levels While Dollarization Continues To Limit Monetary Policy Flexibility

- Year-over-year inflation levels have reached just over 10%, higher than the central bank's 3%-7% target and higher than inflation has been in over 10 years.
- Uruguay's managed float exchange rate regime has helped the country to absorb external shocks.
- A low level of domestic credit and high dollarization still limit the effectiveness of monetary policy.

We expect inflation to remain above the central bank's target over the next several years, reflecting monetary policy effectiveness challenges. Beginning in January 2016, the 12-month accumulated inflation rate reached just above 10% for the first time in over a decade. This peak in inflation was primarily caused by a combination of the pass-through effect of significant depreciation of the Uruguayan peso as well as an increase in utility tariffs. Despite low global oil prices, the transmission of these prices has been restrained as the government has prioritized improving the finances of ANCAP.

The accumulated inflation rate reached just below 11% in June 2016, while inflation expectations over the next 12 months remain in the single digits. By the end of 2016, we expect that inflation will remain close to 10%, as the impact of continued currency depreciation is counterbalanced by contractionary monetary policy, a decelerating economy, and new wage-indexation guidelines. Monetary policy has continued to tighten since 2013. Most recently, the central bank's monetary policy committee lowered its monetary aggregate growth target to 1%-3% and noted that the monetary aggregate remained flat in the second quarter of 2016. The central bank also raised reserve requirements to 28% from 23% for local currency deposits and to 28% from 26% for foreign currency deposits as of April 1, 2016. We expect that the tightening output gap will also prevent an inflationary spiral, while new wage-setting guidelines will limit the impact of backward wage indexation.

The government has set forth new wage-setting guidelines that seek to limit the backward wage indexation that contributed to inflation in the past. As opposed to previous wage agreements, the new guidelines aim to set wage increases in nominal terms that would only be corrected after two years if there is a decline in real wages. The nominal increases also vary by sector and depend on the growth performance of the sector. The guidelines also include a clause that would immediately adjust wages if inflation exceeds 12%--a trigger that the government believes will not be breached over the next couple of years.

Additionally, greater coordination between fiscal and monetary policy should benefit the effectiveness of each. Along those lines, in April 2016, the central bank and the Ministry of Finance established the Public Debt Coordination Committee to coordinate debt management strategies in the local market based on consistent monetary and fiscal policy goals. This coordination between fiscal and monetary authorities follows best practices established by the World Bank.

Nevertheless, low levels of domestic credit and high dollarization limit the effectiveness of monetary policy, in our opinion. Despite still-high levels of credit growth--domestic credit to the private sector grew by 22% in nominal terms in 2015 and has averaged almost 20% over the past five years--private-sector debt remains low, around 25% of GDP. Also, real-estate prices have grown steadily in the past decade as a result of sustained economic growth, rising income, and FDI, rather than because of risky mortgage lending. Low private-sector debt and the stable and still-moderate proportion of residential mortgages in the system underscore the low likelihood of asset-bubble imbalances, in our opinion.

Despite the strong depreciation of the Uruguayan peso in 2015, and the relatively high level of dollarization in the financial system, the overall financial system remained relatively healthy, reflecting improved banking supervision. Deposits denominated in dollars are high, over 75%, while loans in dollars reached 57% as of year-end 2015. Additionally, despite the banking sector's exposure to unhedged borrowers, the relatively modest size of the financial sector, together with a highly liquid financial system, somewhat moderates the risks. At the same time, exposure to nonresident deposits has dropped significantly, to about 15% in 2015 from about 45% in 2002.

The overall financial system has remained healthy over the past few years, with nonperforming loans (NPLs) accounting for 3% of total loans in May 2016. Credit quality in the banking system has remained healthy. For the next two years, we expect NPLs to increase slightly as the peso continues to depreciate, a slower economy weakens household's payment capacity, and low commodity prices may take a toll on some economic sectors. The Uruguayan banking system's NPLs should remain low and in line with the region's other banking systems.

Uruguay's financial system has become less vulnerable to external shocks but is still relatively small. State-owned Banco de la Republica Oriental Uruguay plays a predominant role in the financial system, accounting for nearly half of bank system assets, while the larger private-sector banks are foreign-owned. The banks are generally well-capitalized and bank supervision has improved in recent years as the country implements Basel III standards. The country's debt markets are generally weak, dominated by government and central bank paper, and the stock market is very small. The corporate bond market is also small, and there is little secondary trading of financial instruments.

Local Currency Rating And T&C Assessment

Our local currency rating on Uruguay remains at the same level as the foreign currency rating because dollarization continues to restrict monetary flexibility and domestic capital markets remain modest in capacity.

The two-notch gap between the transfer and convertibility (T&C) assessment and the foreign currency rating reflects our view that the likelihood of the sovereign restricting access to the foreign exchange Uruguay-based nonsovereign issuers need for debt service is moderately lower than the likelihood of the sovereign defaulting on its foreign currency obligations. The foreign exchange rate regime in Uruguay remains fairly open. Uruguay's outward-oriented economic policies suggest a lower likelihood than more interventionist sovereigns that it would resort to such restrictions in a severe downside scenario.

Ratings Score Snapshot

Table 2

Uruguay--Ratings Score Snapshot

Key rating factors	Assessment
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Neutral

Table 2

Uruguay--Ratings Score Snapshot (cont.)	
Key rating factors	**Assessment**
Monetary assessment	Weakness

Note: 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). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors 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 assessments.

Related Criteria And Research

Related Criteria

- Sovereign Rating Methodology, Dec. 23, 2014
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- 2015 Annual Sovereign Default Study And Rating Transitions, May 24, 2016
- Global Sovereign Debt Report 2016: Borrowing To Drop By 2% To US$6.7 Trillion, Feb. 29, 2016
- Sovereign Risk Indicators, found at spratings.com/sri

Ratings Detail (As Of July 12, 2016)	
Uruguay (Oriental Republic of)	
Sovereign Credit Rating	BBB/Negative/A-2
Transfer & Convertibility Assessment	A-
Senior Unsecured	BBB
Short-Term Debt	A-2
Sovereign Credit Ratings History	
06-Jun-2016	BBB/Negative/A-2
05-Jun-2015	BBB/Stable/A-2
03-Apr-2012	BBB-/Stable/A-3
25-Jul-2011	BB+/Stable/B

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.