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CREDIT OPINION
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Update

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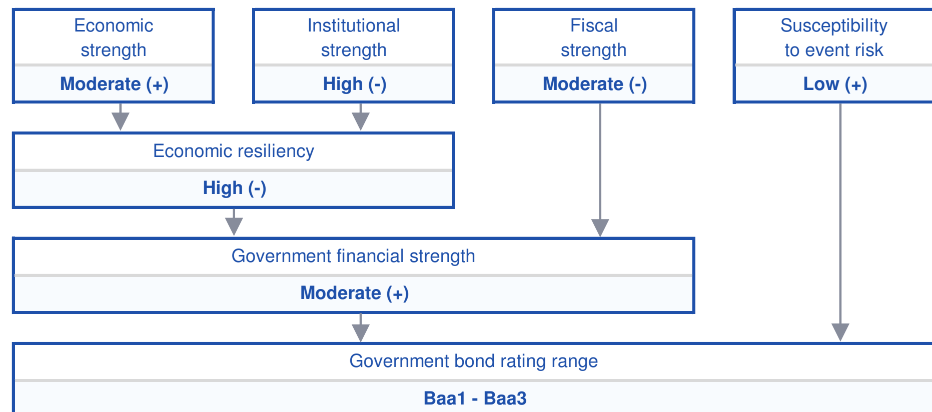
Government of Uruguay – Baa2 Stable

Regular update

Summary

The credit profile of Uruguay is supported by moderate economic strength, which is reflected by the country's relatively high income levels and growth potential of about 3% over the medium term. After two years of weak economic performance, we expect growth to rebound in 2017-18. While stronger growth would support the government's efforts to reduce the fiscal deficit, significant expenditure rigidity limits the authorities' room to maneuver. Although debt metrics deteriorated in recent years, in part due to the relatively high dollarization of government debt, we expect that the debt trend will stabilize.

Exhibit 1
Uruguay's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

- » Moderate government financing needs and a favorable debt maturity profile
- » Large external and financial buffers
- » Strong institutions and a firm commitment to arrest the deterioration in debt metrics

Credit challenges

- » Structural rigidities in the government's expenditure composition
- » A relatively high share of foreign currency-denominated government debt
- » A more moderate growth outlook compared to the 2004-13 period

Rating outlook

Uruguay's stable outlook reflects our expectation that debt metrics will remain relatively stable as authorities implement their fiscal consolidation program, supported by a recovering macroeconomic environment. These improving credit conditions are balanced by continued challenges stemming from a relatively rigid public expenditure structure and the level of dollarization that exists in the economy.

Factors that could lead to an upgrade

Upward rating pressure could result from (1) a significant strengthening of the government balance sheet through a reduction of the sovereign's debt and interest burden, (2) a reduction in vulnerability through a significant decrease in the share of foreign currency government debt and (3) a reduction structural rigidities in the economy such that potential growth increased.

Factors that could lead to a downgrade

Downward rating pressure could result from (1) fiscal measures or outcomes falling significantly short of achieving the authorities' fiscal targets, leading to a continued increase in debt ratios and a deteriorating medium term fiscal profile, (2) a weakening in institutional strength and policy responsiveness, particularly to any renewed fiscal challenges, or (3) a sustained and material erosion of external and financial buffers.

Key indicators

Exhibit 2

Uruguay	2011	2012	2013	2014	2015	2016	2017F	2018F
Real GDP (% change)	5.2	3.5	4.6	3.2	0.4	1.5	3.2	3.6
Inflation (CPI, % change, Dec/Dec)	8.6	7.5	8.5	8.3	9.4	8.1	6.4	7.0
Gen. gov. financial balance/GDP (%)	-0.6	-2.0	-1.5	-2.3	-2.8	-3.7	-3.2	-3.0
Gen. gov. primary balance/GDP (%)	1.9	0.3	0.9	0.0	-0.5	-1.0	-0.5	-0.3
Gen. gov. debt/GDP (%)	39.6	38.5	38.6	39.3	47.4	47.1	46.2	45.4
Gen. gov. debt/revenues (%)	146.6	143.0	138.0	142.7	174.5	168.8	163.5	162.3
Gen. gov. interest payment/revenues (%)	9.0	8.6	8.5	8.3	8.5	9.6	9.6	9.9
Current account balance/GDP (%)	-2.8	-4.0	-3.3	-2.8	-0.7	1.7	2.2	2.1
External debt/CA receipts (%)[1]	134.9	183.8	191.3	210.4	262.3	253.1	267.4	268.4
External vulnerability indicator (EVI) [2]	147.3	100.7	104.2	92.6	121.9	110.5	104.9	102.2

[1] Current Account Receipts
[2] (Short-Term External Debt + Currently Maturing

Source: Moody's Investors Service

Detailed credit considerations

On 13 July, we affirmed the government of Uruguay's Baa2 rating and changed the outlook to stable from negative. The stable outlook reflects (i) the government's strong commitment to fiscal consolidation as demonstrated in policy measures that are likely to stabilize government debt metrics, and (ii) improving macroeconomic performance that will support the ongoing fiscal consolidation process.

Uruguay's credit profile incorporates our "Moderate (+)" **economic strength** assessment on a global basis reflecting moderate potential growth and a relatively high income per capita, counterbalanced by the small scale of the economy, $52 billion in 2016, which is about half the size of the Baa median. We expect the economy to grow in real terms an average of 3.2% from 2017-18. This final score diverges from the indicative "Moderate" as we consider that the implied GDP growth volatility, which covers the 2007-16 period, overstates the potential volatility that the economy will display over the coming years.

Our final score for Uruguay's **institutional strength** of "High (-)" is one notch below the indicative score of "High". This assessment balances Uruguay's strong institutional framework that reinforces policy predictability with still-evolving capabilities to effectively and credibly conduct these policies. Authorities have faced challenges to meet policy goals, as exemplified by stubbornly high inflation rates

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that remained above the official target range, although since early 2017 inflation has come within the inflation target band for the first time since 2010.

Uruguay's “Moderate (-)” **fiscal strength** assessment, adjusted from an indicative score of “Low (+)”, balances its moderate government debt burden, very strong liability management practices and fiscal reserve assets, with lingering vulnerabilities from an elevated proportion of foreign currency debt. Debt ratios are in line with ‘Baa’ medians despite a weaker-than-peers debt affordability as measured by the interest payment-to-revenue ratio. While the share of foreign currency denominated debt exceeded 50% of the total at the end of 2016, we expect that this share will fall over the coming years as the government increases its issuance of Uruguayan peso-denominated debt.

We assess Uruguay's **susceptibility to event risk** as “Low (+)”, driven primarily by banking sector risk. The banking system’s relatively large size for a Latin American economy, with assets equivalent to 69% of GDP, and baseline credit assessment of baa3 inform this risk assessment of potential contingent liabilities materializing on the government’s balance sheet.

Uruguay's government liquidity risk is “Low (-)” and balances relatively low gross borrowing requirements for the government – favored by a long maturity profile – and a relatively high proportion of external debt.

External vulnerability risk is assessed as “Very Low (+)”, from an indicative “Low”, to reflect the country's large external buffers. Foreign direct investment fully covers the current account deficit almost every year. Meanwhile, foreign exchange reserves provide full coverage of external debt amortization payments, an improvement from a decade ago.

Recent developments

Real growth on track in 2017 supported by external demand

Economic performance in 2017 has continued the positive momentum established in Q1 2017, when growth was 4.3% year-on-year. The economy expanded 3.6% year-on-year in the first half of 2017. While growth in the second quarter slowed somewhat, decelerating to 2.8%, we expect the economy to accelerate in the second half of the year. Consumption continues to support growth and has accelerated in seven consecutive quarters. Part of this growth in consumption is due to falling inflation, which has led to increasing real incomes.

Economic recoveries in Argentina and Brazil are further supporting growth in Uruguay because of higher external demand. Argentina contracted an average of 0.1% in real terms from 2012 to 2016, but we expect growth to accelerate to 3.0% in 2017 and then maintain that pace or slightly faster in 2018 and 2019. Brazil, Uruguay's northern neighbor, is also recovering from a sharp recession in 2015 and 2016. We expect growth of 0.6% in 2017, accelerating over the next two years. Part of this external demand strength is reflected in tourist arrivals in Uruguay. After declining year-on-year from 2012 to 2014, tourist arrivals were up 5% in 2015, 12% in 2016 and 25% in the first half of 2017.

Finally, in early November the Finish forestry company UPM signed an investment agreement with the government of Uruguay that would pave the way for a third large pulp mill plant in the country. UPM expects to invest $2.32 billion (3.8% of 2017 GDP) into the project and the government of Uruguay has given commitments to invest an additional $1 billion (1.7% of 2017 GDP) in its rail and road system. Additional infrastructure, such as a port terminal, would be built by private investors. The construction will generate several thousands jobs and create permanent positions as well after 2021. The large investments required in the project will also help reverse a decline in investment, which has been a soft spot in Uruguayan growth since 2014.

Consolidation continues, achieving year-end target not assured

The fiscal consolidation ongoing since January has reduced the central government deficit to 3.2% of GDP in the last twelve months accumulated to September. This figure represents a slight improvement from a deficit of 3.3% the year prior, and we estimate the full-year figure for 2017 to hold steady at 3.2%. Looking ahead, we expect the consolidation to continue making progress and forecast the fiscal balance will improve to 3.0% of GDP in 2018 and then 2.9% in 2019.

The improvement in the deficit is due to increased tax revenue as a result of the consolidation plan. In particular, the plan involved raising income tax rates for the top 10% of earners and reducing tax deductions, measures that have delivered strong revenue gains.

Personal income tax collections over the first nine months of 2017 are up 28% in real terms over the same period in 2016. Overall, revenues in the first nine months are up by 0.9 percentage points of GDP while expenses rose by 0.4 percentage points of GDP, resulting in decline in the fiscal balance of 0.5 percentage points.

The increase in expenditures is primarily due to increased mandatory spending by the government in 2017. The key drivers are spending on pensions and health insurance. Pensions are part of the endogenous component of government spending as annual increases are predetermined by constitutional arrangements that limit the ability of the government to vary their growth rate unless the law was changed, and denote the relatively high rigidity of Uruguay's expenditure structure.

Debt continues to have large USD denominated share

Gross debt as a share of GDP declined slightly as a share of GDP from the end of 2016 through the first half of 2017. One of the key aspects of Uruguay's debt stock is its high share of USD denominated debt. While the percentage has declined to 49% in Q3 2017 from 88% in 2005, this level of foreign currency exposure continues to expose the sovereign to exchange rate risk. Uruguay is mitigating this risk somewhat through increased issuance of nominal peso bonds, which are not inflation linked. The government issued nominal global peso bonds in June and September, in part to replace USD bonds and CPI linked bonds.

Inflation has declined to within the target range

After peaking at 11% in May 2016, annual inflation declined to a low of 5% in July of this year. Since July inflation has risen slightly, driven primarily by increases in the consumer price index for education and health. We had expected inflation to rise slightly in the second half of 2017 and believe it will remain within the inflation target band. We expect that the peso will depreciate next year, likely pushing inflation closer to the upper limit of the target band (7%). However, as the new wage negotiations guidelines are used again in 2018 for the 2019-21, with nominal increases with lower-than-historical rates, we see inflation potentially remaining within the target range beyond 2018. If this happened, it would support the Uruguayan government's policy credibility and overall institutional strength.

Rating methodology and scorecard factors

Rating factors grid - Uruguay

Rating factors	Sub-factor weighting	Indicator	Indicative factor score	Final factor score
Factor 1: Economic strength			M	M+
Growth Dynamics	**50%**			
Average real GDP growth (2012-2021F)		2.9		
Volatility in real GDP growth (standard deviation, 2007-2016)		2.4		
WEF Global Competitiveness index (2017)		4.2		
Scale of the economy	**25%**			
Nominal GDP (US$ billion, 2016)		52.4		
National income	**25%**			
GDP per capita (PPP, US$, 2016)		21,395		
Automatic adjustments	**[-3; 0]**	Scores applied		
Credit boom		0		
Factor 2: Institutional strength			H	H-
Institutional framework and effectiveness	**75%**			
Worldwide Government Effectiveness index (2016)		0.5		
Worldwide Rule of Law index (2016)		0.6		
Worldwide Control of Corruption index (2016)		1.3		
Policy credibility and effectiveness	**25%**			
Inflation level (%, 2012-2021F)		7.6		
Inflation volatility (standard deviation, 2007-2016)		0.9		
Automatic adjustments	**[-3; 0]**	Scores applied		
Track record of default		-2		
Economic Resiliency (F1xF2)			**H-**	**H-**
Factor 3: Fiscal strength			L+	M-
Debt burden	**50%**			
General government debt/GDP (2016)		47.1		
General government debt/revenue (2016)		168.8		
Debt affordability	**50%**			
General government interest payments/revenue (2016)		9.6		
General government interest payments/GDP (2016)		2.7		
Automatic adjustments	**[-6; +4]**	Scores applied		
Debt trend (2013-2018F)		0		
Foreign currency debt/general government debt (2016)		-5		
Other non-financial public sector debt/GDP (2016)		0		
Public sector assets/general government debt (2016)		0		
Government financial strength (F1xF2xF3)			**M+**	**M+**
Factor 4: Susceptibility to event risk	**Max. function**		L+	L+
Political risk			*VL*	*VL*
Worldwide voice & accountability index (2016)		1.2		
Government liquidity risk			*L-*	*L-*
Gross borrowing requirements/GDP		5.2		
Non-resident share of general government debt (%)		59.5		
Market-Implied Ratings		Baa2		
Banking sector risk			*L+*	*L+*
Average baseline credit assessment (BCA)		ba1		
Total domestic bank assets/GDP		69		
Banking system loan-to-deposit ratio		88		
External vulnerability risk			*L*	*VL+*
(Current account balance + FDI Inflows)/GDP		1.1		
External vulnerability indicator (EVI)		102.2		
Net international investment position/GDP		-23.1		
Government bond rating range (F1xF2xF3xF4)			**Baa1 - Baa3**	**Baa1 - Baa3**
Assigned foreign currency government bond rating		**Baa2**		

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range. For more information please see our Sovereign Bond Rating Methodology.

Footnotes: **(1) Indicative factor score: r**ating sub-factors combine with the automatic adjustments to produce an Indicative factor score for every rating factor, as detailed in Moody's Sovereign Bond Methodology. **(2) Final factor score: w**here additional analytical considerations exist, Indicative factor scores are augmented to produce a Final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Bond Methodology; details on country-specific considerations are provided in Moody's research. **(3) Rating range:** Factors 1: Economic strength, and Factor 2: Institutional strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3: Fiscal strength (FS), following a non-linear pattern where FS has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's susceptibility to event risk, is a constraint which can only lower the preliminary government financial strength rating range as given by combining the first three factors. **(4) 15 Ranking categories:** VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL- **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

- **Rating Action:** Moody's changes outlook on Uruguay's Baa2 rating to stable from negative; rating affirmed, 13 July 2017
- **Sector In-Depth:** High compulsory spending levels to impede fiscal consolidation, especially in Brazil, 18 October 2017
- **Issuer Comment:** Government of Uruguay: Structural Measures Key for Additional Fiscal Deficit Reduction Going Forward, 16 February 2017
- **Country Statistics**: Uruguay, Government of, 13 July 2017
- **Credit Analysis**: Government of Uruguay, 18 July 2017
- **Rating Methodology**: Sovereign Bond Ratings, 22 December 2016

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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