Sovereign Overview

Oriental Republic of Uruguay

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DBRS
Insight beyond the rating.

Debt Rated	Current	2017	2016	2015	2014
Long-Term Foreign Currency – Issuer Rating	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)
Long-Term Local Currency – Issuer Rating	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)
Short-Term Foreign Currency – Issuer Rating	R-2 (middle)	R-2 (middle)	R-2 (middle)	R-2 (middle)	R-2 (middle)
Short-Term Local Currency – Issuer Rating	R-2 (middle)	R-2 (middle)	R-2 (middle)	R-2 (middle)	R-2 (middle)

Overview

Supply-side improvements and favorable external conditions have underpinned Uruguay's strong economic performance over the last decade. Product diversification and the incorporation of technological know-how has generated productivity gains and enhanced the economy's resilience to regional volatility. Looking ahead, a large potential investment in the pulp and paper sector presents upside risk to the medium-term growth outlook.

Uruguay benefits from high-quality public institutions, low levels of corruption, and policy predictability, all of which foster a favorable environment for economic growth. Conservative debt management provides the government with ample funding in the event of market turbulence. Furthermore, exchange rate flexibility and high foreign exchange reserves bolster the economy's defenses to potential shocks.

The key challenge facing the sovereign credit profile is the fiscal deficit. The consolidated public sector deficit reached 3.9% of GDP in 2016. The primary cause for the deterioration is the rise in current spending. Tax increases, higher utility and energy tariffs, and cuts in public investment have helped offset higher spending. Nevertheless, a durable consolidation will require measures that curb the trajectory of current spending.

Summary Statistics	2014	2015	2016	2017E	2018F	2019F
Consolidated Public Sector Fiscal Balance (% GDP)	-3.5%	-3.6%	-3.9%	-3.5%	-2.9%	-2.5%
Consolidated Public Sector Debt (% GDP)	58.6%	58.8%	63.4%	64.4%	65.0%	63.8%
GDP per capita (USD thousands)	16,572	15,366	15,062	17,252	18,772	19,765
Real GDP Growth (%)	3.2%	0.4%	1.5%	3.1%	3.4%	3.1%
Consumer Price Inflation (%, eop)	8.3%	9.4%	8.1%	6.6%	6.7%	6.5%
Domestic credit (% GDP)	27.3%	28.5%	30.1%	27.2%	n/a	n/a
Current Account (% GDP)	-3.0%	-0.7%	1.6%	2.3%	1.3%	0.6%
International Investment Position	-30.0%	-28.2%	-30.0%	-29.0%	n/a	n/a
Gross External Debt (% GDP)	71.3%	81.2%	76.2%	67.4%	n/a	n/a
Governance Indicator (percentile rank)	76.8	77.8	77.8	n/a	n/a	n/a

Sources: IMF, World Bank, BCU, MEF, INE, Haver Analytics, DBRS. Footnotes: Fiscal balance and public sector debt are calculated on a consolidated public sector basis. 2017E statistics for consolidated public sector debt, current account, international investment position, and gross external debt are based on data available through Q3 2017. Forecasts (F) for consolidated public sector debt, real GDP growth, consumer price inflation, and the current account are based on data in the IMF Article IV (January 2018).

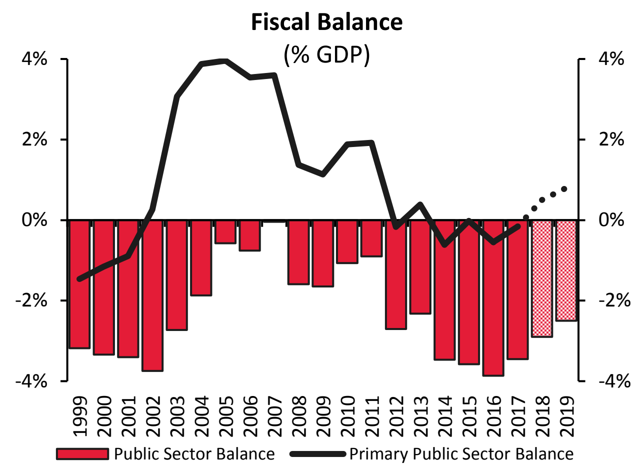
Fiscal Management and Policy

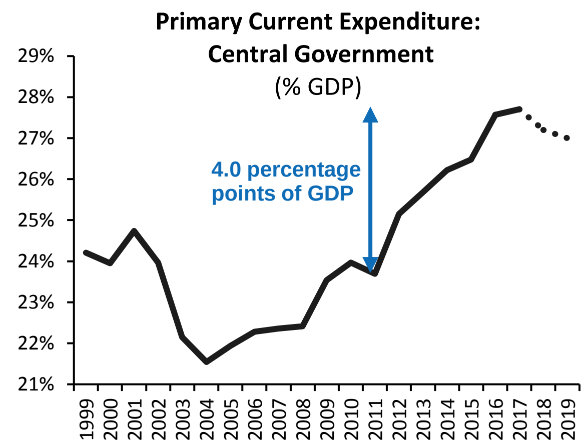
Uruguay's fiscal accounts deteriorated from 2011 to 2016. Over that period, the consolidated public sector deficit widened from 0.9% of GDP to 3.9%. The Vázquez administration is implementing a gradual consolidation plan to narrow the deficit to 2.5% by 2019. Higher taxes, increased utility and energy tariffs, and cuts in public investment helped lower the gap in 2017. However, achieving the 2019 deficit target could be challenging without greater expenditure control. Moreover, even if the deficit target is achieved, additional tightening post-2019 will likely be required to place public debt ratios on a firm downward trajectory and rebuild fiscal space.

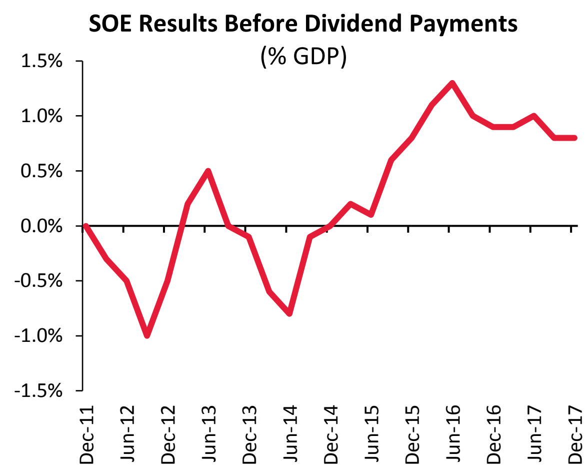
The principal cause of the deterioration is rising current spending. From 2004 to 2011, primary current expenditure recovered to pre-2002 levels. Since then, however, the ratio has continued to climb. In 2017, primary current spending amounted to an estimated 27.7% of GDP, or 4.0 percentage points of GDP higher than 2011. The increase was driven by the expansion of healthcare spending, higher education costs, as well as rising social security expenses (which is partly due to the 2008 reform that expanded coverage). Constitutional and legal protections for some spending items, such as pensions and healthcare, in addition to political commitments, such as higher education spending, complicate the challenge of arresting the upward trajectory.

Measures to offset higher spending have relied on three sources. First, the government has increased taxes. This includes raising personal income taxes last year. Second, public enterprises have increased tariffs relative to input prices. Fiscal results before dividends for public firms increased from 0.0% of GDP in 2014 to just under 1.0% in 2016 and 2017. Third, public investment has been cut. Capital expenditure averaged 3.0% of GDP from 2005 to 2014 but declined to an estimated 2.3% from 2015 to 2017. Looking ahead, there is limited room to reduce the deficit from these three sources without potentially affecting growth prospects.

Achieving the 2019 deficit target looks possible. Stronger than budgeted growth combined with relatively modest adjustments this year, such as higher taxes on gambling and consumer imports, should boost revenues and support deficit reduction. Nevertheless, a durable consolidation will require a sustained effort to curb the trajectory of current spending. With the 2019 elections approaching, implementing such an adjustment in the near term could be politically difficult.







Sources: Ministerio de Economía y Finanzas, Banco Central del Uruguay, Haver Analytics, DBRS.
Notes: Data for 2017 are estimates; 2018-19 are government forecasts.

Debt and Liquidity

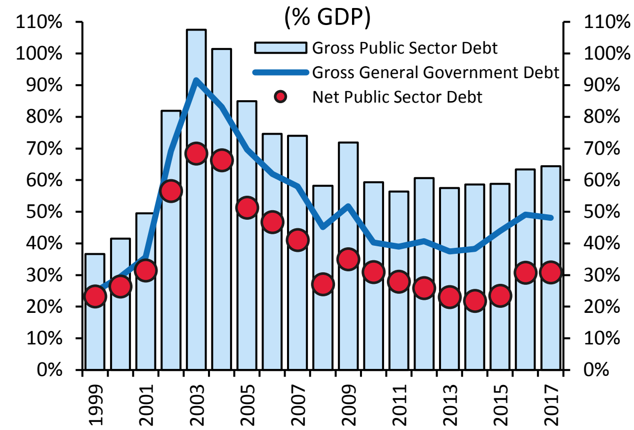
Public debt ratios have increased over the last four years. Uruguay reports debt figures for the consolidated public sector (this includes the central government, local governments, the central bank, state-owned enterprises and some other public entities, but excludes state-owned commercial banks). Based on this broad definition, gross public sector debt increased from 57.5% of GDP in 2013 to 64.4% in the third quarter of 2017. On a gross general government basis (excluding state-owned enterprises and the central bank), the debt ratio increased from 37.5% to 48.1%. The primary drivers of rising indebtedness were weaker growth and peso depreciation, although primary fiscal deficits also contributed.

Debt dynamics are expected to stabilize as long as the fiscal adjustment advances. In the case of Uruguay, DBRS uses net public sector debt, defined as gross public debt minus total financial assets of the public sector, to better assess underlying debt dynamics. Under the baseline scenario, the ratio rises modestly 2018 and then levels off. However, in an adverse scenario characterized by average GDP growth of 0.9% and a fiscal deficit that remains at roughly 3.7% of GDP, the trajectory of public debt would continue to trend sharply upwards through 2022. This highlights the importance of the fiscal adjustment in terms of putting public finances in a more sustainable position.

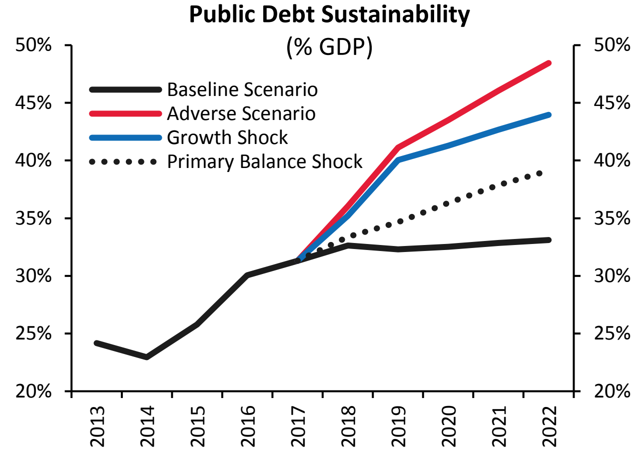
Uruguay's conservative debt management is a credit strength. Uruguay has ample funding flexibility in the event of market turbulence. Liquid assets held by the central government amounted to $2.2 billion in December 2017. The government also has $2.4 billion in precautionary credit lines with the multilateral organizations. Taken together, available resources are well in excess of the $3.2 billion in debt servicing needs for 2018. Rollover risk is also minimal. The average maturity of central government debt is 13 years, and the average redemption from 2018 to 2022 is just $1.7 billion per year (of which more than two-thirds is in local currency).

Efforts to develop the local currency bond market could further bolster the government's defenses to external shocks. In December 2017, 49% of total central government debt was denominated in foreign currency. While this exposes the central government to exchange rate volatility, it is important to note that other government entities – especially the central bank – hold sizable external assets that mitigate exchange rate risk to some extent for the broader public sector. In an effort to build the local currency yield curve, the government completed all of its 2017 funding needs in local currency. In particular, the government issued two global bonds in local currency at nominal fixed rates. In June 2017, a 5-year bond was issued with a yield of 10.0%. This was followed by a 10-year issuance in September with a yield of 8.6%. The decline in long-term nominal yields primarily reflected lower inflation expectations but real rates also declined marginally.

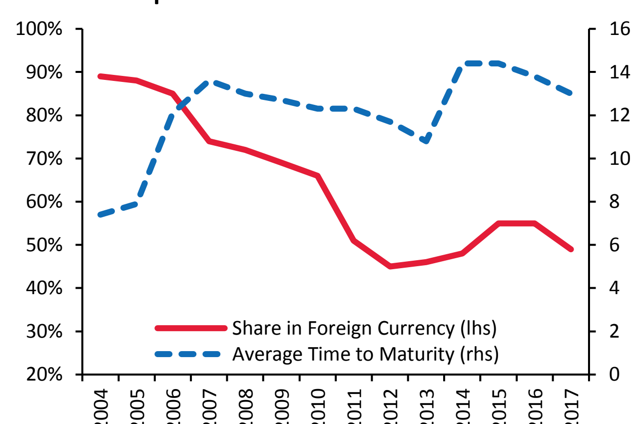
Public Debt Ratios



Public Debt Sustainability



Composition of Central Government Debt



Sources: IMF WEO-October 2017, Banco Central del Uruguay, Ministerio de Economía y Finanzas, Debt Management Unit, Haver Analytics, DBRS.
Notes: Public Debt Ratios for 2017 are through Q3 2017.

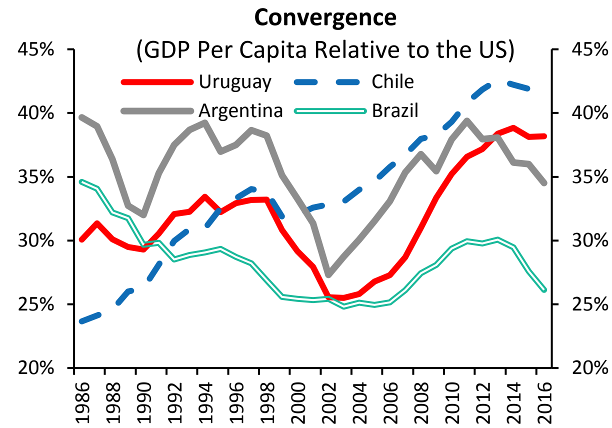
Economic Structure and Performance

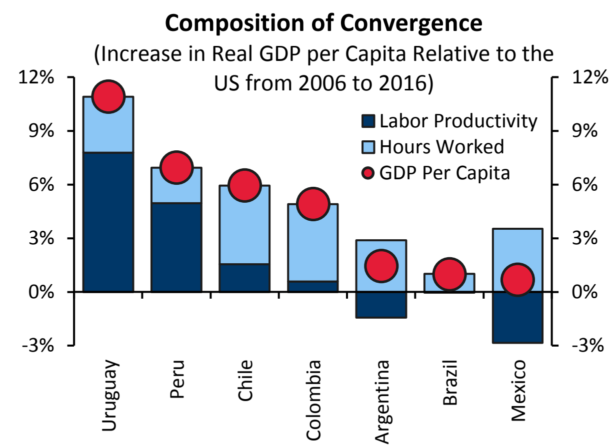
Supply-side improvements and favorable external conditions have underpinned Uruguay's convergence toward advanced-economy income levels. Over the last decade, real incomes in Uruguay increased markedly relative to the United States. Uruguay has clearly surpassed previously achieved relative income levels (going back to 1986), and although the convergence process has recently leveled off, Uruguay has differentiated itself from the sharp reversals experienced by its larger neighbors, Argentina (B Stable) and Brazil (BB Negative). Furthermore, the composition of the convergence is positive. While increased labor utilization has supported rising incomes, most of Uruguay's convergence is due to improvements in labor productivity.

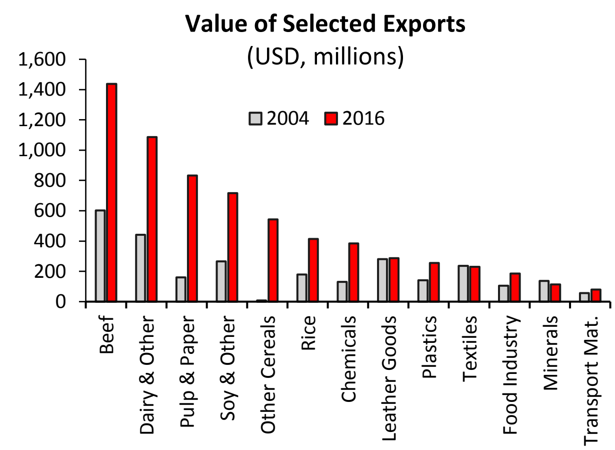
Product diversification partly explains Uruguay's strong performance over this period. Supported by large FDI inflows and technological advances, Uruguay strengthened its comparative advantage in traditional agricultural sectors such as beef and dairy products, and rapidly expanded into new markets such as soy, rice, and other cereals. Furthermore, the development of the pulp and paper industry substantially broadened the export base. Product diversification and the incorporation of technological know-how has generated productivity gains and enhanced the economy's resilience to regional volatility.

In the medium term, Uruguay's growth prospects could benefit from a large investment in the pulp and paper sector. The Finnish firm UPM is considering a new $2.4 billion pulp mill in central Uruguay, and the government plans to attract an additional $1.0 billion of investment in connected infrastructure. Construction could start as early as 2019, with production potentially beginning a few years later. In addition to the direct growth effects, improved infrastructure could generate positive spillovers for other sectors. In particular, agricultural goods in the northeastern part of the country could benefit from substantially lower transport costs. Uruguay signed an investment agreement with UPM in November 2017, although the final investment decision will depend on the progress of infrastructure development. The government aims to build the related infrastructure through public-private partnerships. Opening offers for projects are expected in April 2018. In a positive sign, the offerings appear to be attracting interest from several regional and international firms.

Although the economy has diversified over the last decade, Uruguay is still exposed to commodity price volatility and the economic cycles of its larger neighbors. Roughly 17% of Uruguay's goods exports are destined for Brazil. At the same time, two-thirds of tourism receipts flow from Argentina. A prolonged period of low growth in the region would have adverse effects on economic activity in Uruguay.







Sources: The Conference Board Total Economy Database™ (Adjusted version), November 2017, Instituto Nacional de Estadística, DBRS.

Monetary Policy and Financial Stability

Monetary policy in Uruguay is conducted within an inflation-targeting framework and a flexible exchange rate regime. This has generally supported price stability and enhanced the economy's resilience to external shocks. Financial stability risks are limited, although dollarization limits the effectiveness of monetary policy and may inhibit financial deepening.

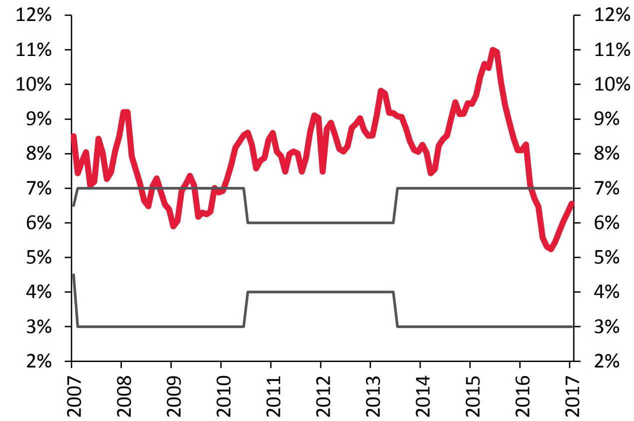
Inflation fell within the central bank's 3-7% target range in March 2017. This followed six consecutive years of inflation above the upper limit. Disinflation was driven by peso appreciation, which reduced price pressures on tradeable goods and services, as well as the moderation in negotiated wage increases. Non-tradable prices also moderated although to a lesser extent. Importantly, inflation expectations also fell within the upper limit of the target range.

A new round of wage negotiations this year could help moderate inertial pressures in price formation. The last round of negotiations, which covered 2015-17, was successful in that it established a declining path for nominal wage adjustments. This year the government aims to incorporate lower inflation expectations and further limit the use of backward-looking indexation mechanisms. Relatively weak labor market conditions as well as the confidence generated from the last round bode well for the negotiations this year.

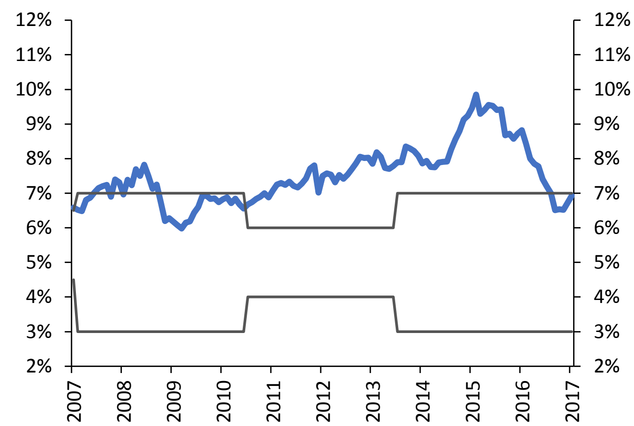
Two challenging features of the Uruguayan financial system are high dollarization and low financial intermediation. Dollarization blunts the effectiveness of monetary policy and complicates the central bank's challenge of reinforcing its inflation-targeting credentials. Dollarization also creates potential exchange rate and liquidity risks. The share of dollarized credit to total loans in Uruguay was 50% in December 2017; the share of total dollarized deposits amounted to 72%. Due to efforts to minimize currency mismatches in the banking system, the bank credit market is shallow. Total credit amounted to just 27% of GDP in September 2017, well below regional peers such as Chile (86%), Brazil (47%), and Colombia (50%).

The Uruguayan financial system is well-prepared to withstand external shocks. The banking system is liquid and well-capitalized. Currency mismatches in the banking system are relatively small. Corporate and household balance sheets do not exhibit any clear imbalances, and asset quality held up well during the recent slowdown. Furthermore, the banking system managed $1.0 billion in non-resident deposit withdrawals in the second half of 2016 (related to a tax amnesty in Argentina) without disruption or stress. Non-resident deposits continued to gradually decline in 2017 and now account for less than 10% of total deposits, the lowest level on record dating back to 1998.

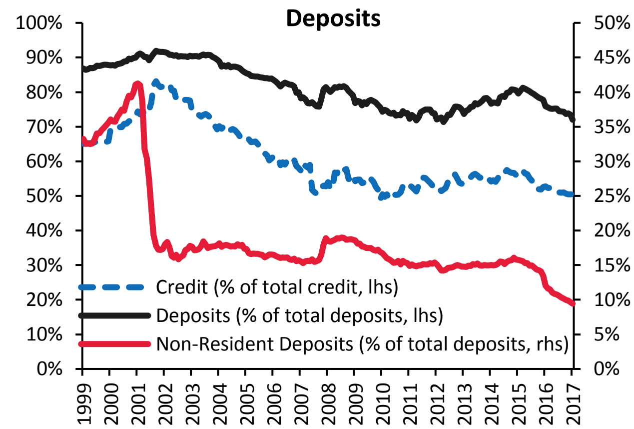
Consumer Price Inflation



12-Month Inflation Expectations



Financial Dollarization and Non-Resident Deposits



Sources: Instituto Nacional de Estadística, Banco Central del Uruguay, Superintendencia de Servicios Financieros, Haver Analytics, DBRS.

Balance of Payments

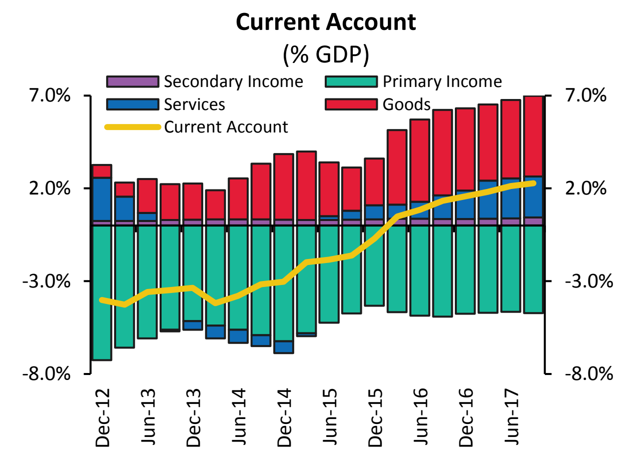
Uruguay has adjusted well to the global commodity price shock since 2014 and external accounts do not exhibit any clear imbalances. The current account is in a surplus position. Exchange rate flexibility helps the economy adjust to evolving global conditions. Furthermore, reserve levels are relatively high and sufficient to provide liquidity in the event of global market turbulence.

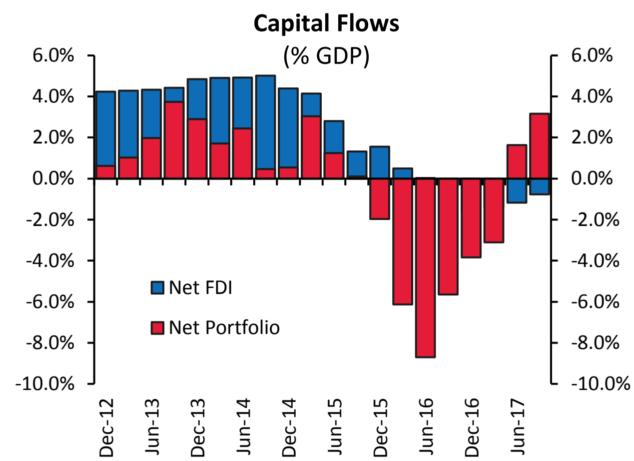
The current account has experienced a large adjustment over the last three years. From the third quarter of 2014 (rolling 4 quarters) to the third quarter of 2017, the current account shifted from a deficit of 3.2% of GDP to a surplus of 2.3%. The adjustment was driven by three factors. First, low international energy prices and weak domestic demand reduced imports. Petroleum imports alone declined 1.6 percentage points of GDP over the three-year period. Second, the new Montes del Plata pulp mill transitioned from the investment phase, which required high levels of imported capital goods, to the production phase, which boosted exports and helped offset lower agricultural prices and weak regional demand. Third, service exports benefited from a pick-up in tourism receipts, as foreign exchange controls in Argentina were lifted and the Argentine economy picked up.

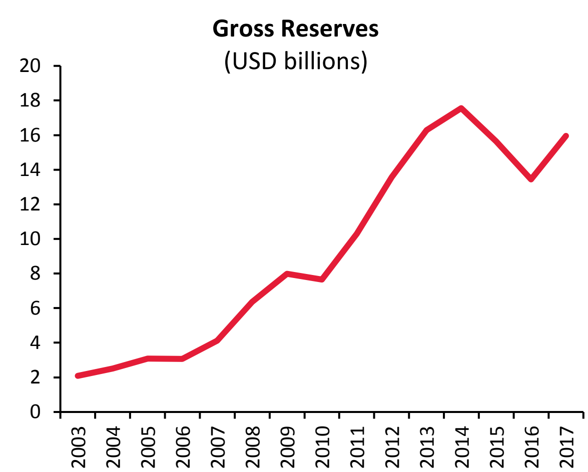
The direction and composition of capital inflows has also shifted. The surge in capital outflows in 2015 and 2016 reversed course in 2017. The outflows took place during a period of peso depreciation. However, flows quickly changed direction in 2017 as local funds de-dollarized amid a stabilization in exchange rate expectations and non-residents purchased government bonds. The composition of capital flows has also changed over the last three years. Foreign direct investment (FDI) into Uruguay declined just as portfolio inflows picked up. Following years of large net FDI inflows, FDI experienced a net outflow in 2016 and the first half of 2017.

Amid strong capital inflows, the central bank intervened in the foreign exchange market to prevent excessive appreciation. As a result, gross reserves increased by $2.5 billion in 2017.

Uruguay's external solvency and liquidity indicators do not raise concerns. The net international liability position is moderate at 29% of GDP and more than 60% of gross international liabilities are foreign direct investment. From an external liquidity perspective, gross reserves are high at $16.0 billion, or 27% of GDP. This is more than 200% of all short-term external debt.







Sources: Banco Central del Uruguay, Haver Analytics, DBRS.

Political Environment

Uruguay is a stable liberal democracy with strong public institutions and low levels of corruption. Well-entrenched democratic traditions are complemented by an effective government. According to the World Bank's Worldwide Governance Indicators, Uruguay scores exceptionally well compared to regional peers and similar to many highly advanced economies in areas such as "Voice and Accountability", "Government Effectiveness", and "Rule of Law".

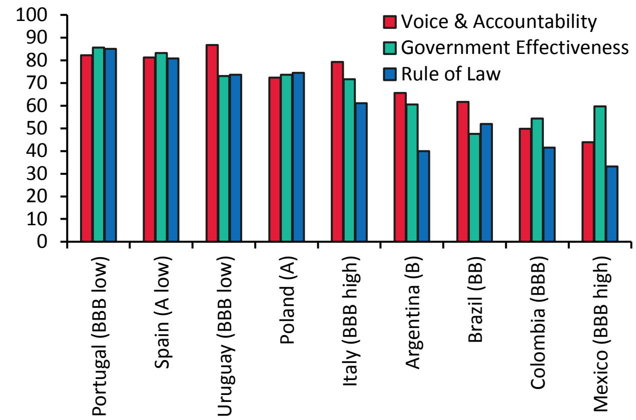
Uruguay also benefits from low levels of corruption. According to Transparency International's Corruption Perceptions Index 2016, Uruguay's public sector is perceived to be the least corrupt in Latin America and on par with many highly rated countries, such as Ireland (A high), Japan (A), and France (AAA).

With a centrist electorate, the party system facilitates moderate politics and pragmatic policymaking. The basic pillars of macroeconomic policy enjoy broad support across the political spectrum. The predictable policy outlook and political stability fosters a favorable environment for economic growth.

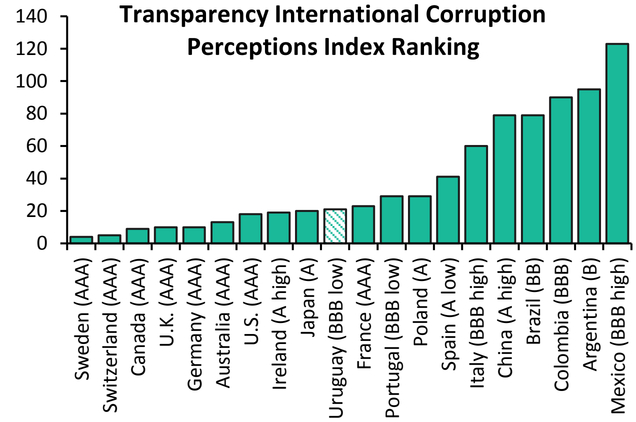
President Vázquez of the Frente Amplio (FA) coalition begins his fourth year of a five-year term in March 2018. One policy objective of the Vázquez administration is to narrow the budget deficit. The fiscal consolidation strategy, however, appears to be creating some tension within the coalition. While the FA coalition holds a one-seat majority in both houses of Congress, intra-coalition policy disagreements could complicate deficit-reduction efforts.

It is still too early to assess the outlook for the general elections, which are scheduled for October 2019. It is unclear who will run as the presidential candidate for the FA and how its policy platform will be presented. The main contender will likely come from the center-right National Party. If no presidential candidate secures a majority in the first round of the vote, a runoff election will be held for the top two contenders in December 2019.

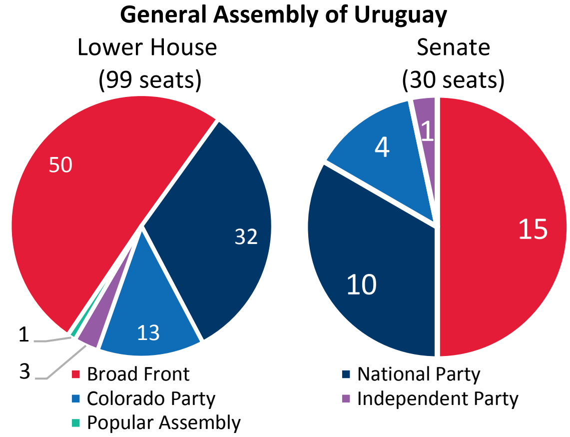
Governance Indicators



Transparency International Corruption Perceptions Index Ranking



General Assembly of Uruguay



Source: World Bank, Brookings, NRGI, Transparency International, Haver Analytics, DBRS.

Previous Actions and Related Research

- DBRS Confirms Uruguay at BBB (low), Stable Trend, January 24, 2018.
- DBRS Confirms Uruguay at BBB (low), Stable Trend, May 26, 2017.
- DBRS Commentary: Uruguay's Stability in an Unstable Neighborhood, March 30, 2016.