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CREDIT OPINION
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Update

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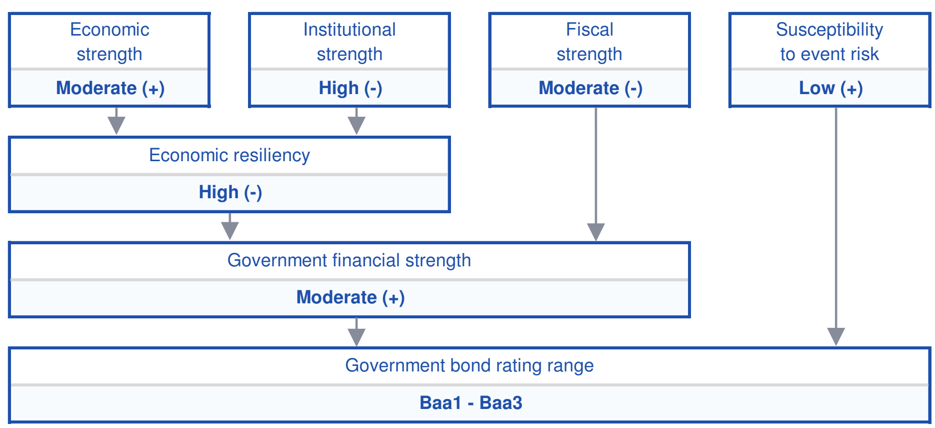
Government of Uruguay – Baa2 Stable

Regular update

Summary

The credit profile of Uruguay is supported by moderate economic strength, 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 activity, we estimate 2017 growth at 3% and expect accelerated growth in 2018-19. 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	2012	2013	2014	2015	2016	2017E	2018F	2019F
Real GDP (% change)	3.5	4.6	3.2	0.4	1.5	3.0	3.3	3.2
Inflation (CPI, % change, Dec/Dec)	7.5	8.5	8.3	9.4	8.1	6.2	7.3	6.9
Gen. gov. financial balance/GDP (%)	-2.0	-1.5	-2.3	-2.8	-3.7	-2.9	-2.8	-2.7
Gen. gov. primary balance/GDP (%)	0.3	0.9	0.0	-0.5	-1.0	-0.3	-0.1	0.1
Gen. gov. debt/GDP (%)	38.8	38.9	39.7	47.7	47.3	46.8	45.7	44.8
Gen. gov. debt/revenues (%)	144.1	139.1	143.8	175.7	169.5	164.5	162.0	160.2
Gen. gov. interest payment/revenues (%)	8.6	8.5	8.2	8.5	9.6	9.3	9.6	9.9
Current account balance/GDP (%)	-4.0	-3.4	-3.0	-0.7	1.6	2.2	1.8	1.3
External debt/CA receipts (%)[1]	184.0	191.1	209.9	261.0	252.2	239.9	245.1	268.9
External vulnerability indicator (EVI) [2]	100.7	103.5	92.2	121.2	88.0	101.4	92.4	88.6

[1] Current Account Receipts
[2] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves

Source: Moody's Investors Service

Detailed credit considerations

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, estimated at $60 billion in 2017, which is about half the size of the 'Baa' median. We estimate the economy grew 3.0% in real terms in 2017 and will grow an average of 3.3% from 2018-19. 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 that remained above the official target range, although in early 2017 inflation fell within the target band for the first time since 2010. Despite this temporary reversal, inflation breached the band at 7.1% as of February.

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 was 55% of the total at the end of 2016, this ratio decreased to 49% in 2017 and we expect that this share will remain around this level 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 ba1 inform this risk assessment of potential contingent liabilities materializing on the government's balance sheet.

Uruguay's government liquidity risk assessment is "Low (-)", adjusted from an indicative score of "Very Low (+)", given current market funding stress is perceived to be lower than the current rating level. The "Low (-)" score balances relatively low gross borrowing requirements for the government – favored by a long maturity profile – and a relatively high proportion of external debt.

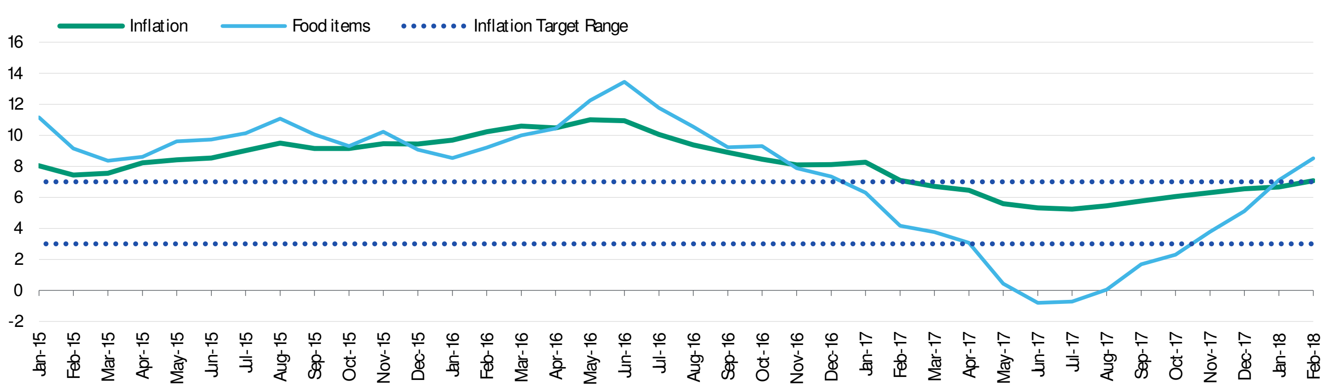
External vulnerability risk is assessed as "Very Low (+)", from an indicative "Low (-)", to reflect the country's large external buffers that partially mitigate the exchange rate risks that stem from the country's high degree of financial dollarization. Foreign direct investment fully covers the current 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

Inflation ended 2017 within target range but expected to exceed it in 2018

Annual inflation fell within the target range of 3%-7% in January for the 11th consecutive month, in contrast with the high inflation that had exceeded the upper limit of the target range since January 2011. However, inflation rose to 7.1% in February, slightly exceeding the band once again. We expect that the CPI print will continue to rise over the coming months mainly led by year-on-year rises in food prices (23% of the CPI basket). Food prices have been volatile over the last two years as weather events contributed to higher prices in Q2 2016. This was followed by a year-on-year decrease in food prices in 2017 due to the higher base (see exhibit). During 2018, food prices will likely increase once again due to the lower base last year, but may also be affected by weather-related factors.

Exhibit 3
Inflation relative to the target range
(%)



Source: BCU, Moody's

The exchange rate has remained broadly stable in 2018, with current pressures pointing to an appreciation of the peso supported by capital inflows and changes in financial institutions' portfolio towards pesos. To stem these pressures, which could in turn affect the country's competitiveness, the central bank's foreign currency position has risen by $1 billion in the first two months of 2018. We continue to expect that the peso will depreciate this year – as the US dollar strengthens internationally in line with the tightening of the US Fed's policy – but for this to have a more limited impact on tradable goods' prices. Additionally, although we forecast that

2018 economic activity will accelerate to 3.3% from 3.0% in 2017 this should not lead to significant inflationary pressures. Overall, we forecast that inflation will hover around the upper limit of the target band this year.

Inflation dynamics and expectations will be key for medium-term fiscal outlook

The next round of wage negotiations for the 2019-21 period will take place over the coming months. During the last round, in 2015, the government was able to change the method employed to set the wages to using nominal increases – that varied depending on the dynamism of each economic sector – instead of past inflation, as had been the case previously. The government will propose to use the nominal-increases methodology again this year. Should inflation expectations remain anchored around the inflation target, this would allow for the increases to better reflect productivity growth in real terms.

Wage increases directly influence the fiscal accounts as key expenditure items like pensions – 30% of spending – are indexed to the median salary growth. Lower-than-historical increases in wages would over time help contain the expansion of pension expenses that are deemed “endogenous” because their annual increases are predetermined by constitutional arrangements that limit the ability of the government to vary their growth rate unless the law was changed.

Fiscal deficit fell in 2017, supporting stability in debt ratios

In our analysis we focus on the consolidated central government, which includes the social security body (BPS). At this level the deficit fell to an estimated 2.9% of GDP in 2017 from 3.7% the prior year. This resulted from the increase in revenue collection – 11.4% y/y – following the measures announced in June 2016 by the government to address the fiscal deterioration. Expenditures grew 8.5% y/y in 2017. The lower deficit, combined with the appreciation of the exchange rate last year, contributed to maintaining the debt/GDP relatively stable in line with our expectations.

The government sets its medium-term deficit target at the public sector level – the current target is a deficit of 2.5% of GDP before the end of the current administration in early 2020. We estimate the public sector deficit declined from 3.9% of GDP in 2016 to 3.4% in 2017 (based on our GDP estimate) compared to the government's estimate of 3.5% and the target of 3.3%. The authorities are targeting a deficit of 2.9% of GDP in 2018 and 2.5% of GDP in 2019. These targets are expected to be achieved by containing expenditure growth, even though the discretionary portion is somewhat small in Uruguay, and improving financial performance of state-owned enterprises. Additional details about the government's fiscal plans for 2019 will be presented in the annual budget review exercises (Rendicion de Cuentas) in June.

Policy focus to incentivize investment

Even though the economy has been recovering since the second half of 2016, the labor market has not performed as well. The authorities have announced a suite of new measures aimed at stimulating investment and increasing employment. These measures range from tax exemptions and improvements in investment project evaluation criteria, to additional support for small companies and a simplification of the tax debt fee and payment processes. Some of the proposed changes can be implemented directly through the executive but others will require parliamentary approval. The share of investment in relation to GDP has fallen in recent years as large projects – related to the construction of two pulp mills over the past decade – concluded. While the construction of a new pulp mill plant would support investment and economic growth over the coming years, a broad-based recovery in investment would further support potential growth in the medium- to long-term.

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)		7.7		
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)		47.3		
General government debt/revenue (2016)		169.5		
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			*VL+*	*L-*
Gross borrowing requirements/GDP		5.2		
Non-resident share of general government debt (%)		59.5		
Market-Implied Ratings		A3		
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		0.9		
External vulnerability indicator (EVI)		92.4		
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: rating 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.

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» **Credit Analysis**: Government of Uruguay, 18 July 2017

» **Country Statistics**: Uruguay, Government of, 29 November 2017

» **Outlook:** Sovereigns -- Latin America & Caribbean: 2018 outlook stable as growth momentum offsets rising debt and policy uncertainty, 9 January 2018

» **Rating Methodology**: Sovereign Bond Ratings, 22 December 2016

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