Uruguay (/gws/en/esp/issr/80442227)

FitchRatings

Fitch Affirms Uruguay at 'BBB-'; Outlook Stable

Fitch Ratings-New York-05 April 2018: Fitch Ratings has affirmed Uruguay's Long-Term Foreign Currency Issuer Default Rating (IDR) at 'BBB-'. The Rating Outlook is Stable.

A full list of rating actions follows at the end of this rating action commentary.

KEY RATING DRIVERS

Uruguay's ratings are supported by strong structural features in terms of social and institutional development, a healthy external balance sheet, and a favourable public debt maturity profile. These factors are balanced by a weak track record of compliance with inflation and fiscal targets, weighing on policy credibility, relatively elevated and dollarized public debt, and high budget rigidity.

Uruguay's real GDP growth rebounded to 2.7% in 2017, from 1.7% in 2016 and 0.4% in 2015, somewhat below 'BBB' peers but reflecting continued resilience to volatile and slow regional growth. The recovery has been uneven, however. Growth was 1.6% in 2017 net of telecommunications, a small sector that due to measurement issues has been making an outsized contribution to real GDP growth. On the demand side, growth was driven by a cyclical boost to private consumption and buoyant net exports led by tourism inflows. However, the labor market remains weak, and investment posted a large, broad-based 15% real contraction in 2017.

Falling investment and protests in the agricultural sector have highlighted competitiveness issues including relatively high taxes and utility rates, labor market rigidities, infrastructure deficiencies and a strong peso. The authorities have responded with targeted tax incentives for investment projects and utility rate cuts for the agricultural sector. They are also promoting guidance for private-sector salary negotiations that aims to support real wages without risking job losses, although the link to productivity remains weak. Construction of a large pulp mill is a major bright spot on the medium-term horizon, but a final investment decision is still pending.

Consumer price inflation stood at 6.7% in March, slightly below the upper bound of the target range of 5% (+/-2pp). Inflation has risen somewhat since mid-2017, but core inflation and inflation expectations remain at their lowest levels in many years at around 7%. This could portend some progress in reduction of Uruguay's structurally high inflation levels, although the coming months should offer a clearer assessment as favourable base effects wear off.

The authorities' disinflation strategy centres on incorporating nominal wage hikes into private-sector salary contracts, instead of real hikes with ex post inflation adjustments. This strategy will face a test in 2018 as most three-year contracts will come up for renewal. Favourable real wage outcomes over the last three-year cycle could facilitate negotiations with resistant unions. However, inertial wage-price pressures could persist in Uruguay despite this policy shift, as reflected in wages that exceeded the nominal guidance over the last three-year wage cycle. Monetary policy officially maintains a contractionary bias, but its transmission channels remain weak due to high dollarization and low financial depth.

Uruguay's external position remains strong. A current account surplus (1.6% of GDP in 2017), sovereign borrowing and resident preference for local-currency assets have driven significant real appreciation of the peso. In response, the central bank (BCU) accumulated USD1.8 billion in "own" reserves (i.e. net of public deposits and reserve requirements in USD) in 2017 and a further USD1.4 billion in the first quarter of 2018 alone. This has further strengthened reserve coverage and external liquidity ratios.

Uruguay's fiscal position improved in 2017 due to tax-focused adjustment measures, breaking a trend of gradual deterioration in the prior five years. Inertial social spending pressures offset some of the savings, however, and the government fell short of its consolidation target. The broad public sector deficit targeted by the government deficit fell to 3.6% of GDP in 2017 from to 3.9% in 2016, but exceeded the 3.3% goal. The central government deficit fell by a larger degree, from 3.7% to 3.0%, reflecting higher dividends and tax payments from public companies supported by utility rate hikes, which net out in consolidated public sector figures.

Fitch projects some improvement in fiscal deficits in 2018 - to 2.8% of GDP for the central government and 3.4% for the public sector - due to modest tax hikes (imports and gambling) and somewhat reduced inertial pressures in pension benefits (indexed to wages). However, Fitch does not expect the government to meet its 2.5%-of-GDP public sector deficit target for 2019. A significant cyclical rebound in taxes is unlikely under Fitch's baseline growth projections, and the authorities are pledging no further tax hikes. A highly rigid budget leaves little room for cuts, and upcoming 2019 elections could fuel spending pressures, especially around the administration's key priority of boosting education funding.

Fitch's fiscal projections do not incorporate the potentially large but uncertain impact of a new law allowing individuals near retirement to abandon their private pensions (AFAPs) and move fully into the public system. This will lead to a transitory fiscal improvement due to a one-off transfer of AFAP funds to the social security bank (BPS) and a cash surplus for the few years that worker contributions in this cohort exceed retiree benefits. Fitch will assess fiscal target compliance net of this impact. Government borrowing needs should be unaffected, as the inflow of funds must go into a trust. The reform will cost USD2.4 billion over the long term, according to the official estimate, adding further to social security imbalances that are already putting pressure on public finances.

General government debt remained stable in 2017 at 57% of GDP, above the 'BBB' median of 40%. Debt metrics are also above the 'BBB' median net of 9% of GDP in recapitalization bonds issued to the central bank, which carry negligible refinancing risk but are included by Fitch for consistency with data reported by other sovereigns. Real peso appreciation since 2015 has kept debt metrics stable despite fiscal deficits, but Fitch projects this favourable effect will wear off in 2018 and that debt-to-GDP will return to a gradual upward path.

The sensitivity of debt metrics to the exchange rate highlights Uruguay's relatively large stock of foreign-currency debt -- a credit weakness. However, global bond issuances in pesos in 2017 highlight progress in deepening local-currency funding. The sovereign's strong debt maturity profile and contingent credit lines help buffer it from vulnerability to external financing risks.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
Fitch's proprietary SRM assigns Uruguay a score equivalent to a rating of 'BBB+' on the Long-Term Foreign Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:
-Macro: -1 notch, to reflect a relatively poor track record of compliance with inflation and fiscal targets, which weighs on policy credibility and narrows counter-cyclical policy scope.
--Public Finances: -1 notch, to reflect a highly rigid expenditure profile dominated by heavily indexed and constitutionally protected social entitlements, with a low share of capital spending. This poses challenges to fiscal consolidation goals. A large stock of

foreign-currency debt exposes fiscal metrics to high exchange-rate risk, although the authorities are making progress on increasing reliance on local-currency funding.

RATING SENSITIVITIES

The main factors that, individually or collectively, could lead to a positive rating action are:
--Fiscal consolidation consistent with stabilization of the public debt trajectory, and de-dollarization of the debt stock;
--A sustained reduction in inflation and better anchoring of inflation expectations;
--Evidence of investments or productivity gains that lift medium-term growth prospects.

The main risk factors that, individually or collectively, could trigger a negative rating action are:
--A faster trend increase in the government debt burden;
--Deterioration in growth prospects;
--Erosion of external liquidity buffers.

KEY ASSUMPTIONS
--Fitch assumes that construction of a new pulp mill project and related infrastructure to begin as soon as 2019, supporting growth during the construction phase and once production begins.
--Fitch projects positive real GDP growth in Brazil and Argentina in 2018-2019, supporting economic activity in Uruguay.

Fitch has affirmed Uruguay's ratings as follows:

--Long-Term Foreign Currency IDR at 'BBB-'; Outlook Stable;
--Long-Term Local Currency IDR at 'BBB-'; Outlook Stable;
--Short-Term Foreign Currency IDR at 'F3';
--Short-Term Local Currency IDR at 'F3';
--Country Ceiling at 'BBB+';
--Issue ratings on Long-term senior-unsecured foreign currency bonds at 'BBB-';
--Issue ratings on Long-term senior-unsecured local currency bonds at 'BBB-'.

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Applicable Criteria
Country Ceilings Criteria (pub. 21 Jul 2017)
(https://www.fitchratings.com/site/re/901393)
Sovereign Rating Criteria (pub. 23 Mar 2018)
(https://www.fitchratings.com/site/re/10024428)

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