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Government of Uruguay

Deficit reduction to continue but important challenges remain

On 30 June, the government of Uruguay (Baa2 stable) released its 2017 Budget Review, which, in addition to assessing last year's fiscal performance, provides guidelines for the 2019 and 2020 budgets. According to the report, the central government's fiscal deficit will decline to 2.5% of GDP by 2019, but the consolidated public sector deficit will only converge to that level in 2020, a year later than originally expected (see highlight box on page 4 for more on this topic). In this report, we analyze the latest fiscal developments and highlight key credit risks going forward.

- **Central government deficit will continue to narrow.** The central government deficit fell to 3.0% of GDP in 2017 from 3.7% in 2016, supported by various revenue enhancing measures implemented by the government last year. We expect the deficit to remain below 3% of GDP in 2018-20, allowing Uruguay's debt ratio to stabilize at around 48% of GDP, in line with similarly-rated peers.

- **But expenditure rigidities pose downside risks.** Non-investment spending accounts for 96% of total spending, with "endogenous" expenditures – which include pension payments and other social transfers that are difficult to adjust – representing almost 58% of total spending (66% including interest payments). In 2017, a continued expansion in pension-related spending led to an overall rise in the government's expenditure burden, despite the authorities' ability to rein in operating expenses. This elevates downside risks should the government's revenue intake decrease at any point. As such, absent pension reform, expenditure rigidities will pose downside risks to fiscal consolidation efforts over the medium-term.

- **Exchange rate depreciation would impact debt ratios, but financial buffers limit credit risks.** Depreciation of the Uruguayan peso could have a material impact on government debt metrics because around 50% of government debt is denominated in foreign currency. However, the government has $3.2 billion (5.3% of GDP) in liquid assets (mostly held in foreign currency) and another $2.2 billion (3.6% of GDP) in contingent credit lines that would allow it to fully cover 12 months of debt service requirements, providing sufficient buffer against heightened global market volatility in the near term.

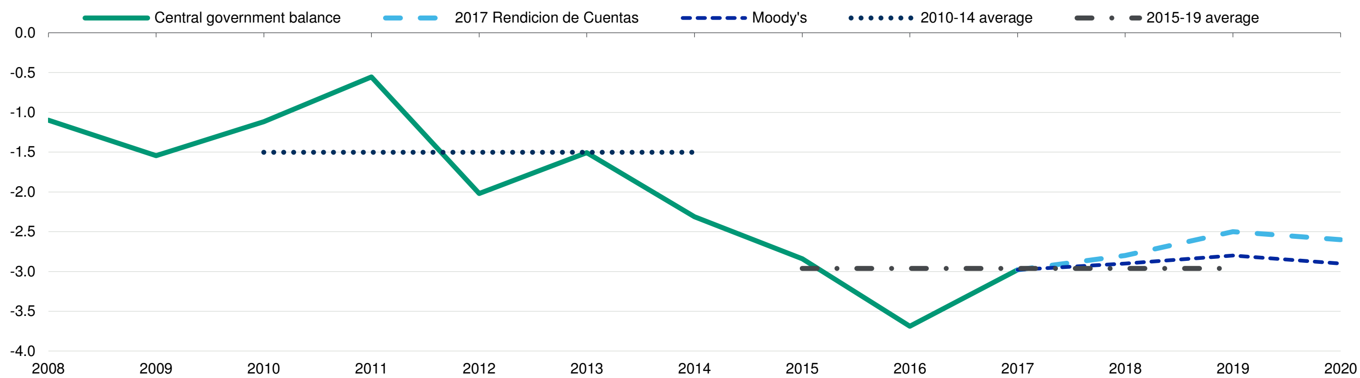
Central government deficit will continue to narrow…

When the current administration took office in 2015, the authorities set a target to reduce the public sector deficit to 2.5% by 2019 from 3.5% of GDP in 2014, such that the adjustment would be gradual and attainable. Official fiscal targets are set at the public sector level in Uruguay, which, in addition to the central government, includes state-owned enterprises (SOEs), the Banco de Seguros del Estado (BSE), local governments, and the Central Bank of Uruguay (BCU). For comparability with other sovereigns, we exclude these entities from our fiscal data and focus instead on central government finances, which incorporate Uruguay's social security entity, i.e., Banco de Prevision Social (BPS), according to national definitions.

The central government deficit gradually widened to 3.7% in 2016 from 1.5% in 2013, driven by slower economic growth and higher "endogenous" expenditures. The authorities refer to expenses like pension payments and other social transfers as "endogenous" because annual increases are determined by constitutional mandates and/or laws that limit the government's ability to adjust the growth rate at which they increase. The endogenous nature of these spending items contributed to a rise in such expenditures relative to GDP.

We expect that under the current administration (2015-19) the central government deficit will come to about 3% of GDP on average, double that of the previous administration (2010-14) (see Exhibit 1). Importantly, although the headline deficit was narrower in 2010-14, this was largely a result of above-potential average economic growth of 4.9% during those years.[1] Since 2015, as GDP growth rapidly declined to below Uruguay's 3% potential, the authorities have found it increasingly difficult to bring down the deficit given the rigidity that characterizes Uruguay's government spending (which we discuss further in the next section of this report).

Exhibit 1
Central government fiscal balance
% of GDP



Sources: Ministry of Finance, Moody's Investors Service

In 2017, the central government deficit narrowed to 3.0% of GDP, supported by various revenue enhancing measures implemented by the government last year.[2] Still, a continued expansion in pension-related spending led to an overall rise in the government spending-to-GDP ratio despite the authorities' ability to rein in operating expenses. Pension spending increased by 0.5 percentage points in 2017 to 10.0% of GDP, while operating expenses (wages and non-personnel expenses) decreased 0.1 percentage points to 8.9% of GDP.

According to the Budget Review forecasts, the central government deficit will continue to narrow and reach 2.5% of GDP in 2019 on account of higher revenue and stable expenditures relative to GDP. However, we see downside risks to the government's assumptions.

On the revenue side, slower economic growth in 2018 points to risks relative to official projections. Growth this year will be lower than initially expected because of (i) a drought that affected agricultural production, (ii) the negative effect of currency depreciation on private consumption, (iii) spillovers from Argentina (B2 stable) that will impact tourism and construction. The authorities expect revenue to benefit from an economic rebound in 2019 and the resumption of dividend payments by the Banco de la Republica Oriental del Uruguay (BROU, Baa2 stable, baa3).

Headline growth numbers could be higher in 2019-20 due to one-offs, such as a base effect from agricultural exports next year following the drought in 2018 or the expected construction of a third pulp mill plant in 2020. However, growth prospects could disappoint as economic performance over the past few years has been characterized by a decline in investment and a loss of jobs.[3] Should these trends persist, government revenue could also come below official expectations.

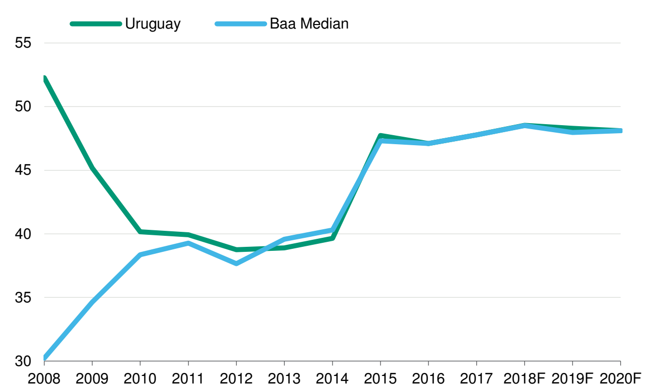
On the expenditure side, the government intends to contain spending by limiting its growth to only 0.25% of GDP in 2019. This is a relatively small increase in spending considering 2019 is an election year and historically, expenditures report large increases during election years. The government is adamant that this time will be different because of limited fiscal space. One element that should contribute to contain spending growth involves measures implemented over the past few years to reduce the central government wage bill.

Our baseline assumes the central government deficit will remain below 3% of GDP in 2018-20, allowing Uruguay's debt ratio to stabilize at around 48% of GDP during this period (see Exhibit 2). At this level, the debt burden will be in line with the median for Baa-rated sovereigns. Still, the relatively high exposure of government finances to currency depreciation and a higher level of international interest rates implies that debt affordability – interest payments-to-revenue – will likely worsen relative to peers (see Exhibit 3).

Exhibit 2

Government debt burden to remain in line with Baa median…

Government debt as % of GDP

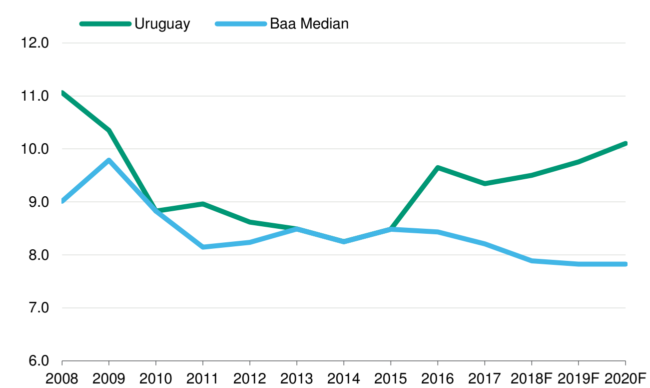


Sources: Central Bank of Uruguay, Moody's Investors Service

Exhibit 3

…but affordability will continue to diverge from peers

Interest payments as % of revenue



Sources: Ministry of Finance, Moody's Investors Service

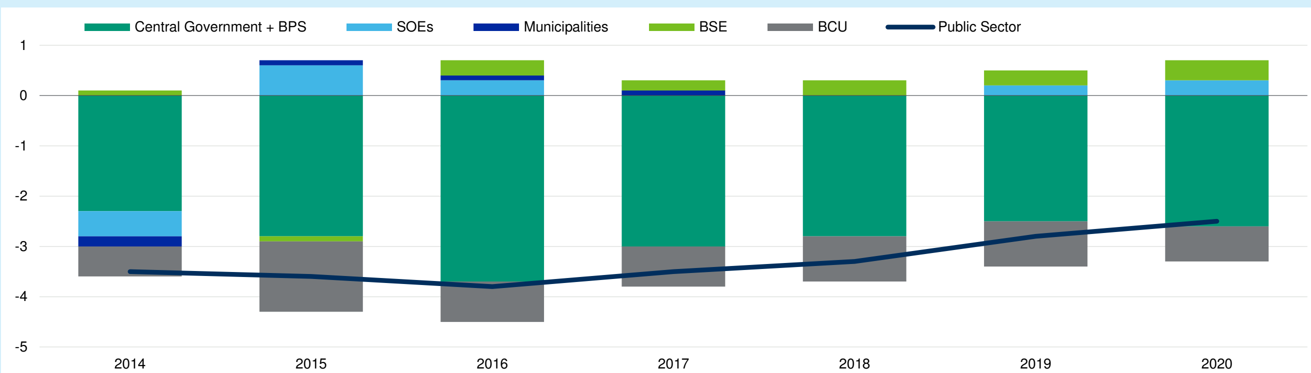
Slower convergence to fiscal target at the public sector level driven by central bank

Under Uruguay's fiscal framework, at the beginning of every administration the authorities set medium-term targets at the consolidated public sector level to be achieved by the end of the term in office. Following the widening of the public sector deficit to 3.5% of GDP in 2015, the government reduced capital expenditures of SOEs and implemented measures to improve central government finances.

In the 2017 Budget Review, the government projects that a public sector deficit of 2.5% of GDP will not be attained until 2020, one year later than previously expected. This will be in good part because of the BCU's relatively high interest bill over the coming years. Over the last two years, in order to stem appreciation pressures caused by strong capital inflows and the current account surplus, the BCU increased its purchases of foreign currency, a decision that led to a surge in international reserves ($2.8 billion net purchases since the third quarter of 2016). To sterilize these purchases, the BCU issues notes that pay interest. As the pace of foreign currency purchases accelerated in the second half of 2017 and first half of 2018, the BCU's interest payments rose higher than expected contributing to a larger quasi-fiscal deficit. We note that this accumulation of international reserves and the subsequent depreciation of the currency will also contribute to a capital gain for the BCU, which will be reflected in its balance sheet but is not recorded in the fiscal accounts as a revenue or inflow.

In addition to the continued reduction of the central government's deficit, to attain the 2.5% of GDP deficit target by 2020, SOEs will have to further improve their finances over the coming years (see Exhibit 4). This highlights the importance of strengthening governance within SOEs to avoid having to sacrifice investments, which would have negative longer-term consequences for the broader economy.

Exhibit 4
Consolidated public sector balance
% of GDP



Source: Ministry of Finance

...but expenditure rigidities pose downside risks

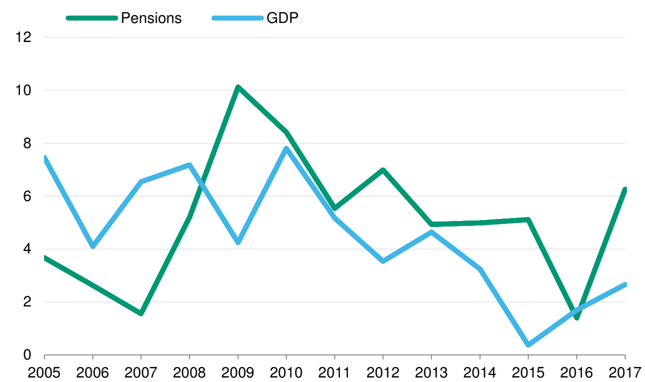
The rigidity of Uruguay's expenditure structure poses important medium-term challenges to public finances. Non-investment spending accounts for 96% of the total, with the so-called endogenous expenditures, which are difficult to adjust, representing almost 58% of total spending (66% when interest payments are included).

The growth of pension-related expenditures is directly linked to the evolution of the average nominal wage growth. The government has sought to de-link wage increases from past inflation by instituting guidelines that tie nominal wage increases to productivity and sector-specific dynamics. This approach, which was employed initially in wage negotiations for the 2016-18 period, will be used once again during ongoing negotiations for the 2019-21 period.

Ensuring the continuation of moderate nominal wage increases will be key for medium-term fiscal consolidation. Over the past decade, pensions have tended to grow faster than the economy itself (see Exhibit 5). The decrease in inflation in 2017 combined with still-high growth in wages in 2016 of 11.7% led to an increase of 6% in real terms in pensions last year. This, in turn, contributed to a further increase in pension outlays as a share of GDP, which are now almost two percentage points of GDP higher than a decade ago (see Exhibit 6). Authorities expect pensions to grow at more a moderate rate going forward, in line with the economy.

Exhibit 5

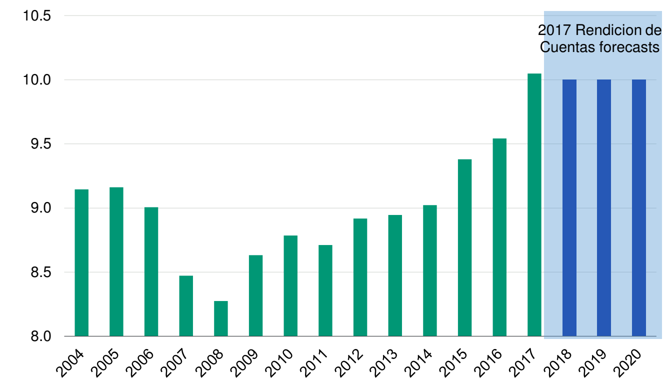
Pensions have been increasing at a higher pace than GDP growth...
Real growth rates, %



Sources: Ministry of Finance, Moody's Investors Service

Exhibit 6

...leading to an upward trend relative to GDP
Pension payments as % of GDP



Sources: Ministry of Finance, Moody's Investors Service

In the near term, the outcome of the ongoing wage negotiations will be key for determining if pension-related spending will report lower growth. With annual inflation reaching 8% in June, unions are likely to demand higher nominal increases than those contemplated in the government's guidelines. Because we expect inflation to continue to rise in the coming months, reflecting the effects of the drought on food items as well as the currency depreciation, the monetary authorities' ability to anchor inflation expectations at a lower level will be key to avoid adverse feedback from higher wages to inflation and vice versa.

Other elements have also contributed to increase pension-related pressures on the fiscal accounts in recent years and could continue to do so if left unaddressed. One such issue was the increase in the number of pensioners resulting from changes that were introduced in 2008 to make access to pensions more flexible, which, according to ECLAC, led to additional spending on pensions of $1.6 to 1.9 billion in 2009-16 – the effect of this measure should dissipate over time but it has already weakened the fiscal accounts. Another element that will influence future spending pressures relates to the military pension fund, which currently requires about 1% of GDP in transfers from the government. Additionally, last year changes were approved that allow people over 50 years old to transfer from the individual defined contribution system to the public defined benefit system. While this may boost pension-related revenues in the short-term, over time this measure will also lead to higher pension outlays. As such, it is difficult to see that pension payments could report an improving trend in the coming years in the absence of reform, which would likely only be addressed by the next government, which takes office in 2020.

Exchange rate depreciation would impact debt ratios, but financial buffers limit credit risks

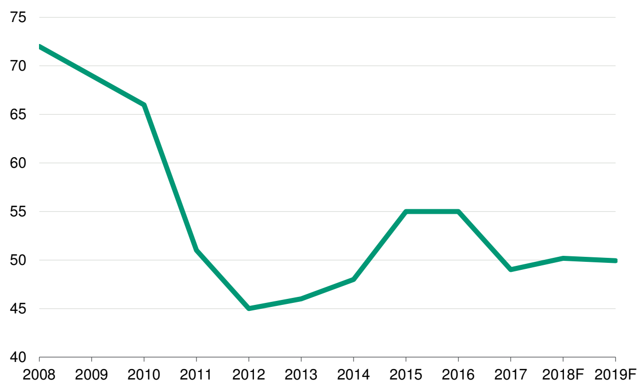
Recent volatility in international financial markets underscores the key role that financial buffers have to stem credit risks. Uruguay's debt metrics are exposed to exchange rate shocks because a large portion of government debt is denominated in foreign currency – around 50%, although the share has come down from a peak of more than 70% in 2008 (see Exhibit 7). As such, a depreciation of the Uruguayan peso can have a material impact on government debt metrics.[4] During the first half of 2018 the peso depreciated by about 9%. We expect the exchange rate to remain at this new level of about UYU31.5/USD barring any new shocks. Consequently, the impact on debt metrics would be more contained than in previous episodes of exchange rate volatility.

Importantly, the government has $3.2 billion (5.3% of GDP) in liquid assets – mostly held in foreign currency – and another $2.2 billion (3.6% of GDP) in contingent credit lines that would allow it to fully cover 12 months of debt service requirements (see Exhibit 8), providing sufficient buffer against heightened global market volatility. Additionally, due to the government's liability management, the government has also reduced potential risks as external debt has a longer maturity profile than domestic debt – 13.6 years compared 10.2 years, respectively. Over the next 12 months, only about 15% of principal payments due are on external debt.

Exhibit 7

Debt dollarization has stabilized around 50%

Share of foreign currency-denominated government debt, %

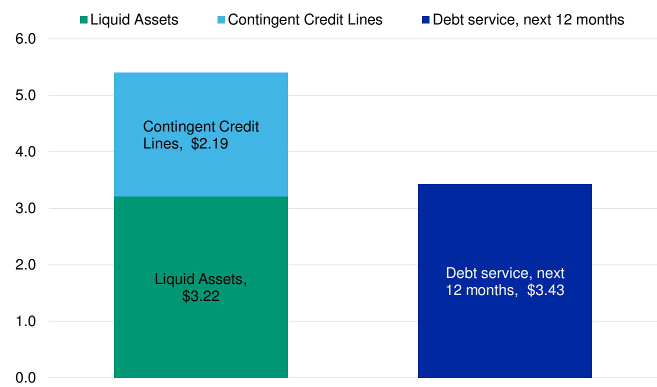


Sources: Ministry of Finance, Moody's Investors Service

Exhibit 8

Fiscal buffers provide important coverage

US$ billions, as of May 2018



Sources: Ministry of Finance, Moody's Investors Service

Moody's related publications

» **Credit Opinion:** Government of Uruguay – Baa2 Stable, 14 March 2018

» **Sector In-Depth:** Sovereigns – Latin America: Erosion of fiscal space across the region continues; policy response key determinant of rating trajectories, 24 January 2018

» **Sector In-Depth:** Sovereigns – Latin America: High compulsory spending levels to impede fiscal consolidation, especially in Brazil, 18 October 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

Endnotes

1 While strong economic growth contributed to above-budgeted revenue, which in turn allowed authorities to keep the deficit relatively low, expenditures turned largely pro-cyclical in the 2010-14 period. This led to a widening of the structural deficit, making the adjustment since 2015 – in the context of lower economic growth – more difficult.

2 The most important measures included: (1) income tax rates were raised for the top 30% of earners; (2) the VAT rate on non-cash purchases was reduced by 2 percentage points as an incentive to formalize and capture more tax from a broader base that was more prone to evasion; (3) simplifying tax compliance.

3 Investment-to-GDP has fallen to 15.7% in 2017 from a peak of 22.9% in 2012. Meanwhile, the unemployment rate has risen to about 8% from 6% in 2012.

4 In 2015, a depreciation of more than 20%, debt-to-GDP rose by eight percentage points.

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