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CREDIT OPINION
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Update

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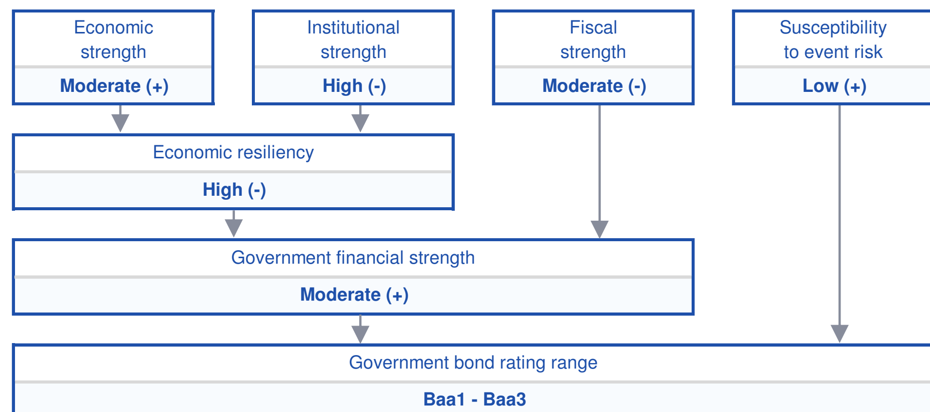
Government of Uruguay – Baa2 Stable

Regular update

Summary

The credit profile of Uruguay is supported by moderate economic and fiscal strength. Uruguay has relatively high income levels and a growth potential of about 3%. Although growth rebounded to 2.7% in 2017 after two years of weak economic activity, we expect GDP to weaken in 2018-19. Lower growth and significant expenditure rigidity limit the authorities' ability to meet fiscal deficit targets. While debt metrics deteriorated in recent years, we expect that the debt trend will be relatively stable over the next two years.

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



Source: Moody's Investors Service

Credit strengths

- » A favorable debt maturity profile and moderate government financing needs
- » Large government financial buffers
- » Strong institutions and firm commitment to arrest the deterioration in some debt metrics

Credit challenges

- » Structural rigidities in the composition of government spending
- » A high, albeit decreased, share of foreign currency-denominated government debt
- » Modest medium-term growth prospects compared to the 2004-13 above potential 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 credit pressure could result from (1) a significant strengthening of the government balance sheet through a reduction in the sovereign's debt and interest burdens, (2) a reduction in vulnerability through a significant decrease in the share of foreign-currency government debt and (3) a reduction in structural rigidities in the economy such that potential growth increased.

Factors that could lead to a downgrade

Downward credit 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 in external and financial buffers.

Key indicators

Exhibit 2

Uruguay	2012	2013	2014	2015	2016	2017	2018F	2019F
Real GDP (% change)	3.5	4.6	3.2	0.4	1.7	2.7	2.3	2.5
Inflation (CPI, % change, Dec/Dec)	7.5	8.5	8.3	9.4	8.1	6.6	7.7	7.3
Gen. gov. financial balance/GDP (%)	-2.0	-1.5	-2.3	-2.8	-3.7	-3.0	-3.1	-3.0
Gen. gov. primary balance/GDP (%)	0.3	0.9	0.0	-0.5	-1.0	-0.3	-0.4	-0.1
Gen. gov. debt/GDP (%)	38.8	38.9	39.7	47.7	47.1	47.7	49.1	49.1
Gen. gov. debt/revenues (%)	144.1	139.1	143.8	175.7	169.5	164.5	170.2	169.7
Gen. gov. interest payment/revenues (%)	8.6	8.5	8.2	8.5	9.6	9.3	9.5	9.8
Current account balance/GDP (%)	-4.0	-3.6	-3.2	-1.0	0.8	1.5	0.6	0.0
External debt/CA receipts (%)[1]	184.1	191.2	210.0	261.6	253.3	220.8	226.4	262.6
External vulnerability indicator (EVI) [2]	96.5	103.5	92.2	84.3	108.2	106.4	83.7	90.1

[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, which at $59 billion in 2017 is about half the size of the 'Baa' median. The economy grew 2.7% in real terms in 2017 and will grow an average of 2.4% from 2018-19. The final score diverges from the indicative “Moderate” because 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, which reinforces policy predictability, with still-evolving capabilities to effectively and credibly conduct these policies. The 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 reached 7.1% in February and was 8.3% in August.

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Uruguay's “Moderate (-)” **fiscal strength** assessment, 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 weaker-than-peers' debt affordability as measured by the interest payment-to-revenue ratio. While the share of foreign currency-denominated debt decreased to 49% in 2017, we expect that this share will once again exceed 50% in 2018-19 following the depreciation of the peso year-to-date. While Uruguay is exposed to exchange rate risk due to the level of government debt dollarization, this risk is mitigated by the government's financial assets, which are mostly denominated in foreign currency and provide 12 months of debt service coverage.

We assess Uruguay's **susceptibility to event risk** as “Low (+),” driven by banking sector risk. The banking sector's risk is assessed as “Low (+),” implying higher risk than the indicative of “Low,” to reflect the relatively high level of financial dollarization in the system. Additionally, this assessment reflects the system’s relatively large size for a Latin American economy, with assets equivalent to 65% of GDP, and a baseline credit assessment of ba1, which informs the risk assessment of potential contingent liabilities materializing on the government’s balance sheet.

Uruguay's government liquidity risk assessment is “Low (-),” balancing the government's relatively low gross borrowing requirements – favored by a long maturity profile – against a relatively high share of external debt in total government debt.

External vulnerability risk is assessed as “Very Low (+),” from an indicative of “Low,” to reflect the country's large external buffers that partially mitigate exchange rate risks stemming from the country's high degree of financial dollarization. Uruguay's external position has strengthened in recent years, with the current account in surplus since 2016, although this reflects a decrease in overall investment in the country. Meanwhile, foreign exchange reserves provide full coverage of external debt amortization payments, an improvement from a decade ago.

Political risk is “Very Low” as we consider that the risk of political events developing in a manner that could compromise the economic, institutional or fiscal features of Uruguay's credit profile to be very low.

Recent developments

Inflation above the target range; Uruguayan peso continues to depreciate

Annual inflation exceeded the target range of 3%-7% for the fourth consecutive month in August, reaching 8.3%. Despite lingering effects of the drought on prices of food items and the depreciation of the currency, we expect that the CPI print will moderate over the remainder of the year, ending within the 7.5%-8.0% range. We expect the Uruguayan peso exchange rate to the US dollar will be around UYU32.0/USD in 2018, from UYU28.8/USD as of the beginning of the year. The UYU has depreciated 14.1% year-to-date (9% over the first six months, see Exhibit 3). The peso's performance is broadly in line with that of other emerging market economies given the stronger US dollar.

Exhibit 3
Depreciation of the Uruguayan peso year-to-date
UYU/USD

Source: Haver Analytics

One method the central bank uses to intervene and manage the exchange rate and inflation rate is through the sale and purchase of Letras de Regulacion Monetaria (LRM). On 5 September, the BCU announced a buyback of LRM operation to avoid sharp movements in the value of the Uruguayan peso in light of the strengthening of the US dollar relative to other currencies. This operation also allowed those agents that wanted to shift their portfolios from pesos to US dollars to do it in an orderly manner. LRM available for repurchase amounted to almost UYU$110 billion (US$3.3 billion) in the latest offer. The bank received offers for UYU$22 billion or US$670.5 million (after previously announcing it would accept buying UYU$30 billion or US$909.3 million). Of the offers received, 76% were from private pension funds (AFAP), 13% from nonresidents, 9% from banks and 2% from other residents. The repurchases of LRM are not only reducing currency volatility but also marginally reducing the central bank's debt load and accompanying interest expense to help (albeit only marginally) lower the deficit at the public sector level.

Better-than-expected economic performance in the second quarter

GDP grew 2.5% in the second quarter over the same period last year, which was better than anticipated in the context of the exchange rate crisis in Argentina (B2 stable), uncertainty surrounding Brazil's (Ba2 stable) upcoming elections and the impact of the drought – first quarter GDP growth registered at 2.2%. However, headline growth was supported by the expected bump to economic performance from the resumption of the ANCAP (Ba2 stable) refinery that was not running during those months in 2017. Growth without the refinery would be closer to 1.7%, instead signaling a slowdown compared to the first quarter. Cumulatively, growth was 2.4% over the first six months, in line with official estimates.

We have revised our expectations for growth this year and in 2019 to 2.3% and 2.5%, respectively, given a drop in tourism and investment from Argentina and Brazil, particularly next year. Also influencing our 2019 projection is a possible intensification of the trade conflict between the United States (Aaa stable) and China (A1 stable), which would make the external context for Uruguay less favorable. In July we had lowered our 2018 growth forecast to 2.5%, from 3.3% previously, and for 2019 to 2.8%, from 3.2% previously.

Contagion, not only from neighbors but also from what is taking place in emerging markets, which in Uruguay is manifested in the depreciation of the peso, can also have an impact on domestic demand. Although the effects of contagion will be mitigated by significant financial buffers – including the level of international reserves and the assets held by the sovereign on its balance sheet – the depreciation of the currency, however, is very likely to negatively affect private consumption. The potential construction of a third pulp mill in the country led by Finland's UPM (Baa2 stable) could provide upside to our growth forecast beyond 2018-19. Initial estimates consider that the project could add 1.5 percentage points to growth once it begins construction, likely in the fourth quarter of 2019. Moreover, structurally, the decreasing trend in employment and investment levels will limit growth over the medium term.

Fiscal deficit still above the official target

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). The 12-month rolling public sector fiscal deficit was 3.9% of GDP as of July, higher than the 3.3% target set for 2018 (end of period) in the latest Budget Review (Rendicion de Cuentas). Looking ahead, we expect reaching an additional deficit reduction to 2.5% of GDP by 2020 will be extremely challenging given current trends. Fiscal consolidation will require (a) narrowing the central government deficit; (b) SOEs maintaining – improving – their financial balances; (c) containing the quasi-fiscal component of the deficit associated to central bank interest expenses.

For comparability with other sovereigns, we focus on central government finances, which incorporate Uruguay's social security entity, i.e., Banco de Prevision Social (BPS), according to national definitions. We estimate that the 12-month rolling central government deficit was 3.1% of GDP in July, compared with the full-year target of 2.8% (and 2.5% in 2019). We are forecasting that the deficit at the central government level will hover around 3% GDP in 2018 and 2019. Slower economic activity will likely weigh on government revenue. Additionally, expenditure rigidities will limit the authorities' ability to rein in spending in the short term. About 66% of total spending is deemed endogenous – 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 rate at which they increase. While some governments cut capital expenditures to adjust to shocks, Uruguay has less room to adjust through this mechanism given that this type of spending only represents about 4% of central government spending.

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 (2013-2022F)		2.6		
Volatility in real GDP growth (standard deviation, 2008-2017)		2.3		
WEF Global Competitiveness index (2017)		4.2		
Scale of the economy	**25%**			
Nominal GDP (US$ billion, 2017)		59.2		
National income	**25%**			
GDP per capita (PPP, US$, 2017)		22,371		
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 (%, 2013-2022F)		7.7		
Inflation volatility (standard deviation, 2008-2017)		1.1		
Automatic adjustments	**[-3; 0]**	Scores applied		
Track record of default		-2		
Economic Resiliency (F1xF2)			**H-**	**H-**
Factor 3: Fiscal strength			M-	M-
Debt burden	**50%**			
General government debt/GDP (2017)		47.7		
General government debt/revenue (2017)		164.5		
Debt affordability	**50%**			
General government interest payments/revenue (2017)		9.3		
General government interest payments/GDP (2017)		2.7		
Automatic adjustments	**[-6; +4]**	Scores applied		
Debt trend (2014-2019F)		0		
Foreign currency debt/general government debt (2017)		-4		
Other non-financial public sector debt/GDP (2017)		0		
Public sector assets/general government debt (2017)		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		5.7		
Non-resident share of general government debt (%)		56.0		
Market-Implied Ratings		Baa2		
Banking sector risk			*L*	*L+*
Average baseline credit assessment (BCA)		ba1		
Total domestic bank assets/GDP		65		
Banking system loan-to-deposit ratio		90		
External vulnerability risk			*L*	*VL+*
(Current account balance + FDI Inflows)/GDP		0.0		
External vulnerability indicator (EVI)		90.1		
Net international investment position/GDP		-26.5		
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:** where 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

- **Credit Analysis**: Government of Uruguay, 26 July 2018
- **Issuer In-Depth**: Government of Uruguay: Deficit reduction to continue but important challenges remain, 19 July 2018
- **Country Statistics**: Uruguay, Government of, 30 May 2018
- **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

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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