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ISSUER COMMENT
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Government of Uruguay

Weaker growth outlook will intensify fiscal challenges

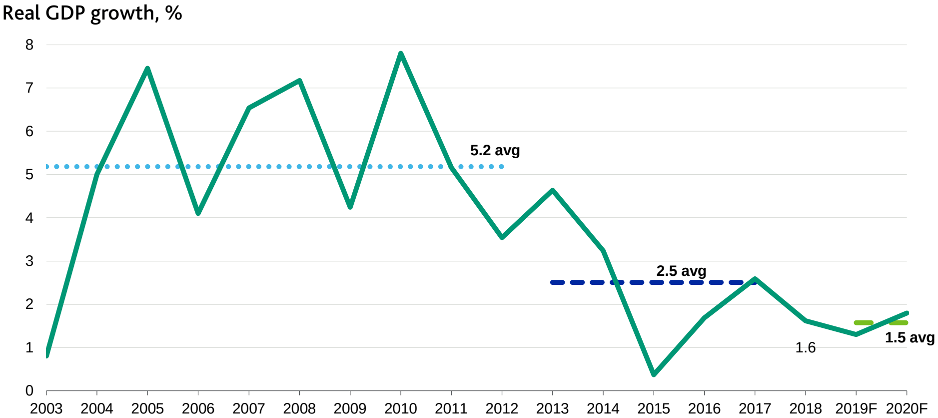
On 28 March, the government of Uruguay (Baa2 stable) announced that real GDP growth last year had slowed to 1.6%, below our estimate of 2% and a marked deceleration from 2.6% in 2017. Moreover, negative dynamics in investment and employment indicate that softer growth is likely in 2019 and 2020. A weak growth outlook will intensify pressures on Uruguay's fiscal prospects, especially given its rigid spending structure.

A drought at the beginning of 2018 weighed on the performance of the primary sector, while Argentina's economic crisis constrained tourism and related services. Several sectors also underperformed. The manufacturing sector grew just 1.9% and the commerce sector contracted 1.3%, which was significant given that each accounted for 13% of GDP. The construction sector saw the largest contraction last year at 2.8%, underscoring perennially low investment. That said, its contribution to the wider economy is limited at around 4% of GDP.

Our expectation was that GDP growth would strengthen in 2017-18 moving towards Uruguay's 3% potential growth rate. However, as a result of declining investment levels and the negative effect on employment dynamics, growth has underperformed. Investment remained weak at some 16% of GDP in 2017-18, after reaching a peak of 23.3% in 2012. If not reversed, low levels of investment will weigh on medium-term growth prospects.

Exhibit 1

Economic growth to remain weak through to 2020
Real GDP growth, %



Sources: Haver Analytics, Moody's Investors Service

A weak economy has weighed on the government accounts. The fiscal deficit at the consolidated central government level increased to 3.4% of GDP (excluding the

"Cincuentones" effect),[1] coming above our expectation of a 3% deficit. The government's rigid spending structure will constrain the authorities' ability to take corrective actions in 2019, as almost two-thirds of government spending is driven by variables that are beyond the control of the authorities, including pensions (30% of the total) that are indexed to the average nominal wage growth.

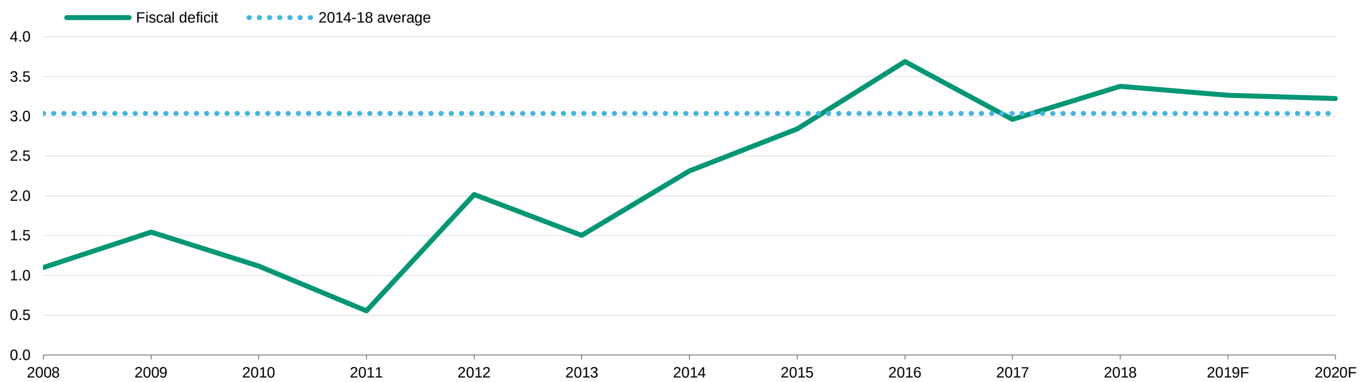
Even though the authorities have tried to reduce the fiscal deficit in recent years by different means (e.g., hiring controls, tax changes and spending reductions at public enterprises), we believe the government will miss its target fiscal deficit of 2.5% in 2020. Instead, we expect the deficit will remain above 3% of GDP through 2020 (see Exhibit 2).

The increase in the deficit last year together with lower growth and the depreciation of the peso (half of government debt is denominated in US dollars) increased the debt-to-GDP ratio to 52% in 2018 (see Exhibit 3), up from around 48% of GDP between 2015 and 2017. It had been 10 years since the government's debt burden exceeded 50%. We expect that the debt ratio will continue to gradually rise over the coming years under a no-policy change scenario.

Exhibit 2

Fiscal deficit will continue to exceed 3% of GDP

Central government deficit excluding "Cincuentones" effect, % of GDP

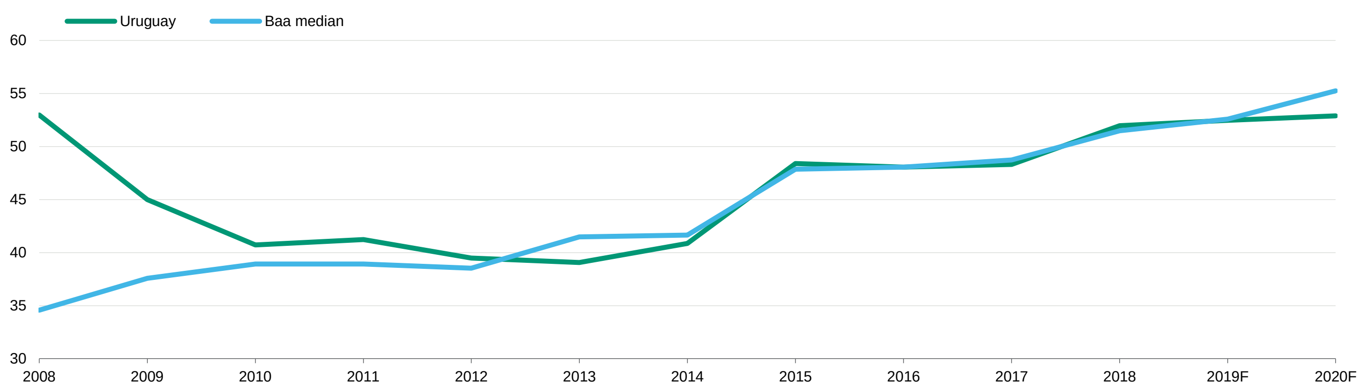


Sources: Haver Analytics, Moody's Investors Service

Exhibit 3

Debt-to-GDP exceeded 50% for the first time since 2008 last year, but is in line with peers

Debt-to-GDP, %



Sources: Haver Analytics, Moody's Investors Service

If economic growth remains weak and the fiscal deficit does not decline, the upward trajectory of the debt-to-GDP ratio can put pressure on the sovereign credit profile. However, mitigating factors, including the government's ample liquidity buffer and a long maturity profile, would limit the effect of more challenging international financial conditions that could lead to exchange rate volatility and higher interest rates.

Presidential and parliamentary elections will be held in October 2019 (with a runoff, if needed, in November). The next administration will inherit a complicated situation. Some candidates have talked about the need for a pension reform during the next administration, a a credit positive development which would help to contain the expansion of one of the government's largest spending items. Additional challenges include, high levels of financial dollarization, inflation that remains outside of the target range, and a rigid public spending structure.

Moody's related publications

» **Sector Comment**: Cross-Sector - Latin America: Steady US rates support favorable funding conditions, 25 March 2019

» **Credit Opinion:** Government of Uruguay – Baa2 stable: Regular update, 16 January 2019

» **Outlook:** Sovereigns – Latin America & Caribbean: 2019 outlook stable as growth, debt structures still favorable; political risks rising, 9 January 2019

» **Methodology**: Sovereign Bond Ratings, 27 November 2018

Endnotes

1 Law 19.590, also known as the "Cincuentones" Law, allows people 50 years old or older who were affected by the 1996 pension reform to transfer the balance of their accounts in the private pension system (AFAPs) to the public one (Banco de Prevision Social, BPS). Starting last November, AFAPs began making transfers into a trust and the government recorded these transfers above-the-line following IMF accounting methodology.

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