MOODY'S
INVESTORS SERVICE

CREDIT OPINION
14 February 2020

Update

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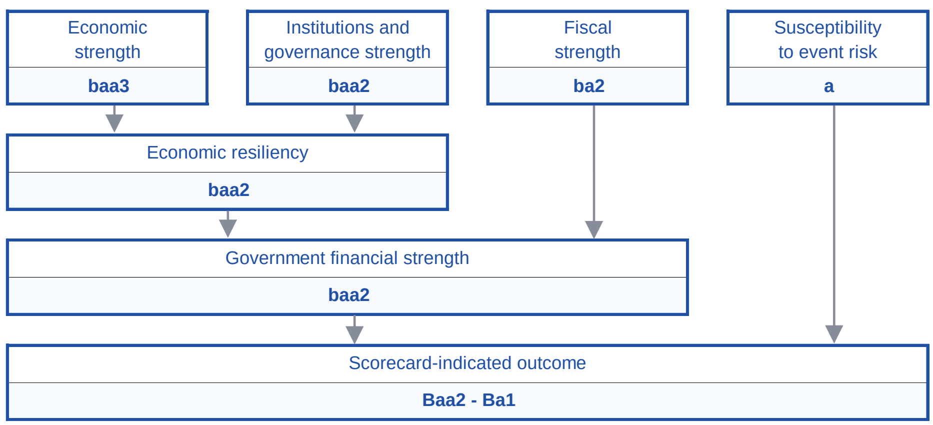
Government of Uruguay – Baa2 stable

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 2.5%. Although growth has been weak in recent years, it should pick up in 2020-21. Lower-than-potential growth and significant expenditure rigidity limit the authorities' ability to meet fiscal deficit targets. While debt metrics have deteriorated in recent years, we expect the debt trend to 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

» Favorable debt maturity profile and moderate government financing needs

» Large government financial buffers

» Strong institutional framework

Credit challenges

» Structural rigidities in the composition of government spending

» Still-significant share of foreign-currency-denominated government debt

» Modest medium-term growth prospects after a period of above-potential growth in 2004-13

Rating outlook

The stable outlook balances negative underlying fiscal and economic pressures against our assumption that the next administration will implement structural economic and fiscal reforms that will counter the ongoing erosion in Uruguay's economy and fiscal strength.

Factors that could lead to an upgrade

Upward credit pressure could result from (1) a reduction in structural rigidities in Uruguay's credit profile including those associated with low and declining productivity, which affect potential growth, as well as the relatively rigid government spending structure; (2) a material strengthening of the government balance sheet through a reduction in the sovereign's debt and interest burdens; and (3) a reduction in vulnerability through a significant decrease in the share of foreign-currency government debt.

Factors that could lead to a downgrade

Downward credit pressure would emerge if we were to conclude that structural fiscal and economic challenges were not likely to be addressed, denoting a weakening in policy responsiveness and likely leading to economic growth underperformance and further fiscal strength deterioration in the medium term, with a continued increase in debt ratios and/or a sustained, material erosion in external and financial buffers.

Key indicators

Exhibit 2

Uruguay	2014	2015	2016	2017	2018	2019E	2020F	2021F
Real GDP (% change)	3.2	0.4	1.7	2.6	1.6	0.5	2.0	2.3
Inflation (CPI, % change, Dec/Dec)	8.3	9.4	8.1	6.6	8.0	8.8	8.0	7.5
Gen. gov. financial balance/GDP (%)[1]	-2.3	-2.8	-3.7	-3.0	-3.4	-4.3	-3.6	-3.2
Gen. gov. primary balance/GDP (%)	0.0	-0.5	-1.0	-0.3	-0.6	-1.6	-0.9	-0.3
Gen. gov. debt/GDP (%)	40.9	48.4	48.0	48.3	52.0	56.1	56.4	56.4
Gen. gov. debt/revenues (%)	148.2	178.1	172.9	167.6	177.6	195.6	198.5	199.0
Gen. gov. interest payment/revenues (%)	8.3	8.5	9.6	9.3	9.6	9.3	9.8	10.2
Current account balance/GDP (%)	-3.2	-0.9	-0.1	0.7	0.1	0.5	-0.6	-0.4
External debt/CA receipts (%)[2]	212.0	263.6	255.7	231.4	226.3	226.8	222.6	215.6
External vulnerability indicator (EVI) [3]	91.3	84.9	108.9	107.1	88.1	87.4	102.9	106.2

[1] Excludes pension transfers related to the 'cincuentones' law starting in 2018
[2] Current Account Receipts
[3] (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 "baa3" **economic strength** assessment on a global basis, reflecting moderate potential growth and a relatively high income per capita, counterbalanced by the small size of the economy, which at $60 billion in 2018 was smaller than the 'Baa' median of around $240 billion. We estimate the economy grew 0.5% in real terms in 2019 and will expand on average 2% in 2020-21.

Our final score for Uruguay's **institutions and governance strength is** "baa2." 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 in meeting policy goals, as exemplified by the stubbornly high inflation rates that have often been above the official target range. Since January 2013, inflation has exceeded the target's upper bound in 71 of the last 84 months, including every month since February 2018. Current institutional arrangements guiding fiscal policy have not provided a strong anchor for the overall fiscal policy, which has led to a deterioration in the structural deficit and a procyclical policy stance.

Uruguay's “ba2” **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-peer debt affordability, as measured by the interest payment-to-revenue ratio. While the share of foreign-currency-denominated debt decreased to 49% in 2017, this share once again exceeded 50% in 2018 and 2019, and we expect it to stay around 54% in 2020-21 following the depreciation of the peso. While Uruguay is exposed to exchange rate risk because of 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. For this reason, we adjust the score up to “ba2” from the initial score of “ba3.”

We assess Uruguay's **susceptibility to event risk** as “a,” driven by banking sector risk, government liquidity risk and external vulnerability risk. Banking sector risk assessment is “a,” which reflects the system’s relatively large size for a Latin American economy, with assets equivalent to 66% of GDP in 2018, and a Baseline Credit Assessment of baa3, which informs the risk assessment of potential contingent liabilities materializing on the government’s balance sheet.

Uruguay's external vulnerability risk assessment is “a,” reflecting its large external buffers that partially mitigate exchange rate risks stemming from the country's still-significant degree of financial dollarization. Uruguay's current account has posted surpluses since 2015, although these have narrowed since 2017, with this trend reflecting the decrease in investment levels.

Uruguay's government liquidity risk assessment is “a,” 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.

The country's political risk assessment is “aa.” We consider 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.

ESG considerations

How environmental, social and governance risks inform our credit analysis of Uruguay

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sovereign issuers’ economic, institutions and governance and fiscal strength and their susceptibility to event risk. In the case of Uruguay, the materiality of ESG to the credit profile is as follows:

Environmental factors affect Uruguay's credit profile in a limited manner. The country's large coastline is not susceptible to major flooding, and extreme weather events are rare in the region. The main risk is disruptive weather effects like excessive rains or droughts, which would affect the agricultural sector.

Social considerations, in particular an aging population, affect Uruguay's credit profile. The country's aging population, coupled with the populace's predilection for social expenditure, will weigh on public finances in the coming years. A recent example of how this situation manifests is the so-called *cincuentones* law, which absorbed private fully funded would-be pensioners into the public system after their forecast pensions were deemed insufficient.

We do not consider governance risks material to Uruguay's credit profile. Uruguay has strong institutions and a broad societal consensus on retaining the country's institutional arrangement.

All of these considerations are further discussed in the “Detailed credit considerations” section above. Our approach to ESG is explained in our report on how ESG risks influence sovereign credit profiles and our cross-sector methodology General Principles for Assessing ESG Risks.

Recent developments

Incoming administration presents its "Urgent Law"

The incoming administration of president-elect Luis Lacalle Pou has unveiled the draft of an omnibus bill, dubbed the "Urgent Law." The bill attempts to kick-start the administration's reform agenda. Lacalle Pou will take office on 1 March 2020. The draft covers a wide range of topics, including reforms in security, education, agricultural policy, health, labor relations, social security and fiscal policy. Of these, the fiscal and labor relations reforms have the most potential for a direct impact on Uruguay's credit profile.

On the fiscal front, the draft proposes a fiscal rule designed to induce compliance with a "structural" balance, which would be calculated by a panel of experts. In addition to the "structural" balance, the rule would be complemented by a cap on real expenditure growth that would be tied to the economy's potential growth rate. A third component would be the creation of a stabilization fund, in the event of fiscal surpluses. At present, details are limited, as the draft is succinct in its description of the proposed fiscal framework. In terms of our rating, the principal issue will be to observe fiscal results under the new rules. This will be complemented by the new administration's multiyear fiscal framework, to be presented by mid-2020, and the compliance with its consolidation targets.

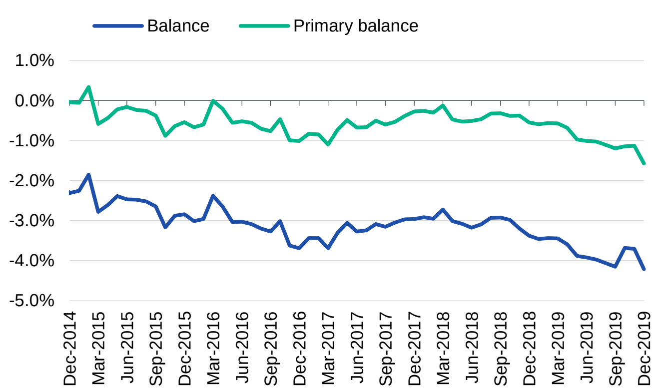
On the labor issue, the draft aims to resolve a long-standing controversy on labor relations, as it bars striking workers from occupying places of business as part of their strike. The current legislation allows for such a behavior, which essentially forces workers who might not wish to strike to join in on the industrial action. This has long been a complaint by business interests, who have obtained support from the UN's International Labour Organisation (ILO), which has stated that current legislation breaks ILO rules.

It is currently too early to determine the potential impact of the "Urgent Law." Greater details will be added to the current draft after the new administration takes office, and Lacalle Pou has readily admitted that he is willing to negotiate with opposition parties and stakeholders to ensure its passage through the legislature. As we have noted, the incoming administration will have to show substantial efforts in consensus-building to see its reform agenda take hold.

Fiscal deficit widened in 2019, pointing to weaker starting point for new administration

The consolidated central government posted an overall deficit of UYU83 billion in 2019 (4.3% of estimated 2019 GDP).[1] The result represents a widening of the overall deficit by 0.9% of GDP compared with the 2018 deficit of 3.4% of GDP (see Exhibit 3).

Exhibit 3
Deficits have widened since mid-2018
(General government balances as a percentage of GDP, 12-month rolling)



Data excludes the effect of law 19.590 (the *cincuentones* law).
Source: Moody's Investors Service

Exhibit 4
The reduction in interest expenses was met with declining revenue, driving a wider deficit
(General government, % of GDP)

	2017	2018	2019
Total revenue	**28.8%**	**29.3%**	**28.7%**
Tax revenue	17.7%	18.0%	17.6%
Social security revenue*	7.7%	7.6%	7.6%
Other revenue	3.4%	3.7%	3.5%
Total expenditure	**31.8%**	**32.6%**	**33.0%**
Current expenditure (excl. interest)	27.8%	28.3%	28.8%
Capital expenditure	1.3%	1.5%	1.5%
Interest expenditure*	2.7%	2.8%	2.7%
Balance	**-3.0%**	**-3.4%**	**-4.3%**
Primary balance	**-0.3%**	**-0.5%**	**-1.6%**

*Data excludes the effect of law 19.590 (the *cincuentones law*).
Source: Moody's Investors Service

The widening deficit materialized in the context of a small reduction in expenditure, the direct result of a successful liability management operation in September, which reduced the government's interest expense significantly from that in the fourth quarter of 2019. Despite these savings on interest, a significant decline in revenue ultimately drove the widening deficit. As such, the widening of deficit was particularly pronounced in terms of the primary deficit (see Exhibit 4). The weaker revenue relative to 2018 was primarily a function of weaker tax collection, itself a function of a sluggish economy. In the first nine months of 2019 (the latest available data), real GDP growth was 0.2% in year-on-year terms. Sluggish private consumption and imports weighed on tax revenue, which expanded by 6.1% year-on-year, well below even the rate of inflation (7.9% in 2019).

For 2020, we currently envision a fiscal deficit of 3.6% of GDP, with most of the deficit reduction likely to come from a decrease in expenditures as a percentage of GDP. However, the incoming administration's fiscal plans are a key variable, with greater details on the fiscal consolidation plan to come over the coming months. Regardless, any major retrenchment in expenditure will prove difficult as over 80% of spending is either set by law, indexed, or financially or politically difficult to adjust.

Moody's rating methodology and scorecard factors: Uruguay - Baa2 stable

				Initial (Factor score)	Final (Factor score)	Weights
Factor 1: Economic strength				baa3	baa3	50%
Growth dynamics	Average real GDP growth (%)	2014-2023F	1.9	ba2		25%
	Volatility in real GDP growth (%)	2009-2018	2.1	baa2		10%
Scale of the economy	Nominal GDP ($ billion)	2018	59.6	ba2		30%
National income	GDP per capita (PPP, Intl$)	2018	23,158	a3		35%
Adjustment to factor 1	*# notches*				0	max ±9
Factor 2: Institutions and governance strength				a3	baa2	50%
Quality of institutions	Quality of legislative and executive institutions			a		20%
	Strength of civil society and the judiciary			aa		20%
Policy effectiveness	Fiscal policy effectiveness			baa		30%
	Monetary and macroeconomic policy effectiveness			baa		30%
Specified adjustment	Government default history and track record of arrears				-2	max -3
Other adjustment to factor 2	*# notches*				0	max ±3
F1 x F2: Economic resiliency				baa1	baa2	
Factor 3: Fiscal strength				ba3	ba2	
Debt burden	General government debt/GDP (%)	2018	52.0	baa1		25%
	General government debt/revenue (%)	2018	177.6	a2		25%
Debt affordability	General government interest payments/revenue (%)	2018	9.6	baa2		25%
	General government interest payments/GDP (%)	2018	2.8	a3		25%
Specified adjustments	*Total of specified adjustment (# notches)*			-5	-5	max ±6
	Debt trend	2015-2020F	8.0	0	0	
	Foreign currency debt/general government debt	2018	53.8	-5	-5	
	Other non-financial public sector debt/GDP	2018	3.4	0	0	
	Public sector assets/general government debt	2018	0.0	0	0	
Other adjustment to factor 3	*# notches*				1	max ±3
F1 x F2 x F3: Government financial strength				baa1	baa2	
Factor 4: Susceptibility to event risk				a	a	Min
Political risk				aa		
	Domestic political risk and geopolitical risk			aa		
Government liquidity risk				a	a	
	Ease of access to funding			a		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				a	a	
	Risk of banking sector credit event (BSCE)	Latest available	baa3	ba1-ba2		
	Total domestic bank assets/GDP	2018	66.3	<80		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				a	a	
	External vulnerability risk			a		
Adjustment to F4 EVR	*# notches*				0	max ±2
Overall adjustment to F4	*# notches*				0	max -2
F1 x F2 x F3 x F4: Scorecard-indicated outcome				Baa1 - Baa3	Baa2 - Ba1	

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 scorecard-indicated outcome. 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 scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

Footnotes: (1) Initial factor score: scorecard indicators combine with the automatic adjustments to produce an initial factor score for every rating factor, as detailed in Moody's Sovereign Ratings Methodology. **(2) Final factor score:** where additional analytical considerations exist, initial factor scores are augmented to produce a final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Ratings Methodology; details on country-specific considerations are provided in Moody's research. **(3) Scorecard-indicated outcome:** Factor 1: Economic Strength, and Factor 2: Institutions and Governance Strength, combine with equal weight into a construct we designate as Economic Resiliency (ER). An aggregation function then combines ER and Factor 3: Fiscal Strength, following a non-linear pattern where Fiscal Strength 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 government financial strength as given by combining the first three factors. **(4) There are 20 ranking categories** for quantitative sub-factors: aaa, aa1, aa2, aa3, a1, a2, a3, baa1, baa2, baa3, ba1, ba2, ba3, b1, b2, b3, caa1, caa2, caa3, ca and 8 ranking categories for qualitative sub-factors: aaa, aa, a, baa, ba, b, caa, ca **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

- **Country Statistics**: Uruguay, Government of, 27 November 2019
- **Issuer Comment:** Government of Uruguay: Consensus-building coalition will be key to passing reforms after elections, 28 October 2019
- **Issuer In-Depth:** Government of Uruguay – Baa2 stable: Annual credit analysis, 14 August 2019
- **Credit Opinion:** Government of Uruguay – Baa2 stable: Update following rating affirmation, outlook unchanged, 7 August 2019
- **Rating Action:** Moody's affirms Uruguay's Baa2 ratings; maintains stable outlook, 6 August 2019
- **Rating Methodology**: Sovereign Ratings Methodology, 25 November 2019

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.

Endnotes

1 Official statistics report a deficit of UYU59.8 billion, which is flattered by the effect of law 19.590, the so-called *cincuentones* law. Our figures net out the effect of law 19.590.

REPORT NUMBER 1213530

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