

## FITCH AFFIRMS URUGUAY AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-New York-21 September 2017: Fitch Ratings has affirmed Uruguay's Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BBB-' with a Stable Outlook. A full list of rating actions follows at the end of this press release.

### KEY RATING DRIVERS

Uruguay's ratings are supported by strong structural features in terms of social and institutional development, a strong external balance sheet, and fiscal financing buffers. 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 economy is on track for a strong rebound in 2017 after two years of sluggish growth. Fitch forecasts growth of 3.5% in 2017, up from 1.5% in 2016 and 0.4% in 2015. Stronger consumption is driving the recovery, reflecting the boost to real wages and social benefits from the sharp slowdown in inflation, as well as a strong local currency. Exports have also surged on a record soy harvest, strong tourism inflows from Brazil and Argentina, and solid growth among other mostly agriculture-oriented goods.

Uruguay's economic recovery is somewhat less robust than the headline GDP figures suggest, in Fitch's view. The small telecom sector alone explains half of cumulative real GDP growth in 2011-2016 and continued to lift the figures in the first half of 2017 (an outsized contribution that mostly reflects measurement challenges affecting national accounting of dynamic service sectors). The labor market remains weak, with unemployment around 8%.

Investment has also continued to contract in 2017, highlighting potential headwinds to the growth outlook as the cyclical factors underpinning strong private consumption wane. Restrictive labor laws and high local costs in terms of taxes and utility prices are key investment bottlenecks according to international surveys. However, there has been recent progress on a major pulp plant and related infrastructure, supporting Fitch's baseline that this project will advance as soon as 2019. Fitch projects growth of 2.8% in 2018 and 3.0% in 2019.

Inflation has fallen considerably to within the target range (5% plus/minus 2pp) in 2017, and stood at 5.4% as of August. It is not yet clear how lasting this lower inflation level will be in Fitch's view, given it mostly reflects a sharp fall in tradables inflation due to peso strength, while non-tradables inflation remains around 8%. Nevertheless, expectations have converged toward the 7% upper bound of the target, which could portend progress in reducing Uruguay's structurally high inflation (among the highest in investment-grade space in the past five years). Monetary policy has taken a less contractionary stance amid the improved inflation backdrop in Fitch's view, evidenced by the fall in real interest rates from 5% to 3%. High dollarization and low financial depth limit continue to weaken the efficacy of monetary policy.

External finances have seen a significant improvement. The current account moved to a 0.5%-of-GDP surplus in the four quarters through 2017Q1 after a decade of deficits, driven by strong exports and tourism inflows and lower capital imports due to the ebb in investment. An improved current account and strong local preference for local currency assets have generated appreciation pressure on the peso in 2017, prompting considerable reserve accumulation by the central bank. This stands to further bolster Uruguay's strong reserve coverage and external liquidity ratios, which had already improved given reduced liquid external liabilities in terms of Argentine deposits and non-resident holdings of local bonds (2% of the total in June, down from 25% at end-2015).

Uruguay's key credit challenge remains reducing its fiscal deficit. Fitch projects that consolidation efforts will lower the central government deficit to 3.2% of GDP in 2017 from 3.7% in 2016. Income tax hikes have boosted revenues in line with projections, while taxes and dividends from public companies have risen as lower energy costs have not been passed on to consumers. Spending pressures have offset some of the improvement: pension costs are rising on indexation and a greater-than-expected impact of prior relaxation of retirement rules, and healthcare costs on expansion of insurance (FONASA) to a final cohort of dependents in 2016.

The authorities aim to reduce the public sector deficit to 2.5% of GDP in 2019 from 3.9% in 2016 (3.7% to 2.5% for the central government). The budget for 2018 includes tax hikes on imports and gambling to keep fiscal targets on track, given that better growth and revenue forecasts have been more than offset by rising pension costs. Fitch believes the government will fall short of its consolidation goals, however, given the further fiscal adjustment this would require will become increasingly difficult ahead of 2019 elections. Appetite for further tax hikes is limited; capital spending is already very low, and spending faces pressure from rigid social entitlements and pledges for further budget hikes (i.e. lifting education spending to 6% of GDP). Uruguay has a poor track record of meeting fiscal targets, and deficits have tended to rise in election years.

Fitch projects that fiscal deficits will lift the general government debt burden to 62% of GDP by 2019, from 57% in 2016. Uruguay's debt level is above the 'BBB' median of around 40% of GDP, although less so when excluding 8.5pp in recapitalization bonds issued to the central bank with low refinancing risk (but included by Fitch for consistency with data reported by other sovereigns). Financing risks are low due to a long-dated debt profile and liquidity buffers including USD 2.4 billion in contingent credit lines and a long-standing pre-financing policy.

Uruguay's sovereign balance sheet has proven sensitive to exchange rate movements, reflecting a relatively high share of foreign-currency debt. Real peso appreciation has slowed the rise in debt metrics in 2016 and 2017, but this benefit is likely to wear off in the coming years. However, the sovereign aims to decrease its reliance on foreign currency funding, taking advantage of lower peso interest rates to issue two peso-denominated global bonds in 2017.

Political challenges for the ruling Frente Amplio (FA) coalition have risen due to a tighter budget envelope and tensions surrounding the resignation of the vice president due to ethical issues. Fitch believes this episode reflects the country's high governance standards rather than signaling a deterioration, but it could pose risks should it weaken the cohesion or public support of the FA in a way that hinders policy priorities such as fiscal consolidation. The FA recently recovered a legislative majority, which should support already strong governability.

#### 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 FC IDR scale. Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final Long-Term FC IDR by applying its QO, relative to rated peers, as follows:

--Macro: -1 notch, to reflect a weak track record of compliance with inflation and fiscal targets, which weighs on policy credibility and 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 relatively 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.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centered averages, including one year of forecasts, to produce a score equivalent to a Long-Term FC IDR. Fitch's QO is a forward-looking qualitative framework

designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

#### RATING SENSITIVITIES

The main risk factors that, individually or collectively, could trigger a negative rating action are:

- Fiscal slippage leading to a faster trend increase in the government debt burden;
- Deterioration in growth prospects;
- Erosion of external liquidity buffers.

Conversely, the main factors that could lead to a positive rating action are:

- Fiscal consolidation consistent with stabilization of the public debt trajectory;
- A sustained reduction in inflation and better anchoring of inflation expectations;
- Evidence of investments or productivity gains that lift medium-term growth prospects.

#### KEY ASSUMPTIONS

- Fitch assumes that construction of a new pulp mill project will take place as soon as 2019, supporting growth during the construction phase and once production begins.
- Fitch assumes that after contracting in 2016, Brazil's economy will post positive growth in 2017-2018, 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. 21 Jul 2017)

<https://www.fitchratings.com/site/re/901261>

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