FitchRatings

FITCH AFFIRMS URUGUAY AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-New York-27 February 2015: Fitch Ratings has affirmed Uruguay's Long-term foreign IDR at 'BBB-' and the local currency IDR at 'BBB'. Fitch has also affirmed the issue ratings on Uruguay's senior unsecured foreign- and local-currency bonds at 'BBB-' and 'BBB', respectively. The Rating Outlook on the Long-term IDRs is Stable. Additionally, Fitch has affirmed the Country Ceiling at 'BBB+' and the short-term foreign currency IDR at 'F3'.

KEY RATING DRIVERS

Uruguay's rating affirmation and Stable Outlook reflects the following factors:

Strengthened external buffers, an improved debt profile and higher growth in relation to peers have underpinned Uruguay's credit profile. Uruguay's ratings are also supported by strong structural factors, including high per capita GDP and social development indicators, and strong institutional quality in relation to 'BBB' peers. These factors are balanced by persistently high inflation, reflecting challenges to the effective implementation of monetary policy, as well as relatively high government debt, a rigid spending profile and significant financial dollarization.

As a small, open and commodity-dependent economy, Uruguay continues to strengthen its capacity to manage external shocks through the accumulation of international reserves, improved exchange rate flexibility and external financing flexibility. Reserves increased to US$17.6 billion in 2014, boosting Uruguay's strong buffers against potential vulnerabilities from high levels of foreign-currency deposits and non-resident participation in the local public debt market. Capacity to use the exchange rate as a shock absorber, despite high financial dollarization, reflects the improved currency composition of public debt and prudent management of currency mismatches in the private sector.

After reaching 5.2% of GDP in 2013, the current account deficit is likely to moderate on lower oil prices (fuel accounted for 14% of imports in 2014), reduced imports of capital goods for large investments, and the full-year effect of production of the new Montes del Plata pulp plant. Moderate FDI inflows should continue to finance most of the country's current account deficit. Uruguay's access to international markets at favourable terms and contingent credit lines with multilateral institutions further bolster external funding flexibility.

The Uruguayan economy's soft landing amidst challenging global and regional conditions demonstrates its improved resilience to external shocks. After outpacing regional and rating peers in the years following the global financial crisis, growth is likely to remain close to potential (3%) in the absence of large investment projects. Continued underperformance in Brazil and Argentina and lower prices for Uruguay's soft commodity exports present downside risks to growth, though these are partially mitigated by lower oil prices.

Inflation rose further above the central bank target band (5%?2%) to 8.9% on average in 2014, remaining one of Uruguay's key policy challenges. The central bank has tightened monetary policy considerably since a change in its instruments in mid-2014. This has been reflected in higher market interest rates and slowing growth in monetary aggregates. While inflation could decline on the back of low oil prices, inflation expectations through 2016 remain well above-target, highlighting the challenge to improving the effectiveness and credibility of monetary policy in the absence of adjustments to wage and fiscal policy.

The consolidated central government deficit increased from 1.9% in 2013 to 2.4% in 2014. Rising primary current spending has driven a structural widening of fiscal deficits in recent years (reflecting expansion of social programs including healthcare and pensions). Revenue growth has not kept pace. Slower growth, UYU peso depreciation and wider fiscal deficits have led general government debt to inch upward to nearly 50% of GDP, above the 'BBB' median of 40%.

Uruguay's financing needs remain manageable with government financing requirements averaging around 4% of GDP in 2015-2016. Moreover, vulnerability to refinancing risks is mitigated by a long-dated debt profile (with one of the highest average maturities in the 'BBB' category), improved currency composition, liquid assets held to cover amortisations for at least 12 months, and precautionary credit lines with multilateral institutions.

In his second term, President Tabare Vazquez is likely to maintain broad policy continuity with previous Frente Amplio administrations, balancing market-friendly policies with expansion of social welfare programs. The congressional majority secured by the Frente Amplio will support progress on the administration's social agenda, though policies aimed at fiscal consolidation or boosting competitiveness could face opposition if they are perceived to pose risks to social protections.

RATING SENSITIVITIES

The Stable Outlook reflects Fitch's assessment that both upside and downside risks to the rating are currently well balanced. Consequently, Fitch's sensitivity analysis does not currently anticipate developments with a high likelihood of leading to a rating change.

The main factors that could lead to positive rating action are:

--Fiscal consolidation consistent with a reduction in government debt levels in relation to peers;
--Improvements in the macroeconomic policy framework that would bring inflation and inflation expectations in line with the announced targets, and widen scope for counter-cyclical monetary policy to support for the economy;
-- Evidence of increased investment and productivity gains that lift medium-term growth prospects.

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

--Material weakening of the fiscal position and public debt burden;
--A sustained period of increased macroeconomic instability that materially erodes external buffers.

KEY ASSUMPTIONS

The ratings and Outlooks are sensitive to a number of assumptions:

--Fitch assumes that Argentina's economic difficulties will not generate destabilizing shocks to Uruguay's growth or financial stability given reduced trade and financial links between the two countries. In addition, Fitch expects the Brazilian economy to continue underperforming in 2015;
--Fitch assumes that China will avoid a hard landing and that the Uruguay's agricultural producers will be able to absorb lower prices for soft commodity exports.

Contact:

Primary Analyst
Todd Martinez
Associate Director
+1-212-908-0897
Fitch Ratings, Inc., 33 Whitehall Street, New York, NY 10004

Secondary Analyst

Erich Arispe
Director
+1-212-908-9165

Committee Chairperson
Shelly Shetty
Senior Director
+1-212-908-0324

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria and Related Research
--'Sovereign Rating Criteria' (Aug. 12, 2014);
--'Country Ceilings' (Aug. 28, 2014)

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Sovereign Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=754428
Country Ceilings
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=752194