FITCH AFFIRMS URUGUAY AT 'BBB-'; OUTLOOK STABLE

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

KEY RATING DRIVERS

The affirmation of Uruguay's sovereign rating at 'BBB-' and of the Stable Outlook reflects the following factors:

Uruguay's creditworthiness is supported by established external buffers, low financing risks, and a strong structural profile in terms of institutional quality and social stability underpinned by high income and human development indicators. These factors are balanced by persistently high inflation in relation to investment-grade peers, relatively high government debt and a rigid spending profile that narrow scope for counter-cyclical policies.

The economy has been resilient to a less favourable external backdrop in spite of high agricultural commodity dependence. The flexible exchange rate has been a first line of defence (the peso has depreciated 15% so far in 2015), reflecting prudent management of currency risks in the public and private sectors in a context of high financial dollarization. The current account deficit is on track to fall to a projected 3.9% of GDP in 2015 from 5.1% in 2013 due to a reduced oil import bill and the boost to export volumes from the first full year of production at the Montes del Plata pulp mill, which have so far balanced the impact of lower exports prices and weaker demand in several key trading partners. As a result, lower external financing requirements remain well covered by FDI.

The presence of external buffers has bolstered resilience to shocks and should facilitate adjustment to the less favourable external context. Strong reserve levels provide solid coverage of potential vulnerabilities from high shares of foreign-currency deposits and non-resident holdings of local public debt securities. Fitch's international liquidity ratio of over 200% for Uruguay is well above the 'BBB' median.

Fitch expects growth to slow from 3.5% in 2014 to 2.5% in 2015 (including the boost from Montes del Plata) and 2.3% in 2016, reflecting a difficult regional backdrop, weaker soft commodity export prices, and the absence of major new investments in the near term. Medium-term growth will depend on new investment and productivity gains. The government has announced plans to better coordinate public agencies in support of competitiveness and invest in infrastructure, although these efforts could face challenges from fiscal constraints and the PPP framework's slow progress so far in generating successful projects.

The new administration has indicated broad policy continuity in its upcoming five-year term, with a gradual fiscal realignment. In its five-year budget proposal to Congress, the administration is targeting a reduction in the public deficit to 2.5% of GDP in 2019 from 3.4% in 2014, involving improvement in the consolidated central government primary balance from 0% to 0.7%. The strategy relies on strengthening the balances of state-owned companies and their fiscal contributions, without tax hikes, as spending could face pressure from prior social reforms and pledges for increased outlays for education and dependent care.

Consolidation could face challenges from slower growth, a rigid spending profile, social expenditure commitments, and resistance from within the ruling coalition and labour unions to efforts perceived to pose risks to social protections and employment. Five-year budget planning and a law limiting the annual increase in net public debt have not proven sufficiently binding to prevent a widening of the fiscal deficit in recent years.

Fitch forecasts general government debt will rise from 48% of GDP in 2014 to 52% of GDP in 2015 on a primary deficit and peso depreciation. The consolidation envisioned by the authorities could stabilise debt around 53% of GDP by 2017 and reduce it gradually thereafter. Refinancing risks in the context of expected U.S. policy rate rises are mitigated by prudent debt management, which has produced one of the lowest financing needs in the 'BBB' category and built important buffers in terms of liquidity, market access, and credit lines with multilaterals.

Persistently high inflation remains a key policy challenge. Inflation rose to 9% in July from 7.4% in February, prompting the authorities to resort to price freezes. Monetary policy has shouldered the burden of reining in inflationary pressures to balance expansive salary and fiscal policies. New guidelines for upcoming wage contracts aim to scale down backward-looking inflation indexation -- a key factor behind inflation inertia -- by replacing real wage increases with nominal increases varied by sectors' strength (with ex post inflation adjustments only to ensure no real wage losses). The guidelines could help reduce inflation slowly given staggered adoption of new contracts in the coming year, but they could face social opposition.

RATING SENSITIVITIES
The Stable Outlook reflects Fitch's view that upside and downside risks to the rating are broadly balanced.

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

--Improvements in the authorities' policy mix that result in an improved trajectory for inflation and inflation expectations;
--Fiscal consolidation consistent with a more favourable trajectory for public debt;
--Evidence of new investments or productivity gains that lift medium-term growth prospects.

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

--Weakening in the fiscal position that puts public debt on sustained upward trajectory.
--Increased macroeconomic instability and erosion of external buffers.

KEY ASSUMPTIONS
--Fitch assumes that Argentina's economic difficulties will not generate destabilizing shocks to Uruguay's macroeconomic 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 and 2016.
--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.

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Applicable Criteria
Country Ceilings (pub. 20 Aug 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869287
Sovereign Rating Criteria (pub. 12 Aug 2014)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=754428

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