FITCH AFFIRMS URUGUAY AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-New York-15 March 2016: Fitch Ratings has affirmed Uruguay's sovereign ratings as follows:

--Long-term foreign-currency Issuer Default Rating (IDR) at 'BBB-', Outlook Stable;
--Local-currency IDR at 'BBB', Outlook Stable;
--Senior unsecured foreign-currency bonds at 'BBB-';
--Senior unsecured local-currency bonds at 'BBB';
--Short-term foreign-currency IDR at 'F3';
--Country ceiling at 'BBB+'.

KEY RATING DRIVERS

Uruguay's creditworthiness is supported by strong structural features in terms of social and institutional development, established external buffers, and low fiscal financing risks. These factors are balanced by persistently high inflation, relatively high government debt, and a rigid spending profile driving growth in fiscal deficits above budget targets in recent years, narrowing scope for counter-cyclical policies.

Uruguay has shown flexibility to external shocks in the past year from lower export prices, weakness in key markets, and global financial volatility. The exchange rate has been the first line of defence, with the peso depreciating 24% in the 12 months through February due to portfolio shifts by both non-residents and residents. The current account deficit is moderating despite lower commodity prices, reflecting a natural hedge to terms of trade given Uruguay is both an exporter of agricultural goods and an importer of oil. Central bank intervention to smooth depreciation lowered reserves to USD14 billion in February from USD18 billion a year earlier. The decline in reserves has coincided with reduced non-resident local debt holdings and imports, thereby maintaining reserve coverage and international liquidity metrics at levels above the 'BBB' medians.

Growth decelerated below trend to an estimated 1.4% in 2015, from 5% on average in 2010-2014, reflecting the impacts of weaker external demand (namely due to recession in Brazil) and also internal factors including moderation in the investment cycle and weaker labour market conditions. Fitch projects these factors will contribute to another year of sluggish growth of 0.9% in 2016, as the statistical boost from production at a new pulp mill will fade.

Medium-term growth is likely to be below the high rates seen over the past decade but sufficient to maintain the country's relatively high per-capita income. Brazil is projected to remain a drag, although Argentina could provide some uplift after recent lifting of trade, FX and transhipment restrictions. The investment cycle could normalise to somewhat lower levels in the absence of new megaprojects in the pipeline. The administration's growth agenda focuses on improving education and infrastructure investment, although this could face risks from fiscal constraints and the slow materialisation of projects under the Public-Private Partnership (PPP) law so far.

Uruguay's inflation rate remains one of the highest among investment-grade sovereigns, and has risen above 10% in recent months on pass-through from peso depreciation and utility rate hikes. Monetary policy has remained contractive, with real interest rates around 5% and money supply growth below target. Inflation breaching double-digits has fewer policy implications than in the past (i.e. automatic wage hikes) but could add to challenges for the adoption of new wage guidelines seeking to scale back ex post inflation adjustment mechanisms.

The public sector deficit remained stable in 2015 around 3.5% of GDP, as sharp reduction in capex by public utilities offset higher interest costs. The underlying central government deficit (including the social security bank) continued on an upward path to 2.8%, from 2.3% in 2014 and 1.3% in 2010-2013. Recent fiscal deterioration reflects cyclical and structural factors, as the dip in growth has weighed on tax revenues, and rigid social spending drivers (namely pensions and healthcare) have continued to climb.

The five-year budget targets a 2.5%-of-GDP public deficit by 2019, focusing consolidation efforts on public companies (lower capex, profit-enhancing tariff adjustments). Fewer explicit consolidation measures have been outlined at the central government level to reach the deficit target of 1.9% by 2019. This could prove challenging given the weaker starting point (3.1% in the 12 months through January), downside risks to budget GDP growth assumptions, and a rigid spending profile dominated by social entitlements and low in capex. The new budget also relaxes the legal limits on annual increases in net debt limits but commits to a mid-cycle review in 2017 to allow for potential adjustments to keep the targeted consolidation on track.

Peso depreciation and pre-financing drove a jump in general government debt to an estimated 57.4% of GDP in 2015 from 49.6% in 2014 (or 41.6% to 49.1% net of bonds issued to recapitalise the central bank in past years, which are non-negotiable and have no refinancing risk). The share of foreign-currency debt has fallen considerably in the past decade but remains high relative to peers, exposing public debt dynamics to FX risk. Fitch projects general government debt could surpass 63% of GDP in 2016 and also projects a more stable path after 2017 due to slower depreciation and fiscal consolidation.

The higher debt burden highlights the narrowing space for fiscal policy to confront shocks. However, prudent debt management mitigates financing risks. Liquid central government assets of 5.5% of GDP at end-2015 cover debt service into 2017, and the average debt maturity is high at 14.4 years. Precautionary credit lines with multilateral banks total around 4% of GDP, and market access remains solid.

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

--Failure to stabilise the rising general government debt burden;
--Failure to reverse the near-term deterioration in growth prospects;
--Erosion of external buffers.

Conversely, the main factors that could lead to 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 declining public debt trajectory;
--Evidence of investments or productivity gains that lift medium-term growth prospects.

KEY ASSUMPTIONS
--Fitch assumes that continued contraction of the Brazilian economy in 2016 will weigh on growth in Uruguay;
--Fitch assumes that China will avoid a hard landing, that Uruguay's agricultural producers will be able to absorb lower prices for soft commodity exports, and that lower oil prices will continue to benefit growth and external metrics.

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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