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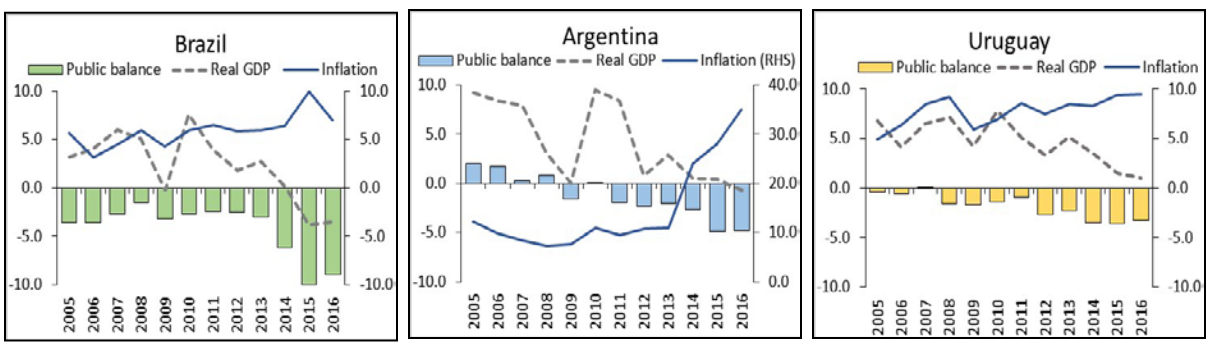
Uruguay's Stability in an Unstable Neighborhood

Commentary Highlights

- The weak outlook for Uruguay's two large neighbors amid political uncertainty in Brazil and a sharp policy adjustment in Argentina are headwinds for Uruguay.
- Despite deterioration in Uruguay's key macroeconomic indicators, underlying trends point to economic resilience and continued political stability.
- Macroeconomic management in Uruguay remains predictable and the economy is well-positioned to weather the regional downturn without a deterioration in its credit profile.

Uruguay's Links to its Neighbors Pose Headwinds

Economic activity in Uruguay's two substantially larger neighbors is contracting amid heightened political uncertainty in Brazil and a sharp policy adjustment in Argentina. The challenges facing Argentina and Brazil are predominantly the result of domestic policies, although the weak regional outlook also stems from the decline in global commodity prices. While the Uruguayan economy has diversified in recent years, it is nonetheless affected by the regional slowdown via the trade and financial channels.



Source: National Finance Ministries, IMF, Itau, Haver Analytics, DBRS

Brazil affects Uruguay primarily through the trade channel, principally goods exports. Exports to Brazil represent roughly 15% of Uruguay's total goods exports and they contracted by 30% in 2015. Vegetable and grain products – such as rice and other cereals – are key exports to Brazil. Policy uncertainty in Brazil continues to weigh on consumer and business confidence, suggesting demand from Brazil is likely to remain weak. The Brazilian economy contracted by 3.8% in 2015 and is expected to remain in a deep recession this year. Thus, underperformance of Uruguay's goods exports is likely to persist.

Uruguay-Argentina links are predominantly in services, trade and financial flows. Argentina is the largest single source of foreign direct investment (FDI) for Uruguay, contributing an average 26% of the total in the decade to 2013. Roughly 22% of FDI into Uruguay goes to construction, 13% to agriculture and livestock, and 11% to financial services. Latest available data shows FDI from Argentina declined 31% in 2013. Furthermore, tourism and travel account for 10% of Uruguay's GDP. Argentine tourists make up two-thirds of total tourism receipts, and from 2010 to 2014 revenues from Argentine tourism declined by one-third. DBRS expects these trends to gradually reverse with the introduction of policy corrections in Argentina that reduce macroeconomic imbalances. Yet, over the near term, the Argentine economy is expected to contract by 0.5% to 1% in 2016, before returning to positive growth in 2017.

Deterioration of Headline Indicators

Economic growth in Uruguay has slowed since 2010, and the fiscal deficit has increased since 2013. However, the underlying trends point to resilience in both economic activity and public finances. This is partly because of the diversification of Uruguay's goods and services, and partly because of Uruguay's longstanding political stability and solid macroeconomic management.

Though growth is slowing and not likely to pick-up in the near term, the diversification of Uruguayan products and geography make the economy resilient to regional slowdowns. After a decade of strong growth, consensus forecasts point to economic expansion of 1.5% in 2015 and less than 1% this year. A weaker external environment is compounded domestically by lower investment, rising unemployment, and weak consumer confidence. However, Uruguay is more resilient than in the past. Brazil and Argentina accounted for 46% of Uruguay's total goods exports in 1995. Today they account for just 20%. In recent years, Uruguay has added agriculture commodities like soy, pulp, and other grains to its traditional export basket. These products should benefit from China's medium-term plan to rebalance its economy towards consumption.

Expectations for inflation remain anchored in the single digits, even though inflation has been consistently above the central bank's inflation targets. The increase in the seasonally adjusted consumer price index has been above the 3-7% target band since December 2010, reaching 10.2% in February 2016. This result, despite a contractionary monetary position since 2013, is a function of several factors: pass-through from peso depreciation, an increase in regulated prices, and wage indexation mechanisms. Nevertheless, 12-month inflation expectations averaged just under 8% over the same period and moved within a tight 7.5% - 9.5% range.

In addition, public debt dynamics remain favorable. The public sector deficit reached 3.5% of GDP in 2014 and is estimated at 3.6% in 2015. The government targets global public sector results, which include the central bank and public sector enterprises. Once interest payments are stripped out of the public sector measure, the primary result for 2015 was in balance. The general government primary result – which subtracts central bank interest payments from the global public sector primary outcome – likely reached a surplus in 2015. As such, the trajectories of public gross and net debt are stable, at 58% and 23% of GDP, respectively. Furthermore, the Vásquez administration recognizes the need to narrow the deficit to ensure a fiscal anchor, reduce inflation, and sustain stable debt dynamics. DBRS considers the government's 2.5% deficit target by 2019 as credible.

Resilient, Stable and Predictable

Notwithstanding the deterioration of key indicators, Uruguay's credit quality remains resilient. In the past, spillovers from its neighbors played a large role in Uruguay's economic performance. While the trade and financial links remain important, three traditional risk areas – the financial sector, external accounts, and public debt – have shown limited signs of stress in the face of current regional and global weakness.

Despite years of instability in Argentina and the recent bout of peso depreciation, the financial sector in Uruguay continues to show signs of stability. Financial links to its neighbors have been significantly reduced. Non-resident deposits as a share of total deposits, which accounted for 41% in 2001 before the Argentine financial crisis, has averaged roughly 15% since 2011. Moreover, risks associated with the dollarized economy and rising global interest rates appear to be contained. Bank regulation ensures that domestic banks are well capitalized and dollar liabilities are more than offset by dollar assets. Dollar lending is predominantly directed towards the tradeable sectors that generate dollar denominated revenues. Nonperforming loans increased in 2015, but remain low at 2.3% of the total. The slight deterioration in asset quality appears to largely reflect the economic slowdown, rather than peso depreciation.

Uruguay's diversified export base and the flexible exchange rate are facilitating an adjustment in its external accounts. The lower oil import bill and strong pulp exports helped narrow the current account deficit to 4.2% of GDP as of 3Q15. This external gap is fully financed by FDI, and the nominal UYU/USD depreciation of 33% since 2014 has served as an effective external price shock absorber. While international reserves declined by 20% between February 2015 and February 2016, the government still holds $14.4 billion in reserves, or 25% of GDP.

Furthermore, debt management remains prudent and predictable. Uruguay has low rollover risk, because redemptions are manageable and liquid external assets are high. The government pre-finances itself 12-18 months ahead and holds ample precautionary liquidity reserves to manage external shocks. Treasury cash and precautionary credit lines with multilateral organizations total 10% of GDP, well in excess of the 3.1% of GDP in debt servicing for 2016. Uruguay also benefits from favorable market access, evident in two large dollar denominated debt issuances last year. For example, in October 2015, the Treasury placed a $1.7 billion bond maturing in 2027 at a 4.38% rate. Market demand would have allowed the government to raise twice as much. The issuance pushed the country's average debt maturity profile to 15 years. Strong debt management is key for the Uruguayan rating during this period of regional instability.

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