Insight beyond the rating.

Date of Release: 29 May 2015

DBRS Confirms Uruguay at BBB (low), Stable Trend

Bloomberg: DBRS Confirms Uruguay at BBB (low), Stable Trend
Industry Group: Public Finance – Sovereigns
Sub-Industry: Sovereign Finance
Region: Rest of World

DBRS, Inc. has confirmed the Oriental Republic of Uruguay's long-term foreign and local currency issuer ratings at BBB (low). DBRS has also confirmed the short-term foreign and local currency issuer ratings at R-2 (middle). The trend on all ratings is Stable.

The Stable trends reflect DBRS's view that risks to the outlook are broadly balanced. Growing public expenditures and above target inflation are main policy challenges. In addition, the Uruguayan economy remains exposed to regional and global spillovers via the terms of trade, tourism, and financial channels. However, due to ongoing economic diversification from high levels of investment, prudent debt management, and large financial buffers, DBRS believes the credit fundamentals in Uruguay are stable.

Upward pressure on the ratings could occur if efforts are made to improve fiscal performance. A framework that aligns expenditure growth with revenues to produce more consistent countercyclical fiscal results could be credit positive. Further progress on de-dollarization and on returning inflation expectations to within the policy target range could also add upward pressure to the ratings. In contrast, deterioration in Uruguay's macroeconomic management that weakens the economy's resilience to adverse shocks could put downward pressure on the ratings.

Despite weaker regional and global economic performance, the Uruguayan economy continues to demonstrate its resiliency by outpacing regional peers. From 2004 to 2014, real GDP expanded at an average annual rate of 5.3%, above the Latin American average of 3.9%. On the supply side, higher levels of investment boosted productivity in the agricultural sector, expanded production into higher value-added agribusiness, and diversified the economy. Positive demand factors include favorable terms of trade and strong regional demand for tourism services. This solid growth performance has been accompanied by a rising employment rate and substantial real wage gains. After expanding by a real 3.5% in 2014, cyclical deceleration is expected to continue through 2016 before converging back to its potential growth rate of approximately 3-3.5%.

Higher levels of investment bode well for growth over the medium-term. Total investment averaged 21.8% of GDP from 2008-2014, up from a low of 15.2% in 2003. FDI in particular is among the highest in its peer group. The Montes de Plata pulp mill began operations last year and, along with impending mining investments in iron ore, will likely improve growth prospects. Furthermore, ongoing efforts to increase infrastructure and energy investments are vital for Uruguay to sustain high rates of economic growth.

Favorable economic performance combined with persistent primary surpluses and proactive debt management led to a significant improvement in Uruguay's debt profile over the last decade. According to official data, gross public debt declined to 58.5% of GDP in 2014 from 107.5% of GDP in 2003. With debt net of liquid assets at 21.0% of GDP, the government achieved its net debt target of 24% of GDP by 2014. However, due to slower growth, wider deficits, and central bank reserve sterilization, public debt is expected to increase gradually. The DBRS baseline is for net debt to approach 30% of GDP by the end of the decade.

The recent weakening of economic and fiscal positions does not pose near-term risks to Uruguay's strong sovereign credit profile. The average maturity of central government debt increased to 15 years. With limited debt maturing and strong precautionary savings, the government has adequate resources to cover gross financing needs for well over 12 months. Contingent credit lines of 3.5% of GDP from multilateral lending institutions supplement the financial cushion. Offsetting these strengths are several challenges.

A widening fiscal deficit limits the scope for discretionary stimulus or countercyclical policy intervention in the event of an adverse shock – despite ample liquidity buffers that provide space for automatic fiscal stabilizers to function. Indeed, economic output and primary surpluses over the last decade have been above long-run trends, resulting in a declining debt burden. Yet, the public sector balance sheet has remained in a deficit position since 2008. It has widened due to an increase in primary spending towards social programs like pensions and healthcare. Revenue growth has not kept pace. As GDP growth moderates, the increase in rigid expenditures could continue to pressure the deficit, which the government expects at 3.2% of GDP in 2015.

As a small, open, and commodity dependent economy, Uruguay remains exposed to changes in external prices and demand. Risks stem from volatile global capital flows, abrupt shifts to the exchange rate, and weaker global and regional economic growth. Trade disruptions or a more severe economic downturn in Brazil or Argentina would directly affect economic activity through weaker demand for tourism services and lower levels of direct investment. A sharp deceleration in China also presents a downside risk to commodity prices and trade. However, the current account deficit of 4.6% of GDP in 2014 is fully funded by FDI. As a result, international reserves rose to $18.8 billion (32% of GDP) in April 2015, exceeding most international benchmarks for adequate reserve levels and cushioning the impact of an external shock.

Above target inflation remains another policy challenge. Consistent near double-digit inflation elevates market interest rates, increases the cost of economic activity, and perpetuates dollarization in the economy. Total dollarized credit and deposits in Uruguay remain well above other dollarized economies in Latin America. High levels of dollarization and low financial intermediation hinder the transmission of monetary policy. Annualized CPI averaged 8.9% in 2014 and 7.9% since 2007, above the central bank target band of 3-7%. The central bank has tightened substantially since it announced a change in its instruments in July 2013, as reflected by slower money aggregates (M1+) and higher private sector interest rates. Despite the tightening, 12-month inflation expectations remain above the target and short-term bank rates have become more volatile. This illustrates the limits of monetary policy effectiveness in the absence of fiscal spending and wage indexation adjustments.

Notes:
All figures are in U.S. dollars unless otherwise noted.

The principal applicable methodology is Rating Sovereign Governments, which can be found on the DBRS website under Methodologies. The principal applicable rating policies are Commercial Paper and Short-Term Debt, and Short-Term and Long-Term Rating Relationships, which can be found on our website under Rating Scales.

The sources of information used for this rating include the Central Bank of Uruguay, Ministry of Economy and Finance, INE, IMF and Haver Analytics. DBRS considers the information available to it for the purposes of providing this rating was of satisfactory quality.

This rating is endorsed by DBRS Ratings Limited for use in the European Union.

For further information on DBRS' historic default rates published by the European Securities and Markets Administration ("ESMA") in a central repository see http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

Generally, the conditions that lead to the assignment of a Negative or Positive Trend are resolved within a twelve month period while reviews are generally resolved within 90 days. DBRS's trends and ratings are under constant surveillance.

Lead Analyst: Jason Graffam
Rating Committee Chair: Roger Lister
Initial Rating Date: 28 February 2008
Most Recent Rating Update: 30 May 2014

For additional information on this rating, please refer to the linking document under Related Research.

Press Release

Insight beyond the rating.

Issuer	Debt Rated	Rating Action	Rating	Trend
Uruguay, Oriental Republic of	Long-Term Foreign Currency - Issuer Rating	Confirmed	BBB (low)	Stable
Uruguay, Oriental Republic of	Long-Term Local Currency - Issuer Rating	Confirmed	BBB (low)	Stable
Uruguay, Oriental Republic of	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-2 M	Stable
Uruguay, Oriental Republic of	Short-Term Local Currency - Issuer Rating	Confirmed	R-2 M	Stable

Jason Graffam
Assistant Vice President
Sovereign Ratings Group
+1 212 806 3220
jgraffam@dbrs.com

Fergus J. McCormick
Head of Sovereign Ratings
Senior Vice President
Sovereign Ratings Group
+1 212 806 3211
FMcCormick@dbrs.com

Alan G. Reid
Group Managing Director
Financial Institutions &
Sovereign Ratings Group
+1 212 806 3232
areid@dbrs.com