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Research Update:

Oriental Republic of Uruguay Ratings Raised To 'BBB/A-2' On Greater External Resilience; Outlook Stable

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Overview

- Uruguay has shown increasing resilience to negative external trends in the region while maintaining economic stability and good access to international financial markets.
- We are raising our long- and short-term foreign and local currency ratings on Uruguay to 'BBB/A-2' from 'BBB-/A-3'.
- The stable outlook is based on our expectation of continuity in key economic policies and a timely and adequate policy response to potential adverse external developments.

Rating Action

On June 5, 2015, Standard & Poor's Ratings Services raised its long- and short-term foreign and local currency ratings on the Oriental Republic of Uruguay to 'BBB/A-2' from 'BBB-/A-3'. The outlook is stable. At the same time, we also revised our transfer and convertibility (T&C) assessment to 'A-' from 'BBB+'.

Rationale

The upgrade reflects two factors. The first is that we believe the newly elected administration of President Tabaré Vázquez will build on Uruguay's track record of cautious macroeconomic policies, gradual diversification of the economy, and prudent debt management. The second is that we believe the regional risks to Uruguay have stabilized and will improve next year.

The gradual diversification of the Uruguayan economy has contributed to recent years of high economic growth and has allowed the economy to weather the regional economic slowdown. High levels of foreign direct investment (FDI) contributed to higher GDP growth, economic diversification, and productivity gains. Although we expect that domestic fiscal tightening and contracting economies in Argentina and Brazil will keep Uruguayan growth below 3% this year and next, we do not foresee marked downside risks.

A significant improvement in Uruguay's external position over the past decade sustains the country's stability. We project that Uruguay has a narrow net external creditor position of 24% of its current account receipts (CAR) in 2015. FDI has consistently exceeded Uruguay's current account deficit,

containing the country's external debt. Strong FDI has also contributed to an accumulation of international reserves that reached US$17 billion as of the end of 2014, or 32% of GDP.

During the past few years, Uruguay has taken steps to reduce the negative fiscal and external impact of droughts, which raise the country's energy import bill. The government has created a stabilization fund and purchased weather insurance to contain the fiscal cost of higher oil imports during periods of drought. Investments in renewable energy have already started reducing the country's dependence on oil imports. Renewable energy (hydraulic, wind power, and biomass) may provide almost half the country's energy in 2015.

Effective debt management has reduced the risks from a sudden disruption in external markets, or a spike in the exchange rate or interest rate. The government has undertaken liability management operations to improve the profile of sovereign debt by de-dollarizing its debt stock, as well as building reserves that provide cushion against external shocks. The central government faces a lumpy external amortization profile of US$1 billion, equivalent to 2% of GDP in 2015. As of March 2015, central government liquid assets covered 2.7x amortization payments due in one year. On Feb. 23, 2015, Uruguay reopened its global bond due in 2050 and issued US$1.2 billion in the international capital markets. The issuance raised foreign currency debt to 51% of total debt from 48% in 2014, but at the same time, it extended the average maturity of the debt to about 15.5 years.

A high level of dollarization and indexation to inflation limit the effectiveness of monetary flexibility. Deposits denominated in U.S. dollars are high at almost 80%, while credits in U.S. dollars reached 50% as of year-end 2014. The relative modest size of the financial sector, together with a highly liquid financial system, moderates the risks of currency mismatches. Nevertheless, a declining level of dollarization would reduce external vulnerabilities.

A persistently high inflation rate is the main macroeconomic weakness in Uruguay. Inflation ended 2014 at 7.8%, above the range limit set by the central bank. Anchoring expectations through clear communication and credible inflation targets, together with both fiscal and monetary contractive policies, would help moderate inflation going forward. Avoiding automatic salary indexation to past inflation would also lessen inflation inertia.

The consolidated public deficit widened to 3.5% of GDP in 2014 from 2.3% in 2013. We expect only gradual improvements in fiscal results given Uruguay's relatively high rigid spending (salaries, pensions, and social assistance) and limited flexibility to increase revenues. Economic growth reached 3.5% in 2014, driven by private consumption growth. The recent construction of a large pulp and paper mill (Montes del Plata) will boost output and exports in 2015. However, a combination of slowdown in Uruguay's main trade partners, along with a modest fiscal adjustment, will likely lead to a deceleration of economic growth to about 2.5% in 2015. We expect the current account deficit to be 4.4% of GDP in 2015 and gradually improve thereafter due to lower oil

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imports.

Uruguay's stable political system, growing middle class, and predictable economic policies should sustain economic growth close to its trend rate at 3%-3.5% from 2016 onward. Medium- and long-term economic growth will depend on the development of infrastructure, mainly ports, roads, and energy. Boosting different financing alternatives, such as public-private partnerships (PPPs) and concessions, would sustain investment. That, along with a more skilled labor force, would sustain long-term GDP growth.

We believe the Argentine economy, which still has ties to Uruguay's economy, will stagnate this year and begin to recover next year. We assume that the next government will gradually begin to address the country's macroeconomic imbalances, which in turn could moderate observed inflation and strengthen public finances. We expect that Brazil's economy, which has weaker links with Uruguay than does Argentina, will contract about 1% this year and return to low growth next year. A growing diversification of Uruguay's exports away from both Argentina and Brazil (thanks to rising exports of soya and pulp, as well as nontraditional service exports to global markets) has also reduced the country's vulnerability to economic setbacks in either neighboring country. Exports to Brazil and to Argentina were 18% and 4%, respectively, of total exports last year.

Outlook

The stable outlook is based on our expectation of continuity in main economic policies over the next three years. The combination of cautious fiscal policy and higher-than-expected investment could accelerate GDP growth, gradually resulting in a lower debt burden and greater economic diversification. A declining level of dollarization in the banking system (the proportion of loans and deposits denominated in dollars), along with persistently lower inflation, would boost the effectiveness of monetary policy. A declining debt burden, together with an improvement in monetary and fiscal flexibility, could lead to a higher rating.

Conversely, we could lower the rating if we perceive a weakening commitment to fiscal and monetary policies that sustain economic stability, resulting in greater external vulnerability. Similarly, an inadequate or untimely government response to adverse external developments could reduce the country's external liquidity and raise its debt burden, leading to a downgrade.

Key Statistics

Table 1

Selected Indicators											
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015f**	**2016f**	**2017f**	**2018f**
Nominal GDP (bil. US$)	30.37	31.66	40.28	47.96	51.38	57.52	57.47	56.42	56.77	60.46	65.21
GDP per capita (US$)	9,108	9,465	12,000	14,236	15,198	16,959	16,883	16,515	16,567	17,580	18,901
Real GDP growth (%)	7.2	4.2	7.8	5.2	3.3	5.1	3.5	2.5	2.8	3.0	3.5
Real GDP per capita growth (%)	6.9	3.9	7.4	4.8	3.0	4.8	3.1	2.1	2.5	2.6	3.2
Change in general government debt/GDP (%)	8.2	1.8	3.9	5.1	5.7	8.9	7.1	6.5	3.5	2.7	2.2
General government balance/GDP (%)	(0.8)	(1.2)	(1.3)	(0.7)	(2.0)	(1.8)	(3.0)	(2.7)	(2.3)	(2.0)	(1.8)
General government debt/GDP (%)	63.5	58.3	55.4	53.5	53.1	56.0	56.4	57.6	55.8	53.3	50.6
Net general government debt/GDP (%)	52.1	48.7	49.0	45.3	45.3	49.5	48.7	51.6	50.0	48.0	45.7
General government interest expenditure/revenues (%)	8.3	7.8	8.1	7.7	6.9	7.1	7.6	7.5	7.5	7.4	7.3
Other dc claims on resident nongovernment sector/GDP (%)	28.6	21.4	22.9	23.7	24.2	26.8	27.8	28.9	29.9	30.8	31.8
CPI growth (%)	7.9	7.1	6.9	8.6	7.5	8.5	8.3	7.8	7.0	7.0	6.5
Gross external financing needs/CARs plus usable reserves (%)	136.9	124.3	108.4	106.1	99.9	97.3	95.2	97.4	97.1	96.8	98.1
Current account balance/GDP (%)	(5.7)	(1.2)	(1.8)	(2.9)	(5.2)	(5.1)	(4.6)	(4.4)	(4.1)	(4.0)	(3.8)
Current account balance/CARs (%)	(16.8)	(4.1)	(6.4)	(10.1)	(19.3)	(20.7)	(18.7)	(17.7)	(15.5)	(14.9)	(14.2)
Narrow net external debt/CARs (%)	26.4	13.5	(3.7)	(11.6)	(13.4)	(21.5)	(24.3)	(23.5)	(22.9)	(23.4)	(20.3)
Net external liabilities/CARs (%)	18.3	20.3	18.7	32.0	37.0	40.8	57.8	78.6	90.1	99.7	94.1

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. f--Forecast.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral

Table 2

Ratings Score Snapshot (cont.)	
Fiscal assessment: debt burden	Neutral
Monetary assessment	Weakness

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014 , summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength," "neutral," or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Sovereign Rating Methodology, Dec. 23, 2014
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Argentina Foreign Currency Ratings Remain 'SD/SD'; 'CCC+/C' Local Currency Ratings Affirmed, Outlook Negative, April 1, 2015
- Sovereign Risk Indicators, found at spratings.com/sri, March 31, 2015
- Brazil 'BBB-/A-3' Foreign Currency Ratings Affirmed; Outlook Remains Stable, March 23, 2015
- Global Sovereign Debt Report 2015: Borrowing To Drop By 5.7% To US$6.7 Trillion, March 5, 2015
- Sovereign Defaults And Rating Transition Data, 2013 Update, Sept. 17, 2014
- Oriental Republic of Uruguay, Aug. 1, 2014

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that all key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Upgraded

	To	From
Uruguay (Oriental Republic of)		
Sovereign Credit Rating	BBB/Stable/A-2	BBB-/Stable/A-3
Transfer & Convertibility Assessment		
Local Currency	A-	BBB+
Senior Unsecured	BBB	BBB-
Short-Term Debt	A-2	A-3

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