Rating Report

Report Date:
May 26, 2017

Previous Report:
May 27, 2016

Insight beyond the rating.

Oriental Republic of Uruguay

Analysts

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Ratings

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

Rating Rationale

On May 26th, 2017, DBRS Inc. confirmed the Oriental Republic of Uruguay's long-term foreign and local currency issuer ratings at BBB (low) and the short-term foreign and local currency issuer ratings at R-2 (middle). The trend on all ratings is Stable.

Factors underpinning Uruguay's ratings include strong public institutions, conservative debt management, and ample external buffers. Counterbalancing these strengths are limited fiscal flexibility, above target inflation expectations, and exposure to external developments.

The Stable trends reflect DBRS's view that risks to the outlook are broadly balanced. Uruguay's credit profile would benefit from greater fiscal space and counter-cyclical capacity. A durable consolidation in the fiscal accounts that place public debt ratios on a firm downward trajectory could put upward pressure on the ratings. On the other hand, the ratings could experience downward pressure if budget dynamics further deteriorate or external buffers erode, thereby weakening Uruguay's resilience to adverse shocks.

The confirmation of the ratings reflects DBRS's view that Uruguay has weathered well the recessions in Brazil and Argentina. The economy expanded 1.5% in 2016, supported by a broad-based acceleration in the fourth quarter. Although negative spillovers stemming from uncertainty in Brazil and tighter fiscal policy domestically could act as headwinds, Uruguay is expected to sustain a gradual recovery amid favorable terms of trade and

(Continued on page 2)

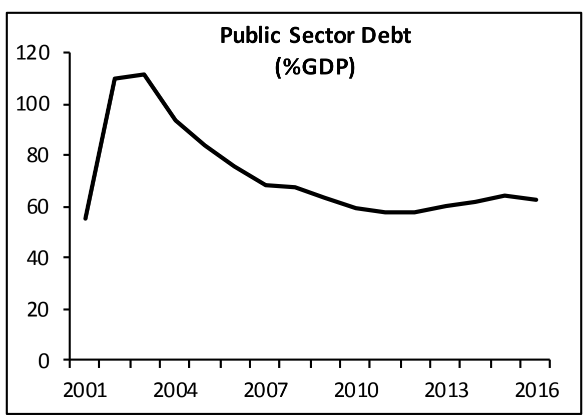
Rating Considerations

Strengths
(1) Strong public institutions
(2) Conservative public debt management
(3) Ample external buffers

Challenges
(1) Limited fiscal flexibility
(2) Anchoring inflation expectations around target
(3) Risks from external volatility

Summary Statistics

For the year ended December 31	2015	2016	2017E	2018E
Nominal GDP (USD billions)	53.4	52.6	58.1	60.8
GDP per capita (USD)	15,318	15,679	16,639	17,354
Real GDP (%chg)	0.4%	1.5%	1.6%	2.6%
Unemployment rate (year end, %)	7.5%	7.9%	7.8%	7.8%
Inflation (year end, %)	9.4%	8.1%	8.4%	7.1%
Current account balance (%GDP)	-2.1%	-0.2%	-1.5%	-1.6%
External debt (%GDP)	53.3%	49.7%	n.a.	n.a.
Public sector balance (%GDP)	-3.6%	-3.9%	-3.4%	-2.8%
Primary balance (%GDP)	0.0%	-0.5%	-0.3%	0.2%
Gross Public Debt (%GDP)	58.8%	63.4%	62.9%	63.9%
Human Development Index	0.80	n.a.	n.a.	n.a.



Sources: IMF WEO April 2017, UNDP, Haver Analytics, DBRS.

Rating Rationale (Continued from page 1)

strengthening demand from Argentina. The IMF projects GDP growth of 1.6% in 2017 and 2.6% in 2018. Moreover, negotiations are well-advanced regarding a potentially large investment in the pulp and paper sector, which could materially strengthen Uruguay's growth prospects.

A fundamental strength of Uruguay's credit profile is its strong public institutions. Uruguay is a stable liberal democracy with an effective government and low levels of corruption. The basic pillars of macroeconomic policy enjoy broad support across the political spectrum. With political stability and a predictable policy framework, Uruguay has fostered a favorable environment for economic growth, as evidenced by the elevated levels of foreign direct investment in the country over the last decade.

Conservative public debt management also supports the ratings. Rollover and liquidity risk is minimal. The average maturity of central government debt reached 14 years in March 2017. In the event of market turbulence, Uruguay has substantial funding flexibility. Treasury cash and precautionary credit lines with multilateral organizations total $4.2 billion (7.9% of 2016 GDP), which is well in excess of the $0.9 billion (1.7% of GDP) in redemptions over the next 12 months.

Sound external accounts and large liquidity buffers further bolster the economy's defenses to potential shocks. The current account deficit is small and net inflows of foreign direct investment provide a stable source of external financing. Exchange rate flexibility has helped the economy adjust to evolving global conditions without generating excessive stress in the banking system or the corporate sector. Furthermore, reserves are high and sufficient to provide liquidity in the event of an external shock.

The key challenge facing the sovereign credit profile is the fiscal deficit. The public sector deficit increased to 3.9% of GDP in 2016, up from 0.9% in 2011. The principal cause of this deterioration is rising current spending. In response, the Vázquez administration is implementing a gradual consolidation plan to narrow the deficit to 2.5% by 2019. Tax increases and spending cuts totaling 0.9% of GDP were incorporated into the 2017 budget and the cyclical recovery will provide further support. However, the strategy faces several challenges. First, reversing the upward trajectory in current spending could be difficult given the constitutional and legal protections for pensions and healthcare. Second, an over-reliance on public investment cuts could weaken medium-term growth prospects. Third, additional deficit-reduction measures will likely be needed even after 2019 in order to place public dynamics of a firm downward trajectory and rebuild fiscal space.

Durably anchoring inflation expectations around the target is another policy challenge. Inflation has been trending downwards for the last 12 months. In March 2017, inflation fell below the upper limit of the central bank's target range for the first time in over six years. The disinflationary process has been driven by peso appreciation, which has reduced price pressures on tradeable goods and services. However, disinflation in the non-tradeable sector has been slower to materialize, and inflation expectations over the next 12 months are still above the target range. The challenge of anchoring expectations is complicated by the weak transmission of monetary policy amid high levels of financial dollarization and low financial intermediation.

As a small and open economy, Uruguay is highly exposed to shifts in global commodity prices and the economic cycles of its large neighbors. Slower-than-expected recoveries in Brazil or Argentina could negatively affect Uruguay through the trade channel, specifically weaker demand for goods exports and tourism services. Outside of the region, a sharp deceleration in China could affect Uruguay's outlook directly through the terms of trade channel, as well as indirectly through the trade channel, as demand could weaken from Uruguay's commodity-exporting neighbors.

Foreign versus Local Currency Ratings

DBRS rates Uruguay's local and foreign currency ratings at the same level, in spite of the greater ability to generate revenues in local currency, because the domestic financial market is shallow. Uruguay also has accumulated a large stock of foreign currency reserves, supporting its capacity to service foreign currency debt.

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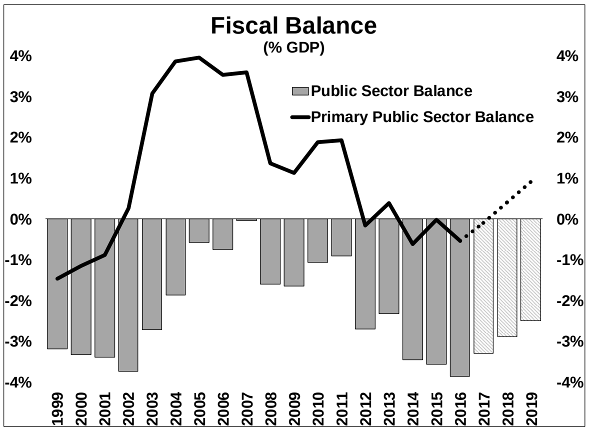
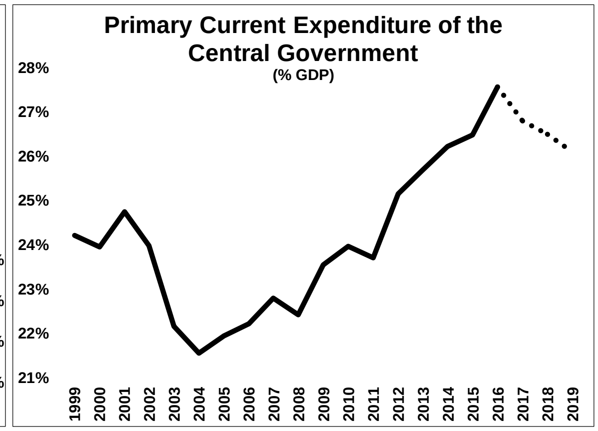
Fiscal Management and Policy

Uruguay's fiscal accounts have deteriorated over the last five years. The consolidated public sector deficit widened from 0.9% of GDP in 2011 to 3.9% in 2016. The Vázquez administration has responded with a gradual consolidation plan that aims to narrow the deficit to 2.5% by 2019. Though the pace of the deficit-reduction effort appears well-calibrated, an over-reliance on cuts to public investment could weaken medium-term growth prospects. In addition, further fiscal tightening could be needed post-2019 in order to firmly place public debt ratios on a downward trajectory and rebuild fiscal space.





Sources (left graph): Ministerio de Economía y Finanzas, Haver Analytics, DBRS.
Sources (right graph): Ministerio de Economía y Finanzas, Haver Analytics, DBRS.

The principal cause of the deterioration is rising current spending. From 2004 to 2011, primary current expenditure recovered to pre-2002 levels. However, it continued to climb for the next five years. In 2016, primary current spending amounted 27.6% of GDP, or 3.9 percentage points of GDP higher than 2011. The increase was driven by the expansion of healthcare spending, higher education costs as well as rising social security expenses. Constitutional and legal protections for some spending items, such as pensions and healthcare, in addition to political commitments, such as higher education spending, complicate the challenge of arresting the upward trajectory.

The consolidation plan is designed to be gradual and sufficiently large to stabilize debt dynamics. The gradual pace is appropriate given the presence of a modest negative output gap. Consolidation measures for 2017, which amount to 0.9% of GDP, include higher personal and corporate income taxes, higher capital gains taxes, and expenditure rationalization in public enterprises. It is unclear whether the cyclical recovery will be sufficient to achieve the deficit target or whether additional measures will be required. Public debt ratios will likely stabilize if the government is able to achieve its deficit target. However, putting public debt ratios on a clear downward trajectory will likely require further tightening beyond 2019.

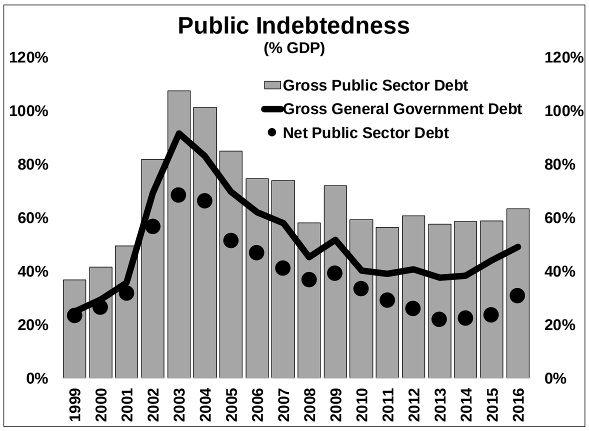
In terms of the composition of the adjustment, an over-reliance on public investment cuts could weaken medium-term growth prospects. Although Uruguay benefits from well-developed infrastructure compared to its regional peers, there is a strong need to upgrade roads and railroads. Public investment averaged 3.0% of GDP from 2005 to 2014 but declined to 2.4% over 2015 and 2016. DBRS estimates that public investment fell to roughly 1.5% of GDP in the first quarter of 2017. The government plans to utilize public-private partnerships (PPP) to upgrade the country's infrastructure but execution under the PPP framework has been slow to pick up thus far.

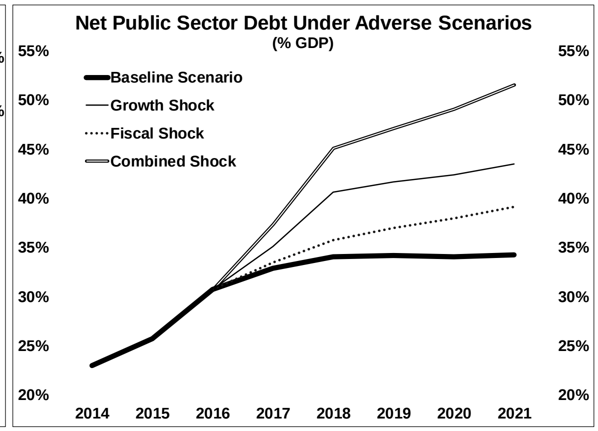
Debt and Liquidity

Public debt ratios have increased over the last few years. Uruguay reports debt figures for the consolidated public sector (this includes the central government, local governments, the central bank, state-owned enterprises and some other public entities, but excludes state-owned commercial banks). Based on this broad definition, gross public sector debt increased from 57.5% of GDP in 2013 to 63.4% in 2016. On a gross general government basis (excluding state-owned enterprises and the central bank), the debt ratio increased from 37.5%

to 49.1%. The drivers of rising indebtedness over the last three years were weaker growth, peso depreciation and primary fiscal deficits.

Debt dynamics are expected to stabilize as the fiscal adjustment advances. DBRS uses net public sector debt, defined as gross public debt minus total financial assets of the public sector, in order to better assess underlying debt dynamics. Under the baseline scenario, the ratio rises gradually through 2019 and then levels off. However, under both the fiscal and growth shock scenarios, the trajectory of the debt ratio would continue to trend upwards through 2021. This highlights the importance of the fiscal adjustment in terms of putting public finances in a more sustainable position.





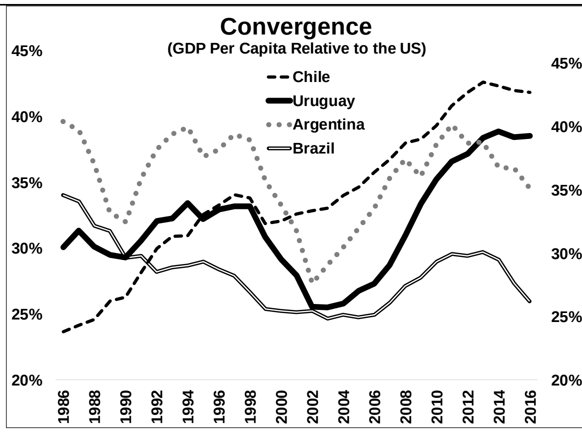
Sources (left graph): Banco Central del Uruguay, Haver Analytics, DBRS.
Sources (right graph): IMF WEO April 2017, Ministerio de Economía y Finanzas, Banco Central del Uruguay, Haver Analytics, DBRS.
Notes (right graph): Baseline assumptions for 2017-2021 are from the IMF WEO April 2017. This includes average GDP growth of 2.7% and average primary balance of 0.4% of GDP. Adverse shocks include: average GDP growth of 0.9%; average primary balance of -0.6% of GDP; and materialization of contingent liabilities of 0.6% of GDP.

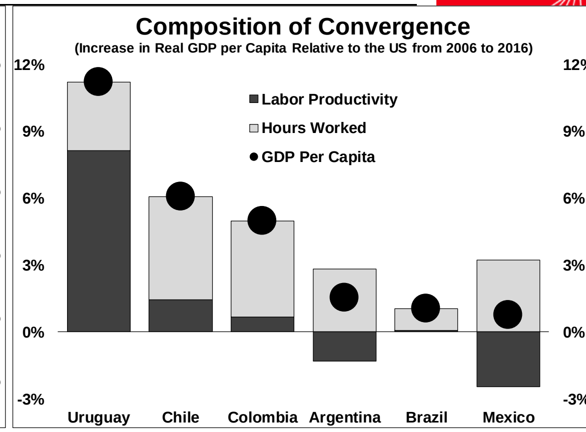
Uruguay has ample funding flexibility in the event of market turbulence. Rollover and liquidity risk is minimal. The average maturity of central government debt reached 14.0 years in March 2017. In addition, the government pre-finances the next 12 to 18 months of debt servicing and holds ample reserves to manage external shocks. Treasury cash and precautionary credit lines with multilateral organizations totaled $4.2 billion as of March 2017 (7.9% of 2016 GDP), which is well in excess of the $0.9 billion (1.7% of GDP) in redemptions over the next 12 months. Uruguay also benefits from favorable market access. In July 2016, the Treasury issued $400 million in dollar bonds maturing in 2027 at a yield of 3.5% and $747 million in dollar bonds maturing in 2050 at a yield of 4.9%.

Efforts underway to develop the local currency bond market could further bolster the government's defenses to external shocks. In March 2017, 53% of total central government debt was denominated in foreign currency. While this exposes the central government to exchange rate volatility, it is important to note that the sizable external assets of other government entities – especially the central bank – mitigate exchange rate risk to some extent for the broader public sector. In an effort to de-dollarize the public debt through local market development, the government is examining strategies to build a local currency nominal fixed rate curve and boost foreign participation in the local market.

Economic Structure and Performance

Supply-side improvements and favorable external conditions have underpinned Uruguay's convergence toward advanced-economy income levels. Over the last decade, real incomes in Uruguay increased markedly relative to the United States. Uruguay has clearly surpassed previously achieved relative income levels (going back to 1986), and although the convergence process has recently leveled off, Uruguay has differentiated itself from the sharp reversals experienced by its larger neighbors, Argentina (B, Stable) and Brazil (BB, Negative). Furthermore, the composition of the convergence is positive. While increased labor utilization has supported rising incomes, most of Uruguay's convergence is explained by improvements in labor productivity.





Sources: The Conference Board Total Economy Database (Adjusted Version), May 2017, DBRS.

Product diversification has structurally transformed the Uruguayan economy. This is particularly evident in the agricultural sector. Supported by large FDI inflows and technological advances, Uruguay built on its comparative advantage in traditional sectors such as beef and dairy products but also rapidly expanded into new markets such as soy, rice, and other cereals. The development of the pulp and paper industry also substantially broadened the export base. Product diversification and the incorporation of technological know-how has generated productivity gains and enhanced the economy's resilience to regional volatility.

Higher investment has supported Uruguay's strong performance and bodes well for medium-term prospects. Investment as a share of GDP averaged 21% from 2007 to 2016. This is up from 16% the previous decade. Furthermore, negotiations over a $4.0 billion megaproject in the pulp and paper sector and another $1.0 billion in connected infrastructure projects are well-advanced. Construction could begin as early as the second half of 2018 with production starting in 2020. The project represents the largest private investment in the Uruguay's history and could bolster growth prospects as early as next year.

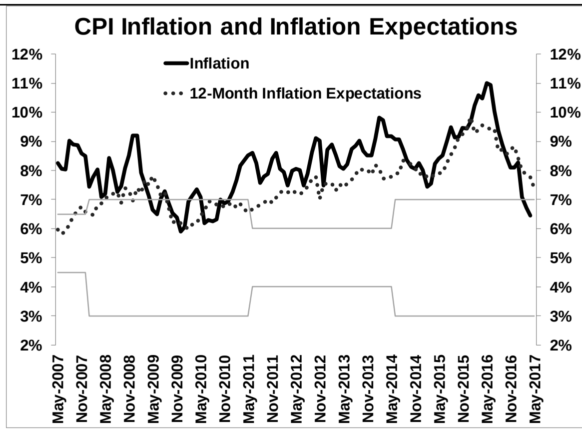
Although the economy has diversified over the last decade, Uruguay is still exposed to regional volatility through trade and financial channels. Roughly 18% of Uruguay's goods exports are destined for Brazil. At the same time, roughly one quarter of Uruguay's inward FDI and nearly two-thirds of tourism receipts flow from Argentina. A prolonged period of low growth in the region would have adverse effects on economic activity in Uruguay.

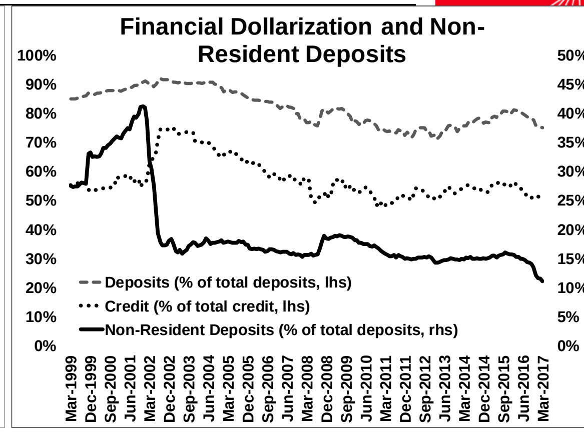
Monetary Policy and Financial Stability

Inflation has been trending downwards for the last 12 months. Inflation fell below the upper limit of the central bank's 3-7% target range in March 2017 and continued to moderate in April. The disinflationary process has been primarily driven by peso appreciation, which has reduced price pressures on tradeable goods and services. On the other hand, disinflation in the non-tradeable sector has been slower to materialize, and inflation expectations over the next 12 months are still above the upper limit of the target range. These factors reflect the strong inertial effects evident in the Uruguayan economy.

Tight monetary policy has filtered through to financial market conditions. The central bank changed its operational framework in 2013 in order to utilize a reference range of money supply growth (M1+). From 2013 to 2016, monetary conditions were relatively tight, with M1+ growth averaging 6% per year, down from roughly 18% on average from 2007 to 2013. Short-term real and nominal market rates consequently increased. However, the monetary policy stance under the current framework is difficult to communicate, particularly in the context of high dollarization, thereby complicating the central bank's challenge of reinforcing its inflation-targeting credentials and anchoring inflation expectations around the target.

The new wage setting policy should help moderate inflation pressures. Wage setting guidelines propose nominal adjustments every two years. Previous rounds focused on wages set in real terms with adjustments occurring semi-annually or annually. The proposed guidelines are expected to help reduce inertial pressures in price formation.





Sources (left graph): Instituto Nacional de Estadística, Banco Central del Uruguay, Haver Analytics, DBRS.
Sources (right graph): Banco Central del Uruguay, Haver Analytics, DBRS.

High dollarization and low financial intermediation are challenging features of the Uruguayan financial system. Dollarization blunts the effectiveness of monetary policy. The BCU has no control over dollar interest rates and less ability to affect aggregate savings and demand through changes in the local money supply. Dollarization also creates potential exchange rate and liquidity risks. The share of dollarized credit to total loans in Uruguay was 51% in March 2017; the share of total dollarized deposits amounted to 75%. Due to efforts to minimize currency mismatches in the banking system, the bank credit market is shallow. Total credit amounted to just 30% of GDP in 2016, well below regional peers such as Chile (87%), Brazil (50%), and Colombia (44%).

The Uruguayan financial system is well-prepared to withstand external shocks. The banking system is liquid and well-capitalized. Currency mismatches in the banking system are relatively small and asset quality has held up well during the recent slowdown. Non-resident deposits declined by $1.0 billion in the second half of 2016. However, the banking system managed withdrawals without disruption or stress. Elevated withdrawals occurred as Argentina implemented a tax amnesty in 2016 and a financial information-sharing-agreement between Argentina and Uruguay came into effect at the start of 2017. Non-resident deposits declined to just 11% of total deposits in March 2017, the lowest level on record (going back to 1998).

Balance of Payments

Uruguay's external accounts appear resilient and sound. The current account deficit is small and fully financed by stable net inflows of foreign direct investment. Exchange rate flexibility has helped the economy adjust to evolving global conditions without causing excessive stress on the banking system or the corporate sector. Reserve levels are relatively high and sufficient to provide liquidity in the event of an external shock.

The current account deficit narrowed from 4.5% of GDP in 2014 to 0.2% in 2016. The adjustment was driven by three factors. First, low international energy prices and weak domestic demand reduced imports. Over the two year period, imports as a share of GDP declined 5.6 percentage points. Second, the Montes del Plata pulp mill transitioned from the investment phase, which required high levels of imported capital goods, to the production phase, which boosted exports and helped offset lower agricultural prices and weak regional demand. Third, service exports benefited from a pick-up in tourism receipts, as foreign exchange controls in Argentina were lifted and the Argentine peso experienced a real appreciation against Uruguayan peso. DBRS expects the current account deficit to widen modestly this year as domestic demand picks up.

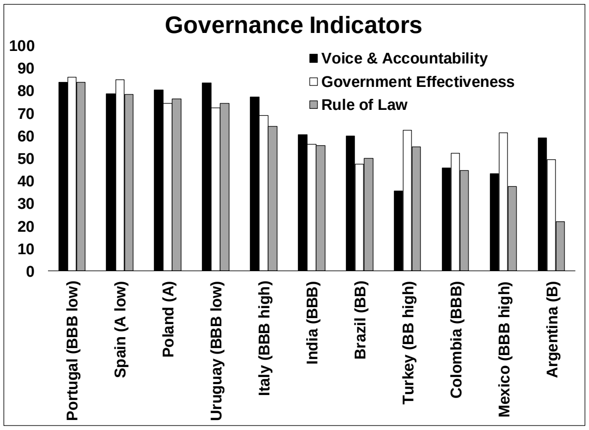
The smaller current account deficit was accompanied by lower capital inflows. Net FDI inflows slowed from 3.8% of GDP in 2014 to 1.8% in 2016. Net portfolio inflows turned negative in the second half of 2015 and the first half of 2016 – as global push factors waned and regional pull factors were weak – but reversed in the second half of 2016.

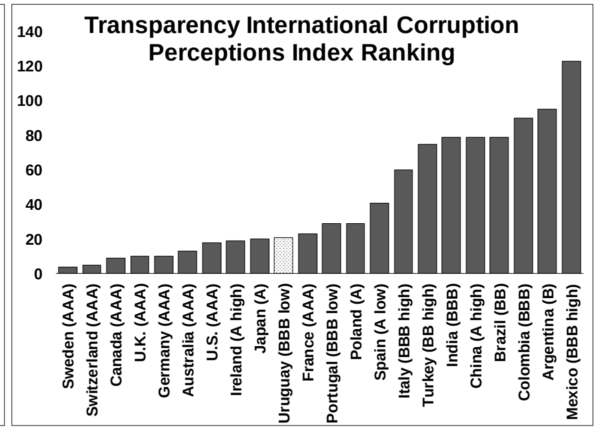
Uruguay's external solvency and liquidity indicators appear sound. The net international liability position increased to 24% of GDP in 2016 but remains at a moderate level. Moreover, nearly half of the international liabilities are foreign direct investment. From an external liquidity perspective, gross international reserves are high at $12.8 billion, or 24% of 2016 GDP. This is more than 200% of all short-term external debt.

Political Environment

Last election: October 26, 2014 (first round)
Next election: October 2019
Party in power: Coalition – Broad Front (Frente Amplio)
Government Structure: Presidential system with bicameral legislature
President: Tabaré Vázquez – Broad Front

Uruguay is a stable liberal democracy with strong public institutions and low levels of corruption. Well-entrenched democratic traditions are complemented by effective government. According to the World Bank's Worldwide Governance Indicators, Uruguay scores exceptionally well compared to regional peers and similar to many highly advanced economies in areas such as "Voice and Accountability", "Government Effectiveness", and "Rule of Law".





Notes: Ratings provided are DBRS Long-Term Foreign Currency Issuer Ratings.
Sources (right graph): World Bank, NRGI, Brookings, Haver Analytics, DBRS.
Sources (left graph): Transparency International, Haver Analytics, DBRS.

Uruguay also benefits from low levels of corruption. According to Transparency International's Corruption Perceptions Index 2016, Uruguay's public sector is perceived to be the least corrupt country in Latin America and on par with many highly advanced economies, such as Ireland (A high), Japan (A), and France (AAA).

With a centrist electorate, the party system facilitates moderate politics and pragmatic policymaking. The basic pillars of macroeconomic policy enjoy broad support across the political spectrum. The predictable policy outlook and political stability fosters a favorable environment for economic growth, as evidenced by the elevated levels of foreign direct investment the country has attracted over the last 15 years.

President Vázquez of the Broad Front took office in March 2015. The administration has expanded social programs without deviating from the broader macroeconomic policy mix. However, the Vázquez administration acknowledges the need to narrow the public sector deficit in order to put debt dynamics on a sustainable path.

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Uruguay: Selected Indicators

For the year ended December 31 (USD billions unless otherwise noted)	2011	2012	2013	2014	2015	2016
Public Sector Debt						
Public Sector Debt	27.0	31.1	33.1	33.5	31.4	33.3
% GDP	56.4%	60.6%	57.5%	58.6%	58.8%	63.4%
Net Public Sector Debt	13.9	13.3	12.5	12.8	12.5	16.2
% GDP	29.0%	25.9%	21.8%	22.3%	23.5%	30.8%
General Government Debt	18.7	20.9	21.6	21.9	23.4	25.8
% GDP	38.9%	40.7%	37.5%	38.2%	43.9%	49.1%
Domestic Debt						
Public Sector	13.0	14.9	15.5	15.1	13.4	16.2
% GDP	27.1%	29.0%	27.0%	26.4%	25.1%	30.7%
External Debt						
Public Sector	14.1	16.2	17.6	18.4	18.1	17.1
% GDP	29.3%	31.6%	30.5%	32.2%	33.8%	32.6%
Private Sector	3.9	4.3	4.6	5.0	5.2	3.7
% GDP	8.1%	8.4%	8.1%	8.7%	9.7%	7.1%
Gross External	18.3	24.0	26.5	28.1	28.5	26.1
% GDP	38.2%	46.8%	46.1%	49.1%	53.3%	49.7%
Fiscal Balances (% GDP)						
Revenues	28.3%	27.8%	29.5%	28.8%	28.8%	29.3%
Expenditures	29.2%	30.5%	31.8%	32.3%	32.3%	33.3%
Interest Payments	2.8%	2.5%	2.7%	2.8%	3.6%	3.3%
Public Sector Balance	-0.9%	-2.7%	-2.3%	-3.5%	-3.6%	-3.9%
Interest Payments (% Revenues)	10.1%	9.1%	9.2%	9.8%	12.3%	11.3%
Primary Balance	1.9%	-0.2%	0.4%	-0.6%	0.0%	-0.5%
Balance of Payments & Liquidity						
Current Account Balance	-1.3	-2.6	-2.9	-2.6	-1.1	-0.1
% GDP	-2.7%	-5.0%	-5.0%	-4.5%	-2.1%	-0.2%
Trade Balance (% GDP)	0.3%	-2.3%	-1.9%	-1.3%	0.4%	2.0%
Foreign Direct Investment (% GDP)	5.2%	4.9%	5.3%	3.8%	2.4%	1.8%
International Reserves	10.3	13.6	16.3	17.6	15.6	13.4
External Liquidity Ratio	158.7%	128.6%	138.0%	138.0%	140.7%	151.7%
International Investment Position	-4.8	-7.6	-8.4	-9.9	-10.2	-12.6
% GDP	-10.0%	-14.8%	-14.7%	-17.4%	-19.0%	-24.0%
External Assets	29.1	33.0	36.4	38.2	38.7	35.2
External Liabilities	33.9	40.6	44.8	48.2	48.8	47.8

Source: Ministry of Economy and Finance, Central Bank of Uruguay, National Statistics Institute, Haver Analytics, DBRS.
Notes: Public sector includes the central government, local governments, public companies, and the Central Bank of Uruguay (excluding public banks). Net public sector debt is gross public sector liabilities minus financial assets. General Government includes central government and local governments. External liquidity ratio = (International reserves + Exports of goods, services and income + Net transfers) / (Amortizations + Short-term external debt + Imports of goods, services and income).

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Ratings History

Issuer	Debt Rated	Current	2016	2015
Uruguay, Oriental Republic of	Long-Term Foreign Currency –Issuer Rating	BBB (low)	BBB (low)	BBB (low)
Uruguay, Oriental Republic of	Long-Term Local Currency – Issuer Rating	BBB (low)	BBB (low)	BBB (low)
Uruguay, Oriental Republic of	Short-Term Foreign Currency – Issuer Rating	R-2 (middle)	R-2 (middle)	R-2 (middle)
Uruguay, Oriental Republic of	Short-Term Local Currency – Issuer Rating	R-2 (middle)	R-2 (middle)	R-2 (middle)

Notes:
All figures are in U.S. dollars unless otherwise noted.
This rating is endorsed by DBRS Ratings Limited for use in the European Union.