R&I

NEWS RELEASE

Aug 31, 2015

R&I Affirms BBB-, Changes Outlook to Positive: Oriental Republic of Uruguay

Rating and Investment Information, Inc. (R&I) has announced the following:

ISSUER: **Oriental Republic of Uruguay**
Foreign Currency Issuer Rating: BBB-, Affirmed
Rating Outlook: Positive, Changed from Stable

RATIONALE:

The growth potential of Uruguay has been lifted up in recent years on the back of high investment and productivity enhancement supported by stable business climate. While a slowdown in economic growth is inevitable for some time, consumption and investment are expected to be steady, and economic growth will become more solid as the external environment improves. The effective public debt burden is light, and the fiscal balance will likely improve gradually under the new government. R&I believes that the current account deficit can be largely financed with foreign direct investment (FDI), and given the accumulated foreign reserves, there are no major concerns over its external position. Positively viewing the fact that Uruguay's economic and fiscal prospects are relatively stable even amid the harsh external environment, R&I has affirmed the Foreign Currency Issuer Rating of BBB- and changed the Rating Outlook to Positive.

As momentum in the Latin American economy is softening on the whole mainly owing to falling commodity prices, capital flows and economic activities in Uruguay would be under stress ahead of rate hikes in the U.S. Attention also needs to be paid to trends in the Chinese economy, which has a direct and indirect impact on Uruguay's economy. If Uruguay's economy is likely to expand stably amid such circumstances with fiscal and external deficits kept in check, the possibility of a rating upgrade will increase.

The growth rate of real gross domestic product (GDP) in 2014 slightly decelerated to 3.5%, as private investments slowed down. In 2015, the economies of neighboring major countries, Brazil and Argentina, have worsened at a faster-than-expected pace, which may affect manufacturing and service sectors as well as FDI-based projects in Uruguay. The government forecasts real GDP to grow 2.5% in 2015, and analysts in the private sector also project the same level.

Uruguay's real GDP was growing at an average of 5% per year until 2014, as its stable business climate and energy-related projects attracted investment and productivity increased. The country enjoys the highest income level in South America with relatively small income gap, which makes household consumption stable. In the five-year fiscal strategy for 2015-2019, the government expects an average growth rate of 2.7% for that period. Although current trends in the world economy will act as downward pressure, Uruguay's economy will unlikely decelerate rapidly because of domestic factors.

Investment holds the key of the economic trends. While private companies are expected to wait and see amid the severe external environment, the government announced a large-scale infrastructure project worth US$12 billion, which will be partly financed through public-private partnership (PPP) over the next five years. To carry out the project as planned, government's strong project management capability, including risk management, will be required more than ever.

The public sector fiscal deficit was 3.5% of GDP in 2014, the highest level seen since 2002. The primary balance also showed a deficit equivalent to 0.6% of GDP. In the five-year fiscal strategy, the Vazquez administration aims to gradually narrow the deficit to 2.5% by 2019 and turn the primary balance into a surplus by 1.0% of GDP. R&I considers this is a gradual pace with due consideration to economic trends. However, the government has set the targets based on an assumption that contributions from state-owned enterprises will increase, while clarity is lacking in how to consolidate the state budget. R&I is paying attention to the fiscal management, including whether the government prioritizes the improvement of the fiscal balance in a year when revenues exceed expectations and whether discussions to increase

■Contact : Investors Service Division TEL.+81-(0)3-3276-3511 E-mail. infodept@r-i.co.jp
■Media Contact : Corporate Planning Division (Public Relations) TEL.+81-(0)3-3276-3438
Rating and Investment Information, Inc. Nihonbashi 1-chome Mitsui Bldg., 1-4-1, Nihonbashi, Chuo-ku, Tokyo 103-0027, http://www.r-i.co.jp

fiscal flexibility will emerge.

The Uruguay's outstanding public debt (the total debt of the general government, the central bank and state-owned enterprises) to GDP ratio is the second highest in major Latin American countries after that of Brazil, standing at 59.5% as of end-March 2015. Besides financing fiscal deficits, however, the government borrows actively for its debt management purpose. The net debt, which subtracts liquid financial assets from the gross debt, is on a downward trend, standing at 20.5% of GDP as of end-March 2015. Financing risk is thus not as high as the gross debt level suggests, in R&I's view. The government has mitigated risks from refinancing, liquidity, exchange rate and interest rate fluctuations through its active debt management practices, while ensuring sufficient liquid assets to cover debt due within a year.

Containing inflation, which has surged since 2010, is a significant challenge in the macroeconomic policy realm. The root cause of this inflation is considered to lie in the fact that the economy has grown at a pace higher than its potential growth rate. Structural factors, however, such as the mechanism of wage settlements that have been linked to past inflation rates and carried over inflationary expectations, cannot also be neglected. Market participants forecast the inflation rates will exceed 8% over the next two years, which is beyond the 3.0%-7.0% target range applied since July 2014. As the economy is projected to trend slightly below the potential growth rate, R&I pays attention to whether the government will be able to lower the inflation rates by changing wage setting formulas, among other measures.

The current account remains in deficit. This is mainly because the trade balance has been in deficit since 2006 owing to growth in imports related to both consumption and investment, as well as increased interest and dividend payments stemming from brisk capital inflows. Since 2013, a rapid contraction in the service account surplus, especially in the travel account, has offset improvements in the trade balance. R&I expects the current account balance to remain in deficit of 3-4% of GDP, against the backdrop of, among others, the government’s new infrastructure investment plan, which is likely to be associated with high imports of capital goods. That said, the deficit has been comfortably financed through ample FDI so far. As of end-2014, foreign reserves have been built up to a little more than 30% of GDP, which is equivalent to a 14.5-month worth of the total of goods and services imports in 2014. The risk is limited that the economy will be destabilized due to insufficient external liquidity.

Generally speaking, in member countries of MERCOSUR, government intervention in the economy is pervasive, making business environment very uncertain. Uruguay is, however, increasingly recognized as a business hub in South America, particularly in the logistics field, because of its low level of corruptions and policy consistency. Meanwhile, the country shares common values with Brazil and other welfare countries, in that it puts importance on formal employment and narrowing of income gap. While President Tabare Vazquez assumed his second-term office in 2015, the direction of the policy that focuses on the balance between worker protection and business environment will remain intact.

The primary rating methodology applied to this rating is provided at "R&I's Analytical Approach to Sovereigns". The methodology is available at the web site listed below, together with other rating methodologies that are taken into consideration when assigning the rating.

http://www.r-i.co.jp/eng/cfp/about/methodology/index.html

R&I RATINGS:

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	Foreign Currency Issuer Rating
RATING:	**BBB-, Affirmed**
RATING OUTLOOK:	**Positive, Changed from Stable**

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