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Dec 26, 2016

R&I Affirms BBB-, 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

RATIONALE:

Since the financial and economic crisis in the early 2000s, Uruguay has increased economic stability substantially. The country's economy has maintained positive growth, in contrast to its neighboring major countries Brazil and Argentina, which are mired in recessions. In 2016, Uruguay's economy and fiscal position deteriorated more than R&I had anticipated. Nevertheless, the government rather reinforced its commitment to fiscal consolidation, and the economic outlook has been brightened, in R&I's view, particularly through investment. With current account deficits largely financed by foreign direct investment (FDI), concern over the external position is small. Given the uncertainty of the external environment, however, economic trends and execution risks for fiscal and monetary policies continue to warrant attention. R&I has therefore affirmed the Foreign Currency Issuer Rating at BBB- and left the Positive Rating Outlook unchanged. A rating upgrade will become more likely if the steady implementation of a fiscal consolidation plan can be envisaged.

In 2016, the economy appears to have grown only modestly, but has presumably hit the bottom. With a turnaround in investment firmly in place, real gross domestic product (GDP) growth is expected to recover to around 3.0%, which is equal to the country's potential growth rate. While an optimistic view should be avoided, medium-term prospects are encouraging. UPM-Kymmene Corp., a major paper manufacturer in Finland, announced a plan for a huge investment project worth US$4 billion, or over 7% of Uruguay's GDP, to construct its second mill in Uruguay. In addition, the government will invest US$1 billion (nearly 2% of GDP) in logistics infrastructure to reduce export costs. R&I believes that existing large infrastructure investment plans have also become more feasible, since an infrastructure investment fund was established to provide financing, with investments from Corporacion Andina de Fomento and institutional investors such as pension funds and insurance companies.

The current account balance remains in deficit, but will likely be stable on the whole. Deficits have been mostly financed by FDI net inflows. The investment climate in Uruguay is highly regarded compared to other South American countries, which is not anticipated to alter materially. Foreign reserves are ample, covering around 14 months' worth of goods and services imports. Given the market environment, R&I must continue to be mindful of capital flows. Even so, the risk is low that the economy will be destabilized due to insufficient external liquidity, in R&I's view.

Since 2012, the government has been taking a relatively expansionary fiscal stance. The primary balance turned negative, and the public sector fiscal deficit for 2016 seems to have widened from 3.6% of GDP in 2015. R&I favorably viewed the fact that the Vazquez administration embarked on fiscal consolidation in earnest, but considered that clarity was lacking in how to consolidate the state budget. The additional measures implemented in June 2016, however, call on higher tax revenue and lower expenditure at the central government level, which R&I believes heightened the effectiveness of consolidation processes. Uruguay's outstanding public debt to GDP ratio of above 60% is high relative to other Latin American countries'. Nonetheless, actual fiscal risk has been mitigated by ample liquid assets on hand, lines of credit from multilateral development banks and prudent debt management practices.

Containing inflation has been a significant challenge in the macroeconomic policy realm. Inflation stays beyond the 3-7% target range of Uruguay's central bank, suggesting that monetary policy management lacks credibility. While survey-based inflation expectations are falling in tandem with the appreciation of the currency, a more structural anchor is required. Because wage hikes have so far been linked to past

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inflation rates, inflationary pressures stemming from economic growth in excess of potential have been carried over. The government introduced new wage-setting guidelines that take into account economic growth and sector trends to a certain extent and call for wage increases set in nominal terms. R&I needs to keep an eye on whether such efforts will help anchor inflation expectations gradually and rein in inflation structurally.

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:

ISSUER:	**Oriental Republic of Uruguay**
	Foreign Currency Issuer Rating
RATING:	**BBB-, Affirmed**
RATING OUTLOOK:	**Positive**

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