Press Release

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Insight beyond the rating.

DBRS Confirms the Oriental Republic of Uruguay at BBB (low), Stable Trend

Industry: Public Finance--Sovereigns, Sovereign Finance

DBRS, Inc. (DBRS) 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. High inflation and pro-cyclicality in public expenditures are concerns and weigh on economic prospects. 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 steps are taken to ensure that revenues related to future commodity production or economic growth are used to build a countercyclical fiscal buffer, or if there is further progress on de-dollarization and on returning inflation to within the policy target range. Conversely, deterioration in Uruguay's macroeconomic management that weakens the economy's resilience to adverse shocks could put downward pressure on the ratings.

Supply and demand factors have contributed to Uruguay's strong economic performance of the last decade. From 2005 to 2013, Uruguay expanded at an average annual real rate of 5.7%, above the Latin American regional average of 3.8%. 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. Slowing from its long-run average in tandem with its two large neighbors, Uruguay's economy expanded by a real 3.7% in 2012 and 4.4% in 2013. The economy is expected to continue a cyclical deceleration over the next two years before converging back to its potential growth rate of roughly 4%.

Higher levels of investment bode well for growth over the medium-term. Total investment averaged 20.3% of GDP from 2008-2013, up from a low of 15.2% in 2003. FDI in particular, having averaged 5.9% of GDP from 2005 to 2013, is among the highest in its peer group. Once operational, recent agriculture and impending mining investments will likely improve the country's 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. Gross public debt declined to 59.4% of GDP in 2013 from 107.5% of GDP in 2003. The IMF expects gross debt to GDP to remain stable at around 62% over its five year forecast. Higher than expected debt issuance related to sterilization of Uruguay's rapidly growing foreign exchange reserves has caused the government to abandon its goal to reduce gross debt to 40% of GDP by 2015. Instead, it set a target for net-debt-to-GDP of 24% by end-2014. With net debt of 23.5% of GDP in 2013, this target has already been achieved.

Debt management operations have also reduced refinancing and exchange rate risk. With limited debt maturing and 3.8% of GDP in precautionary savings, the government has adequate resources to cover gross financing needs for well over 12 months. This financial cushion is supplemented by contingent credit lines of $2 billion (3.9% of GDP) from multilateral lending institutions. Gross international reserves rose to $16.5 billion in March 2014, up $3 billion from a year prior.

Offsetting these strengths are several challenges. Reducing persistent high inflation while tempering excessive capital inflows has remained a key policy concern over the last few years. To address this dual challenge, authorities deployed a series of macro-safeguards, including tightening the monetary policy stance, increasing reserve requirements on deposits and additional capital inflows, price control agreements on basic goods with retailers, and in June 2013 the Central Bank of Uruguay's (BCU) shifted to a money supply growth target from an interest rate target. Consequently, the government has had some success at containing the inflow of short-term capital. However, inflation has remained near or above the upper limit of the BCU target range and short term interest rates have become more volatile. Higher and less predictable interest rates have proven challenging for public debt issuances in pesos and for the extension of bank lending to the private sector.

Moreover, high levels of dollarization and low financial intermediation hinder the transmission of monetary policy, as the BCU has no control over dollar interest rates. The high level of dollarization in the economy also creates currency mismatches, and exchange rate and liquidity risks. The share of total dollarized credit and deposits in Uruguay remains well above the average for its peer group.

Despite ample liquidity buffers that provide space for automatic fiscal stabilizers to function, DBRS believes that the scope for discretionary stimulus or countercyclical policy intervention in the event of an adverse shock is somewhat limited. Economic output over the last decade has been above trend, resulting in primary surpluses and a declining debt burden, but the public sector balance remained in a deficit position. Central government expenditures have increased to 26.5% of GDP in 2013, from 22.2% in 2003, while revenues have remained broadly flat at around 21% of GDP over the decade. As GDP growth rates moderate, the increases seen in rigid social expenditure items could continue to pressure the fiscal position.

Uruguay remains exposed to external volatility – primarily risks stemming from volatile global capital flows, a strong real effective exchange rate, and weaker global and regional economic growth – that could further widen the 5.7% of GDP current account deficit. Trade disruptions or an 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 Uruguay's outlook for growth in trade. Agricultural products account for more than 60% of exports and therefore are exposed to fluctuations in world prices. However, the current account deficit remains fully funded by FDI and anticipated growth in exports from agriculture and mining investments is expected to reduce the deficit over the medium term. Moreover, foreign exchange reserve assets exceed most international benchmarks for adequate reserve levels, cushioning the impact of an external shock.

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: 3 May 2013

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

Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Uruguay, Oriental Republic of	Long-Term Foreign Currency - Issuer Rating	Confirmed	BBB (low)	Stb	May 30, 2014
Uruguay, Oriental Republic of	Long-Term Local Currency - Issuer Rating	Confirmed	BBB (low)	Stb	May 30, 2014
Uruguay, Oriental Republic of	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	May 30, 2014
Uruguay, Oriental Republic of	Short-Term Local Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	May 30, 2014

For more information on this credit or on this industry, visit www.dbrs.com or contact us at info@dbrs.com.

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