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Research Update:

Uruguay Outlook Revised To Negative On Risks Of A Weaker Economy; 'BBB/A-2' Ratings Affirmed

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Research Update:

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Overview

- Amid a pronounced regional economic slowdown, higher-than-expected inflation, falling consumer confidence, and low commodity prices, we expect real GDP growth in Uruguay of 0.7% in 2016 and 1.5% in 2017, following only 1% growth in 2015.
- We expect this lower growth trajectory will lead to Uruguay's fiscal deficit widening further this year, but then narrow thereafter, following the implementation of fiscal reforms to meet the government's five-year deficit goal.
- We are revising our outlook on Uruguay to negative from stable and affirming our 'BBB/A-2' foreign and local currency sovereign credit ratings.
- The negative outlook reflects the risks that the economy could weaken beyond our current expectations and that per capita income in U.S. dollar terms could continue to decline, which would weigh on Uruguay's revenue base and the government's planned fiscal adjustment.

Rating Action

On June 6, 2016, S&P Global Ratings revised its outlook on the Oriental Republic of Uruguay to negative from stable. At the same time, we affirmed our 'BBB' long-term foreign and local currency sovereign credit ratings. In addition, we affirmed our 'A-2' short-term foreign and local currency ratings. The transfer and convertibility assessment is unchanged at 'A-'.

Rationale

The outlook revision reflects the risk that weaker-than-expected growth could lead to a continued decline in per capita GDP in U.S. dollar terms that weakens Uruguay's creditworthiness. While the country's income level is still relatively high for the region, in our opinion, low growth could compromise the government's plans to further strengthen the country's revenue base, reduce the general government deficit, and stem the rise in government debt.

The economic challenges facing Uruguay--external, monetary, and fiscal--have increased owing to regional and global factors. We expect real GDP to grow 0.7% this year and 1.5% in 2017, versus 1% in 2015; GDP per capita should average just below \$17,000 between 2016-2019. The economies of two of

Uruguay's main trading partners and sources of foreign direct investment (FDI)--Brazil and Argentina--are set to contract by 3.6% and 0.5%, respectively, in 2016, with growth in Brazil only expected to rebound slowly in the next two years. Although we believe that the Uruguayan economy's links with these countries are weaker than in the past, it will still suffer from the regional recession. In addition, lower trend growth in China (which buys 23% of Uruguay's exports) and weak global commodity prices also weigh on Uruguay's growth prospects. At the same time, inflation dynamics have worsened amid depreciation of the Uruguayan peso; we expect consumer confidence to remain weak in a context of inflation that remains close to 10%.

In our view, low economic growth has, and will continue to, hurt Uruguay's fiscal performance, including government tax collection. The general government deficit increased to 4.3% of GDP in 2015, and we expect it to remain at this higher level, around 4.5% of GDP this year, up from an average deficit of 2.4% in 2013-2014 (unlike the government's definition of public sector, our definition of general government includes the central bank and excludes public-sector enterprises). Although the government has begun to implement expenditure efficiency measures, particularly in public-sector enterprises, which partly led to a surplus in public-sector enterprise balances in 2015, we do not expect these measures to be sufficient to avoid a higher general government deficit in 2016. However, we assume that new fiscal measures the government currently is contemplating will be implemented later this year following the government's budget accountability process. We assume these measures will lead to a reduced deficit over the coming three years.

We expect that the change in general government debt will rise by close to 6% of GDP this year--boosted by depreciation of the Uruguayan peso since around 52% of general government debt is denominated in foreign currency--and gradually decline to below 3% by 2019. At the same time, we expect net general government debt to peak at 54% of GDP in 2016 and then decline to 49% by 2019, while we expect general government interest to average 7.4% of general government revenues between 2016-2019. We include central bank debt as part of our calculation of general government debt.

The country's flexible exchange rate and, to some extent, its natural trade hedge as both a commodity exporter and oil importer, have helped to moderate the deterioration in the country's external liquidity and indebtedness, in our opinion. We expect Uruguay's gross external financing needs to average 109% of current account receipts (CARs) plus usable reserves in 2016-2018, and we expect external debt net of public- and financial-sector external assets to average 26% of CARs over this same period.

The current account deficit (CAD) fell to 3.6% of GDP in 2016 from 4.6% in the previous year. However, net FDI fell to 3% of GDP in 2016 from 3.8% in the previous year, no longer fully funding Uruguay's CAD (as it had during most years over the past decade). The 23% depreciation of the Uruguayan peso in 2015 supported the country's external competitiveness amid regional and global volatility. Yet, central bank intervention in the foreign exchange market to help smooth this depreciation partly led to the fall in international

reserves, which reached \$14.3 billion by March 2016 (excluding gold holdings), from \$17.5 billion at the end of 2014. Despite the decline in reserves, the central government's liquid external assets and contingent funding lines help to limit external liquidity risks, in our opinion. Liquidity buffers include the central government's liquid assets and contingent credit lines from multilateral institutions worth close to 7.7% and 4.5% of GDP, respectively.

We believe that higher inflation and still-high dollarization continue to limit Uruguay's monetary policy flexibility. Year-over-year inflation exceeded 10% in the beginning of 2016, higher than the central bank's 3%-7% target range and higher than inflation has been in over 10 years. The rise in inflation reflects a combination of the pass-through effect of significant currency depreciation and a hike in utility tariffs. By the end of 2016, we expect that inflation will remain close to 10%, and gradually decline thereafter, as the impact of recent currency depreciation is counterbalanced by contractionary monetary policy, a decelerating economy, and new wage-indexation guidelines, which should somewhat limit the impact of backward wage indexation.

The ratings on Uruguay reflect its stable political system, cohesive society, moderately prosperous economy, moderate fiscal flexibility and debt burden, and limited monetary flexibility.

The broad political consensus on the need for fiscal consolidation reflects Uruguay's stable and well-established institutions that anchor economic stability. We expect that the administration of President Tabaré Vazquez of the Frente Amplio will continue to implement policies to facilitate growth, although the speed of this progress may be slower than originally expected. In particular, we expect the government to advance with its capital investment plans, somewhat counterbalancing its otherwise contractionary fiscal measures. We expect that the new budget adjustments in 2016 will broadly maintain the government's infrastructure plan, relying in part on the private sector for financing, some of which will come from public-private partnerships (PPPs).

Outlook

The negative outlook reflects our view that there is a greater than one-in-three likelihood that we could lower the ratings on Uruguay over the next two years. We could lower the ratings if economic growth disappoints beyond our current expectations, leading to lower per capita income, or if Uruguay's growth prospects deteriorate such that we expect its revenue base, policy flexibility, or debt burden to be weaker than our base-case scenario. This risk would be exacerbated by a failure to implement timely fiscal adjustment measures currently under debate, leading us to believe that fiscal deficits would continue to widen over the next two years, or if the measures passed are insufficient to revert deterioration. At the same time, if, contrary to our expectations, inflation continues to rise, eventually breaching 12%, new wage agreement clauses could be triggered, causing nominal wage increases that could lead to spiraling inflation levels and reflecting

weaker effectiveness of monetary policy, we could also lower the ratings.

On the other hand, the ratings could stabilize if, in line with our base-case scenario, the economy gradually strengthens, supporting per capita income, and thus the country's revenue base, its fiscal and monetary policy flexibility, and its capacity to absorb growing debt levels. This, combined with the implementation of fiscal reform measures this year that keep Uruguay on track to reduce its deficit in order to meet its five-year budget goal in such a way that doesn't deteriorate growth, would support the rating.

Key Statistics

Table 1

Oriental Republic of Uruguay--Selected Indicators											
	2009	2010	2011	2012	2013	2014	2015	2016f	2017f	2018f	2019f
ECONOMIC INDICATORS (%)											
Nominal GDP (bil. LC)	714.52	808.08	926.36	1,041.21	1,178.33	1,330.51	1,460.44	1,617.73	1,784.85	1,960.73	2,144.40
Nominal GDP (bil. \$)	31.66	40.28	47.96	51.26	57.53	57.24	53.44	52.89	55.91	59.34	63.32
GDP per capita (\$000s)	9.5	12.0	14.2	15.2	17.0	16.8	15.7	15.4	16.3	17.2	18.3
Real GDP growth	4.2	7.8	5.2	3.5	4.6	3.2	1.0	0.7	1.5	2.0	2.5
Real GDP per capita growth	3.9	7.4	4.8	3.2	4.3	2.9	0.7	0.4	1.2	1.7	2.2
Real investment growth	(5.8)	16.0	7.0	18.2	3.8	2.4	(8.2)	0.7	1.5	2.0	2.5
Investment/GDP	19.6	19.4	20.9	22.9	22.5	21.2	19.8	20.0	20.0	20.0	20.0
Savings/GDP	18.4	17.6	18.1	17.9	17.5	16.6	16.2	16.7	17.1	17.5	17.7
Exports/GDP	27.1	26.3	26.4	25.9	23.4	23.5	22.3	22.3	22.3	22.3	22.3
Real exports growth	4.5	7.2	5.8	3.6	(0.1)	3.5	(1.2)	0.7	1.5	2.0	2.5
Unemployment rate	7.7	7.2	6.3	6.5	6.5	6.6	7.5	8.0	8.0	7.0	6.0
EXTERNAL INDICATORS (%)											
Current account balance/GDP	(1.2)	(1.8)	(2.7)	(5.1)	(5.0)	(4.6)	(3.6)	(3.3)	(2.9)	(2.4)	(2.2)
Current account balance/CARs	(4.1)	(6.4)	(9.6)	(18.4)	(20.2)	(18.8)	(15.5)	(14.1)	(12.6)	(10.6)	(9.6)
Trade balance/GDP	(1.6)	(1.3)	(3.0)	(4.6)	(2.4)	(1.6)	(0.5)	(0.0)	0.3	0.6	0.7
Net FDI/GDP	4.8	5.8	5.2	5.0	5.3	3.8	3.0	3.1	3.0	3.0	2.9
Net portfolio equity inflow/GDP	(0.1)	(0.0)	0.0	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Gross external financing needs/CARs plus usable reserves	124.3	108.4	105.8	99.4	98.4	96.9	97.0	106.9	110.7	110.9	109.5
Narrow net external debt/CARs	23.8	8.6	(2.8)	8.1	5.3	3.7	7.3	20.5	25.8	28.0	28.5
Net external liabilities/CARs	30.6	29.2	40.7	59.4	68.1	79.8	92.5	106.1	107.9	104.8	99.5

Table 1

Oriental Republic of Uruguay--Selected Indicators (cont.)											
	2009	2010	2011	2012	2013	2014	2015	2016f	2017f	2018f	2019f
Short-term external debt by remaining maturity/CARs	54.8	49.0	40.6	33.8	41.0	47.9	57.0	57.5	57.6	54.1	50.2
Reserves/CAPs (months)	3.2	4.9	4.6	5.4	6.4	7.3	8.1	6.4	5.7	5.3	5.0
FISCAL INDICATORS (%, General government)											
Balance/GDP	(1.2)	(1.3)	(0.7)	(2.1)	(1.8)	(3.0)	(4.3)	(4.5)	(3.8)	(3.2)	(2.8)
Change in debt/GDP	1.8	3.9	5.1	5.7	8.9	7.0	8.3	6.2	4.3	3.3	2.7
Primary balance/GDP	1.6	1.6	2.1	0.5	0.9	(0.2)	(0.7)	(1.5)	(1.2)	(0.5)	(0.5)
Revenue/GDP	35.8	36.6	36.8	36.6	38.0	37.5	36.8	35.9	36.1	36.5	37.1
Expenditures/GDP	37.0	37.9	37.5	38.6	39.8	40.5	41.1	40.5	40.0	39.7	39.9
Interest /revenues	7.8	8.1	7.7	6.9	7.1	7.6	9.6	8.4	7.4	7.3	6.3
Debt/GDP	58.3	55.4	53.5	53.3	56.0	56.6	59.8	60.2	58.9	57.0	54.8
Debt/Revenue	163.1	151.6	145.4	145.5	147.1	150.9	162.4	167.7	163.1	156.1	148.0
Net debt/GDP	48.7	49.5	45.3	45.6	49.7	49.0	50.3	53.8	53.0	51.4	49.4
Liquid assets/GDP	9.7	5.9	8.2	7.7	6.2	7.6	9.5	6.4	6.0	5.6	5.4
MONETARY INDICATORS (%)											
CPI growth	7.1	6.9	8.6	7.5	8.5	8.3	9.4	10.0	8.7	7.7	6.7
GDP deflator growth	7.7	4.9	9.0	8.6	8.2	9.4	8.7	10.0	8.7	7.7	6.7
Exchange rate, year-end (LC/\$)	19.63	20.09	19.90	19.40	21.39	24.33	29.87	31.30	32.55	33.53	34.20
Banks' claims on resident non-gov't sector growth	(15.8)	20.8	18.9	15.0	24.9	18.0	22.4	13.0	11.5	9.3	7.2
Banks' claims on resident non-gov't sector/GDP	21.3	22.8	23.6	24.2	26.7	27.9	31.1	31.7	32.1	31.9	31.3
Foreign currency share of residents' bank deposits	71.5	69.1	67.5	67.1	69.1	72.5	75.8	75.8	75.8	75.8	75.8
Real effective exchange rate growth	2.7	11.9	2.0	3.1	6.6	(1.7)	3.8	N/A	N/A	N/A	N/A

Note: Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository 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. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. f--Forecast.

Ratings Score Snapshot

Table 2

Oriental Republic of Uruguay--Ratings Score Snapshot	
Key rating factors	Assessments
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Neutral
Monetary assessment	Weakness

Note: S&P Global Ratings' 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; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "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 S&P Global Ratings' 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
- Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- 2015 Annual Sovereign Default Study And Rating Transitions, May 24, 2016
- Global Sovereign Debt Report 2016: Borrowing To Drop By 2% To US\$6.7 Trillion, Feb. 29, 2016
- Sovereign Risk Indicators, found at spratings.com/sri

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 fiscal risk had deteriorated and that debt risk had improved. All other 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

Ratings Affirmed; Outlook Action

	To	From
Uruguay (Oriental Republic of) Sovereign Credit Rating	BBB/Negative/A-2	BBB/Stable/A-2

Ratings Affirmed

Uruguay (Oriental Republic of) Transfer & Convertibility Assessment	A-
Senior Unsecured	BBB
Short-Term Debt	A-2

Not Rated Action

	To	From
Banco Central del Uruguay Sovereign Credit Rating	NR/NR	BBB-/Stable/A-3
Senior Unsecured	NR	BBB-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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