Jul 20, 2012

R&I Upgrades to BB+, Stable: The Oriental Republic of Uruguay

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

ISSUER: **The Oriental Republic of Uruguay**
Foreign Currency Issuer Rating: BB+, Previously BB
Rating Outlook: Stable

RATIONALE:

Uruguay's economy is expanding steadily, supported by solid direct investment inflows. The fiscal and financial systems remain sound, and the current account deficit is limited. The country has gained a certain level of resilience against external shocks. Reflecting such improving trends in the economic base, R&I has upgraded the Foreign Currency Issuer Rating for Uruguay to BB+. The Rating Outlook is Stable. Nevertheless, upward pressure on wages remains strong, and the inflation rate is still high. The public debt to gross domestic product (GDP) ratio has more room to fall. R&I will thus continue to keep close eyes on such developments.

Private consumption and investment drive Uruguay's economy. While economic growth in neighboring Brazil and Argentina is slowing down to the 1% level, Uruguay's economy for 2012 is expected to grow by 3%-4%. Although this forecast is lower than the 6.1% average growth for five years through 2011, the country maintains relatively favorable fundamentals, given the damage it has incurred from droughts since early this year, among others. Solid personal consumption on the back of wage increases and fixed capital formation spurred by the entries of foreign companies are expected to underpin the economic growth of the country.

Uruguay's current account deficit is small and covered entirely by direct investment inflows, and the country has international reserves for more than 9 months of imports of goods and services. As 75% of bank deposits are foreign currency-denominated deposits (mainly U.S. dollar-denominated deposits), of which approximately 20% are held by non-residents, Uruguay's banking sector bears the risk of deposit outflows depending on overseas political and economic conditions, but has enhanced its capability to cope with such event risk by strengthening liquidity management over the past few years. The banking sector maintains sufficient provisions for non-performing loans as well as a certain level of risk resilience. These have led to restoration of trust in the banking system. Since the beginning of 2012, the outflow of foreign currency deposits from Argentina's banking system has been accelerating, but unlike 10 years ago, there is no sign that such moves have spread to banks in Uruguay.

Uruguay's prudent financial management remains unchanged. Under the "Fiscal Responsibility Law", which calls for rigorous budget execution, the government fiscal deficit including that relating to public corporations has been held to less than 2% of GDP since 2005. Uruguay's public debt balance stood at 55.5% of GDP as of end-December 2011. Though not a light burden, this is a considerable improvement from earlier levels. The government plans to cut the ratios of the fiscal deficit and public debt to GDP to 1.2% and 47%, respectively, by 2014. Since the ratio of rigid expenses like pension payments, public sector employee salaries, and interest payments is high, reducing the fiscal deficit will not be easy. R&I is paying attention to whether the government is able to implement structural reform that allows it to review those areas.

The possibility of a further rating upgrade depends on curtailment of inflation, as well as further reduction of the public debt to GDP ratio. The unemployment rate as of end-April 2012 was historically low at 6%, and the tight labor market has led to strong upward pressure on wages. Consumer prices continue to rise at an annual rate of around 8%. It still requires time for Uruguay to move away from dollarized economy, and the effectiveness of controlling inflation only through monetary policy is limited. In R&I's view, against such a background, employers, employees and the government will need to work together to contain wage increases to an appropriate level and make concerted efforts to maintain the

■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 Bldg., 1-4-1, Nihonbashi, Chuo-ku, Tokyo 103-0027, Japan http://www.r-i.co.jp

competitiveness of the economy.

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:	**The Oriental Republic of Uruguay**
	Foreign Currency Issuer Rating
RATING:	**BB+, Previously BB**
RATING OUTLOOK:	**Stable**

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