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Supplementary Analysis:

Oriental Republic of Uruguay

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This report supplements our research update "Oriental Republic of Uruguay Ratings Raised To 'BBB/A-2' On Greater External Resilience; Outlook Stable," published on June 5, 2015. To provide the most current information, we may cite more recent data than that stated in the previous publication. These differences have been determined not to be sufficiently significant to affect the rating and our main conclusions.

Rationale

Sovereign Credit Rating
BBB/Stable/A-2

The ratings on the Oriental Republic of Uruguay reflect Standard & Poor's Ratings Services' belief that the newly elected administration of President Tabaré Vázquez will build on Uruguay's track record of cautious macroeconomic policies, gradual diversification of the economy, and prudent debt management. We believe the regional risks to Uruguay have stabilized and will improve next year.

The gradual diversification of the Uruguayan economy has contributed to recent years of high economic growth and has allowed the economy to weather the regional economic slowdown. High levels of foreign direct investment (FDI) contributed to higher GDP growth, economic diversification, and productivity gains. Although we expect that domestic fiscal tightening and contracting economies in Argentina and Brazil will keep Uruguayan growth below 3% this year and next, we do not foresee marked downside risks.

A significant improvement in Uruguay's external position over the past decade sustains the country's stability. We project that Uruguay has a narrow net external creditor position of 24% of its current account receipts (CAR) in 2015. FDI has consistently exceeded Uruguay's current account deficit, containing the country's external debt. Strong FDI has also contributed to an accumulation of international reserves that reached US$17 billion as of the end of 2014, or 32% of GDP.

During the past few years, Uruguay has taken steps to reduce the negative fiscal and external impact of droughts, which raise the country's energy import bill. The government has created a stabilization fund and purchased weather insurance to contain the fiscal cost of higher oil imports during periods of drought. Investments in renewable energy have already started reducing the country's dependence on oil imports. Renewable energy (hydraulic, wind power, and biomass) may provide almost half the country's energy in 2015.

Effective debt management has reduced the risks from a sudden disruption in external markets, or a spike in the exchange rate or interest rate. The government has undertaken liability management operations to improve the profile of sovereign debt by de-dollarizing its debt stock, as well as building reserves that provide cushion against external shocks. The central government faces a lumpy external amortization profile of US$1 billion, equivalent to 2% of GDP in 2015. As of March 2015, central government liquid assets covered 2.7x amortization payments due in one year. On Feb. 23, 2015, Uruguay reopened its global bond due in 2050 and issued US$1.2 billion in the international capital markets. The issuance raised foreign currency debt to 51% of total debt from 48% in 2014, but at the same time, it extended the average maturity of the debt to about 15.5 years.

A high level of dollarization and indexation to inflation limit the effectiveness of monetary flexibility. Deposits denominated in U.S. dollars are high at almost 80%, while credits in U.S. dollars reached 50% as of year-end 2014. The relative modest size of the financial sector, together with a highly liquid financial system, moderates the risks of currency mismatches. Nevertheless, a declining level of dollarization would reduce external vulnerabilities.

A persistently high inflation rate is the main macroeconomic weakness in Uruguay. Inflation ended 2014 at 7.8%, above the range limit set by the central bank. Anchoring expectations through clear communication and credible inflation targets, together with both fiscal and monetary contractive policies, would help moderate inflation going forward. Avoiding automatic salary indexation to past inflation would also lessen inflation inertia.

The consolidated public deficit widened to 3.5% of GDP in 2014 from 2.3% in 2013. We expect only gradual improvements in fiscal results given Uruguay's relatively highly rigid spending (salaries, pensions, and social assistance) and limited flexibility to increase revenues. Economic growth reached 3.5% in 2014, driven by private consumption growth. The recent construction of a large pulp and paper mill (Montes del Plata) will boost output and exports in 2015.

However, a combination of slowdown in Uruguay's main trade partners, along with a modest fiscal adjustment, will likely lead to a deceleration of economic growth to about 2.5% in 2015. We expect the current account deficit to be 4.4% of GDP in 2015 and gradually improve thereafter due to lower oil imports.

Uruguay's stable political system, growing middle class, and predictable economic policies should sustain economic growth close to its trend rate at 3%-3.5% from 2016 onward. Medium- and long-term economic growth will depend on the development of infrastructure, mainly ports, roads, and energy. Boosting different financing alternatives, such as public-private partnerships (PPPs) and concessions, would sustain investment. That, along with a more skilled labor force, would sustain long-term GDP growth.

We believe the Argentine economy, which still has ties to Uruguay's economy, will stagnate this year and begin to recover next year. We assume that the next government will gradually begin to address the country's macroeconomic imbalances, which in turn could moderate observed inflation and strengthen public finances. We expect that Brazil's economy, which has weaker links with Uruguay than does Argentina, will contract about 1% this year and return to low growth next year. A growing diversification of Uruguay's exports away from both Argentina and Brazil (thanks to rising exports of soya and pulp, as well as nontraditional service exports to global markets) has also reduced the country's vulnerability to economic setbacks in either neighboring country. Exports to Brazil and to Argentina were 18% and 4%, respectively, of total exports last year.

Outlook

The stable outlook is based on our expectation of continuity in main economic policies over the next three years. The combination of cautious fiscal policy and higher-than-expected investment could accelerate GDP growth, gradually resulting in a lower debt burden and greater economic diversification. A declining level of dollarization in the banking system (the proportion of loans and deposits denominated in dollars), along with persistently lower inflation, would boost the effectiveness of monetary policy. A declining debt burden, together with an improvement in monetary and fiscal flexibility, could lead to a higher rating.

Conversely, we could lower the rating if we perceive a weakening commitment to fiscal and monetary policies that sustain economic stability, resulting in greater external vulnerability. Similarly, an inadequate or untimely government response to adverse external developments could reduce the country's external liquidity and raise its debt burden, leading to a downgrade.

Summary Statistics:

Table 1

Selected Indicators

	2008	2009	2010	2011	2012	2013	2014	2015f	2016f	2017f	2018f
Nominal GDP (bil. US$)	30.37	31.66	40.28	47.96	51.38	57.52	57.47	56.42	56.77	60.46	65.21
GDP per capita (US$)	9,108	9,465	12,000	14,236	15,198	16,959	16,883	16,515	16,567	17,580	18,901
Real GDP growth (%)	7.2	4.2	7.8	5.2	3.3	5.1	3.5	2.5	2.8	3.0	3.5
Real GDP per capita growth (%)	6.9	3.9	7.4	4.8	3.0	4.8	3.1	2.1	2.5	2.6	3.2
Change in general government debt/GDP (%)	8.2	1.8	3.9	5.1	5.7	8.9	7.1	6.5	3.5	2.7	2.2
General government balance/GDP (%)	(0.8)	(1.2)	(1.3)	(0.7)	(2.0)	(1.8)	(3.0)	(2.7)	(2.3)	(2.0)	(1.8)
General government debt/GDP (%)	63.5	58.3	55.4	53.5	53.1	56.0	56.4	57.6	55.8	53.3	50.6
Net general government debt/GDP (%)	52.1	48.7	49.0	45.3	45.3	49.5	48.7	51.6	50.0	48.0	45.7
General government interest expenditure/revenues (%)	8.3	7.8	8.1	7.7	6.9	7.1	7.6	7.5	7.5	7.4	7.3
Other dc claims on resident nongovernment sector/GDP (%)	28.6	21.4	22.9	23.7	24.2	26.8	27.8	28.9	29.9	30.8	31.8
CPI growth (%)	7.9	7.1	6.9	8.6	7.5	8.5	8.3	7.8	7.0	7.0	6.5
Gross external financing needs/CARs plus usable reserves (%)	136.9	124.3	108.4	106.1	99.9	97.3	95.2	97.4	97.1	96.8	98.1
Current account balance/GDP (%)	(5.7)	(1.2)	(1.8)	(2.9)	(5.2)	(5.1)	(4.6)	(4.4)	(4.1)	(4.0)	(3.8)
Current account balance/CARs (%)	(16.8)	(4.1)	(6.4)	(10.1)	(19.3)	(20.7)	(18.7)	(17.7)	(15.5)	(14.9)	(14.2)
Narrow net external debt/CARs (%)	26.4	13.5	(3.7)	(11.6)	(13.4)	(21.5)	(24.3)	(23.5)	(22.9)	(23.4)	(20.3)
Net external liabilities/CARs (%)	18.3	20.3	18.7	32.0	37.0	40.8	57.8	78.6	90.1	99.7	94.1

Table 1

Selected Indicators (cont.)
Other depository corporations (dc) are financial 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. CARs--Current account receipts. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Institutional And Governance Effectiveness: Macroeconomic And Institutional Stability Will Likely Contribute To Growth

- We expect continuity in main policies after Tabaré Vázquez from Frente Amplio (FA) won the 2014 presidential elections.
- The government has stated the importance of achieving fiscal sustainability while bringing inflation down to improve competitiveness and continue attracting FDI.
- Macroeconomic and institutional stability together with an increasingly prosperous middle class and healthy social indicators augurs well for long-term growth.

On March 1, 2015, Vázquez from FA, a coalition of parties from the moderate to extreme left, took office for the second time for a five-year term. Vázquez served as a president from 2005 to 2010 and was followed by Jose Mujica, also from the FA coalition. We expect economic policy to remain stable and predictable under Vázquez's new presidential term. The government has stated the importance of achieving fiscal sustainability while bringing inflation down to improve competitiveness and continue attracting FDI. Education and the maintenance of infrastructure development are also priorities.

Danilo Astori, former vice president for Mujica, has been named as minister of economy, and Mario Bergara, former minister of economy, was named president of the central bank. During the next month, the economic team will be facing the 2016 and five-year budget discussions. Gradually eliminating de facto indexation adjustment to past inflation will help anchor future inflation expectations and control the operating expenses burden.

The new administration enhances the importance of maintaining a clear, transparent, and stable economic environment with long-term rules to sustain Uruguay's attractiveness for private investment and continued growth.In that sense, we are not expecting major modifications in the country's tax structure. Uruguay's institutional strength sustains investor confidence in the country despite adverse events in neighboring Argentina and Brazil. Uruguay is a largely middle class society with a relatively strong social contract that emphasizes consensus and social cohesion. The country ranks highly in international scores for governance and has the best ranking, indicating the least corruption, in Latin America in Transparency International's index of perception of corruption. The Getulio Vargas Foundation ranked Uruguay first in the economic climate index, and the Economist Intelligence Unit ranked Uruguay first in its Democracy Index. Most recently, Uruguay was the best-ranked country in Latin America for Rule of Law Index, which indicates better rule of law implementation than Latin American peers, as published by The World Justice Report in 2014, and was ranked 20th worldwide, behind the U.S.

We expect the new administration to continue promoting economic and exports diversification. A new trade agreement within Mercosur (a region made up of Argentina, Brazil, Paraguay, Uruguay, and Venezuela) is also in the government's agenda. Reducing the country's external vulnerabilities by enhancing energy independence will remain a priority.

Uruguay's stable political system provides an anchor for economic stability. The FA has managed to maintain its unity despite consistent internal tensions between different factions over economic and social policies. The opposition to the FA is divided largely between the two former dominant parties, the Colorados and the Blancos. The policy differences between the main political parties have narrowed over the last decade. Opposition to some of the government's economic policies has sometimes been stronger within the FA than from the external opposition parties, and all of them agree on the need to maintain macroeconomic stability.

Uruguay is similar to Chile in terms of per capita income (projected to be about US$17,000 in 2014), political stability, and level of development but very different in terms of greater social cohesion and a more even income distribution. For example, Uruguay's Gini co-efficient (a measure of inequality with zero being perfect equality and one being perfect inequality) fell to 0.38 in 2013 from 0.45 in 2004 and is the lowest in Latin America--Chile's is 0.52. The middle class, using World Bank definitions, accounts for more than 72% of the population. The poverty rate is less than 10%, and about 95% of the population has access to health insurance. Average life expectancy is nearly 80 years.

Uruguay faces no external or internal security threats.However, it has suffered from trade frictions caused by protectionist measures, as well as currency controls, imposed by Argentina. Such steps have hurt tourism from Argentina, as well as trade, although the impact on the economy has been contained so far.

Economic Analysis: Moderate Growth In The Next Two Years On Weaker Regional Economic Context

- We expect lower economic growth in 2015 and 2016 given the slowdown in Uruguay's main commercial partners--Brazil and Argentina--an adjustment in fiscal policy, and no large investment project on the agenda.
- Medium-term growth prospects at about 3.5% reflect Uruguay's macro-stability, recent diversification of the economy, and Uruguay's attractiveness for FDI.
- Efforts to improve the development of key infrastructure, mainly in transportation and energy, and human development will be key factors for sustaining long-term growth.

The gradual transformation and diversification of the Uruguayan economy underpinned recent years of high economic growth and allowed the economy to weather the regional economic slowdown. High levels of FDI contributed to productivity gains and increasing investment levels while consumer demand increased. The introduction of new technology and management practices (often from Argentina) has led to impressive growth in soya and dairy products output.

Economic growth reached 3.5% in 2014, mainly because of private consumption growth, while investment moderated. The recent construction of the second pulp and paper mill (Montes del Plata) will affect output and exports in 2015. Still, a combination of a slowdown in Uruguay's main trade partners, Brazil and Argentina, and some expected fiscal adjustment, together with the absence of large investment projects, will lead to a deceleration of economic growth to about 2.5%.

During the past decade the Uruguayan economy has grown at an average of 5.4%, while population barely grew, leading to a significant increase in GDP per capita estimated at US$16,800 in 2014 from US$4,000 in 2004. The main factors contributing to this increase were increasing investment levels averaging 20% of GDP and domestic demand boosted by several years of an increase in real salaries. Much of the growth in domestic demand in recent years has been funded by income growth, rather than lending. Overall credit to families (including consumer and mortgage) remains low at about 12.5% of GDP while domestic credit private-sector and nonfinancial public-sector enterprises to

GDP was 28% as of year-end 2014.

Recent diversification of the economy has improved the economic resilience to external shocks. So far, Uruguay has been able to overcome worsening economic conditions of two of its major partners, Brazil and Argentina. Still, direct links with both countries have diminished in recent years. Uruguay places 4% of total exports to Argentina and 18% to Brazil from higher levels a decade ago of 13% and 33%. There are some specific industries that will likely be hurt, such as the automobile industry. At the same time, Uruguay has already been dealing with lower services exports coming from less tourism from Argentina.

The country's growing middle class, along with a stable political system and predictable economic policies, should sustain economic growth close to its trend rate at 3%-3.5% from 2016 onward. Medium- and long-term economic growth will also depend on the development of the infrastructure of Uruguay, mainly ports, roads, and energy. Boosting different financing alternatives to sustain investment such as PPPs and concessions, while continuing to reinforce human development, would be key.

Increasing FDI in the country has increased demand for labor, and the unemployment rate fell to 6.2% in 2014 from about 8.5% at the end of 2008. According to official calculations, increases in total factor productivity (the increase in output that is greater than the proportionate increase in inputs) account for just under half of the output growth in recent years, followed by higher use of labors inputs and then capital.

Uruguay's savings rate remains low, leading it to depend on external financing for a substantial share of its recently high level of investment. FDI will continue to be an important economic driver in the medium term. According to the government, FDI for at least US$16 billion is already committed for the 2015-2020 period in diverse sectors such as logistics, renewable energy, mining, real estate, and other services.

Further development in the energy sector could make an important long-term contribution to GDP growth and external liquidity, helping reduce the country's dependence on high-cost fuel imports (especially when droughts force the government to shift to costly oil-powered generation to compensate the loss of hydropower). Several companies have recently started oil and gas exploration off shore. The government has ambitious goals to generate more than half of the country's energy from renewable sources such as wind and solar by 2015, along with plans to boost use of natural gas.

PPPs have developed slowly with only very gradual results so far. Still, we expect the first PPP (public-private partnership) project, a new prison, to begin during 2015 or early next year and for the second project, a new highway, to begin to work under this framework of a PPP. We expect that the pace of plans to build new highways, railways, and a massive new deepwater port through such partnerships will likely be slow.

External Analysis: Greater Resilience Against Shocks

- The current account deficit fell to 4.6% of GDP in 2014 from 5.1% in 2013 mainly because of a lower deficit in the trade balance.
- We expect the current account deficit to be between 4%-4.5% of GDP in 2015-2017 and gradually improve thereafter as higher commodity exports and pulp paper come online and lower oil imports.
- We expect FDI flows to continue to provide a strong source of external financing.
- Ample foreign exchange reserves and the availability of funding from several contingency credit lines, together with the reduction of energy vulnerabilities, should sustain external liquidity in the event of an external crisis.

A significant improvement in Uruguay's external position over the past decade sustains the country's stability. We project that Uruguay has a narrow net external creditor position of 24% of its CAR in 2015. FDI has consistently exceeded Uruguay's current account deficit, resulting in the accumulation of international reserves. Uruguay's foreign exchange reserves reached a record US$17.5 billion as of the end of 2014, or 32% of GDP. At the same time, central government liquid reserves reached US$3.5 billion, equivalent to 6.1% of GDP, and Energy Stabilization Funds reached US$300 million. Uruguay continues to have contingent lines, which help moderate potential external shocks. It has total contingent lines for US$2 billion, equivalent to 3.5% of GDP, of which US$550 million are with the Inter-American Development Bank (IDB), US$520 million with World Bank, US$470 million with Fondo Latinoamericano de Reservas (FLAR), and US$400 million with Corporacion Andina de Fomento (CAF). Moreover, we believe that Uruguay could quickly qualify for the International Monetary Fund's (IMF's) Flexible Credit Line facility. As a result, we expect Uruguay to have ample external liquidity to manage potential disruptions in global conditions.

We project narrow net external debt to be -23.5% of current account receipts in 2015, thanks to foreign exchange reserves and other liquid assets. Gross external financial needs are expected to remain slightly lower than 100% of current account receipts plus usable reserves in the next three years.

Declining current account deficit

Contrary to most Latin American countries during the past decade, Uruguay's terms of trade (price of exports divided by price of imports) have barely improved given its conditions of oil importer. However, a growing diversification of exports away from both Argentina and Brazil (thanks to rising exports of soya and pulp) has reduced the country's vulnerability to economic setbacks in either country. The current reversal of the global conditions is not expected to have a negative impact on the country's external accounts. The continuation of a more diverse set of exports of both goods and services, along with less dependence on neighboring markets, could continue reducing the risk of a negative external shock.

Despite lower expected exports, given lower export prices for soy and grains, and weakening economic conditions in Uruguay's main export destination Brazil, we expect an improvement in 2015's trade balance because of lower oil imports. We expect a weaker economy in Brazil will outweigh the positive impact of higher pulp exports after the completion of Montes del Plata pulp mill. We expect the current account deficit to be 4.4% of GDP in 2015 and gradually improve thereafter on lower dependence on oil imports.

We expect a deceleration in overall exports given the region's economic context. We expect pulp to be the largest product to be exported in 2015, followed by soya and meat. Soy exports accounted for 16% of 2014 total exports, and meat accounted for 14%, followed by pulp (9%) and dairy products (8%). The lower oil price will most likely have a positive impact on Uruguayan trade balance as oil imports account for about 13% of total imports. The central bank estimates a net decrease of US$453 million in oil imports, equivalent to 0.8% of GDP in 2015.

During 2014, the trade balance deficit declined to US$918 million from US$1.3 billion in 2013, mainly because of a decline of 2.7% in imports related to lower imports in energy (-15%) given a combination of lower oil prices (6.1%) and lower purchases (9.7%). Exports grew 1.2%. Uruguay has consistently diversified its exports markets. Brazil is the largest export country with 18% of total exports, followed by China with 17%, free trade zones with 12%, and the U.S. and Venezuela with 5% each. Exports to Argentina account for only 4% of total exports. Meat and soybean are the largest export products, accounting for almost 20% and 17.4%, respectively, followed by cereals (10%) and dairy products (9.2%). While soybean prices have declined, meat and dairy products prices have increased about 7% in 2014.

Continued success in diversifying the economy could positively change the pattern of Uruguay's balance of payments in the next three years. Earnings from tourism and nontourism service exports have increased over recent years and account for 25% of total exports. More importantly, nontourism service exports (such as software, transport, and logistics) account for an increasing share of total services exports at 40% in 2014, and more than 40% of those nontourism service exports goes to the U.S.

The service trade balance declined in 2014, hurt by lower receptive tourism from Argentina (60% of total tourism) and Brazil (20%). A gradual improvement in Argentina's economy could trigger an improvement in Uruguay's tourism receipts.

Decreasing energy vulnerabilities

The CAD has historically been vulnerable to large spikes in imports due to higher oil imports when drought reduces the generation of electricity from hydropower plants. During the past few years, Uruguay has taken several steps to reduce fiscal and external risks stemming from the impact of droughts on energy balances, including boosting investments, creating a stabilization fund, and having weather insurance. For 2010-2017, total investments are estimated to reach US$6.8 billion, both from private and public sources. Of that, US$1.4 billion, or 3%, of GDP, was invested in 2013. Investments in renewable energy have already started reducing the country's dependence on oil imports, and for the first time in 20 years, Uruguay did not need to import electric energy in 2014. At the same time, 49% of 2013's energy came from renewable sources (hydraulic, wind power, and biomass)--close to the 50% objective for 2015. According to the Ministry of Industry, Energy and Mining, in 2016 Uruguay will have 90% of renewable energy by increasing participation of wind power, biomass, and liquefied natural gas (LNG). At that point, the ministry projects to have energy independence even in drought years and export capacity in rainy years.

FDI will continue to be an important external financing source

Average FDI has accounted for 5.7% of GDP on average for the past decade, significantly increasing from the decade before. FDI reached US$2.7 billion in 2014, or 4.8% of GDP. This is slightly down from US$3 billion in 2013, partly because of lower real estate investments. For 2015, we are expecting FDI to reach about US$2.8 billion and to be mainly focused on infrastructure and energy. According to 2013 official data, FDI came mainly from Argentina (22%), followed by China (16%), Chile (10%), and Brazil (8%). FDI from Mercosur decreased to US$245 million in 2013 and was covered by increases from countries such as France and the Netherlands.

The bulk of the FDI in the last decade consists of new flows, not re-invested earnings of existing foreign enterprises.Just less than 20% of the flows have gone to primary and extractives, about 60% to manufacturing, and the remaining 15% to services. Substantial FDI from Argentina has helped transform the productivity of Uruguayan agriculture, introducing new technology and management practices that have boosted output and land prices. FDI inflows from Argentina declined in 2014 and may also decline in 2015. However, such potential declines should be offset by increasing FDI in the oil and gas sector, as well as in various energy projects. Offshore oil exploration has picked up after two recent rounds of bidding for exploration. A new round of bidding for oil exploration, scheduled in 2015, is projected to attract $1.5 billion in FDI. Some firms have begun seismic exploration for oil onshore. Recently, in May 2015, the Australian company Petrel Energy--holding 51% of Schuepbach Energy--confirmed the certification of prospective resources in Salto and Piedra Sola (Tacuarembó and Durazno, and Salto and Paysandú). The areas would have 62% of oil and 38% of gas. Schuepbach Energy Uruguay will do four explorations between 2015 and 2017. Oil company Total is projecting to begin with perforation over the maritime platform beginning January 2016.

The weaker Brazilian economy's impact on Uruguay

Uruguay's economic and financial links to Brazil have lessened during the past decade but remain relevant.During the past decade, exports to Brazil accounted for 20% of Uruguay exports on average. During 2014, exports to Brazil were 18% of Uruguay's exports (reached US$1.6 billion), and exports to Argentina accounted for 4%. Still, there are some specific sectors with high exposures to Brazil. For instance, the plastic sector sold 78% of exports to Brazil, and automobiles (79%), malt (70%), rubber (77%), chemical substances (67%), and auto parts (41%) all have a high dependence on Brazil. Exports with at least 50% of dependence on the Brazilian market accounted for US$842 million of US$10.4 billion total exports in 2014.

There are some sectors that could more easily reallocate part of the lower expected demand from Brazil, such as the plastic sector, which exports to more than 60 different countries. On the other hand, the automobile and auto parts sectors will suffer the most because almost 99% and 77%, respectively, of their exports go to Brazil and Argentina, under a favorable regime within Mercosur. These two sectors are already suffering, as seen by the recent closing of automobile company Cheryl-Socma.

In terms of FDI, Brazil has the second-highest portion of total FDI in Mercosur with 8% of total FDI, after Argentina with 22%. In 2013, FDI coming from Brazil reached US$255 million, accounting for 8.4% of total received FDI. According to Uruguayan central bank estimations, total accumulated FDI stock from Brazil reached US$1.4 billion, or 7.3% of total stock as of 2013. Argentina's stock accounted for 27%. Brazilian FDI is important in the financial sector, which accounts for 49% of Brazilian FDI in the country (mainly through Itau).

In this context, Uruguay is trying to promote an open regionalism within Mercosur via trade agreements outside Mercosur with the European Union and other regions. Still, Uruguay would need support from other Mercosur members.

Approximately 75% of exports are products, while services have been gaining importance and account for 25% of total exports. Within the 25% of services exports, 40% are related to tourism mainly from Argentina (60%) and Brazil (20%). About 40% of export services go to the U.S.

Fiscal Analysis: Manageable Fiscal Deficits And An Improved Debt Profile

- Public deficit widened to 3.5% of GDP in 2014 in an election year, and we expect only gradual improvements in the fiscal.
- We project that net general government debt (Standard & Poor's includes liquid government assets in this calculation but excludes the central bank's foreign exchange reserves) will reach 56% to GDP in 2015 and decline modestly in the next three years.
- The central government faces the amortization of US$1 billion, equivalent to 2% of GDP in 2015. As of March 2015, central government liquid assets covered 2.7x amortization payments due in one year.

Fiscal performance

We expect only gradual improvements in the fiscal results given Uruguay's relatively high, rigid spending and limited flexibility to increase revenues. We are expecting a 2.8% fiscal deficit for 2015 that could improve thereafter should the government follow the announced plan to cut some public companies' nonpriority investment expenses and limit real salaries increases. A set of investment projects from state companies are coming to an end (such as Antel's fiber optic network), which will help stabilize overall expenses. The government will foster alternative financing sources for part of its investment plans through PPPs and concessions. Management of administered prices could generate an extraordinary income resource because despite lower oil prices, the government has not translated this lower oil price to the domestic market, positively affecting the state owned oil company ANCAP (Administración Nacional de Combustibles Alcohol y Portland) results.

In general, public-sector enterprises do not depend on government financial support. However, the government typically incurs a large expense during years of drought because it has to fund the purchase of expensive oil imports to compensate for lost hydroelectric output. Steps to limit energy vulnerability will also help diminish this risk. We estimate that public-sector enterprises pose a limited level of contingent liability for the sovereign.

Uruguay's contingent liabilities assessment is limited, partly as a result of other depositary corporation assets accounting for more than 66.5% of GDP. About 2.5% of banking assets are to the central government, but it increases to almost 26% when including central bank exposure (most of it is reserves at the central bank and treasury notes).

Debt burden

Despite recent fiscal deficits, general government debt (including central bank debt issued for open market operations) to GDP only increased gradually in 2014 to 56.4%. We project that net general government debt over GDP will slightly increase to 51.6% in 2015 given expected general government deficit at almost 3% of GDP and given expected currency depreciation. Then we expect net general government debt to gradually decline as fiscal deficits diminish and the economy resumes growth. The projections are subject to volatility due to sharp movements in the exchange rate as just less than half the central government's debt is denominated in foreign currency.

On Feb. 23, 2015, Uruguay reopened its global bond due in 2050 and issued US$1.2 billion in the international capital markets. This issuance boosted central government liquid assets to about US$3.9 billion, or 6.1% of GDP. After this issuance, foreign currency debt increased to 51% from 48% in 2014, but at the same time, extended the average time to maturity of the debt to about 15.5 years. Approximately 94% of the debt is at fixed rate. Bonds composed 91% of central government debt, 9% are loans. External market debt accounts for 73% of debt, while local market was 27%. The central government faces US$2.4 billion debt service (US$1 billion in amortizations and US$1.3 billion in interest) in 2015, equivalent to 4.5% of GDP and slightly declining in 2016.

Effective debt management has significantly reduced the risks from a sudden disruption in external markets, or a spike in the exchange rate or interest rate. The government has undertaken countercyclical liability management operations to improve the profile of sovereign debt, as well as to build reserves that provide cushion against external shocks. Over the past few years, Uruguay made important efforts to de-dollarize its debt even when issuing in U.S. dollars would have implied a lower cost. Also, it gradually changed the debt amortization profile to longer-term, minimizing the risk of heavy debt service in the short term. At the same time, Uruguay is working on diversifying sources of funding while broadening the investor base.

The government has continued with its pre-financing policy to cover debt services payment for the following 12 months. The strategy of pre-funding future amortization payments and of holding substantial levels of liquid assets provides insulation against Uruguay's external vulnerabilities but also imposes a fiscal cost.

Central bank debt, much of it issued for open market operations, reached 16.5% of GDP in 2014 (all in local currency). The central bank could be in a position to pay down a substantial share of debt as it matures if the exchange rate depreciates or remains weak, accommodating an outflow of foreign exchange reserves as foreign investors repatriate their investments.

Total pension fund assets are just below 20% of GDP, providing a growing source of funding for the sovereign in case external markets are closed in the future. Most of the funds (about 80%) are invested in public debt. The government and central bank are working on a plan to set up an investment fund for retail investors who could directly purchase central bank debt, widening the range of potential buyers.

Monetary Policy Analysis: High Dollarization Limits Monetary Flexibility

- The effective coordination of contractive fiscal and monetary policy could help reduce inflation in the next two years within the target range of the central bank.
- Working on inflation expectations and salary negotiations will be key to sustain a low level of inflation in the next

few years.

- High reserve levels provide flexibility to adjust the exchange rate. Given the recent depreciation for its main trade partners, Uruguay could slightly depreciate its currency to avoid an appreciation of the real exchange rate.
- A high level of dollarization and indexation to inflation limit the effectiveness of monetary flexibility.

A low level of domestic credit together with a high level of dollarization and indexation to inflation limit the effectiveness of the transmission mechanism of monetary flexibility. A persistently high inflation rate is the main macroeconomic weakness in Uruguay. Inflation ended 2014 at 7.8%, slightly down from the 8.3% in 2013 but above the target range set by the central bank. In March 2015, inflation was 0.7%, implying an annualized inflation of 7.6%. The government has announced lowering inflation as a priority, and a credible plan could drive inflation down gradually to the middle range of the target in a couple of years. Still, this would mean a major challenge for the current government after several years of inflation in exceeding the upper target range. Anchoring expectations through clear communication and credible inflation targets together with both fiscal and monetary contractive policies should help moderate inflation going forward. Avoiding automatic salary indexation to past inflation would also be critical for lessening inflation inertia.

In June 2013, the central bank expanded its inflation range to 3%-7% from 4%-6%, keeping the target at 5%. It also formally changed to using money supply growth instead of short-term interest rates as its primary policy tool. The new monetary policy has arguably become less transparent but perhaps more effective politically. Since the change last year to using money supply growth, the central bank has allowed short-term interest rates on its debt to rise substantially in order to contain inflation. Its inflation rate has typically exceeded the central bank's target, weakening the credibility of its inflation targeting policy.

The high inflation rate of recent times reflects various factors, including recent supply shocks, depreciation of the currency, many years of good GDP growth that has boosted demand, and rising public-sector tariffs. Prices in the nontradable sector of the economy (such as health care, education, rents, and public transport) have risen faster than in the tradable sector. Booming personal income and a tight job market have boosted domestic demand and input costs for producers. Real wages have increased every year since 2005. In addition, a high level of salary indexation with inflation creates substantial inertia, making it harder for the central bank to reduce the inflation rate.

Uruguay no longer has automatic salary adjustments when inflation exceeds 10%, but such an inflation rate could raise political pressure to compensate workers in some manner, thereby potentially reinforcing second round inflation pressures.

In line with most Latin American emerging countries' currencies, after nominally depreciating 13.8% in 2014 to Uruguayan peso (UY) 24.33 per dollar, the Uruguayan peso already depreciated to UY26.8 per dollar as of May 2015--a depreciation of 10.2% since year-end 2014. According to the central bank, the real exchange rate has remained practically unchanged in the first four months of 2015, though it appreciated almost 5% in the past two years. High reserves levels together with lower dollarization in the government's debt give the central bank flexibility to adjust the exchange rate in face of external shocks.

The banking sector holds a net external creditor position; banks invest their excess dollar deposits abroad and must fully match their dollar liabilities with dollar assets. However, the still-significant 16% share of nonresident deposits is one of the system's main weaknesses. The sector's creditor position is the result of large holdings in investments abroad. In the past 10 years, credit demand has grown, but the loans-to-deposits ratio remains low because FDI has mostly covered large investment projects' credit needs. Banks have developed a business model in which they maintain high levels of liquidity in investments abroad.

Real-estate prices have grown steadily in the past decade due to sustained economic growth, rising income levels, and FDI, rather than because of risky mortgage lending. Although private-sector leverage is low and income and household debt capacity have improved in recent years, the system's high exposure to foreign-currency lending to unhedged borrowers significantly increases credit risk, especially if the Uruguayan peso depreciates. Domestic credit to the private sector grew 18% in nominal terms in 2014 and has averaged 19% in the past four years. Still, private-sector debt remains low, at 28% of GDP. Low private-sector debt and the stable and still-moderate proportion of residential mortgages in the system underscore the low likelihood of asset-bubble imbalances despite a sharp growth in real housing prices in the past few years. We expect private-sector credit to grow 14%-16% in nominal terms in 2015 and 2016, and the sector's debt will probably reach 30% of GDP by 2016. The continued rise in real-estate prices will be slower than in the past few years, which eliminates the risk of a credit asset bubble in the next three years. We expect a minor increase in nonperforming loans (NPLs) due to a likely further peso depreciation in 2015--which could have some impact on foreign-currency loans' credit quality--low commodity prices, and the economic slowdown. However, credit losses will remain only about 1% and in line with those of regional banking systems.

Although dollarization is less of a concern in the central government debt structure because the government has made important efforts to de-dollarize debt stock, relatively high dollarization levels in the financial system is still a concern and remains a weakness. Deposits denominated in dollars are high, at almost 80%, while credits in dollars reached 50% as of year-end 2014. The banking sector's exposure to unhedged borrowers is high at about 30% of total private-sector credit. The relative modest size of the financial sector, together with a highly liquid financial system, somewhat moderates the risks. Still, bringing dollarization down should be a priority to reduce external vulnerabilities. Credits to families are 95% denominated in local currency. Overall household consumption is almost 90% financed by income, while the remaining 10% is financed by credits from banking and nonbanking institutions.

Exposure to nonresident deposits has dropped significantly, to about 16% in 2014 from about 45% in 2002, but it still poses risks because these deposits tend to be more volatile. The share of foreign-currency deposits in banks' deposit bases approaches a whopping 80%, while 87% of deposits are on demand. Credit to nonresidents is tiny, less than 2% of total lending. Unlike in 2002, Uruguayan banks have next to no credit extended to Argentine residents, reducing their risks in the event of a sharp deterioration in that country.

The overall financial system has remained healthy in the past few years, with NPLs accounting for a low 2% of total loans and provisions accounting for 5% of total credits. Credit quality in the banking system has remained healthy. For the next two years, we expect NPLs to increase slightly as the peso continues to depreciate, a slower economy weakens household's payment capacity, and low commodity prices may take a toll on some economic sectors. The Uruguayan banking system's NPLs should remain low, at 1.8%-2.2%, and in line with the region's other banking systems.

Uruguay's financial system has become less vulnerable to external shocks than in the past but is still relatively small. State-owned Banco de la Republica Oriental Uruguay (BROU) plays a predominant role in the financial system, accounting for nearly half of bank system assets while the larger private-sector banks are foreign-owned. The banks are generally well-capitalized and bank supervision has improved in recent years as the country implements Basel II standards. The country's debt markets are generally weak, dominated by government and central bank paper, and stock market is very small. The corporate bond market is also small, and there is little secondary trading of financial instruments.

Local Currency Rating, T&C Assessment

Our local currency rating on Uruguay remains at the same level as the foreign currency rating because dollarization continues to restrict monetary flexibility and domestic capital markets remain modest in capacity.

The two-notch gap between the transfer and convertibility (T&C) assessment and the foreign currency rating reflects Standard & Poor's view that the likelihood of the sovereign restricting access to the foreign exchange Uruguay-based nonsovereign issuers need for debt service is moderately lower than the likelihood of the sovereign defaulting on its foreign currency obligations. The foreign exchange regime in Uruguay remains fairly open. Uruguay's outward-oriented economic policies suggest a lower likelihood than more interventionist sovereigns that it would resort to such restrictions in a severe downside scenario.

Table 2

Uruguay (Oriental Republic of)

	2008	2009	2010	2011	2012	2013	2014	2015f	2016f	2017f	2018f
Economic Indicators											
Nominal GDP (bil. LC)	636.15	714.52	808.08	926.36	1,043.64	1,178.20	1,335.98	1,476.19	1,623.75	1,789.53	1,972.56
Nominal GDP (bil. US$)	30.37	31.66	40.28	47.96	51.38	57.52	57.47	56.42	56.77	60.46	65.21
GDP per capita (US$)	9,108	9,465	12,000	14,236	15,198	16,959	16,883	16,515	16,567	17,580	18,901
Real GDP growth (%)	7.2	4.2	7.8	5.2	3.3	5.1	3.5	2.5	2.8	3.0	3.5
Real GDP per capita growth (%)	6.9	3.9	7.4	4.8	3.0	4.8	3.1	2.1	2.5	2.6	3.2
Real investment growth (%)	19.3	(5.8)	16.0	7.0	18.5	4.3	2.6	2.5	2.8	3.0	3.5
Gross domestic investment/GDP (%)	20.6	18.7	19.1	19.1	22.2	21.8	21.4	21.4	21.4	21.4	21.4
Gross domestic savings/GDP (%)	14.9	17.5	17.3	16.3	16.9	16.8	16.8	17.0	17.2	17.3	17.5
Real exports growth (%)	8.5	4.5	7.2	5.8	3.1	0.2	1.9	2.5	2.8	3.0	3.5
Unemployment rate (average %)	8.0	7.7	7.2	6.3	6.5	6.5	6.6	6.5	6.5	6.5	6.5
External Indicators											
Narrow net external debt/CARs (%)	26.4	13.5	(3.7)	(11.6)	(13.4)	(21.5)	(24.3)	(23.5)	(22.9)	(23.4)	(20.3)
Gross external financing needs/CARs plus usable reserves (%)	136.9	124.3	108.4	106.1	99.9	97.3	95.2	97.4	97.1	96.8	98.1
Net external liabilities/CARs (%)	18.3	20.3	18.7	32.0	37.0	40.8	57.8	78.6	90.1	99.7	94.1
Current account balance/GDP (%)	(5.7)	(1.2)	(1.8)	(2.9)	(5.2)	(5.1)	(4.6)	(4.4)	(4.1)	(4.0)	(3.8)
Current account balance/CARs (%)	(16.8)	(4.1)	(6.4)	(10.1)	(19.3)	(20.7)	(18.7)	(17.7)	(15.5)	(14.9)	(14.2)
Trade balance/GDP (%)	(5.6)	(1.6)	(1.3)	(3.0)	(4.6)	(2.4)	(1.6)	(1.4)	(1.0)	(0.9)	(0.8)
Share of external liability owed to official sector (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Nonresident deposits/FI external liabilities (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net FDI/GDP (%)	7.0	4.8	5.8	5.2	4.9	5.3	4.8	4.9	5.0	4.9	4.6
Net portfolio equity inflow/GDP (%)	(0.0)	(0.1)	(0.0)	0.0	(0.0)	(0.0)	0.0	0.1	0.1	0.2	0.1
Short-term external debt by remaining maturity/CARs (%)	44.7	54.8	49.0	40.7	34.1	39.1	45.4	47.6	42.3	37.8	35.4

Table 2

Uruguay (Oriental Republic of) (cont.)											
Reserves/CAPs (months)	1.8	3.2	4.9	4.6	5.4	6.4	7.3	7.1	6.5	6.0	5.5
Fiscal Indicators											
Change in general government debt/GDP (%)	8.2	1.8	3.9	5.1	5.7	8.9	7.1	6.5	3.5	2.7	2.2
General government balance/GDP (%)	(0.8)	(1.2)	(1.3)	(0.7)	(2.0)	(1.8)	(3.0)	(2.7)	(2.3)	(2.0)	(1.8)
General government primary balance/GDP (%)	2.1	1.6	1.6	2.1	0.5	0.9	(0.2)	0.2	0.5	0.8	1.0
General government revenue/GDP (%)	35.4	35.8	36.6	36.8	36.5	38.0	37.3	37.5	37.9	38.1	38.4
General government expenditures/GDP (%)	36.2	37.0	37.9	37.5	38.6	39.8	40.4	40.2	40.2	40.1	40.2
General government interest expenditure/revenues (%)	8.3	7.8	8.1	7.7	6.9	7.1	7.6	7.5	7.5	7.4	7.3
General government debt/GDP (%)	63.5	58.3	55.4	53.5	53.1	56.0	56.4	57.6	55.8	53.3	50.6
Net general government debt/GDP (%)	52.1	48.7	49.0	45.3	45.3	49.5	48.7	51.6	50.0	48.0	45.7
General government liquid assets/GDP (%)	11.4	9.7	6.4	8.2	7.8	6.4	7.7	6.0	5.8	5.4	5.0
Monetary Indicators											
CPI growth (%)	7.9	7.1	6.9	8.6	7.5	8.5	8.3	7.8	7.0	7.0	6.5
GDP deflator growth (%)	8.0	7.7	4.9	9.0	9.0	7.4	9.6	7.8	7.0	7.0	6.5
Other dc claims on resident nongovernment sector growth (%)	36.3	(15.8)	20.7	18.8	15.0	24.9	18.0	14.6	13.7	13.8	13.8
Other dc claims on resident nongovernment sector/GDP (%)	28.6	21.4	22.9	23.7	24.2	26.8	27.8	28.9	29.9	30.8	31.8
Foreign currency share of claims by other dc on residents (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Foreign currency share of deposits in other dc (%)	108.8	102.5	95.3	86.0	86.4	93.1	92.2	92.2	92.2	92.2	92.2
Local currency nongovernment debt market capitalization/GDP (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

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. Other depository corporations (dc) are financial 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. CARs--Current account receipts. CAPs--Current account payments. FI--Financial Institutions. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. f--Forecast.

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

Related Research

- Research Update: Oriental Republic of Uruguay Ratings Raised To 'BBB/A-2' On Greater External Resilience; Outlook Stable, June 5, 2015
- Global Sovereign Debt Report 2015: Borrowing To Drop By 5.7% To US$6.7 Trillion, March 5, 2015
- Sovereign Defaults And Rating Transition Data, 2013 Update, Sept. 17, 2014
- Oriental Republic of Uruguay, Aug. 1, 2014
- Sovereign Risk Indicators, found at spratings.com/sri

Ratings Detail (As Of July 29, 2015)	
Uruguay (Oriental Republic of)	
Sovereign Credit Rating	BBB/Stable/A-2
Transfer & Convertibility Assessment	A-
Senior Unsecured	BBB
Short-Term Debt	A-2
Sovereign Credit Ratings History	
05-Jun-2015	BBB/Stable/A-2
03-Apr-2012	BBB-/Stable/A-3
25-Jul-2011	BB+/Stable/B
06-Sep-2010	BB/Stable/B

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.