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DBRS Confirms Uruguay at BBB (low), Stable Trend

Industry: Public Finance--Sovereigns

DBRS, Inc. has confirmed the Oriental Republic of Uruguay's long-term foreign and local currency issuer ratings at BBB (low) and the short-term foreign and local currency issuer ratings at R-2 (middle). The trend on all ratings is Stable.

Factors underpinning Uruguay's ratings include strong public institutions, conservative debt management, and ample external buffers. Counterbalancing these strengths are limited fiscal flexibility, above target inflation expectations, and exposure to external developments.

The confirmation of the ratings reflects DBRS's view that Uruguay has weathered well the recessions in Brazil and Argentina. The economy expanded 1.5% in 2016, supported by a broad-based acceleration in the fourth quarter. Although negative spillovers stemming from uncertainty in Brazil and tighter fiscal policy domestically could act as headwinds, Uruguay is expected to sustain a gradual recovery amid favorable terms of trade and strengthening demand from Argentina. The IMF projects GDP growth of 1.6% in 2017 and 2.6% in 2018. Moreover, negotiations are well-advanced regarding a potentially large investment in the pulp and paper sector, which could materially strengthen Uruguay's growth prospects.

A fundamental strength of Uruguay's credit profile is its strong public institutions. Uruguay is a stable liberal democracy with an effective government and low levels of corruption. The basic pillars of macroeconomic policy enjoy broad support across the political spectrum. With political stability and a predictable policy framework, Uruguay has fostered a favorable environment for economic growth, as evidenced by the elevated levels of foreign direct investment in the country over the last decade.

Conservative public debt management also supports the ratings. Rollover and liquidity risk is minimal. The average maturity of central government debt reached 14 years in March 2017. In the event of market turbulence, Uruguay has substantial funding flexibility. Treasury cash and precautionary credit lines with multilateral organizations total \$4.2 billion (7.9% of 2016 GDP), which is well in excess of the \$0.9 billion (1.7% of GDP) in redemptions over the next 12 months.

Sound external accounts and large liquidity buffers further bolster the economy's defenses to

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potential shocks. The current account deficit is small and net inflows of foreign direct investment provide a stable source of external financing. Exchange rate flexibility has helped the economy adjust to evolving global conditions without generating excessive stress in the banking system or the corporate sector. Furthermore, reserves are high and sufficient to provide liquidity in the event of an external shock.

The key challenge facing the sovereign credit profile is the fiscal deficit. The public sector deficit increased to 3.9% of GDP in 2016, up from 0.9% in 2011. The principal cause of this deterioration is rising current spending. In response, the Vázquez administration is implementing a gradual consolidation plan to narrow the deficit to 2.5% by 2019. Tax increases and spending cuts totaling 0.9% of GDP were incorporated into the 2017 budget and the cyclical recovery will provide further support. However, the strategy faces several challenges. First, reversing the upward trajectory in current spending could be difficult given the constitutional and legal protections for pensions and healthcare. Second, an over-reliance on public investment cuts could weaken medium-term growth prospects. Third, additional deficit-reduction measures will likely be needed even after 2019 in order to place public dynamics of a firm downward trajectory and rebuild fiscal space.

Durably anchoring inflation expectations around the target is another policy challenge. Inflation has been trending downwards for the last 12 months. In March 2017, inflation fell below the upper limit of the central bank's target range for the first time in over six years. The disinflationary process has been driven by peso appreciation, which has reduced price pressures on tradeable goods and services. However, disinflation in the non-tradeable sector has been slower to materialize, and inflation expectations over the next 12 months are still above the target range. The challenge of anchoring expectations is complicated by the weak transmission of monetary policy amid high levels of financial dollarization and low financial intermediation.

As a small and open economy, Uruguay is highly exposed to shifts in global commodity prices and the economic cycles of its large neighbors. Slower-than-expected recoveries in Brazil or Argentina could negatively affect Uruguay through the trade channel, specifically weaker demand for goods exports and tourism services. Outside of the region, a sharp deceleration in China could affect Uruguay's outlook directly through the terms of trade channel, as well as indirectly through the trade channel, as demand could weaken from Uruguay's commodity-exporting neighbors.

RATING DRIVERS

The Stable trends reflect DBRS's view that risks to the outlook are broadly balanced. Uruguay's credit profile would benefit from greater fiscal space and counter-cyclical capacity. A durable consolidation in the fiscal accounts that place public debt ratios on a firm downward trajectory could

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put upward pressure on the ratings. On the other hand, the ratings could experience downward pressure if budget dynamics further deteriorate or external buffers erode, thereby weakening Uruguay's resilience to adverse shocks.

Notes:

All figures are in U.S. dollars unless otherwise noted.

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The sources of information used for this rating include the Ministerio de Economía y Finanzas, Banco Central del Uruguay, Instituto Nacional de Estadística, IMF, World Bank, NREGI, Brookings, Transparency International, The Conference Board Total Economy Database, UNDP, and Haver Analytics. DBRS considers the information available to it for the purposes of providing this rating was of satisfactory quality.

The rated entity or its related entities did participate in the rating process. DBRS did not have access to the accounts and other relevant internal documents of the rated entity or its related entities.

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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.

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Rating Committee Chair: Thomas R. Torgerson, Senior Vice President, Global Sovereign Ratings

Initial Rating Date: 28 February 2008

Last Rating Date: 27 May 2016

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

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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 26, 2017
Uruguay, Oriental Republic of	Long-Term Local Currency - Issuer Rating	Confirmed	BBB (low)	Stb	May 26, 2017
Uruguay, Oriental Republic of	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	May 26, 2017
Uruguay, Oriental Republic of	Short-Term Local Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	May 26, 2017

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