MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes outlook on Uruguay's Baa2 rating to stable from negative; rating affirmed

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New York, July 13, 2017 -- Moody's Investors Service has today affirmed the government of Uruguay's Baa2 issuer and government bond ratings and raised the outlook to stable from negative. The government's senior unsecured government bond ratings were affirmed at Baa2, as was the senior unsecured shelf program rating at (P)Baa2.

RATINGS RATIONALE

Two key drivers underpin the change in outlook to stable from negative:

1) The government's strong commitment to fiscal consolidation as demonstrated in policy measures that are likely to stabilize government debt metrics;

2) An improving macroeconomic performance that will support the ongoing fiscal consolidation process.

The affirmation of the Baa2 rating reflects a balance of credit strengths and weaknesses including moderate government financing needs and a favorable debt maturity profile, large external and financial buffers, a strong institutional framework and a firm commitment to arrest the deterioration in debt metrics. The rating also incorporates credit challenges which include structural rigidities in the government's expenditure composition, a relatively high share of foreign currency-denominated government debt, a high degree of financial dollarization in the banking system, and a more moderate growth outlook compared to the 2004-13 period.

Uruguay's long-term local currency country risk ceilings remain unchanged at A2. The foreign currency bond ceiling and the foreign currency bank deposit ceiling also remain unchanged at A2/P-2 and Baa2/P-2, respectively.

RATIONALE FOR THE CHANGE TO STABLE OUTLOOK

-- FIRST DRIVER: MEASURES ANNOUNCED DEMONSTRATE AUTHORITIES' COMMITMENT TO FISCAL CONSLIDATION AND WILL SUPPORT THE STABILIZATION OF DEBT METRICS

The first factor driving Moody's decision to change the outlook to stable from negative are the measures undertaken and announced by the government that will contribute to the reduction of fiscal deficits and likely ensure the stabilization of debt metrics. The negative outlook on the rating, placed in June 2016, was driven in part by the likelihood that the consolidated central government deficit, which had widened to 2.8% of GDP in 2015 from 2.3% in 2014, would widen further. This, combined with a sharp depreciation of the exchange rate, would add to the government's debt burden. Indeed, in 2016, the fiscal deficit widened to 3.7% of GDP. However, authorities have demonstrated their capacity and willingness to arrest this deterioration in the fiscal profile, and our expectation is that their fiscal measures will stabilize government debt ratios.

In 2016, as part of the budget review process, the government announced a series of measures that sought to increase revenues and restrain growth of discretionary spending in 2017 in order to reduce the fiscal deficit. Through May 2017, these measures have supported a reduction in the deficit as revenues grew 13.6% y/y in nominal terms, compared to an expansion in expenditures of 8.7% y/y. As a result, the fiscal deficit in the first five months of the year fell to UYU2.7 billion from UYU10.8 billion during the same period in 2016. We expect the full year deficit to fall closer to 3.2% of GDP in 2017.

Despite an improving macroeconomic environment since the second half of 2016, authorities have maintained a conservative approach to fiscal policy for 2018. While stronger economic growth will likely support higher revenues, the government is proposing limiting the expansion of discretionary spending in next year's budget. Additional expenditures in the education sector, the only discretionary item that is budgeted to see a significant increase in 2018, will be financed by revenue proposals, making the impact of this higher spending deficit-neutral. The government has also announced its intention to address the medium-term challenges of payroll- and pension-related spending.

The government's debt-to-GDP ratio peaked at 47.4% of GDP in 2015, up from 39.3% in 2014. In 2016, despite the wider fiscal deficit, currency appreciation and relative faster economic growth than the previous year led the ratio to fall to 47.1%. The government is currently targeting a public sector deficit of 2.5% of GDP by 2019. Moody's baseline currently assumes that the government will be able to reduce the deficit to levels close to this target. Moreover, this deficit reduction combined with economic growth close to potential and a moderate rate of exchange rate depreciation beginning in 2018, Moody's forecasts that the government's debt-to-GDP will stabilize around 46% in 2017-19, compared with the Baa-median of 45%. Meanwhile, after rising from 8.5% in 2015, Moody's expects Uruguay's interest-to-revenues ratios will stabilize over the coming years at around 10%, compared with the Baa-category median of 8%.

-- SECOND DRIVER: IMPROVING MACROECONOMIC PERFORMANCE WILL SUPPORT FISCAL CONSLIDATION PROCESS

The second driver of the outlook change is the improving macroeconomic performance in Uruguay, which will support the government's deficit reduction efforts. Uruguay's economic performance in 2016 exceeded Moody's original expectations as real GDP growth was 1.5% compared to our 0.0-0.5% range estimate. While still below potential, which Moody's estimates at about 3%, last year's growth was driven by both improving domestic demand and, more recently, stronger external demand. Moody's also notes that Uruguay's performance has shown greater resilience than in the past to external shocks stemming from neighbors and key trading partners Argentina and Brazil, both of which experienced recessions last year. Moody's now forecasts growth of about 3.3% in 2017, compared to 1.9% previously, and for output expansion to remain around 3% in 2018-19. Stronger economic growth will support fiscal consolidation via higher government revenues. Additionally, ongoing discussions about a potential large-scale pulp mill project presents an upside for growth starting in 2019.

Meanwhile, inflation dynamics have also been more favorable over the past year. Inflation peaked at 11% in May 2016 and has since fallen to 5.3% as of June 2017. This marked the fourth consecutive month that inflation came within the monetary authorities' inflation targeting band of 3-7%, with inflation exceeding the target since December 2010. Historically, inflation has been an important factor in fiscal dynamics because it determined growth in wages and pensions, which together represent almost half of government spending. Pension payments are linked to average wage growth in the country and wage-setting negotiations in the private and public sectors previously used past inflation to determine salary increases. Authorities have sought to de-link wages from past inflation by setting new guidelines for salary negotiations based on forward looking nominal increases to reflect gains in productivity by economic sectors. Should inflation remain at moderate levels in future years, Moody's expects that wage growth will be lower than in the past, likely better reflecting productivity growth in the country. This in turn would reduce the rate at which an important portion of public expenditures currently expands, thus providing some additional fiscal space over the medium term.

More moderate and stable inflation in the country would also support the development of a domestic financial market that allows the government to increasingly finance itself in local currency. Access to local currency financing would address a key credit challenge: the large share of debt denominated in foreign currency, which was 55% in 2016, that leaves government finances vulnerable to exchange rate depreciation.

AFFIRMATION OF Baa2 RATING SUPPORTED BY STRONG INSTITUTIONAL FRAMEWORK, FINANCIAL BUFFERS

While Uruguay's debt metrics have deteriorated in recent years, the sovereign's creditworthiness is supported by factors such as its fiscal buffers and favorable maturity profile that mitigate the potential financing risks of a moderate debt burden of about 47% of GDP for the central government. The government's liquid fiscal assets were 3.2% of GDP as March 2017 and as part of its liability management, Uruguay's government aims to hold liquid assets worth at least 12 months of debt service. In addition, the government also has contingent credit lines with multilateral development banks that would allow it to have an additional 12 months of debt service coverage. Uruguay's government also has a very long debt maturity profile, which helps mitigate rollover risk. The government's external debt has an average maturity of almost 15 years, while that of domestic debt is closer to 10 years. Given Uruguay's extended debt maturity, the government faces modest refinancing requirements over the medium term given yearly principal payments of 2% of GDP on average over the next five years.

Uruguay's high institutional strength is also an important factor supporting its Baa2 rating. This feature of its credit profile has allowed Uruguay to become an attractive destination for foreign investment and has also supported the government's willingness and ability to implement a fiscal consolidation program.

At the same time, Uruguay's Baa2 rating incorporates the weaknesses within its credit profile. Among the credit challenges is the rigidity in the government's expenditure composition due to constitutional arrangements that set the growth rate of spending items such as pensions and other social expenditures, thus limiting the ability of the government to adjust their growth rate as part of its fiscal management. While the changes made to wage negotiation guidelines will contribute to lower some fiscal pressures, Moody's notes that over the medium term these expenditure items, particularly pensions, may lead to a deterioration of the government's structural balance if left unaddressed.

Another vulnerability of Uruguay's credit profile is the share of government debt that is denominated in dollars. After falling from 90% over a decade ago, this ratio has remained close to 50% since 2010. At this level, Uruguay's debt metrics are exposed to exchange rate volatility to a higher degree than most of its Baa-rated peers.

Moody's also notes that the Baa2 rating considers Uruguay's more moderate growth outlook over the coming years, particularly compared to the high growth recorded in 2004-13, when GDP expanded on average 5.6%. This strong economic performance supported the decline in the government's debt ratios. More recently, the growth slowdown has presented fiscal challenges, including lower than expected revenue growth. However, growth closer to 3% in 2017-19 will help stabilize debt ratios.

WHAT COULD CHANGE THE RATING - UP

Upward rating pressure could result from (1) a significant strengthening of the government balance sheet through a reduction of the sovereign's debt and interest burden, (2) a reduction in vulnerability through a significant decrease in the share of foreign currency government debt and (3) a reduction structural rigidities in the economy such that potential growth increased.

WHAT COULD CHANGE THE RATING - DOWN

Downward rating pressure could result from (1) fiscal measures or outcomes falling significantly short of achieving the authorities' fiscal targets, leading to a continued increase in debt ratios and a deteriorating medium term fiscal profile, (2) a weakening in institutional strength and policy responsiveness, particularly to any renewed fiscal challenges or (3) a sustained and material erosion of external and financial buffers.

GDP per capita (PPP basis, US$): 21,527 (2016 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 1.5% (2016 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 8.1% (2016 Actual)

Gen. Gov. Financial Balance/GDP: -3.7% (2016 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -0.1% (2016 Actual) (also known as External Balance)

External debt/GDP: 49.9% (2016 Actual)

Level of economic development: High level of economic resilience

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 12 July 2017, a rating committee was called to discuss the rating of the Uruguay, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially increased. The issuer's institutional strength/framework, have materially increased. The issuer's fiscal or financial strength, including its debt profile, has materially increased.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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