Jan 25, 2019

R&I Affirms BBB, Stable: Oriental Republic of Uruguay

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

ISSUER: **Oriental Republic of Uruguay**

Foreign Currency Issuer Rating: BBB, Affirmed
Rating Outlook: Stable

RATIONALE:

Uruguay is a socially stable country with a high income level. While the country has a traditional worker protection culture like other South American countries, it ranks among the best in Latin America for democracy, lack of corruption, adherence to the rule of law, etc., which makes it stand out among other member countries of Mercosur. Economic growth is softening, but the medium-term prospects for the economy are not bad. Although the current account is expected to turn into deficit, the deficit is unlikely to be a significant destabilizing factor. While fiscal deficits continue to narrow gradually, fiscal risk is kept in check under prudent debt management policy. Inflation pressure stemming from the depreciation of its currency is a cause for concern. Even so, stable economic and fiscal management would basically be maintained. Accordingly, R&I has affirmed the Foreign Currency Issuer Rating at BBB.

The pace of economic growth is slowing due in part to the depreciation of the currencies of South American countries including its own and economic turmoil in neighboring Argentina. On the other hand, a new project by UPM-Kymmene Corp., a major paper manufacturer in Finland, to construct its second mill in Uruguay will bring along public investments in related infrastructures such as railways and port facilities and drive medium-term economic growth. The focal point will be on whether the government is able to help return the growth rate to the potential level of around 3% by carrying out such an epoch-making investment project steadily through utilization of private capital.

Although its current account has been in surplus in recent years, Uruguay is yet to become structurally a current account surplus country. Once the above-mentioned infrastructure investment starts in earnest, an increase in imports of capital and intermediate goods is envisaged. Needless to mention, exchange rates and terms of trade also will matter a great deal. Even if the current account moves back into deficit, however, R&I does not believe that the deficit will become a significant destabilizing factor, as long as it is caused mainly by a surge in imports related to foreign direct investments. There is no concern about foreign currency liquidity.

Since 2012, the government had taken a relatively expansionary fiscal stance. The Vazquez administration is focusing on fiscal consolidation, but struggling with spending cuts that are constrained by the provisions of the constitution, among others, partly because of pressure from his left-wing government. While the public sector fiscal deficit is expected to have narrowed in 2018, sustained political efforts are still required. Uruguay's general elections are slated for October 2019. A major focal point in evaluating its future creditworthiness will be whether a new government that takes office in 2020 is able to implement pension reform and other initiatives and thereby rein in structural expenditures.

Uruguay's ratio of outstanding public debt to gross domestic product (GDP) is high relative to those of other Latin American countries or other sovereigns rated in the BBB category, standing at 66% as of end-June 2018. Meanwhile, the outstanding debt, excluding short-term borrowings by the central bank for liquidity management purpose and preliminary borrowings to cover redemptions for the next 12 months, was 42% of GDP. Given this, together with credit lines from multilateral development banks and prudent debt management practices, actual fiscal risk has been mitigated, in R&I's view.

Containing inflation remains a major challenge in the macroeconomic policy realm. Since a sharp fall in the peso in May 2018, Uruguay's consumer price index has been rising above an inflation target ceiling of 7%. The government has already shifted to a new wage-setting system that takes into account economic growth and sector trends to a certain extent and call for wage increases set in nominal terms, from the

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conventional wage-setting system linked to past inflation rates. The new system has acted as a headwind for consumption, as it has led to negative growth in real wages. If such measures are firmly in place and help rein in inflation structurally, however, Uruguay's economic stability would increase.

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.
https://www.r-i.co.jp/en/rating/about/rating_method.html

R&I RATINGS:

ISSUER:	**Oriental Republic of Uruguay**
	Foreign Currency Issuer Rating
RATING:	**BBB, Affirmed**
RATING OUTLOOK:	**Stable**

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