Date of Release: January 29, 2021

DBRS Morningstar Confirms Uruguay at BBB (low), Stable Trend

Industry Group: Public Finance – Sovereigns
Region: Americas

DBRS Inc. (DBRS Morningstar) confirmed the Oriental Republic of Uruguay's Long-Term Foreign and Local Currency – Issuer Ratings at BBB (low). At the same time, DBRS Morningstar confirmed the Short-Term Foreign and Local Currency – Issuer Ratings at R-2 (middle). The trend on all ratings is Stable.

KEY RATING CONSIDERATIONS

The BBB (low) ratings balance Uruguay's strong political and economic fundamentals with its ongoing fiscal pressures. The political environment is characterized by high-quality public institutions, low levels of corruption, and predictable macroeconomic policymaking, all of which constitute an important source of credit strength. Ample foreign exchange reserves, conservative public debt management, and sound regulation of the banking system also bolster the economy's defenses to external shocks. The key challenge facing Uruguay's credit profile is the fiscal deficit. The Stable trend reflects DBRS Morningstar's view that the risks to the ratings are balanced despite the economic and health fallout from the pandemic.

While Uruguay has weathered the COVID-19 shock relatively well compared to regional peers, the negative impact on the economy adds to preexisting challenges. Output declined 7.1% in the first half of 2020 relative to the same period one year ago. Activity rebounded in the third quarter, supported in part by the construction of a large pulp plant in the center of the country. Other high frequency indicators suggest that the recovery continued into the fourth quarter. According to the central bank's January 2021 economic survey, the average projection is for the economy to contract by 5.4% in 2020 and then expand by 3.1% in 2021 and 2.6% in 2022. However, the outlook is still highly uncertain, even in the near term. The pace of the recovery will largely depend on the evolution of the virus, including the severity and duration of the current outbreak in the country, as well as the timing and efficiency of vaccine distribution.

The evolution of the ratings – up or down – will depend on the government's ability to put public finances on a more sustainable trajectory once the pandemic passes. In the absence of budgetary tightening, public debt ratios are expected to increase over the medium term. The Lacalle Pou administration is pursuing a multi-year fiscal consolidation plan, underpinned by reforms to the fiscal framework and the pension system. We view this plan positively, though implementation of the agenda could be politically challenging.

RATING DRIVERS

The ratings could be upgraded in the coming years if the government implements a durable consolidation in the fiscal accounts. The ratings could be downgraded if (1) budget outcomes fail to materially improve in the aftermath of the COVID-19 shock, or if (2) external buffers erode over time, thereby weakening Uruguay's resilience to adverse shocks.

RATING RATIONALE

Fiscal Consolidation Delayed By COVID-19 But Reforms Enhance the Credibility of the Deficit-Reduction Plan

The key challenge for the credit profile is the fiscal deficit. In the 12 months to November 2020, the central government deficit is estimated to have reached 5.5% of GDP (excluding the "Cincuentones" pension transfers). However, fiscal imbalances were increasing even prior to the COVID-19 shock. The underlying source of pressure has been rising current spending: higher education and healthcare costs combined with greater social security expenses. The rigidity of these expenditures complicates deficit-reduction efforts. Yet without budgetary tightening, public debt ratios are expected to increase over the medium term. Given the ongoing risks to the fiscal outlook, we incorporate a negative adjustment to the "Fiscal Management and Policy" building block.

The government has put in place a fiscal strategy to stabilize public finances. In our view, several features of the plan increase the prospects for a successful fiscal adjustment. First, the response to the pandemic has been targeted and temporary. This includes allowing for the full operation of automatic stabilizers as well as some discretionary spending. The discretionary measures have been relatively modest in size. The net cost is estimated at 1.2% of GDP in 2020. Moreover, the government created a COVID-19 Solidarity Fund to demarcate pandemic-related spending from the rest of the budget, which should ensure emergency items do not become permanent.

Second, the Lacalle Pou administration aims to implement a multi-year fiscal adjustment and pass pension reform. The consolidation plan is expenditure-based, with the spending-to-GDP ratio set to decline through 2024. Tight spending control is expected to help narrow the central government deficit to 2.7% of GDP in 2024 (before taking into account the revision to national accounts in December 2020). At the same time, an advisory council was established to propose adjustments to the pension system to ensure financial sustainability. The council is expected to submit its proposal to Congress later this year. Third, reforms to the fiscal framework enhance the credibility of the plan. In particular, the establishment of a structural fiscal rule should foster counter-cyclicality and sustainability over the medium term. A fiscal adjustment, combined with the passage of a reform that stabilizes pension spending, would put public finances on a more sustainable trajectory.

Large Liquidity Buffers Have Helped Uruguay Weather the Shock

The larger fiscal deficit combined with the recession have led to a higher level of government debt. Gross debt for the consolidated public sector increased from 60% of GDP in 2019 to 73% in the third quarter of 2020. However, the debt ratio is expected to stabilize as the economic recovery takes hold in 2021 and the fiscal consolidation advances.

Moreover, Uruguay's credit profile is supported by conservative public debt management. Rollover and liquidity risks are minimal. Liquid assets held by the central government combined with contingent credit lines from multilateral organizations are in excess of debt servicing needs for 2021. Exposure to interest rate risk is also limited due to the long average maturity of government debt (14 years) and the high share of debt that carry fixed rates (96%).

Sound external accounts and large liquidity buffers also bolster the economy's defenses. The current account is in a modest surplus position. Exchange rate flexibility has helped the economy adjust to the shock without generating excessive stress on balance sheets in the private sector. From January to May, the Uruguayan peso depreciated 13% in nominal terms against the U.S. dollar and then stabilized. Reserves are also high at USD 16.3 billion, or 30% of GDP. This provides the central bank with substantial foreign exchange liquidity in the event of turbulence in global financial markets.

Anchoring Inflation Expectations Around the Target is a Policy Challenge

Uruguay's central bank responded to the pandemic by delivering accommodative monetary policy to support the economy and by reducing banks' reserve requirements to boost liquidity. The banking system has weathered the COVID-19 shock relatively well so far, and financial stability risks appear contained.

However, anchoring inflation expectations around the target remains a challenge. Inflation has been above the upper limit of the 3-7% target range for most of the last decade. In December 2020, headline inflation was 9.4% and inflation expectations for yearend 2021 were 7.5%. To better anchor inflation, policymakers have made some changes to the monetary policy framework: reaffirming price stability as the principal objective, changing the main policy instrument from the growth in monetary aggregates to a short-term policy rate, and lowering the upper limit of the target range to 6% starting in September 2022. Moreover, the central bank signaled that monetary policy will shift to a contractionary stance once the COVID-19 crisis passes. However, the challenge of anchoring expectations is complicated by the weak transmission of monetary policy amid high financial dollarization and low financial intermediation.

Post-Pandemic Growth Prospects Look Better Than the Last Five Years

Before the pandemic hit in 2020, the Uruguayan economy was growing at a slow pace. GDP growth averaged just 0.9% from 2015 to 2019. This followed a decade (2005-2014) of rapid growth when the economy expanded 5.4% per year. The slowdown was partly due to lower commodity prices and deep recessions in neighboring Brazil and Argentina, but weak underlying domestic dynamics were also contributing factors. The two most salient features during this period of weak economic growth were rising unemployment and declining investment.

However, we think growth prospects look better in the post-pandemic period. Construction of a large new pulp mill in central Uruguay by Finnish firm UPM, as well as various railway and port facility projects, cushioned the downturn in 2020 and should bolster growth prospects over the medium term. Micro-reforms that promote greater efficiency in the domestic market (i.e. reforms to state-owned utilities) and that foster greater integration in global markets (i.e. potential ratification of the EU-Mercosur free trade agreement) could also have a positive impact on productivity and investment. The IMF expects GDP growth of 2.6% per year from 2022 to 2025.

Volatility in the external environment poses risks to the outlook. The small and open nature of the Uruguayan economy leaves it 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 sharper-than-expected deceleration in China could affect Uruguay's outlook directly through the terms of trade channel, as well as indirectly through weaker demand from Uruguay's commodity-exporting neighbors.

Strong Institutions and Effective Government Underpin the Ratings

Uruguay is a stable liberal democracy with an effective government and low levels of corruption. A centrist electorate facilitates political moderation and pragmatic policymaking. The basic pillars of macroeconomic policy are broadly supported across the political spectrum. The predictability of the policy framework through the electoral cycle fosters a favorable environment for economic growth.

The political landscape following the 2019 general elections creates some space to advance a reform agenda. In addition to Lacalle Pou winning the presidency, center-right parties in Congress - consisting of the Colorado Party, the Cabildo Abierto, the Independent Party, and the People's Party - coalesced around the National Party to form a majority coalition in both houses. The Lacalle Pou administration has proceeded with its reform agenda since entering office, even as it has had to manage the health and economic fallout from the pandemic. In the second half of 2020, the coalition passed the several important laws that underpin its multi-year fiscal and economic agenda.

ESG CONSIDERATIONS

Human Rights and Human Capital (S) were among the key ESG drivers behind this rating action. Uruguay's per capita GDP is relatively low at USD 15,331 in 2020. This factor has been taken into consideration in the "Economic Structure and Performance" building block.

A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework and its methodologies can be found at https://www.dbrsmorningstar.com/research/357792.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments:
https://www.dbrsmorningstar.com/research/372933.

Notes:
For more information regarding rating methodologies and Coronavirus Disease (COVID-19), please see the following DBRS Morningstar press release: https://www.dbrsmorningstar.com/research/357883.

All figures are in U.S. dollars unless otherwise noted. Public finance statistics reported on a general government basis unless specified. The non-financial public sector includes: the central government (including the Social Security public fund), local governments, public enterprises, and the state-owned insurance bank. The consolidated public sector includes the non-financial public sector and the central bank. Metrics in the report calculated with the recently released (December 2020) rebased GDP statistics from the Banco Central del Uruguay, unless indicated otherwise.

The principal methodology is the Global Methodology for Rating Sovereign Governments https://www.dbrsmorningstar.com/research/364527/global-methodology-for-rating-sovereign-governments (July 27, 2020)

Generally, the conditions that lead to the assignment of a Negative or Positive trend are generally resolved within a 12-month period. DBRS Morningstar's outlooks and ratings are monitored.

The primary sources of information used for this rating include the Ministerio de Economía y Finanzas, Banco Central del Uruguay, Instituto Nacional de Estadística, Superintendencia de Servicios Financieros, the IMF, the World Bank, NRGI, Brookings, Bank for International Settlements, UNDP, Transparency International, and Haver Analytics. DBRS Morningstar 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 for this rating action. DBRS Morningstar did not have access to the accounts and other relevant internal documents of the rated entity or its related entities in connection with this rating action.

For more information on this credit or on this industry, visit www.dbrsmorningstar.com.

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Issuer	**Debt Rated**	**Rating Action**	**Rating**	**Trend**
Oriental Republic of Uruguay	Long-Term Foreign Currency – Issuer Rating	Confirmed	BBB (low)	Stable
Oriental Republic of Uruguay	Long-Term Local Currency – Issuer Rating	Confirmed	BBB (low)	Stable
Oriental Republic of Uruguay	Short-Term Foreign Currency – Issuer Rating	Confirmed	R-2 (middle)	Stable
Oriental Republic of Uruguay	Short-Term Local Currency – Issuer Rating	Confirmed	R-2 (middle)	Stable

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Uruguay

Scorecard Indicators

Fiscal Management and Policy	2015	2016	2017	2018	2019	2020	2021	2022	2023	Source	Current Scorecard Input	
Overall Fiscal Balance (% of GDP)	-2.0%	-2.9%	-2.7%	-2.0%	-3.0%	-5.8%	-4.0%	-3.6%	-3.1%	IMF WEO	13 year average	-2.8%
Government Effectiveness (Percentile Rank)	72.6	73.1	68.3	73.1	74.5	-	-	-	-	World Bank	5 year average	72.3
Debt and Liquidity	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
General Government Gross Debt (% of GDP)	63.2%	61.7%	61.0%	63.4%	65.9%	69.5%	69.0%	69.2%	69.4%	IMF WEO	5 year projection	69.5%
Interest Costs (% of GDP)	2.3%	2.6%	2.6%	2.6%	2.5%	2.9%	2.9%	2.9%	2.9%	IMF WEO	5 year average	2.7%
Economic Structure and Performance	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
GDP per Capita (USD thousands)	15.4	15.1	17.0	17.1	16.1	15.3	16.3	17.1	17.9	IMF WEO	10 year average	15.8
Output Volatility (%)	3.7%	3.7%	4.0%	4.0%	3.8%	3.7%	2.7%	-	-	IMF WEO	Latest	3.7%
Economic Size (USD billions)	53	53	60	60	57	54	58	61	64	IMF WEO	5 year average	57
Monetary Policy and Financial Stability	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
Rate of Inflation (%, EOP)	9.4%	8.1%	6.6%	8.0%	8.8%	9.5%	7.5%	6.0%	4.7%	IMF WEO	13 year average	7.8%
Total Domestic Savings (% of GDP)	11%	12%	13%	13%	13%	14%	-	-	-	BCU/IMF	Latest[1]	14%
Change in Domestic Credit (% of GDP)	2.6%	-2.1%	-2.3%	1.3%	0.8%	0.8%	-	-	-	BIS/IMF	7 year average[1]	0.4%
Net Non-Performing Loans (% of Capital)	3.9%	6.9%	5.7%	6.0%	3.6%	-	-	-	-	IMF IFS	Latest[1]	-
Change in Property Price/GDP Index (%)	12.8%	1.9%	-3.6%	-6.2%	5.2%	0.0%	-	-	-	INE/IMF	7 year average[1]	0.0%
Balance of Payments	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
Current Account Balance (% of GDP)	-0.9%	0.6%	0.7%	0.0%	0.6%	-1.7%	-3.3%	-2.4%	-1.4%	IMF WEO	8 year average	-0.9%
International Investment Position (% of GDP)	-31.4%	-29.1%	-28.6%	-27.4%	-31.1%	-31.5%	-	-	-	IMF	5 year average[1]	-29.5%
Share of Global Foreign Exchange Turnover (Ratio)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	-	-	-	BIS/IMF	Latest	0.0%
Exchange Rate Classification (see footnote)	3	3	3	3	3	3	-	-	-	IMF	Latest	3
Political Environment	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**			
Voice and Accountability (Percentile Rank)	85.7	86.7	86.7	89.7	89.7	-	-	-	-	World Bank	5 year average	87.7
Rule of Law (Percentile Rank)	75.0	73.6	72.1	73.1	74.5	-	-	-	-	World Bank	5 year average	73.7

See DBRS Morningstar's Global Methodology for Rating Sovereign Governments for additional details on the methodology behind the scorecard indicators and associated scoring thresholds. Exchange Rate Classifications: Freely floating exchange rate = 1; Float = 2; Crawls, banded pegs, and other managed = 3; Stabilized = 4; Pegs, currency unions and dollarized arrangements = 5.

[1] *Scores for 2020 have been computed using the most recent data when year-end data is not available.*

[2] *GDP figures are taken from the IMF's October 2020 World Economic Outlook, prior to the publication of rebased National Accounts statistics in December 2020.*

Rating Committee Date: 27-Jan-2021

Uruguay

Building Block Assessments and Rating Committee Summary

27-Jan-2021

Building Blocks	Scorecard Result	Quantitative Assessment	Net Impact of Qualitative Factors	Building Block Assessment
Fiscal Management and Policy	14.37	Good	- 2 Categories	Moderate
Debt and Liquidity	10.45	Moderate	N/A	Moderate
Economic Structure and Performance	5.38	Poor	N/A	Poor
Monetary Policy and Financial Stability	12.01	Good/Moderate	N/A	Good/Moderate
Balance of Payments	12.05	Good/Moderate	N/A	Good/Moderate
Political Environment	18.11	Strong	N/A	Strong

Overall Assessment	Composite Scorecard Result	Scorecard Rating Range	Composite Building Block Assessment	Indicative Rating Range
	60.3	A (low) - BBB	57.0	BBB (high) - BBB (low)

Uruguay's Long-Term Foreign Currency - Issuer Rating BBB (low)

Main topics discussed in the Rating Committee include: near-term growth prospects and risks surrounding the fiscal outlook. For additional details on DBRS Morningstar analysis and opinions, please see the accompanying rating report.

DBRS Morningstar Scorecard: Scoring Ranges and Associated Assessment Categories

Lower Bound	0.00	1.00	3.00	5.00	7.00	9.00	11.00	13.00	15.00	17.00	19.00
Upper Bound	0.99	2.99	4.99	6.99	8.99	10.99	12.99	14.99	16.99	18.99	20.00
Assessment Category	Very Weak	Weak	Weak/ Poor	Poor	Poor/ Moderate	Moderate	Good/ Moderate	Good	Strong/ Good	Strong	Very Strong