R&I

NEWS RELEASE

Aug 29, 2014

R&I Upgrades to BBB-, Stable: The Oriental Republic of Uruguay

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

ISSUER: **The Oriental Republic of Uruguay**
Foreign Currency Issuer Rating: BBB-, Previously BB+
Rating Outlook: Stable

RATIONALE:

Since the financial crisis necessitated the rescheduling of public debt in 2003, Uruguay has worked to increase its resilience to changes in the external environment by diversifying trades and strengthening the financial system. While the current economic turmoil in neighboring Argentina will inevitably affect Uruguay's economy, the launch of production at a large paper mill and mining-related infrastructure investment projects will likely underpin economic growth. With its stable business environment favored by investors, foreign investments have been solid, especially in the logistics sector, an area of strength. Although the current account deficit is expected to remain high, there are no major concerns over its external position, given that a considerable amount of foreign reserves have been accumulated.

In consideration of the above-mentioned factors, R&I has upgraded the Foreign Currency Issuer Rating to BBB-. The Rating Outlook is Stable. For stable economic growth, the government needs to be able to hold inflation in check. R&I will pay attention to whether the government is able to control inflationary expectations appropriately by changing monetary policy frameworks and wage setting formulas, among other measures.

In 2013, real gross domestic product (GDP) grew 4.4%, higher than most anticipated. Economic growth for 2014 and 2015 is projected to slow down to around 3.0-3.5%. Growth in real wages has fallen because of the rising inflation rate, and the unemployment rate has turned upward; both could be a drag on private consumption. The Central Bank of Uruguay (BCU) is tightening the growth of money supply to cool down the inflation. R&I will closely follow the developments, including the effects of Argentina's fresh economic malaise.

The fiscal stance is slightly expansionary. The public sector fiscal deficit forecast for 2014 and 2015 has been revised upward by 1.0 ppt from the previous one to 3.3% and 3.2% of GDP, respectively. It will be the first time since 2002 that the fiscal deficit exceeds 3% of GDP, and the government projects the primary balance for the two years will show a minor deficit. Compared to the first half of the 2000s, policy-related expenditures increased, but the size of tax revenues remains basically unchanged. In the government's revenue base, social security contributions and profit contributions from state-owned enterprises are playing more significant roles nowadays.

In order to reduce fiscal deficits, it is important to restrain growth in current expenditures while expanding tax revenues. Eyes will be on the fiscal management stance of a new government to be formed after a general election. Uruguay's outstanding public debt to GDP ratio is relatively high compared to other major Latin American countries, standing at 59% as of end-2013. The government projects the ratio to rise further, albeit slightly, to 63% at end-2015, but will likely stick to the goal of keeping the net debt, which subtracts government financial assets from the gross debt, at a target of 25% relative to GDP.

The government is working to enhance liquidity by extending debt duration and through measures such as formation of benchmarks in the government bond trading market. The ratio of peso-denominated central government debt, which was only 11% in 2004, has risen to over 50%. Although financing costs are larger due to high interest rates, risks associated with foreign currency financing have been reduced substantially. On the whole, the stability of the government bond market is increasing, which will help underpin the government's fiscal management.

To keep the economy on a stable growth track, it is essential to cool down the inflation, which stays

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high at an average of 9.3% for January to July 2014. The factors behind the inflationary pressures include the impact of the weak peso on the prices of traded goods, the stronger domestic demand boosted by continued active inflows of capital and slight expansion of fiscal deficits, and the fact that inflationary expectations are not being anchored appropriately because wage increases have been linked to past inflation rates amid a low credibility in monetary policy conduct.

In June 2013, the BCU changed its operating target for monetary policy from the overnight money market rate to the growth rate of money supply (M1+) and announced the return of its target inflation range for July 2014 onwards to 3.0-7.0%. The mid-term target growth rate of M1+ has been set at 8%, the sum of the 5% center value of the target inflation range and the estimated potential growth rate of 3%. The government is encouraging the introduction of a framework that reflects prospects for economic growth and industry trends to some extent in wage setting negotiations, mainly at private companies. Close attention needs to be paid to whether such changes of institutional frameworks will weaken inflation inertia and thereby lead to lower inflation.

The current account deficit for 2013 widened to 5.8% of GDP year on year, despite the fact that the impact of the sharp increase in fuel imports caused by a drought was absent. This is mainly because the services account turned into a deficit. The current account deficit will likely hover around the same level for some time. On the other hand, the capital account balance has been basically positive, except in a few quarters in 2009-2010 when the outflows of securities and other investments exceeded their inflows due to the turmoil in overseas markets. The amount of net foreign direct investment (inflows-outflows) in 2013 remained solid at 5.3% of GDP.

In R&I's view, Uruguay's balance of payments structure is stable on the whole. As of June 2014, foreign reserves have been built up to US$18.6 billion or 31% of GDP, which is equivalent to a 13-month worth of the total of goods and services imports in 2013. Although capital inflows in resort construction and other projects may stall due to the economic disturbance in Argentina, the historically largest foreign direct investor, R&I believes that the risk that Uruguay's economy will be destabilized in terms of external position is limited.

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.

http://www.r-i.co.jp/eng/cfp/about/methodology/index.html

R&I RATINGS:

ISSUER:	**The Oriental Republic of Uruguay**
	Foreign Currency Issuer Rating
RATING:	**BBB-, Previously BB+**
RATING OUTLOOK:	**Stable**

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