Press Release

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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 Short-Term Foreign and Local Currency – Issuer Ratings at R-2 (middle). The trend on all ratings is Stable.

The rating confirmation balances Uruguay's solid economic and political fundamentals with ongoing fiscal challenges. The economy expanded faster than anticipated in 2017. Strong real wage growth boosted private consumption. Recoveries in Argentina and Brazil strengthened external demand and contributed to a record tourist season. In the near term, these tailwinds are expected to continue. GDP is forecast to expand 3.1% in 2018 and 2019. In addition, a large potential investment in the pulp and paper sector presents upside risks to the medium-term growth outlook. Challenging fiscal dynamics, however, remain the key constraint to a rating upgrade. While the deficit appears to have narrowed in 2017, broadly in line with our expectations, a durable consolidation will depend on curbing expenditure growth.

Uruguay's BBB (low) ratings are underpinned by several credit strengths. Uruguay benefits from high-quality public institutions, low levels of corruption, and policy predictability, all of which foster favorable conditions for economic growth. Conservative liability management provides the government with ample funding flexibility in the event of market stress. Furthermore, exchange rate flexibility and large foreign exchange buffers bolster the economy's defenses against potential shocks.

These credit strengths are balanced by several policy and structural challenges. First and foremost, Uruguay has limited fiscal flexibility. Further tightening is needed to place public debt ratios on a clear downward trajectory and rebuild fiscal space. Second, high dollarization and low financial intermediation complicate the central bank's challenge of firmly anchoring inflation expectations around the midpoint of the target range. Third, Uruguay is a small open economy and, therefore, highly exposed to shifts in global commodity prices as well as the economic cycles of its large neighbors.

One 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. General elections are scheduled for October 2019. While it is too early to assess the electoral outlook, DBRS does not anticipate any major changes to the policy framework.

Conservative public debt management also supports the ratings. Rollover and liquidity risk are minimal. The average maturity of central government debt is 14 years. In the event of market turbulence, Uruguay has substantial funding flexibility. With $1.5 billion in redemptions in 2018, the central government held $2.7 billion in liquid assets in September 2017. This is complemented by another $2.4 billion in contingent credit lines from multilateral organizations.

Sound external accounts and large liquidity buffers further bolster the economy’s defenses against potential shocks. Exchange rate flexibility has helped the economy adjust to evolving global conditions without generating excessive stress on balance sheets in the private sector. The current account is in a surplus position. Furthermore, reserves are high at 16.0 billion, or 27% of GDP. This provides the government with ample buffers in the event of an external shock.

Despite the slowdown in 2015 and 2016, the Uruguayan economy has performed well over the last decade and growth prospects are relatively good. Product diversification and the incorporation of technological advances in the agricultural sector have generated large productivity gains and enhanced the economy’s resilience to regional volatility. From 2006 to 2016, the economy expanded at a compound annual rate of 4.4%. Looking ahead, a potentially large investment in the pulp and paper sector could raise growth prospects. If carried out, investment in the new mill and ancillary infrastructure is estimated to total $3.4 billion, or 6% of GDP. The project would represent the largest private investment in the Uruguay’s history and could boost growth as early as next year.

Notwithstanding these positive developments, there are downside 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, an unexpected 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.

The key challenge facing the sovereign credit profile is the fiscal deficit. The consolidated public sector deficit widened from 0.9% of GDP in 2011 to 3.9% in 2016. The Vázquez administration is implementing a gradual consolidation plan to narrow the deficit to 2.5% by 2019. Tax increases, higher utility and energy tariffs, and cuts in public investment have helped offset higher spending.

The deficit is estimated to have narrowed to 3.3% of GDP in 2017. Meeting the 2019 deficit target looks achievable, particularly given the strong growth outlook. A durable fiscal consolidation based on slower primary expenditure growth would likely have positive rating implications. However, implementing such an adjustment ahead of next year's elections could be politically difficult.

Anchoring inflation expectations around the the mid-point of the central bank's target range is another policy challenge. In March 2017, inflation fell below the upper limit of the target range for the first time in six years. Disinflation has been driven by peso appreciation, which has reduced price pressures on tradeable goods and services. However, inflation expectations over the next 12 months are still near the upper limit of the target range. The challenge of anchoring expectations is complicated by the weak transmission of monetary policy amid high financial dollarization and low financial intermediation.

RATING DRIVERS

Uruguay's credit profile would benefit from greater fiscal space and counter-cyclical capacity. A durable consolidation in the fiscal accounts would likely put upward pressure on the ratings.

DBRS does not foresee much downside risk to the ratings in the near term. Nevertheless, the ratings could experience downward pressure if budget dynamics deteriorate or external buffers erode over time, thereby weakening Uruguay's resilience to adverse shocks.

RATING COMMITTEE SUMMARY

The DBRS Sovereign Scorecard generates a result in the A (low) – BBB range. Additional considerations factoring into the Rating Committee decision included: 1) Uruguay's high level of financial dollarization, low financial intermediation, and weak monetary policy transmission, and 2) downside risks to the fiscal trajectory given spending rigidities. The main points of the Rating Committee discussion included: 1) Uruguay's fiscal performance and outlook, 2) inflation dynamics, and 3) the balance of payments.

KEY INDICATORS
Fiscal Balance (% GDP): -3.9% (2016); -3.3% (2017F); -2.9% (2018F)
Gross Public Debt (% GDP): 63.4% (2016); 62.0% (2017F); 61.3% (2018F)
Nominal GDP (USD billions): 52.4 (2016); 60.3 (2017F); 65.8 (2018F)
GDP per capita (USD thousands): 15.1 (2016); 17.3 (2017F); 18.8 (2018F)
Real GDP growth (%): 1.5% (2016); 3.5% (2017F); 3.1% (2018F)

Consumer Price Inflation (%, eop): 8.1% (2016); 6.6% (2017); 6.7% (2018F)
Domestic credit (% GDP): 30.1% (2016); 26.4% (Sept-2017)
Current Account (% GDP): 1.6% (2016); 2.3% (2017F); 1.0% (2018F)
International Investment Position (% GDP): -30.0% (2016); -29.0% (Sept-2017)
Gross External Debt (% GDP): 76.2% (2016); 67.4% (Sept-2017)
Foreign Exchange Reserves (% GDP): 25.6% (2016); 26.5% (Sept-2017)
Governance Indicator (percentile rank): 77.8 (2016)
Human Development Index: 0.80 (2016)

Notes:

All figures are in U.S. dollars unless otherwise noted. Fiscal balance and gross public debt statistics are reported on a consolidated public sector basis. Forecasts for national accounts and consumer price inflation are based on the IMF WEO–October 2017. Current account and international investment position data are based on BPM6. Governance indicator represents an average percentile rank (0-100) from Rule of Law, Voice and Accountability and Government Effectiveness indicators (all World Bank). Human Development Index (UNDP) ranges from 0-1, with 1 representing a very high level of human development.

The principal applicable methodology is Rating Sovereign Governments, which can be found on the DBRS website www.dbrs.com at http://www.dbrs.com/about/methodologies. The principal applicable rating policies are Commercial Paper and Short-Term Debt, and Short-Term and Long-Term Rating Relationships, which can be found on our website at http://www.dbrs.com/ratingPolicies/list/name/rating+scales.

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

The rated entity or its related entities did participate in the rating process for this rating action. DBRS 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.

This rating is endorsed by DBRS Ratings Limited for use in the European Union.

For further information on DBRS' historic default rates published by the European Securities and Markets Administration ("ESMA") in a central repository see http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

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.

Lead Analyst: Michael Heydt, Vice President, Global Sovereign Ratings
Rating Committee Chair: Thomas R. Torgerson, Co-Head of Sovereign Ratings, Global Sovereign Ratings
Initial Rating Date: 28 February 2008
Last Rating Date: 26 May 2017

Information regarding DBRS ratings, including definitions, policies and methodologies, is available on www.dbrs.com.

Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Uruguay, Oriental Republic of	Long-Term Foreign Currency - Issuer Rating	Confirmed	BBB (low)	Stb	Jan 24, 2018
Uruguay, Oriental Republic of	Long-Term Local Currency - Issuer Rating	Confirmed	BBB (low)	Stb	Jan 24, 2018
Uruguay, Oriental Republic of	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	Jan 24, 2018
Uruguay, Oriental Republic of	Short-Term Local Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	Jan 24, 2018

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