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Insight beyond the rating.

DBRS Confirms Uruguay at BBB (low), Stable Trend

Industry: Public Finance--Sovereigns

DBRS, Inc. (DBRS) 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.

KEY RATING CONSIDERATIONS

The rating confirmation balances Uruguay's strong political and economic fundamentals with ongoing fiscal challenges. Uruguay's 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. The economy continues to demonstrate a high degree of resilience. GDP is estimated to have grown 2.1% in 2018 and is projected to grow 1.9% in 2019, despite a severe drought last year and a recession in neighboring Argentina. Ample foreign exchange reserves, conservative public debt management, and sound regulation of the banking system bolster the economy's defenses to external shocks. In addition, the growth outlook could materially improve if a large potential investment in the pulp and paper sector advances.

However, challenging fiscal dynamics are the key constraint to a rating upgrade. Despite efforts to consolidate fiscal accounts, the fiscal deficit has not materially narrowed over the last few years. Public debt ratios could increase gradually over the medium term in the absence of budgetary tightening. This highlights the importance of the next administration's fiscal strategy. General elections are scheduled for October 2019. A sustained effort to curb spending growth will likely be needed to place public debt ratios on a firm downward trajectory.

RATING DRIVERS

Uruguay's credit profile would benefit from greater fiscal space and counter-cyclical capacity. If the next administration implements a durable consolidation in the fiscal accounts, the ratings could experience upward pressure.

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

RATING RATIONALE

One Fundamental Strength of Uruguay's Credit Profile Is Strong Public Institutions.

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

With general elections still nine months away, it is too early to assess the electoral outlook. The Frente Amplio coalition has controlled the presidency and both houses of congress since 2005. However, early polls suggest the race is competitive among Uruguay's three main political parties. If no presidential candidate secures a majority in the first round, a runoff election will be held for the top two contenders in November 2019. Regardless of the outcome, DBRS expects the next administration to be committed to fiscal sustainability.

Prudent Liability Management and Ample Reserves Enhance the Resilience of the Economy to Shocks

Creditworthiness is supported by Uruguay's conservative public debt management. Rollover and liquidity risk are minimal. The average maturity of central government debt is 15 years. In the event of market turbulence, Uruguay has substantial funding flexibility. Liquid assests held by the central government amounted to $2.2 billion in September 2018. This is complemented by another $2.4 billion in contingent credit lines from multilateral organizations. Taken together, available resources are well in excess of the $3.2 billion in debt servicing needs for 2019.

Sound external accounts and large liquidity buffers also 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 modest deficit position. Furthermore, reserves are high at $16 billion, or 26% of GDP. This provides the government with ample buffers in the event of a shock.

Risks to the Growth Outlook Are Two-Sided

Despite the recent slowdown, the Uruguayan economy has performed well for more than a decade.

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. The economy has expanded 16 consecutive years at a compound annual rate of 4.2%. Looking ahead, a potentially large investment in the pulp and paper sector could support 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 start contributing to growth as early as the end of this year.

However, volatility in the external environment poses downside risk 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.

The Next Administration Will Inherit Fiscal and Monetary Policy Challenges

The key challenge facing the sovereign credit profile is the fiscal deficit. Despite consolidation plans by the Vázquez administration, the overall fiscal deficit has not materially narrowed in recent years. The underlying source of pressure is rising current spending: higher education and healthcare costs combined with greater social security expenses. Excluding transfers related to some workers shifting from the private to the public pension regime (the "cincuentones effect"), the 12-month consolidated public sector deficit was 3.8% of GDP in November 2018. Including the pension funds, the deficit amounted to 2.7%. While the transfer of pension funds reduces the headline deficit in the near term, the net effect is to add implicit liabilities to the public sector balance sheet. In the absence of fiscal consolidation measures, budget dynamics will remain challenging with public debt ratios set to gradually increase over the medium term.

Anchoring inflation expectations around the the mid-point of the central bank's 3-7% target range is another policy challenge. Consumer prices increased 8.0% in December 2018 relative to one year ago, and 12-month inflation expectations remain above 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 COMMITTEE SUMMARY

The DBRS Sovereign Scorecard generates a result in the BBB (high) – BBB (low) range. The main points discussed during the Rating Committee include 1) the political environment and electoral outlook, 2) Uruguay's recent economic performance, and 3) fiscal dynamics.

KEY INDICATORS

Fiscal Balance (% GDP): -3.5% (2017); -3.7% (2018F); -3.5% (2019F)
Gross Debt (% GDP): 65.7% (2017); 68.2% (2018F); 67.8% (2019F)
Nominal GDP (USD billions): 59.2 (2017); 60.9 (2018F); 62.9 (2019F)
GDP per capita (USD thousands): 16.9 (2017); 17.4 (2018F); 17.9 (2019F)
Real GDP growth (%): 2.7% (2017); 2.0% (2018F); 1.9% (2019F)
Consumer Price Inflation (%, eop): 6.6% (2017); 8.0% (2018F); 7.5% (2019F)
Domestic credit (% GDP): 26.3% (2017); 27.5% (Sept-2018)
Current Account (% GDP): 1.5% (2017); -0.2% (2018F); n/a (2019F)
International Investment Position (% GDP): -27.8% (2017); -24.7% (Sept-2018)
Gross External Debt (% GDP): 69.5% (2017); 70.1% (Sept-2018)
Foreign Exchange Reserves (% short-term external debt + current account deficit): 263% (2017); 268% (June-2018)
Governance Indicator (percentile rank): 75.5 (2017)
Human Development Index: 0.80 (2017)

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 and exclude the impact of transfers related to "cincuentones". Forecasts are based on the IMF WEO – October 2018 and the IMF Staff Concluding Statement of the 2018 Article IV Mission. 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 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, IMF, The Conference Board Total Economy Database, World Bank, NRGI, Brookings, Bank for International Settlements, UNDP, Transparency International, and Haver Analytics. DBRS 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 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.dbrs.com.

Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Uruguay, Oriental Republic of	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	Jan 29, 2019
Uruguay, Oriental Republic of	Short-Term Local Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	Jan 29, 2019
Uruguay, Oriental Republic of	Long-Term Foreign Currency - Issuer Rating	Confirmed	BBB (low)	Stb	Jan 29, 2019
Uruguay, Oriental Republic of	Long-Term Local Currency - Issuer Rating	Confirmed	BBB (low)	Stb	Jan 29, 2019

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