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Research Update:

Uruguay Long-Term Sovereign Ratings Raised To 'BB'; Outlook Stable

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Table Of Contents

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Overview

- There is a growing track record of sustained GDP growth and vulnerabilities are diminishing despite a challenging 2009.
- We expect prudent macroeconomic policy mix combined with an ongoing reform agenda to continue under President Mujica and Minister of Finance Lorenzo.
- Therefore, we have raised the long-term foreign and local currency sovereign credit ratings on Uruguay to 'BB' from 'BB-'.
- The stable outlook reflects Standard & Poor's expectation that the continuation of prudent macroeconomic policies will balance the risks still pertaining to a relatively high government debt and a high dollarization.

Rating Action

On Sept. 6, 2010, Standard & Poor's Ratings Services raised its long-term foreign and local currency sovereign credit ratings on the Oriental Republic of Uruguay to 'BB' from 'BB-'. At the same time, the '2' recovery rating was affirmed. Furthermore, the issue ratings on Uruguay's foreign currency-denominated senior unsecured bonds were raised to 'BB+' from 'BB'. The outlook is stable.

Additionally, our long-term corporate credit rating on state-owned Administración Nacional de Combustibles Alcohol y Portland (ANCAP) was raised to 'BB-' from 'B+'. The outlook is stable. This rating action results from our assessment of a "very high" likelihood that the government of Uruguay would provide timely and sufficient extraordinary support to the company in the event of financial distress, and from its stand-alone credit profile (SACP) in the 'B' category.

Rationale

The upgrade on Uruguay reflects our assessment that prudent macroeconomic management in a context of sustained economic growth will continue to reduce Uruguay's still-remaining credit vulnerabilities over the medium term. We expect that a successful economic policy framework that combines a solid commitment with strengthening macroeconomic stability and a gradual progress on the reform agenda will continue under President Mujica's administration based on the support initially given to an experienced economic team.

Uruguay's GDP growth declined markedly in 2009, but remained in positive territory, unlike most other peers, despite the prevailing negative factors including the international crisis and a severe drought in the context of presidential elections. GDP grew by 2.9% in 2009, and is expected to rebound strongly with an estimate of 6.5% for 2010. We expect growth to remain within the 4% and 4.5% range over the medium term, although our forecast could be revised upward if some large-scale investment projects in the pipeline finally take place.

This solid growth path will contribute to further reductions in Uruguay's government debt to GDP, which remains high compared to other rated peers. General government deficits are expected to remain close to 1% of GDP over the next three years, as established in the government's five-year budget plan. Net general government debt will converge to the 40% of GDP range from the actual 45% (our calculation includes about 10% of GDP in Central Bank debt issued on open market operations).

We expect debt sustainability to continue to strengthen by an active debt management now devoted to develop a domestic yield curve in local currency inflation-linked bonds. The government is currently issuing inflation-linked bonds with maturities up to 15 years, but government bonds issued domestically only account for 16% of total debt. While the government expects to prefinance most of 2011 debt amortizations in 2010, principal payments on government debt represent a manageable yearly average of 1% of GDP between 2012 and 2016.

Uruguay's economic policy flexibility remains limited by a high level of dollarization; 80% of deposits and 65% of loans remain denominated in foreign currency. In addition, and despite the greater levels of economic and financial flexibility, Uruguay will remain vulnerable to developments in the region, mostly through real economy channels pertaining to its good and services trade links with major partners, in particular Argentina. Finally, President Mujica's administration will still be tested by continued pressures that could jeopardize the government's ongoing economic policy approach. The government's party has a majority in Congress, but maintaining a cohesive front within Frente Amplio's heterogeneous coalition remains in itself a challenge. Ongoing negotiation in Congress on the executive multiyear budget proposal will constitute an important signal on the level of political commitment with the current economic management.

Outlook

The stable outlook reflects Standard & Poor's expectation that the continuation of prudent macroeconomic policies will balance the risks still pertaining to a relatively high government debt and a high dollarization. The sovereign rating on Uruguay could benefit in the future from greater levels of investments that enhance growth prospects and from advances on the development of the domestic capital market in local currency. On the contrary, a weakening on the political support for the ongoing economic approach and/or signs of fiscal slippage could put downward pressures on the rating.

Related Criteria And Research

Sovereign Credit Ratings: A Primer, May 29, 2008.

Ratings List

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Upgraded
                 To                       From
Uruguay (Oriental Republic of)
Sovereign credit rating
                 BB/Stable/B              BB-/Stable/B

Administración Nacional de Combustibles Alcohol y Portland
Issue credit rating
                 BB-/Stable/--            B+/Stable/--
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NB: This list does not include all ratings affected.

Complete ratings information is available to RatingsDirect subscribers on the Global Credit Portal at www.globalcreditportal.com and RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.