Press Release

Date of Release: April 4, 2012

# DBRS Upgrades Uruguay to BB (high), Trend Remains Positive

**Industry: Public Finance--Sovereigns**

DBRS, Inc. (DBRS) has upgraded the ratings on the long-term foreign and local currency debt of the Oriental Republic of Uruguay to BB (high) from BB, and maintained the Positive trends on both ratings. The reasons for the upgrade are: (1) sustained high rates of economic growth driven by investment, exports and a structural transformation of the agriculture sector, (2) very low rollover risk, and (3) larger financial buffers. These factors have improved public debt dynamics and enhanced the resilience of the economy to adverse shocks. The Positive trends reflect DBRS's assessment that the ratings could be raised to investment grade if fiscal discipline is sustained and public debt ratios continue on a downward trajectory.

From 2006 to 2011, Uruguay expanded at an average annual rate of 5.8%. Supply and demand factors contributed to this strong economic performance. On the supply side, the agriculture sector has undergone a structural transformation, supported by large FDI inflows and technological advances, that has significantly expanded and diversified production. Higher investment rates overall have also increased the economy's productive capacity. Positive demand factors include favorable terms of trade and strong regional demand for tourism services. This solid growth performance has been accompanied by a rising employment rate and substantial real wage gains. The economy expanded 5.7% in 2011 and is expected to grow 4.0% in 2012, indicating resilience during a period of weak global economic growth.

This strong economic performance combined with persistent primary surpluses and proactive debt management has led to a significant improvement in the level and composition of Uruguay's debt profile. Gross public debt declined from 100.8% of GDP in 2003 to 55.6% of GDP in 2011. The government aims to reduce debt-to-GDP to 40% by 2015, which DBRS views as a realistic baseline scenario. Net public sector debt – which deducts liquid financial assets from gross debt – declined to 27.3% of GDP in 2011. Debt management operations have also substantially reduced vulnerabilities, including refinancing and exchange rate risks. The average maturity of central government debt is 12.3 years, and the share denominated in local currency increased from 11% in 2005 to 49% in 2011.

Fallout over sovereign debt and financial fragility in the Euro area or a sharp deceleration in China present downside risks to Uruguay's growth outlook, principally through the terms of trade channel. Agricultural products account for more than 60% of Uruguay's merchandise exports and therefore are exposed to fluctuations in world agricultural prices. Moreover, first round effects from a terms of trade shock could be amplified by reduced demand from Uruguay's commodity-producing neighbors, particularly Argentina. Trade disruptions or an economic downturn in the region would likely have a negative effect on economic activity in Uruguay, principally through weaker demand for tourism services.

However, low rollover risk, high international reserves and economic diversification bolster the economy's defenses to potential negative shocks. The government, with limited debt maturing and $2.5 billion (5.4% of GDP) in precautionary savings, has ample resources to cover gross financing needs over the next twelve months. Contingent credit lines totaling $1.1 billion (2.4% of GDP) from the World Bank, CAF and FLAR offer additional financial cushion. On the external front, high FDI provides the economy with a stable source of financing. Annual FDI inflows averaged 5.9% of GDP from 2005 to 2011, among the highest in Latin America, and several large projects are underway or in the process of negotiation, suggesting this trend will continue. In addition, international reserves rose to $11.3 billion (24.0% of GDP) in March 2012, up $3.5 billion from a year prior, further strengthening the economy's liquidity position.

Economic diversification and prudent financial regulation have reduced Uruguay's exposure to regional volatility. While benefiting from its comparative advantage in traditional products such as beef, Uruguay has expanded into new agricultural markets, such as soy, dairy and wheat. With more exports destined for global markets, Uruguay has reduced its exposure to country-specific shocks, particularly from Argentina. The share of merchandise exports destined for Argentina was 7% in 2011, down from 18% in 2000. Furthermore, the share of non-resident deposits in the Uruguayan banking system, primarily from Argentina, account for just 15% of total deposits, down from 41% in 2001.

However, in the event of an adverse shock DBRS believes Uruguay has very limited fiscal space to provide expansionary policy. The debt burden, though declining, is still high compared to most investment grade sovereigns in the region, and the fiscal accounts are in a modest deficit position, despite above-trend growth in 2010 and 2011. Moreover, inflation has remained near or above the upper limit of the Central Bank of Uruguay (BCU) target range for the last five years. With tight labor market conditions and rising real salaries, continued vigilance will be needed to anchor inflation expectations within the target range. Moreover, the high level of financial dollarization creates balance sheet vulnerabilities throughout the economy which carry exchange rate and liquidity risks. Measures that enhance the credibility of monetary policy could facilitate de-dollarization and increase policy flexibility.

Sound macroeconomic management, a stable political environment and strong public institutions have provided a foundation for economic growth and social development in Uruguay. Weakened political commitment to debt reduction or a change in policy that reduces the resiliency of the economy to adverse shocks could result in a stabilization of the ratings at the current level. On the other hand, continuing prudent fiscal management alongside solid growth prospects – in line with DBRS's baseline expectations – could result in an upgrade of the ratings.

Note:
All figures are in U.S dollars unless otherwise noted.

The principal applicable methodology is Rating Sovereign Governments, which can be found on the DBRS website under Methodologies.

The sources of information used for this rating include the Central Bank of Uruguay, Ministry of Economy and Finance, INE, IMF and Haver Analytics. DBRS considers the information available to it for the purposes of providing this rating was of satisfactory quality.

Lead Analyst: Michael Heydt
Rating Committee Chair: Roger Lister
Initial Rating Date: 28 February 2008
Most Recent Rating Update: 15 February 2011

For additional information on this rating, please refer to the linking document under Related Research.

| Issuer | Debt Rated | Rating Action | Rating | Trend | Latest Event |
|---|---|---|---|---|---|
| Uruguay, Oriental Republic of | Long-Term Foreign Currency - Issuer Rating | Upgraded | BB (high) | Pos | Apr 4, 2012 |
| Uruguay, Oriental Republic of | Long-Term Local Currency - Issuer Rating | Upgraded | BB (high) | Pos | Apr 4, 2012 |

For more information on this credit or on this industry, visit www.dbrs.com or contact us at info@dbrs.com.

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