Press Release

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DBRS Upgrades Uruguay to BBB (low), Trend Revised to Stable

Industry: Public Finance--Sovereigns, Sovereign Finance

DBRS, Inc. (DBRS) has upgraded the Oriental Republic of Uruguay's long-term foreign and local currency issuer ratings to BBB (low) from BB (high). In addition, the short-term foreign and local currency issuer ratings were upgraded to R-2 (middle) from R-3. The trend on all ratings has been revised to stable.

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) large financial buffers. These factors have improved public debt dynamics and enhanced the resilience of the economy to adverse shocks. The stable trends reflect DBRS's view that risks to the outlook are broadly balanced. On the one hand, Uruguay is likely to experience continued strong growth and a declining debt burden, and ongoing economic diversification is expected to further reduce Uruguay's vulnerability to external shocks. On the other hand, the economy would benefit from steps to reduce pro-cyclicality in public expenditure and achieve lower inflation. In addition, regional and global spillovers could still have a serious impact on the Uruguayan economy through terms of trade, tourism, real estate values, and financial channels.

From 2004 to 2012, Uruguay expanded at an average annual rate of 5.8%. Supply and demand factors contributed to this strong economic performance. On the supply side, higher levels of investment have boosted productivity in the agricultural sector, expanded production into higher value-added agribusiness, and diversified Uruguay's economy. 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 3.9% in 2012, slowing in tandem with its two large neighbors and the global economy, but demonstrating resilience during a period of weak external demand.

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 hedged exposure from country-specific shocks, particularly from Argentina. The share of merchandise exports destined for Argentina was 5.7% in 2012, 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.

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 107.3% of GDP in 2003 to 62.2% of GDP in 2012. Net debt has declined to just 27.3% of GDP as of end-2012. Due to higher than expected debt issuance related to sterilization of Uruguay's rapidly growing foreign exchange reserves, the government has abandoned its goal to reduce gross debt to 40% of GDP by 2015; instead, the government is targeting a net-debt-to-GDP ratio of 23%. DBRS believes Uruguay is likely to achieve this target, particularly if the government uses increased revenue from expected growth in pulp and mining production to boost public savings.

Debt management operations have also substantially reduced vulnerabilities, including refinancing and exchange rate risks. The government, with limited debt maturing and 4.7% of GDP in precautionary savings as of end-2012, has adequate resources to cover gross financing needs for well over 12 months. In addition, Uruguay's financial cushion is supplemented by contingent credit lines totaling $2 billion (3.9% of GDP) from the World Bank, CAF, FLAR, and IADB. On the external front, annual net FDI averaged 5.9% of GDP from 2005 to 2012, among the highest in Latin America. Gross international reserves rose to $13.2 billion (26.7% of GDP) in February 2013, up $2.6 billion from a year prior, further strengthening the economy's liquidity position.

Nonetheless, in the event of an adverse shock, DBRS believes that the scope for countercyclical policy intervention remains somewhat limited. High levels of dollarization and the small scale of financial intermediation hinder the transmission of monetary policy. The debt burden is declining but fiscal accounts remain in a deficit position in spite of above-trend growth in recent years. And, while liquidity buffers would certainly provide space for automatic fiscal stabilizers to function, room for discretionary stimulus would likely be limited.

Inflation has remained near or above the upper limit of the Central Bank of Uruguay (BCU) target range for the last six years. With tight labor market conditions and rising real salaries, continued vigilance will be needed to anchor inflation expectations within the target range. Furthermore, the high level of financial dollarization throughout the economy creates balance sheet vulnerabilities which carry exchange rate and liquidity risks. Measures which enhance the credibility of monetary policy could facilitate de-dollarization and increase policy flexibility.

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 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. While ongoing investment into the mining sector is expected to significantly boost exports in 2014 and beyond, these exports will heighten Uruguay's exposure to shocks in external demand.

Despite these challenges, Uruguay's sound macroeconomic management, stable political environment and strong public institutions have provided a sustainable foundation for economic growth and social development. Continued fiscal discipline, particularly with regard to commodity-based revenue, combined with further progress on de-dollarization and inflation control could contribute to upward pressure on ratings. On the other hand failure to utilize commodity revenues for countercyclical purposes and deal with long-term fiscal challenges could weaken the resiliency of the economy to adverse shocks and put downward pressure on the ratings.

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

The principal applicable methodology is Rating Sovereign Governments, which can be found on our website under 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 under Rating Scales.

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.

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

Lead Analyst: Thomas Torgerson
Rating Committee Chair: Roger Lister
Initial Rating Date: 28 February 2008
Most Recent Rating Update: 17 December 2012

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	BBB (low)	Stb	May 3, 2013
Uruguay, Oriental Republic of	Long-Term Local Currency - Issuer Rating	Upgraded	BBB (low)	Stb	May 3, 2013
Uruguay, Oriental Republic of	Short-Term Foreign Currency - Issuer Rating	Upgraded	R-2 (middle)	Stb	May 3, 2013
Uruguay, Oriental Republic of	Short-Term Local Currency - Issuer Rating	Upgraded	R-2 (middle)	Stb	May 3, 2013

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