Uruguay: Risks from Argentina's Economic Stress

Special Report

Uruguay's Reduced Risks and Higher Buffers

Lower Contagion Risks: Uruguay's financial position is substantially stronger than a decade ago when it suffered contagion from Argentina's economic crisis. Nevertheless, recent heightened macroeconomic instability and a severe downturn in Argentina could still have important consequences for Uruguay's real economy as transmission channels between the two economies remain strong. A renewed period of turmoil in Argentina could reduce investment flows to Uruguay, which have been large in recent years.

Stronger Banking Position: Argentina's problems a decade ago ignited a run on the highly dollarised Uruguayan financial system, drained foreign reserves, put pressure on its exchange rate, substantially increased government indebtedness due to high debt dollarisation and resulted in a public-debt restructuring. In 2013 financial dollarisation was still high at 74% of total bank deposits but foreign-currency deposits and credit to non-residents represented 15% of total deposits and 1.5% of total credit, respectively, down from 41% and 11% in 2002.

Weaker Transmission from Trade: The share of Uruguayan exports to Argentina decreased to 5.5% of total exports in 2013 from 15.4% in 2001. However, the products are highly tailored for the Argentine market, which would make it difficult for Uruguayan exporters to sell them elsewhere if Argentine demand softens or if administrative measures hinder trade. Specific economic sectors in Uruguay could also be at risks from arbitrary policy decisions in Argentina. Exports of goods to China represent 21% of total exports, mostly in the primary sector.

Tourism Shows Strongest Link: The importance of the Argentine economy for Uruguay is most evident in tourism, with Argentineans representing almost 60% of total arrivals. In 2013 Argentine visitors fell by 6.5% due to deteriorating economic conditions, limited access to foreign currency and higher taxes on Argentines' credit card usage abroad. Fewer arrivals would have consequences for Uruguay's economy, employment and FX earnings generation capacity, which is further undermined by increasing outflows from Uruguayans traveling abroad.

FDI could Fall: Argentine FDI flows into Uruguay increased persistently from 2007, replacing some of the traditional accumulation of deposits in Uruguayan banks. On average 29% of total FDI over 2007-2012 came from Argentina (peaking at 36% in 2012), with most of it going to land acquisition and real estate. Limited access to foreign currency and deteriorating local conditions in the case of heighted instability in Argentina could hurt investment flows into Uruguay.

Improved Creditworthiness: Large external and fiscal buffers together with its improved fiscal position, large contingency lines, a flexible exchange-rate regime and a sound financial system give Uruguay substantial room for manoeuvre in the face of potential adverse external shocks. In addition, Uruguay's sovereign debt profile has substantially improved in the last decade with longer government debt maturities and a higher share of debt denominated in local currency, thus reducing rollover and exchange rate risks.

Related Research

Global Economic Outlook (March 2014)

2014 Outlook: Latin America Sovereign Review (December 2013)

Uruguay Credit Reports (March 2014)

Analysts

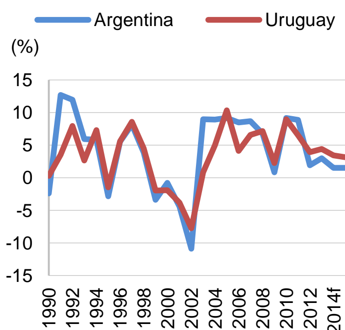
Santiago Mosquera
+1 212 908 0271
santiago.mosquera@fitchratings.com

Lucila Broide
+1 212 908 0898
lucila.broide@fitchratings.com

Shelly Shetty
+1 212 908 0324
shelly.shetty@fitchratings.com

Figure 1

Real GDP Growth

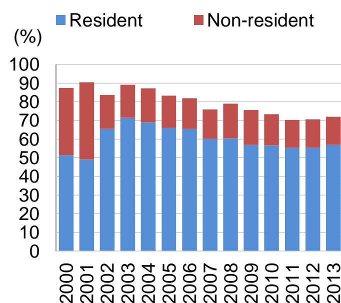


Source: Statistical Offices and Fitch

Figure 2

FC Deposits in Uruguay

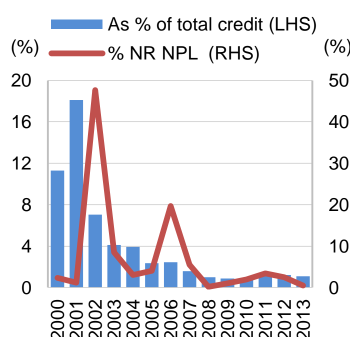
As % of total deposits



Source: BCU and Fitch

Figure 3

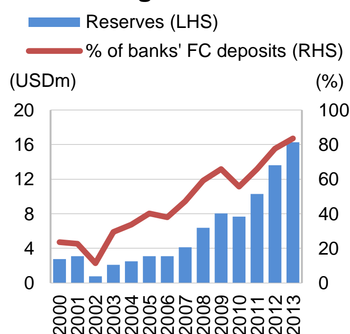
Bank Loans to NR



Source: BCU and Fitch

Figure 4

BCU Foreign Reserves



Source: BCU and Fitch

Improved Credit Profile but Risks Remain

Uruguay's financial position is substantially stronger than a decade ago when it suffered contagion from the Argentine economic crisis. Nevertheless, increased economic instability in Argentina now could still have important consequences for Uruguay's real economy as certain transmission channels between both economies remain strong. On the upside, large external and fiscal buffers, together with its improved fiscal position, large contingency lines, a flexible exchange-rate regime and a strong financial system give Uruguay significant room for manoeuvre in the face of potential adverse external shocks.

Decreased Financial Vulnerabilities

Financial Position: Then and Now

Uruguay's financial position in 2013 was substantially stronger than in the early 2000s when negative spill overs from Argentina ignited a run on the highly dollarised Uruguayan financial system, drained foreign reserves, imposed pressure on the exchange rate, significantly increased the public debt burden due to high dollarisation of debt and eventually resulted in a public-debt restructuring in May 2003[1].

Financial dollarisation was still at 74% of total bank deposits in 2013, the highest among 'BBB' rated countries, although below the 90% mark in 2001. Foreign-currency (FC) deposits by non-residents (NR), mostly from Argentina, have fallen over the last ten years, reducing the potential impact that a crisis in Argentina could have on the Uruguayan financial system.

Bank credit to NR also decreased rapidly after 2001 and was equivalent to 1.1% of total loans in 2013, while the level of non-performing loans is at record lows. Strong regulation by the Uruguayan Central Bank (BCU) limits exchange-rate risks by FC borrowers. Foreign reserves are climbing and reached USD16.3bn in 2013, almost four times the amount of NR-FC deposits and 85% of total FC deposits. This shows improved resilience to withstand periods of financial turbulence.

The Sovereign: Then and Now

The government has made significant progress in reducing its own exchange-rate risks, with the ratio of foreign-currency (FC) debt falling to 46% in 2013 from 81% in 2003. The rapid increase in foreign investor participation in the local market of central government debt exposes Uruguay to swings in investor risk aversion. Positions by non-residents, however, did not fall in 2013 despite the increased financial market volatility and reserve requirements on capital inflows imposed in June 2013[2]. There is no indication yet that Argentina's deteriorating economy has led to material financial contagion in Uruguay.

In recent years the Uruguayan government has implemented a strategy to shield the economy from external shocks and reduce the refinancing risks of public debt. This strategy, which includes the accumulation of public savings, the availability of contingency credit lines and improvements in sovereign debt profile, was tested during the recent period of financial volatility for emerging markets and proved satisfactory.

In 2009 the authorities in Uruguay set up a policy to maintain liquid assets at a minimum of 12 months of debt service (interest payments plus amortization) in case of an unexpected loss of access to financial markets. The central government had over USD1.8bn in liquid assets by the end of 2013 for such payments. To limit financial costs in further asset accumulation, the authorities secured contingency credit lines with multilateral organisations for USD1.9bn.

---

[1] The 2003 sovereign debt exchange did not compensate bondholders sufficiently to offset the loss in the present value of extended principal payments, so bondholders incurred an economic loss in the exchange. Because of the loss implied by the exchange Fitch deemed the exchange a default according to its criteria for distressed debt exchanges.

[2] On June 2013 Uruguay's Finance Ministry imposed a reserve requirement of 50% of inflows to non-residents on CG local securities. A 40% requirement was already operating for BCU Securities, but after June both were unified at 50%. Such reserve ratio applies to new investments.

Figure 5
Average Duration of CG Debt (Year 2013)

Rating Category[a]	BBB		A
Panama	12.9	Taiwan	7.9
Peru	12.9	Slovakia	6.5
Ireland	12.6	Malaysia	5.8
Uruguay	**10.8**	China	5.6
San Marino	10.4	Czech Republic	5.6
Indonesia	10.0	Poland	5.6
South Africa	9.7	Japan	3.8
Aruba	9.3		
Thailand	8.3		
Colombia	6.9		
Bulgaria	6.8		
Iceland	6.4		
Spain	6.2		
Morocco	5.5		
Lithuania	4.9		
Latvia	4.5		
Romania	4.3		
Bahrain	4.0		

[a] BBB category/sovereigns rated 'BBB+', 'BBB' and 'BBB−'; 'A' category/sovereigns rated 'A+','A' and 'A−'.
Source: Fitch

The government extended public debt maturities through a combination of timely new debt placements and liability management operations, bringing public debt average maturity to 10.8 years (7.4 years in 2004), among the highest in the 'BBB'-rating category (Figure 5).

Transmission Channels from Argentina

Argentina's government limited financing flexibility could lead to greater monetisation of its fiscal deficit. This may worsen the inflation outlook and economic prospects in the context of complicated wage negotiations, price controls and political discontent. While the authorities have taken some positive measures that could avoid a severe crisis (such as showing willingness to settle creditors' arrears, marginally decrease the fiscal deficit and allow higher interest rates) policy uncertainty remains high.

The Trade Channel

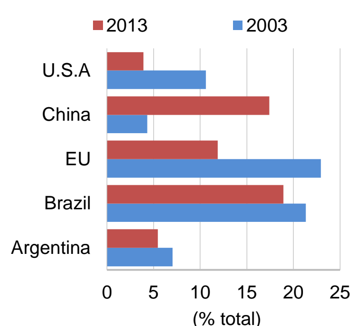
Despite weaker financial transmission channels, the Uruguayan economy is closely linked to Argentina, and further economic deterioration across the Plata River could undermine economic activity in Uruguay.

The share of Uruguayan exports to Argentina decreased to 5.5% of total exports in 2013 from 15.4% in 2001 (Figure 6). However, the products are highly tailored for the Argentine market, which would make it difficult for Uruguayan exporters to sell them elsewhere if Argentine demand softens or if administrative measures hinder trade as has occurred since 2012 with the imposition of import restrictions.

Specific economic sectors in Uruguay could also be at risk from arbitrary policy decisions in Argentina. For instance, in October 2013 the authorities in Argentina prohibited transhipments of Argentinean cargo in ports that did not sign the Multilateral Agreement for Cargo within MERCOSUR. The Port of Montevideo has been blocked for transhipment services since Uruguay is not party to this agreement, with potential losses that could exceed USD100m a year plus employment losses.

The share of exports to China has increased, which is partly explained by developments in the soybean and pulp industries, with some downside risks due to lower commodity prices.

Figure 6
Main Exports Destination



Source: BCU and Fitch

The Tourism Channel

The importance of the Argentine economy for Uruguay is most evident in tourism, a sector that generates 6.5% of Uruguay's GDP and employs around 13% of its labour force. Incoming tourists from Argentina represent 58.5% of total arrivals, followed by Brazil with 13.9%. The number of visitors in 2013 fell 1.1%, mostly explained by a 6.5% reduction in those coming from Argentina. This was due to deteriorating economic conditions, limited access to foreign currency and higher taxes on Argentine's credit card usage abroad (Figure 7). The authorities in Uruguay have implemented compensatory measures to support tourism at a relatively low fiscal cost (0.2% of GDP in 2013), including VAT refunds on credit card purchase by foreigners. Uruguayan hoteliers have also offered compensatory measures, including differential exchange rates, at the expense of lower earnings.

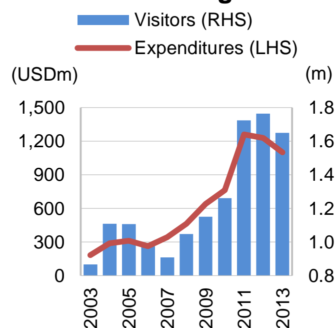
From a balance of payments perspective, lower tourism receipts were recently joined by increasing tourism outflows by Uruguayans thanks to the relatively strong currency, high employment and gains in real wages. As a result, the balance of services in 2013 could have reached its worst reading since 2008. The outlook for 2014 is even weaker as conditions in Argentina could further deteriorate and adverse weather in Uruguay in early 2014 affected the end of the 2013-2014 summer season.

The Investment Channel

Argentine FDI flows into Uruguay have persistently increased since 2007, somewhat replacing the traditional accumulation of deposits in Uruguayan banks (Figure 8). On average 29% of total FDI in 2007-2012 came from Argentina (peaking at 36% in 2012), with most of it going to

Figure 7

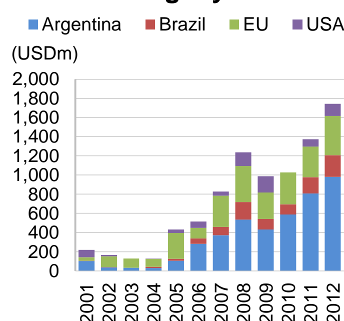
Tourism from Argentina



Source: Direccion de Turismo and Fitch

Figure 8

FDI into Uruguay



Source: BCU and Fitch

land acquisition and real estate. Investment in residential housing supported significant price appreciation across the country, although this is most evident in Punta del Este.

Construction activity weakened in 2013 after 19% annual expansion in real terms in 2012, which coincided with the increased difficulties for Argentines in obtaining FX for cash transactions in Uruguay. A potential correction in real estate prices should not have major consequences for the Uruguayan financial system given the relatively low loan-to-value ratios and small banks' mortgage portfolios. However, it could be a dampener for construction activity.

Argentine investment in land has changed the primary sector in Uruguay in practical terms as it has moved from mostly cattle towards agribusiness during the last decade. Argentine soy producers not only expanded the agriculture frontier in Uruguay but brought productivity-enhancing technology, resulting in soybean output increasing seven-fold between 2006 and 2013. It is unlikely that deteriorating conditions in Argentina would affect Uruguayan agribusiness. Risks instead come from higher production and land costs, adverse weather, lower commodity prices and increasing competition from other destinations, particularly neighbouring Paraguay. Under this scenario, it is unlikely that that the gains in the aftermath of the crisis of the last decade would again benefit Uruguay.

Deteriorating conditions in Argentina could slow the pace of investment but not necessarily halt it. The impact would depend on the magnitude of the adjustment and Argentine investors' access to foreign currency. Negative spill overs could be amplified by the impact of a disorderly adjustment in Argentina on Brazil, Uruguay's second trading partner in terms of exports after China.

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2014 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004.Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.