Uruguay: Close to Return to Investment Grade

Special Report

Investment Grade Threshold: In this report Fitch Ratings looks at Uruguay's current progress in creditworthiness compared with other 'BB+' sovereigns that successfully made the transition to the investment grade (IG) category. Uruguay's relative performance lags in terms of general government debt but there are positive trends and mitigating factors that signal that Uruguay could be upgraded to 'BBB–' over the Outlook horizon of 12 to 18 months.

Stronger External Balance Sheet: International liquidity has improved compared with peers and higher-rated sovereigns, particularly in 2011. Large inflows of FDI and public debt placements have exceeded current account deficits, resulting in strong foreign reserves accumulation. Uruguay's overall net external creditor position is robust relative to the median in the 'BB' rating category, although the sovereign remains a net external debtor with a weaker position than its peers.

Continued, Slow Debt Reduction: Gross and net general government (GG) debt in Uruguay fell in recent years, but remains above the median for countries that have moved into IG since 2006. The major improvement in Uruguay during recent years comes from public debt composition. GG debt has an extremely light repayment profile, showing the third highest debt maturity among all countries rated by Fitch. The share of GG debt denominated in local currency has substantially increased, although is low relative to countries moving into IG.

Growth Dynamics Affect Inflation: Uruguay's growth performance is stronger than other countries in the 'BB' and 'BBB' categories, while it closely tracks the median of countries upgraded to IG. Solid investment is needed to maintain the positive momentum, a criterion where Uruguay underperforms. The fast expansion in recent years has resulted in inflation rates above its peers. Bringing inflation to announced targets is particularly challenging due to limited transmission channels available to implement monetary policy.

Structural Factors Support Upgrade: Uruguay's strong structural features position the country well into IG territory based on governance and Human Development indicators. Social risks are reduced thanks to the country's high GDP per capita, which currently exceeds 'BB' and 'BBB' medians. Further improvements may materialize in the near term as the current government prioritizes housing, education, security, infrastructure, and safety net enhancements.

What Could Trigger a Rating Action

Improving Debt Ratios: Further progress on reducing government indebtedness as well as strengthening external credit metrics, given commodity dependence and relatively high financial dollarisation, would support an upgrade to investment grade.

Increased Instability: A material deterioration in the government debt burden and composition or increased macroeconomic instability could weigh on Uruguay's credit profile.

Related Research

Uruguay (July 2011)

Global Economic Outlook: Keep Belts Fastened, Bumpy Recovery Ahead (March 2012)

2012 Outlook: Latin America Sovereign Review (December 2011)

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Figure 1

Uruguay: Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
14 Jul 11	BB+	BBB-
27 Jul 10	BB	BB+
27 Jul 07	BB–	BB
07 Mar 05	B+	BB–
29 Mar 04	B	B+
17 Jun 03	B–	B
19 May 03	D	B
10 Apr 03	C	CCC–
12 Mar 03	CCC–	CCC–
07 Jan 03	B–	B
30 Jul 02	B	B
28 May 02	B+	BB–
13 Mar 02	BB+	BBB–
19 May 00	BBB–	BBB+
23 Jan 97	BBB–	NR
26 Oct 95	BB+	NR

Source: Fitch

Up From the Bottom

Uruguay is close to regaining the investment grade status that it lost early in the last decade. Then, adverse financial conditions spilled over from neighbouring Argentina highlighting Uruguay's vulnerabilities such as its public debt profile, limited access to finance, exchange rate risks, and the vulnerability of its banking system. Uruguay's creditworthiness was rapidly eroded, falling into default in May 2003 after a distressed debt exchange.[1]

As shown by Fitch's rating actions on Uruguay, there have been important advances in creditworthiness in recent years. The authorities in Uruguay have strengthened the policy framework, reduced external and fiscal vulnerabilities, increased macroeconomic stability and supported high rates of growth compared with its peers. Proactive debt management initiatives have improved Uruguay's debt composition, reducing exchange rate and refinancing risks, with favourable debt dynamics. The country's external balance sheet is stronger thanks to the accumulation of foreign assets, and robust FDI inflows that more than compensate for moderate current account deficits. Sound structural factors, including high GDP per capita income, strong social indicators, and a strong institutional framework create the conditions for policy continuity over the forecast period.

Some of the elements weakening Uruguay's creditworthiness before the 2003 default have lessened in recent years, including the real and financial linkages with the Argentine economy. Non-resident deposits in Uruguay's financial system, mostly of Argentine origin, fell from 41% of total deposits in 2003 to 15% at the end of 2011. Strict restrictions on loans' operations with non-resident deposits are now in place to reduce liquidity and FX risks. Uruguayan exports to Argentina in 2011 represented only 7.3% of the total, down from 15.4% a decade earlier, in favour of other destinations like Brazil, Russia and China. The linkage in tourism remains strong as Uruguay is the main summer destination for Argentines, which will continue in the near future.

Uruguay's creditworthiness continues to face challenges. The public debt burden remains high, even compared to the 'BB' rating category, although this is partially compensated for with its long maturity profile and sovereign's liquid asset position. The country's fiscal consolidation has been slow, while fiscal rigidities are growing due to increased public expenditure. Conducting monetary policy is particularly challenging due to high vulnerability to terms-of-trade shocks and the limited transmission channels available. Financial dollarization remains high, although exchange rate risks are contained thanks to effective prudential regulation and improving external liquidity.

Figure 2

Recent Moves into IG

	Date	Default (year cured)
Indonesia	15 Dec 11	2002
Colombia	22 Jun 11	-
Latvia	15 Mar 11	-
Azerbaijan	20 May 10	-
Panama	23 Mar 10	1995
Brazil	29 May 08	1994
Peru	2 Apr 08	1997
India	1 Aug 06	-

Source: Fitch

Comparison with Recent Upgrades to Investment Grade

In 2006-2011 Fitch upgraded eight sovereigns to 'BBB–'. These included, in chronological order, Indonesia, Colombia, Latvia, Azerbaijan, Panama, Brazil, Peru, and India. Latin American countries represent most of these upgrades as a result of higher trend growth, improved macroeconomic performance characterized by relatively low inflation, and the strengthening of the sovereign's external and fiscal balance sheets[2].

Each sovereign rating action is based on a complete analysis of all relevant rating factors across credit profiles following Fitch's sovereign rating methodology. It is not possible to identify a single rating trigger or even a group of triggers that would move a country into the 'BBB' category.

Related Criteria

Sovereign Rating Methodology (August 2011)

[1] Holders of 93% of the $5.1 billion in eligible bonds then accepted the exchange, but were not compensated enough to offset the economic loss, in present value terms, of extended principal payments (see Fitch's Sovereign Distressed Debt Exchanges and Sovereign Rating Methodology).

[2] A sample of sovereigns' performance on their road towards investment grade is illustrated in the following charts, although all countries are included in the median calculation. Latvia is excluded from the analysis because it was downgraded into the 'BB' category in December 2008 before returning to investment grade in 2011. Uruguay's figures for 2006-2011 are presented for comparison purposes.

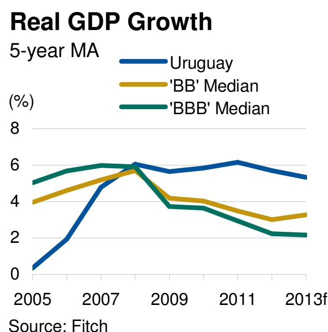
Strong Growth Prospects in Uruguay

It is clear from our small sample that the median country showed some acceleration in economic growth during the years preceding an upgrade to the 'BBB–' category. The upgrade, however, did not necessarily take place at the peak of the business cycle (eg, Azerbaijan, Brazil), but when higher growth was evident and could be projected beyond the forecast period.

Figure 3

Real GDP Growth

5-year MA



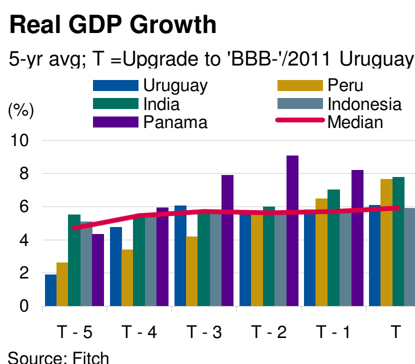
Source: Fitch

Uruguay's economic performance closely tracks the median of the group in our sample, with its five-year average economic growth in 2011 at 6.1% (growth peaked in 2010 at 8.2%). Such performance makes Uruguay an over-performer with respect to countries in the 'BB' and 'BBB' categories using 2011 figures. Following a structural change in the economy after the 2002 financial crisis, Uruguay's potential GDP growth accelerated, with the IMF estimating it in the 4.6%-5.3% range. This has been possible through a healthy diversification of the economy, important gains in productivity, and the emergence of the transport, service and logistic sectors supported by its highly-skilled labour force. Fitch expects some deceleration in economic activity in 2012 before accelerating in 2013, for an average 4.8% GDP growth rate during the forecast period.

Figure 4

Real GDP Growth

5-yr avg; T =Upgrade to 'BBB-'/2011 Uruguay

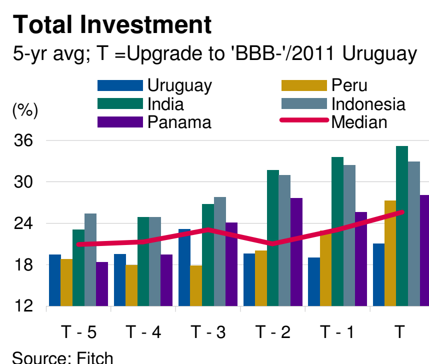


Source: Fitch

Figure 5

Total Investment

5-yr avg; T =Upgrade to 'BBB-'/2011 Uruguay



Source: Fitch

An important acceleration in capital stock accumulation has supported Uruguay's faster growth rates, but higher investment is needed in the short-to-medium term to maintain the positive momentum. It is here that Uruguay remains behind other countries that have moved into investment grade. Despite the strong growth performance, investment to GDP has only exceeded 20% once since 1990.

Narrow fiscal space limits the government's capacity to take on the large infrastructure projects needed to maintain the economy's competitiveness, including highways, rail, and power generation. Public sector investment is expected to remain close to 3% of GDP, which explains the government's decision to promote the role of the private sector in infrastructure projects through Public Private Partnerships. The private sector, responsible for 75% of total investment, has shown more dynamism in recent years with even brighter prospects for the medium term as new sectors emerge, including oil and mining production. In order to approach the position at the time of the upgrade of the median in our sample, Uruguay would need at least five more years with real investment growing above 7% annually, which Fitch sees as feasible.

The improvement in macroeconomic performance across sovereign upgrades to the 'BBB–'category was also seen in inflation. Four out of seven countries that were upgraded had inflation targeting (IT) frameworks in place at the time of Fitch's rating action (Brazil, Colombia, Peru, and Indonesia), with relative success in maintaining low and stable consumer inflation. By the time of the upgrade, only India (not an IT country) had an inflation rate above 6%.

Uruguay's performance on this criterion is weaker, even though inflation has been below 10% since August 2004 and considerably below historical performance. However, Uruguay's five-

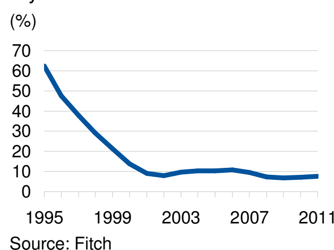
year inflation is not significantly above the median of the new investment grade sovereigns. The BCU announces inflation targets[3], but success has proved difficult with inflation exceeding the band ceiling in over 60% of the observations (inflation was 8.6% at end-2011, falling to 7.5% by March 2012). Higher inflation volatility puts Uruguay in a weaker position not only compared with the sample of countries that moved into investment grade, but also relative to current 'BB' and 'BBB' median categories[4].

Higher inflation and real exchange rate appreciation have not undermined growth performance as productivity and investment growth have allowed the country to cope with these pressures. Higher inflation has not resulted in a major credibility loss for the central bank as Uruguayans' inflation tolerance seems to be higher than in IT economies, perhaps as a result of recent experiences with high inflation. Conducting monetary policy in a highly dollarized economy, with low financial intermediation and shallow local capital markets, present some challenges for the monetary authorities in Uruguay as the credit transmission channel remains weak.

Figure 7

Uruguay Consumer Inflation

5-year MA

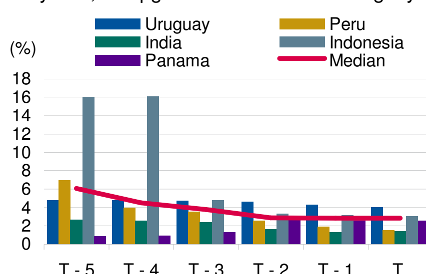


Source: Fitch

Figure 8

Volatility of CPI

10-yr SD; T=Upgrade to 'BBB-'/2011 Uruguay

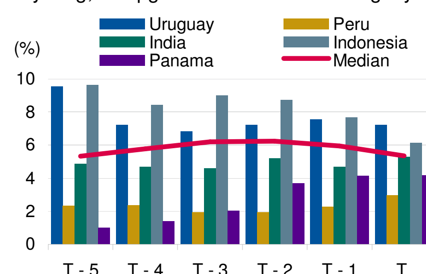


Source: Fitch

Figure 9

Consumer Inflation

5-yr avg; T=Upgrade to 'BBB-'/2011 Uruguay



Source: Fitch

Improvements in policy making are needed to strengthen the current monetary framework, reinforce credibility in the central bank, reduce inflation inertia, and align inflation expectations to central bank's targets. This would bring Uruguay's macroeconomic policies to standards observed in investment market economies, which include credible monetary regimes, capacity to prevent macro imbalances from emerging, and the possibility of implementing countercyclical fiscal and monetary policies.

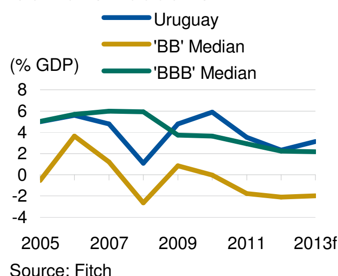
Uruguay's External Balance Sheet Is Strengthening

The sovereign external balance sheets of six out of the seven countries in our sample improved in the years preceding their upgrade. In the cases of Peru and Brazil, the sovereigns became net external creditors, while in the other cases the net debtor position substantially decreased; only Panama showed a small deterioration[5].

Uruguay's net external debt has fallen in recent years thanks to moderate increases in public external debt, low private external indebtedness and an important foreign assets accumulation. The accumulation in foreign reserves, 34.5% in 2011 alone, was not propelled by portfolio flows that could reverse because the local financial market is too shallow to nest large bets by foreign players. Instead, the accumulation responds to the build-up of foreign currency-denominated sovereign assets (partially debt-financed) and large FDI inflows into Uruguay, attracted by its economic dynamism and strong structural features (annual FDI inflows averaged 5.8% of GDP between 2006 and 2011). Surpluses in the financial account have compensated for larger

Figure 10

Current Account + FDI



Source: Fitch

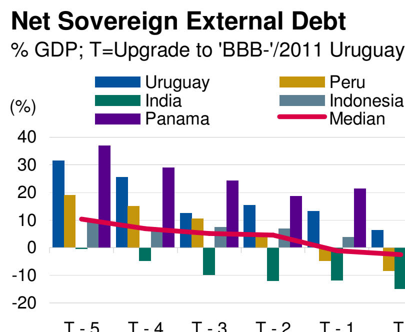
[3] Authorities started the transition towards IT in 2005, although it cannot be labelled as a fully-fledged inflation targeting regime.

[4] Volatility will decrease in 2013 after the inflation spike in 2002/3 leaves the sample.

[5] Panama is fully dollarized economy with no central bank and its reserves position can't be strictly compared with non-dollarized countries.

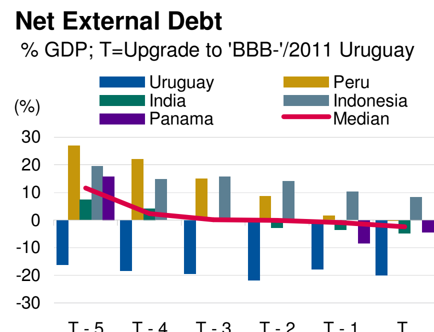
current account deficits, partially related to larger imports of capital goods, putting the country in a strong position relative to other countries in the ‘BB’ category.

Figure 11



Source: Fitch

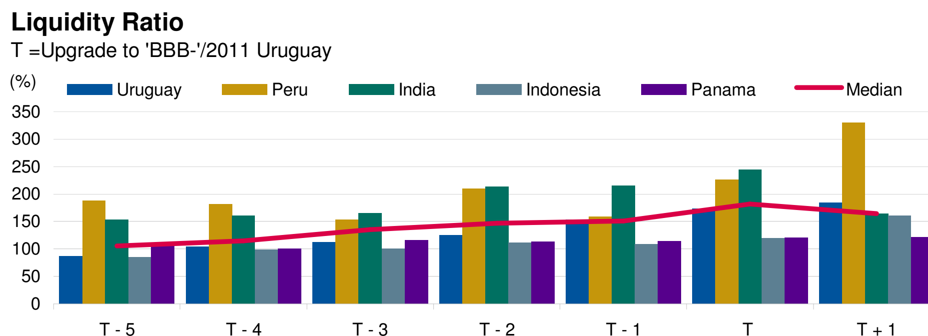
Figure 12



Source: Fitch

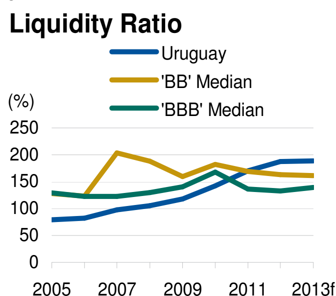
Despite these advances, Uruguay’s net sovereign external position in 2011 remains weaker than all countries in our sample at the time of moving into the ‘BBB–‘ category except Panama. Compensating for larger public external indebtedness, the amortization schedule of public debt is extremely light, with only 2.4% of total debt coming due in one year (down from 16% in 2005). Once the private sector’s external position is included (with an equally weighted contribution of banks and non-banking private sector using 2010 figures), Uruguay becomes a large net external creditor compared to the countries included in our sample at the time of their upgrade. Only Azerbaijan had a stronger position, with net external assets equivalent to 45% of GDP in 2010.

Figure 13



Source: Fitch

Figure 14



Source: Fitch

The combination of larger foreign assets and a light debt service schedule has improved Uruguay’s liquidity ratio consistently since 2003. By 2011, it was equivalent to 173%, slightly below the median of our country sample at the time of the upgrade to ‘BBB-‘, and behind Peru, Brazil and Azerbaijan, countries with a strong liquidity position. In the context of current ratings, Uruguay currently has larger liquidity ratios than those of the median in the ‘BB’ and ‘BBB’ categories. Similar to Colombia at the time of obtaining IG, Uruguay has contingent credit lines from multilaterals (USD1.4bn, 14% of foreign reserves or 3% of GDP) to reinforce its external assets cushion in the event of adverse external conditions.

Further advances are expected for 2012 and beyond thanks to limited increases in external debt, light debt service, and further accumulation of foreign reserves. This would be positive given Uruguay’s moderate commodity dependence and still considerable levels of financial dollarization.

Mixed Results on Public Finances

Public debt for the countries included in our small sample does not show a consistent trend in the years preceding the upgrade. While GG debt in Peru and Indonesia fell, and by the year of the upgrade were both equivalent to 25% of GDP, other countries stabilized at higher levels, like Panama (at about 43%), Colombia (41%), India (77%), and Brazil (58%)[6]. The median for the sample shows little movement in the three years before the upgrade, standing in the 41%-43% range. A side-to-side comparison using 2006-2011 for Uruguay shows some improvements, with GG debt decreasing from over 53% of GDP in 2006 to 47.9% in 2011, but still above the median for our country sample at the time of the upgrade. GG debt in Uruguay in 2011 would decrease to 42.6% of GDP if debt issued to capitalize Uruguay's central bank was excluded[7]. Despite the accumulation of government assets in Uruguay in recent years, net debt seems is still higher relative to countries moving into IG, although its trend is decreasing.

Figure 15

Average Duration of CG Debt (Year 2010)

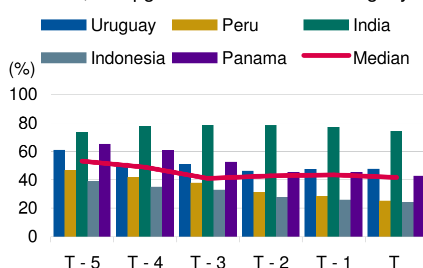
Rating	BBB		BB
Aruba	5.0	Costa Rica	3.5
Brazil	2.4	Egypt	2.1
Bulgaria	7.2	El Salvador	9.0
Colombia	4.4	Gabon	5.6
Cyprus	4.6	Indonesia	5.7
Hungary	3.6	Macedonia	1.2
Indonesia	5.7	Turkey	3.0
Kazakhstan	16.0	Uruguay[a]	10.3
Lithuania	3.8		
Mexico	5.0		
Morocco	5.7		
Namibia	4.8		
Panama	8.5		
Peru	7.8		
Russian Federation	5.3		
South Africa	7.4		
Thailand	10.3		
Tunisia	6.0		

[a] 2011
Source: Fitch

Figure 16

General Government Debt

% GDP; T=Upgrade to 'BBB-'/2011 Uruguay

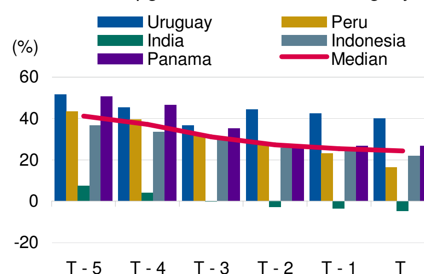


Source: Fitch

Figure 17

Net General Government Debt

% GDP; T=Upgrade to 'BBB-'/2011 Uruguay



Source: Fitch

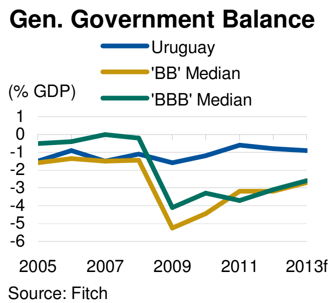
In some cases where the general government debt burden was higher than the 'BBB' median, other factors mitigated risks. For example, in the case of Brazil, improvements in the composition of debt (maturity and duration) as well as a higher share of domestic debt on fixed rates mitigated concerns about the vulnerability of debt dynamics to interest rate shocks and roll-over risks. Similar trends can be observed in the case of Uruguay where a higher level of GG debt is mitigated by its light repayment schedule. This is the result of a widely recognized debt management strategy implemented in recent years, which has brought CG average duration to 10.3 years, the third highest among all sovereigns rated by Fitch for which data is available, after the United Kingdom and Kazakhstan. The government set up a policy in 2009 to maintain liquid assets for debt amortization equivalent to 12 months of future payments, although by 2011, such assets covered over three years of expected amortization.

Proactive liability management has reduced foreign currency risk in Uruguay, increasing the participation of local-currency debt in total indebtedness. By the end of 2011 GG debt denominated in local currency represented 49% of total debt, up from only 15% in 2006, and 34% in 2010. Nevertheless, compared to the countries upgraded to 'BBB–' since 2006, Uruguay's level of GG debt in local currency in 2011 remains substantially below the median, and only above Peru at the time of the upgrade (Peru's GG debt in local currency was 36.6% of total debt, but compensated for such weakness with the strongest external position in the sample). Fitch expects that in the absence of further liability management exercises, the share

[6] On the year of the upgrade Colombia passed reforms to strengthen its fiscal framework. Panama passed a revenue-enhancing tax reform, which combined with its strong growth and moderate deficits, ensured that debt would eventually converge with the 'BBB' median in a short period of time. Brazil, on the other hand, showed a strong track record in generating high primary surpluses to put debt on a sustainable path. Despite its large gross public debt India showed in 2006 some improvements in its fiscal position, and had also enough assets to remain a net creditor.

[7] In 2010 Uruguay issued USD1.9bn in perpetual bonds and USD486m in 30-year bonds to capitalize the BCU. These bonds are not negotiable. The Brazilian government also capitalized the BCB with debt, but these bonds are used for open market operations.

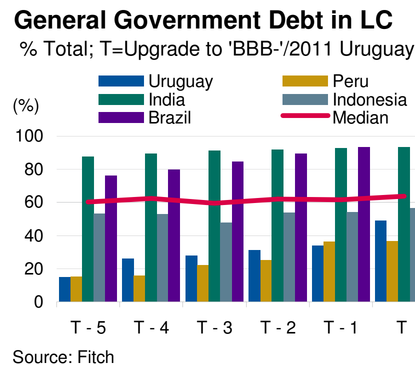
Figure 18



Source: Fitch

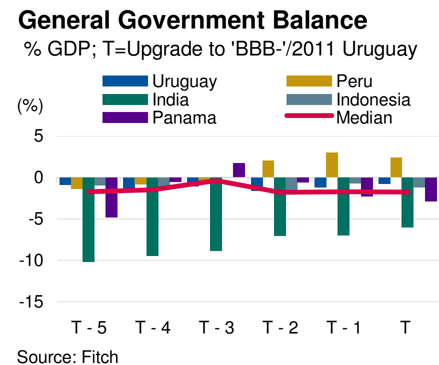
of local currency debt in total GG debt will increase only gradually in the coming years as the government develops the local debt market and places debt mainly in pesos.

Figure 19



Source: Fitch

Figure 20



Source: Fitch

The reduction in GG debt in Uruguay is in line with smaller deficits in public accounts observed in recent years, except in 2009 due to the effects of the global financial crisis. It is on government balances where Uruguay has shown a strong performance relative to both the sample of countries upgraded to investment grade, and peers in the 'BB' and 'BBB' categories. Not only deficits have been smaller and in line with government targets, but also more stable thanks to low volatility in public revenues given the existing tax structure. Compared to 2011 figures for Uruguay, only Azerbaijan and Peru had stronger fiscal results on the year of their upgrade, with surpluses equivalent to 14.0% and 2.3% of GDP, respectively. However, both countries faced significant positive terms of trade shock and the latter has considerable budget execution limitations.

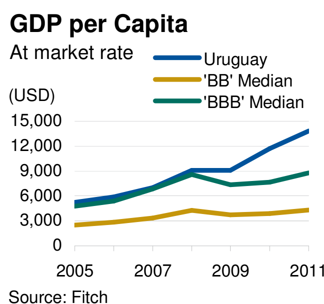
Uruguay's strong fiscal performance has been achieved without a fiscal responsibility framework, signalling the strong preference of the current and previous administration towards prudent fiscal management[8]. This was in evidence during 2008/2009 when authorities allowed automatic stabilizers to work rather than pursuing an aggressive fiscal stimulus programme that would have affected its fiscal and debt position. The fiscal consolidation process in Uruguay could have been much faster given the strength of its local economy, but the authorities opted instead for supporting and improving structural features of the economy, particularly through additional social expenditure.

Sound Structural Features

Uruguay's institutional strength stands out among rating and regional peers, reducing the risk of social and political instability even in times of economic hardship (ie, during the 2002/2003 financial crisis). According to the World Bank's governance indicators, Uruguay outperforms the 'BBB'-median in all six categories, but particularly in Political Stability, Control of Corruption, and Accountability.

Social risks are reduced thanks to the country's high GDP per capita, which currently exceeds 'BB' and 'BBB' medians, and has grown at a faster pace in recent years thanks to large gains in productivity and limited population growth. Currently, Uruguay's GDP per capita is well above those of countries moving into investment grade at the time of their upgrade. The country shows superior social indicators, as measured by the United Nations' Human Development Index, declining poverty and unemployment, and low income inequality. Further improvements

Figure 21



Source: Fitch

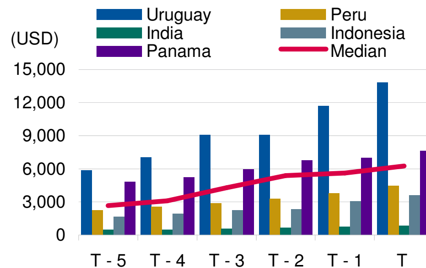
[8] Since 2006 the Indebtedness Limit Law sets a cap in net public debt increases for any given year, further strengthening the fiscal framework currently in place.

may materialise in the near term as the current government prioritises housing, education, security, infrastructure, and safety net enhancements.

Figure 22

GDP per Head

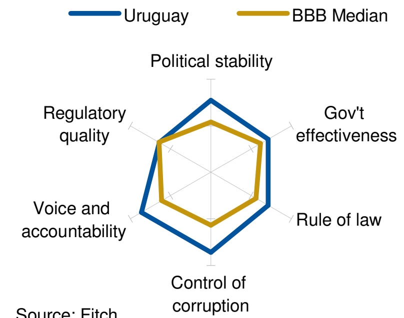
USD; T=Upgrade to 'BBB-'/2011 Uruguay



Source: Fitch

Figure 23

Governance Indicator, 2010



Source: Fitch

There are challenges, but these are usually observed in higher rating tiers. The abundance streaming from higher economic growth, lower unemployment and higher real wages have benefited an enlarging middle class. Lower income groups, on the other hand, mostly see their income level improved by increasing government transfers, but without evidence of a real social and economic transformation. This is aggravated by Uruguay's demography that shows high birth rates among low income tiers while middle and upper tiers barely cover their replacement rates. Some deterioration in structural factors, including public education, safety, and a highly-skilled labour force requires attention to maintain the country's strong features over the long term.

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