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INVESTORS SERVICE

CREDIT ANALYSIS

Uruguay

Uruguay

Table of Contents:

Analyst Contacts:

NEW YORK +1.212.553.1653

Mauro Leos +1.212.553.1947
Vice President - Senior Credit Officer
mauro.leos@moodys.com

Gabriel Torres +1.212.553.3769
Vice President - Senior Credit Officer
gabriel.torres@moodys.com

Ariane Ortiz Marrufo +1.212.553.4872
Associate Analyst
ariane.ortizmarrufo@moodys.com

Bart Oosterveld +1.212.553.7914
Managing Director - Sovereign Risk
bart.oosterveld@moodys.com

This Credit Analysis provides an in-depth discussion of credit rating(s) for Uruguay and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website.

Summary Rating Rationale

Uruguay

	Foreign Currency	Local Currency
Government Bond Rating	Baa3 – Positive	Baa3 – Positive
Country Ceiling	Baa1	Baa1
Bank Deposit Ceiling	Baa3	Baa1

Moody's sovereign rating list

Rating Rationale

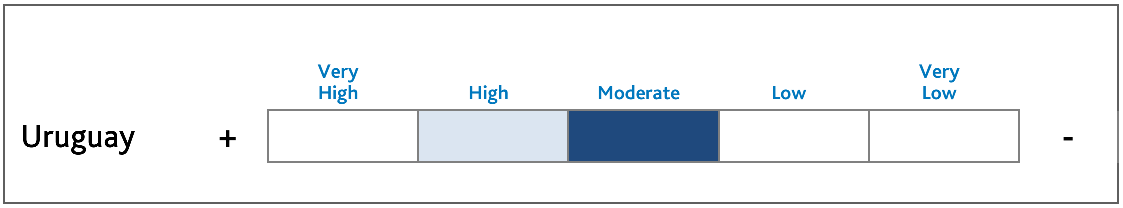
Uruguay's sovereign rating was upgraded to Baa3 from Ba1 in July 2012, with a positive outlook, to reflect a steady improvement in the government's credit profile that has led to a gradual convergence of its fiscal metrics with Baa peer medians. A significant strengthening of the government's balance sheet and reduced vulnerabilities to regional shocks were also contributing factors to our decision to assign an investment grade rating to Uruguay.

The government's credit resiliency is supported by a debt structure with a maturity profile that exceeds that of most Baa-rated countries and gross financing needs that are among the lowest for sovereigns rated by Moody's. Ample government liquidity buffers place Uruguay in a strong position relative to similarly-rated countries as the authorities are capable of managing stress scenarios, including those involving events that could restrict market access.

Uruguay's income level is above the median for Baa peers and its institutional strength indicators comparable to those of higher-rated countries. The economy's performance has been characterized by robust growth with GDP reporting growth in excess of 6% during 2004-2011. Potential growth has increased as well backed by an upward shift in total factor productivity that should support prospects of sustained growth.

The country's exposure to regional risks has declined as a result of increased economic and financial diversification. Still, credit risks derived from Uruguay's commodity dependence and a relatively high degree of dollarization continue to pose non-negligible risks.

FACTOR 1: ECONOMIC STRENGTH – Moderate shade High



A Small, Dynamic Investment-Driven Economy

Uruguay has a small, relatively open economy. With GDP of $47 billion, Uruguay's economy is significantly smaller than the average Baa country's ($72 billion median). Uruguay's economy is comparable to that of Azerbaijan (Baa3; $52 billion), Guatemala (Ba1; $52 billion), Lithuania (Baa1; $42 billion) and Tunisia (Baa3; $47 billion).

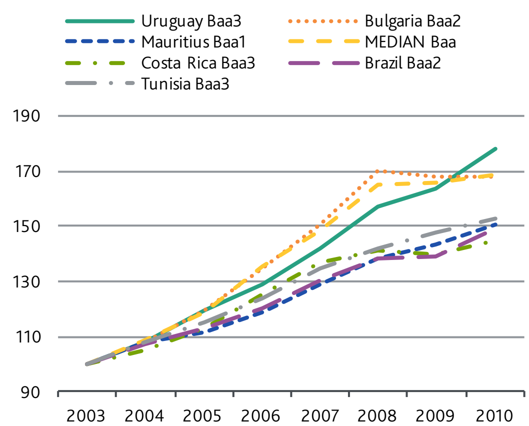
Uruguay's per-capita GDP of $14,400 (PPP basis) is slightly higher than the $13,700 median and fits right in the Baa peer group. The dynamism of its per-capita GDP, which has increased an average 8.6% annually during the last eight years, underscores our favorable assessment.[1]

From 2004 to 2011, the economy's average annual growth rate was 5.9%, which compares with median GDP growth of 4.4% for Baa peer group. During this period, Uruguay's growth was slightly higher than the 5.7% of Indonesia, a country with a successful growth story whose sovereign rating was recently upgraded to investment grade (Baa3).

EXHIBIT 1

GDP per capita

(PPP basis US$, 2000=100)

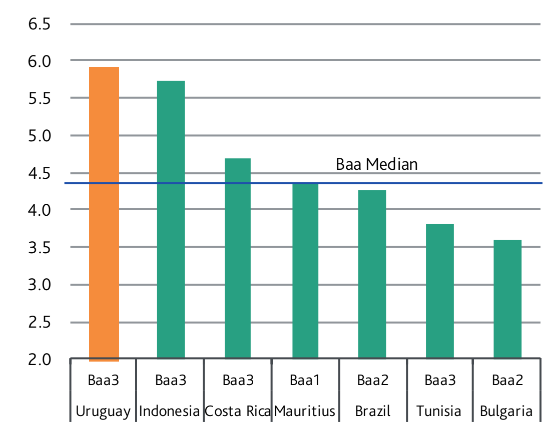


Source: Moody's Investors Service; WB

EXHIBIT 2

Real GDP Growth, Average 2004-2011

(Annual rate %)



Source: Moody's Investors Service

Uruguay's growth has not been associated to consumer or credit booms, nor has its growth exhibited the boom-bust pattern of other emerging economies. Annual growth rates have fluctuated between 4% and 7% during the last eight years, a relatively narrow range for a small open economy.[2]

[1] The country's favorable standing extends to other socio-economic indicators, such as poverty, life expectancy, and years of schooling; Uruguay's Human Development Index (HDI) of 0.783 ranks the country 48 out of 187 countries worldwide.

[2] 2009 and 2010 were the only exceptions during this period reflecting the impact of the global financial crisis.

During 2004-2008, GDP rose 6.6% annually reflecting a combination of factors that included: (i) an initial bounce-back effect following the 2002-2003 financial crisis, (ii) favorable external conditions, and (iii) the one-off impact of large investment projects.[3] In 2009, the impact of the global crisis on the economy was relatively mild and short-lived. Uruguay avoided a recession, as the economy contracted only during the first quarter, reporting annual growth of 2.4% for the year. Growth accelerated again in 2010 at a record annual rate of 8.9%, followed by 5.7% growth in 2011.

We expect the economy will report lower growth in the near term given a less favorable external environment that will include a sudden and abrupt stop in Argentina, as well as a deceleration in Brazil. Accordingly, we estimate Uruguay's GDP will rise at an annual rate of 4% to 5% in 2012 and 2013.

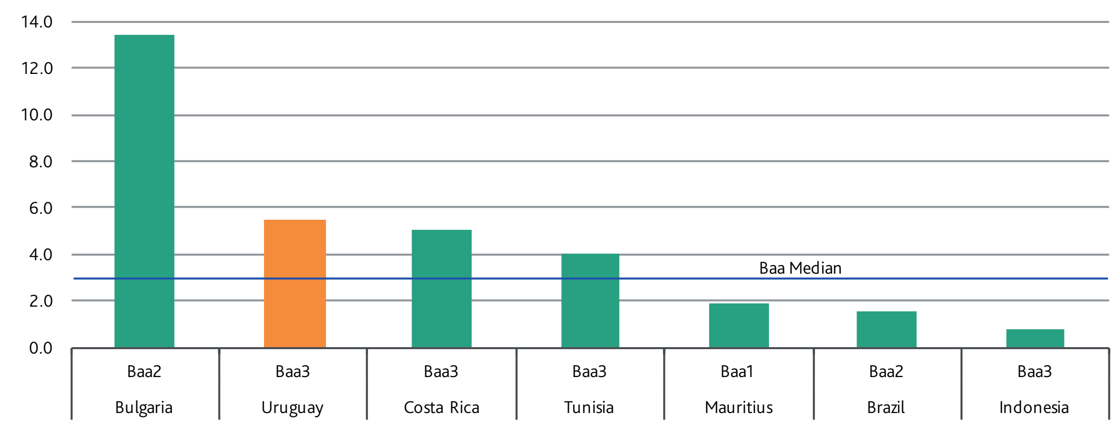
Although external conditions and commodity-related factors have contributed to the country's favorable economic performance in previous years, Uruguay's extended growth streak was due mostly to a steady increase in investments, with gross fixed investment reporting 7.6% average annual growth in the last decade. As a result, an investment ratio that was at 12% of GDP at the beginning of the decade is now at around 20%, converging with the ratios of other Baa-rated countries.

Foreign direct investment (FDI) has played an important supporting role in Uruguay's economy going mostly to export-oriented projects and enhancing the country's export potential. Additionally, high FDI levels have been, and are likely to remain, an important source of non-debt financing for the balance of payments. With average annual FDI coming to 5.5% of GDP during 2004-2011, Uruguay's ratio is nearly twice the median of Baa-rated countries and higher than the FDI ratios for Baa3-rated Costa Rica (5.1%) and Tunisia (4.0%).

EXHIBIT 3

Net FDI / GDP, Average 2004-2011

(%)



Source: Moody's Investors Service

[3] In 2008, the start of operations at BOTNIA's pulp mill spiked GDP growth to nearly 9%.

Increased Diversification Despite the Small Scale of the Economy

One shortcoming of Uruguay's economy is its relatively small size, given GDP of some $50 billion. A small scale limits the degree of diversification a country can achieve. Nevertheless, although scale can be a potential rating constraint, 13 countries whose nominal GDP ranges from $20 billion to $60 billion have ratings in the Baa category, indicating that a small scale does not preclude an investment-grade rating at this rating level.

Despite the challenges inherent in its small scale, Uruguay has made strides in diversifying its economic base. Efforts backed by an aggressive investment promotion program based on fiscal incentives have been effective in developing new sectors that have reshaped the country's economic structure.

The Uruguayan economy has always had a dual character with both primary sector activities and services playing important roles. Traditional primary sector activities involve livestock/beef, agriculture and dairy products; financial services and tourism complete the picture.

A more balanced structure is evident in a traditional sector that is no longer dominated by beef and beef-related products. The most significant developments include the consolidation of an agro-business complex during the last decade that has led to a three-fold increase in grain production to 6 million tons and to exports of more than $1 billion, and the emergence of an export-oriented dairy sector driven by foreign investment from New Zealand with sales of more than $500 million annually.

Additionally, two new sectors have become integral to Uruguay's new economic profile:

1. **A globally competitive pulp industry.** In 2005, the Finnish paper producer Botnia launched a pulp mill project to take advantage of Uruguay's supply of high-quality timber. With an initial investment of $1.5 billion, a top-of-the-line mill with a capacity of 1.1 million tons of pulp was completed in 2007. The mill has been in operation since 2008 making Uruguay a major player in the pulp market with annual exports of around $700 million. The country's global standing in this market will be reinforced by a second pulp mill project, Montes de Plata, of similar dimensions currently underway. With total investment of $2 billion, this joint venture by Swedish-Finnish Stora Enso and Chilean Arauco will have a 1.3 million tons production capacity and annual exports of $750 million.
2. **Transportation and logistics.** As a result of a major revamping of its port facilities following a concession to private operators, the port of Montevideo has become a major regional hub in South America managing more than half a million containers working and supporting the country' strategic goal of becoming a gateway to Mercosur.

Medium-Term Potential Growth Supported by Stronger Economic Fundamentals

In addition to a recent track record for persistent growth, the evolution of total factor productivity supports the view that Uruguay's potential growth is higher as the country's economic fundamentals are stronger because of structural changes that took place in the last decade.

An analysis of Uruguay's long-term growth trends reveals that higher total factor productivity has been a key element supporting GDP growth. Exhibit 4 breaks down GDP growth by the contribution of factors of production, e.g., capital and labor, and the productivity component. The data shows that the salient feature of Uruguay's economic growth from 2005 to 2011 was the upward shift in total factor productivity, which increased by 3.2% annually, compared with average productivity growth of 1.4% during the 1990s and -1.9% from 2000 to 2004. In Moody's opinion, higher productivity growth indicates that Uruguay's medium-term economic prospects are fundamentally sound.

EXHIBIT 4

Uruguay: Contribution to GDP Growth by Factors, 1990-2011

Period	GDP growth	Capital	Labor Quantity	Labor Quality	Total Factor Productivity
1990-1999	3.30%	0.70%	0.90%	0.30%	1.40%
2000– 2004	-1.60%	0.20%	-0.10%	0.20%	-1.90%
2005 – 2011	6.40%	1.00%	2.00%	0.30%	3.20%

Source: Ministry of Economy and Finance

These findings are consistent with recent IMF estimates indicating that Uruguay's potential growth has increased due to the impact of both higher investment ratios and stronger total factor productivity. Using different statistical methods, the IMF developed potential GDP growth estimates for two different periods. In the first period, which comprised the 1980s and the 1990s, the IMF found that potential growth was 2.0%-2.5%. For the second period, which went from 2000 to 2010, it found that potential growth estimates were significantly higher.[4]

The main conclusion from these findings is that, as Uruguay's economic fundamentals have strengthened during the last decade, the economy is capable of higher, sustained growth. Hence, our positive view of the economy's medium-term prospects.

Stable Terms of Trade = Moderate Impact of Commodity Price Shocks

Unlike most commodity-producing countries, Uruguay's exposure to terms-of-trade (TOT) shocks is relatively low marking a fundamental difference between Uruguay and other commodity producers. This is so because, while higher prices for soft commodities benefit Uruguay, the opposite is true in the case of energy prices given the country's high dependence on energy imports.

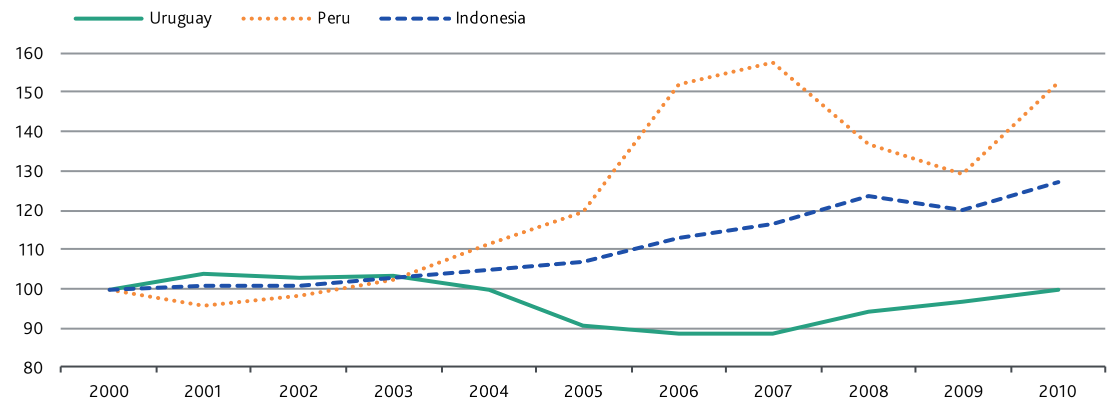
As a result, during the last 10 years, the net impact of TOT changes has been muted as changes in the prices of soft commodities and energy have canceled each other out. This is a fundamental difference between Uruguay and other commodity producing countries.

Exhibit 5 shows the terms of trade for Uruguay, Peru, and Indonesia. As can be seen, Uruguay's TOT have hardly changed in the last 10 years declining during the middle of the last decade and staging a comeback in later years. As a result, in 2010 the level of Uruguay's TOT were virtually similar to the one observed 10 years ago. The contrast with Indonesia and Peru, two Baa-rated commodity-producing countries is evident since TOT rose 27% in the case of Indonesia and 52% in Peru.

The bottom line is that just like Uruguay did not benefit as much as other commodity producers on the upturn of the price cycle, in the event of a downturn in prices, the economic impact on Uruguay will be mild when compared with other commodity producers.

[4] Uruguay Article IV Consultation, Selected Issues, IMF, December 2011.

EXHIBIT 5
Terms of Trade
(2000=100)



Source: World Bank, World Development Indicators (WDI)

Low External Imbalances Financed by FDI flows; Moderate External Financial Vulnerabilities

Foreign direct investment (FDI) inflows have more than covered moderate current account deficits of 1%-2% of GDP that have been reported in four of the last five years, the exception being 2008.[5] Looking ahead, even though our projections incorporate a spike in the current account deficits to 3%-4% of GDP in 2012-2014, FDI should be large enough to continue to cover them.

The anticipated increase in the current account deficit should be transitory and self-correcting because it will reflect mostly higher capital imports for the Montes de Plata pulp mill project.[6] Given that the construction phase of Montes de Plata will last two years and that the mill will become operational in 2015 with annual exports of $700 million, the current account should revert back toward lower levels commensurate to those observed beforehand.

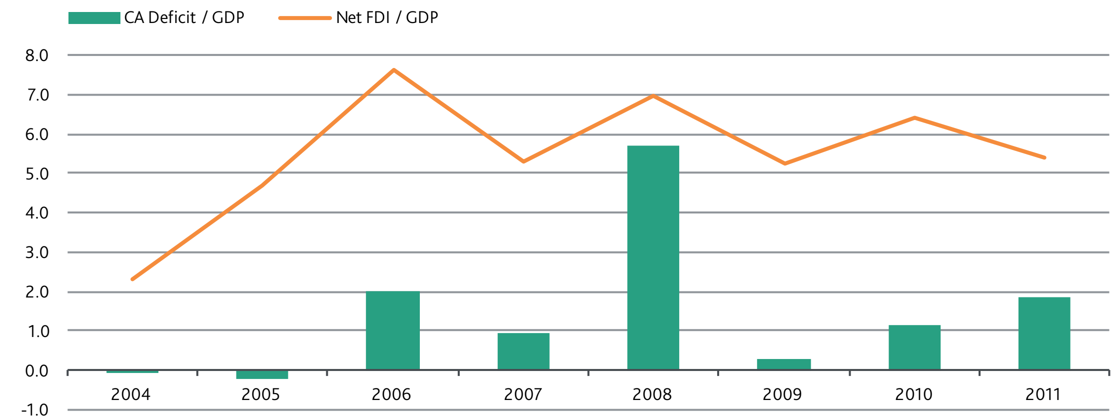
International reserves have been rising steadily coming to nearly $10 billion in 2011 from $3 billion five years ago. Unlike other emerging economies where portfolio inflows have had a significantly impact on the level of reserves, exposing them to sudden stops during periods of global risk aversion, steadier FDI flows dominate capital inflows in Uruguay.

[5] The global economic crisis, in conjunction with an extended drought on the agriculture sector, resulted in a jump in the current account deficit to 5% of GDP.

[6] Montes de Plata, a joint venture between Chile's Arauco and Swedish-Finnish Stora Enso, is a pulp mill mega-project with total investment of $2 billion that broke ground last June.

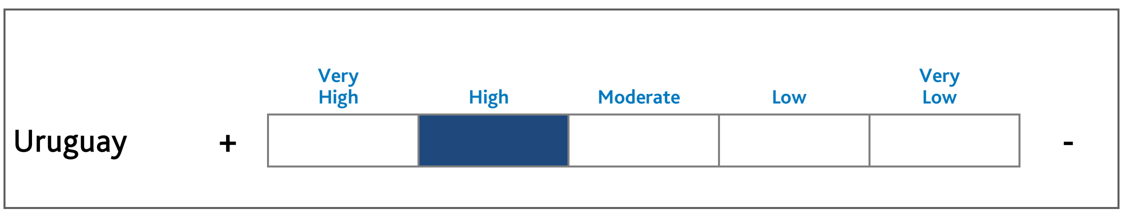
EXHIBIT 6

Uruguay: Current Account Deficit and FDI



Source: Moody's Investors Service

FACTOR 2: INSTITUTIONAL STRENGTH – High



A Robust Institutional Framework

A distinct feature of Uruguay's sovereign credit profile is the strength of its institutional framework. Uruguay's institutional strength is an important support factor for the country's investment-grade rating. Moody's analytical approach is based on the premise that institutional rules enhance creditworthiness by underpinning policy continuity. Social and political consensus is another important factor that helps enhance policy predictability.

Moody's uses World Bank governance indicators as proxies to assess the strength of a country's institutional strength. In the case of Uruguay, the picture that emerges from these indicators is a favorable one, with the country placing in the 70th percentile.[7]

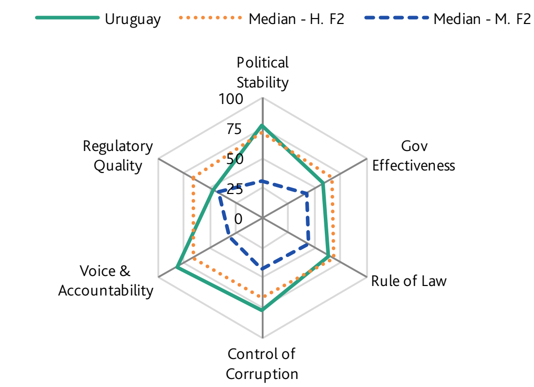
Uruguay's World Bank governance indicators are much higher than the Baa median and on par with the median of countries with high institutional strength (H. F2). Exhibit 7a shows that, based on the World Bank's governance indicators, the country's institutional profile is superior to that of countries with medium institutional strength (M. F2) and comparable to that of high institutional strength countries (H. F2).[8]

[7] The percentile rank indicates the percentage of countries placing below Uruguay.

[8] Furthermore, Uruguay's WB indicators of political stability, control of corruption, and voice-accountability are higher than the median for high institutional strength countries.

EXHIBIT 7A

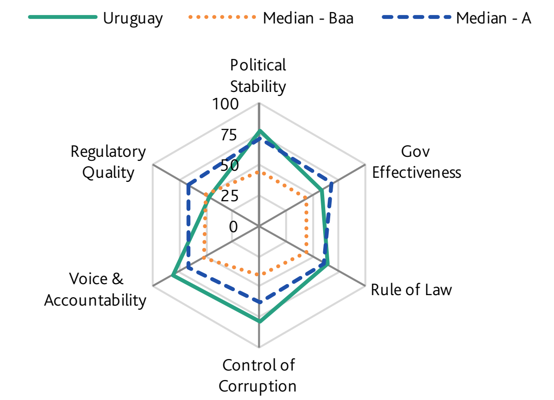
World Bank Indicators



Source: World Bank

EXHIBIT 7B

World Bank Indicators



Source: World Bank

Exhibit 7b presents an alternative look at Uruguay's institutional strength. We compared the World Bank's indicators with the median values for Baa- and A-rated countries. Uruguay's institutional profile is more in line with that of A-rated countries than of Baa countries.

Looking Beyond WB Indicators: A Similar Story

If we expand the definition of institutional strength to incorporate comparisons derived from alternative indicators, the conclusion remains the same. Exhibit 8 lists institutional quality measures from a number of sources and for different categories. Here, too, the country's global ranking is consistently in the upper ranks, reinforcing the high institutional strength of Uruguay's economy.

EXHIBIT 8

Uruguay: Institutional Quality Indicators

Index	World Ranking	Uruguay in South America
Worldwide Governance Indicators (WB 2009)	--	2
Democracy Index (EIU, 2010)	17	1
Corruption Perception Index (Transparency International 2010)	25	2
Press Freedom Index (Reporters without Frontier 2011)	32	1
Global Peace Index (Institute for Economics and Peace 2011)	21	1
Economic Climate Index (SA) (Getulio Vargas Foundation & IFO 2011)	--	2
Economic Freedom Index (Heritage Foundation 2011)	29	2
International Property Rights (Property Rights Alliance 2011)	44	2

Source: Moody's Investors Service, World Bank, The Economist Intelligence Unit 2010, and Transparency International 2010, Reporters Without Frontiers 2011, Institute for Economics & Peace, 2011, Getulio Vargas Foundation & IFO 2011, Heritage Foundation 2011, and Property Rights Alliance 2011.

A Track Record of Policy Continuity: Limited Relevance of Politics

During the last 10 years, and under different administrations, governments have shown a will and ability to maintain conservative economic policies revealing broad-based political consensus on this area.

In 2004, Tabaré Vázquez, the candidate from the left-of-center coalition Frente Amplio (FA) was elected president. The election was significant because, for the first time in Uruguay's political history, the hold of Uruguay's two conservative parties have had on power was broken. Still, the impact of this event on economic was modest as the Vázquez administration adopted as its own the economic stabilization program to which the previous right-of-center administration had been agreed with the IMF.

Overall, economic policies throughout the Vázquez administration were similar to the previous administration's proving that politics have a limited impact on economic policy continuity. This idea was reinforced by the 2009 presidential election which resulted in the coming to office of a second FA administration. At the time of the election concerns emerged because of the perception that the FA's candidate, José Mujica, had a too-far-left profile given his affinity with the more radical elements in the FA.

Concerns proved unjustified. Since taking office, President Mujica has shown a clear commitment to policy continuity. Policies under his administration have been in line with those of the past reinforcing the notion that policy continuity is a quasi-structural feature of Uruguay's sovereign credit profile.

An Additional Institutional Element: Multi-year Budget Framework

In Moody's opinion, institutional arrangements should be incorporated into a country's institutional strength assessment whenever present, particularly if they are of direct credit relevance from a sovereign credit perspective. Uruguay's multi-year budget framework qualifies in this category.

The framework incorporates medium-term fiscal targets consistent with the five-year macroeconomic scenario put together at the beginning of an administration.[9] In addition to providing a guideline for fiscal policy management, the multi-year framework also incorporates a monitoring mechanism consisting of annual reviews by the Uruguayan congress.

The oversight process requires a detailed annual report of fiscal performance, with special attention to any deviations. When deviations exceed the framework's narrow parameters, the government must take corrective measures to assure compliance with the medium-term targets. Given a high degree of compliance over the years, with only minimal deviations, the multi-year fiscal framework is an institutional arrangement that fosters policy predictability and reinforces Uruguay's sovereign credit profile.

"Regulatory Quality": Banking Regulation/Supervision

Of the six World Bank governance indicators, regulatory quality is the one in which the country's position is the weakest compared to peers. This could cast doubts about Uruguay's sovereign rating, if the assessment is related in any way to the quality of bank regulation/supervision, a particularly relevant subject from a sovereign credit standpoint.

[9] Five years is the length of a presidential term in Uruguay.

The World Bank's concept of "regulatory quality" is broad and somewhat vague as it captures "perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development." However, one of the measures the World Bank uses in assessing regulatory quality is the banking/finance sub-index from the Heritage Foundation Index of Economic Freedom.

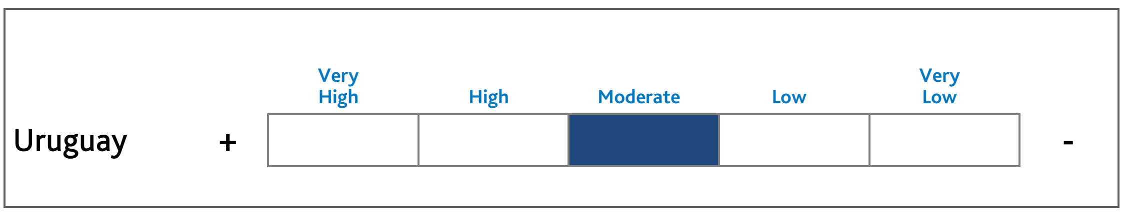
In our opinion, judging the quality of banking regulation/supervision based on an index published by the Heritage Foundation is not a best practice. Instead, we prefer to rely on the IMF's latest Article IV on Uruguay to assess whether the country's banking regulation/supervision is satisfactory.

According to the IMF, "one of the most relevant structural changes (in Uruguay) occurred in the regulation and supervision of the financial system which has been substantially strengthened." The IMF also states that "the regulatory regime is in line with international best practices with many measures on credit risk and foreign exchange exposures in place." [10]

The limited vulnerability of the banking system owes significantly to Uruguay's strong supervision, with the IMF noting that "risk management and internal control systems have been strengthened and the authorities have taken various measures to internalize credit risks from dollarization and cross-border activities."

The IMF's favorable assessment of the quality of banking supervision/regulation supports the case for high institutional strength in Uruguay and, thus, for an investment-grade rating as well.

FACTOR 3: GOVERNMENT FINANCIAL STRENGTH – Medium



Sound Government Accounts Reflect Strong Commitment to Fiscal Discipline

A distinct feature of Uruguay's sovereign credit profile has been a steady decline in government debt ratios supported by a robust fiscal performance. A strong commitment to fiscal discipline, evidenced by government deficits of around 1.5% of GDP since 2005, has led to declining government debt metrics. We expect that the government will maintain its conservative fiscal stance in line with the guidelines in the multi-year budget framework.

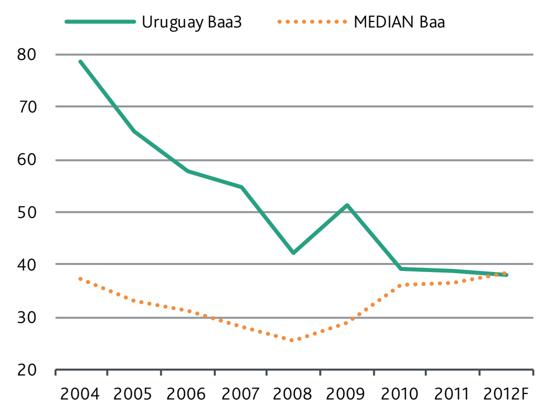
In previous years, the country's fiscal accounts benefited from higher-than-expected revenues as the strength of the economic recovery exceeded initial official estimates. For the future, the most likely scenario is one in which economic conditions will be less favorable, albeit still positive. Nevertheless, despite lower GDP growth and thus less dynamic government revenues, we expect the authorities will adjust spending to preserve moderate fiscal deficits.

[10] Uruguay Article IV Consultation, IMF, December 2011

The government accounts reflect the authorities' commitment to fiscal responsibility and provide evidence of their willingness and ability to comply with the targets in the multi-year budget framework. Since 2004, government deficits have been 1%-2% of GDP, with primary balances exceeding 1% of GDP. Low deficits and strong GDP growth have led to declining debt ratios, which have moved towards 40% of GDP from 80% in 2004. As a result, debt-to-GDP has converged with the median ratio for Baa-rated sovereigns, as Exhibit 9 shows, with a similar pattern in other government debt metrics.[11]

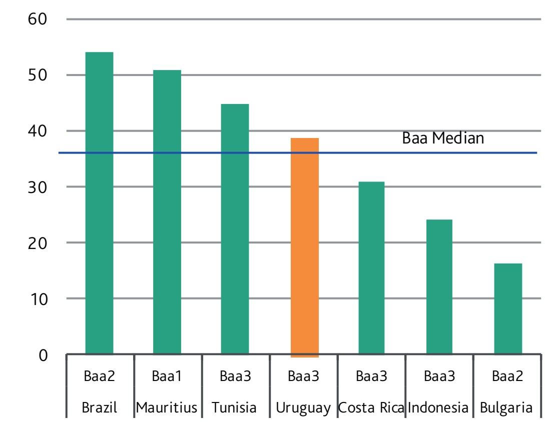
Although the decline in government debt ratios reflects in part strong economic growth, the main reason for their steady decline has been the strict compliance with the targets in the medium-term fiscal framework, which, in 2005, established the goal of reducing the government's debt ratio to less than 50% of GDP. Moreover, given the government's commitment to the meeting the targets in the framework, we expect debt ratios will continue to decline during the rest of this administration.

EXHIBIT 9
Government Debt/GDP, 2004-2012
(%)



Source: Moody's Investors Service

EXHIBIT 10
Government Debt/GDP, 2011
(%)



Source: Moody's Investors Service

A Long Maturity Profile Translates Into Low Gross Financing Needs

The government's debt management strategy, through the extension of average debt maturities, a reduction in the share of foreign currency-denominated debt, and the build-up of precautionary liquidity reserves, was a major reason behind Moody's decision to upgrade Uruguay's sovereign rating to investment-grade.

The re-profiling of government debt, particularly the reduction of refinancing (roll-over) risks as liability management operations extended debt maturity, has had a significant impact on the sovereign's credit profile. With government debt maturity of around 11 years since 2007, Uruguay's is among the longest in the sovereign rating universe – few countries have government debt maturities exceeding 10 years. As a result, the country is part of a select group and ranks among the top for

[11] Fiscal numbers refer to the central government as the country does not report general government data. Regional or provincial governments (*intendencias*) have a limited presence. The revenues of the public pension system are sizeable at 6%-7% of GDP. If we incorporate pension system revenues, the debt-to-revenue ratio comes to 142% (Baa median: 140%) and the interest-to-revenue ratio to 9% (Baa median: 7%).

sovereigns rated by Moody's in the company of Peru (12.3 years), the Philippines (10.1 years) and India (9.3 years) – the government intends to maintain average debt maturity at more than 11 years.[12]

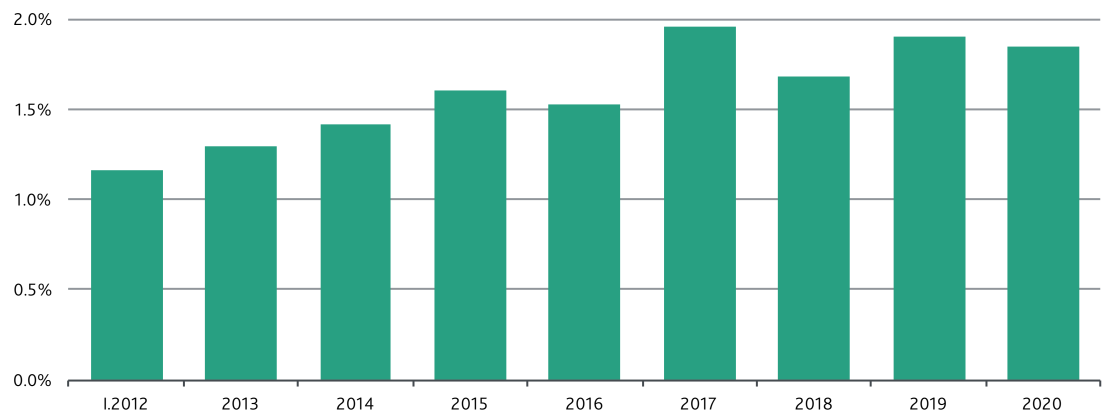
In this area, Uruguay stands out from most of its regional peers: Average government debt maturity in Chile (11.4 years) and Costa Rica, (10.1 years), both of which have investment grade ratings, is comparable to Uruguay's. For the remaining investment-grade countries in the region debt maturity is lower than 10 years, ranging from 5 to 7 years – Brazil (5.6 years), Mexico (7.2 years).[13]

An extremely favorable maturity profile translates into modest rollover risk. Because of Uruguay's lengthened debt maturity, the government has modest refinancing requirements over the medium term with principal payment on the order of 1.5% of GDP during the next eight years, as Exhibit 11 shows.

EXHIBIT 11

Uruguay: Amortization Calendar Central Government, 2012-2020

(%GDP)



Source: Ministry of Economy and Finance

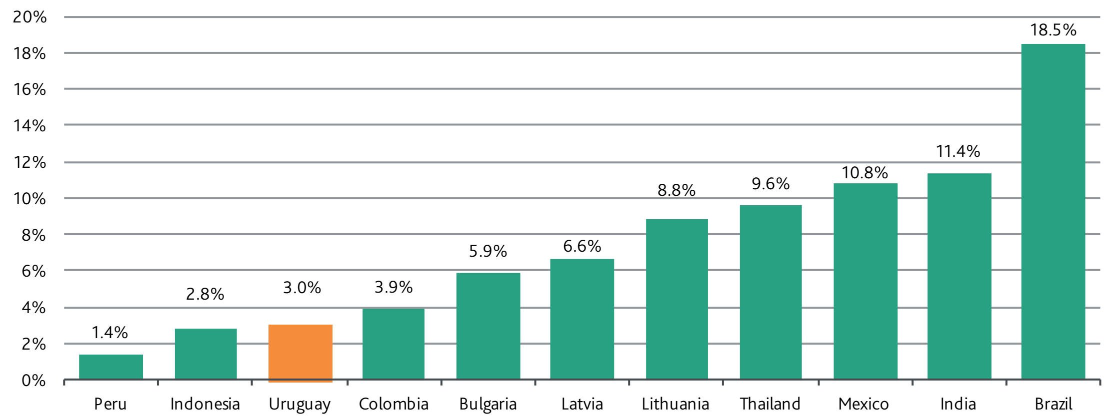
Moderate fiscal deficits and a low amount of maturing debt translate into fairly small gross financing needs. Using as a reference information from the IMF's latest *Fiscal Monitor* – Exhibit 12 below – we can see than Uruguay' places toward the bottom among emerging economies, along with Colombia (Baa3) and Indonesia (Baa3), just slightly above Peru (Baa2). Given the expectation of ongoing compliance with the targets in the multi-year framework and projections for low amounts of maturing debt, gross financing needs will remain minimal, at less than 3% of GDP, over the next three to five years.

12 The government's debt profile also incorporates modest interest rate risk given a 94% share of fixed-rate debt.

13 Non-investment-grade-rated El Salvador and Guatemala have average debt maturities of 12.7 years reflecting the preponderance of multilateral development bank loans and their limited market access.

EXHIBIT 12

Government Gross Financing Needs (%GDP), 2012-2013



Source: Fiscal Monitor IMF, April 2012 and Ministry of Economy and Finance

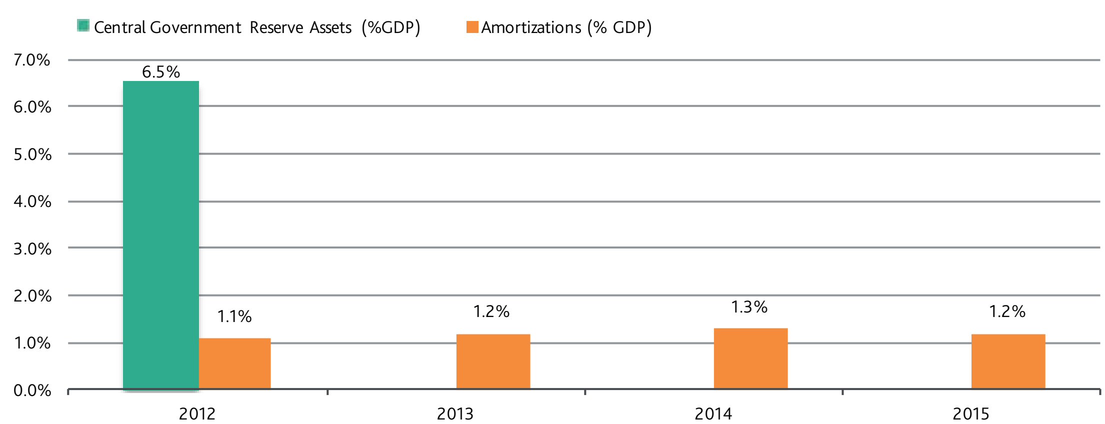
The Financial Buffer: Precautionary Liquidly Reserves

In addition to an extremely healthy maturity profile, ample precautionary liquidity reserves should allow the government to withstand the equivalent of a severe stress test. The government's liquidity policy establishes that precautionary cash reserves must be cover at least 12 months' debt service (principal + interest).

Government cash reserves came to $3.1 billion, or 6.5% of GDP, at mid-year 2012 – cash reserves were large enough to cover total principal payments for the next four years.[14]

EXHIBIT 13

Uruguay: Low Government Refinancing Risk, 2012-2015



Source: Ministry of Economy and Finance

In addition, the authorities have added an extra layer of financial support: The government has reached agreements with three multi-lateral development banks (WB, CAF, FLAR) to establish fast-disbursement contingent credit lines amounting to $1.3 billion, or an additional 2.8% of GDP.

[14] Alternatively, cash reserves were equivalent to the government's total gross financing needs for 2012 and 2013.

Given low gross financing requirements, large precautionary liquidity reserves, and contingent lines, it is unlikely that the government could face significant credit risks in the next 12 to 24 months under most scenarios, thereby supporting an investment grade rating in the Baa category.

The Push to LC Debt From FC Debt

The share of foreign-currency debt has been one of the weak spots in Uruguay's sovereign credit profile. Just six years ago, the share of foreign currency-denominated debt was 85% exposing the government's balance sheet to exchange rate risks. In recent years, government efforts have been effective in significantly reducing foreign currency debt through liability management operations to 66% by year-end 2010.[15]

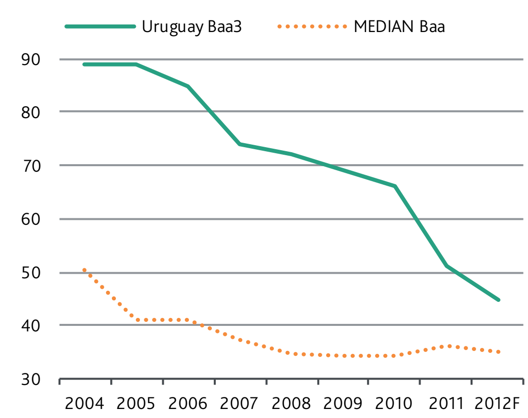
When the current administration took office, it set the goal of lowering the country's foreign-currency debt to 55% by the end of its term in office (year-end 2014). The government surpassed the target well ahead of time by carrying two large liability management operations in the last nine months, one in the international market and another in the local one.

The first transaction, which involved an external debt exchange amounting to $2 billion, extended the average maturity and reduced the share of foreign-currency debt.[16] The government debt profile also benefited from a $826 million domestic debt exchange in the first quarter, which also extended average maturity and reduced the share of foreign currency debt.

As a result of these two operations, the share of foreign-currency debt declined to 47% by the end of the first quarter, allowing the government to achieve its self-imposed goal three years earlier than it expected. Treasury officials have indicated that, as long as market conditions are propitious and the average maturity holds, they will continue to take advantage of opportunities to reduce foreign-currency debt. Thus, it is Moody's opinion that the share of foreign-currency debt could decline to 40%, closer to the current Baa median of 37%, before 2015.

EXHIBIT 14

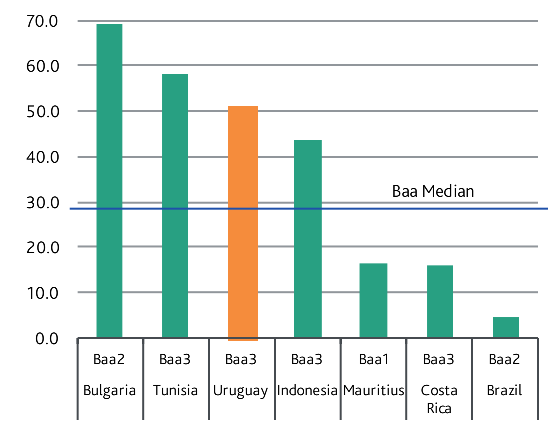
Government FC Debt / Government Debt



Source: Moody's Investors Service

EXHIBIT 15

Government FC Debt / Government Debt, 2011

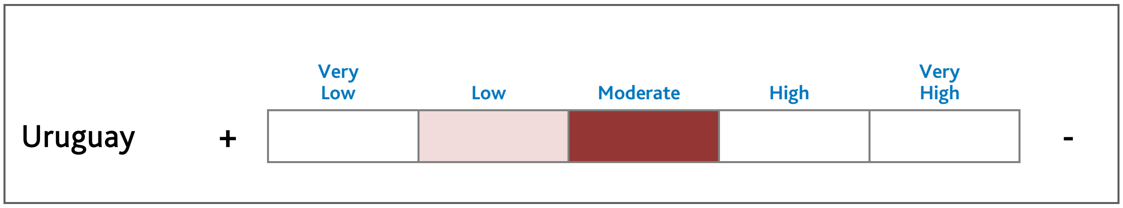


Source: Moody's Investors Service

15 Since 2008, the government has issued only local-currency denominated debt with two exceptions: (a) the USD$500 million 2025 Global bond issued in September 2009 and (b) a JPY 40billion Samurai bond issued in May 2011.

16 This transaction created a new long-dated 2028 Global CPI-linked bond benchmark with a nominal outstanding value equivalent to $2 billion at the time of issuance.

FACTOR 4: SUSCEPTIBILITY TO EVENT RISK – Medium shade Low



Susceptibility to event risk captures the potential impact of political, economic and financial adverse shocks on sovereign ratings. Overall, the elements that have a bearing on Uruguay's susceptibility to event risk have declined steadily in recent years. Consequently, the significance of this factor for Uruguay's sovereign ratings has declined contributing to our decision to upgrade Uruguay's ratings to investment-grade.

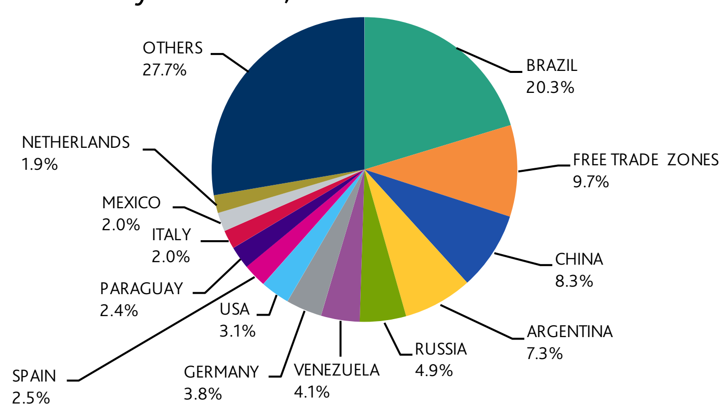
Political event risk is of limited relevance in the case of Uruguay. As we discussed in the section on Institutional Strength, policy continuity and predictability have been maintained by different governments. Credit risks resulting from political events are low given that successive administrations have repeatedly endorsed principles that have led to conservative economic policies. Accordingly, the analysis of Uruguay's susceptibility to event risk centers on economic and financial factors.

The Argentina Factor: Latent Vulnerabilities But Significantly Reduced Exposure

Regional shocks, particularly those originating in Argentina, have had an impact on Uruguay's economic and financial performance over the years. At present, the country is not nearly as vulnerable as it used to be. Despite its neighbor's looming presence, Uruguay's vulnerabilities to Argentina-based event risks are much lower now because the links between the two countries are weaker.

EXHIBIT 16

Exports of Goods Breakdown by Destination, 2011



Source: Uruguay XXI

Overall, the trade relevance of Argentina for Uruguay is not nearly as significant as it is perceived to be, and it has been declining over time. While merchandise exports to Argentina used to account for about 15% of the total, the corresponding share had plunged to 7.3% by 2011. An important structural change has involved a shift in the country's export pattern towards Brazil and away from Argentina with exports to the Brazilian market accounting for more than 21% at present.[17]

Regarding inter-regional trade diversification, although Mercosur (Brazil, Argentina, and Paraguay) continues to account for the largest share of Uruguay's exports, its relative importance has declined over the years.

While nearly half of Uruguay's exports went to Mercosur at the beginning of the previous decade, only about one-third of merchandise exports are kept on the region at present. Conversely, the share of "other markets," which includes Asia, Africa and the Middle East, has increased significantly. "Other markets" accounted for 18% of total exports in 2001, but their combined share reached 42% in 2011, evidencing a reduction in economic concentration risk, whether individually from Argentina or collectively from South America.

On the subject of financial event risk, Uruguay's exposure to Argentina comes mostly through the banking system, via non-resident deposits. Similar to the case of economic contagion via trade channels, financial links to Argentina are notably weaker at present.

The role of non-resident deposits during Uruguay's 2002 financial crisis was significant. At that time, deposits by Argentines accounted for almost 40% of the total exposing Uruguayan banks to the risk of a sudden deposit withdrawal – non-resident deposits plunged from $6.1 billion to $1.3 billion during 2002. Conditions are dramatically different now as non-resident deposits make up less than 15% of the total.

External Financial Vulnerabilities On the Decline

Uruguay's external vulnerability indicator (EVI)[18] has been declining steadily supported by an increasing level of international reserves. After approaching 150% in 2007, the EVI went below the 100% critical level in 2009 and came to 85% at year-end 2011. In Moody's opinion, last year's EVI overstates the degree of external financial vulnerabilities the country will face in coming years. According to our estimates, Uruguay's EVI will move towards a new reference level of some 50% coming closer in line with the Baa median.

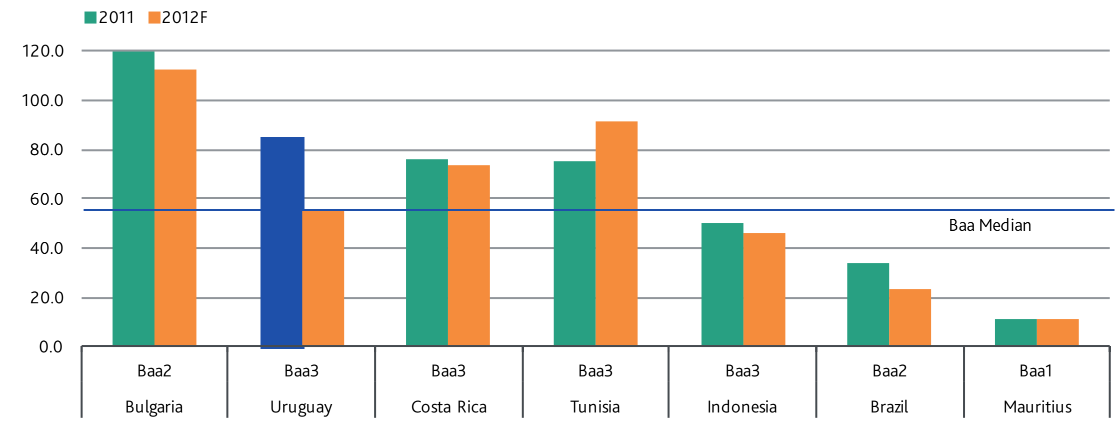
The anticipated reduction of nearly 30 points in Uruguay's EVI reflects the impact of a liability management operation the government completed last December. Last year's debt exchange led to higher-than-normal principal payments in 2011 since the government pre-paid external debt as part of this transaction. Alternatively, the transaction lowered principal payments for the next five years as average external debt maturity was extended. Overall, this year's EVI level of around 50% indicates that Uruguay faces only moderate external financial vulnerabilities in coming years.

[17] Throughout the 1990s the share of exports to Argentina exceeded 15%; Argentina also accounts for a large share of tourism revenues - 45% at present - albeit lower than in the previous decade.

[18] External vulnerability indicator = Total upcoming external debt payments + total short-term external debt + non-resident deposits

EXHIBIT 17

External Vulnerability Indicator, 2011-2012F



Source: Moody's Investors Service

Stress Testing Uruguay's Banking System

Analyzing Uruguay's financial susceptibility to event risk requires consideration of shocks coming from the banking system that could affect the government's credit standing. In the case of Uruguay, the relatively small scale of the banking system along with sizeable capital and liquidity buffers significantly mitigate potential credit risks to the sovereign.

Total banking system assets are equivalent to less than 30% of GDP at present, about a third of the amount 10 years ago, which implies modest absolute risks in the event of a systemic bank crisis. The overall quality of the loan portfolio has been outstanding with NPLs constituting only 1% of the total loan portfolio since 2007, and loan-loss provisions equivalent to almost six times NPLs. Capital adequacy ratios exceed 15%, while liquidity ratios are in excess of 50%.

A relatively small banking system that is over-capitalized, holds excessive liquidity, and is over-provisioned does not pose a significant credit threat to the sovereign. Moreover, stress tests carried by the banking authorities provide evidence of the banking system's financial resilience.

The stress test exercise incorporated two scenarios. The first was an "adverse scenario" associated with macroeconomic conditions listed in the first column of Exhibit 18; the second was a "crisis scenario" that incorporated extreme-case conditions similar to those observed during the 2002 financial crisis as presented in the second column.

Exhibit 18 shows that in the adverse scenario, capital adequacy declines only modestly to 14.5% from 15.1%. Alternatively, in the crisis scenario, with conditions that include an 8% contraction in GDP, 40 nominal depreciation of the exchange rate, and 1,000bp sovereign spread, the banks' capital adequacy ratio falls dramatically, but remains above the 8% mark signaling that, even in a dire situation, the banking system should be capable of managing without direct assistance from the sovereign.

EXHIBIT 18
Uruguay: Banking System Stress Test Scenarios

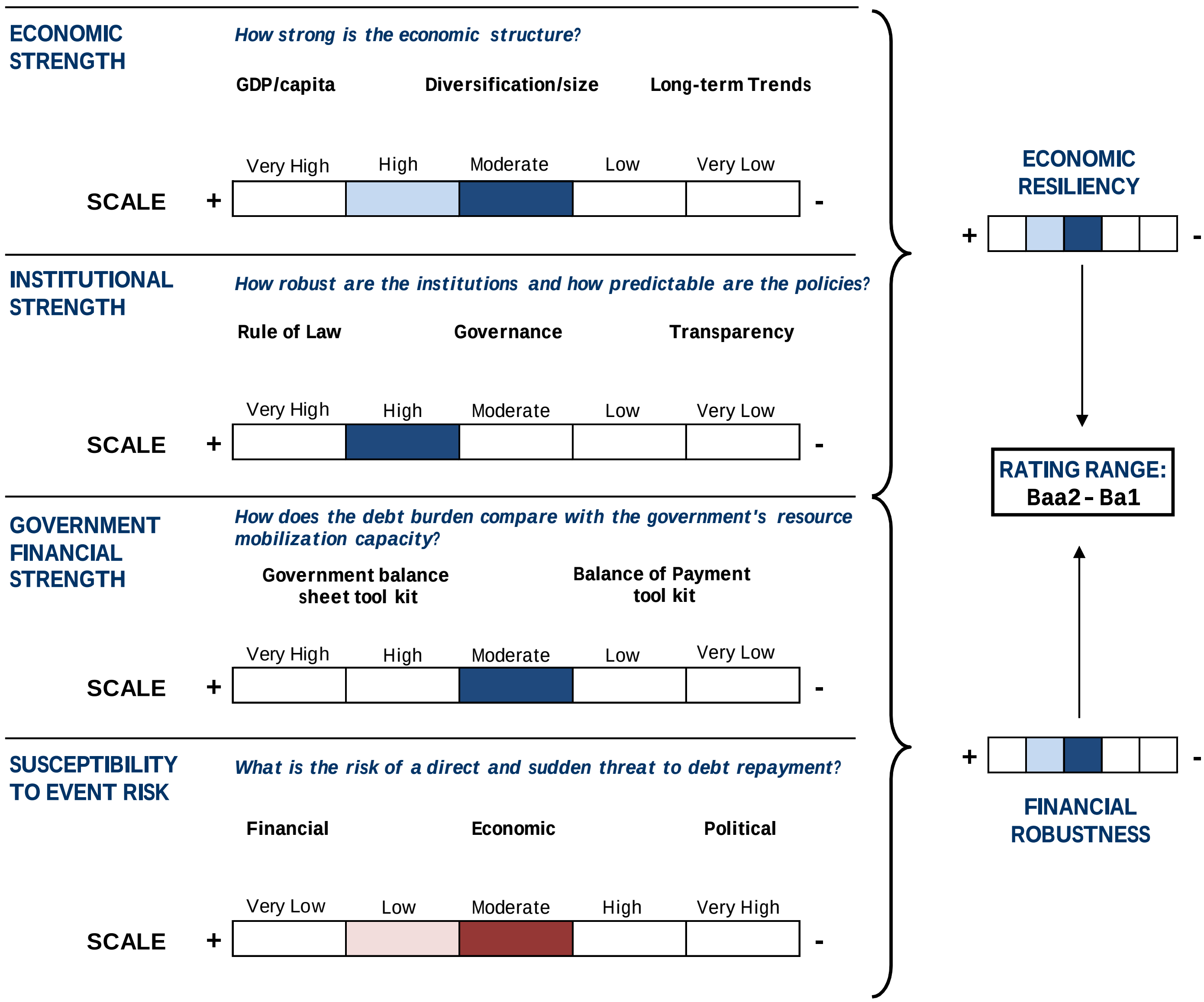
	Adverse Scenario	Crisis Scenario
GDP Variation	-3.6%	-8.0%
Exchange Rate Variation	20.0%	40.0%
Sovereign Spread	4.2%	10.0%
Capital Adequacy BEFORE Shock	15.1%	
Capital Adequacy AFTER Shock	14.5%	8.4%

Source: Superintendence of Financial Institutions, Central Bank

Rating History

Uruguay	Foreign Currency Ceilings				Government Bonds		Outlook	Date
	Bonds & Notes		Bank Deposit		Foreign Currency	Local Currency		
	Long-term	Short-term	Long-term	Short-term				
Rating Raised	Baa1	--	Baa3	--	Baa3	Baa3	Positive	July-12
Outlook Changed	Baa1	--	Ba2	--	Ba1	Ba1	Positive	January-12
Rating Raised	Baa1	--	Ba2	--	Ba1	Ba1	Stable	December-10
Review for Upgrade	Ba1	--	B1	--	Ba3	Ba3	RUR+	July-10
Rating Raised	Ba1	--	B1	--	Ba3	Ba3	Stable	January-09
Review for Upgrade	Ba2	--	B2	--	B1	B1	RUR+	August-08
Rating Raised	Ba2	--	B2	--	B1	B1	Stable	December-06
Review for Upgrade	B1	--	Caa1	--	B3	B3	RUR+	September-06
Rating Raised	B1	--	--	--	--	--	--	May-06
Outlook Changed	--	--	--	--	--	--	Stable	November-04
Rating Lowered	B3	--	Caa1	--	B3	B3	Negative	July-02
Rating Lowered	B1	--	B3	--	B1	B1	Negative	July-02
Review for Downgrade	Ba2	--	Ba3	--	Ba2	Ba2	RUR-	May-02
Rating Lowered	Ba2	NP	Ba3	NP	Ba2	Ba2	Negative	May-02
Review for Downgrade	Baa3	P-3	Baa3	P-3	Baa3	Baa3	RUR-	April-02
Outlook Changed	--	--	--	--	--	--	Negative	February-02
Rating Assigned	--	--	--	--	--	Baa3	--	October-98
Rating Raised	Baa3	P-3	Baa3	P-3	Baa3	--	--	June-97
Outlook Assigned	--	--	--	--	--	--	Stable	March-97
Rating Assigned	--	NP	Ba2	NP	--	--	--	October-95
Rating Assigned	Ba1	--	--	--	Ba1	--	--	October-93

Sovereign Rating Mechanics – Uruguay



Annual Statistics

Uruguay	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Economic Structure and Performance									
Nominal GDP (US$, Bil.)	17.4	19.6	23.4	30.4	30.5	39.4	46.7	48.7	52.8
Population (Mil.)	3.3	3.3	3.3	3.3	3.3	3.4	3.4	3.4	3.4
GDP per capita (US$)	5,252	5,907	7,043	9,108	9,117	11,740	13,871	14,412	15,588
GDP per capita (PPP basis, US$)	9,683	10,403	11,461	12,679	13,200	14,384	--	--	--
Nominal GDP (% change, local currency)	8.2	10.9	16.6	15.8	8.2	14.9	14.1	11.7	11.4
Real GDP (% change)	7.5	4.1	6.5	7.2	2.4	8.9	5.7	4.2	4.4
Inflation (CPI, % change Dec/Dec)	4.9	6.4	8.5	9.2	5.9	6.9	8.6	7.5	7.0
Gross Investment/GDP	17.7	19.5	19.5	23.2	19.5	18.6	19.4	20.4	21.9
Gross Domestic Saving/GDP	19.6	18.1	18.5	18.4	20.3	19.4	19.2	19.3	20.3
Nominal Exports of G & S (% change, US$ basis)	20.1	12.4	14.8	34.7	-7.0	24.0	19.6	12.0	10.0
Nominal Imports of G & S (% change, US$ basis)	23.0	25.4	13.7	50.7	-21.9	23.5	24.5	15.0	12.0
Openness of the Economy [1]	58.9	62.0	59.2	65.2	55.2	52.9	54.4	59.3	60.7
Government Effectiveness [2]	0.51	0.40	0.50	0.51	0.6	0.7	--	--	--
Government Finance									
Gen. Gov. Revenue/GDP [3]	20.9	21.6	21.0	20.6	21.0	21.2	21.1	21.0	21.2
Gen. Gov. Expenditure/GDP [3]	22.4	22.6	22.6	21.7	22.6	22.4	21.7	22.0	22.3
Gen. Gov. Financial Balance/GDP [3]	-1.6	-1.0	-1.6	-1.1	-1.5	-1.2	-0.6	-1.0	-1.1
Gen. Gov. Primary Balance/GDP [3]	2.7	3.2	2.1	1.8	1.3	1.3	1.9	1.3	1.1
Gen. Gov. Debt (US$ Bil.) [3]	11.3	11.3	12.8	12.8	15.7	15.5	18.2	18.7	19.2
Gen. Gov. Debt/GDP [3]	65.2	57.7	54.6	42.1	51.4	39.2	38.9	38.3	36.4
Gen. Gov. Debt/Gen. Gov. Revenue [3]	307.4	270.3	238.2	238.2	212.5	185.4	189.8	189.6	169.8
Gen. Gov. Int. Pymt/Gen. Gov. Revenue [3]	20.2	19.5	18.0	14.0	13.4	11.4	11.8	11.1	10.5
Gen. Gov. FC & FC-indexed Debt/GG Debt [3]	89.0	85.0	74.0	72.0	69.0	66.0	51.0	45.0	45.0

Uruguay	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
External Payments and Debt									
Nominal Exchange Rate (local currency per US$, Dec)	24.1	24.4	21.5	24.4	19.6	20.1	19.9	21.5	21.0
Real Eff. Exchange Rate (% change)	13.2	2.3	1.7	11.3	4.4	13.4	4.1	--	--
Current Account Balance (US$ Bil.)	0.0	-0.4	-0.2	-1.7	-0.1	-0.4	-0.9	-1.4	-1.9
Current Account Balance/GDP	0.2	-2.0	-0.9	-5.7	-0.3	-1.1	-1.9	-2.9	-3.6
External Debt (US$ Bil.)	11.4	10.6	12.2	12.0	14.1	14.6	14.4	14.8	15.3
Public Sector External Debt/Total External Debt	89.3	88.4	90.7	89.4	90.8	88.7	93.3	90.0	90.5
Short-term External Debt/Total External Debt	6.4	7.0	7.4	6.8	7.8	8.4	3.8	6.6	6.5
External Debt/GDP	64.7	54.7	47.8	46.0	40.1	37.0	31.8	31.6	28.6
External Debt/CA Receipts [4]	196.5	158.1	153.1	116.5	150.5	129.5	107.4	98.4	92.5
Interest Paid on External Debt (US$ Bil.)	0.8	0.9	0.9	0.8	0.8	0.6	0.6	0.5	0.6
Amortization Paid on External Debt (US$ Bil.)	2.2	0.6	0.9	0.8	1.0	1.0	1.6	1.4	0.6
Net Foreign Direct Investment/GDP	4.7	7.6	5.3	7.0	5.3	6.4	5.4	4.5	4.5
Net International Investment Position/GDP	-7.5	-3.6	-8.7	-6.7	-16.6	-17.2	--	--	--
Official Foreign Exchange Reserves (US$ Bil.)	3.1	3.1	4.1	6.3	7.6	7.2	9.8	11.0	12.0
Net Foreign Assets of Domestic Banks (US$ Bil.) [5]	2.0	2.2	2.3	1.7	2.8	4.9	5.2	--	--
Monetary, Vulnerability and Liquidity Indicators									
M2 (% change Dec/Dec) [5]	0.0	11.6	3.8	28.6	-2.6	22.1	17.2	--	--
Monetary Policy Rate (% per annum, Dec 31)	4.6	3.5	7.3	7.8	6.3	6.5	8.8	--	--
Domestic Credit (% change Dec/Dec) [5]	-18.2	-8.4	-8.0	61.1	-9.4	27.7	11.7	--	--
Domestic Credit/GDP	38.4	31.7	25.0	34.8	29.1	32.4	--	--	--
M2/Official Forex Reserves (X)	2.6	2.9	2.5	1.9	1.9	2.4	--	--	--
Total External Debt/Official Forex Reserves	372.2	342.4	297.0	189.3	184.0	203.2	147.6	134.5	127.5
Debt Service Ratio	52.9	23.1	22.0	15.9	19.8	14.7	16.1	12.5	7.2
External Vulnerability Indicator [6]	215.8	123.1	137.8	123.9	90.5	79.4	84.5	54.8	48.4
Liquidity Ratio [7]	17.6	20.5	19.2	25.0	26.5	25.9	40.9	--	--
Total Liab. due BIS Banks/Total Assets Held in BIS Banks	24.7	20.1	24.1	26.9	27.8	41.9	51.1	--	--
"Dollarization" Ratio [8]	86.6	84.8	79.8	81.9	78.1	75.3	72.4	--	--
"Dollarization" Vulnerability Indicator [9]	118.4	120.1	110.3	105.3	94.7	92.4	--	--	--

Notes:

[1] Sum of Exports and Imports of Goods and Services/GDP

[2] Composite index with values from -2.50 to 2.50: higher values suggest greater maturity and responsiveness of government institutions

[3] Central government

[4] Current Account Receipts

[5] 2011 as of November

[5] (Interest + Current-Year Repayment of Principal)/Current Account Receipts

[6] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Non Resident Deposits due over one year)/Official Foreign Exchange Reserves

[7] Liabilities to BIS Banks Falling Due Within One Year/Total Assets Held in BIS Banks.

[8] Total Foreign Currency Deposits in the Domestic Banking System/Total Deposits in the Domestic Banking System

[9] Total Foreign Currency Deposits in the Domestic Banking System/(Official Foreign Exchange Reserves + Foreign Assets of Domestic Banks)

Moody's Related Research

Credit Opinion:

» Uruguay

Rating Action:

» Moody's upgrades Uruguay's sovereign ratings to Baa3 from Ba1; outlook remains positive

Statistical Handbook:

» Moody's Country Credit Statistical Handbook, May 2012 (141528)

Rating Methodologies:

» Sovereign Methodology Update – Narrowing the Gap – a clarification of Moody's approach to local vs. foreign currency government bond ratings, February 2010 (118820)

» Sovereign Bond Ratings, September 2008 (109490)

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Author
Mauro Leos

Associate Analyst
Ariane Ortiz Marrufo

Senior Production Associate
Ginger Kipps

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