

Research Update:

Uruguay Upgraded To 'BBB-' On Increasing Ability To Withstand External Shocks; Outlook Stable

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Overview

- Uruguay's cautious economic management has resulted in economic diversification, an improved external position, and a smoother debt amortization profile, diminishing Uruguay's vulnerability to potential external shocks.
- We expect that Uruguay's stable political system and institutions will continue to provide broad support for an economic policy mix that addresses future challenges.
- We're raising our long-term foreign and local currency sovereign credit ratings on Uruguay to 'BBB-', the lowest level within our investment-grade category, from 'BB+'.
- The outlook is stable. We expect the administration will sustain its commitment to fiscal prudence, even under more severe external conditions.

Rating Action

On April 3, 2012, Standard & Poor's Ratings Services raised its long-term foreign and local currency sovereign credit ratings on the Oriental Republic of Uruguay to 'BBB-' from 'BB+'. We also raised our short-term foreign and local currency ratings to 'A-3' from 'B' on the Republic. The outlook on the long-term ratings is stable.

Standard & Poor's also changed its transfer and convertibility assessment on Uruguay to 'BBB+' from 'BBB'. As per our sovereign rating methodology, we are withdrawing our recovery rating of '2' on Uruguay. Our recovery analysis is only applicable to speculative-grade issuers.

At the same time, we are equalizing our rating on the Central Bank of Uruguay with the sovereign rating by raising our long-term foreign and local currency ratings on the Central Bank of Uruguay to 'BBB-' from 'BB-'.

We also raised our long-term corporate credit rating on state-owned Administracion Nacional de Combustibles Alcohol y Portland (ANCAP) to 'BB' from 'BB-'. The outlook is stable. This rating action results from our assessment of a "very high" likelihood that the government of Uruguay would provide timely and sufficient extraordinary support to the company in the event of financial distress, and from our 'b+' stand-alone credit profile (SACP) on ANCAP.

Rationale

The upgrade is based on Uruguay's sound economic growth prospects and improving external and fiscal indicators, as foreign direct investment (FDI) strengthens and improves economic diversification. Prudent economic policies in recent years, backed by a broad political consensus, have allowed Uruguay to grow rapidly and reduce its main credit vulnerabilities. Per capita real GDP growth averaged about 6% between 2006 and 2011. In contrast with much of South America, Uruguay managed to grow rapidly without a significant improvement in its terms of trade in the last decade.

Uruguay's net external debt position continued its declining trend in 2011, supported by a strong accumulation of international reserves. Liquid assets exceeded external debt in 2011 by 8% of current account receipts. The country's external debt position is likely to improve in coming years, because strong FDI inflows are expected to exceed the projected current account deficit. We expect the country's net external liability position to stabilize at about 25% of current account receipts, having fallen from 47% in 2009.

The stronger external performance provides policy flexibility to withstand the impact of a potential external shock, especially from negative developments transmitted through Uruguay's still significant economic links with Argentina (B/Stable/B). Economic diversification and more market-oriented policies have reduced the relative importance of Uruguay's financial and trade links with its neighbor. The combination of stronger external accounts, gradually lower levels of dollarization (now 50% of total loans and 72% of total deposits), and the fruits of a sovereign debt management strategy that has materially reduced roll-over risk in the next five years, provides greater scope for the government to maintain stability in the event of potential economic disruptions in Argentina.

We expect the government's liquidity position to remain strong over the next five years, given low principal debt payments in foreign currency, high government deposits (estimated at about \$2.5 billion), and existing agreements to gain access to contingency credit lines--lines for \$1.13 billion were already signed--from multilateral lenders. Total annual amortization payments are estimated at about 1.2% of GDP between 2012 and 2015--an equivalent average of about \$670 million--of which only 21% correspond to bonds denominated in foreign currency with the rest pertaining to local currency (inflation linked) bonds and payments to multilaterals. If needed, Uruguay could remain outside the dollar debt market for several years if financial market conditions were to deteriorate; Uruguay's last issuance in the global dollar debt market was in 2009.

We expect significant FDI inflows to continue to boost Uruguay's still low level of investment to GDP (20% for 2011), strengthen its net external debt position, and support medium-term GDP growth. Large and diversified net FDI inflows (equivalent to an average of about 6% of GDP per year between 2006 and 2011) had a strong role in supporting high growth rates in Uruguay over the

last six years.

Despite recent gains, economic policy flexibility in Uruguay will continue to be restricted by dollarization (dollar deposits still represent 72% of total) and limited fiscal flexibility. Inflation has tended to be above levels in trading partners, with 7.2% projected for 2012, which is above the target of 4% to 6% set by the central bank. A commitment to limit fiscal deficits to about 1% of GDP allowed net general government debt to decline to 43.8% of GDP in 2011. This incorporates the equivalent of 10% of GDP in Central Bank notes issued for sterilization of financial account inflows, an item whose recent increase explains most of the increase in absolute debt levels in recent years. However, fiscal policy has remained mostly pro-cyclical, as there is no consensus supporting stronger fiscal results and, therefore, improving the fiscal position at a more rapid pace.

Our local currency rating remains at the same level as the foreign currency rating because monetary flexibility continues to be restricted in Uruguay by dollarization. In addition, and despite recent growth, the development of the local currency domestic debt market is still, in our opinion, at an early stage. Our transfer and convertibility assessment reflects our opinion that the likelihood of the sovereign restricting access to foreign exchange needed by Uruguay-based non-sovereign issuers for debt service is moderately lower than the likelihood of the sovereign defaulting on its foreign currency obligations.

Outlook

The stable outlook balances the expected commitment to cautious economic policies with the government's still relatively limited fiscal and monetary policy flexibility amid growing uncertainty in global and regional markets. Standard & Poor's expects the government will sustain its commitment to fiscal prudence, even under more severe external conditions.

Continuing improvement in fiscal indicators, with declining debt as well as lower levels of debt dollarization, combined with a further diversification of the sources of economic growth, could, over time, lead to a higher rating. Conversely, a weaker commitment to macroeconomic stability and a failure by the authorities to respond appropriately to external risks could weaken external liquidity and raise the country's debt burden, resulting in a lower rating.

Related Criteria And Research

- Oriental Republic of Uruguay, Aug. 5, 2011
- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Ratings List

Upgraded

	To	From
Uruguay (Oriental Republic of)		
Sovereign Credit Rating	BBB-/Stable/A-3	BB+/Stable/B
Transfer & Convertibility Assessment	BBB+	BBB
Senior Unsecured	BBB-	BB+
Short-Term Debt	A-3	B
Banco Central del Uruguay		
Sovereign Credit Rating	BBB-/Stable/A-3	BB-/Stable/B
Senior Unsecured	BBB-	BB-
Administracion Nacional de Combustibles Alcohol y Portland		
Corporate credit rating	BB/Stable/--	BB-/Stable/--

Rating Withdrawn

	To	From
Uruguay (Oriental Republic of)		
Senior Unsecured		
Recovery Rating	NR	2

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