



*Insight beyond the rating.*

Date of Release: September 21, 2009

## **DBRS Raises Uruguay's Trend to Positive on Debt Profile and Structural Improvements**

**Bloomberg: DBRS Changes Trend on Uruguay to Positive**

**Industry Group: Public Finance / Sub-Industry: Sovereigns & Related Entities**

DBRS has today confirmed the Oriental Republic of Uruguay's Long-Term Foreign and Local Currency securities at BB (low), and changed the trends to Positive from Stable on both ratings.

"The Positive trends reflect Uruguay's improved debt profile, greater resilience to external shocks and high foreign direct investment, all in the context of its stable political system and sound macroeconomic management," says Michael Heydt, Senior Financial Analyst, Sovereigns. "The economy has a greater ability to rebound from external shocks, as evidenced by Uruguay's performance over the last twelve months."

DBRS sees clear evidence of positive structural changes in the Uruguayan economy. First, the public debt ratio has been cut in half, from 100.8% of GDP in 2003 to 51.4% in 2008, and liability management operations have reduced refinancing and exchange rate risk. From 2004 to mid-2009, the average maturity of central government debt increased from 7.4 years to 12.5 years, and pre-financing operations have largely covered expected needs through 2010.

Second, a more flexible exchange rate has facilitated adjustments in the balance of payments, cushioned the impact on the real economy and preserved competitiveness. This is a notable policy improvement. Furthermore, Uruguay's export and tourism sectors are more diversified, and strengthened financial regulation has reduced risks associated with Argentine and other non-resident participation in the domestic banking system. Regulatory reforms since the 2002 financial crisis, especially higher reserve and capital requirements and improved management of exchange rate risk, better prepare Uruguay to withstand external volatility. International reserves have also increased, bolstering Uruguay's defenses against future external shocks.

Third, Uruguay's stable political environment and predictable macroeconomic policies have attracted unprecedented levels of foreign direct investment (FDI) over the last six years – particularly in the pulp and paper industry – which has helped diversify the export base, increase productivity and raise the country's medium-term growth outlook. In 2008, FDI inflows were among the highest in Latin America, at 6.8% of GDP. Presidential and congressional elections are scheduled for October 25, 2009. Regardless of outcome, DBRS expects prudent macroeconomic management to continue.

Notwithstanding these improvements, Uruguay will need to address several structural concerns over the long term. First, Uruguay's dollarized financial system creates currency mismatches that expose the economy to balance sheet vulnerabilities. Second, the country remains subject to potential disruptions in trade, tourism and the banking sector due to volatility in Argentina, albeit to a lesser

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extent than in 2002. Third, narrow local capital markets limit domestic financing options for the public and private sector. Given narrow local markets, debt de-dollarization will take time.

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Persistent inflationary pressures are also a concern. Inflation reached 9.2% in January 2009, approaching the 10% threshold which would trigger automatic adjustments in public sector wages and pensions. Policymakers effectively reduced inflationary pressures through monetary and fiscal measures, and by May 2009, inflation had fallen within the Central Bank of Uruguay's (BCU) target range for the first time since January 2007. However, the BCU will need to remain vigilant to anchor expectations within the target range.

Drought-related spending and lower-than-expected revenue growth due to the global financial crisis led to a higher deficit in 2008 and 2009. However, given the improvements in public finances over the last five years and the precautionary measures taken to reduce refinancing risk, these deficits are manageable. Following a smooth transition to the next government, a reinforced commitment to fiscal discipline and debt reduction in next year's multi-year budget would improve Uruguay's creditworthiness. Should further external shocks impair the recovery, DBRS would look to continued sound policy management as a prerequisite to an upgrade.

#### Notes:

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

This is a Corporate (Public Finance) rating.

<u>Issuer</u>	<u>Debt Rated</u>	<u>Rating Action</u>	<u>Rating</u>	<u>Trend</u>
Oriental Republic of Uruguay	Long-Term Foreign Currency	Confirmed	BB (low)	Positive
Oriental Republic of Uruguay	Long-Term Local Currency	Confirmed	BB (low)	Positive

DBRS will publish a full report shortly that will provide additional analytical detail on this rating action. If you are interested in receiving this report, contact us at [info@dbrs.com](mailto:info@dbrs.com).

Michael Heydt  
Senior Financial Analyst – Sovereigns  
+ 1 212 806 3210  
[mheydt@dbrs.com](mailto:mheydt@dbrs.com)

Fergus McCormick  
Senior Vice President – Sovereigns  
+ 1 212 806 3211  
[fmccormick@dbrs.com](mailto:fmccormick@dbrs.com)