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Uruguay After The Upcoming Elections: An Increasingly Distant Neighbor Of Argentina

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Uruguay After The Upcoming Elections: An Increasingly Distant Neighbor Of Argentina

Uruguay will elect a new president on Nov. 30 in the second round of presidential elections, following the first round on Oct. 26. Standard & Poor's Ratings Services expects that Uruguay will maintain stability and continuity in key economic policies regardless of which of the two candidates wins the presidential elections.

Standard & Poor's ratings on the Oriental Republic of Uruguay (BBB-/Stable/A-3) reflect the country's stable political system and predictable economic policies. They also reflect the country's robust medium-term growth prospects and diminishing vulnerability in its debt amortization profile. The ratings are constrained by limited fiscal and monetary flexibility, as well as the vulnerabilities that arise from a high level of dollarization in the financial system.

Overview

- We expect that Uruguay will maintain stability and continuity in key economic policies regardless of which of the two candidates wins the second round of presidential elections.
- The divergence in the sovereign credit ratings of Uruguay and Argentina in recent years reflects different trends in their economic policies.
- Uruguay's improved credit standing in recent years demonstrates the importance of stable political leadership that pursues pragmatic, pro-growth economic policies, based on a strong political consensus.

Lower commodity prices have reduced prospects for economic growth in most of South America. However, those countries that took advantage of recent years of booming commodity exports to strengthen their public finances, boost their external liquidity, and set the foundations for future economic growth will be in a better position to withstand the strains of lower commodity prices compared with countries that did not undertake such reforms. Both Uruguay and Argentina have benefited from the recent commodity boom, but Uruguay's economic performance has increasingly diverged from that of Argentina despite the historically close economic and financial links between the two countries. And we expect this divergence will continue after Uruguay's presidential elections on Nov. 30, no matter which candidate wins.

The widening gap in economic growth, and in overall economic resilience, between the two countries is reflected in the gap in our respective sovereign credit ratings (we assign a foreign currency sovereign rating of 'SD' [selective default] on Argentina and a long-term foreign currency sovereign rating of 'BBB-' on Uruguay). Uruguay has taken steps in recent years to improve its net external position and its access to external liquidity. It has also diversified its economy, and strengthened its financial system and the framework of its monetary policy. As a result, it has gained greater resilience against adverse external developments. Its improved credit standing in recent years demonstrates the importance of stable political leadership that pursues pragmatic, pro-growth economic policies based on a strong political consensus.

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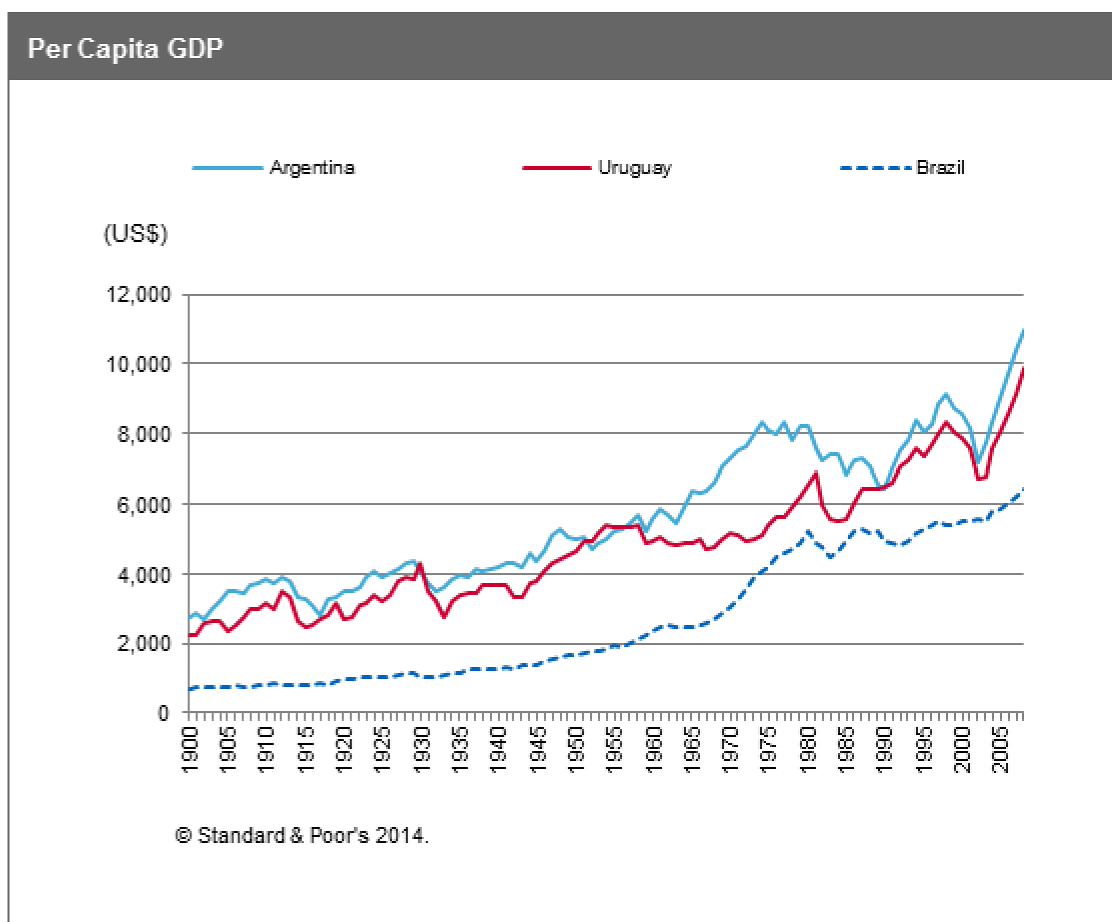
Past Performance Does Not Always Foreshadow The Future

As a small, open economy, Uruguay's economic performance has historically been correlated with that of its larger neighbor, Argentina. Chart 1 shows the long-term evolution of per capita GDP in Uruguay and Argentina, as well as Brazil, from the beginning of the 20th century (data comes from Angus Maddison, Historical Statistics of the World Economy and reflects various adjustments for differing purchasing power among currencies).

Chart 1



The historical similarity between per capita GDP growth in Uruguay and Argentina is clear, especially in the 1990s and the early 2000s. The similarity between the two countries reflected their strong bilateral commercial and financial ties, as well as their dependence on common global economic trends (such as commodity prices and availability of external funding).

The historical similarities between Uruguay and Argentina extend to credit rating trends as well. Argentina defaulted on its debt in November 2001, and suffered a severe economic crisis. The negative spillover from the Argentina crisis contributed to undermining the ratings on Uruguay through the damaging impact on both economic output and on the health of the financial sector. The Uruguayan government undertook a debt exchange with its creditors in May 2003

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that we classified as a distressed exchange, leading us to lower the rating on Uruguay to SD.

However, Uruguay's economic performance has begun to diverge from that of Argentina in recent years, largely due to economic and other policies that have diversified its economy and reduced its vulnerability to adverse external developments. Uruguay has strengthened economic links to markets beyond its region, strengthened its financial system to reduce the vulnerability to events in Argentina, and boosted external liquidity to limit the risk of a sudden loss of access to global financial markets. Work by the International Monetary Fund (IMF) indicates that the reduced trade and financial links between Uruguay and Argentina have diluted the impact of a slowdown in GDP growth in Argentina on Uruguay's own growth performance.

Uruguayan exports to Argentina accounted for only 5% of total exports last year, down from 13% in 1995. Similarly, exports to Brazil fell to only 19% of total exports last year from 33% in 1995. China has become the largest single export market at about 20% of total exports, overtaking Brazil. Soya accounted for more than one-fifth of total exports, about two-thirds of which went to China. Argentina remains the main source of tourism in Uruguay, contributing about half of all earnings from that sector, followed by Brazil. However, higher tourist inflows from other countries have partly compensated the decline in tourism earnings from Argentina in recent years.

The weakening of trade links with Argentina has been complemented by a similar weakening in financial sector links. Nonresident dollar deposits in Uruguayan banks, mainly from Argentina, rose to a peak of 40% of total deposits before 2002 (just under half of GDP at that time), which increased the country's vulnerability to a sudden outflow. Uruguayan banks also had exposure to assets in Argentina. Nonresident deposits have fallen to about 20% of total deposits in 2014 (about 7% of GDP), and local banks have almost no exposure to Argentine assets.

Uruguay has accumulated substantial external liquidity in recent years, with foreign exchange reserves at about 30% of GDP. Active debt management has reduced the sovereign's vulnerability to sharp movements in the exchange rate by raising the share of local currency debt to just over half the central government's total debt, up from barely 10% in 2005. According to official calculations, the depreciation of the local currency would have boosted the government's debt burden by three percentage points of GDP since late 2012 in the absence of a policy to shift toward local currency debt. Prudent debt management has also lengthened the maturity of external debt, reducing rollover risk. For example, the government issued a $2 billion global bond this year that matures in 2050. The average life of the government's debt is 15 years, reflecting minimal amortization needs in the coming couple of years.

The government has signed up for contingent credit lines worth 3.5% of GDP from multilateral lenders (World Bank, Inter-American Development Bank, Corporacion Andina de Fomento [CAF] and Fondo Latinoamericano de Reservas [FLAR]) in the event of adverse events that block its access to external capital markets. We believe that Uruguay could quickly qualify for the IMF's Flexible Credit Line facility. In addition, the government has liquid assets exceeding 4% of GDP, exceeding its debt service needs for the coming 12 months. As a result, we expect Uruguay to have ample external liquidity to manage potential disruptions in global conditions as the U.S. Federal Reserve Bank withdraws its monetary stimulus.

Although GDP growth has declined in recent years in Uruguay, the gap in the growth rate between Uruguay and Argentina is notable (see chart 2). The Uruguayan economy is likely to expand 3% or more in 2014, down from 4.4% in

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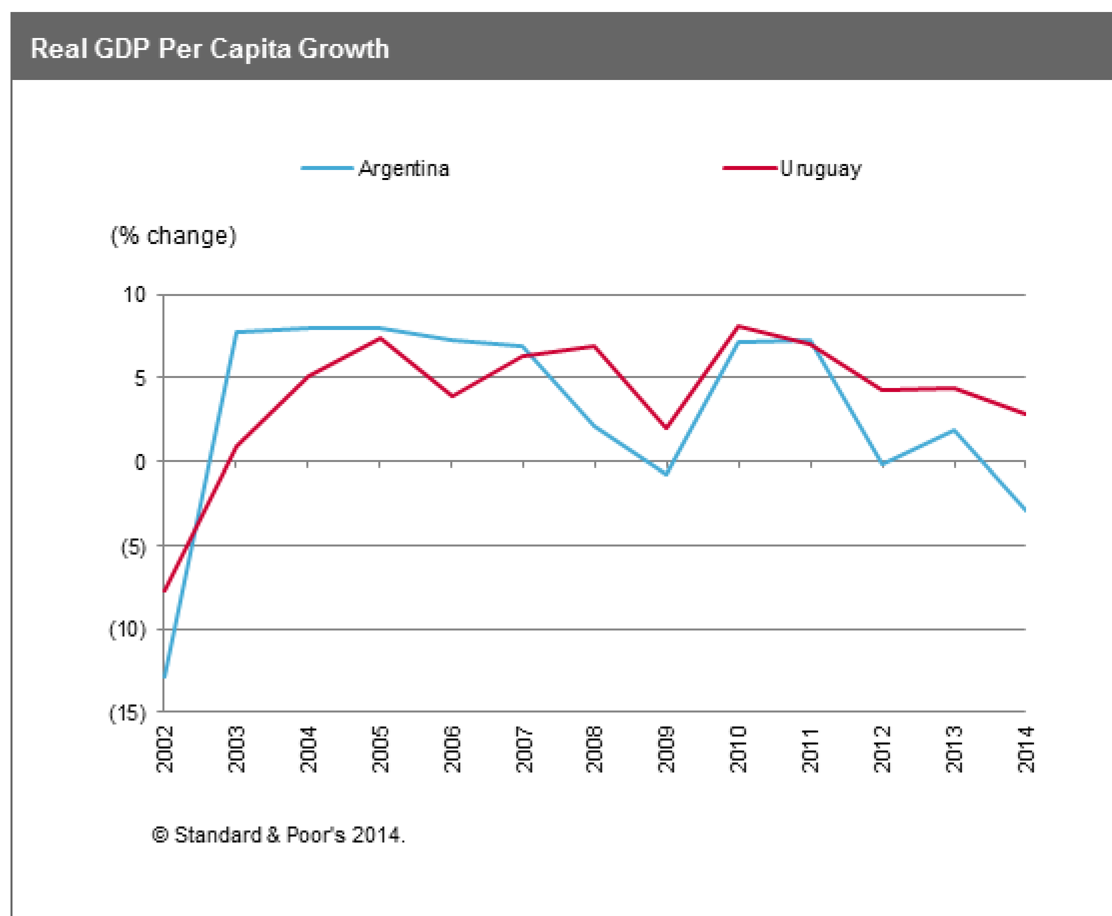
the previous year.

Chart 2



Uruguay has had an average per capita growth rate of 5.4% since 2006. We expect GDP per capita to approach $17,000 in 2014 from just over $5,000 in 2005. In contrast, GDP growth averaged less than 1% in the two decades prior to 2005. The higher growth rates reflect, in large part, policies that have helped boost private-sector investment. Total investment has averaged about 20% of GDP since 2005, compared with an average just below 15% during the previous two decades. Total investment was almost 23% of GDP in 2013, including 4.6% of GDP in public-sector investment.

The good economic growth of recent years has taken place along with reduced external vulnerability. Foreign direct investment (FDI) has averaged 5.7% of GDP during 2005-2013, more than double the level in Argentina. FDI in Uruguay was nearly double the average level of current account deficits (3% of GDP), containing the growth of external debt. FDI had averaged less than 1% of GDP in the previous two decades.

GDP growth has kept unemployment low, below 7% in the last four years. Growth has also contributed to cutting the poverty rate, which has fallen toward 11%, compared with a peak of 40% in 2004 and an average level of about 20% during the last decade of the 20th century. The distribution of income has also become more equal in recent years. The

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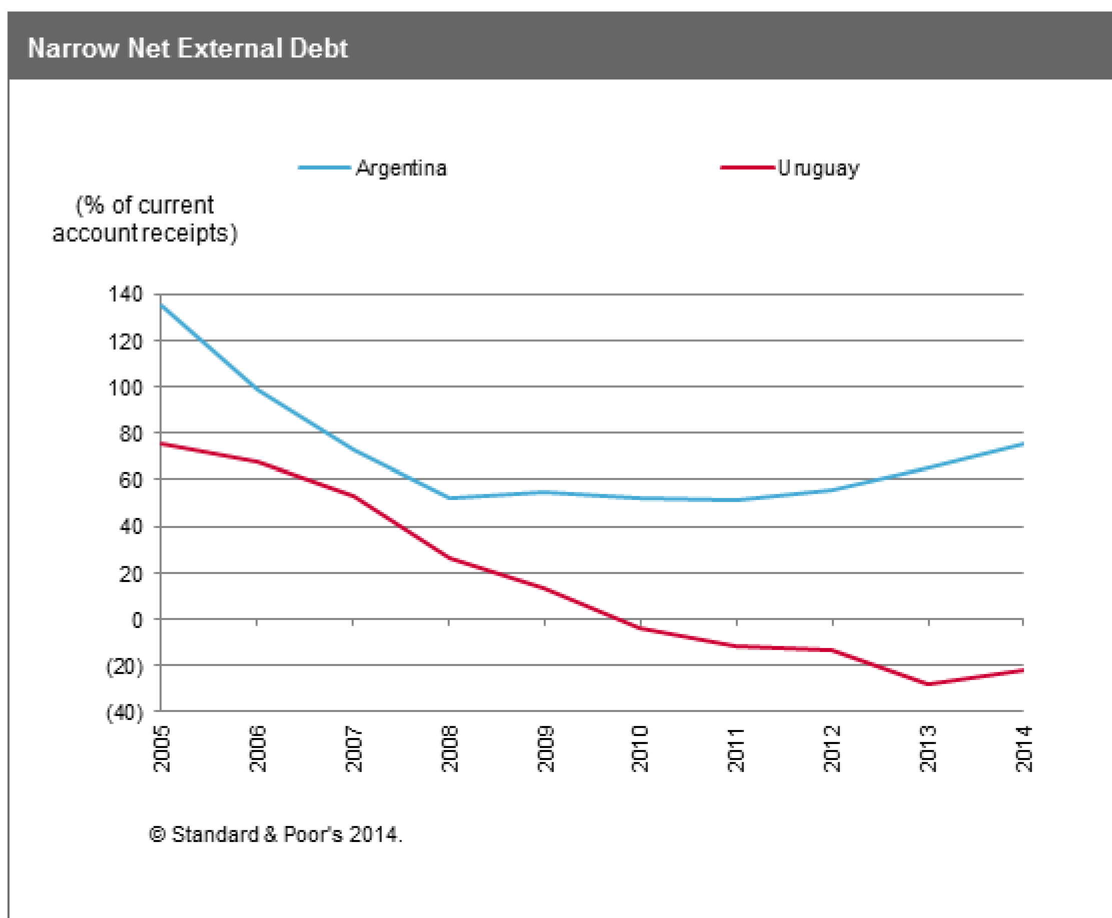
Gini co-efficient (a measure of inequality with zero being perfect equality and one being perfect inequality) fell to a historical low of 37.9 in 2012 from 45.7 in 2007, based on government data. About 95% of the population now has health insurance, reflecting a significant improvement in social protection in recent years.

Uruguay's external liquidity position has also improved substantially, in contrast with Argentina. Uruguay has recently moved into a net external asset position, as measured by our definition of narrow net external debt (total external debt less foreign exchange reserves, other liquid assets of the public sector, and all financial sector external assets) (see chart 3).

Uruguay moved to a floating exchange rate in 2005 and began to use the interest rate as the main tool of monetary policy in 2007 to target inflation. The Uruguayan currency has depreciated about 14% against the U.S. dollar since the end of 2013, easing the economic adjustment to changing global conditions. The shift toward a more flexible exchange rate was an important change in providing more insulation for the economy against external shocks. The change in monetary policy was successful in reducing inflation to historically low rates.

Chart 3



The gap in economic performance between Uruguay and Argentina is also apparent in the wide gap in the credit ratings on the two countries. The foreign currency sovereign credit rating on Argentina remained in the 'B' category

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after it emerged from its previous debt default in 2005 until September 2013, when we lowered it to the 'CCC' category. We lowered our foreign currency ratings on Argentina to 'SD' on July 30 of this year, following its failure to make payments on external bonds. We raised Uruguay's long-term foreign currency credit rating to 'BBB-' as a result of reduced vulnerability to external shocks in April 2012 and have maintained a stable outlook.

Economic Diversification

Uruguay's comparatively favorable economic performance in recent years reflects pragmatic policies to encourage investment, including foreign direct investment, boost output, diversify the economy, and mitigate the country's external vulnerability. It also reflects a sustained level of investor confidence, in contrast with policy uncertainty and unpredictability in Argentina.

Uruguay ranks 19th out of 177 countries in the Corruption Perceptions Index published by Transparency International, well above Argentina (106th) and Brazil (72nd). Uruguay ranks 82nd out 189 countries in the World Bank's Doing Business index, which indicates the ease of starting and operating businesses, better than Argentina (124th) and Brazil (120th).

Better governance has attracted FDI in recent years, helping to diversify the economy. About 26% of FDI went into construction; 21% into livestock, agriculture, and forestry; and another 10% into manufacturing. Uruguay has received more FDI (as a share of GDP) than Argentina in recent years (see chart 4).

Several large industrial projects, as well as a transformation of the country's agricultural sector, have sustained economic growth in recent years. Construction of two large pulp and paper mills has boosted exports and employment. The introduction of new technology and management practices (often from Argentina) has led to impressive growth in soya and milk output (productivity per hectare has nearly doubled in the last decade). The dairy sector has expanded at an average annual rate of 6% in the last decade, exporting nearly 70% of its production.

Off-shore oil exploration has picked up after two recent rounds of bidding for exploration. A new round of bidding for oil exploration, scheduled in 2015, is projected to attract $1.5 billion in FDI. Some firms have begun seismic exploration for oil onshore. A new $1.1 billion floating liquefied natural gas regasification plant (by Gas de France-Suez and Marubeni Corp.) is likely to start operations in early 2015. The government has ambitious goals to generate more than half of the country's energy from renewable sources such as wind and solar by 2015, along with plans to boost use of natural gas.

The composition of current account receipts has changed over the last decade. Exports of services have grown in tandem with goods exports in recent years, helping to diversify the economy. Tourism, which accounts for just over half of all service exports, has declined since its peak in 2011, mainly because of economic problems in Argentina. However, other service exports (such as IT, design, pharmaceuticals, research and development, and other back office and business processing operations) have grown much faster. Such service exports now approach one-third of total service exports, and more than one-third of them go to the U.S. and more than one-fifth go to the rest of Latin America.

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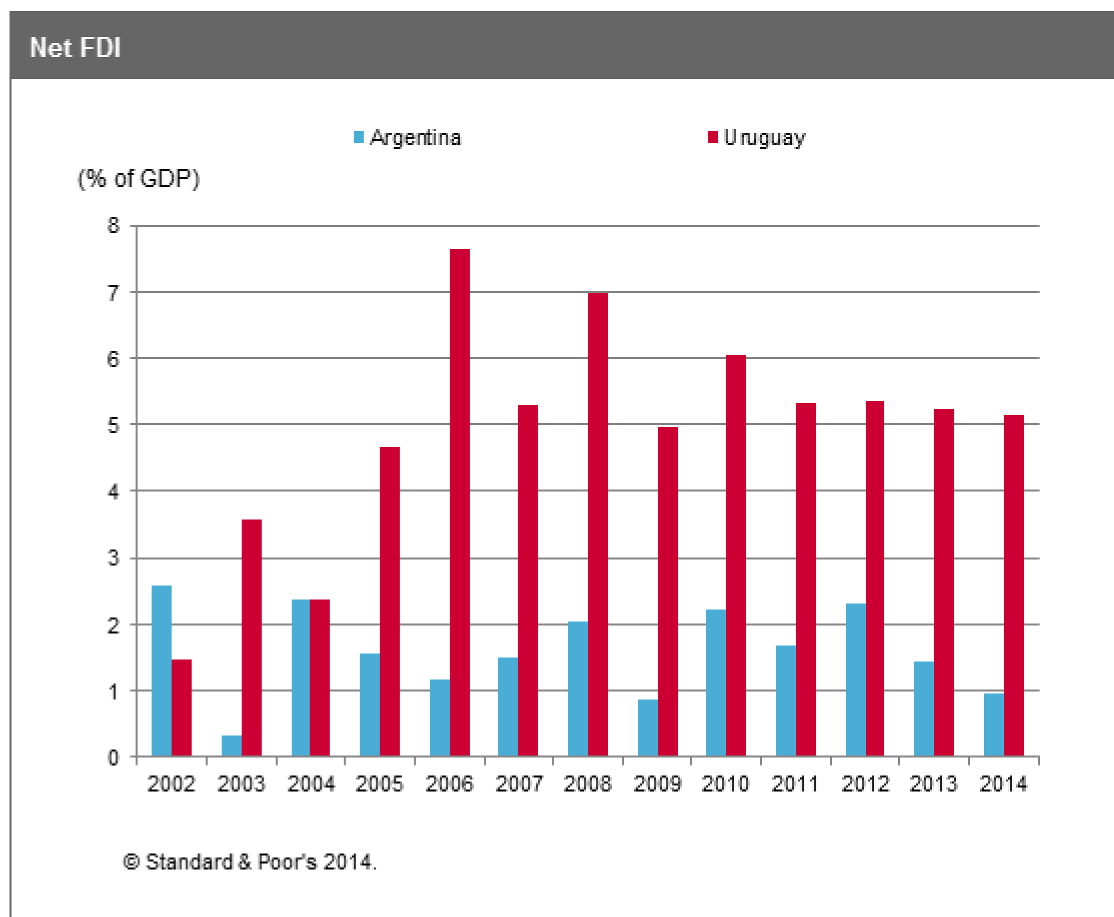
By offering a more stable business environment, Uruguay has also benefited from economic uncertainty in Argentina by receiving talent, technology, and capital from its neighbor. FDI from Argentina has accounted for 25%-30% of total FDI in Uruguay since 2007 and it rose to over 36% of total FDI in 2012. Much of the investments went to residential construction, but a portion also went into agriculture, where Argentine firms have introduced new production methods and management techniques to boost productivity and output (especially in soybeans, which account for almost one-half of all agricultural land in Uruguay, up from almost nothing in 2000). The IMF estimates that agricultural productivity rose about 80% in the last decade in Uruguay, compared with only rising 21% in the 1990s.

Chart 4



Uruguay's higher GDP growth rate in recent years compared with its neighbors (including Brazil) cannot be attributed to the good fortune of a commodity price boom, as other countries enjoyed a bigger boom in their export prices. Uruguay benefited less from an improvement in its terms of trade (the price of exports divided by the price of imports) than its two neighbors in recent years (the data comes from the United Nations' Economic Commission on Latin America and the Caribbean) (see chart 5).

According to official calculations, increases in total factor productivity (the increase in output that is greater than the proportionate increase in inputs) account for just less than half of Uruguay's output growth in recent years, followed by higher use of labor inputs and then capital.

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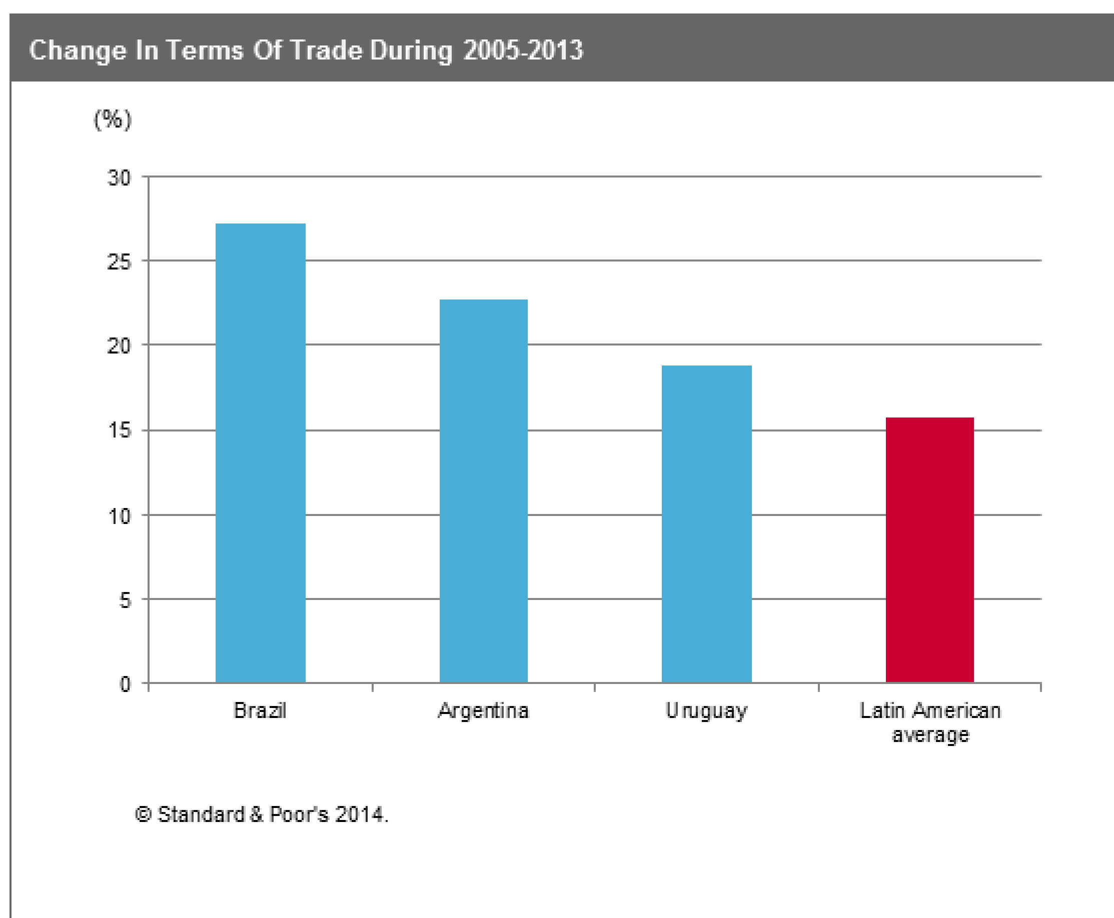
Chart 5



Stable And Pragmatic Economic Policies

We expect that Uruguay will maintain its pragmatic, pro-investment approach to economic policy during the term of the next president. There is considerably more certainty about economic and other policies after elections in Uruguay than after the next presidential elections in Argentina, due in October 2015.

Former Uruguayan President Tabare Vasquez of the incumbent Frente Amplio (Broad Front), a coalition of several center-left and leftist parties, received almost 48% of the vote in the first round of presidential elections in Uruguay on Oct. 26. His main opponent, Luis Lacalle Pou of the National Party, received 31% of the vote. Vazquez had been president during 2005-2010 and Lacalle Pou's father was president during 1990-1995. The second round of the presidential elections is on Nov. 30. The incumbent Frente Amplio gained 50 out of 99 seats in Congress and 15 out of 30 seats in the Senate in the October elections.

Political debate during the elections has reflected a consensus on economic strategy across the country's political spectrum. The main issues during the campaign have been crime and education, not joblessness or economic growth. The main political parties agree on the need to maintain macroeconomic stability and continue diversifying the

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economy but differ over the level of taxation and government spending, as well as the composition of spending.

Policy Challenges

The next Administration will face the challenge of reducing inflation, maintaining GDP growth, and insulating the economy from adverse external developments. Despite its impressive economic performance in recent years, Uruguay is vulnerable to the general economic slowdown that is affecting all of Latin America.

Uruguay suffers from limited monetary flexibility and the vulnerabilities of a persistently high level of dollarization, which poses potential threats in the event of drastic movements in the exchange rate. Moreover, the share of commodities has increased in Uruguay's total exports during recent years, as has been the case in Argentina and Brazil, exposing the country to a potentially sharp and prolonged fall in commodity prices. The next government will have to decide whether to proceed with a proposed massive iron ore mining project. The project could sustain the country's long-term growth prospects and diversify economic output, but it is controversial because of its environmental impact.

Uruguay's domestic savings rate remains low, leading it to depend on external financing for a substantial share of its recently higher level of investment. FDI remains key to GDP growth and further diversification of the economy. Moreover, unlike most Latin American countries, Uruguay will not enjoy a demographic dividend to boost labor supply (and GDP growth) in coming years as its population is older and growing more slowly than most of them. Future GDP growth will depend heavily on productivity growth (as well as more capital). In addition, the country's physical infrastructure constrains growth. Uruguay has been slower than many Latin American countries in advancing with public-private partnership projects, which have the potential to boost investment in infrastructure.

The shift in monetary policy toward inflation targeting has been common in many investment-grade sovereigns in Latin America, but Uruguay has not been as successful as most others in meeting its targets. In Uruguay, inflation has typically exceeded the central bank's target, weakening the credibility of its policy. The inflation rate is likely to be about 8% in 2014, again above the bank's target of 3%-7%. A high level of salary indexation with inflation creates substantial inertia, making it harder for the central bank to reduce the inflation rate. The central bank continues to post moderate losses, typically less than 1% of GDP.

Total credit from the financial system to the private sector and the nonfinancial public sector was less than 28% of GDP in 2013, small compared with other countries at a similar level of per capita income. Foreign currency lending has hovered between 50%-60% of total lending since 2007, while deposits in dollars have been about 70% of the total in recent years. Bank credit to households is denominated almost entirely in local currency while all other types of lending are denominated mostly in dollars. A low level of domestic credit and high level of dollarization limits the effectiveness of the transmission mechanism of monetary policy.

Potential Changes In The Uruguay Sovereign Credit Rating

Substantial changes in economic policy in Uruguay have contributed to growing divergence in economic performance,

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as well as credit ratings, between itself and Argentina over recent years. Both countries remain vulnerable to external trends, such as potentially prolonged lower commodity prices. However, Uruguay's progress in reducing its external vulnerability, diversifying its economy, and creating new sources of GDP growth demonstrates the importance of political leadership and the pursuit of pragmatic, pro-growth economic policies. While small, open economies are vulnerable to external shocks, Uruguay's experience shows that governments can reduce such vulnerabilities by pursuing favorable policies over many years.

Continued GDP growth and economic diversification, along with a declining debt burden and improvement in monetary and fiscal flexibility, would provide Uruguay with greater capacity to withstand negative external shocks. A declining level of dollarization, along with lower inflation, would boost the effectiveness of monetary policy. The resulting improvement in economic resilience could lead to an upgrade.

Conversely, a weakening commitment to policies that sustain macroeconomic stability, or an inadequate response to adverse external developments that could reduce the country's external liquidity and raise its debt burden, could result in a downgrade.

Related Criteria And Research

Related criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013

Related research

- Oriental Republic of Uruguay, Aug. 1, 2014
- Argentina Foreign Currency Ratings Lowered To 'SD' After Holders of Discount Bonds Did Not Receive Interest Payment, July 30, 2014

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