FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Uruguay at 'BBB'; Outlook Stable

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Fitch Ratings - New York - 04 Jun 2024: Fitch Ratings has affirmed Uruguay's Long-Term (LT) Foreign-Currency (FC) and Local-Currency Issuer Default Rating (IDR) at 'BBB'. The Rating Outlook is Stable.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Credit Fundamentals: Uruguay's 'BBB' rating is supported by relatively high GDP per-capita, strong governance indicators, and robust external finances. The rating is constrained by muted medium-term economic growth prospects affected by competitiveness challenges, a public debt burden sensitive to exchange-rate movements, a long record of high inflation (albeit improving) and policy flexibility constrained by dollarization, indexation, and shallow financial depth.

Growth Rebound, Structural Challenges: We project GDP growth will rebound to 3.2% in 2024 from 0.4% in 2023, as the negative effects recede from last year's once-in-a-century drought, consumption diversion towards Argentina and a scheduled shutdown of the country's main oil refinery. The new pulp mill project which started operations in 2023 will also boost growth having its first full year of production at capacity. We anticipate growth will hover around 2.5% in 2025. Low investment levels continue to constrain potential growth.

Improving Inflation: Inflation declined to 3.7% in April 2024, the lowest level in almost nineteen years and marking the eleventh consecutive month within the Banco Central del Uruguay's (BCU) target range of 3%-6%. This follows the appreciation of the Uruguayan peso, falling import prices and a swift increase of the policy rate in 2022. The BCU's ability to maintain inflation within the target is a significant achievement, marking the first time in over two decades that it has done so for an extended period. Inflation expectations have converged to the upper level of the target range but remain elevated reflecting historically high inflation levels.

Slightly Wider Fiscal Deficits: The central government posted a budget deficit of 3.3% of GDP in 2023 (excluding "cincuentones" pension transactions), above the original budget projection of 2.6% but broadly in line with a revised 3.2% projection incorporating the effects of the 2022-23 once-in-a-century drought. Fitch anticipates the fiscal balance will decline slightly to 3.2% in 2024 and remain in similar levels through 2025. Consolidation this year will hinge on the clearing of the 2023 one-off effects, such as the drought and price differential with Argentina. We do not expect the election cycle to be a source of spending pressure as has been the case in the past.

Fiscal Rule Compliance: The government invoked the exception clause in the borrowing limit of its fiscal rule (which includes a spending limit, net borrowing limit and a structural balance target) due to the impact of the drought and a mid-year revision to the structural balance target. Uruguay's fiscal rule has enhanced credibility and transparency by facilitating greater scrutiny and accountability around fiscal performance. The relaxation of fiscal goals has been marginal but may highlight a challenging environment for further fiscal consolidation. Fitch does not anticipate the next administration to materially deviate or remove the fiscal rule.

Gradual Upward Government Debt Trend: General government debt rose to 63.5% at end-2023 from 59.1% in 2022, above the 55% 'BBB' median. The debt increase was driven by a 2pp rise in loans and commercial bonds and 2pp in bonds issued to recapitalize the central bank. The BCU's equity fell into negative territory in 2022 and was below the legal minimum due to peso appreciation. Our deficit forecasts are consistent with broadly stable debt/GDP, but we expect a moderate rise in the debt ratio in the outer years of our forecast horizon reflecting muted economic medium-term growth.

Competitive Elections: The October 2024 general elections are shaping up to be competitive, according to current polls, amid an increase of grievances on income inequality, corruption, criminality and education attainment. Strong political and social stability in Uruguay suggests that a radical policy shift is unlikely, regardless of the outcome. The next administration will face the challenge of complying with the fiscal rule amid budgetary rigidities and pressure to address social demands. The opposition Frente Amplio coalition's decision not to endorse the social security referendum signals a basic political consensus around policy continuity.

Referendum Present a Tail Risk: The Labor Union, PIT-CNT, proposed a constitutional amendment to the social security system through a public referendum. The referendum will contain three modifications to the current system: a decrease in the retirement age from 65 to 60, aligning the minimum pension to the minimum wage, and the elimination of private individual savings.

The referendum is binding and, if successful, would incorporate the changes in the constitution. Fitch anticipates the population will reject the referendum as it has little political backing. Most politicians and presidential candidates have been vocal in their rejection of the proposal.

Current Account Deficit to Ease: Fitch forecast the current account deficit to decline to 0.7% of GDP in 2024 from 3.6%, owing to driven by UPM's first year at full production capacity, exports recovery from last year's drought and rising relative prices in Argentina. Uruguay's foreign exchange reserves remain relatively high, which, coupled with robust banking sector external liquidity, results in one of the highest Fitch-calculated international liquidity ratios among 'BBB'-rated countries.

ESG--Governance: Uruguay has an ESG Relevance Score (RS) of '5' [+] for both Political Stability and Rights, and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGIs) have in our proprietary Sovereign Rating Model (SRM). Uruguay has a high WBGI ranking at 83nd percentile, reflecting its long track record of stable and peaceful political transitions, well established rights for participation in the political process, strong institutional capacity, effective rule of law and a low level of corruption.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Public Finances: A substantial rise in government debt/GDP, for example due to widening of the fiscal deficit;

--Macro: Significant weakening of economic growth prospects or developments that undermine policy predictability and macroeconomic stability, particularly should this weaken public finances.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Macro: A sustained reduction in inflation and anchoring of expectations around the target, and progress in de-dollarization and/or reducing indexation that improves policy flexibility:

--Public Finances: A sustained decline in government debt/GDP consistent with a low budget deficit;

--Macro: Improved economic growth and investment prospects; for example, via economic reforms that address competitive weaknesses.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Uruguay a score equivalent to a rating of 'BBB+' on the Long-Term Foreign Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its qualitative overlay (QO), relative to SRM data and output, as follows:

Macro: -1 notch, to reflect macroeconomic policy flexibility is constrained by high dollarization, indexation and high inflation expectations. A poor record of compliance with inflation targets reflects institutional shortcomings not captured in the strong governance indicators that feed into the SRM, though the authorities are taking steps to improve this. Fitch projects medium-term growth prospects at a relatively modest 2%, partly reflecting low investment rates.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

COUNTRY CEILING

The Country Ceiling for Uruguay is 'A-', 2 notches above the LT FC IDR. This reflects no material constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of +2 notches above the IDR. Fitch's rating committee did not apply a qualitative adjustment to the model result.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Uruguay has an ESG Relevance Score of '5' [+] for Political Stability and Rights as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Uruguay has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Uruguay has an ESG Relevance Score of '5' [+] for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Uruguay has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Uruguay has an ESG Relevance Score of '4' [+] for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver. As Uruguay has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Uruguay has an ESG Relevance Score of '4' [+] for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Uruguay, as for all sovereigns. As Uruguay has record of 20 years without a restructuring of public debt, which is captured in our SRM variable, this has a positive impact on the credit profile.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Uruguay	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
	ST IDR	F2	Affirmed	F2
	LC LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
	LC ST IDR	F2	Affirmed	F2
	Country Ceiling	A-	Affirmed	A-
senior unsecured	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Sovereign Rating Criteria (pub. 06 Apr 2023) (including rating assumption sensitivity)

Country Ceiling Criteria (pub. 24 Jul 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v2.0.2 (1)

Debt Dynamics Model, v1.3.2 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.14.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Uruguay	EU Endorsed, UK Endorsed

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