FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Uruguay to 'BBB'; Outlook Stable

Wed 07 Jun, 2023 - 12:25 PM ET

Fitch Ratings - New York - 07 Jun 2023: Fitch Ratings has upgraded Uruguay's Long-Term (LT) Foreign-Currency (FC) and Local-Currency Issuer Default Rating (IDR) to 'BBB' from 'BBB-'. The Rating Outlook is Stable.

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

KEY RATING DRIVERS

Rating Upgrade, Stable Outlook: The upgrade reflects Uruguay's resilient fiscal performance in absorbing the COVID-19 pandemic shock coupled with its record of compliance with its modified fiscal framework, which has enhanced its fiscal credibility, increased resilience to economic shocks and reduced the risk of a potential marked future increase in the government debt burden. The recent approval of a reform that improves the sustainability of the pension system further signals the commitment to fiscal policy that is more prudent and consistent with its high governance scores.

Uruguay's 'BBB' rating continues to be 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, persistently high inflation and policy flexibility constrained by dollarization, indexation, and shallow financial depth.

Improved Fiscal Credibility: Uruguay implemented a meaningful structural fiscal consolidation in 2020-2022, guided by the modification to the fiscal rule introduced in 2020. The government has consistently complied with new fiscal rules implemented in 2020, improving the credibility of Uruguay's fiscal policy. Fitch anticipates a challenging fiscal backdrop in 2023 given the impact of the drought and the reversal of real wage losses over past years, as well as the government's decision to reduce taxes. Fitch projects the central government deficit (excluding "cincuentones" pension transactions) will widen slightly to 3.3% of GDP in 2023, from 3.2% in 2022, but gradually narrow to 2.6% by 2025.

Fitch expects the government will continue to target debt stability in its medium-term framework and proposed 2024 budget changes, scheduled to be presented to parliament by the end of June.

Pension Reform Improves Sustainability: Congress approved a pension reform on April 27, which will not offer fiscal savings for many years given long transition rules, but which represents a strong demonstration of fiscal responsibility in contrast to prior years when pension rules were relaxed. The reform improves the system's long-term sustainability through parametric modifications and stabilizes pension-related expenditures in terms of GDP, namely by increasing the retirement age to 65 years from 60 years in a one-year increments starting in 2034. The retirement age will be linked to life expectancy, avoiding the need for future reforms to modify it.

The reform also converges the different existing pension schemes into a single uniform mixed-system regime, creates an independent regulatory agency to oversee the pension system and seeks to encourage voluntary savings.

Stable Government Debt Dynamics: General government debt declined to 58.3% of GDP at end-2022 from 61.9% in 2021, reflecting resilient economic activity, and real peso appreciation. Fitch expects debt/GDP will increase to 60% in 2023 given an economic slowdown and an expected recapitalization of the central bank, and then to very gradually increase over the forecasting period, similar to previous projections.

The foreign-currency debt ratio declined to 45.5% in 2022 from 50.0% in 2021, reflecting the government's ongoing efforts to de-dollarize the debt structure by prioritizing domestic financing sources. However, the ratio remains among the highest ratios in 'BBB' countries, rendering the debt trajectory vulnerable to periods of currency volatility.

Economic Activity to Slow: Fitch anticipates GDP growth will slow down to 1.8% in 2023 and hover around 2.5% in 2024 and 2025, down from 4.9% in 2022. Uruguay is facing its most severe drought over the past 40 years. The loss of production as a consequence of the drought is estimated at about USD2 billion (2.5% of GDP), but Fitch assumes the climate event will be temporary. Potential growth continues to be affected by low investment levels (18.8% of GDP in 2022), adverse demographic trends, and competitiveness issues (e.g. a wage framework disconnected from productivity and high energy costs).

High Inflation Persists: Inflation reached 7.1% in May 2023, down from 10% in September of 2022, although it remains above the target range of 3%-6% of the central bank (BCU). Inflation expectations also remain stuck above the target range. The BCU began to tighten its monetary policy in August 2021, raising its policy rate by 700bps to 11.5% by December 2022. The swift increase of the monetary policy to a restrictive stance coupled with strong appreciation of the Uruguayan peso resulted in a moderate inflation decrease.

The BCU began to unwind its policy stance by reducing the policy rate by 25bps in April 2023. While the monetary policy remains in a restrictive stance, the move highlights the BCU's rising concern with a strong exchange rate and thus the difficult trade-offs it faces with disinflation goals.

More Orthodox Monetary Framework: The BCU introduced changes to its monetary policy framework in 2020. These included reaffirming price stability as the primary monetary objective, using the short-term interest rate as the policy instrument and reducing the upper band of the target range to 6% from 7% starting in September 2022. The BCU is also targeting a reduction of dollarization while developing the local-currency financial market, though progress has been limited and these features remain a hindrance to the effectiveness of monetary policy, along with still-prevalent wage indexation.

Robust External Finances: 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. Lower FX intervention from the BCU has been one of the key modifications to the monetary policy revamp back in 2020. The exchange rate will act as a shock absorber, reducing external pressures as the central bank limits FX interventions, absent a reversal from the recently implemented modifications to the policy framework.

Uruguay's current account deficit (CAD) expanded to 3.2% in 2022 up from 2.5% in 2021, driven by high fuel prices along with import needs of the UPM project. Fitch anticipates an improvement of the CAD to 2.7% in 2023 and 1.7% in 2024 as the UPM production ramp up coupled with lower fuel prices will offset the effect from the drought.

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 (WBGI) 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, particularly should this weaken public finances.

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

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

--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:

--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 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 Fitch's criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

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 a fairly recent restructuring of public debt in 2003, this has a negative impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Uruguay	LT IDR	BBB Rating Outlook Stable	Upgrade	BBB- Rating Outlook Stable
	ST IDR	F2	Upgrade	F3
	LC LT IDR	BBB Rating Outlook Stable	Upgrade	BBB- Rating Outlook Stable

	LC ST IDR	F2	Upgrade	F3
	Country Ceiling	A-	Upgrade	BBB+
senior unsecured	LT	BBB	Upgrade	BBB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

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

APPLICABLE MODELS

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

Country Ceiling Model, v1.7.3 (1)

Debt Dynamics Model, v1.3.2 (1)

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

Sovereign Rating Model, v3.13.3 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Uruguay	EU Endorsed, UK Endorsed

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