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Credit FAQ:

What Challenges Will The New Administration In Uruguay Face?

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The results of Uruguay's presidential elections on Nov. 24 were closer than we expected. Current estimates indicate that Luis Lacalle Pou from the opposition Partido Nacional (PN) received 48.0% of the votes, just ahead of Daniel Martínez from the incumbent Frente Amplio coalition (FA), which has governed the country for the past 15 years. The country's Electoral Court will announce final results this week.

Below, S&P Global Ratings' answers frequently asked questions about Uruguay's credit standing, how it compares with regional peers, and key challenges for the new administration.

Frequently Asked Questions

What supports the rating on Uruguay, and what are the key risks?

The 'BBB' long-term sovereign credit rating on Uruguay with a stable outlook incorporates our assumption of continuity in key economic policies after the election. We expect that, over the next two years, Uruguay will continue to show high general government (GG) fiscal deficits and an increase in its net GG debt burden. At the same time, we expect that Uruguay will continue to sustain GDP growth, with per capita GDP likely expanding by 1.9% per year during 2020-2022.

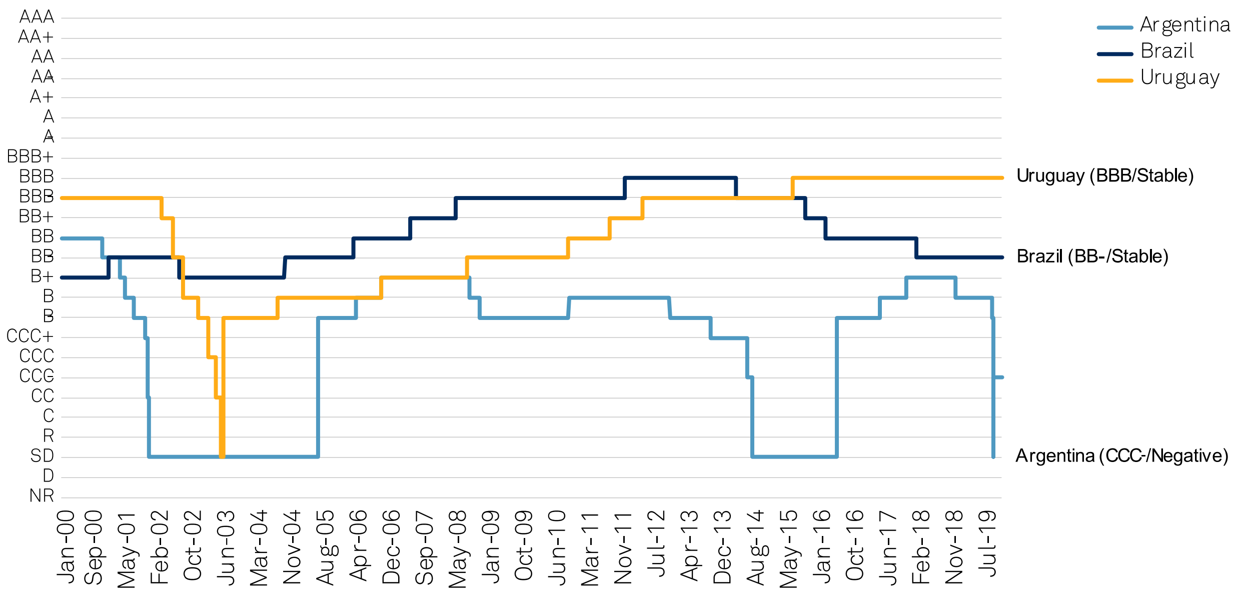
Our ratings on Uruguay are supported by its track-record of prudent and predictable economic policies and its well-established institutions, which have underpinned consistent economic growth over the past 16 years. The ratings also benefit from Uruguay's strong external position. Uruguay's persistently high--and increasing--fiscal deficits and debt burden are constraints on the sovereign ratings, as are its relatively high inflation and still-high level of dollarization in the financial system.

How does the rating on Uruguay compare with other sovereign ratings in the region?

Uruguay's record of continued economic growth and stable economic policies in recent years distinguishes it from its neighbors Argentina and Brazil and has contributed to the gap in our respective sovereign credit ratings. (We assign a foreign currency long-term sovereign rating of 'CCC-' on Argentina and 'BB-' on Brazil.) In fact, the rating trajectory over the past two decades shows that Uruguay has increasingly diverged from Argentina and Brazil; its current investment-grade peers in the region are Peru (foreign currency BBB+/Stable/A-2), Colombia (BBB-/Stable/A-3), and Chile (A+/Stable/A-1) (see chart 1).

Over the years, Uruguay has been able to improve its net external position and its access to external liquidity while diversifying its economy and strengthening its financial system and 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 political consensus. This explains why our institutional assessment for Uruguay is similar to that of investment-grade peers in the region and is a rating strength, along with our assessments of the country's economy and external indicators. At the same time, weaknesses lie in fiscal performance, as well as Uruguay's stubbornly high inflation and dollarization levels that limit our monetary assessment (see table).

Uruguay's Rating Trajectory: An Increasingly Distant Neighbor Of Argentina And Brazil



Source: S&P Global Ratings.

Uruguay's Relative Rating Strengths And Weaknesses

	Chile	Peru	Uruguay	Colombia	Brazil	Argentina
Sovereign foreign currency ratings	A+/Stable/A-1	BBB+/Stable /A-2	BBB/Stable /A-2	BBB-/Stable /A-3	BB-/Stable/B	CCC-/Negative/C
Institutional assessment	2	3	3	3	4	6
Economic assessment	4	4	3	4	5	5
External assessment	4	3	2	5	3	6
Fiscal assessment: budget performance	2	2	5	3	6	6
Fiscal assessment: debt	1	2	4	4	6	5
Monetary assessment	2	3	5	3	3	5

Note: 1 represents lowest risk, while 6 represents highest risk. Source: S&P Global Ratings.

What does the close election outcome mean for the credit rating?

The close results will likely increase the importance of building political consensus on key policies. The outgoing FA coalition held a majority in both chambers of Congress over the past 15 years, facilitating passage of legislation. In the new Senate (which has 30 seats), the FA will hold 13 seats, the PN only 10, the Partido Colorado (PC) will have four seats, and the recently created Cabildo Abierto (CA) will have three. Both the PC and the CA allied with the PN in the second round of the presidential elections. In the Lower House (which has 99 seats), the FA will hold 42 seats, compared with 30 for the PN, 13 for the PC, 11 for the CA, and three for other parties.

Regardless of who wins the presidency, the new leader will have to build support across various parties in Congress to advance with difficult measures to encourage GDP growth, address weaknesses in public finances, and contain inflation. The next administration will take office on March 1, 2020.

What are your expectations for economic growth?

We expect the economy will stagnate in 2019, growing only 0.5%, down from 1.6% in the previous year. Investment has been dropping for the last four years, while unemployment remains high at about 9% of the workforce. We expect GDP growth to be only 1.5% in 2020. Uruguay's GDP per capita doubled over the past 10 years to an estimated US$16,400 in 2019, one of the highest in Latin America. However, boosting and sustaining economic growth remains a challenge, as in other Latin American countries.

The trend rate of GDP growth is an important factor in our rating assessment. We expect that gradual increases in investment over the next couple of years will boost per capita GDP growth toward 2.0%. Much depends on the ability of the next administration to advance large infrastructure projects through public-private partnerships. Importantly, after 2020, we think investment will rise due to the construction of Finnish company UPM-Kymmene Oyj's second pulp mill, the largest-ever private investment in Uruguay (approximately US$3 billion, or 5% of GDP).

What are the underlying fiscal challenges for the new government?

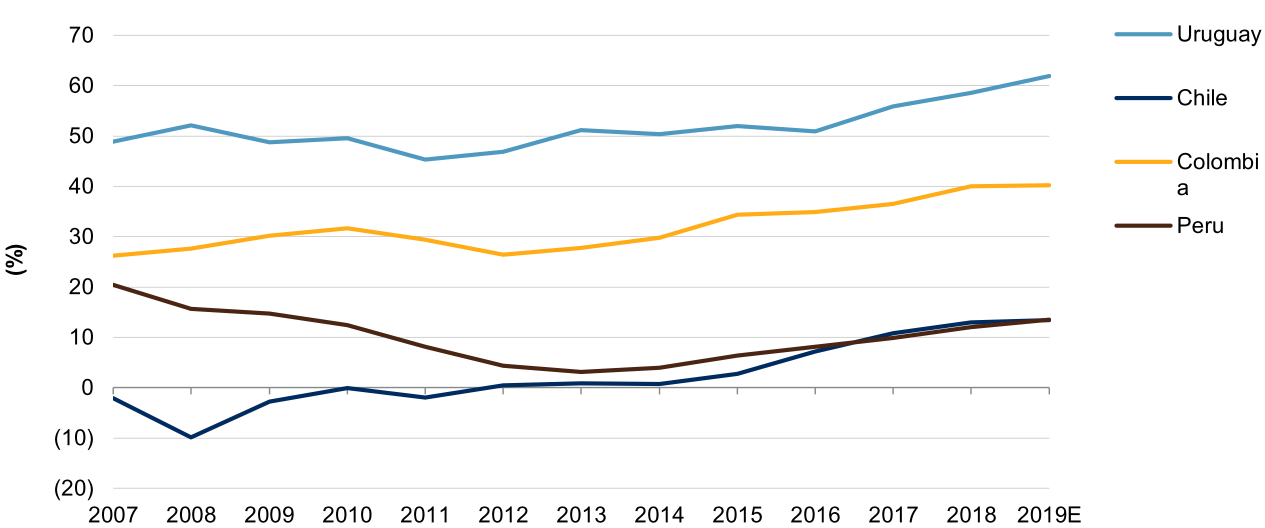
Subdued economic growth, moderately high inflation, and spending rigidities have put pressure on the government's finances in recent years, and represent a key challenge for the new administration. In late 2017, Congress approved changes to the social security system to allow groups of future retirees in the private pension system to switch to the public-sector pension system. This boosted government revenues in 2018 by 1.3% of GDP (thanks to higher pension contributions) and lowered the GG fiscal deficit (our definition of the GG includes the central bank and excludes public-sector enterprises). The fiscal deficit stood at 2.8% of GDP in 2018, but it would have been 4.1% excluding such transitory pension revenues. Thanks to these transitory revenues in 2019 and 2020, we expect the GG deficit to average around 3% of GDP in these years. Containing the deficit once these transitory revenues disappear in 2021 will be a fiscal challenge for the next administration, as Uruguay's debt burden has increased in recent years.

How does Uruguay's debt burden compare with its peers'?

Uruguay has higher debt and a less favorable composition of debt compared with its regional rating peers. Its net GG debt will exceed 60% of GDP in 2019, reflecting continued fiscal deficits and peso depreciation (see chart 2). Although debt in foreign currency declined to 53% of total debt as of September 2019 from 88% in 2005, Uruguay is more vulnerable to exchange-rate risk than peers, which have most of their debt denominated in local currency. Foreign currency debt is 34% of total debt in Peru, 33% in Colombia, and only 20% in Chile.

Chart 2

Net General Government Debt/GDP



E--Estimated.

Our analysis of public finances focuses on the change in net GG debt as a percentage of GDP. In contrast with the reported fiscal deficit, this measure captures the impact of exchange-rate movements and other factors that may affect the sovereign's debt burden. With over half of its debt in foreign currency, the sovereign's debt burden (and debt servicing) is sensitive to exchange-rate movements. We also count debt issued by Uruguay's central bank to intervene in the foreign currency market to contain depreciation due to its magnitude. Hence, steps that reduce the sovereign's exposure to adverse movements in the exchange rate and enhance the effectiveness of monetary policy would also have a positive impact on our assessment of public finances.

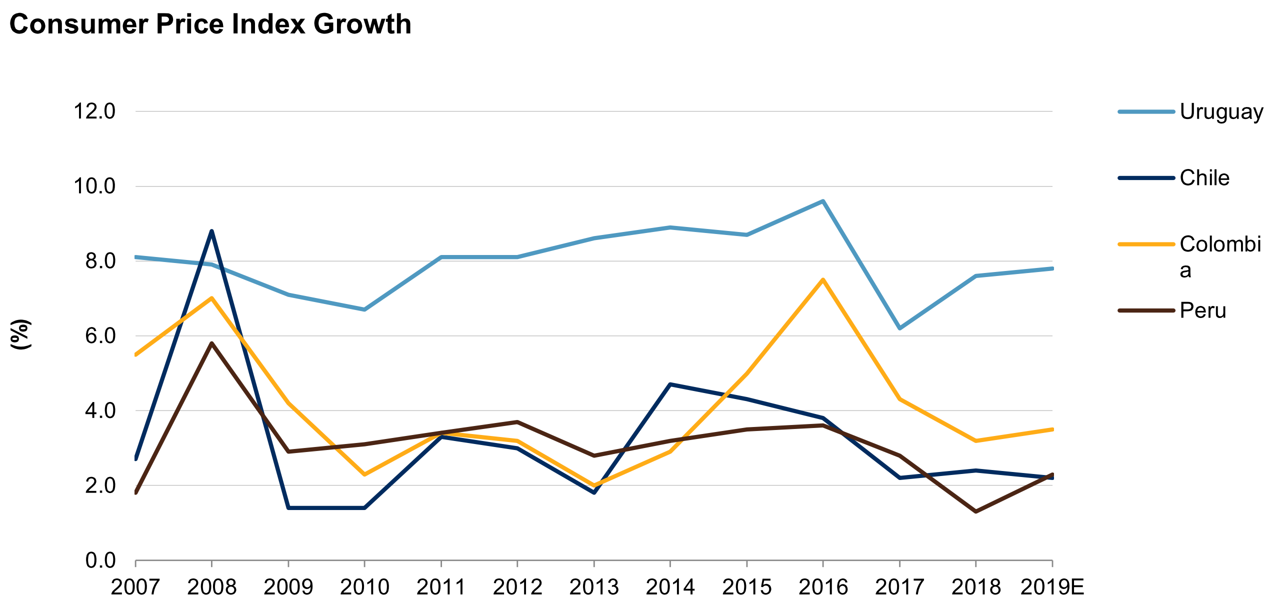
How does S&P Global Ratings evaluate Uruguay's monetary flexibility?

In our view, Uruguay has more limited monetary flexibility than investment-grade peers in the region. This stems from still-high inflation and dollarization, which also pose risks to the financial sector should sudden spikes in the exchange rate occur, given that over 50% of resident loans are denominated in dollars, while more than 70% of resident deposits are denominated in dollars.

Accumulated inflation reached 8.3% in October, and our inflation expectations over the next 12 months remain above the central bank target range of 3%-7%. By the end of 2019, we expect that inflation will still be above the target, as continued depreciation of the Uruguayan peso and pass-through effects to the tradable sector will continue to put pressure on prices. This is in contrast with much lower inflation in Brazil (3.8% estimated for 2019), Colombia (3.5%), and Peru (2.3%).

The FA government tried to reduce the indexation of wages to inflation in order to reduce the inertia that sustains inflation. However, currency volatility has made it difficult to contain inflationary pressure. Success in gradually reducing inflation would boost the effectiveness of monetary policy, alleviate fiscal pressures, and help the government manage the economic consequences of an aging population as well.

Chart 3



E--Estimated.

How does an aging population affect the rating analysis on Uruguay?

Uruguay has the oldest population in Latin America, with 14.8% of its residents aged above 65, similar to some European countries and above the 7.9% average for Latin America. An aging population could depress future GDP growth, absent policies that increase labor productivity. It also poses a fiscal problem through higher future spending on pensions.

Pension spending is roughly 10% of GDP and is high by international standards due to the system's wide coverage, as well as the impact of indexation. Political pressures will make it difficult for the next administration to raise the country's tax burden, demonstrating the importance of addressing rigidities on the spending side.

Ensuring the long-term health of the pension system and consolidation of public finances in general depends on fiscal reforms and on sustaining good GDP growth. Both of these challenges will require skillful political leadership and political consensus.

This report does not constitute a rating action.