Commentary

Uruguay's Budget Sets Course Correction For Public Finances

DBRS Morningstar
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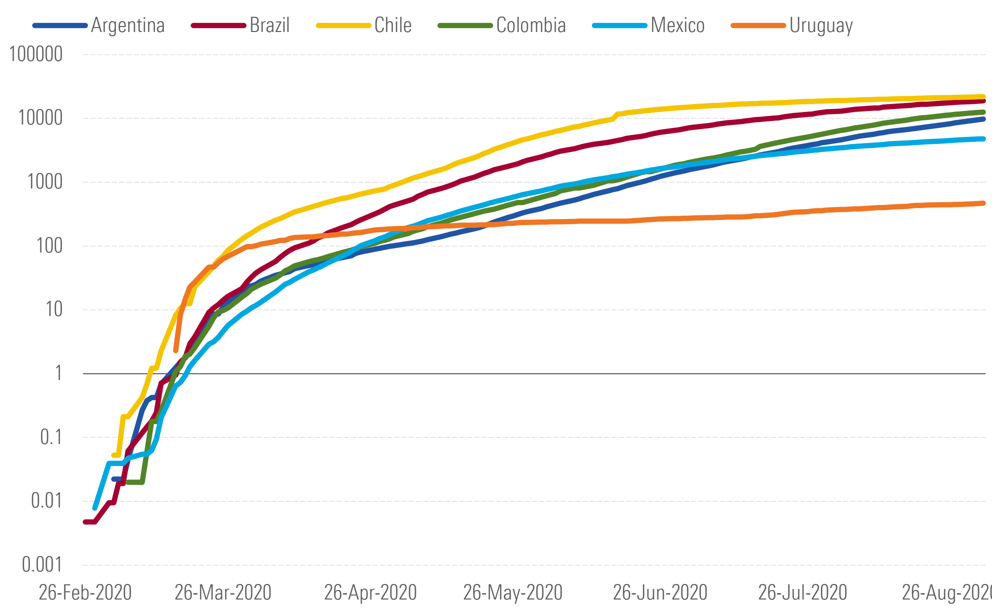
The new Uruguayan president Luis Lacalle Pou has faced a challenging social, economic, and political environment since taking office on March 1st. Even before the Coronavirus Disease (COVID-19) global outbreak, Uruguay had experienced five years of anemic growth and deteriorating public finances. Then, just 12 days after the President was sworn into office, Uruguay recorded its first confirmed case of COVID-19. Social-distancing measures to contain the virus, combined with weakened global and regional demand, have led to a sharp decline in economic activity and employment.

Despite the difficult circumstances, DBRS Morningstar continues to view the risks to Uruguay's BBB (low) ratings as broadly balanced. While there continues to be uncertainty around the evolution of the virus, the incidence of new COVID-19 cases in Uruguay is low. Post-pandemic growth prospects look better than the last five years. In addition, the Lacalle Pou administration is putting in place a fiscal strategy that aims to stabilize public finances over the medium term. The key challenge may be to hold the congressional coalition together.

Exhibit 1 Cumulative COVID-19 Cases (per million, log scale)



Source: Johns Hopkins University, DBRS Morningstar.

Three Features of the Fiscal Consolidation Plan

The Lacalle Pou administration outlined its fiscal consolidation strategy in the Urgent Consideration Law (UCL), which Congress passed on July 8th, and the five-year Budget outlook, which was submitted to Congress on August 31st. In DBRS Morningstar's view, the administration's fiscal consolidation strategy includes three key features which increase the prospects for a successful adjustment.

First, the fiscal measures adopted to mitigate the impact of the pandemic on the economy are targeted and temporary. Emergency spending - including expanded eligibility for unemployment insurance and increased transfers to low-income families - is being partially offset by several temporary taxes, so the net cost is estimated at just 1.3% of GDP. The government also created a Coronavirus Fund to demarcate pandemic-related spending from the rest of the budget, which should ensure emergency items do not become permanent. Consequently, if public health and economic conditions allow, the deficit should improve next year as emergency measures expire.

Second, the Lacalle Pou administration aims to implement a multi-year fiscal adjustment and pass pension reform, both of which are needed to put public finances on a sustainable path. The fiscal adjustment is expenditure-based, with the spending-to-GDP ratio set to decline through 2024. Tight spending control is expected to help narrow the deficit from 6.5% of GDP in 2020 to 2.5% in 2024 (excluding one-off transfers from workers who chose to switch from their private pension to the public pension scheme via the "Cincuentones Law"). At the same time, the UCL created an advisory council to propose adjustments to the pension system to ensure financial sustainability. On its current path, pension spending is projected to outpace fiscal resources over the medium term. To highlight the urgency of reform, the ULC imposed a deadline of mid-2021 for the council to submit its proposal to Congress. Passage of a reform that stabilizes pension spending, along with the fiscal adjustment, would put public finances on a more sustainable trajectory.

Exhibit 2 Public Sector Results (% GDP)

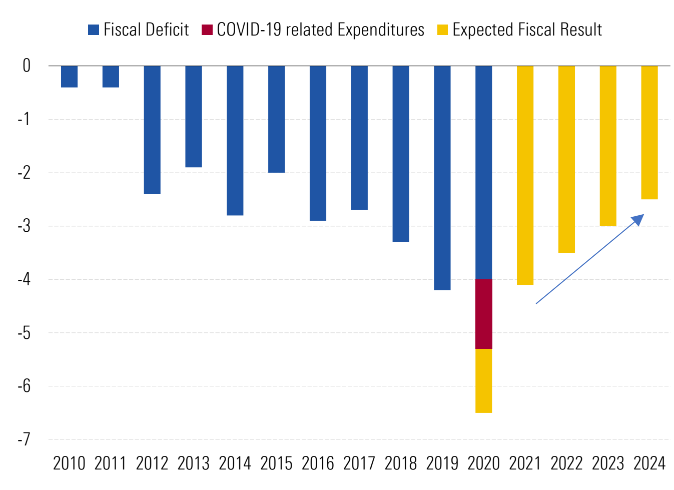
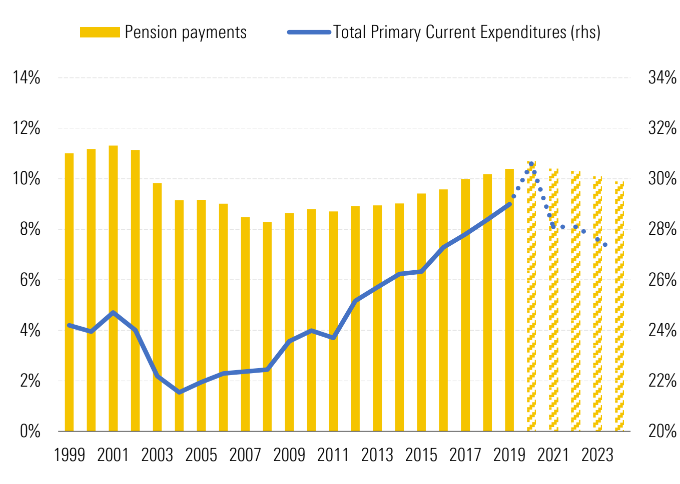


Exhibit 3 Composition of Public Expenditures (% GDP)



Source: Uruguay MEF, DBRS Morningstar.

Third, the Lacalle Pou administration aims to strengthen the fiscal framework. The UCL establishes a framework for a fiscal rule. Consequently, fiscal policy will be guided by a spending cap and a structural deficit rule, which should foster counter-cyclicality through the business cycle and sustainability over the medium term. The government is also amending the budgetary process so that macroeconomic and fiscal projections are provided over a rolling five-year period, thereby providing an outlook beyond the current administration.

Recovery May Provide a Favorable Environment for Fiscal Adjustment

The COVID-19 shock has had a severe impact on the Uruguayan economy. Employment fell to the lowest rate of the last ten years, and manufacturing output declined by 22% between March and April. However, high frequency indicators suggest the economy is starting to recover. Fuel demand is now approaching pre-pandemic levels, mobility data shows an improvement relative to a few months ago, and requests for unemployment insurance have fallen since May’s peak. The government expects GDP to decline by 3.5% in 2020, a comparatively strong performance relative to others in the region.

Strong growth in the post-pandemic period could facilitate fiscal consolidation. Several large investment projects boost Uruguay's near-term growth outlook. The Finnish firm UPM is investing USD 3 billion, or 5% of GDP, on a new pulp mill in central Uruguay. Construction has begun and operations should start in 2022. In addition, a pipeline of new public-private infrastructure projects, including a USD 1 billion railroad project, is just getting underway. Bolstered by the cyclical rebound in 2021 and these massive investments, the government expects the economy to expand 3.8% on average from 2021 to 2024.

Consensus on Policy Direction Within Government Coalition Holds For Now

The political landscape following the 2019 general elections creates some space to advance a reformist agenda. In addition to Lacalle Pou winning the presidency, center-right parties in Congress - consisting of the Colorado Party, the Cabildo Abierto, the Independent Party, and the People's Party - coalesced around the National Party to form a majority coalition in both houses. The coalition withstood any early test of its cohesion when it passed the ULC in July. Passing the 2020-24 Budget without any significant changes in the overall fiscal strategy would be another step forward for the administration in pursuit of its agenda.

Public opinion of the administration has been positive thus far, particularly surrounding its handling of the coronavirus outbreak. Approval ratings for the president have consistently come in around 60%. However, tight fiscal policy, particularly in the aftermath of a recession and with elevated levels of unemployment, could galvanize public opposition. Proposed cuts to tertiary education recently led to large demonstrations around the country. A durable consolidation will likely depend on the administration’s ability to maintain public support.

Risks Remain Two-Sided

The challenges and risks facing the new administration are significant. Uncertainty around the growth outlook in the near term is elevated due to the potential for a surge of the virus, particularly as it continues to spread quickly in neighboring countries. A second, more severe outbreak of COVID-19 or weaker than expected growth in the post-pandemic period could derail fiscal consolidation plans. Moreover, the coalition in congress might not last. Although it has held together so far, divisions between allied parties may become more visible over time.

On balance, these downside risks are tempered by several positive developments. Uruguay's public health response has effectively contained the spread of COVID-19 so far. The UCL and Budget 2020-24 outline a strategy that could materially improve the outlook for Uruguay's public finances. Moreover, the economy looks set to grow at a solid pace starting next year, which could create a more favorable political environment for reform. DBRS Morningstar will be watching the budget debate and the pending pension reform; the evolution of the Uruguay's ratings - up or down - will depend on this government's ability to put public finances on a more sustainable trajectory.

About DBRS Morningstar

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On July 2, 2019, Morningstar, Inc. completed its acquisition of DBRS. Combining DBRS' strong market presence in Canada, the U.S., and Europe with Morningstar Credit Ratings' U.S. footprint has expanded global asset class coverage and provided investors with an enhanced platform featuring thought leadership, analysis, and research. DBRS and Morningstar Credit Ratings are committed to empowering investor success, serving the market through leading-edge technology and raising the bar for the industry.

Together as DBRS Morningstar, we are the world's fourth-largest credit ratings agency and a market leader in Canada, the U.S., and Europe in multiple asset classes. We rate more than 2,600 issuers and 54,000 securities worldwide and are driven to bring more clarity, diversity, and responsiveness to the ratings process. Our approach and size provide the agility to respond to customers' needs, while being large enough to provide the necessary expertise and resources.