FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Uruguay at 'BBB-'; Outlook Stable

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Fitch Ratings - New York - 29 Jun 2022: 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 institutional strength evidenced by a successful pandemic response, and robust external finances. The rating is constrained by muted medium-term economic growth prospects affected by competitiveness challenges, a public debt burden above rating peers and sensitive to exchange-rate movements, persistently high inflation and policy flexibility constrained by dollarization, indexation, and shallow financial depth. The government is committed to policies to improve these credit weaknesses, but faces challenges in advancing these.

Better-than-Expected Fiscal Consolidation: The central government deficit fell to 4.3% of GDP in 2021 from 5.8% in 2020. The consolidation has been driven by resilient tax revenues surpassing nominal GDP growth, real declines in public wages and pensions, cuts to public investment and tight control of other current spending items. Fitch projects the deficit to fall to 3.1% in 2022 as pandemic spending and the extraordinary revenues secured to fund it are mostly phased out. We project the deficit will fall further to 2.7% by

2023, in line with the targets outlined in the five-year budget, though scope for further outperformance could become limited due to pre-election political pressure for tax cuts and higher social spending.

Improved Fiscal Framework: The government has achieved fiscal progress guided by a modified fiscal rule that includes three pillars: a structural balance target, a limit to real government expenditures linked to potential growth (estimated at 2.1%), and a legal limit on net financing. The structural balance helps avoid a pro-cyclical bias that has characterized Uruguay's fiscal policy in the past, while the limit to net financing provides a nominal anchor to the fiscal balance regardless of the output gap. The government has complied with the new fiscal framework over the past two years over the course of the pandemic shock.

Stable Debt Dynamics: General government debt declined to 63.9% of GDP in 2021 from 66.3% in 2020, reflecting a real GDP rebound, high GDP deflator exceeding peso depreciation as well as inflation and wages (to which most local debt is indexed), and cancelation of 1.3% of GDP in recapitalization bonds held by the BCU. Fitch expects debt/GDP will fall to 60.2% in 2022 on strong growth, fiscal consolidation, and ongoing peso appreciation. Fitch projects debt will stabilize around 60% thereafter as growth normalizes and the fiscal deficit converges to the authorities' goal of around 2.5% of GDP, assuming a stable real exchange rate.

Robust Economic Recovery: Fitch expects real GDP will grow 4.7% in 2022, following 4.4% in 2021, and thus surpass its pre-pandemic levels. Uruguay's quarterly GDP data signals a continued recovery as growth reached 8.3% in 1Q22 (0.6% qoq, seasonally adjusted). The projection for 2022 benefits from strong statistical carryover, as Uruguay's recovery gained speed later on in 2021. Growth has benefitted from robust external demand (primarily agricultural exports) and a significant increase in investment led by the large UPM pulp mill project. Consumption has gradually recovered, nearing pre-pandemic levels supported by a continued recovery of the labor market and despite a decline in real wages. The unemployment rate remains well below pre-pandemic levels while employment has recovered its losses during the pandemic.

Medium-term Economic Challenges: Fitch expects growth to slow down to 3.1% in 2023 and gradually converge to a 2% trend pace thereafter. Potential growth remains limited by adverse demographic trends and key competitiveness issues, including a rigid wage framework, increasing education challenges and high energy prices. The government intends to pass reforms addressing these issues, but it remains to be seen how much progress it can achieve before 2024 elections. Trade opening remains a government objective to improve growth prospects. Authorities are pursuing a bilateral trade agreement with top trading partner China but prospects remain uncertain given lack of clear appetite from the Chinese authorities.

Persistent High Inflation: Inflation rose to 9.4% in May 2022 due to global pressures including higher food and energy commodity prices. The government has lifted fuel prices by less than global energy prices, deviating from the current framework based on import parity established in the 2020 LUC, and also exempted taxes on some food items (e.g. meat) to mitigate the social impact of higher prices. Fitch expects inflation to end 2022 at 8.5% and moderate to 7.3% in 2023, given inertial effects related to prevalent wage indexation.

Improving Monetary Policy: Uruguay's central bank (BCU) introduced substantive changes in 2020 to its monetary policy framework, reaffirming price stability as the primary objective, changing policy instrument to short-term interest rate, and reducing the upper band of the target range from 7% to 6% by September 2022. Yet it still faces challenges in anchoring inflation expectations over the longer time horizon. The BCU has also communicated its commitments to reduce dollarization and develop local-currency financial markets, as high economic dollarization hinders the effectiveness of monetary policy transmission channels. These efforts are constrained in the near term by the current episode of high inflation.

Continued Political Support: In a March referendum, Uruguayans voted against overturning the 2020 "urgent consideration law", an omnibus law touching on areas including education, security, labor relations and economic policymaking frameworks. The result shows the government maintained its support among the electorate, albeit with a thin margin (50.0% vs 48.7%) that bodes for a competitive election in 2024.

This makes it unclear if the administration will be able marshal consensus within its governing coalition to advance on its pending reforms, that could be politically unpopular. The authorities have pledged action on key priorities including an education reforms, a pension reform, and fuel market reforms. However, there is a narrowing window of opportunity for these reforms before the campaign process begins ahead of the presidential elections scheduled for 2024.

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 82nd 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: Record of prudent fiscal policy consistent with a declining government debt/GDP;

--Macro: Improved economic growth and investment prospects beyond the completion of the pulp megaproject; for example, due to progress on economic reforms;

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

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 constraints to policy flexibility posed by high dollarization, indexation and shallow financial markets not fully captured in the SRM, and high inflation and public debt. 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 government is trying to improve this.

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.

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(ies), either due to their nature or to the way in which they are being managed by the entity(ies). 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	Affirmed	BBB- Rating Outlook Stable
	ST IDR	F3	Affirmed	F3
	LC LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	LC ST IDR	F3	Affirmed	F3
	Country Ceiling	BBB+	Affirmed	BBB+

senior unsecured	LT	BBB-	Affirmed	BBB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 11 Apr 2022) (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, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

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

Sovereign Rating Model, v3.13.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Uruguay	EU Endorsed, UK Endorsed

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Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

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