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Uruguay's Orsi to Uphold Status Quo Amid Policy Progress, Challenges

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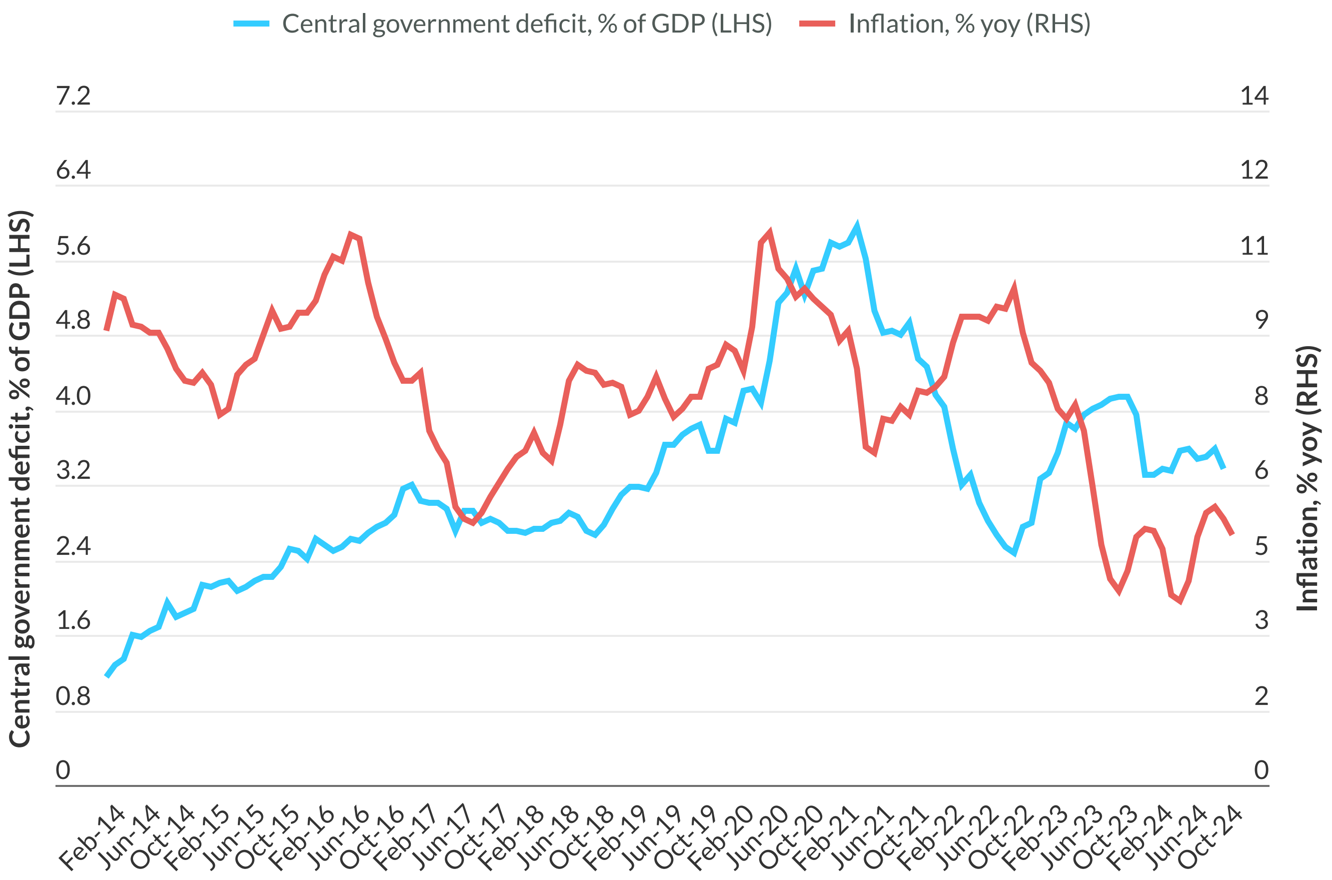
Fitch Ratings-New York-27 November 2024: The election of Yamandu Orsi of the left-wing Frente Amplio coalition to Uruguay's presidency is unlikely to bring major policy changes, Fitch Ratings says. Policy continuity should preserve the economic and institutional stability underpinning the sovereign's 'BBB' rating, and the progress achieved on disinflation and fiscal institutionality. However, it could also mean a lack of bold action by the administration to address the growth and fiscal challenges constraining the rating.

Orsi's coalition secured a majority in the Senate but fell slightly short in the lower chamber. Legislation will require negotiation with smaller parties, reinforcing incentives for the centrist policymaking that Orsi has pledged. It also reduces the chances for bold reforms that would either improve or aggravate longstanding challenges.

Fiscal restrictions will be a key challenge for Orsi. The central government deficit has been stable in 2024 at around 3.4% of GDP as of September, but this was partly due to 0.5pp in extraordinary dividends from state owned enterprises. We project the deficit to rise to 3.7% in 2025. This deficit and additional capitalizing interest on inflation- and wage-indexed bonds will keep debt/GDP on a 1.7pp-per-year upward path from a relatively high 66.3% projected for 2024, above the 'BBB' category median of 55.8%.

Uruguay Deficit and Inflation



Source: Fitch Ratings, Uruguay Ministry of Economy and Finance, National Institute for Statistics

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Reducing the deficit will be difficult. Uruguay's budget is dominated by social programs that Orsi plans to reinforce. This leaves only a small share of investment and operating spending that will be hard to cut. His platform calls for greater progressivity in the tax code and changes in tax incentives to comply with the "global minimum tax". But Orsi also ruled out tax increases late in the campaign, suggesting a political climate that may not support major revenue-enhancing measures. The five-year budget to be submitted in mid-2025 will be a key indicator of his plans.

Despite a weaker-than-expected fiscal picture, other improvements reflected in Uruguay's 2023 rating upgrade remain. The government has increasingly been able to rely on local-market funding. A fiscal rule enacted in 2020 has not insured an improvement in the headline fiscal deficit, but still represents an important achievement in our view, as it has helped improve accountability and transparency in fiscal policy. The new administration plans to preserve and fine-tune the rule.

Furthermore, voters rejected a high-stakes pension referendum in the October first-round vote. This outcome upheld a 2023 reform that was important for long-term fiscal sustainability and private pension funds crucial to the domestic capital market. Orsi says he will pursue a "national dialogue" to revisit lingering concerns, but we do not expect this to lead to major changes or unfunded mandates.

Lackluster growth is another challenge Orsi faces. Economic growth has averaged 1.2% since 2019, below the regional median of 2.4%, and roughly the same as in 2014-2019, as the execution of a major pulp project coincided with the Covid-19 pandemic. Investment has fallen to a low 16% of GDP through 2Q24 following completion of the project.

Orsi has pledged to support growth, including infrastructure and digitalization. But he has not unveiled plans for major reforms to address high production costs, low trade openness, and other issues holding back investment. Consequently, we continue to expect modest medium-term trend growth of about 2%.

Inflation, while a longstanding challenge, has improved significantly in recent years. Inflation is currently 5.0%, and inflation expectations of about 5.8% are within the government's target range (4.5%+/-1.5pp) for the first time in many years. Tight monetary policy and peso appreciation drove disinflation, but this process has become self-reinforcing and resilient to recent peso depreciation.

Uruguay's central bank will have new leadership after the administration changes in March. This could affect monetary policy reaction or appetite for further disinflation, particularly given the Frente Amplio's concern about currency overvaluation. However, we believe major changes are unlikely, because the new administration will have incentives to preserve the disinflation progress achieved so far.

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