Commentary

Uruguay's Governing Coalition Targets Pension Reform After Referendum Win

DBRS Morningstar
March 31, 2022

Michael Heydt
Senior Vice President, Sovereign Ratings
+1 212 806 3210
michael.heydt@dbrsmorningstar.com

Yolanda Ngo
Senior Analyst, Sovereign Ratings
+1 212 806 3276
yolanda.ngo@dbrsmorningstar.com

Thomas R. Torgerson
Co-Head of Sovereign Ratings
+1 212 806 3218
thomas.torgerson@dbrsmorningstar.com

Key Highlights

- On March 27, the referendum to repeal 135 articles of the Law of Urgent Consideration (LUC) was narrowly rejected by Uruguayan voters.
- The outcome of the referendum means that the key policy changes of Lacalle Pou administration, including the new fiscal framework, will remain in law and reinforce the country's improving fiscal management.
- However, passing pension reform, the governing coalition's next legislative priority, could be challenging.

The Government Overcomes The Referendum

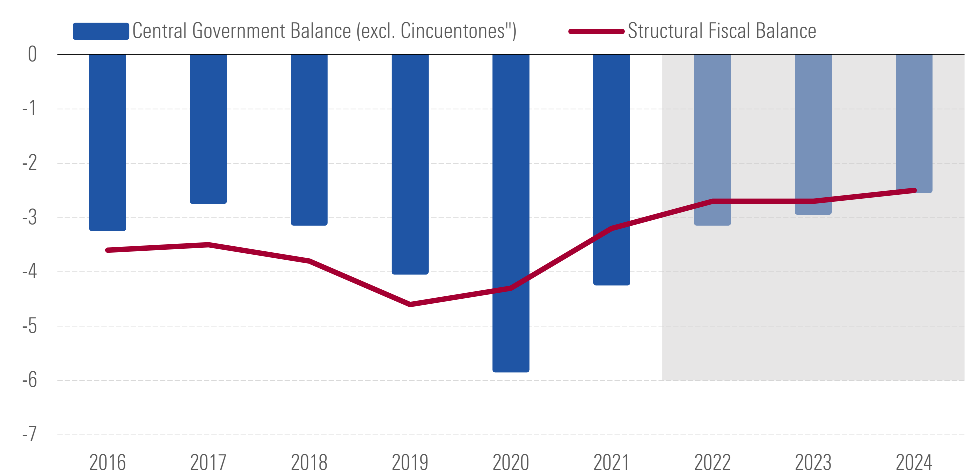
On March 27, Uruguayan voters narrowly rejected a referendum to repeal 135 articles in the Law of Urgent Consideration (LUC), the omnibus bill that Congress passed in July 2020. As President Lacalle Pou's signature legislation at the start of his administration, the LUC introduced a broad array of reforms, including laws on security, education, and the fiscal framework. The final tally had the "No" camp winning 50% of the vote, with the repeal option garnering 49% of the vote.

In DBRS Morningstar's view, the outcome of the referendum is positive in that the new fiscal framework will remain enshrined in law and strengthen the country's fiscal institutions. However, the governing coalition's next legislative objective - passing pension reform - could be a challenging political undertaking.

The New Framework Supports The Government's Fiscal Consolidation Strategy

On November 24, 2021, DBRS Morningstar placed Uruguay's BBB (low) rating on a Positive trend to reflect the progress on reducing the deficit and the institutional improvements to the budgetary framework. The headline central government deficit (excluding the "cincuentones" pension transfers) narrowed from 5.8% of GDP in 2020 to 4.2% in 2021. As emergency expenditures expire and the cyclical recovery advances, the deficit is projected to decline further to 3.1% in 2022.

Exhibit 1 Central Government Balance (%GDP)



Source: Ministry of Economy and Finance of Uruguay.

In our view, the credibility of this planned fiscal adjustment is enhanced by the new framework put in place through the LUC. In particular, the establishment of a spending cap and structural deficit rule should foster counter-cyclicality and a more sustainable fiscal stance over time while the creation of an advisory fiscal council should promote accountability. As we noted in our last review, we expected the Lacalle Pou administration to continue conducting fiscal policy within the bounds of the new framework even if the LUC articles were repealed, but the government's success in the referendum points to a strengthening of the country's fiscal institutions.

Passing Pension Reform Will Be Challenging

While the fiscal outlook in the near term is improving, putting public finances on a sustainable path over the medium term requires pension reform. Public pension expenditure is expected to rise over time given the country's ageing population. On the positive side, social security coverage is nearly universal, so Uruguay does not face the potential fiscal challenge of expanding coverage, as in many other Latin American countries. However, parametric adjustments, such as changes to the retirement age or the replacement rate, are necessary to put public spending on a sustainable path. In 2020, the Lacalle Pou administration convened a Commission of Experts on Social Security to propose adjustments that would ensure the financial sustainability of the system. The proposal was delivered in November 2021 and the administration has said it plans to introduce a reform in 2022.

There appears to be consensus across political parties on the need for pension reform, which could lay the groundwork for a widely-accepted deal. While the ruling coalition holds the presidency and both houses of congress, the government will likely want buy-in from the opposition in order to support passage of a potentially unpopular reform. However, finding agreement on the reform's details among key political and social stakeholders could be difficult. On the Commission of Experts, representatives of the main opposition party, the workers union, and the national pensioners' association voted against the proposal sent to the government. Even within the governing coalition, views on the pension reform may differ and complicate the process. In addition, we expect the social dialogue on pension reform to take time and the political environment may become less conducive to consensus-building as elections approach in late 2024.

Risks To Uruguay's Credit Rating Are Skewed To The Upside

Uruguay's fiscal outlook has improved due to sizable fiscal consolidation efforts and institutional improvements to the budgetary framework. This is reflected in the Positive trend on Uruguay's BBB (low) rating. In the near term, we think the fiscal results will continue to improve, and with the referendum outcome, the new fiscal framework will continue to guide policy and strengthen fiscal management.

However, in the medium term, fiscal pressures are likely to build on the back of rising pension spending. The government has signaled that pension reform is its next legislative priority, but the political challenge is considerable. The government has successfully implemented its policy agenda during the first two years of its administration. Continued success could further strengthen Uruguay's credit profile.

About DBRS Morningstar
DBRS Morningstar is a full-service global credit ratings business with approximately 700 employees around the world. We're a market leader in Canada, and in multiple asset classes across the U.S. and Europe.

We rate more than 3,000 issuers and nearly 60,000 securities worldwide, providing independent credit ratings for financial institutions, corporate and sovereign entities, and structured finance products and instruments. Market innovators choose to work with us because of our agility, transparency, and tech-forward approach.

DBRS Morningstar is empowering investor success as the go-to source for independent credit ratings. And we are bringing transparency, responsiveness, and leading-edge technology to the industry.

That's why DBRS Morningstar is the next generation of credit ratings.

Learn more at dbrsmorningstar.com.

MORNINGSTAR | DBRS