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Uruguay's Fiscal Rule Has Helped Credibility but May Not Stabilize Debt

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Fitch Ratings-New York/London-28 March 2024: Uruguay's fiscal rule is helping to improve fiscal credibility but has yet to anchor consolidation sufficient to fully stabilize debt/GDP, Fitch Ratings says. Improved credibility supported the upgrade of Uruguay to 'BBB'/Stable last June, but greater consolidation consistent with debt reduction would support further uplift.

The central government posted a deficit of 3.3% of GDP in 2023, above the original budget projection of 2.6% but in line with a revised 3.2% projection incorporating the effects of the recent severe drought. The government again met its fiscal rule introduced in 2020, including the associated spending cap, net borrowing limit and structural balance target. This was partly due to an escape clause in the borrowing limit invoked for the drought and a prior revision to the structural balance target.

Uruguay's fiscal rule is enhancing policy credibility by facilitating greater scrutiny and accountability around fiscal performance (including via an independent fiscal council), and discouraging a pro-cyclical policy bias. Last year's pension reform represents a proactive effort to address long-term challenges, consistent with the country's strong institutional scores. These were key factors in Fitch's June upgrade.

However, the rule has only facilitated moderate consolidation, with the deficit only decreasing to 3.3% of GDP in 2023 from 3.9% in 2019. The authorities estimate a larger improvement in the structural balance (1.8pp of GDP) but there is some uncertainty about this calculation. For example, it assumes that a negative output gap is restraining revenues below their potential, but this is not assured, and revenue outperformance in recent years (reflected in a 0.9pp-of-GDP increase since 2019) could mean that further cyclical upside as the economy recovers is limited.

Recent relaxation of fiscal goals, while modest, highlights how consolidation is becoming harder. The authorities raised their 2024 deficit projection and the structural deficit target for a second year to 3.0% and 2.9%, respectively, from 2.3% for both in 2022. Social benefits will add pressure, as their backward indexation will reverse the savings from prior years when inflation was high. Consolidation will therefore hinge on a cyclical revenue improvement, which is uncertain, and spending restraint, which may be harder in an election year. However, the fiscal balance will benefit modestly from the central bank's remuneration of government deposits, agreed this year.

General government debt rose by 4pp to 63.3% in 2023, above the 55% 'BBB' median, driven by a 2pp rise in loans and commercial bonds and 2pp in bonds issued to recapitalize the central bank. We expect deficits around 3% of GDP to keep debt/GDP on a slight upward path. This is consistent with our assumptions underlying the June upgrade, and not a significant risk given Uruguay's strong market access and increasing use of local-market funding. However, it limits rating upside, which would require accumulation of fiscal headroom through lower debt/GDP.

The fiscal plans of the next government after the October 2024 elections will therefore be important for Uruguay's rating trajectory. Spending rigidities and pressure to address social demands could make further consolidation challenging, and appetite for tax increases is unclear. The ratings could also benefit from evidence of stronger growth, after a muted performance relative to peers in the past decade, or improvement in monetary policy credibility after some recent progress.

The main labor union is also pushing for a referendum to overturn the pension reform and overhaul the broader pension system. This could have significant implications for public finances and pension funds at the heart of the local capital market. For now, the referendum seems unlikely to be successful and the opposition Frente Amplio coalition's decision not to endorse it signals a basic political consensus around the economic model and policy continuity.

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