

The Uruguayan economy has expanded for 16 consecutive years, a remarkable achievement for a small open economy in a highly volatile region. Favorable external conditions buoyed this performance, but the primary growth drivers were structural. This included a transformation of the agricultural sector that significantly increased and diversified production. The result was rising incomes and gains across most socioeconomic indicators. Sovereign creditworthiness also improved. In May 2013, DBRS upgraded Uruguay's sovereign rating to investment grade, or BBB (low).

However, this prolonged expansion is showing some signs of fatigue. As elections approach in October, Uruguay faces two fundamental economic challenges: weak growth and a rising fiscal deficit. In contrast to neighboring Argentina, which will hold its election on the same day, the election in Uruguay does not pose a risk to the basic pillars of macroeconomic policy. Instead, the key question is whether the next government will have the political support to reinvigorate growth while reinforcing fiscal sustainability. The answer could have implications for Uruguay's sovereign rating, both to the downside and the upside.

#### Growth is Stuck in Low Gear...

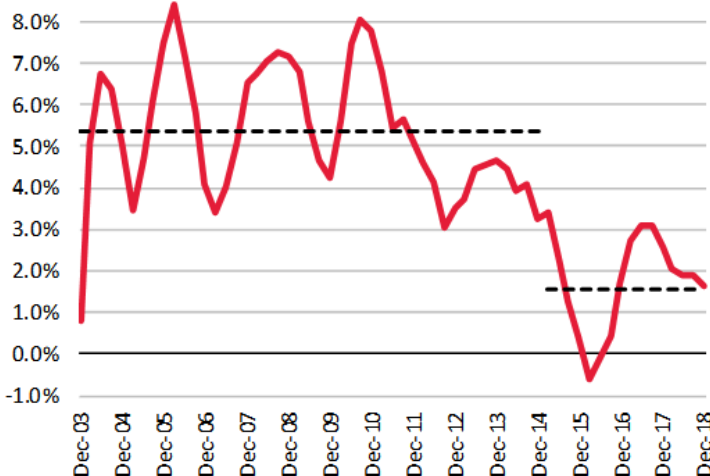
The Uruguayan economy has expanded at a modest pace for four years following a decade of rapid expansion. GDP growth averaged 5.4% from 2004 to 2014, but slowed to just 1.6% from 2015 to 2018. Subdued growth looks set to continue. According to a Banco Central del Uruguay (BCU) survey, the market expects GDP growth of 0.8% in 2019 and 1.7% in 2020. The slowdown is partly due to lower commodity prices and the deep recessions in neighboring Brazil and Argentina, but weak underlying domestic dynamics are also contributing.

The two most salient features of this economic slowdown are higher unemployment and lower investment. The demand for labor has declined as firms face rising real labor costs, a strong real effective exchange rate, and less favorable commodity prices. The national unemployment rate hit 8.4% (3mma) in April 2019, close to its highest level in more than a decade. The same challenging conditions have led to a 26% decline in investment since 2014.

#### Key Highlights:

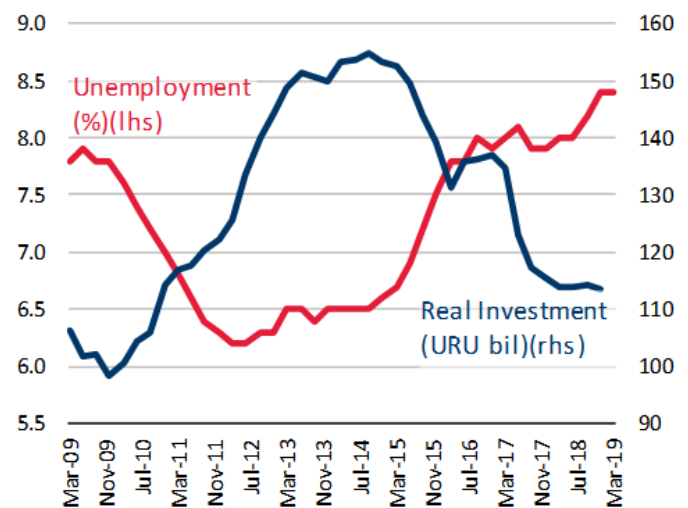
- As general elections approach in October, Uruguay faces two fundamental economic challenges: weak growth and a rising fiscal deficit.
- The election in Uruguay does not pose a risk to the basic pillars of macroeconomic policy. However, there is a question about whether the next government will be able to build a coalition in congress that is able to pass legislation and address the country's challenges.
- Risks to Uruguay's sovereign rating are two-sided and broadly balanced. The rating could be downgraded if policy inaction in the coming years leads to a deterioration in public debt dynamics. Alternatively, the rating could be upgraded if the next government implements a deficit-reduction plan that curbs the trajectory of public spending and passes reforms that revitalize growth.

**Exhibit 1. Real GDP Growth (rolling 4Q, %YoY)**



Source: Banco Central de Uruguay, Haver.

**Exhibit 2. Unemployment Rate & Investment**



Source: Banco Central del Uruguay, Haver.

Several large investments should cushion the growth outlook in the near term. The Finnish firm UPM is expected to make a decision soon regarding the construction of a new pulp mill in central Uruguay. If carried out, the investment in the mill and ancillary infrastructure is estimated to total \$3.4 billion, or 6% of GDP. Growth in 2019 and 2020 will also be supported by a

pipeline of public-private infrastructure projects. However, to increase employment, durably boost investment, and spur productivity growth in Uruguay, structural economic reforms are likely needed.

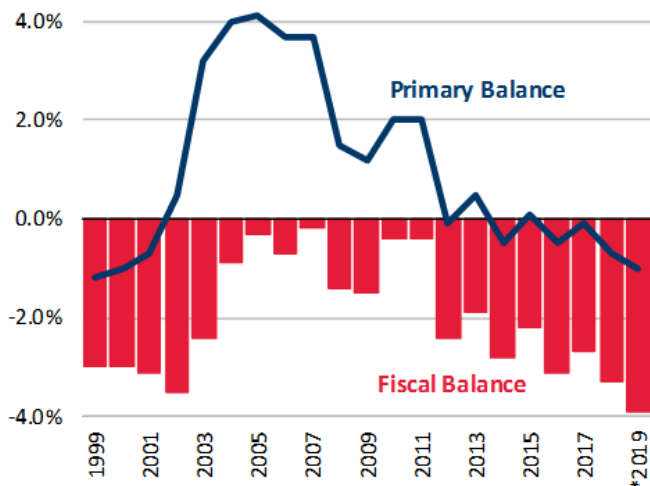
### ..and Fiscal Imbalances are Rising

The fiscal deficit continues to widen despite consolidation efforts by the Vazquez administration. In April 2019, the deficit reached 3.9% of GDP.<sup>1</sup> The underlying source of pressure is rising spending. Primary current expenditure has increased 5.0 percentage points of GDP since 2011, when spending recovered to pre-2002 levels.

Stabilizing public debt-to-GDP requires a fiscal adjustment of about 1-2 percentage points of GDP. Although the size of the adjustment is not particularly large, its implementation is complicated by the rigidity of key expenditure items: pensions are linked to nominal wage growth, healthcare spending is legally protected, and education expenses have significant political support. Squeezing investment might also be difficult, as capital expenditures are already low at 2.3% of GDP relative to the average of 3.0% from 2005 to 2014. Without any low hanging fruit, consolidating fiscal accounts may need to rely on a combination of tight expenditure control and revenue-raising measures.

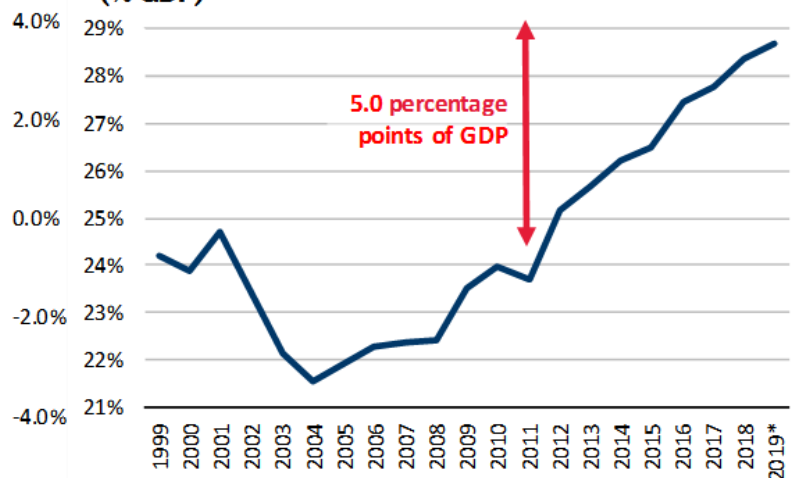
In addition to a fiscal adjustment, social security reform is needed to preserve the sustainability of public finances. Public pension expenditure is expected to rise over time given the country's ageing population. On the positive side, social security coverage is nearly universal, so Uruguay does not face the potential fiscal challenge of expanding coverage, as in many other Latin American countries. However, parametric reforms (i.e. changing parameters of the pension system such as the retirement age or replacement rate) are necessary to put public spending on a sustainable path.

**Exhibit 3. Fiscal Balance (% GDP)**



Source: Ministerio de Economía y Finanzas, Haver.

**Exhibit 4. Primary Current Expenditure (% GDP)**



Source: Ministerio de Economía y Finanzas, Haver.

### No Electoral Fireworks in Uruguay

While Uruguayans and Argentines head to the polls on the same day (October 27<sup>th</sup>), the risks associated with each election are quite different. In Uruguay, the broad direction of macroeconomic policy is not in play, as it is in Argentina. Uruguay's three major political parties recognize the need for sustainable public finances, price stability, and sound regulation of the financial system. Moreover, anti-establishment sentiment or populist politics have not emerged as driving forces in Uruguay, as they recently have in many other countries. Without an insurgent party or a rising political outsider, there is a greater degree of policy predictability in the post-election period.

The question is not so much who wins the election but whether there will be a viable coalition to address Uruguay's underlying economic problems. For the last 15 years, the *Frente Amplio* has held the presidency and both houses of congress. This has given the *Frente Amplio* substantial power to pass its legislative agenda without having to court outside support. However, early opinion

<sup>1</sup> This is based on the non-financial public sector, which excludes the central bank. In addition, the data excludes the effect of the "cincuentones" law, which amounted to revenue of 1.6% of GDP in the 12 months to April 2019.

polls suggest that no single party is likely to win outright majorities in October, so the next president would need to build a coalition in congress to pass some potentially unpopular measures.

### *Risks to the Sovereign Rating are Two-Sided*

Uruguay's BBB (low) rating balances the country's strong political fundamentals and external resiliency with its ongoing fiscal concerns. Uruguay's political environment is characterized by high-quality public institutions, low levels of corruption, and predictable macroeconomic policymaking, all of which constitute an important source of credit strength. The economy's resilience to external shocks is supported by ample foreign exchange reserves, conservative public debt management, and sound regulation of the banking system. The key rating constraint is the fiscal accounts.

As Uruguayans head to the polls, risks to the country's sovereign rating are two-sided and broadly balanced. While there is a consensus across the political parties on the need for fiscal consolidation, implementation is key. If the post-election environment is characterized by policy inaction, fiscal imbalances could continue to widen and growth could remain stuck in low gear. In such a scenario, deteriorating public debt dynamics could put pressure on Uruguay's "investment grade" rating.

On the other hand, the election in October could provide a new generation of political leaders with the opportunity to rebuild the policy agenda and revitalize Uruguay's ageing expansion. The rating could be upgraded if the next administration implements a deficit-reduction plan that is underpinned by reforms that curb the trajectory of public spending. Stronger economic growth would increase the likelihood of such a plan's success. In that sense, passing reforms that introduce greater competition and promote efficiency in the domestic market would be credit positive.

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