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Uruguay Referendum Could Energize Government's Economic Agenda

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Fitch Ratings-New York-04 April 2022: A referendum on a government legislative package in Uruguay could catalyse the economic agenda espoused by the administration of Luis Lacalle Pou since it took office, Fitch Ratings says. The result shows the government has maintained support among the electorate in its first two years, partly through its deft management of the pandemic, but it remains to be seen how far it can capitalise on this to advance economic reforms.

On 27 March, Uruguayans voted "no" to overturning 135 of 476 articles of the 2020 "urgent consideration law" (LUC) in a popular referendum initiated following a signature campaign last year by the opposition Frente Amplio party. The LUC is the Lacalle Pou administration's signature legislation, touching on areas including education, security, labor relations, and economic policymaking frameworks.

The vote to uphold the LUC has more symbolic importance than direct policy consequences, in our view. The LUC mainly set high-level policy objectives and made some institutional changes to help achieve them (such as a new fiscal rule and framework for setting fuel prices), which the government could have kept in any case. It did not by itself make major economic reforms.

But the vote was widely seen as a referendum on the government itself as it approaches the middle of its five-year term. The narrow margin of victory (49.9% to 48.8% of eligible votes) could limit the political capital it confers. But it was similar to Lacalle Pou's margin in the November 2019 presidential run-off vote (50.0% to 48.4%), indicating his preservation of support despite conservative fiscal policy, real wage losses, and fuel price rises.

The government expects to use its political capital to enact reforms in the second half of its term. These include addressing key competitiveness issues: high fuel costs, slipping education outcomes, labor market rigidities, and narrow trade openness. A post-referendum priority will be pension reform, which is crucial for long-term fiscal sustainability.

This agenda has made limited progress so far, partly due to ideological diversity within the ruling coalition. For example, some coalition parties opposed a provision in the LUC to end the fuel monopoly of state-owned ANCAP, resulting in its removal from the final bill. They also pushed a bill restricting the forestry industry that the president vetoed.

More substantial progress on structural reforms could be important for lifting weak potential growth (estimated at 2.1% by a newly formed fiscal council). Investment/GDP rose to 18.4% in 2021 from a low of 14.6% in 2019, driven by construction of the UPM pulp mill (Uruguay's largest-ever investment project), but is still low relative to regional and rating peers.

The victory could also bolster the government's ability to maintain prudent macroeconomic policy settings. This was a key driver of Fitch's revision of the Outlook on Uruguay's 'BBB-' sovereign rating to Stable in December 2021.

In its first two years in office the government has made meaningful progress on fiscal consolidation, reflecting well-targeted pandemic relief measures, resilient revenues, and below-inflation wage increases resulting in savings in public salaries and indexed pension benefits. The government pledges a real wage recovery that could erode some of these savings, but its strong political standing could help it navigate this trade-off prudently.

Fuel pricing has been a more difficult policy area, especially in the context of sharply higher international oil prices. Since September, the authorities have deviated from their rule established in the LUC by lifting fuel prices below import parity, and did so again after the referendum, widening the undercharge to 11% for gas and 24% for diesel. This effective subsidization avoids further increases in fuel prices, which the government wants to reduce, but places a substantial financial burden on ANCAP.

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