FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Uruguay's Outlook to Stable, Affirms IDRs at 'BBB-'

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Fitch Ratings - New York - 15 Dec 2021: Fitch Ratings has affirmed Uruguay's Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BBB-' and revised the Rating Outlook to Stable from Negative. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

The revision of Uruguay's Outlook to Stable reflects its fiscal resilience through the pandemic and ongoing improvement in the structural fiscal position. Fitch's fiscal expectations have improved amid tax revenue outperformance, lower borrowing costs, and improved confidence in the authorities' spending-oriented consolidation plans. Fitch projects these developments will substantially slow the upward path of debt/GDP, with a narrower gap to rating peers than seen pre-pandemic.

The 'BBB-' rating is supported by relatively high per-capita GDP, strong governance indicators and institutional strength evidenced by a successful vaccination campaign, as well as a robust external liquidity position. It is constrained by weak economic growth and a relatively slow post-pandemic recovery, high public debt and its large foreign-currency component, a record of high inflation, and policy flexibility that is weak in the context of prevalent dollarization, indexation, and shallow financial depth.

Fitch projects real GDP will grow 3.4% in 2021 after falling 5.9%, stronger than Fitch's prior projections. The relative importance of the lagging tourism sector and a small counter-cyclical policy effort compared to peers have meant a slower recovery than the 'BBB' and regional medians, but this is being supported by the large UPM pulp mill project, marked dynamism in exports, and improving confidence. The labor market has seen a strong recovery, supported in part by prudent wage policies.

Fitch projects real GDP growth will moderate to 2.7% in 2022 and gradually to a 2.0% trend pace thereafter as UPM construction ends and production ramps up - better than the pre-pandemic trend (0.8% average in 2015-2019) but still relatively low. Key competitiveness issues - high fuel prices, slipping educational outcomes, and a rigid salary framework - could persist in the absence of major reforms to address them. Even so, higher agriculture prices and Uruguay's institutional stability in a volatile region could support investment. Trade opening is a bright spot in the microeconomic agenda, as the authorities plan to pursue a trade agreement with China.

Uruguay's fiscal position is improving in cyclical and structural terms, following a relatively small deterioration in 2020-2021 that reflects prudent fiscal policy and resilient revenues during the pandemic. Fitch projects the central government deficit (net of "cincuentones" pension effects) will fall to 4.5% of GDP in 2021 from 5.8% in 2020.

This deficit is below its 2019 level net of emergency pandemic spending and extraordinary revenues including dividends from the state commercial bank and electricity company and capital gains on above-par bond re-taps (netted out of interest). This improvement has been driven by outperformance in tax collections relative to real GDP (due to booming highly-tax imports) and growth in non-pandemic-related spending below inflation. Fitch expects phase-out of most pandemic spending will lower the deficit to 3.9% in 2022.

Fitch's fiscal projections reflect improved confidence in the authorities' spending-focused consolidation strategy. The authorities are achieving savings by containing non-discretionary spending below high inflation, aided by real declines in wages (to which pensions are indexed). Fitch expects public wages to be cut again in real terms in 2022, after a 5% cut in January 2021, and private-sector real wages continue to fall amid ongoing collective bargaining talks. As a result, pensions and public salaries are on track to fall in real terms in 2022 for a third consecutive year. Efforts to cut discretionary operating and capex have contributed additional fiscal savings.

Interest costs are being contained by favorable external market access at low yields, supported by Uruguay's strong ESG credentials, as well as a major reduction in peso borrowing costs that Fitch expects could be partly structural in nature. Real yields on peso securities have fallen sharply amid monetary easing during the pandemic even at longer tenors (from 3.5% to 1% at five years), and they remain low amid incipient policy tightening.

Gradually falling effective interest rates have counterbalanced the larger government debt stock to keep interest payments broadly stable at their pre-pandemic level of 2.7% of GDP in gross terms (i.e. before netting out of capital gains). Uruguay's cash-basis fiscal data do not capture interest capitalizing on inflation-indexed bonds, worth an additional 2pp-of-GDP at current inflation levels.

Fiscal challenges could re-emerge eventually given the authorities' pledge for eventual restitution of real wage losses, but they have signalled this will be very gradual. Post-pandemic social spending demands could be a source of pressure, particularly closer to elections in 2024, but the authorities

have kept new outlays small thus far (e.g. 0.1% of GDP in childhood benefits). Fitch expects a pension reform to be submitted in 2022 that would offer fiscal relief over a long horizon given transition rules. The outlook for tax collections, after their outperformance in 2020-2021, is a source of some uncertainty given the authorities project a permanent 0.7pp-of-GDP increase without having raised rates.

Fitch projects general government debt will decline to 65.0% of GDP at end-2021 from 66.2% in 2020, capturing broadly stable central government (around 62%), consolidation of securities held within the 'cincuentones' pension trust, and bonds issued to recapitalize the central bank (BCU) being partially cancelled at end-2021. Debt is projected to rise slowly in the coming years, diverging from the 'BBB' median projected to fall back below 60% in 2022-2023, and this gap is much smaller than observed before the pandemic. These projections assume peso depreciation in line with relative inflation, but are highly sensitive to any divergence in these variables.

Inflation rose to 7.9% as of November, back above the target range (3%-7%), driven by global pressures. Expectations have drifted slightly further above target range (which falls to 3%-6% in 2022), signalling challenges ahead for the authorities' disinflation goals. Guidelines for wage talks include conservative nominal increases but also an ex-post inflation corrective in 2023 that could contribute to inertia, as could higher increases and more frequent correctives being adopted in many sectors. The BCU has lifted its policy rate by 125 basis points to 5.75% since July, which is still highly negative in ex-ante real terms, but the gradual tightening is helping contain inflation pressure by keeping the peso strong.

The Lacalle Pou administration retains strong political standing, supported by a successful vaccination campaign, but faces a test in March 2022 around a referendum of its "urgent consideration law" (LUC) passed in 2020. Should the LUC be upheld, this could further strengthen the government's political standing and ability to carry out reforms and sustain conservative policies in the rest of its term, while derogation of the LUC could make this more difficult.

ESG - Governance: Uruguay has an ESG Relevance Score (RS) of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Uruguay has a high WBGI ranking at the 82nd percentile reflecting a track record of peaceful political transitions, a high level of rights and participation in the political process, high institutional capacity, well established rule of law and a low level of corruption.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Public Finances: A substantial rise in government debt/GDP, for example due to failure to achieve further fiscal consolidation.

--Macro: Evidence of a weak economic recovery and/or post-recovery trend growth, particularly should this weaken public finances.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Public Finances: Fiscal consolidation that puts government debt/GDP on a downward path.

--Macro: Evidence of stronger post-pandemic economic growth prospects; for example, due to progress on economic reforms or new investments that compensate for completion of the pulp megaproject.

--Macro: A sustained reduction in inflation and anchoring of expectations around the target, and progress in de-dollarization and financial deepening efforts that improve policy flexibility.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Uruguay a score equivalent to a rating of 'BBB' on the LT FC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

- Macro: -1 notch, to reflect constraints to policy flexibility posed by high dollarization, indexation and shallow financial markets not fully captured in the SRM, and high inflation and public debt. A poor record of compliance with inflation targets reflects institutional shortcomings not captured in the strong governance indicators that feed into the SRM, though the government is trying to improve this. Growth was the lowest in the 'BBB' category before the coronavirus in 2015-2019, and prospects for reforms to improve this are unclear.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to

determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Uruguay has an ESG Relevance Score of '5[+]' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM this is highly relevant to the rating and a key rating driver with a high weight. As Uruguay has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Uruguay has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Uruguay has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Uruguay has an ESG Relevance Score of '4[+]' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As Uruguay has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Uruguay has an ESG Relevance Score of '4' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Uruguay, as for all sovereigns. As Uruguay has a fairly recent restructuring of public debt in 2003, this has a negative impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Uruguay	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Negative

	ST IDR	F3	Affirmed	F3
	LC LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Negative
	LC ST IDR	F3	Affirmed	F3
	Country Ceiling	BBB+	Affirmed	BBB+
senior unsecured	LT	BBB-	Affirmed	BBB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Sovereigns Latin America Uruguay