Case Study

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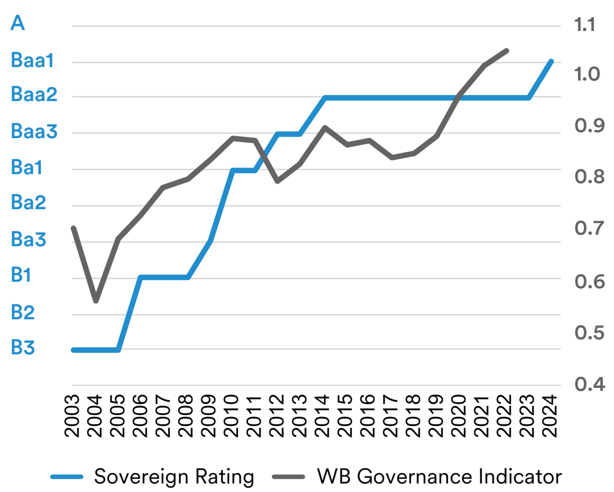
Uruguay: How Governance Drives Fundamentals, Sovereign Ratings, and Credit Risk Premium

MetLife Investment Management

We believe the influence of governance on Uruguay's credit profile and risk premium has been positive. The country has a long history of strong institutions and consensus-based policy-making tradition that leads to durable policy decisions and supports social cohesion. Uruguay has a high ranking at 83rd percentile in the World Bank Governance Indicators (WBGI)[1] reflecting its long track record of stable and peaceful political transitions, well established rights for participation in the political process, strong institutional capacity, effective rule of law and a low level of corruption. Uruguay`s score in the WBGI has risen since 2004, supporting better sovereign credit ratings and lower credit risk premium. As can be seen in Chart 1, there is a strong positive correlation between the WBGI and sovereign ratings as improvements in political stability and government effectiveness have led to rating upgrades over the years, while Chart 2 shows how credit risk premium[2] has compressed over time.

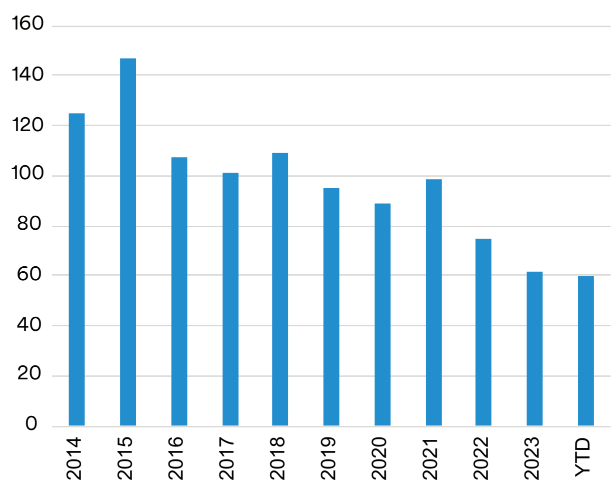
Uruguay`s governance indicators improved meaningfully since the current administration took over in 2020. The government implemented reforms to the fiscal framework, introduced changes to the monetary policy framework, and approved a pension reform. The reforms to the fiscal framework introduced a structural deficit target, a limit on real spending growth, a net debt ceiling, and a new autonomous fiscal council. The Central bank of Uruguay replaced monetary target aggregates with short-term interest rates as the policy instrument and reduced the upper band of the inflation target range. While Congress approved an important pension reform increasing the retirement age and consolidating different pension systems, which will contain budget pressures in the long-term. These reforms, can be seen as both a cause and an effect of good governance creating a positive feedback loop. As a result, WBGI is reflecting the improvement in governance (83rd percentile in 2023 vs 79th in 2018), sovereign ratings were upgraded (agencies upgraded Uruguay by 1-notch in 2023-24), and credit risk premium has fallen (60bps on average in 2023-24 vs 100bps in 2018).

Chart 1 | Rating (Moody's) vs WB Governance Indicator (Avg)



Source: World Bank Governance Indicators, Moody`s

Chart 2 | URUGUAY 5YR CDS (Annual Avg, Bps)



Source: Bloomberg

[1] The Worldwide Governance Indicators (WGI) project constructs aggregate indicators of six broad dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. Estimate of governance ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance.

[2] Credit default swaps (CDS) of 5 years

The case study described herein is meant to provide an example of on how governance drives fundamentals, sovereign ratings, and credit risk premium. The case study has not been selected to highlight past specific profitable recommendations made by the investment manager.

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