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Uruguay Strategy Flash

BCU lowers the policy rate by 50bp to +9.5%

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In October's COPOM meeting, board members decided to lower the policy rate by 50bp to +9.5%. The BCU's decision came in slightly over expectations, with market consensus expecting a 25-50bp cut. Still, the 50bp slash was justified by the very favorable CPI prints of the last months, which pushed yoy inflation to its lowest levels in seventeen years. With this, the BCU deepened its cutting cycle, which started in April. However, with the strong slowdown in inflation experienced since May, the general bias of the monetary policy continues to be hawkish. The move is consistent with the BCU's policy bias, which was expected to hold a contractive stance, as the drop in inflationary pressures and expectations was forecasted to edge the drop in the nominal policy rate. The BCU press release did give some forward guidance regarding further rate cuts. It indicates the COPOM will maintain its current stance, as expectations continue to align, and the credibility of inflation remaining inside the BCU's target range grows. In that sense, the press release suggests the cutting cycle is coming to a close, and that policy rates are close to target levels. According to the BCU, the decision not to lower the policy rate further comes on the back of the relative stickiness of inflation expectations, which are converging towards the target, reacting favorably to the slowdown in headline inflation. The press release highlighted the convergence of both headline and core inflation to the BCU's target, which stands at 6%-3% since Sept-22. The abrupt descent in the yoy index responded to both a normalization of Food prices after the drought, and a significant tailwind provided by the baseline effect.

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In its announcement, the COPOM continues to signal the path of the key rate will be conditioned by the evolution of the economic agent's inflation expectations. In turn, the Monetary Policy Committee assessed the local and international contexts and their effect on policy bias. On the external side, the COPOM is wary of the complex global scenario, with higher growth projected for 2024 in USA and Brazil, while China and Europe decelerate, and Argentina's outlook worsens. Regarding terms of trade, these should improve as expected in 2023, while also proving to be less unfavorable than envisaged in 2024. Finally, a higher-than-expected FED rate should be partially compensated by reduced country risk premiums throughout the Monetary Policy horizon. Looking at Uruguay, the second quarter of the year posted a seasonally adjusted -1.4%qoq GDP print, which translated into a -2.5%yoy variation. Economic activity is poised to pick up, with qoq GDP variations clocking in at +0.5%qoq and +1.5%qoq in the 3Q23 and 4Q23 respectively. This will come on the back of the waning impact of the drought, compounded by UPM II producing at full capacity. This scenario is consistent with a +0.1% yearly growth in 2023.

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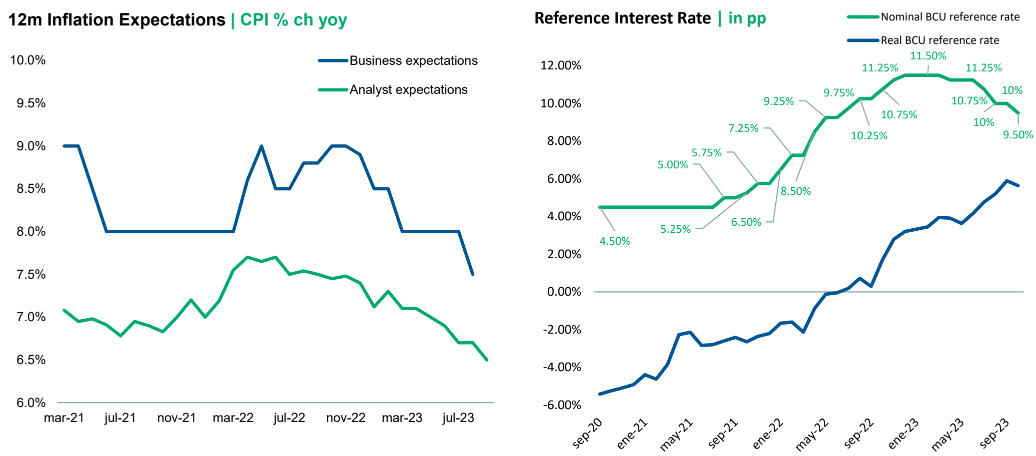
Expectations continue to evolve to the BCU's satisfaction, finally accelerating their convergence towards the CenBank's target. Real economy agents now expect a 12m-running inflation of +7.5% in August's poll (-0.4pp relative to July), while September's market forecasts dropped to +6.50%, showcasing a 20bp reduction relative to August's estimates. Still, in a context where the BCU's target range has tightened from 7%-3% to 6%-3% in Sept-22, both estimations end with inflation slightly outside the eop upper bound. Consistently, real economy agents see inflation closing the year at +7.5% (-0.4pp vs. July) while market analysts forecast a +5% inflation by end-2023 (-0.50pp vs. August). The official forecasts for 2023 see inflation closing the year at 6.7%. Market analyst estimates already project a lower inflation for the year, given the surprising deacceleration experienced in the last months by the CPI index. However, real economy agents still expect a stubbornly high inflation for the year. We believe the expectations of economic agents should continue to converge to the BCU's target range, albeit slowly.

Figure 1: The BCU cut the policy rate to +9.5%



Source: TPCG Research based on INE & BCU

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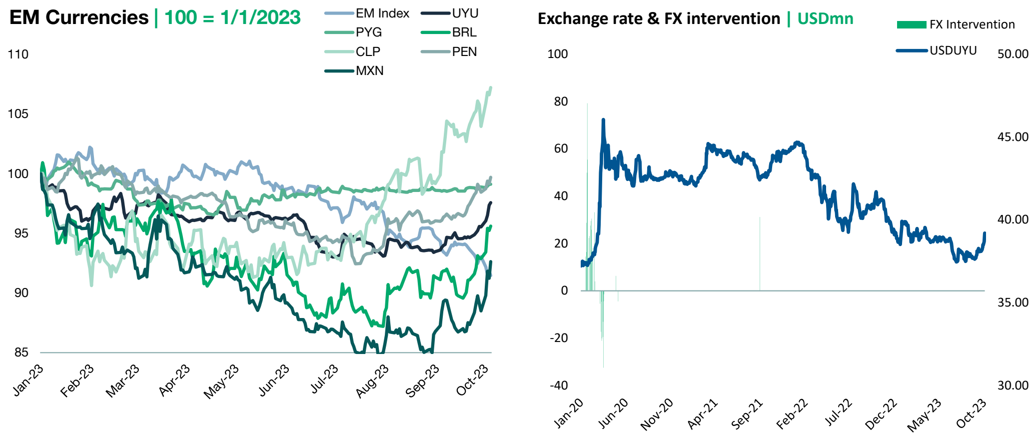
In addition, we believe the recent slippage of the FX takes some pressure off the BCU, allowing it to maintain a more hawkish policy stance in the near future. Since early September, the UYU began to lose ground quite rapidly against the USD, reversing nearly all its YTD gains. The UYU started the year strong, appreciating by +6% 1H23. Since, the FX had a relatively quiet 3Q23, before slipping by nearly 4.2% in the last month, virtually returning all the gains it made in the first half of the year. We find this slip is significantly correlated to the weak performance of the LATAM currencies in the same period, making this sudden depreciation region-driven, rather than propelled by the idiosyncratic factors of the Uruguayan economy. In fact, relative to its peers, the Uruguayan peso outperformed in the last month, as the BRL (+4.9%), CLP (+7.3%), and MXN (+6.2%) experienced wider depreciations in the same timeframe. Whatever the cause, the depreciation lifts a significant weight off the BCU's shoulders, as most fingers in both the traditional sectors of the economy and the government pointed at the CenBank as the main responsible behind the robust FX performance. With the BCU's pledge to not intervene in the FX market, the only policy tool the CenBank counted on to weaken the FX was to cut rates more aggressively. Now, with the FX at more "safe" levels for the traditional, less dynamic sectors of the economy, the BCU has more leeway to implement a more hawkish policy stance. The mounting political pressure was forcing the BCU into a more dovish stance than its officials preferred. Now, the weaker FX should result in a relatively more hawkish BCU. In our view, yesterday's press release points in that direction.

Figure 2: The UYU suffered significant stress in the last month, albeit outperforming most of its peers



Source: TPCG Research based on INE & BCU

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