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Uruguay Strategy Flash

BCU mantains the policy rate at +11.25%

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In May's COPOM meeting, board members decided to maintain the policy rate at +11.25%. The BCU's decision was consistent with our expectations and with the price action in the LRM curve. In this context, the CenBank did not double down with rate cuts in May, after starting a lowering cycle in April. Still, 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 were forecasted to edge the drop in the nominal policy rate. This strategy should see the real policy rate stay plateaued at a high level until inflation expectations converge with the target. The BCU press release did not give any forward guidance regarding further rate cuts. It only indicates the COPOM will continue assessing the local and international context with both inflation prints and expectations evolving to the Cenbank's satisfaction. According to the BCU, the decision to maintain the policy rate at +11.25% comes on the back of the relative stickiness of inflation expectations, which remain stable, proving somewhat inflexible on the downside. In addition, the CenBank pointed out that the decision looked to minimize the influence of expectations in salary agreements and prices, with the objective being the former interiorize the inflation target to make expectations converge to the 3%-6% range. Still, the headline index continues to run 161bp over the BCU's target range, which stands at 6%-3% since Sept-22. Yoy inflation benefited from a significant tailwind provided by the baseline effect. However, monthly prints during 1Q23 ran high (at an annualized rate of 15%), as a consequence of the drought affecting food prices, and said effect extended to April when inflation clocked in at +0.75%mom. The effect of the drought is proving more persistent than expected, and May's CPI index should also be affected by the high Food and Drink prices. However, following that we expect monthly inflation to temper, as the Core index stands very close to the BCU's target range at +6.22%yoy.

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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, especially as the global context is riddled with risks, with the two most concerning being a reduction in growth rates worldwide and the financial fragility associated with the US banking crisis. Furthermore, the sluggish slowdown in global inflation does trigger some alarms in the BCU. On the regional side, Brazil's economy is forecasted to deaccelerate, while neighboring Argentina continues to endure a very delicate economic context. Looking at Uruguay, the country is expected to have a mildly positive GDP print in 1Q23, albeit not during 2Q23, as the second quarter will be heavily affected by the reduced supply caused by the drought. Therefore, growth prospects for 2023 are not extremely promising. In a delicate context, the BCU decided to maintain the policy rate flat, especially as inflation clocked in at +7.61%yoy in April, increasing from March's +7.33%yoy print, marking the first rise after six decreases in a row for the index, following prints of +7.55%yoy in February, +8.05%yoy in January, and +8.29%yoy in December. With the effect of the drought still hampering prices, the CenBank proved its commitment to lowering inflation by maintaining the key rate.

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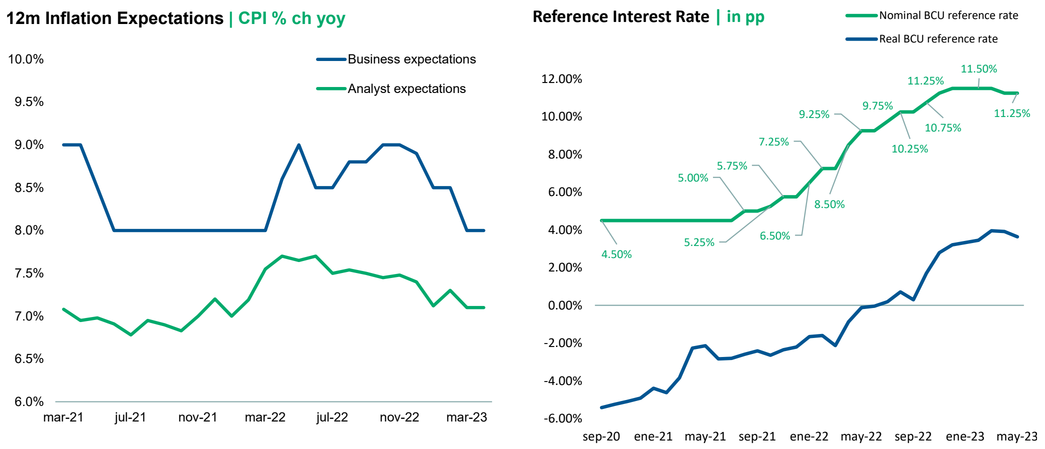
Expectations continue to evolve to the BCU's satisfaction, albeit still proving somewhat inflexible on the downside. Real economy agents now expect a 12m-running inflation of +8% in April's poll (unchanged relative to March), while April's market forecasts continue to stand at +7.10%, remaining level with March's estimates. Still, in a context where the BCU's target range has tightened from 7%-3% to 6%-3% in September, both estimations end with inflation very much outside the eop upper bound. Consistently, real economy agents see inflation closing the year at +8.0% (-0.2pp vs March) while market analysts forecast a +7.3% inflation by end-2023 (+0.1pp vs March). This contrasts with the government's forecast, as Mrs. Arbeleche announced the administration excepts the year to close at 6.7%. With the real rate firmly in positive territory, we expect the BCU to maintain its hawkish bias throughout 2H23, especially up until the effect of the drought dissipates.

Figure 1: The BCU kept the policy rate at +11.25%



Source: TPCG Research based on INE & BCU

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