Juan Manuel Pazos
Chief Economist
+54 11 4898 6606
jmpazos@tpcgco.com

Santiago Resico
LATAM Strategist
sresico@tpcgco.com
+54 11 4898 6615

Uruguay Strategy Flash

BCU lowers the policy rate by 25bp to +11.25%

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In April's COPOM meeting, board members decided to lower the policy rate by 25bp to +11.25%. The BCU's decision surprised slightly, with market consensus expecting the rate to remain flat. In this context, the CenBank started to shave rates sooner than expected, even as the general bias of the monetary policy continues to be hawkish. This COPOM meeting is the first since the pandemic to enact a reduction in the policy rate. Even with the key rate moving downwards sooner than expected, the move is consistent with the BCU's policy bias, which was expected to remain hawkish, 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 drop the policy rate by 25bp to +11.25% comes on the back of the positive trend portrayed by headline inflation, which continues to decelerate. Still, the headline index continues to run 133bp over the BCU's target range, which stands at 6%-3% since Sept-22. While inflation prints continue to converge, two juxtaposing effects are driving the CPI index. Even as monthly prints during 1Q23 ran high (at an annualized rate of 15%), as a consequence of the drought affecting food prices, the yoy gauge continues to drop on the back of a significant tailwind provided by the baseline effect. In this context, both drivers will start to dilute as the 2Q23 continues, with both indexes starting to stabilize.

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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, as even with improved growth prospects for China, the banking crisis effects will likely result in less economic activity in the Western Hemisphere. Furthermore, the sluggish slowdown in global inflation does trigger some alarms in the BCU. On the local side, the drought continues to stand at the center of the conversation, affecting both Uruguay and neighboring Argentina. This context is adverse due to the inflationary and economic implications the natural phenomenon had and still could have on the country. Growth prospects for 2023 are not extremely promising, and in this context, we believe the slowdown in economic activity during 4Q (reflected in the weak GDP print) could have influenced the BCU's call of lowering the policy rate. However, the BCU´s stance comes mostly on the back of the positive evolution of the inflationary process which is starting to converge to the CenBank's target range. March's print clocking in at 7.33%yoy marked the sixth decrease 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. In addition, the COPOM press release highlighted the performance of the Core index, which clocked in at 6.16%yoy, the lowest mark in over five years, and very close to the upper range of the CenBank's target.

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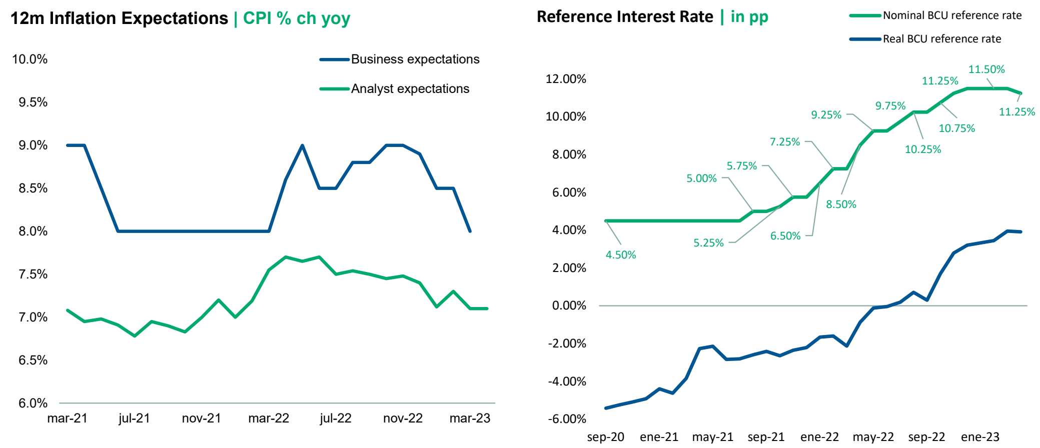
Expectations continue to evolve to the BCU's satisfaction, albeit still proving somewhat inflexible on the downside. Real economy agents now expect a 12m-running inflation of +8% in March's poll (-0.5pp relative to February), while April's market forecasts stand at +7.10%, remaining level with March's 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 +8.2% while market analysts forecast a +7.3% inflation by end-2023. 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, mostly on the back of the nominal policy rate being cut at a slower rate than at the one in which inflation expectations converge with the target.

Figure 1: The BCU lowered the policy rate to +11.25%



Source: TPCG Research based on INE & BCU

TPCG Analysts & Staff

Research			
Juan Manuel Pazos	**Chief Economist**	**jmpazos@tpcgco.com**	**+54 11 4898-6606**
Paula La Greca	Corporate Research Analyst	plagreca@tpcgco.com	+54 11 4898-6638
Federico Martin	Strategist	famartin@tpcgco.com	+54 11 4898-6633
Santiago Resico	LATAM Strategist	sresico@tpcgco.com	+54 11 4898-6615

Sales & Trading			
Juan Manuel Truppia	**Head of Sales & Trading**	**jmtruppia@tpcgco.com**	**+54 11 4898-6659**
Juan Martin Longhi	S&T Director	jlonghi@tpcgco.com	+54 11 4898-6656
Lucia Rodriguez Pardina	S&T Director	lrodriguezpardina@tpcgco.com	+54 11 4898-6614
Agustina Guadalupe	Sales	aguadalupe@tpcgco.com	+54 11 4898-6682
Maria Pilar Hurtado	Sales	mhurtado@tpcgco.com	+54 11 4898-6616
Juan Ignacio Vergara	Sales	jivergara@tpcgco.com	+54 11 4898-1936
Santiago Baibiene	Sales	sbaibiene@tpcgco.com	+54 11 4898-6648
Pedro Nollmann	Sales	pnollmann@tpcgco.com	+54 11 4898-6617
María Ruiz de Castroviejo Salas	Sales	mruizdecastroviejo@tpcgco.com	+54 11 4898-6643
Victoria Faynbloch	Desk Analyst	vfaynbloch@tpcgco.com	+54 11 4898-6635
Felipe Freire	Trader	ffreire@tpcgco.com	+54 11 4898-1921
Homero Fernandez Bianco	Trader	hfbianco@tpcgco.com	+54 11 4898-6667
Andres Robertson	Trader	arobertson@tpcgco.com	+54 11 4898-6693

Corporate Banking			
José Ramos	**Head of Corporate Banking**	**jramos@tpcgco.com**	**+54 11 4898-6645**
Camila Martinez	Corporate Sales	cmartinez@tpcgco.com	+54 11 4898-6621
Fernando Depierre	Corporate Sales	fdepierre@tpcgco.com	+54 11 4898-6636
Sol Silvestrini	Corporate Sales	ssilvestrini@tpcgco.com	+54 11 4898-6641
Nicolas Iglesias	Corporate Sales	niglesias@tpcgco.com	+54 11 4898-6612

Capital Markets			
Fernando Lanus	**Head of Capital Markets**	**flanus@tpcgco.com**	**+54 11 4898-6632**
Nicolás Alperín	Investment Banking Analyst	nalperin@tpcgco.com	+54 11 4898-6604

Asset Management			
Ileana Aiello	**Portfolio Manager**	**iaiello@tpcgco.com**	**+54 11 4898-6611**
Claudio Achaerandio	**Portfolio Manager**	**cachaerandio@tpcgco.com**	**+54 11 4898-6618**

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