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Uruguay Strategy Flash

Uruguay's Monthly Inflation Prints -0.01%mom

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May CPI prints -0.01%mom, coming in 49bp under the +0.50%mom expectations portrayed in the BCU's survey. Monthly inflation printed -0.01%mom,— coming in well under April's+0.75%mom, March's +0.9%mom, and February's +1%mom. The collapse of the monthly index comes mostly on the back of the end of the drought, which pressured food prices to the downside, and allowed them to normalize. In this context, the inflationary process presented an abrupt stop in May, which is consistent with the normalization of agricultural prices. After posting an average +1.9% monthly print since the start of the year, the Food & Non-Alcoholic Beverages segment presented a negative monthly variation, coming in at -0.54%mom. The subsection had printed +1.93%mom in April, +2.24%mom in March, +1.84%mom in February, and +1.85%mom in January, accumulating a +8.1% rise in the first four months of the year. The segment nearly singlehandedly spearheaded the decreases, with Financial Services (+0.99%mom) Housing (+0.28%mom), and Restaurants&Hotels (+0.43%mom) partially offsetting the drop in food prices. The rest of the segments had little influence on the monthly print. On the yearly gauge, consumer prices rose by +7.1%yoy, decreasing relative to April's +7.61%yoy print, and clocking in at the lowest mark in 2023. The yearly index in May was aided by the tailwind provided by the baseline effect, as May-22's print came in at nearly 0.5%mom, nudging the headline trend down. In this context, the yoy variation now surpassed the +6%yoy upper bound of the BCU's target range for two full years. With May's inflation clocking in at -0.01%mom, YTD inflation currently stands at +4.26%, roughly unchanged since April.

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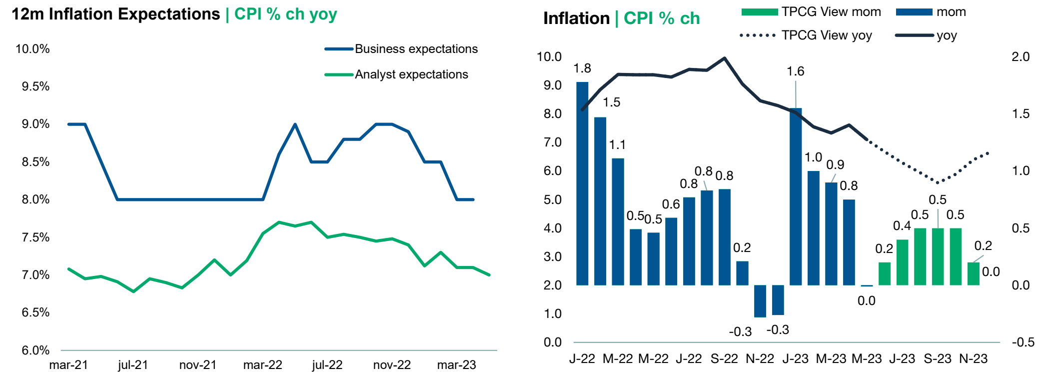
May's CPI print came mostly on the back of the Food & Non-Alcoholic Beverages segment, as the end of the drought marked a normalization of food prices, explaining most of the monthly print. The Food & Non-Alcoholic Beverages finally reverted the 1Q23 trend, posting a -0.54%mom drop. In May, subsection performance was also marked by volatility, with several sub-indexes experiencing large decreases, marking some significant reversions relative to April. The always volatile Fruits segment experienced a -7.67%mom drop, as did Vegetables, which fell by -4.78%mom, as the effect of the drought finally subsided. On the other hand, Meat prices jumped by +1.04%mom, partly offsetting the effect of Fruits and Vegetables, and accelerated relative to April. We believe this could respond to the end of the dry climatic conditions, which affected meat supply, which is now beginning to normalize. Dairy products also saw their prices increase, by +0.91%mom. In this context, Food & Non-Alcoholic Beverages' contribution singlehandedly contributed 15bp to the monthly print. The only other three subsections that affected prices significantly were Financial Services (+0.99%mom) Housing (+0.28%mom) and Restaurants&Hotels (+0.43%mom). The first increased mainly due to a rise in Medical Insurance prices (+3.68%mom), offsetting the monthly fall of the general index by 6bp. The second was affected by increases in Rent (+0.48%mom), Gas provision services (+10.93%mom), and added 4bp to the print. Finally, Restaurants and Hotels rose driven by Restaurant Services (+0.53%mom), contributing an extra 4bp to the monthly gauge. Finally, the rest of the sectors experienced increases mostly in the 0%mom — +0.5%mom range, contributing the remainder of the May print.

Figure 1: May's inflation came way under expectations



Source: TPCG Research based on INE & CINVE

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As we expected, the effects of the drought proved transitory, and looking forward we expect inflation to slowly converge to the BCU's target, given the administration's income policy stays consistent with the CenBank's efforts. As we expected, the transitory effect of the drought kept inflation prints artificially high during 1Q23, and now that it has subsided, prints should start to converge to the core index, which excluding January, came in the 0.3-0.5pp range in the first months of the year. In this context, we believe the BCU has some additional wiggle room to shift its policy bias, and we expect the CenBank to possibly cut the policy rate by another 50bp until the end of the year. In turn, we believe the inflationary process should start to behave to the BCU's satisfaction, given the administration does not go overboard with its promise to increase real wages. If the government becomes adamant to keep its promise, then salary negotiations should prove inflexible on the downside, and that should add additional persistence to the inflationary process. Said woes should aggravate if the government also starts to intervene in the FX market, depriving the BCU of a key instrument in its battle against inflation. Finally, the solid May print should also provide the administration with its long-awaited window to issue a new local currency (UYU) global bond, which we expect to come to market in the near future.

Some thoughts on the recent FX announcements

Let me tell you a story about a Latin American country. This country is just past the middle point of a center-right administration that took over after three left-wing governments that gradually weakened the economy's fundamentals. The new administration announced a new monetary policy framework, re-introducing inflation targeting. The market approved the new framework, rapidly going OW in local currency instruments. Halfway through its first term, the new monetary framework is finally gaining traction. Inflation remains stubbornly above the target, but it's been gradually decreasing, and inflation expectations seem to be quickly converging toward the target. Still, the gains have come at a steep cost as the REER appreciation increased unit labor costs, softening the labor market and eroding support from a critical constituency in the Government's coalition: commodity exporters.

In this context, the Central Bank is plowing through the good fight increasingly alone, with little support for its disinflationary effort from the rest of the economic policy mix. The fiscal policy anchor has eroded. The Government has vowed to boost wages to compensate for any loss against inflation, regardless of the unsustainable increase in dollar costs. Still, more is needed to shore up voter support. The ruling coalition is doing very well with voters, considering it's midway through its term and went through a complicated few years after being inaugurated. Still, the figures fail to ensure policy continuity in the next presidential election. The Government now faces a difficult choice. Support the CenBank, and expect the disinflationary process to contribute to voter support. Or force the Central Bank out of its framework, pushing it to abandon the disinflation target in favor of correcting the REER to breathe some air into legacy exporters overwhelmed by unsustainable unit labor costs.

This sounds like the story of Argentina 2016-17. It very well could be, but it's not. It's Uruguay 2020-23. Like the Macri Administration before, the Lacalle Pou Administration also opted for the easy road. Under heavy pressure from exporters, the Government announced that it would try to "depreciate the currency without generating inflation." Of course, the new objective comes at odds with the previous Government commitment, vowing to increase real wages to pre-COVID levels, even if that implied a substantial increase in dollar wages. It's also inconsistent with bringing inflation down from the current 7.1% to the BCU's 3-6% target range. In other words, despite being separated by about 200 miles and six years, Mr. Labat is now locked in Mr. Sturzenegger's conundrum; accommodating an infant disinflationary process that barely stands on its own feet to the contradictory objectives required by a Government more concerned about votes than policy consistency.

Let's think about this in theoretical terms. If we define the REER as the ratio between tradable prices and non-tradable prices, the only way to "depreciate the currency without adding to inflation" would be to have non-tradable goods growing well behind tradable goods and the headline CPI. In other words, since labor is the most important non-tradable, it would mean cutting wages in dollar and real terms. Of course, that would mean burying the vow to improve real wages to pre-COVID levels, which would be as costly in political terms -or more- than just suffering through the current REER. In this context, how does the Government plan to compensate for the pass-through of a weaker currency?

The most likely outcome is that the Government zig-zags the policy response. It starts with the BCU abandoning its zero FX market intervention policy to weaken the currency, albeit promising that inflation would remain a core focus of the policy mix. The problem is that after an initial REER correction and the tradable goods pass-through, the pressure would mount for the Government to hike wages. The combined effect of the pass-through of a weaker currency and higher salaries would wipe out any gains in inflation expectations, leaving the credibility of the monetary policy framework in tatters. The administration could choose a more intermediate response, having the finance ministry intervene the FX market via the BROU, utilizing excess UYU from local-market issuances to nudge the USDUYU upwards. However, with a global issuance coming in soon, the government will find itself with excess USD, rather than UYU, forcing it to become a net USD supplier on the FX market, rather than an USD absorber. So, this policy could only have a very short-term effect, marginally decreasing the MEF’s role as a net supplier of USD, albeit not meddling with the BCU’s bias.

Does the story end like Argentina 2018-19? We hope not. Inflation is lower, expectations seem more anchored, and the REER overvaluation is less severe. Also, the alternative to the Government reelecting is not the return of Kirchnerism. During its decade and a half in office, the Frente Amplio deteriorated the fiscal position considerably but refrained from exploring a populist policy mix. Uruguay's politics and policymaking are more civilized than Argentina's. In this context, the result of a contradictory set of policy objectives is not chaos, but a disappointing muddle, where the Government fails to make any significant progress towards its inflation targets nor correct the REER.

Of course, even if the story doesn't evolve into a horror story like Argentina's, it makes us less constructive about the prospects of the UYU space. Our OW in UYU expected the BCU policy stance to clash with the Government's political needs. Ultimately, we expected some accommodation and the BCU to flex its bias on political considerations, but it seems too early in the game. Elections are still almost a year and a half away, and inflation barely signals some green shoots. We expected a 25bp more aggressive rate-cutting path than the market consensus, assuming 50bp in cuts until end-December. The cuts should have been enough to gradually push the currency closer to USDUYU40. If the BCU goes back to bidding dollars in the FX market, the resulting easing could turn too aggressive, making us more cautious about the UYU space until the FX finds a new level to settle.

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