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Uruguay Strategy Flash

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Yesterday, the President of the BCU, Mr. Labat participated in an interview, where he stated that for the next political cycle, the BCU's objective should be to nudge inflation down to the 3% mark. The BCU's president highlighted the current slowdown in the inflationary process and commented that the effect of the drought delayed the convergence of the headline CPI towards the BCU's target range. In terms of estimates, Mr. Labat stated that inflation should hover around the 5% mark, up until the end of the Monetary Policy Horizon (24 months) and that the BCU's objective is to keep inflation near said levels. In addition, he referred to inflation expectations, mentioning the stickiness of the real economy agent expectations, which remained unchanged in July, stubbornly standing at the 8% mark for the next 12 months. Still, Mr. Labat expects businessmen to start nudging their estimates downwards as inflation consistently remains inside the BCU's target. When consulted on salary negotiations, the BCU's president stated that CenBank officials are aware of the administration's policy of allowing real wages to recover to pre-pandemic levels and that this is both monitored and incorporated into the BCU's policy mix. On that topic, most of the salary negotiations are ongoing, with few sectors having reached an agreement. We believe this might be keeping the real economy expectations at the 8% level, as business owners are closely monitoring the negotiations, which have the potential to keep non-tradeable prices at high levels, forcing an extra persistence in the inflationary process in the medium run. With the government's guidelines being an increase in real wages, it is not surprising that real economy agents see an inflexible inflationary process going forward.

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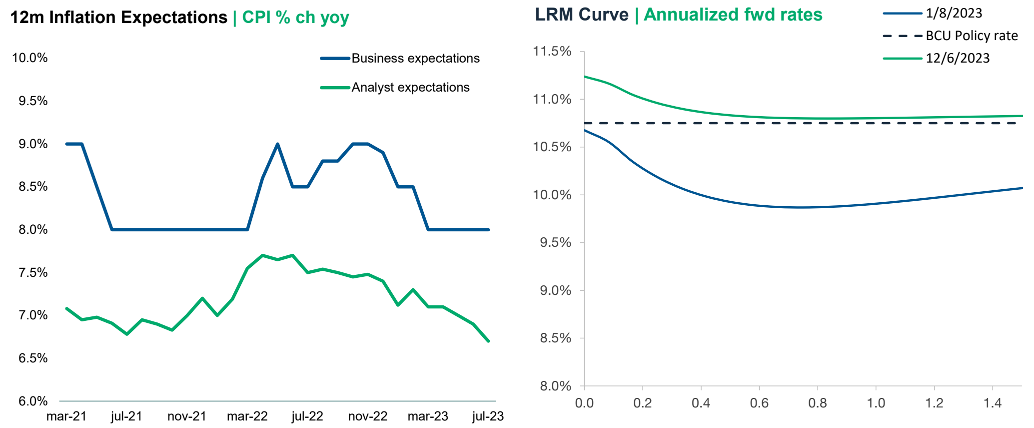
Mr. Labat also hinted that the CenBank is considering a cut for the upcoming COPOM meeting (scheduled for the 15th of August) but did not clarify its magnitude. Looking at the policy rates implicit in the LRM curve, the market is pricing a 25bp cut in August, followed by another two 25bp cuts up until the end of the year, with the policy rate closing 2023 near the 10% mark. In our view, the BCU should cut the policy rate by around 50 bp in August, given the deep slowdown in running inflation. The president of the BCU reaffirmed the fact that the Board has significant room to maneuver and stated that the Committee is closely monitoring inflation expectations, in addition to the regional and international dynamics of real rates.

Regarding the FX, the president of the BCU stated that according to their estimates, it is currently somewhat rich in fundamental terms.

Regarding the FX, the president of the BCU stated that according to their estimates, it is currently somewhat rich in fundamental terms. The USDUYU carries a substantial overperformance since 2022, and according to Mr. Labat, it is somewhat misaligned relative to the fundamental exchange rate estimated by the BCU. However, he stated that the appreciation of the FX reflects the solid dynamics enjoyed by the Uruguayan economy in the last years, especially as the terms of exchange have favored exports, while 2022 was a record year for net FDI inflows. Furthermore, he declared that the BCU is happy with the way the FX market is run, ruling out any possibility of direct intervention by the CenBank. For 2024, the BCU expects a slight upwards correction in the REER, with a nominal depreciation slightly higher than inflation, with the current FX misalignment standing in between the 12% and 15% mark.

Figure 1: The LRM curve is pricing a 25bp cut in August



Source: TPCG Research based on INE & BCU

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We identify two issues regarding the convergence of inflation to the 3% mark. In the short run, its inconsistency with the administration's current and expected policy mix, and in the medium run its reliance on policy continuity. The predisposition of the current CenBank Board to reduce inflation and its non-intervention policy in the FX market has granted the institution significant credibility since the start of the administration's tenure. However, putting running inflation at a 3% level is not consistent with the administration's expectations and policy mix going forward. For starters, inflation is bound to pick up some pace once the disinflationary effect of the end of the drought wanes off. In addition, due to the very weak prints in 4Q22, the baseline effect should nudge the inflationary process upwards in the last quarter of the year. This should compound with two additional factors, which are, the administration's willingness to push real salaries upwards, and the BCU's cutting cycle. All in all, the government's policy mix (the BCU's cutting cycle, a deviated fiscal position, and a supportive income policy), are not consistent with compressing inflation down to the 3% mark.

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In addition, we find the changes implemented by this board may not survive a regime change, as the Board of the BCU is generally reshuffled if the administration is defeated in the elections. In this context, the statement made by Mr. Labat largely relies on the current administration maintaining power, which does not seem as likely, with the FA standing as the top dog ahead of the 2024 elections, and, based on recent history, may not see eye to eye regarding reducing inflation to the 3% level, below the center of the BCU's target range (4.5%). If the administration succeeds in securing a new tenure, then the BCU's board could focus on completing the said objective. However, even with political support, cutting inflation to said levels should be no easy task. In this context, we highlight the importance of salary negotiations in the inflationary process. The administration's insistence on giving real increases across the board could make non-tradeable prices stickier, which could drive a reacceleration of inflation entering 2024. In this context, we will continue to monitor salary arrangements, to evaluate their impact on inflation ahead of 2024.

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