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Uruguay Strategy Flash

The Govt. presented the guidelines for the 10th round of salary negotiations.

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The administration enters the 10th round of salary adjustments having promised to shore up real wages, allowing them to recover from the COVID hit and back to pre-pandemic levels. After impromptu salary agreements in and coming out of the pandemic, where the administration prioritized maintaining employment levels rather than addressing the loss in real wages, the government must now address its promise. The government presented its adjustment proposal. The latter includes an increase for forecasted inflation, annual correction clauses, and the main novelty, a wage recovery component, which will increase the salary of the workers who are below the pre-pandemic levels. For those who still have to recover more than 2% of their pre-pandemic wage, this increase will be given in three parts, one per semester, starting in July. For those whose salary stands less than 2% of the benchmark, the increase will be split into four semesters. The baseline wages were established at Jul-20 figures. In this context, the negotiations will impact nearly 660.000 workers, coming from 164 different sectors. Of these, nearly 40% must still recover an additional +2.6% in their real wages to reach pre-pandemic levels. However, another 41.7% have already recovered most of the lost ground since the COVID crisis. While the administration's promise is looking at real wages in UYU, observing the labor costs in USD, wages have risen abruptly since the end of the pandemic. In fact, the general salary index stands nearly 30.5% over Dec-19 levels. And this is true looking at all sectors, including the less competitive, Non-tradeable section of the Uruguayan economy. Sectors such as Construction (+24.3%), Commerce (+24.3%) Hotels, and Restaurants (+22.7%) have underperformed both the general and private sector (+26.9%) indexes. Still, said increases in labor costs measured in USD are currently straining the sector's competitiveness to the limit.

Figure 1: A significant portion of real wages are still off from pre-pandemic levels

Situation	Sectors	Estimated Number of Workers	Workers as % of Total	Including corrective measures
Must recover more than 2.6%	17	35,000	5.3%	7
Must recover 2.6%	69	220,000	33.3%	36
Must recover less than 2.6%	24	130,000	19.7%	3
Complete Recovery	54	275,000	41.7%	6
Total	164	660,000	100.0%	52

Source: TPCG Research based on Instituto Cuesta Duarte

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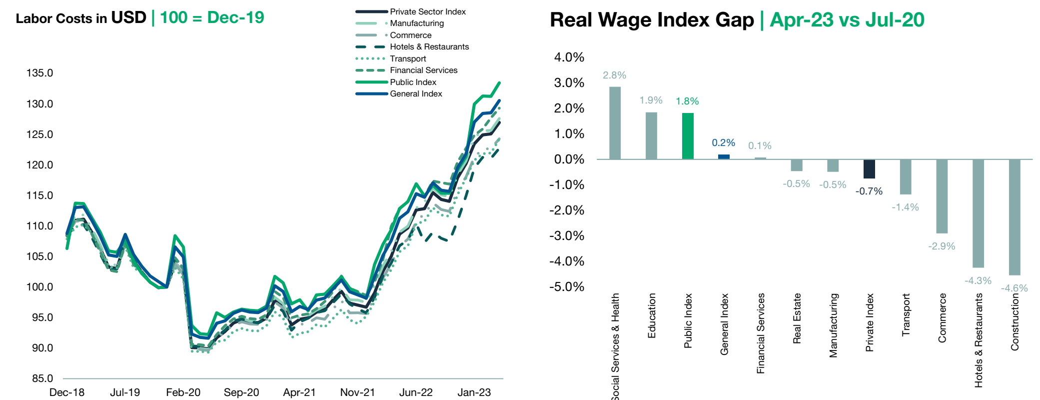
Traditional sectors have the most ground left to recover in real terms, with the Private sector index currently standing -1.9% below the Jul-20 figure. The Construction (-4.6%), Commerce (-2.9%), Transportation (-1.4%), and Hotels & Restaurants (-4.3%) indices stand well below their Dec-19 levels. So, the less competitive sectors of the economy are also the ones with the most ground left to recover. In this context, we believe the administration's move to bolster real wages should force inflation to be more persistent in the medium run. In addition, we find that the measure could have unwanted effects on activity levels and unemployment. With an appreciating FX and increased real wages, labor costs in USD should continue to rise. Considering the less competitive dynamics of Uruguay's traditional industries, and its large labor force, this rise, if not compounded by increased productivity, could result in increased unemployment, which could hurt consumption dynamics. Heading into an electoral year, we find the administration is still trapped inside this conundrum, where if it does not comply with its promise, it may suffer a loss of face, but proving its words true could result in more unemployment and worse electoral numbers either way.

Figure 2: Labor costs in USD are poised to hurt employment in less dynamic sectors



Source: TPCG Research based on INE

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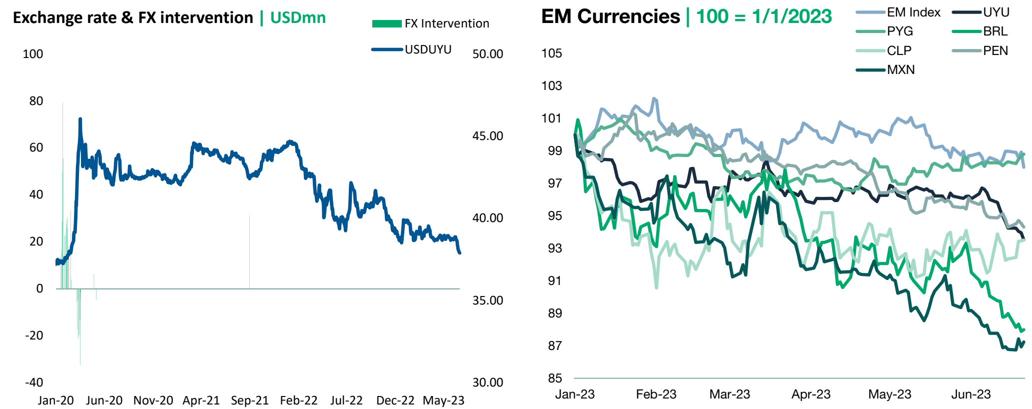
Taking a look at FX levels, we find the USDUYU weathered the 1H23 storm well, and for 2H23, idiosyncratic factors for depreciation should start to dilute. The UYU managed to continue appreciating vs. the USD during the first half of the year, which was impressive, especially given agriflows, and exports in general, were heavily hit by the harsh climatic conditions. However, most of these flows are currently accounted for by the end of 1H, which means that the UYU got through the most challenging part of the year without depreciating. It is also worth mentioning that a strong tailwind from EM currencies aided the Uruguayan peso during the first half of the year. Looking at drivers for the 2H, firstly, we believe exports should recover during the second half of the year as UPM II reaches peak production levels. In addition, with the administration poised to issue a local currency (either UYU or UI) global bond for general financing purposes, the Treasury should become a net supplier of USD in the Uruguayan market, as most subscriptions to the bond should come in USD. On the other hand, we do expect the BCU to shift to a more dovish stance. We expect the CenBank to cut the policy rate by around 25-50bp in the next COPOM meeting, to take place in July. However, we believe that the BCU's bias will not shift abruptly and that the rather small transmission mechanism will not be able to outweigh, on the one hand, the USD influx during 2H, and on the other, the upside pressures to the CPI index generated by relatively high wage agreements.

Figure 3: Idiosyncratic depreciation drivers should wane in 2H



Source: TPCG Research based on TPCG Trading Desk

All in all, while the revealed wage adjustment mechanism should be credit positive for linkers, we continue to believe that the macro context will remain more supportive of nominals for the rest of the year.

All in all, while the revealed wage adjustment mechanism should be credit positive for linkers, we continue to believe that the macro context will remain more supportive of nominals for the rest of the year. We believe the current round of salary negotiations will affect the persistence of the inflationary process to the upside. However, we also find that the inflation prints post-drought should be influenced to the downside by Food prices normalizing. Still, core inflation is poised to continue printing around 0.3-0.4% on average during 2H23. This, combined with a strong baseline effect pushing the yoy rate to the downside, should generate adverse conditions for the linkers, especially considering December's deflation. In addition, we believe most of the idiosyncratic drivers for depreciating the UYU are poised to dilute. The main risk on the FX side is a general depreciation in the EM space dragging the UYU. In this context, we believe the macro drivers should support a UYU position in the LCD space rather than linkers.

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