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Uruguay Strategy Flash

BCU lowers the policy rate by 50bp to +10.75%

In June's COPOM meeting, board members decided to lower the policy rate by 50bp to +10.75%.

In June's COPOM meeting, board members decided to lower the policy rate by 50bp to +10.75%. The BCU's decision came in slightly under expectations, as after June's very favorable CPI print, the CenBank was expected to lower rates more aggressively to avoid more hawkish real rates. Still, the BCU deepened its cutting cycle, which started in April, slashing the policy rate by 50bp. With the strong slowdown in inflation experienced since May, 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 was forecasted to edge the drop in the nominal policy rate. 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 not to lower the policy rate further comes on the back of the relative stickiness of inflation expectations, which remain stable, but should react to the slowdown in headline inflation favorably. In addition, the CenBank pointed out that the deacceleration in prices should also help temper salary agreements, which carry a risk of derailing the BCU's anti-inflationary program. The press release highlighted the convergence of both headline and core inflation to the BCU's target which stands at 6%-3% since Sept-22. The abrupt descent in the yoy index responded to both a normalization of Food prices after the drought, and a significant tailwind provided by the baseline effect.

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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 most concerning being a reduction in growth rates worldwide. Furthermore, the sluggish slowdown in global inflation does trigger some alarms in the BCU. On the regional side, Brazil's economy surpassed expectations during 1Q23, albeit neighboring Argentina continues to endure a very delicate economic context. Looking at Uruguay, the second quarter of the year is expected to be heavily affected by the reduced supply caused by the drought. Therefore, growth prospects for 2023 are not extremely promising. In this context, the BCU decided to keep a slightly more hawkish policy bias by lowering the policy rate by 50bp.

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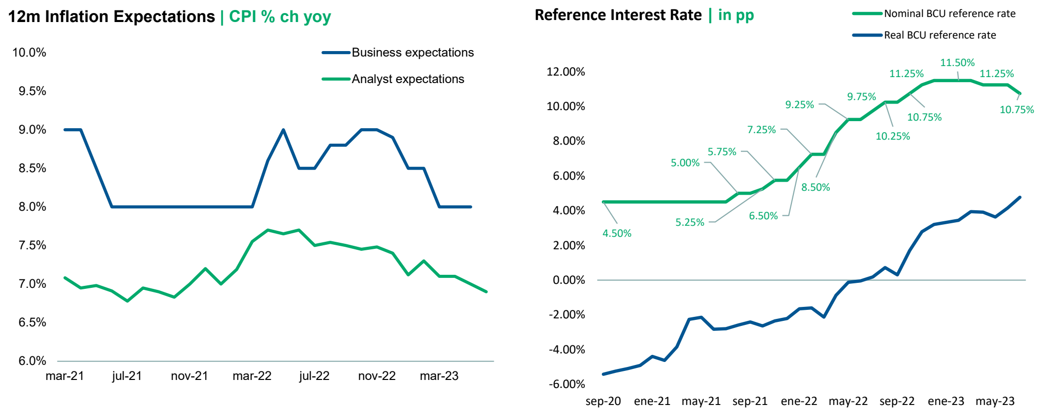
Expectations continue to evolve to the BCU's satisfaction and should now start to converge to the BCU's target faster, given the slowdown in inflation. Real economy agents now expect a 12m-running inflation of +8% in May's poll (unchanged relative to April), while June's market forecasts dropped to +6.90%, showcasing a 10bp reduction relative to May'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% (+0.0pp vs April) while market analysts forecast a +6.95% inflation by end-2023 (-0.55pp vs May). We observe these estimates are slowly converging to the government's forecast, as Mrs. Arbeleche announced the administration expects the year to close at +6.7%. Still, the June slowdown is not priced in economic expectations. Therefore, we believe said estimates will adjust to the downside in the coming months, accelerating their convergence to both official estimates and the BCU's target.

Figure 1: The BCU cut the policy rate to +10.75%



Source: TPCG Research based on INE & BCU

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We find the BCU's 50bp drop in the policy rate to be supportive of our position in nominals. Even with a very significant slowdown in inflation, the BCU decided to maintain a more hawkish stance than expected, as the rate cut was not enough to mark a reduction in the real policy rate. In this context, we believe the BCU does not want to be caught in a faux pas. Before committing to larger trims in the policy rate, we believe the CenBank will first wait for the effect of the slowdown in inflation to seep into the economic agents' expectations. Once the latter have converged to the target, the BCU is more likely to become more aggressive in its rate cuts. Still, this prudential approach is positive for UYU-denominated securities, maintaining the real rate higher for some more time. In this context, we expect the BCU to be somewhat more aggressive in August's COPOM meeting. We believe the CenBank has dual incentives to do so. Firstly, the traditional need for the real rate to be aligned with the monetary policy objectives of the BCU, as the slowdown in inflation demands a reduction in the nominal rate. But secondly, more aggressive cuts in the policy rate allow the BCU to take away some pressure from the FX, without having to actively intervene in the spot market, issue which was caused some frictions between the administration and the BCU in recent months.

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