BANCO CENTRAL
DEL URUGUAY

Uruguay: a tale of inflation stabilization and dedollarization in three (?) steps

Jornadas Monetarias y Bancarias del BCRA 14 y 15 de octubre 2024

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Stabilization in three steps

- Inflation stabilization the old fashion way 1990-2004
- Combating financial fragility under moderate inflation
- The push for dedollarization and peso market development

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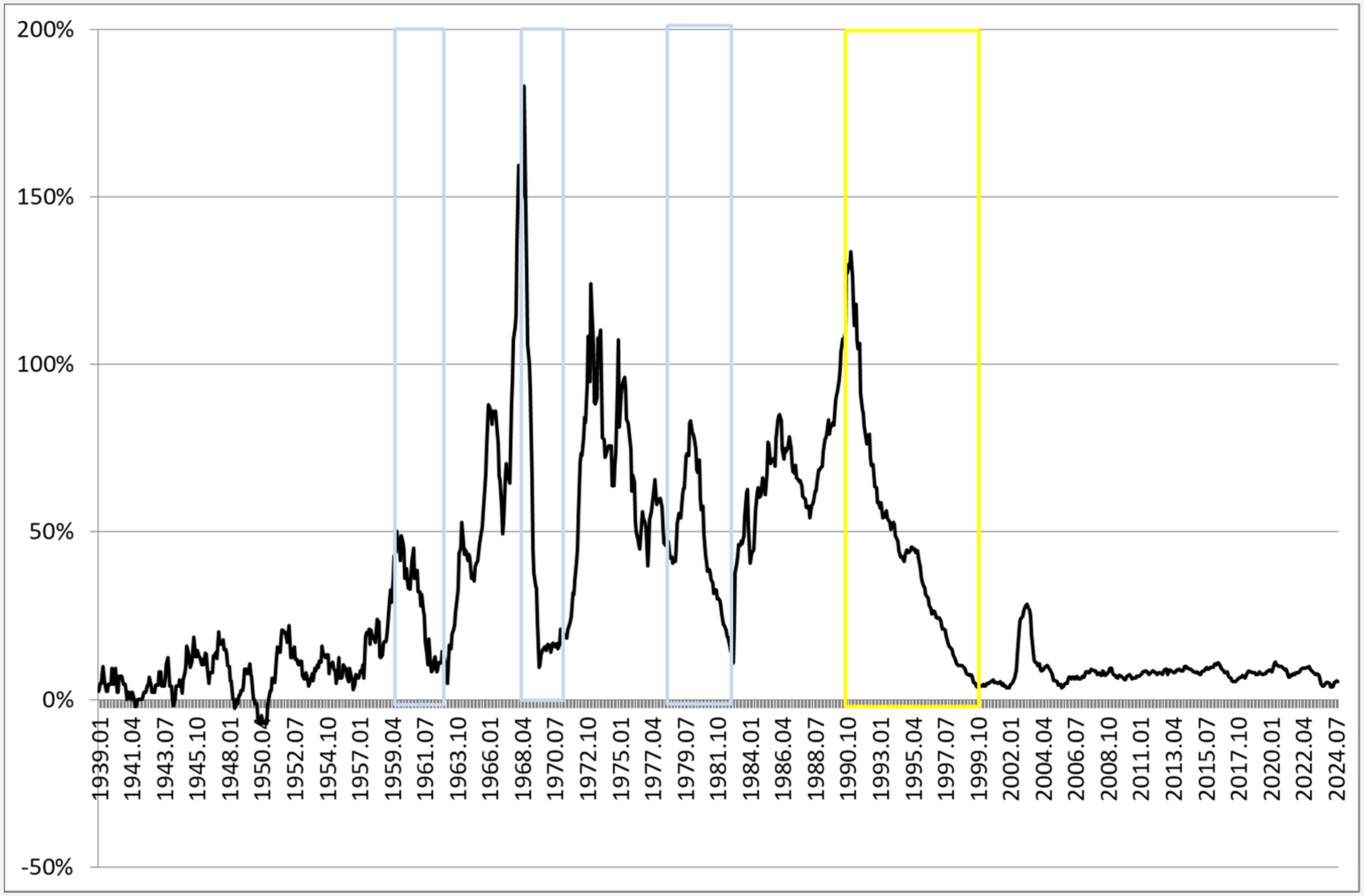
From chronic inflation to inflation stabilization



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recap

Uruguay has a long history of financial crises with several common roots

- They have all a fiscal root and are linked to sudden stops in public financing
- They are accompanied by large exchange rate depreciations and inflation surges
- Most cases are linked to banking crisis episodes

año	Bp/TC	fiscal	Run on debt	banking
5/63	Yes	Yes	No	No
3/65	Yes	Yes	No	Yes
11/67	Yes	Yes	No	No
2/72	Yes	Yes	No	Yes
11/82	Yes	Yes	No	Yes
76/02	Yes	Yes	Yes	Yes

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Plan design keys.

- Small open economy. 40% opening
- Primary production
- Lost between two giants. Region operates as a Dutch disease through tourism. Bergara, Dominioni and Licandro (1994) and Talvi (1995)
- Trade agreements
- Construction boom of the 80s and Argentine tourism
- Refuge of regional capital in times of crisis
- Long inflationary history/lack of credibility/need for strong anchoring
- Dollarization/indexation

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Background

- Fiscal Deficit with Inflationary Financing, 3,5% of GDP with a MB of 5% of GDP
- Circumstantial factors:
  - Drought 1988-89
  - Political Cycle by elections
  - Smuggling due to regional situation
- Constitutional reform of pension adjustments indexes liabilities to the average salary index in 1989.
- Deficit 1989 6.9%
- Brady Plan generates an opening to private financing January 1991.
  - Buyback of 1/3 of the debt at half price
  - New bonds are mainly long term bonds (30 years)

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Stabilization Plan

- Real anchor:1990 fiscal adjustment.
  - Tax increase
  - Part of the fiscal adjustment is attributed to the expected consumption boom and the reversal of the Olivera-Tanzi effect
- Nominal anchor: In 1990 the plan opted initially for increasing nominal interest rates, but rapidly switched to the establishment of an exchange band with pre-announced drift.
  - Emphasis on gradual disinflation to prevent excessive rer appretiation due to lack of credibility
  - Systematic reduction of the drift rate from 4% in December 1991 to 2% by 11/92 and to 0.7% by 9/96
- It was expected that the debt restructuring under the Brady plan would favor capital inflows
- The initial boom of exchange rate stabilization plans was also supposed to help increasing revenues

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Structural reform to boost sustainability and growth

- Trade. Creation of Mercosur. Treaty of Asunción and Ouro Preto
- Fiscal reform
    - 1995 Social security. Transition to mixed system. Savings of 5.5% of GDP in 35 years Masoller and Rial (1996)
    - Public Sector Reform.
        - Ban on hiring public officials for 10 years
        - privatization of Pluna
        - AFE Reform
        - Management improvements in energy companies
- Financial.
    - Insurance Superintendency
    - Organic charter of the Central Bank
    - Technical independence of the Superintendency of Financial Intermediation Institutions
    - Private fixed rate paper (ley de obligaciones negociables).
    - Securitization
    - Investment Funds

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First charter of the Banco Central del Uruguay

- Until 1996. CBU operated under the charter of the Banco de la República, a universal bank with a mandate for economic development.
- 1996 charter. Though failed to incorate the most advanced features of contemporaneous CB charters it introduced a limitation on the financing to the government: The CB could only finance up to 10% of last year's effective expenditures by the Central Goverment (stock restriction)

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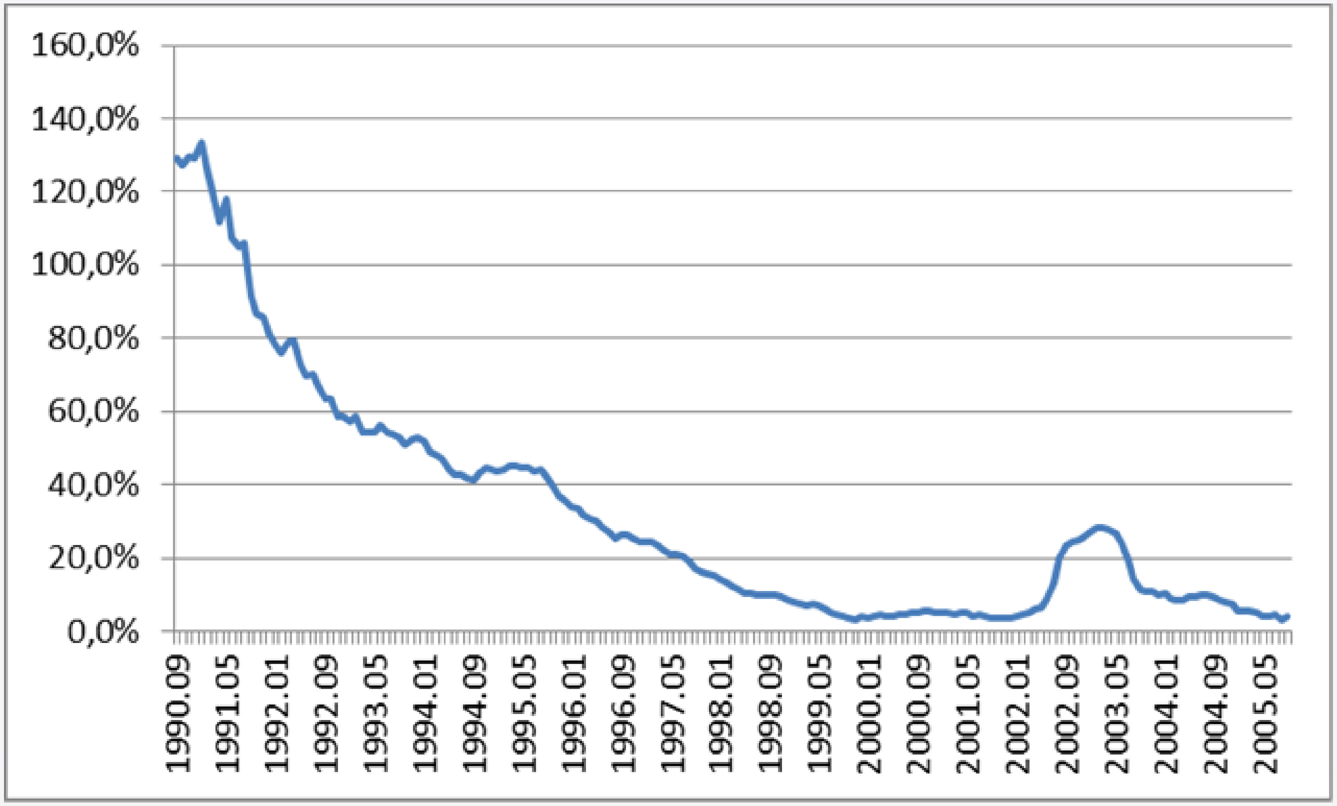
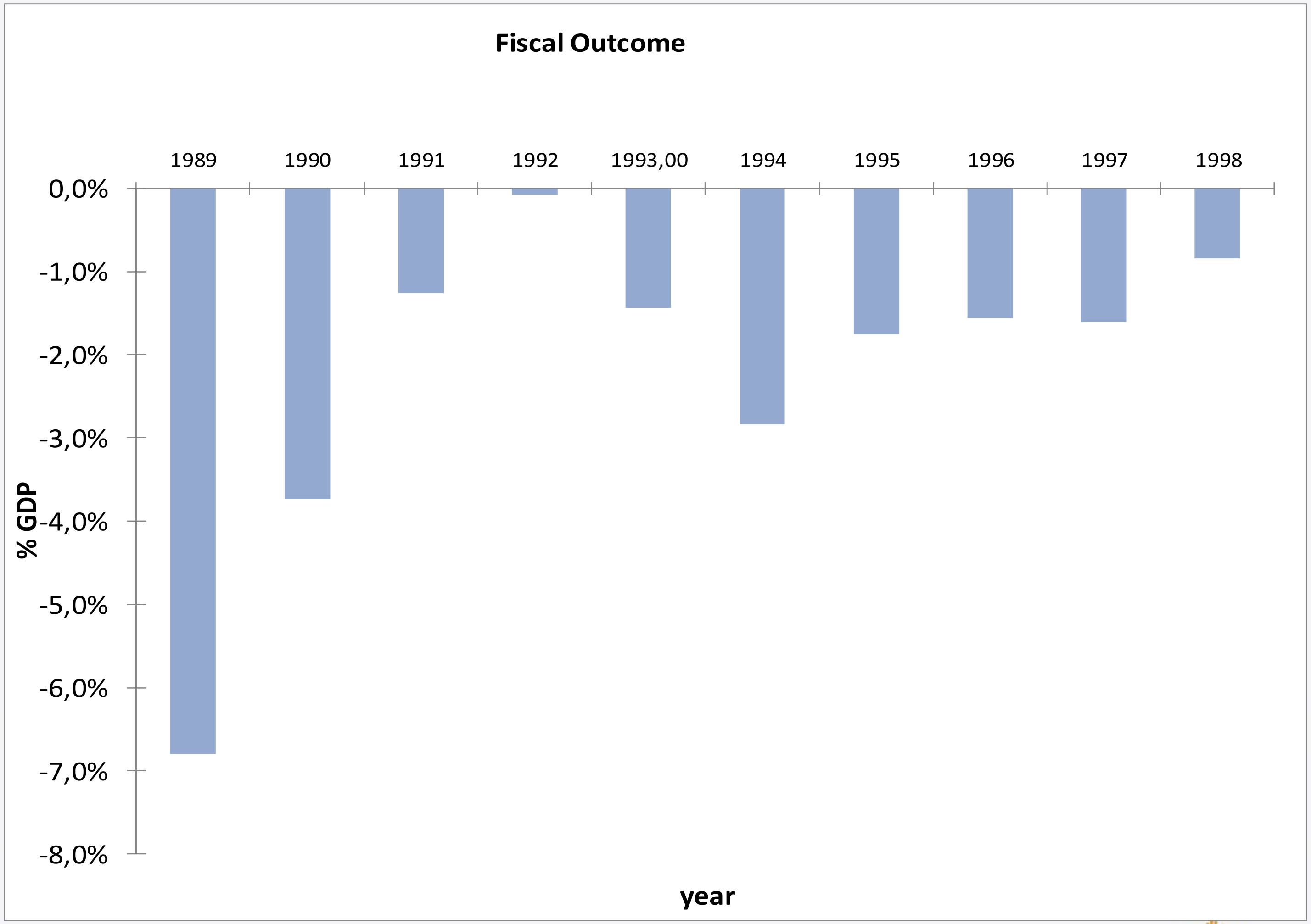
One digit inflation by 1998



Plan results : Fiscal Front



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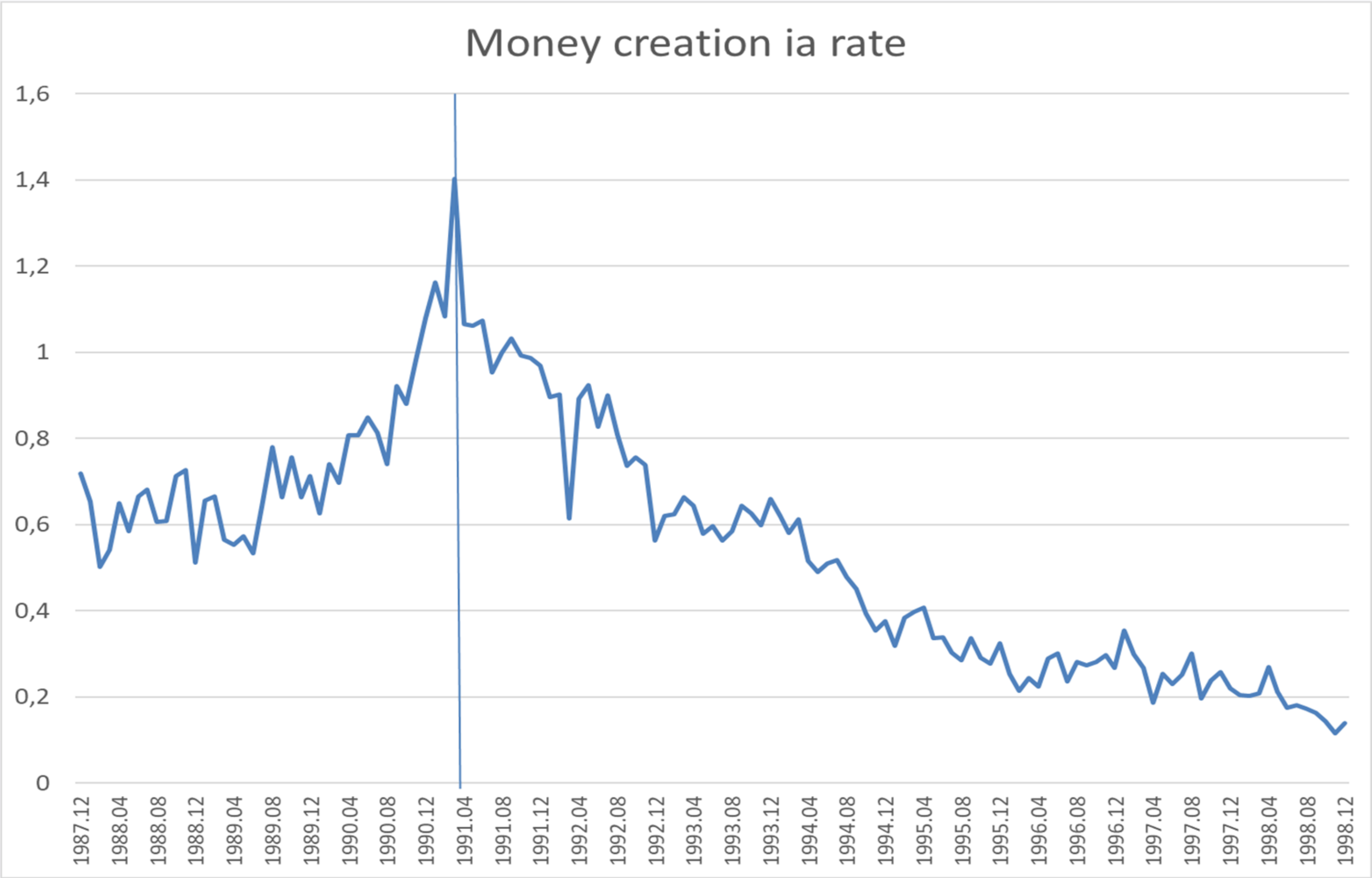
Endogenous reduction of money creation



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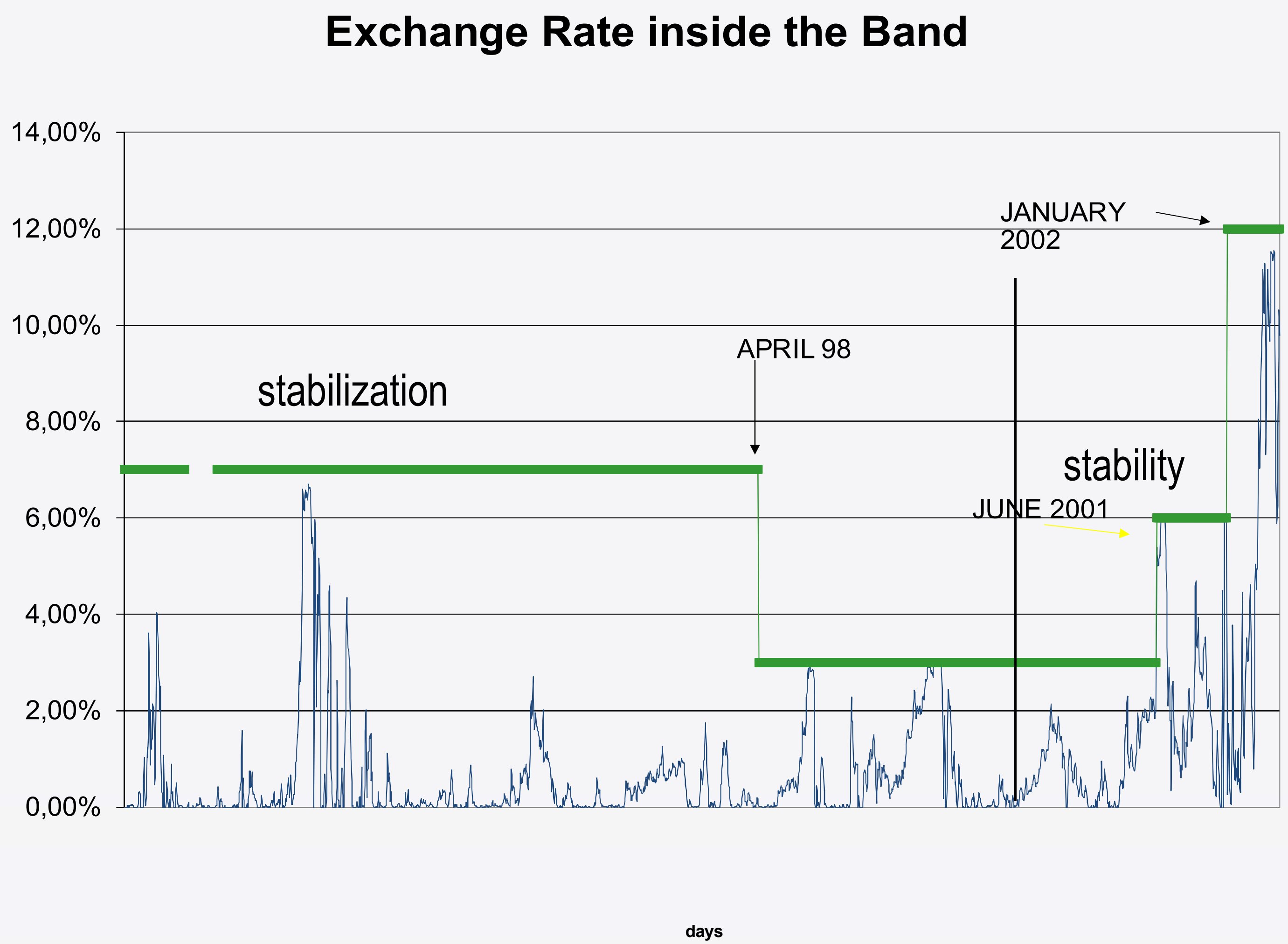
The exchange rate inside the band



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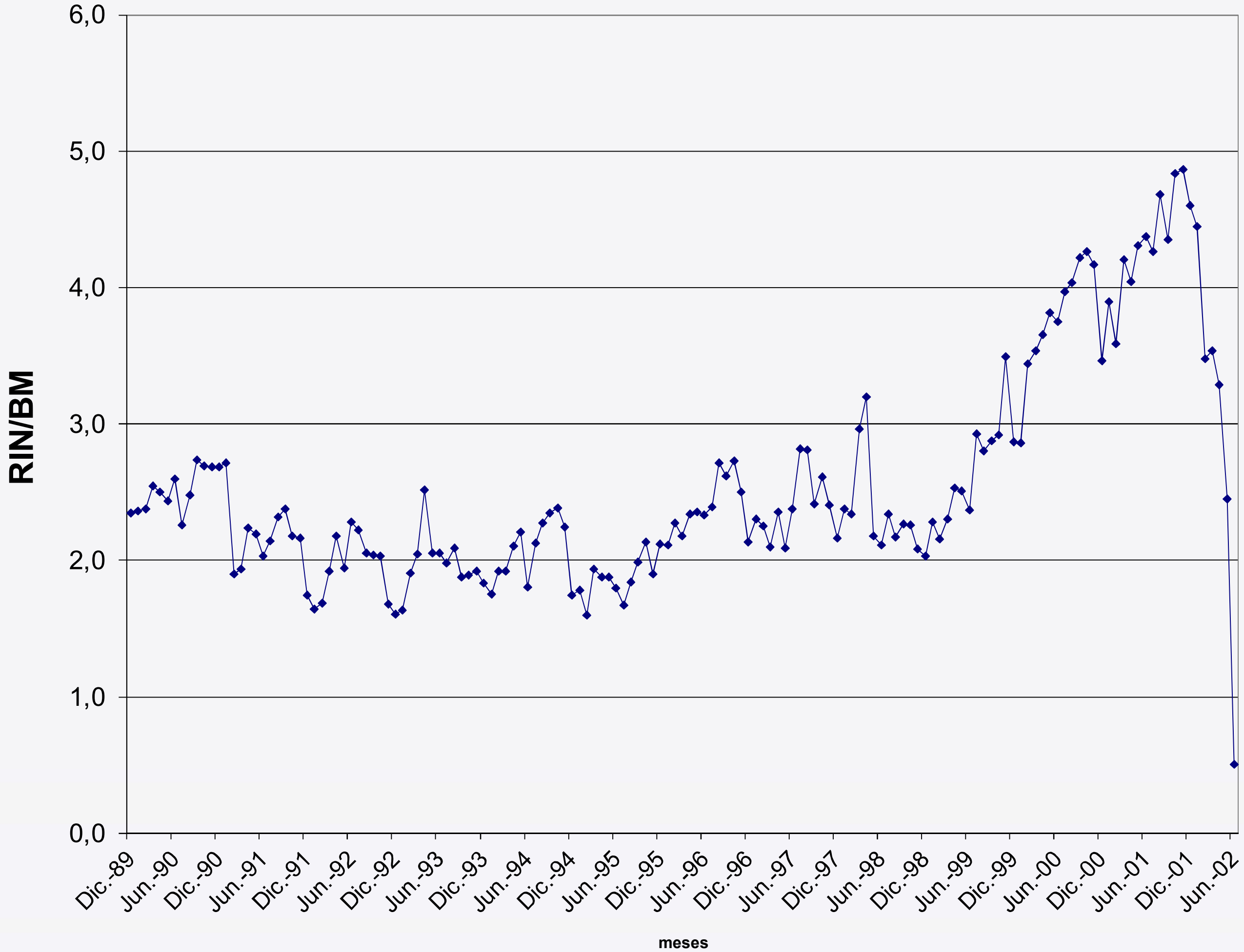
Strong international reserves backing



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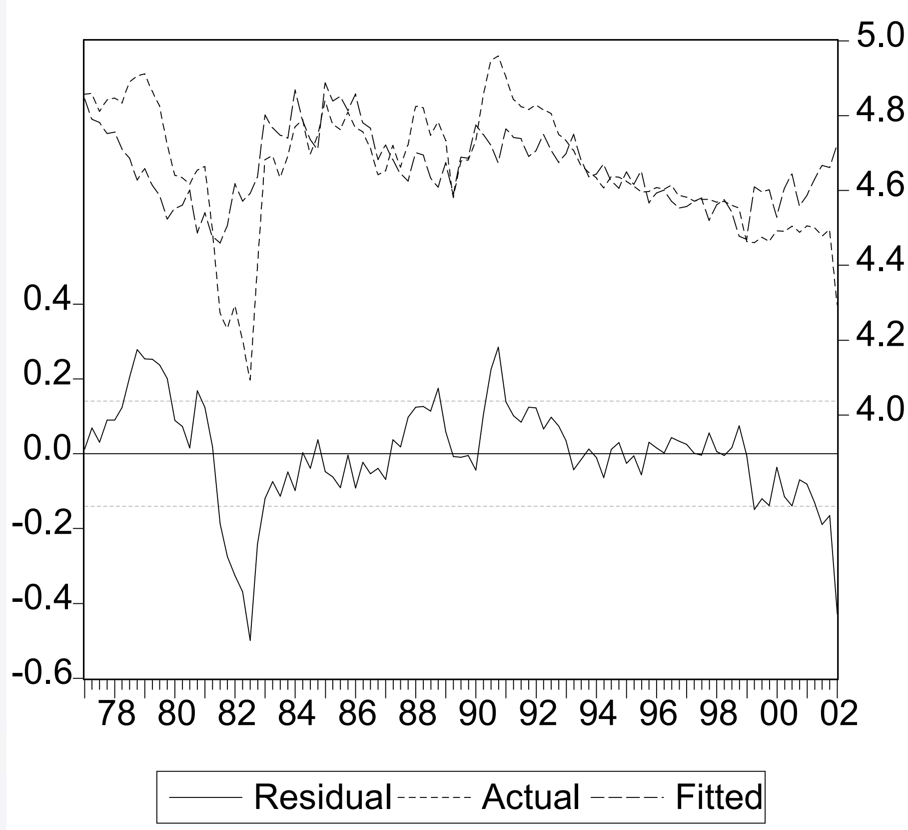
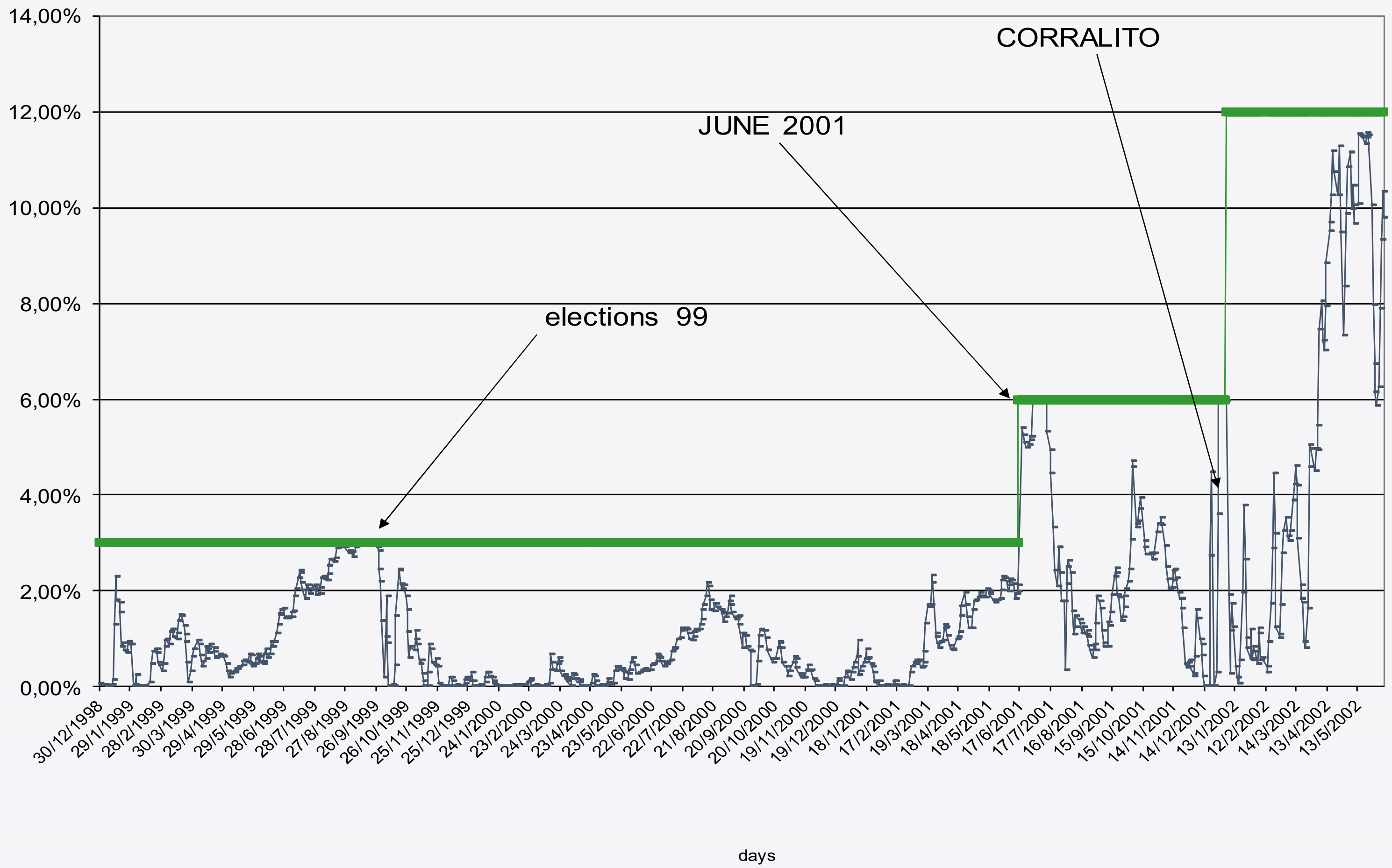
Effective and fundamental RER.

- Exchange rate alignment until 1998
- Uruguayan Disease
- Real crisis misalignment, compensated by band changes
- Strong misalignment after Argentine crisisLicandro y Masoller (2002)



Exchange Rate inside the Band



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The band as Shock Absorber: 1999-2002

- Brazilian Shock 1999
  - Initial diagnosis:
    - Temporary shock
    - Rapid convergence of Brazilian prices (inflation)
    - Little impact on Brazilian demand
  - Policy response
    - Do not reduce drift to .4% monthly
    - Gradual increase in the stock of international reserves (debt)
    - Fiscal expansion linked to elections
  - Results
    - Reduction of inflation
    - Small deflation in dollars
    - Fall in product and exports to Brazil
    - Increase in exports to Argentina

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The June 2001 adjustment

- Argentine instability and foot and mouth disease shock
  - Why wasn't the drift accelerated before?
  - Effects on public debt
  - Effects on payment chain
  - Lack of inflation convergence
  - Access to voluntary financing
- The Measures
  - Band expansion to 6%
  - Doubling of slip rate to 1.2%
- Results
  - Greater deflation in dollars
  - First noises in the financial system
  - Questioning the Investor grade

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The fragility of the government finances

- The Uruguayan fiscal equation
  - sustainability conditions
    - sustainability over a range
    - There is a variation in the RER that makes the fiscal accounts unsustainable
  - Potential liabilities and shocks to the RER
  - debt dollarization/Procyclicality of debt

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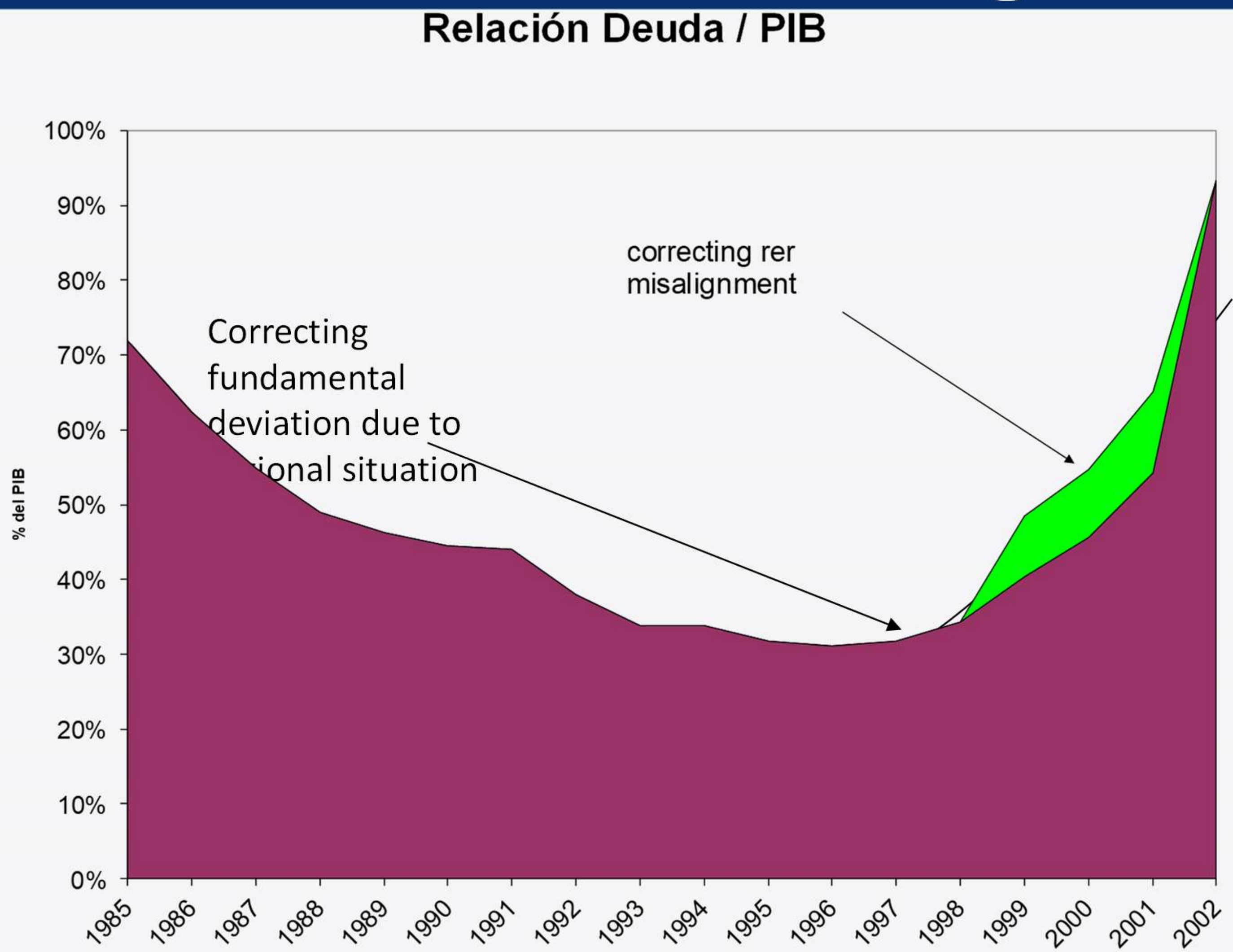
Dollar debt mirage



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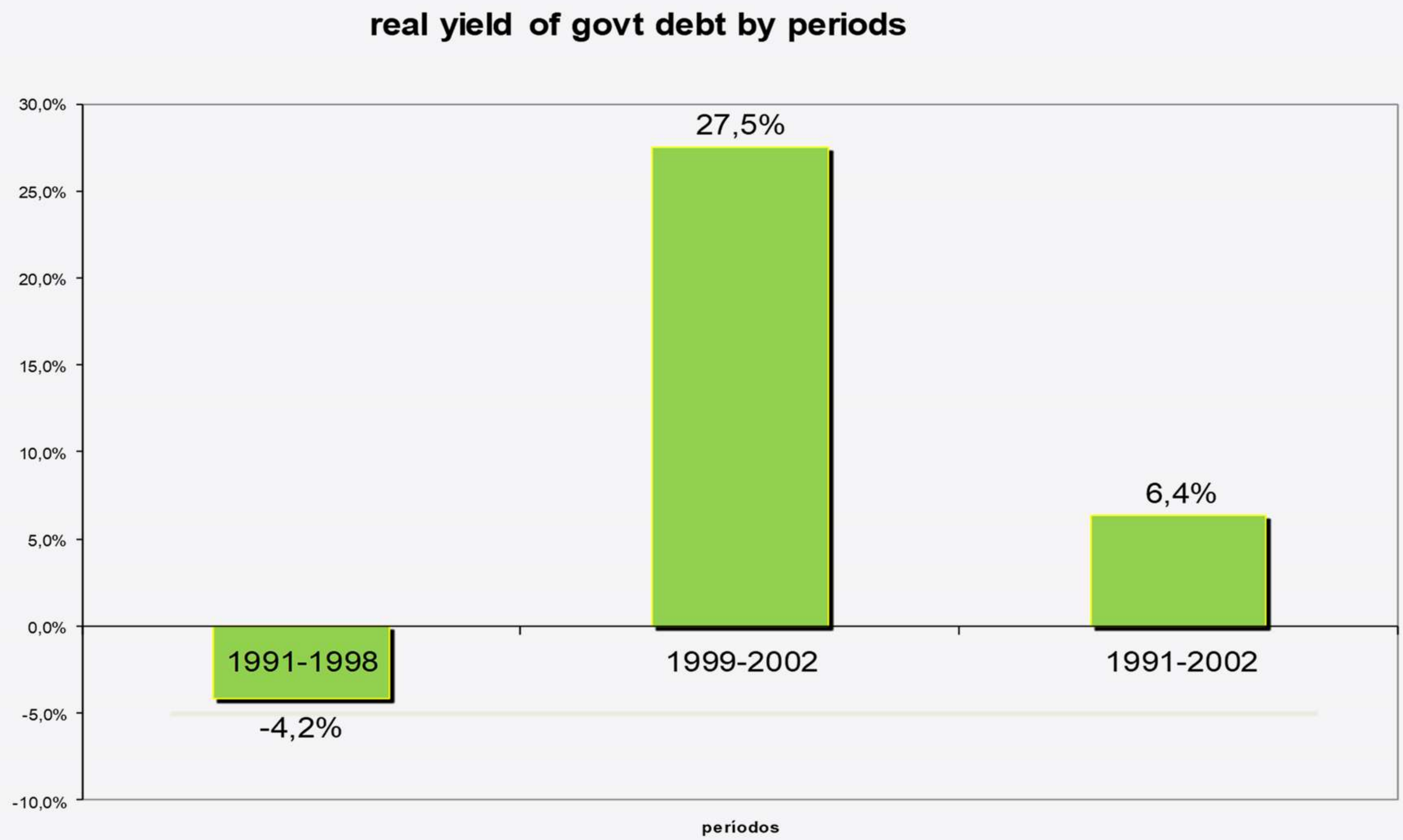
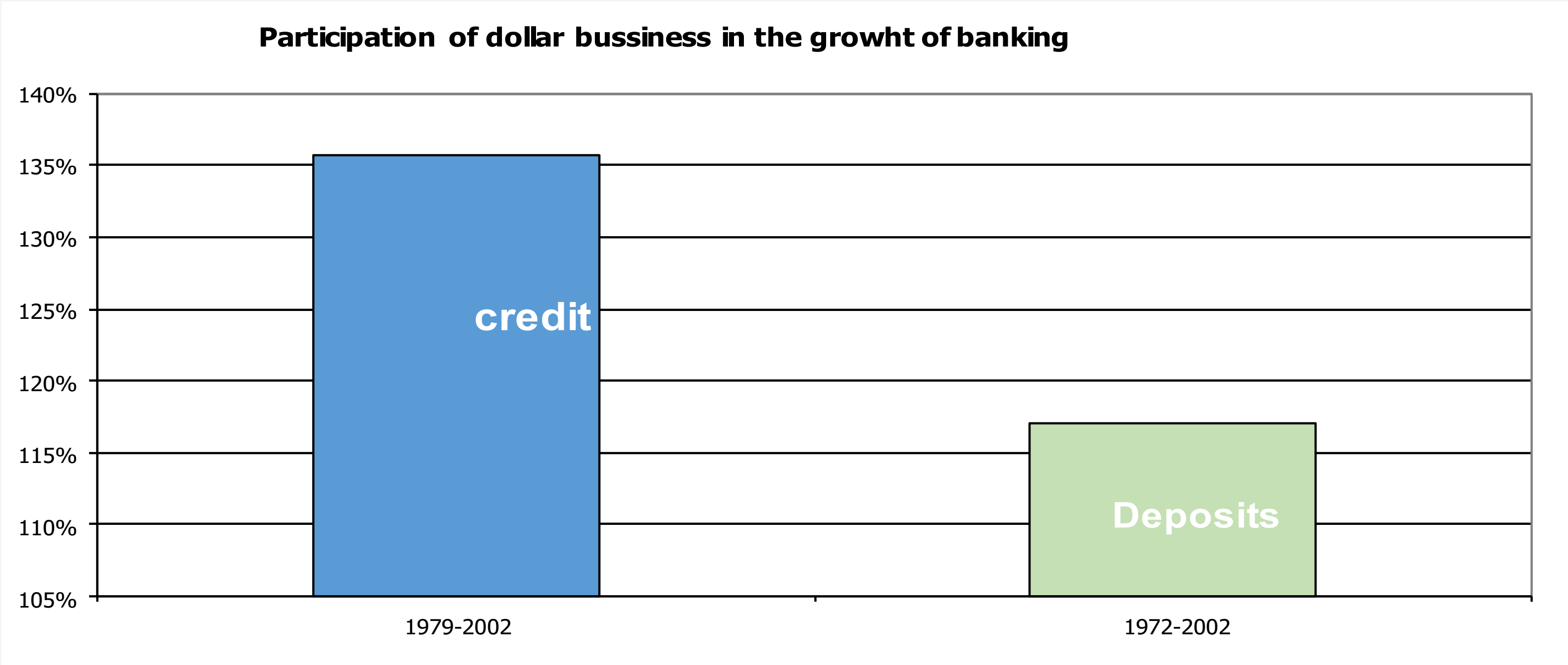
Prociclical yield of dollar debt



The dollarization of the banking sector grew



- Banking of the economy based on currency mismatches
  - Perception of cheap credit due to regulatory failures and currency appreciation
  - Exchange guarantee and risk misperception Caballero and Krishnamurthy (2001)
- High exposure to regional risk of regional and national banks
- Implicit deposit insurance based on supposed historical state guarantee with asymmetric capabilities in dollars and peso.

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the seven plagues of egypt

- Brazilian Crisis 1998-1999
- Fall in Argentine demand 1998-2001
- Dollar appreciation
- Oil Shock and Terms of Trade
- Foot-and-mouth shock 2000 and 2001 (1.5-2% GDP)
- Argentine Collapse (GDP drop 15%)
- Bank Run and Credit Crunch

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¿Porqué se llega a la flotación?

- Bancos usan sus depósitos en el Banco Central para cubrir corrida
- Estado usa sus disponibilidades para servir la deuda y cubrir el déficit
- Asistencia financiera a instituciones menos líquidas
- ¿Venta de divisas en el mercado de cambios? Ninguna
- Condicionamiento del FMI

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Crises but not inflation? Why?

- Solution to banking crises
  - Good Bank/ bad bank solution, 4 big bank closures-restructures
  - Forceful but remunerated lenghtening of maturity in public sector Banks
  - Limited assistance to the banking sector with multilateral financing concentrated in transactional deposits
  - Commitment of international Banks to their branches and subsidiaries
- Debt restructuring in may 2003 to restore fiscal sustainability. Market friendly process with no nominal cuts, just maturity and interest rated concessions.
- No monetary financing of deficit

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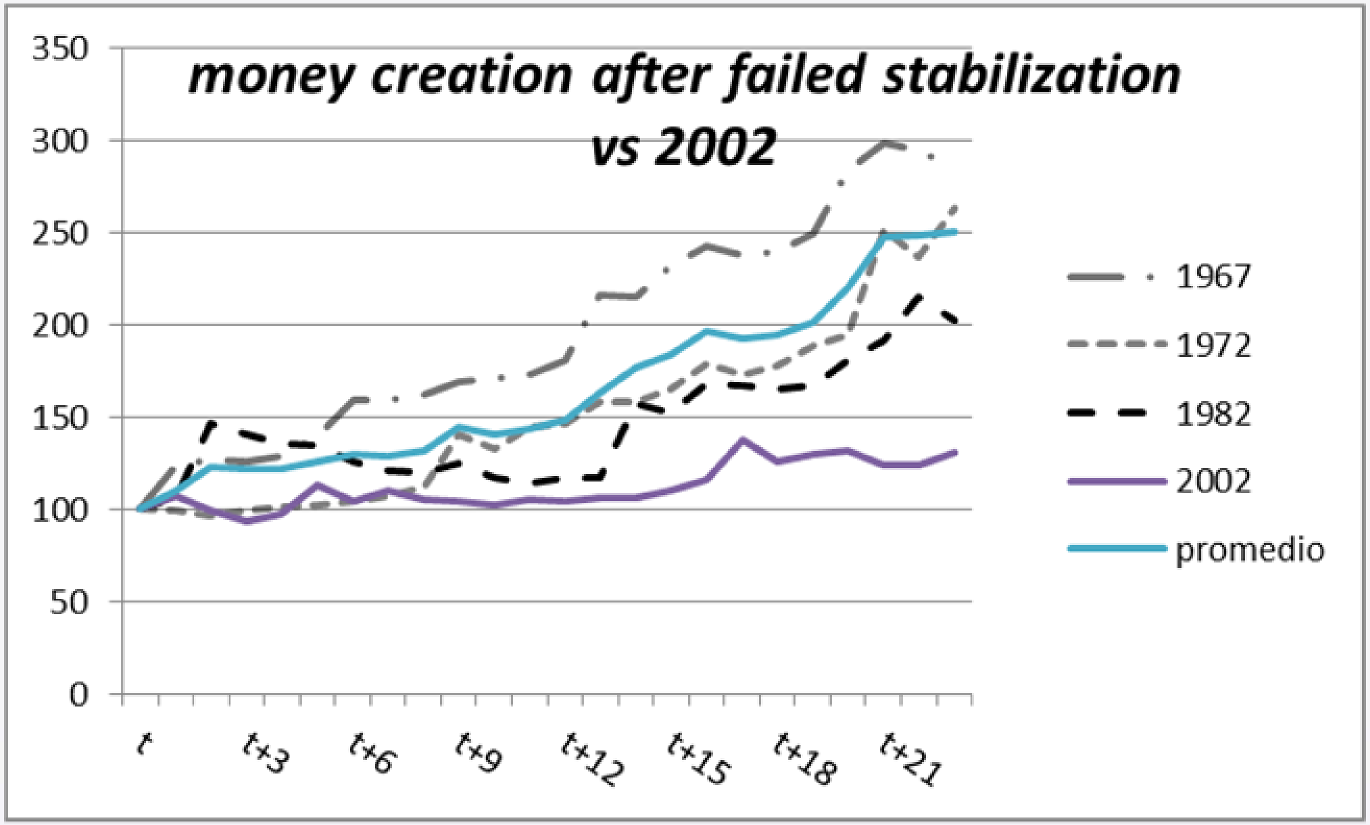
CB charter reform as a binding constraint on monetary financing



Keys in achieving and preserving stabilization

- Strong fiscal. Short run changes to fix flows, but also long term changes to ensure sustainability
- Strong nominal anchor. Under low credibility it is necesary to borrow the strenght of a strong nominal anchor: interest rates might not do it or might be too blunt.
- No monetary financing

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Fighting financial fragility under moderate inflation

- The 2002 crisis made clear the financial fragility derived from currency mismatches
- Government reacts by implementing measures in regulatory and market pillars
  - Regulatory pillar
    - Review of risks in the banking system (liquidity, credit, solvency)
    - Investment limits per currency in AFAP and C. Insurance
    - Deposit insurance with difference coverage and differential premiums per currency.
- Markets pillar
  - UI creation
  - Creation of debt unit; Public debt policy aimed at de-dollarization and market development (lengthening maturities as well)
  - Exchange rate float (change in the relative volatility of returns in dollars and pesos
  - Inflation stabilization around 8%
- Result: Disappearance of currency mismatches in companies and reduction of public sector exposure towards 2012

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Dollarization is here to stay though…

- People learnt to live with the dollar, and they like it
  - Dollar assets are a good hedge when most household debt is non tradable
- Firms need usd in small open economies
- Transnational companies
- So some dollarization will remain

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Why reducing f.fragility is not enough?

- F. fragility reduction came at the expense of the reduction of the financial sector
  - Uruguay has a déficit in
    - Long term financing
    - Risk financing
    - Peso financing
- Firms lack the tolos to hedge against Exchange rate shocks in a very volatile región
  - Evidence shows that firms (to cope with dollarization) reduce leverage, increase domestic pricing of sales, reduce inventories of finished goods and increase inventories of raw materials. Lack of peso markets affect the productivity of firms.
- The asymmetry in the LOTR function remains

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The push for peso market development

- Starting in 2020, a new push to develop peso markets was undertaken encompassing:
  - Improvements in monetary policy
    - Reduction of the inflation target and the target range width
    - Changing the practice of mp institutions to allow for more Independence of the CB
    - New interpretation of mandate where in normal times Price stability is the main objective
    - Adoption of the interest rate as the mp instrument
    - Enhancing transparency and communications
  - Dedollarization and peso market measures
    - Further regulatory reform

Thank you…

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