Monetary Policy in EMEs, Current Challenges: The case of Uruguay

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Outline

1. The Global Financial Crisis’ Aftermath, UMPs, and Capital Inflows

2. The ‘Taper Tantrum’ and Capital Outflows

3. The Low Interest Rates Environment and EMEs’ Policy Outlook
1. Uruguay: some relevant features

- Small open economy
- High degree of dollarization
- Investment grade (since 2012-2013)

ER regime:
- 1991-2002: Crawling band
- From 2003: Floating ER regime + Inflation targeting
  - 2003-2007: Monetary aggregates
  - 2007-2013: Interest rate
  - From 2013: Monetary aggregates
1. Capital flows and exchange rate

- After GFC, AE’s expansive MPs led to substantial capital flows to EMEs
- Uruguay achieved “Investment Grade” (2012-2013) and followed a contractive MP stance
- Uruguay became more attractive to capital inflows
1. Capital flows: benefits

- Strong foreign direct investment
  - high commodity prices
  - development of pulp paper production
  - restrictions on agricultural production in Argentina

- Investment, and output/productivity growth promotes appreciation of long run RER, but RER also experimented some misalignment. A bigger misalignment was avoided following different polices.
1. Challenges for monetary policy

- Strong growth process + wage indexation implied inflationary pressures
1. Capital flows: risks

- Capital inflows, followed by sudden stops could damage economy (balance sheet effects associated with dollarization + asymmetric effects on prices)

- Depreciations have more impact on prices than appreciations:
  - EMEs: Caselli and Roitman (2016), ERPT: 38% / 10% (depreciation/appreciation)
  - Uruguay: Gianelli (2011): 53% / 4%; own calculations (tradables): 45% / 15%.
  - Implies a sort of “inflationary bias” of ER volatility

- Economic policy needs to reduce capital flows volatility, from a monetary and macro-prudential perspective:
  - FX intervention
  - Reserves requirements on NR’s holdings of public debt instruments
  - Reserves requirements on bank’s deposits (average and marginal)
1. Reserve accumulation greater than risk accumulation

CB’s Reserve Assets and short run risks
millions of USD, selected periods

Jun.-10  Oct.-13

Reserve Assets  Risks to cover
1. Capital inflows: challenges for monetary policy

- Reserve accumulation, sterilized with CB’s bills in local currency in a contractive MP stance, leading to an increasing CB’s deficit.
2. MP after ‘Taper Tantrum’

- After tapering:
  - More risk aversion
  - More volatility in financial markets
  - Capital outflows from EME to US

- Currency depreciation, fostering inflation and increasing CB’s deficit (MP reaction and higher interest payments)

- CB’s interventions in FX market to avoid excess FX volatility

- CB smoothed this process eliminating reserves requirements on NR’s holdings and on marginal bank’s deposits

- Two days before the announcement of tapering, Uruguay announced a return to monetary aggregates.
2. MP challenges after ‘Taper Tantrum’

- Growth and wage moderation vs currency depreciation

  wage councils: nominal decreasing wage adjustment….
2. MP challenges after ‘Taper Tantrum’

- Macroeconomic problems in region with consequences in Uruguay
- Money demand instability hinders MP with monetary aggregates
- Inflationary pressures
2. FX and macroprudential as complements of MP

CB’s interventions in FX market to avoid excess FX volatility

![Foreign Exchange Net Purchases and Exchange Rate](image-url)

- Net foreign exchange purchases
- Exchange rate (left axis)
2. FX and macroprudential as complements of MP

- CB smoothed this process eliminating reserves requirements on NR’s holdings and on marginal bank’s deposits.
3. External conditions and MP

- Risks associated to external conditions increased during last years

- Relevant external factors:
  - AEs MP stance (particularly Fed)
  - China
  - Region
  - US-China trade war
  - Europe
3. Main trade offs of MP

- RER Misalignment + negative output gap vs inflation above target

![Chart showing Long run RER and Effective RER over time, as well as Observed inflation vs target.](image-url)
3. Main trade offs of MP

- FX intervention vs CB deficit

![Graph showing FX intervention vs CB deficit over the years from 2008 to 2019. The graph includes the following data points:

- **Yearly Interest Payments and Overall Deficit**:
  - Interest payments and overall deficit are shown as line graphs.
  - The deficit is expressed as a percentage of GDP, 12 rolling months.

- **Central Bank Deficit**:
  - Central Bank deficit is depicted as a percentage of GDP for each year from 2008 to 2019.

- **BCU: ER market and CB bills**:
  - BCU: ER market and CB bills are illustrated as a bar graph in millions of USD accumulated.
  - The bars are color-coded to indicate CB bills and FX sales/purchases.
3. An integrated framework for macro stability

- Consolidation of a flexible IT framework for MP
- FX intervention + macroprudential measures to reduce volatility of capital flows and ER
- Development of an asset-liability management (ALM) approach
- New banking regulation
Thank you