by Gabriel Oddone and Joaquín Marandino

by Eduardo Fernández-Arias

This chapter by Oddone and Marandino is a comprehensive account of the evolution of fiscal and monetary policy in Uruguay since 1960. It highlights major macroeconomic crises that disrupted the process and often led to stages with distinct policy regimes. This is a systematic and serious analysis of Uruguayan economic history that provides a solid background for understanding policy regimes over time and how lessons have been learned the hard way. It should become mandatory reading for economists interested in Uruguay's macroeconomic experience and a useful reference for current policy debates.

The authors open with a decomposition of the budget constraint of the consolidated public sector based on the accounting framework of the introductory chapter and then move on to examining the monetary and fiscal policy regimes throughout the period. From my understanding of the framing chapter of this book, "the purpose of the project is to test the hypothesis that bad fiscal policy, at the macroeconomic level, was a main responsible for macroeconomic instability: balance of payment crisis, financial crisis, defaults, [and] hyperinflation." While the authors do not test that hypothesis explicitly, they do attempt to integrate both parts of the analysis and trace macroeconomic events to the budget constraint. In my view, however, the prevalence of macroeconomic crises associated with the balance of payments and the richness of these key experiences discussed in the second part far exceed what can be accounted for by the budget constraint. In my reading, the second part contains the meat, and the first part is background. Consequently, I will concentrate my comments on the second part.

Before moving on to my main points, I would like to mention that the budget constraint decomposition elaborated by the authors is a welcome extension of the limited accounting scope usually found in other analysis, namely, the nonfinancial public sector (or the general government, which leaves aside state-owned enterprises that are crucial to having an accurate fiscal picture of Uruguay). The authors should be commended for usefully supplementing the basic accounting framework of the introductory chapter with an adjustment to take into account international reserves, reserve requirements, and transfers, producing a finer decomposition that would merit a full-fledged presentation in the chapter. This extended accounting framework can be fruitfully used by itself and in conjunction with the conventional nonfinancial framework. Having said that, it is important to remember that accounting is informative but not conclusive because it is consistent with multiple interpretations of the driving forces. For example, the chapter tends to focus on the importance of the inflation tax as a gauge of fiscal policy, while high inflation may be simply the mechanical consequence of persistence in the context of
costly disinflation. I found that the attention given to the inflation tax as a smoking gun was overemphasized.

The authors organize their analysis into three subperiods: stagflation (1960–1973); opening, liberalization, and the balance of payments crisis (1974–1990); and boost, halt, and the golden years (1991–2017). This published version successfully incorporates some of comments made by me and other participants in the IADB conference “Monetary and Fiscal History” in September 2018 in Washington, DC. In this updated chapter, I will focus my comments on the last subperiod, “boost, halt, and the golden years,” and organize them under three headings: (1) Boost and Tripping over the Same Stone (1991–2002), (2) The Golden Years (2003–2017), and (3) What’s Next? My comments are broadly complementary to the authors’ points except in relation to the pre-2002 period, where I have a somewhat different assessment.

Boost and Tripping over the Same Stone (1991–2002)

The public external debt restructuring under the Brady Plan in 1991, with the financial support of multilateral institutions after carrying out a deep fiscal adjustment, allowed Uruguay to finally emerge from the lost decade of the debt crisis, regain access to external financing, and boost the economy. Over the decade, and with the help of a benign external economic environment, the fiscal deficit remained balanced, and inflation decreased from very high to tolerable levels. Social security reform and the approval of the central bank act further helped macroeconomic stability going forward.

Despite these achievements, however, a macroeconomic crisis visited Uruguay again shortly thereafter, in 2002. What went wrong? In a nutshell, continued vulnerability to the external opening and financial liberalization in the context of a rigid exchange rate regime—a preannounced crawling peg in this case—led to a major macroeconomic crisis, when external shocks hit, that was reminiscent of the 1982 balance of payments crisis. The increase in financial dollarization, in both the public and private sector, and an implicit deposit insurance on dollar deposits, multiplied potential claims to international reserves and made macroeconomic stability fragile. This otherwise successful period of the 1990s continued with many of the vulnerabilities of the past and tripped over the same stone. The authors did not highlight this fatal flaw of the policy framework, which failed to incorporate past lessons regarding macroeconomic stability risks and continued deepening financial liberalization without proper concern for Uruguay’s vulnerabilities.

The currency appreciation against the dollar created by the crawling-peg policy was possible only because Argentina and Brazil, the main trade partners, embarked on a similar policy of exchange rate appreciation. In fact, extraregional currency overvaluation led to an increase in the already high exposure to regional trade, as well as intense financial flows. The risk of a negative regional shock was clearly in play. After Brazil devalued in 1999 and Argentina, chained to the fixed exchange
rate of the currency board, entered a recession, exchange rate pressures in Uruguay mounted without a corresponding adjustment in the crawling peg. The crawling peg was sustained as if regional shocks were temporary. The exchange rate commitment was abandoned only by mid-2002 after Argentina imploded following the abandonment of the currency board and all the elements for a macroeconomic triple crisis in Uruguay (balance of payments, public debt, and banking) were in place.

While it is always difficult to disentangle multiple crises because of their positive feedback loops, I do not concur with the authors that the macroeconomic crisis of 2002 originated in a bank run. The root problem was not in banking but in the multiple vulnerabilities to a currency depreciation originated in a balance of payments shock. While it is clear that many of the successful policy changes made before 2002 helped to sustain the golden years in the subsequent period, I differ from the authors that they laid the foundation for a stronger economy after 2003. I think that such a foundation can be found elsewhere—a point to which I now turn.

**The Golden Years (2003–2017)**

In my view, the golden years should not be lumped together with the period prior to the 2002 crisis, as the authors do, for the fundamental reason that policies after 2003 substantially fixed the previous policy pitfalls leading to the crisis. This true foundation of the golden years was accomplished in two stages: first, through a model resolution of the 2002 crisis, which had the potential to become a second Argentina debacle and was successfully reduced to a deep but short downturn; and second, with policies going forward designed to minimize the vulnerabilities that led to the crisis. (For more details, see Fernández-Arias 2007.)

The crisis resolution rested on four pillars that signaled Uruguay’s commitment to a sustainable recovery and earned multilateral support, in stark contrast to Argentina’s experience. The first pillar was a minimalist bank resolution strategy prioritizing the payment system, organizing a friendly, value-preserving reprofiling of time deposits only in banks lacking access to liquidity, and facilitating bilateral loan renegotiations abstaining from legal imposition. The second was a minimalist and friendly public debt reprofiling designed to substantially preserve the value to investors. The third pillar was a decisive fiscal adjustment based on wage austerity that counted on broad political support across the spectrum. And finally, the fourth pillar was careful monetary policy to keep inflation low.

Once the crisis was resolved in 2003, macroeconomic policies were set to support a new policy regime designed to reduce the underlying vulnerabilities. Exchange rate policy was made flexible, consistent with inflation control. Regional trade vulnerabilities were reduced through diversification, and regional financial vulnerabilities were addressed through regulation. The deleterious risk impacts of financial dollarization in banking and real activity were recognized and addressed through a range of financial prudential policies aimed at reducing those impacts. An
active prudential management of public debt produced a substantial shift toward less dollar debt and longer terms, as well as advancing debt issuance and contracting international lines of credit to be used contingently. Finally, fiscal policy was restrained using self-imposed bounds to ensure acceptable sovereign credit ratings.

In addition, as the authors mention, structural policies and reforms helped to create a favorable business climate. This is not to say that the policy shift was entirely responsible for the miraculous recovery. In part, it was sustained by good luck. For example, international interest rates quickly declined to a point where bondholders participating in the debt exchange actually made money, as country risk fell to a record low. As mentioned by the authors, commodity prices helped Uruguay. But it is clear that it was a positive policy shift that addressed some of the endemic macroeconomic risk factors. Furthermore, once implemented, it was not backtracked despite favorable winds—yet another virtue of the new policy regime.

Nevertheless, the authors perceptively point to signs of possible exhaustion of fiscal discipline in recent years. As in most Latin American countries, fiscal expansion associated with the global crisis of 2009 was not shed as expected once the business cycle turned positive (see Fernández-Arias and Pérez Pérez 2014), and debt appears to be on an upward trend. The key question is, what is next, to which I now turn.

What’s Next?

The main element missing from making fiscal policy reliable and placing it beyond the point of no return is the lack of appropriate fiscal rules and supporting institutions (see Fernandez-Arias 2007). As of now, policy performance rests on the exercise of fiscal restraint to avoid large deficits. Self-discipline may fail under pressure, and even if unwavering, it may create overspending in good times.

Uruguay needs a structural approach to fiscal management, meaning considering fiscal accounts and public debt purged from the effects of the business cycle and temporary valuation fluctuations (such as real exchange rates and interest rates). Structural measurements reveal the true stance of fiscal policy and the real content of debt, avoiding the illusion that debt is lower when the currency is appreciated, and that spending can be expanded without risk when fiscal revenues rise. They are needed for a correct assessment of fiscal sustainability and prudent fiscal policy as well as macroeconomically efficient fiscal decisions over time.

Structural accounting requires independent and reliable institutions to produce estimations and forecasts as well as ex post verification. Within a structural fiscal policy framework, Uruguay needs appropriate fiscal rules and processes to define targets that account for parameters such as the debt level and social security spending projections. These are some of the pending items in the reform agenda.
References


Fernández-Arias, Eduardo, and Jorge Eduardo Pérez Pérez. 2014. “Grading Fiscal Policy in Latin America in the Last Decade.” Policy Brief 216, Research Department, IADB.