BANCO CENTRAL
DEL URUGUAY

# 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

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# 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

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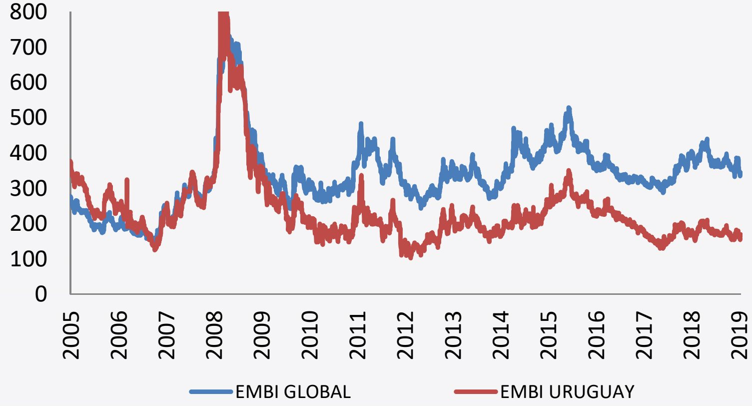
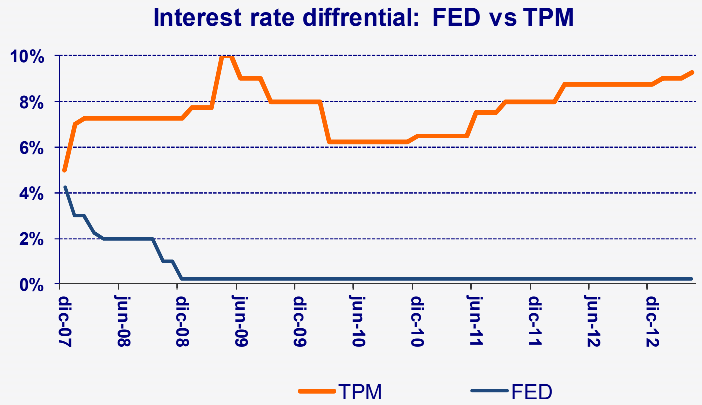
# 1. Capital flows and exchange rate

- 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

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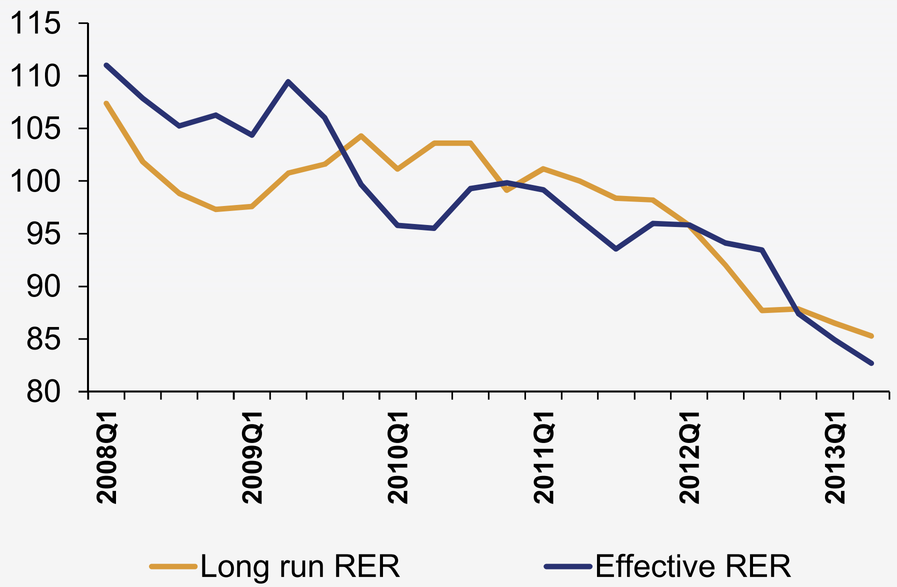
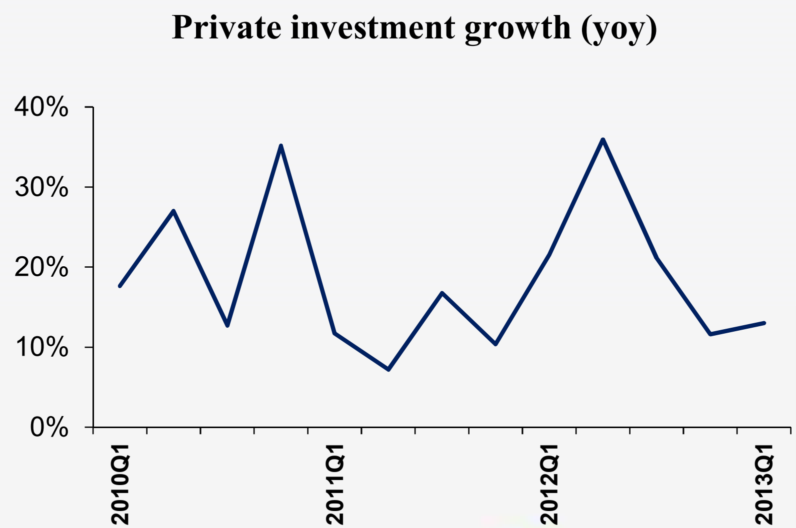
# 1. Capital flows: benefits

- **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.**

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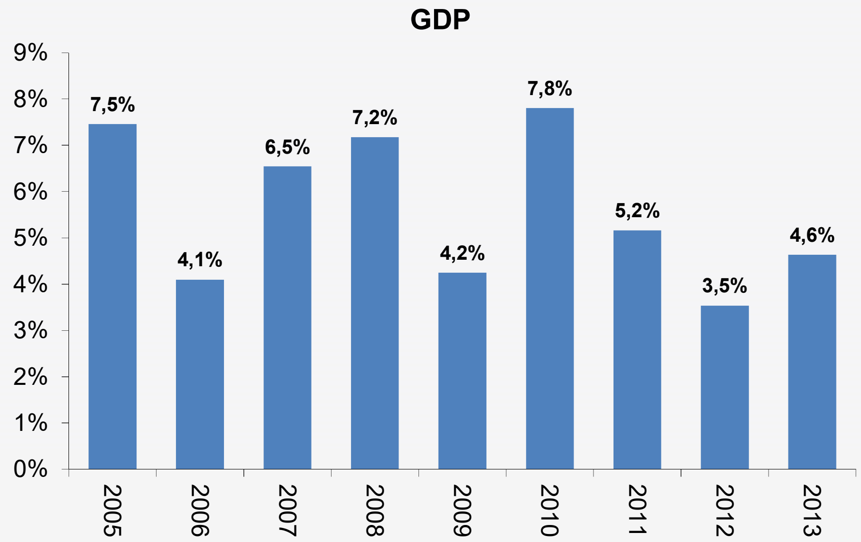
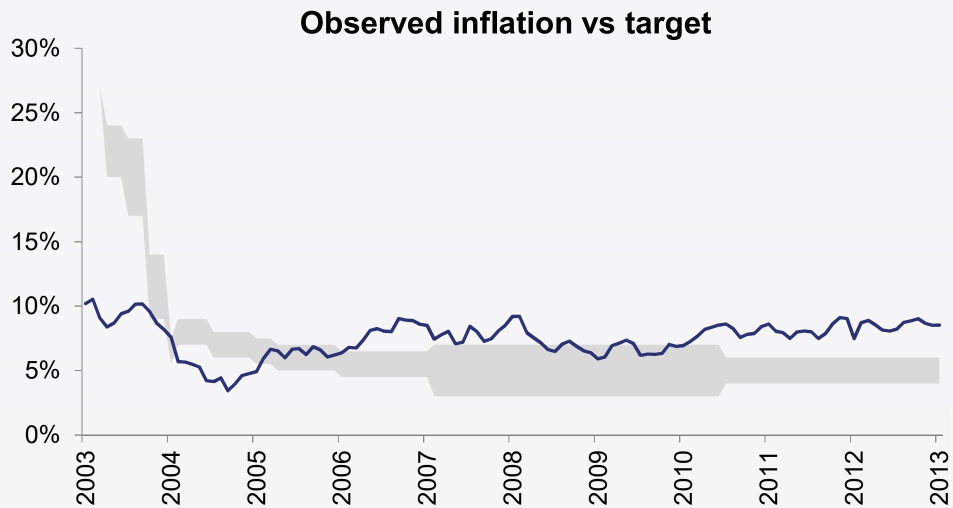
# 1. Challenges for monetary policy

➢ **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)**

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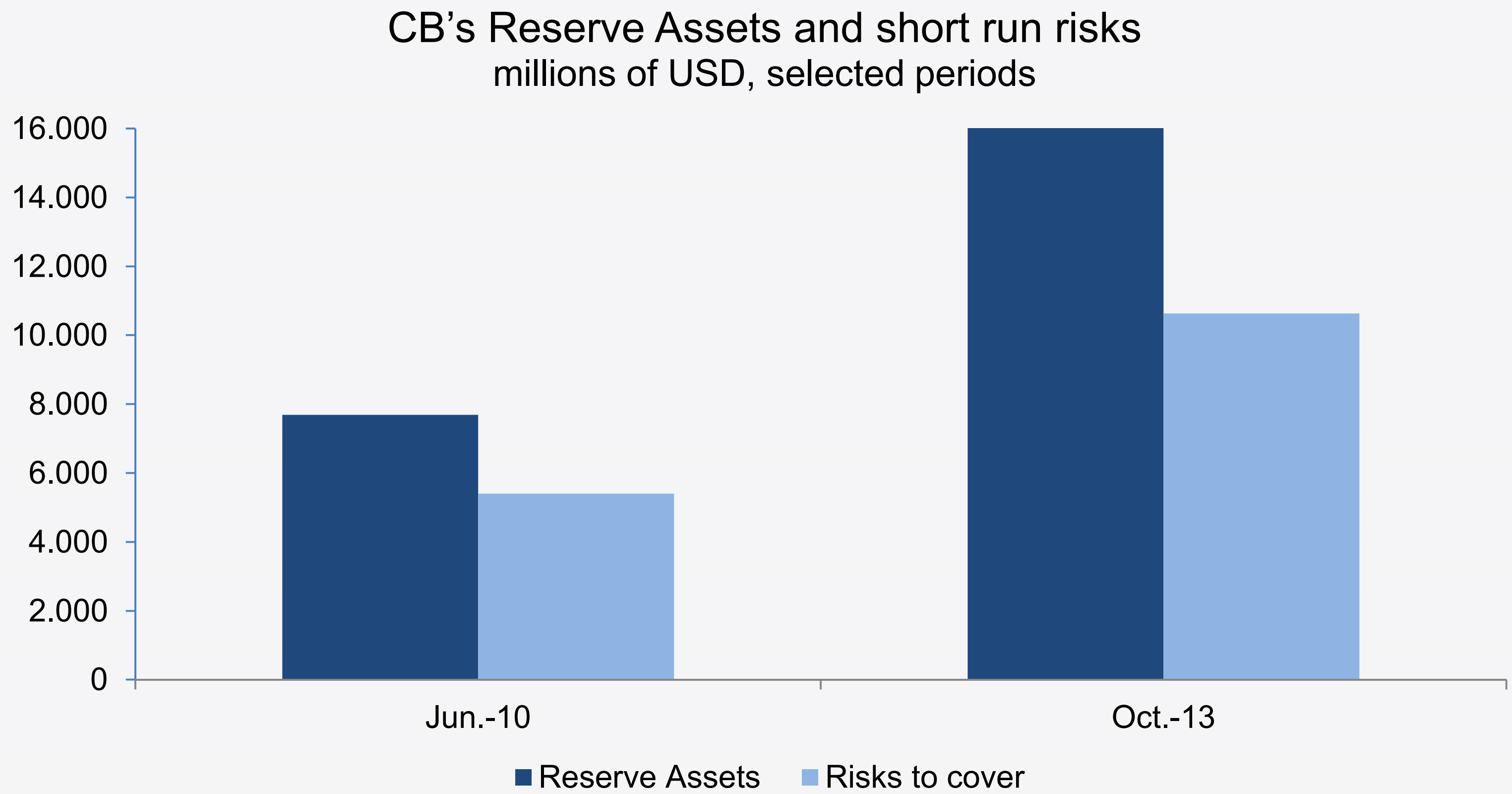
# 1. Reserve accumulation greater than risk accumulation

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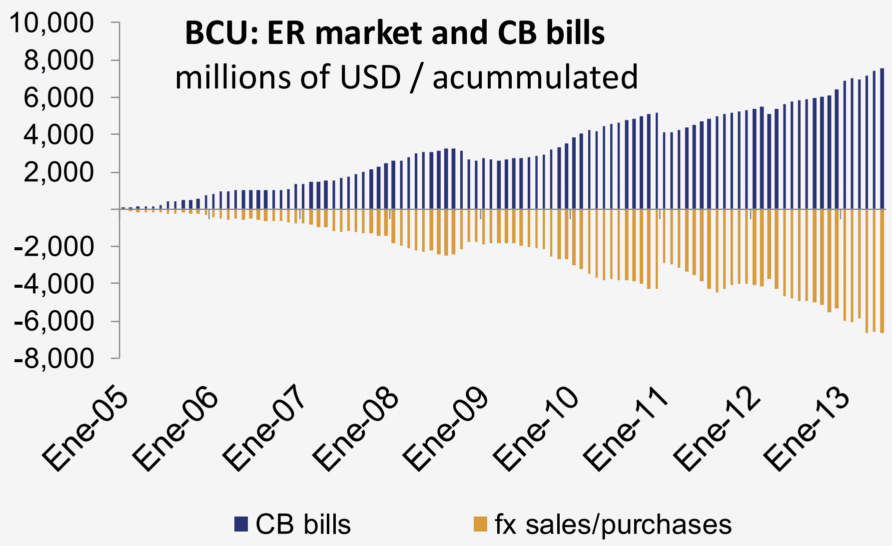
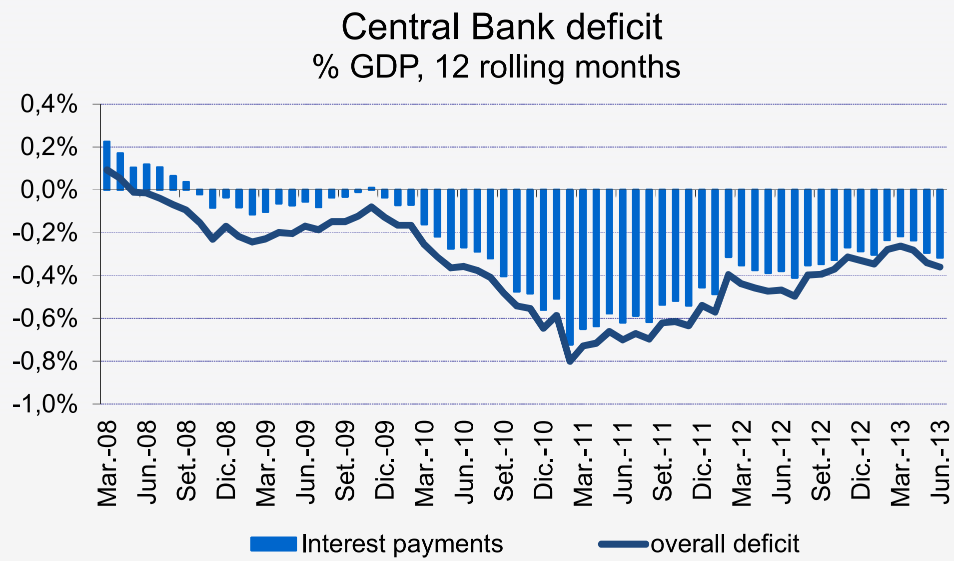
# 1. Capital inflows: challenges for monetary policy

- **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.**

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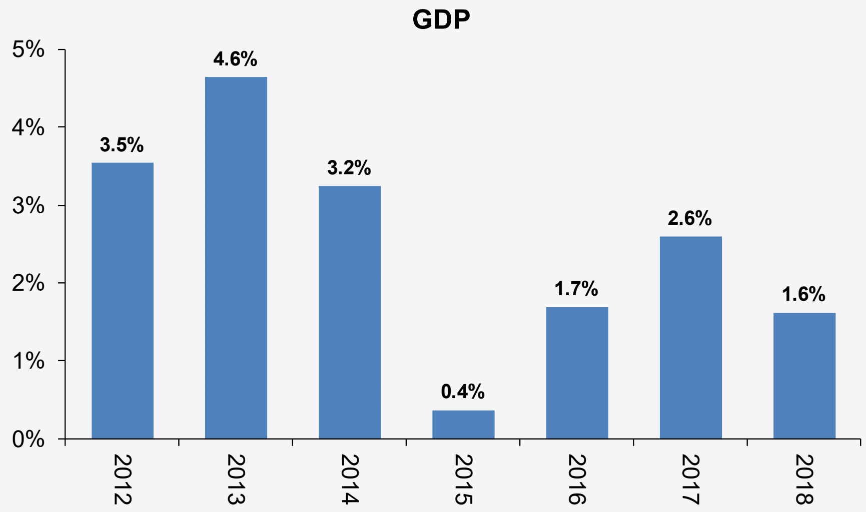
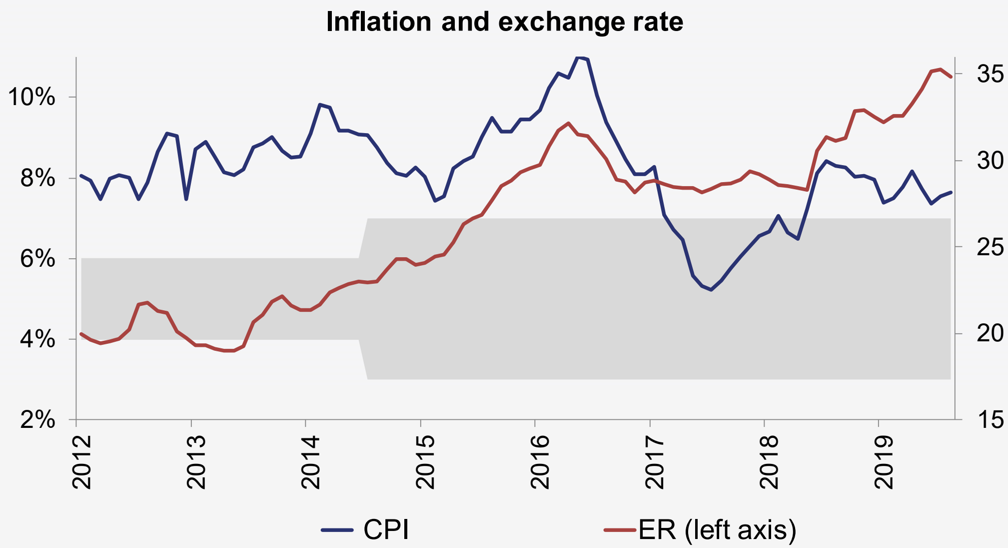
# 2. MP challenges after ‘Taper Tantrum’

➢ **Growth and wage moderation vs currency depreciation**

**wage councils: nominal decreasing wage adjustment….**

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# 2. MP challenges after ‘Taper Tantrum’

- **Macroeconomic problems in region with consequences in Uruguay**

- **Money demand instability hinders MP with monetary aggregates**

- **Inflationary pressures**

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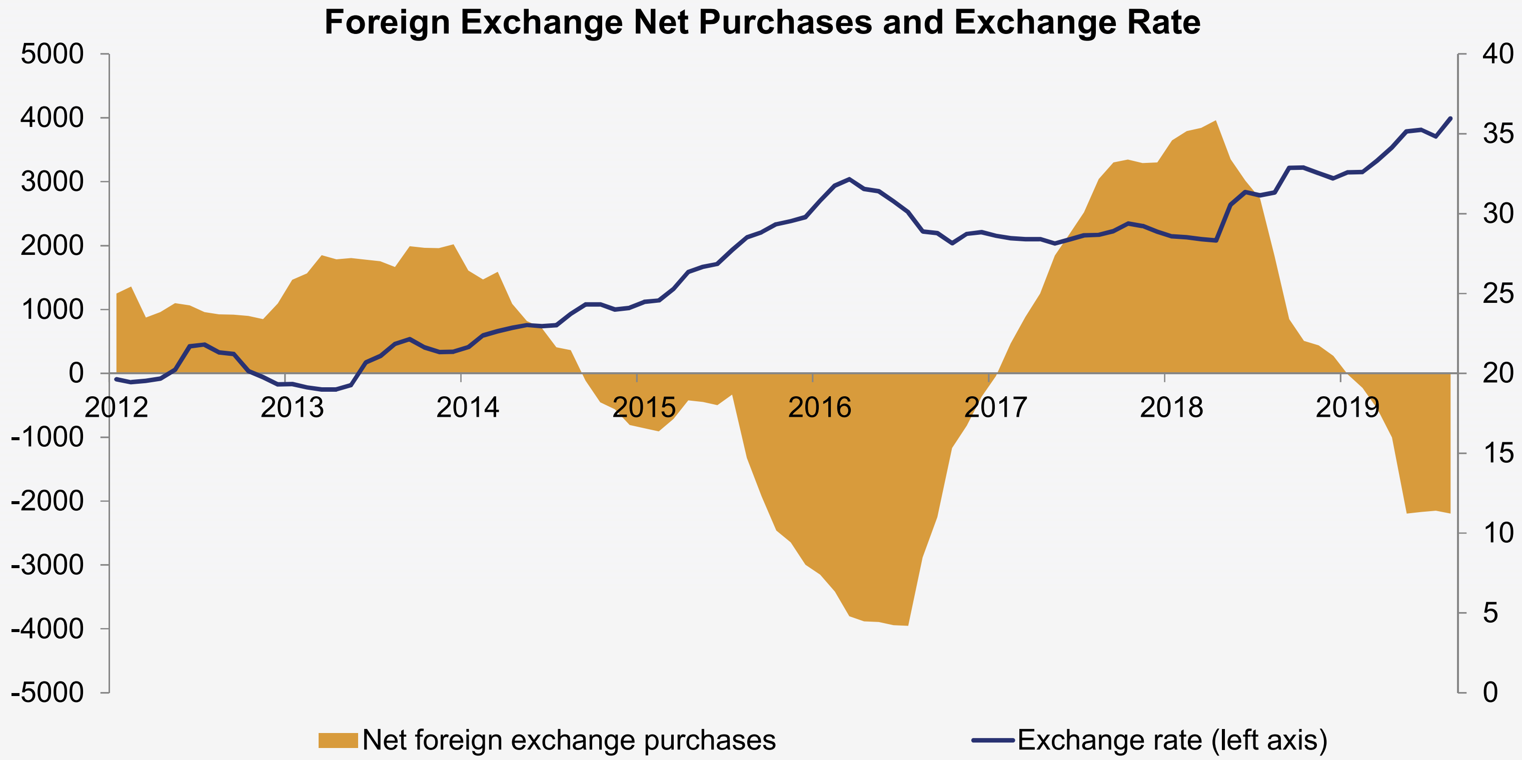
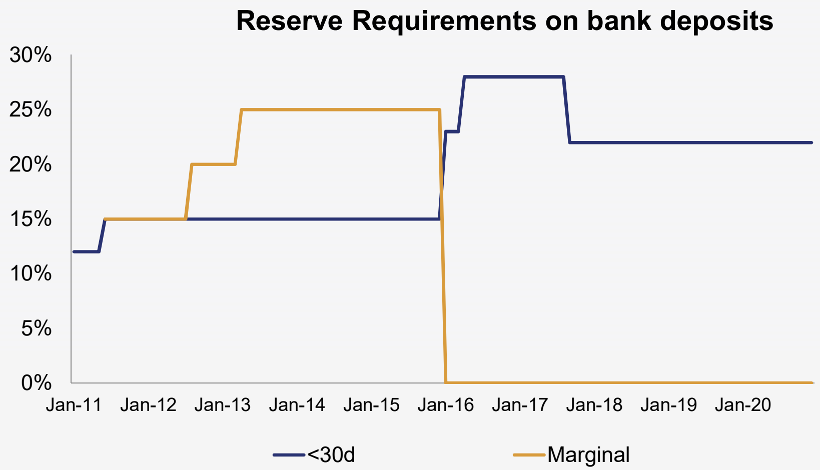
# 2. FX and macroprudential as complements of MP

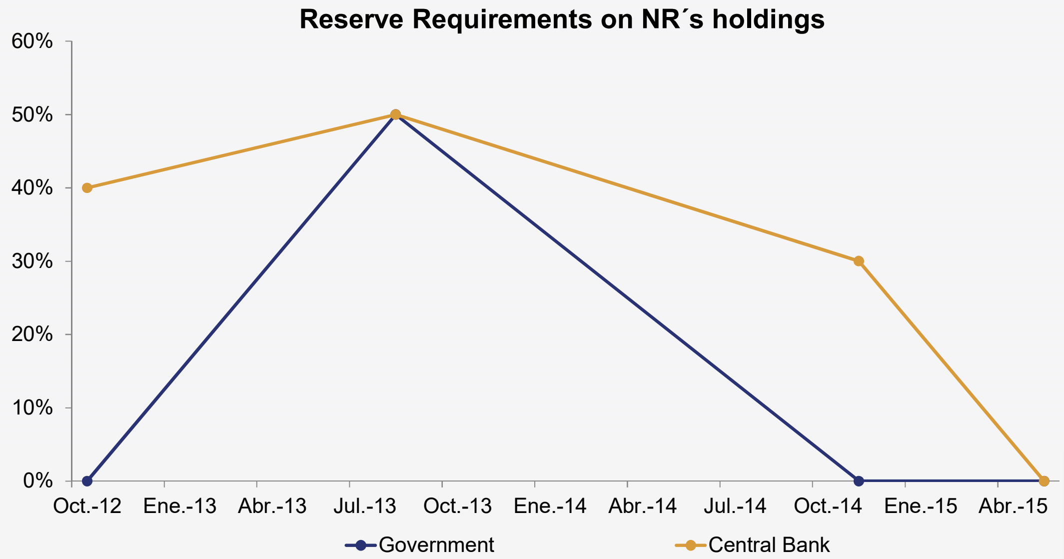
- **CB's interventions in FX market to avoid excess FX volatility**



# 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**

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# 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**

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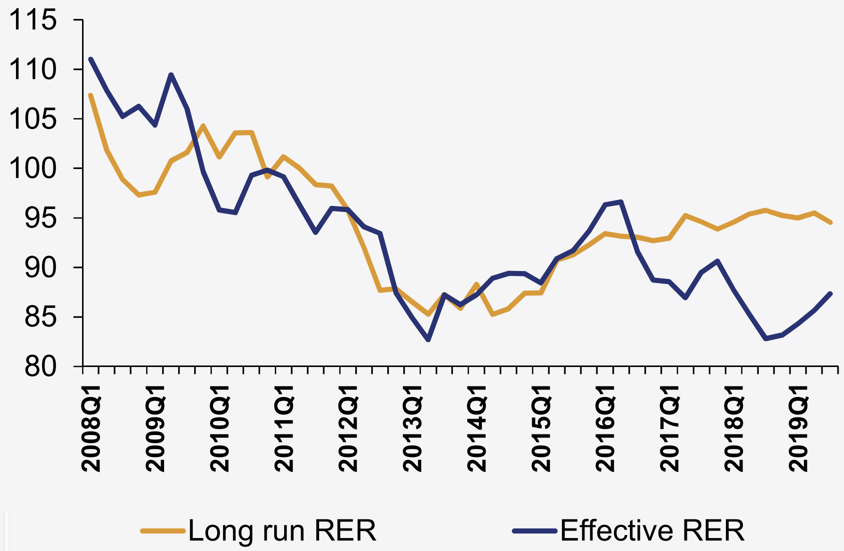
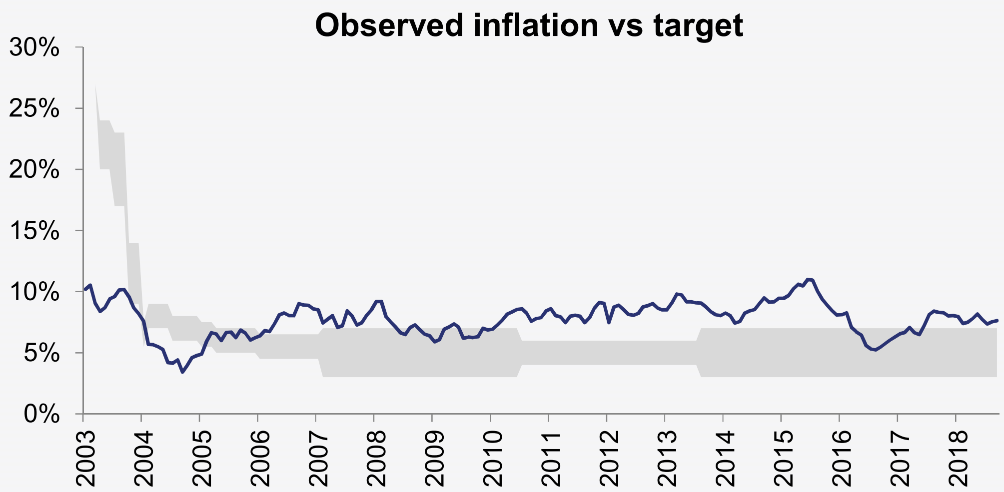
# 3. Main trade offs of MP

- **RER Misalignment + negative output gap vs inflation above target**

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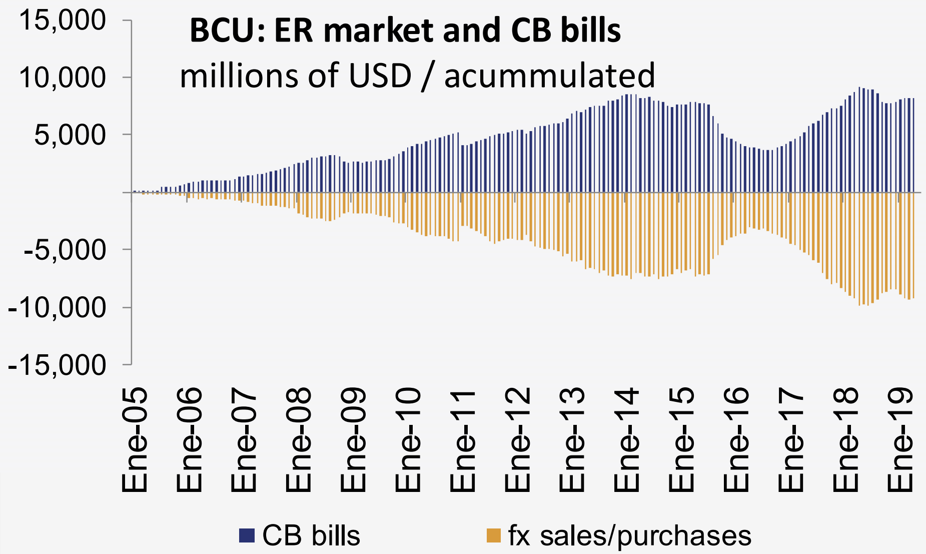
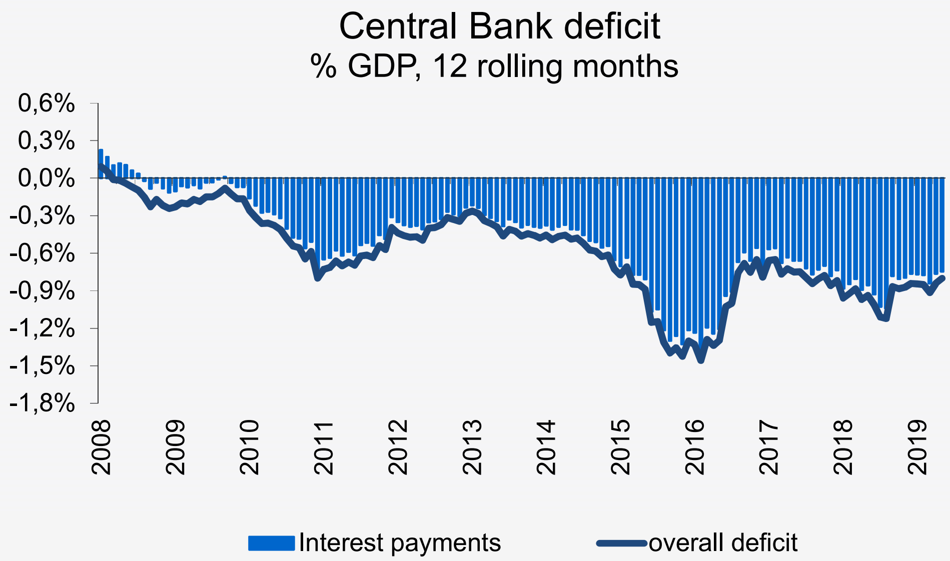
# 3. Main trade offs of MP

➢ **FX intervention vs CB deficit**

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# 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**

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Thank you

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