Towards a quality currency

Policy Paper

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Towards a quality currency

Diego Labat and Gerardo Licandro
Foreword.
As we write these words Uruguay and the world are going through a severe pandemic, which is having a deep impact in every aspect of society. Central Banks all over the world are doing as much as they can to help people to get over this calamity and its aftermath, as is the Central Bank of Uruguay. At the same time that we put all our energy into short-term problems, we believe it is important to share these long-term ideas for the day after.
1) Why should we aim at having a quality currency?

We will argue that having a quality currency promotes growth, promotes financial stability, makes cycles less pronounced and may dampen the negative effects of inflation on income inequality.

High inflation hurts economic growth and the development of the financial sector. Starting with the work of Barro (1995), and Sarel (1995) the empirical literature on growth has suggested that inflation hurts growth, particularly high inflation. This conclusion has been confirmed several times in the literature, as can be seen in Khan and Senhadji (2001) and more recently in Ibarra and Trupkin (2016) among others. Particularly, Ibarra and Trupkin (2016) show that inflation starts to be detrimental to growth in countries like Uruguay once it reaches the threshold of 8%.

The most likely channel through which inflation hurts growth is through the disappearance of domestic financial markets that arises with inflation. Rousseau and Wachtel (2002) have shown that the financial depth of financial markets increases growth, but if inflation is high, that link is lost. The most likely reason why the financial system does not contribute to growth lies on indexation. As inflation increases, the development of financial markets can only come from the development of indexed financial instruments like the dollar. Uruguay is just one example of this hypothesis, as our history shows.

As nominal peso markets disappear, domestic firms lose a critical instrument to hedge macroeconomic shocks and the likelihood of systemic financial failure increases. Small open economies like Uruguay experiment large external shocks that generate large volatility in the real value of the dollar. Every time a negative shock hits the economy, the real value of the dollar increases as economic activity, employment, and real household income fall. If peso markets are operative, indebted firms and households can hedge that risk with peso debt. If – on the other hand- dollarization prevails, indebted firms and households see the cost of debt service rise at the same time their incomes are falling resulting in increasing credit risk to the financial sector. The rest of the story is well known to Uruguayan history: if such a negative external shock hits the economy, the health of the financial sector can be questioned and the country might face a financial instability event as the sustainability of public finances and of the financial sector enter a vicious cycle.
To cope with the lack of peso financing, firms react with the instruments at their disposal, generating inefficiencies in the production process, the commercialization process and their balance sheets. Licandro et al. (2014) show that firms see reducing leverage, increasing the rotation of inventories, the accumulation of inputs and increasing the maturity of debt as substitutes for currency derivatives use. Mello (2017) and Licandro and Mello (2017) show that accumulating liquidity and domestic invoicing of sales in U.S. dollars are strategies used to hedge currency risk by Uruguayan firms, a result that is confirmed in Barón et al. (2017). Mello (2017) also shows that firms seek liquidity to react rapidly to changes in the value of the dollar. Besides, Mello (2016) and Barón et al. (2017) show that firms resort to foreign currency invoicing of domestic transactions as a hedging device. Other common practices are: reducing leverage, increasing dollar liquidity, and -in very low proportion- using currency derivatives. These inefficiencies not only generate financial costs, but affect the size, cyclical behavior and productivity of the private sector, and end up hurting growth.

Besides, price dollarization makes real cycles deeper, as dollar price rigidities place a higher burden on the adjustment of quantities than regular price rigidities in domestic currency. When prices are rigid, a negative demand shock generates more effects on quantities than when prices are flexible. Dollar price rigidities are worse. As the negative shock hits, the value of the dollar increases (as is the case in Uruguay) and the real price (the price in pesos) of the good increases instead of staying constant (as would be the case with peso rigidity) thus generating a more pronounced fall in the quantities produced. A clear example of this happens in the housing sector in Uruguay, which reacts negatively to shocks that increase the real value of the dollar, unlike countries like Colombia and Chile that property prices are not in U.S. dollars.

One final point has to be made regarding the distributrial effects of monetary policy. In countries in which the mortgage market in pesos is developed, the increase in inflation reduces the real value of mortgage debt. If poor households own their houses, as monetary policy becomes expansive increasing inflation and eroding real wages, the real cost of debt falls. In the case of USA, that factor makes income inequality fall with inflation. In Uruguay, as this type of debt does not exist income inequality rises with inflation (Coleman et al. 2010). Poverty and inequality also rise with inflation in Uruguay. Lluberas and Odriozola (2015) also show that inflation and dollarization might have a negative effect on wealth distribution as well.
As the lack of well-developed peso markets and dollarization hurt growth, increase the costs of cyclical adjustment and affects income distribution, we see the development of a quality currency as the main contribution the Central Bank can make to the Uruguayan society.

2) The state of the currency

To understand what should be corrected, let’s take a quick look at monetary policy and its results after the float in the currency in 2002.

a. A general (and short) description of monetary policy between 2003-2019

Uruguay started to manage monetary policy under a freely floating exchange rate only after the 2002 crisis. Uruguayan history is marked by the succession of different types of fixed exchange rate arrangements, with very short intervals of chaotic floating episodes in between them until the abandonment of the exchange rate band in July 2002.

In the midst of the crisis, the Central Bank opted to move towards the management of monetary base, as the Central Bank understood that it was important to commit in the short term to a goal that could be achieved in order to build long term credibility. Starting in September 2002, the Central Bank began to announce quarterly targets for the monetary base, initially without any reference to an inflation target. Once the debt exchange was completed in the first semester of 2003, the Central Bank started to introduce a reference to an inflation number. Gradually the commitment of monetary policy shifted first to monetary aggregates and then to inflation.

By early 2005 Uruguay was operating under what could be called an inflation targeting regime, with monetary aggregates as the instrument of monetary policy. Initially the center of the target range for inflation was set by the ministry of finance at 5.5 % and by early 2005 it was changed to 5% where it would remain until August 2020. The width of the target range was initially set to ±2%, by 2009 would be transitorily reduced to ±1% to return to the original design by 2013.

As previously stated, the initial instrument of monetary policy under inflation targeting was M1'. In July 2007 the Central Bank of Uruguay switched to using the one-day interbank rate as the monetary policy instrument, to later return by July 2013 to monetary aggregates management.
In 2008 a new charter of the Central Bank was passed. This law would give more autonomy to financial services regulator, but, despite the initial intentions to provide a better framework for monetary policy, no improvements would pass in this new chart. The initial draft sent from the Central Bank to the Ministry of Finance was aligned with best practices, and provided for several improvements of monetary institutions that would not end up being reflected in the final text. In particular, the prioritization of inflation as the primary goal of monetary policy, a board with overlapped eight year mandates, and increased accountability, were ideas that went under in the parliamentary process (they had already been rejected in the 1995 discussion). None of these ideas were finally approved. Instead, the creation of a Macroeconomic Coordination Committee (MCC) with a rather ambiguous mandate and a clear preeminence of the Ministry of Finance over the Central Bank ended up reducing the independence of the Central Bank (see Licandro and Licandro (2010)). Also, the new charter included a rather ambiguous wording of the objectives of the Central Bank that could lead to rather different interpretations of the way the bank should manage policy tradeoffs.

The practice of monetary policy did not improve the institutional design, as the Central Bank maintained a close institutional coordination with the Ministry of Finance. After the creation of the MCC, it started to meet every quarter in the day before (or even in the same day as) the monetary policy committee meetings (prior to the COPOM). That would be the routine of policy coordination until early 2020.

The entire period is characterized by a permanent and visible conflict between objectives at the Central Bank. The Central Bank emphasized this conflict in public communication using several images that referred to monetary policy as a balancing exercise, an imperfect discipline, and the flexibility of the Central Bank using its instruments. This attitude corresponds to an interpretation of the mandate set forth in the charter of the bank that imagined the tradeoff between activity and inflation as permanent. In practice, Inflation became a priority whenever inflation came close to breach the 10% level, and activity was a priority when inflation neared the inflation target.

b. Advances in the treatment of financial fragilities arising from dollarization
After the 2002 crisis, Uruguay started to develop a strategy to address the financial fragility arising from currency mismatches (See Licandro and Licandro (2001, 2003 and 2010). The strategy had two pillars: the first pillar was the regulatory recognition of market failures that lead to dollarization, and the second pillar was the recreation of peso markets to generate a viable alternative to dollar financing.

The regulatory agenda moved forward in several directions. To acknowledge that the Central Bank cannot offer limitless lender of last resort services in foreign currency, a deposit insurance scheme was created, with higher coverage in peso than in dollars. Liquidity regulation was reformed, eliminating prior subsidies to dollar activity in the banking sector, and peso reserve requirements were lowered. To mitigate exchange rate risk in credit risk, credit risk regulation was modified to require balance sheet resiliency to exchange rate risk to achieve good credit ratings. Banking capital regulation was changed to incorporate exchange rate risk. Also, the limits of dollar exposure for pension funds and insurance companies were lowered. In the second pillar there were significant changes in several avenues. The float of the currency eliminated implicit exchange rate insurance; public debt management started to increase the weight of peso debt, helping to develop a yield curve in pesos for the Uruguayan market; two indexation instruments were created to compete with the dollar: the indexed unit (UI) and the provisional unit (UP) indexed to inflation and wages respectively; the Central Bank helped develop an exchange rate futures market and the activity of public banks shifted towards peso activity. These are the main examples of a profound overhaul of both monetary policy and financial regulation that aimed at reducing the financial vulnerabilities arising from dollarization.

The results of the strategy previously described are mixed, both in monetary policy front and the reduction of financial fragility previously described.

c. The results

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1 Regulation and supervision of the financial sector improved notably also in other matters besides the examples listed above. The changes in the charter passed in the period allowed for a notable improvement in the dynamics of regulation, which is constantly measuring itself against best practices.
In the monetary policy front, inflation and inflation expectations were contained outside the target range.

Uruguay inflation control performance places it in the top 13% of highest inflations in the world in the last five years, whilst had we achieved our inflation target would have placed us amongst the 20% in the same ranking. In the ten years ending in 2019, inflation was above the target range 83% of the time, and only 17% inside. Compared to the countries on table 1, Uruguay’s record on inflation control looks consistently biased upwards, as Uruguay shows the highest spread with the center of the target range and did not spend even a month below the target range in the period considered. Inflation expectations remained outside of the target range 82% of the time in the last ten years, while other countries in the region managed to keep them inside it most of the time.

Table 1. Percentage of months that inflation is inside and outside the target range in the period January 2010-July 2020

<table>
<thead>
<tr>
<th>Current inflation target range</th>
<th>% months within target range</th>
<th>% months above upper limit</th>
<th>% months below the lower limit</th>
<th>Percentage deviation from the center of the target range</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 ± 2</td>
<td>17%</td>
<td>83%</td>
<td>0%</td>
<td>47%</td>
</tr>
<tr>
<td>4 ± 1.5</td>
<td>54%</td>
<td>32%</td>
<td>13%</td>
<td>18%</td>
</tr>
<tr>
<td>2 ± 1</td>
<td>85%</td>
<td>5%</td>
<td>10%</td>
<td>-10%</td>
</tr>
<tr>
<td>3 ± 1</td>
<td>52%</td>
<td>24%</td>
<td>24%</td>
<td>-1%</td>
</tr>
<tr>
<td>3 ± 1</td>
<td>67%</td>
<td>25%</td>
<td>8%</td>
<td>18%</td>
</tr>
<tr>
<td>4 ± 1</td>
<td>63%</td>
<td>8%</td>
<td>29%</td>
<td>-6%</td>
</tr>
<tr>
<td>3 ± 1</td>
<td>57%</td>
<td>43%</td>
<td>0%</td>
<td>23%</td>
</tr>
<tr>
<td>4 ± 2</td>
<td>80%</td>
<td>8%</td>
<td>12%</td>
<td>-8%</td>
</tr>
<tr>
<td>2 ± 1</td>
<td>49%</td>
<td>46%</td>
<td>6%</td>
<td>25%</td>
</tr>
</tbody>
</table>

In the period considered, inflation was above the target range 83% of the time, and only 17% inside. Compared to the countries on table 1, Uruguay’s record on inflation control looks consistently biased upwards, as Uruguay shows the highest spread with the center of the target range and did not spend even a month below the target range in the period considered. Inflation expectations remained outside of the target range 82% of the time in the last ten years, while other countries in the region managed to keep them inside it most of the time.

Table 2. Percentage of months that inflation expectations are within and outside the target range in the period January 2010-July 2020

<table>
<thead>
<tr>
<th>Country</th>
<th>Current inflation target range</th>
<th>% months within target range</th>
<th>% months above upper limit</th>
<th>% months below the lower limit</th>
<th>Percentage deviation from the center of the target range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uruguay</td>
<td>5 ± 2</td>
<td>11%</td>
<td>85%</td>
<td>0%</td>
<td>51%</td>
</tr>
<tr>
<td>Brazil</td>
<td>4 ± 1.5</td>
<td>50%</td>
<td>2%</td>
<td>0%</td>
<td>13%</td>
</tr>
<tr>
<td>Canada</td>
<td>2 ± 1</td>
<td>58%</td>
<td>1%</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td>Chile</td>
<td>5 ± 1</td>
<td>45%</td>
<td>2%</td>
<td>0%</td>
<td>1%</td>
</tr>
<tr>
<td>Colombia</td>
<td>3 ± 1</td>
<td>93%</td>
<td>7%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Mexico</td>
<td>3 ± 1</td>
<td>81%</td>
<td>16%</td>
<td>11%</td>
<td>7%</td>
</tr>
<tr>
<td>Paraguay</td>
<td>4 ± 2</td>
<td>24%</td>
<td>7%</td>
<td>1%</td>
<td>4%</td>
</tr>
<tr>
<td>Peru</td>
<td>2 ± 1</td>
<td>83%</td>
<td>17%</td>
<td>0%</td>
<td>33%</td>
</tr>
</tbody>
</table>

Twelve months expectations, except Canada (2-3 years) and Paraguay (1 year).
The data suggests that the Central Bank targeted inflation above the inflation target set by the MCC. In Basal et al. (2016) the estimated inflation target is around 8%. In Frache et al. (2017) it is also shown that the Uruguayan Central Bank was less conservative than several of its peers in the region, responding relatively more to the output and exchange rate gaps, and less to the inflation gap than its peers. This is a good explanation of the tables above and a clear result of the way the Central Bank managed conflicting objectives.

One very controversial issue in Uruguay has been the power of monetary policy. In various instances, international organisms or domestic analysts have questioned the ability of monetary policy to manage inflation due to the notorious weaknesses in monetary transmission generated by dollarization. Dollarization, as a form of indexation, generates inertia in the price formation process and increases the cost of inflation stabilization as has been pointed out by the literature. However, dollarization does not seem to have stopped dollarized countries like Peru, Bolivia, Paraguay and Costa Rica from stabilizing inflation. So, how big an obstacle is dollarization in Uruguay? To answer this concern, we divide the question in two parts: is monetary policy able to anchor expectations in Uruguay? and are monetary transmission channels working?

Can monetary policy anchor inflation expectations in Uruguay?

The short answer to this question is yes. To understand whether inflation expectations were anchored and where, we develop a simple exercise using data from the firm’s inflation expectation survey. The first thing to check is whether expectations return to a mean: they do. Since expectations are anchored, the following question is: anchored to what level of inflation? So we run the following regression

$$\pi_{it} - \pi^* = \alpha_i + \mu_{it}$$

Where $\pi_{it}$ refers to expected inflation for firm i at time t, $\pi^*$ is the Central Bank target, $\alpha_i$ is a persistent bias in inflation forecasts (or how larger does the firm believe the target is above the announced value by the CB) and $\mu_{it}$ is a firm specific error term. If the firm believes in the CB target, the $\alpha_i$ should be zero. If $\alpha_i$ is significantly positive, the firm believes the real target is higher than the one announced by the CB. Our findings can be summarized by the next graph:
Three facts can be drawn from this graph. First, as alpha is positive, inflation expectations are not anchored at the value of the target announced by the central bank. Second, inflation expectations were anchored, but to a target that is between 3-4% points above the one announced by the CB. Third, the distribution of the alpha is wide, reflecting uncertainty over the real inflation target. While firms knew that the announced target was not the real target, the lack of information about what the real target was led to uncertainty and disagreement over the real value. As a result, the signal of the target became noisy and that reflected on price formation.

These three facts are rather important because they say three important things. The first is that the announced target was clearly not credible. The second is that monetary policy did not have a problem anchoring inflation expectations. Many have questioned in Uruguay the ability of monetary policy to achieve stability due poor structural conditions, like dollarization, the weight of administered prices in the CPI, the large weight of agricultural commodities in the consumption basket and the lack of development of peso markets. The evidence we have shown proves them wrong. The third conclusion is that hiding the real target from the public only generates uncertainty over the real value, which ends up passing through to inflation.
On the second point: are monetary transmission channels active in Uruguay?

Here the evidence is also clear: the transmission of monetary policy seems to work, despite the small size of peso markets. This should not come as a surprise either, since other countries with similar problems of peso market development and dollarization in the region have been able to develop independent monetary policy quite successfully (see, for example, Peru, Bolivia and Paraguay).

All monetary policy transmission channels appear to work in the data but those operating through asset prices other than the exchange rate. Uruguay has almost no development of the stock market, and households do not have mechanisms to make liquid capital gains in housing through the financial sector, which limits the impact of wealth effects related to monetary policy. Leaving that aside, there is evidence of the presence of the rest of the channels. Basal et al. (2010) show the impact of the interest rate on aggregate demand both through investment and consumption. Bucacos (2017) also finds evidence of the impact of financial conditions on activity through investment. Other evidence of the impact of the traditional channel of monetary policy can be found in Ferreira (2007) and more recently in Portillo and Ustyugova (2015). The credit view is also present and seems to thrive with the development of peso markets. Despite the doubts raised by early work (see Capurro et al. (2010)), Licandro and Mello (2012) show the presence of the credit channel of monetary policy. Acosta-Ormaechea and Coble (2011) suggest that the development of peso markets is key in the transmission of interest rate shocks to aggregate demand. Also, Licandro and Mello (2012) show that the balance sheet channel operates as expected in Uruguay in normal times. The transmission of monetary policy and monetary policy communications to inflation expectations has been widely shown by the work of Borraz and Mello (2020), Licandro and Mello (2014, 2015), Mello and Ponce (2020) and Frache and Lluberas (2019). Recently, Cuitiño, Medina and Zacheo (2020) and Güenaga and Zacheo (2019) have suggested that one of the reasons behind the poor performance of monetary policy may lie in the lack of credibility of the policy. Overall, the evidence suggests that monetary transmission channels work and that their functioning will improve with monetary policy credibility and peso market development.

We have shown that evidence suggest that monetary transmission works in Uruguay. Then, the question remains: If monetary policy works, why has inflation been outside the target all along?
We will argue that the conflict of objectives of a non-independent Central Bank was the main cause of this result. Basal et al. (2016) estimate the parameters of a linear Taylor rule in a DSGE model with Uruguayan data and find that the rule was centered around 8% inflation in the period 2005-2016. This finding is consistent with firm’s inflation expectations and with the behavior of the government regarding inflation control. In practice, every time inflation got close to 10% the tone of the communication of the Central Bank turned more contractive and, every time it got close to 7% it turned less contractive (See for example Mello and Ponce (2020), Bucacos et. al (2019), and Licandro and Mello (2016)). Something similar could be said about the Ministry of Finance as the likelihood of price control measures increased as inflation neared the effective upper bound for inflation: 10%.

Although deficit financing is not allowed in the charter of the Central Bank since its approval in 1995, fiscal concerns still affect the formation of inflation expectations and prices. As Mello and Ponce (2020) have recently shown, fiscal concerns affect the expectations of firms. A similar result was obtained by Gelós y Rossi (2008) for the inflation expectations of the participants of the consensus forecast survey. Bucacos (2021) also shows that fiscal factors still affect inflation. Possible explanations are set forth in Licandro and Vicente (2007), where it is shown that despite cutting the ability of the Central Bank to lend to the Government, as long as surprise inflation is able to improve the fiscal deficit, the credibility of the Central Bank might be affected by the conflict between monetary and fiscal policy. As a result, as long as the Central Bank maintains its current institutional design, it is central to any effort to lower inflation to ensure the consistency between fiscal and monetary targets.

One final evaluation point can be made regarding instrument choice. We have seen that neither instrument but the credibility of the Central Bank mainly related to the way it managed its conflict of objectives, was the main cause of the poor performance regarding inflation control. While the instrument might have had no part in the inflation performance of Uruguay, the abandonment of the interest rate as the instrument of monetary policy might have played a role in the poor development of peso markets. Indeed, as Licandro and Mello (2017) show, the volatility of interest rates all along the yield curve was significantly lower during the period of interest rate management. A more stable yield curve plays in favor of the development of peso markets as it helps to reduce uncertainty in private credit references. Furthermore, as Lahiri and
Végh (2001) have shown, when a country manages monetary aggregates, the volatility of the money market passes on to investment and aggregate demand.

What can be said regarding the financial stability and depth of the Uruguayan financial markets?

On the positive side, the large agenda of regulatory and monetary policy reform led to a large correction in currency mismatches and a reduction in financial fragility. As graphs 2 and 3 show, currency mismatches were vastly corrected in the balance sheet of firms, and dollarization of public debt fell substantially, lowering the mismatch of public sector accounts. At the same time, peso operations increased their participation in total transactions, dollarization fell in the banking sector balance sheets (both in the asset and liability side) and there is evidence of a reduction of price dollarization in some sectors. On the negative side, Uruguay has a clear deficit in the development of peso market, long term and risk financing. Uruguay was successful eliminating fragility but at the cost of achieving a very small and indexed financial system.

Graph 2. Short term currency position of Uruguayan firms for selected dates
Overall, the evidence suggests that a vicious cycle between poor inflation control and lack of development of peso markets, which—as we have argued—impose clearly identifiable inefficiencies to firms in their production and balance sheet management.

3) The new agenda

In our view, to correct the lack of development of peso, long term and risk financing—to have a quality currency— inflation has to fall and dollarization has to be abated. To do so, it is imperative to correct the main problems of monetary policy and be proactive in the development of peso markets. In the following lines we describe the vectors of improvement in both agendas.

a. New monetary policy framework

The first and most important issue to correct is the lack of credibility of monetary policy. To do this, it is advisable to reform monetary policy institutions, for example decoupling the appointment of boards from the political cycle or the demand for greater accountability.
Even though a legal change would be desirable, and as long as the consistency between fiscal and monetary policy is assured, there is ample room for reform on the practice of existing monetary institutions.

Firstly, the balance of objectives has to be interpreted in light of the discussion we have made in the beginning of this essay. As the inflation that contributes to growth and employment is low and stable, the Central Bank in normal times should ensure a level of inflation consistent with the development of peso markets in the long run. Of course, there will be times like the present in which clear emergencies will require the Central Bank to make bold moves to support the economy, but in normal times it should only be allowed to do so insofar inflation expectations are anchored around the long term target.

Secondly, it is important to enhance Central Bank independence and accountability in practice. To do so, the relationship between the Central Bank and the Ministry of Finance has to improve. One first step achieved during 2020 was to separate meetings of the MCC and COPOM, reducing the frequency of MCC meetings and increasing the frequency of COPOM’s. The CB and the MF need to meet to coordinate several aspects of their mandates, as financial stability, debt policy, and to share macroeconomic information, but that does not need a formal meeting of the MCC, which should concentrate on discussing the long run target for monetary policy, and trust the management of monetary policy to the CB. To enhance accountability of the Central Bank, existing reports of the CB to the Executive and to the public should make a clear account of how policy would help achieve targets and why it might have failed to do so in the past.

Our record in Central Bank transparency has to be improved. Transparency helps agents understand how the Central Bank sees the economy and the effects of monetary policy aiding the guidance of economic expectations. We have already started to work in this direction, releasing the minutes of monetary policy with forward looking statements, changing the monetary policy report and improving communications with professional forecasters and the press among other changes, but much remains to be done. Transparency has many components in the monetary policy framework, not only implies a clear target and a system of evaluation but also the disclosure of performance and the measures to be taken in case of failure must be specified. Relevant information has to be disclosed to help anchor inflation expectations, as is the case with core inflation and central bank’s forecasts. Several improvements have been made.
to policy communication: there is a press release for each fixed announcement date, the communication is explained by a one-page statement followed three days later by a publication of the Monetary Policy Committee Minutes. Quarterly there is a monetary policy bulletin with larger explanations and analysis, including growth and inflation forecasts, which is accompanied with press conference and meetings during the year.

Besides institutional reform, monetary policy has started to change by lowering the inflation target in the long run, and using the interest rate as an instrument. The long run inflation target should be lowered further towards a value around 3%. This target would still be large compared with developed economies but, even though higher target incentives carry trade, Uruguay needs nominal room to adjust the large shocks that affect the economy.

Policy implementation and market operations must be in line with the former aspects. In the case of Uruguay, the new monetary framework establishes a target rate for total CPI within a range; according to it the policy implementation has the one day interest rate in the money market as the key policy rate with standing facilities and remuneration of excess reserves in line with the policy rate. Smoothing volatility in short term financial markets (including the exchange rate market) –as is common practice in all central banks- is also very important in the conduct of monetary policy, and will be carried out as long as it does not collide with the main targets of monetary policy, nor damages monetary policy communication.

b. Peso market reconstruction/dedollarization

As inflation converges to its lower long run target, it is possible to develop a set of measures both at the micro and macro level that would help reduce dollarization and improve peso markets in a program of dedollarization. The dedollarization initiative has four main avenues: micro reforms in the financial system, changes in debt policy, the treatment of price dollarization –particularly the price of durables – and the study and treatment of the causes of dollarization at a more granular level.

The financial system –as has been documented above- already went through a profound overhauling in the past years. Despite that change, deposits in domestic currency remain small, peso spreads remain large and access to peso products is still a pending issue. Part of the problem lies in the dollarization of prices that makes people save in dollars to purchase durables.
Another part of the problem lies in the costs of financial intermediation and the microstructure of the financial sector. Despite that, there are other motives at a more granular level that need further study.

Debt policy, as the changes in the regulation of the financial system, has been one of the main causes for the present achievements in peso market development and dedollarization, but still has a pending agenda. The development of debt instruments in Indexed Units (UI), and provisional units (UP) and the recent push towards nominalization are just some of the main initiatives led by the debt unit (DU) in the pursuit of dedollarization. In this front, the Central Bank of Uruguay and the DU are working on a new way to coordinate debt issuance to improve the depth of peso markets. Increasing access by non-residents of peso instruments through Euroclear, confining the CBU participation to shorter maturities are two elements being developed that will help in this agenda.

Price dedollarization is a new element in the dedollarization agenda that targets the role of the peso as a numeraire of the economy. As evidence shows price dollarization recedes as inflation decreases. Evidence, such as in the case of Peru, also shows that reforming consumer defense regulation can also be a way to reduce price dollarization. Nevertheless, as progress in this area has been slow, there is the need to understand why and to convince agents of the need to switch back to peso pricing. As the numeraire is a coordination equilibrium, to go back to peso pricing is necessary to convince and coordinate. Convince agents of the externalities that dollarization poses on growth, the economic cycle, financial stability and distributional issues. Coordinate with interested parts to understand what do we need to reform in order to change existing behavior.

One of the main lines of action in this dedollarization initiatives is to lead a dialogue with interested parts in the financial system, public institutions, firms, etc. This process will allow us to understand the deep mechanics of dollarization and help us convince and coordinate the return of peso as the dominant numeraire of the economy. We expect that this process will make clear what regulations, practices and laws need changing and then use the full power of public communication to help speed up dedollarization.
In the end, it is necessary to reaffirm the idea that the lack of proper peso markets caused by chronic inflation and institutionalized in the economic practices of government, culture, firms, and the financial system generate large externalities that need policy action to be corrected.

4) Final Remarks

Monetary independence –understood as the ability of countries to reign over their monies in a floating exchange rate system- and monetary stability have been a hard fought challenge for Uruguay. Decades after the fall of Bretton Woods we are still not quite where we want to be. We have come a long way since the chronic inflation country, but we need to go further. This essay sets up a course to cover the final stretch towards monetary stability. We think that the ideas put forward in here are the best contribution the Central Bank can make to long term growth, to financial stability, and also to the reduction of the procyclicality of income inequality in the long run.
References


