

James Hanson and Jaime de Melo

The Uruguayan Experience with Liberalization and Stabilization, 1974–1981

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JAMES HANSON
JAIME DE MELO
World Bank
Washington, DC

*THE URUGUAYAN EXPERIENCE WITH
LIBERALIZATION AND STABILIZATION,
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After a period of economic stagnation that lasted from the late 1950s to the mid-1970s, Uruguayan economic growth took off. Between 1974 and 1981 real GDP growth averaged 3.8% per annum (p.a.) versus .7% p. a. between 1956 and 1974. Yet, in 1974 Uruguayan prospects appeared rather dismal—inflation was high and accelerating, the fiscal deficit amounted to 4.5% of GDP, international reserves were largely exhausted, the debt service ratio exceeded 40%, the terms of trade were falling as a result of the oil price rise, and the EEC had just cut off imports of Uruguayan beef. How Uruguay achieved a dramatic turnaround in the face of these poor initial conditions is an interesting case study in the role of stabilization cum liberalization programs.

The need for stabilization, to adjust to the dismal situation described above, was apparent to all in 1974. An important component of this adjustment involved dealing with external

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shocks over which Uruguay had no control. However, the economy's turnaround cannot be understood without also referring to the prevailing set of internal conditions and policies. Transactions with the outside world were limited by a full battery of tariffs, quantitative restrictions, and export taxes. Imports amounted to only 17% of GDP for an economy of 2.5 million people, of whom over one-half lived in metropolitan Montevideo. The internal market was subject to extensive price and wage controls. In the domestic capital market, negative real interest rates and allocation of credit by quantitative guidelines were the rule. While the need to move away from this state-directed economy often had been recognized, little had been done up to 1974. Since that date, Uruguay has implemented major liberalization reforms. Along with the stabilization program and a series of further external shocks related mostly to developments in Argentina, these reforms shaped the turnaround of the economy as well as its recent difficulties.

This article reviews the major Uruguayan reforms and the macroeconomic developments since 1974 to the end of 1981. To provide a historical comparison, it covers the prereform period. Financial reforms and trade reforms are all covered, as is a look at the macroeconomic performance during the period 1974 to 1981. The role of trade reforms is assessed, while the next section examines the stabilization program and the interaction between exchange rates, interest rates, and inflation. Conclusions follow.

The Prereform Period

Uruguay often has been called the Switzerland of Latin America. In the pre-World War II period, it had one of the world's highest living standards. The population, almost entirely of European origin and largely concentrated in Montevideo, was slow-growing and relatively well-fed, well-educated, and well-housed. Social welfare programs were introduced fairly early by international standards, following the philosophies of Batlle (twice president between 1900 and 1920). After World War II,

TABLE 1
Average Growth Rate of Real Value Added*

	Agriculture and Fishing	Manufacturing	Construction	GDP (Factor Cost)
1944-1951	3.6	7.8	10.6	5.4
1951-1956	1.4	5.7	6.3	3.0
1956-1967	-0.4	0.1	-3.9	0.1
1967-1974	1.9	2.3	1.8	1.6
1974-1981	2.8	3.8	12.4	3.8

SOURCE: 1944-1967: ECLA (1980)

1967-1981: BCU (1979, 1982b). The latter figures are in 1978 prices, all others are based on 1961 prices.

* Average compound rate, beginning to end of period.

growth spurred, averaging 5.4% p.a. between 1944 and 1951 (see Table 1). This growth reflected both the worldwide boom in primary commodities (real agricultural output grew 3.6% p.a.) and the rapid growth of local manufacturing (averaging 7.8% p.a.) The growth in manufacturing took place despite a sharp rise in the ratio of manufactured imports to total local supply (Anichini et al., 1978). With a population growing at only 1.8% p.a. Uruguay reached a per capita income of nearly \$900 (at 1970 value) in 1951.

The economy continued to grow fairly rapidly (averaging 3.0% p.a.) until 1956, but some underlying problems also began to appear in this period. Agricultural growth stagnated after 1951 (1.4% p.a.), and growth in manufacturing (5.7% p.a.) was sustained only by a sharp increase in import substitution that lowered the import ratio of the sector to below its World War II levels. The import substitution program was implemented through multiple exchange rates for inputs and competitive imports, prior deposits, and quotas, as well as high tariffs.

Between 1956 and 1967, the economy became caught in a stop-go cycle of inflation and stabilization cum devaluation and stagnated. Balance of payments problems in 1957 and 1958 led the new government to sign an IMF stabilization package that resulted in an improvement in inflation and exports, albeit at the cost of some growth. However, inflation soon rebounded to its previous level (over 40% p.a.), forcing a new devaluation in 1963. The fiscal situation deteriorated as revenues fell as a percentage of

GDP throughout the sixties, steadily widening the gap between revenues and expenditures. Inflation continued to rise along with the fiscal deficit, reaching levels of 75% to 100% p.a. in 1966 to 1968 (Harberger, 1975). Capital flight accelerated and debt service on the public sector's growing foreign obligations reached alarming proportions for that era.

The economy also suffered from longer run, structural problems. The inward-looking, import-substituting-industrialization (ISI) policy seemed to have reached the limits of the small Uruguayan market by the late 1950s. At the same time, attempts to explicitly and implicitly tax agriculture to finance a continuation of the ISI growth and the increasing social welfare expenditure reduced a stagnation in real output. Agricultural exports especially suffered, and contraband livestock exports to Brazil became a serious problem.¹

The financial sector was severely repressed during this period. The Banco de la República operated as a development and central bank, as well as a commercial bank, financing fiscal deficits of 2% to 5% of GDP (Harberger, 1975:40) and a few favored projects at low interest rates. Financial intermediary offices multiplied in almost cancerous fashion to capture deposits at 5% (time) or 0% (checking) interest (Daly, 1969). Private capital flight was endemic and the systems for allocating foreign exchange, imports, and credit clearly favored rent-seeking over productive activities.²

In 1967, a new government was forced into another IMF stabilization program. The currency was devalued sharply in 1967 and 1968 and real exports jumped. At the same time, real government spending was curtailed as inflation cut real transfers. Between 1969 and 1971 growth accelerated, owing to the combination of expansive demand policies as the fiscal deficit widened once again, and to wage and price controls which suppressed inflation. However, first the excesses of fiscal spending in the 1971 election campaign and then the collapse of the balance of payments (caused by the fixed value of the peso, the growth of contraband, and capital flight) made clear the bankruptcy of this emphasis on short-run gains at the expense of the

longer term (Finch, 1980). In January 1972, the peso once again had to be devalued sharply, but this time a crawling peg was adopted. Real product declined 3% in 1972 and recovery was slow, so that output remained below its 1972 level until 1975, despite a revival of the world market for meat. Clearly, the political turmoil and uncertainty which accompanied the take-over by the Armed Forces in early 1973 also affected the economy.

The new government adopted an economic policy along the lines of the program of the conservative wing of the Colorado party. That program's basic objectives were to (a) restore the role of the price system; (b) reduce inflation; and (c) reduce the fiscal deficit. The poor economic performance over the period of 1956 to 1974 and the external shocks suffered in the early 1970s led to a perception in the early 1970s that the economy could not continue to be managed in the future as it had been in the past. In particular, government intervention in the economy was viewed as excessive.

The 1973-1977 development plan, approved in August 1973, laid out the specific orientation of the reforms. The plan was based on the idea that Uruguay was a small economy that had been closed to the outside world. As a result of the lack of foreign competition and of the small size of the domestic market, the economy had become dominated by monopolies and oligopolies. To control these tendencies, reforms would be implemented to deregulate domestic commodity markets and to reduce protection from foreign competition. Moreover, public enterprises would be governed by efficiency criteria similar to those of the private sector to prevent them from taking advantage of their position. In sum, the plan recognized the need to diminish several aspects of the past interventionist role of the state.

Initially, little progress was made in implementing this plan. In 1974 inflation remained at nearly 8.0% p.a. and the fiscal deficit grew to 4.5% of GDP versus 1.4% in 1973. Net international reserves were negative, the jump in oil prices increased the annual import bill by nearly \$100 million, and the debt service ratio reached nearly 45%. Then, in mid-1974 the EEC closed its market

to beef imports, eliminating Uruguay's principal export market. At that point it became clear that the economy also required a substantial dose of stabilization. In July 1974, Vegh Villegas was appointed finance minister to right the situation. His economic team put together a policy package which is described below, reconciling the objectives of stabilization and diminished state intervention.

Liberalization of Financial Markets

The post-1974 liberalization of capital markets proceeded more rapidly and was ultimately more fully implemented than the liberalization of trade. Both internal and external financial markets were liberalized. Some foundations for reform had been laid previous in 1974, with the creation of a separate Central Bank in 1968 and the switch to a crawling peg in 1972. As long as the crawl was fast enough to avoid a substantial overvaluation, this measure tended to reduce the risk of major capital loss to holders of peso-denominated assets. Thus, the crawling peg helped stimulate demand for peso-denominated assets and reduce the demand for dollars. Nonetheless, legal foreign exchange transactions, especially those on the capital account, remained tightly controlled until late 1974. At that date, domestic residents were officially allowed to hold foreign exchange. Further easing of restrictions on foreign exchange transactions accompanied the improvement in the international reserves and the gradual reduction of the fiscal deficit in 1976 and 1978. In 1978, a solid international reserve position permitted the Central Bank to accept the responsibility of supporting the exchange rate without controls and to unify the trade and financial foreign exchange markets. In October 1978, the Central Bank also adopted the policy of prefixing the future value of the exchange rate in an attempt to bring down the domestic rate of inflation, while providing exporters with greater certainty, a policy discussed in more detail below.

Another liberalizing measure substantially raised the ceiling interest rates on peso loans and deposits in late 1974. Then in

1975, the elimination of the guidelines for credit allocation by sector permitted a further rise in deposit rates. Interest rate ceilings were increased substantially again in March 1976, and in September were eliminated altogether. In 1979, taxes on private commercial bank credit were eliminated and reserve requirements abolished.

In general terms, these measures were intended to achieve the benefits of financial liberalization (McKinnon, 1973). Saving rates were expected to rise as a result of the higher rates of return to savers, while credit for investment would be allocated to its most productive uses, thereby resulting in a virtuous circle of higher and more productive investment leading to greater growth. The reduction in the government deficit would reduce the need for forced loans from the Central Bank. This in turn would allow the spreads between borrowing and lending rates to be reduced by lowering reserve requirements, thereby reducing the implicit tax on financial intermediaries and leaving more resources available for private investment.

The policymakers also sought to integrate the Uruguayan financial sector with international financial markets through the establishment of free convertibility and the legalization of contracts in foreign currency. Initially, the objective was simply to use international capital to finance investment in Uruguay. It gradually became clear, however, that internationalization of the financial system substantially weakened the role of monetary policy. At this point the approach to the financial sector and the exchange rate policy became less unified. On some occasions internationalization of the financial system was viewed as an end in itself, either to ensure fiscal discipline or to permit Uruguay to reap the benefits of becoming a Panamanian-style financial center. On other occasions, the international linkages resulting from financial liberalization were viewed as allowing the exchange rate policy to slow inflation by reducing inflationary expectations through the use of a prefixed exchange rate. Although this topic is covered in greater detail later, it is worth noting some important points here.

The two approaches involve fundamentally different views regarding price determination and ultimately, the role of the

exchange rate. The first approach views prices and interest rates as determined by world conditions and the rate of devaluation, and considers interference with this process as undesirable (Gil Díaz, 1980). The second approach views inflation as higher than it "ought to be" because "sticky" domestic expectations of inflation push up prices and assumes that these expectations can be altered by varying the rate of devaluation. The first approach, however, views prices as being set competitively, based on costs including foreign exchange costs. Variations in exchange rate policy only affect prices directly via costs or competition from imports, since producers have no price-setting power. Moreover, too much unpredictable variation in exchange rates is undesirable because it can affect confidence and capital flows. In contrast, the second approach views prices as being set by local monopolists, based not only on their costs but on their expectations of what they can charge without losing market share. Thus, both approaches allow for a direct, positive influence of the rate of devaluation on the rate of inflation. Moreover, in the second approach, the monopolies can maintain a high rate of inflation behind existing tariff barriers, provided exchange rate policy passively justifies their price increases. Therefore, in the second approach exchange rate (and commercial) policy must be actively directed toward disciplining these price setters, not only directly through costs, but also by affecting their expectations through a prefixed schedule of devaluations. However, the question is never raised of what will happen to capital flows if the prefixed rate of devaluation differs sharply from expectations and the rate of inflation for some period of time. Thus, the second approach neglects the potential interaction between capital flows and expectations that is the centerpiece of the first approach.

Reforms in the Commodity Markets

To get an idea of the potential for reform in the commodity market, it is useful to summarize the extent of regulation that existed in 1974. As mentioned above, beginning in June 1968

pervasive wage and price controls were imposed on the economy. Wonsewer and Notaro (1980) report that 96% of the CPI basket was under price controls when the reforms started in 1974. Between 1968 and 1973, the proportion of agricultural products subject to price control rose from 48% to 65%. Wage controls, coupled with devaluations, resulted in falling real wages during that period.

Restrictions on foreign trade were also pervasive. Over the years, an elaborate system of import controls had developed to restrict imports. These included quantitative restrictions, tariffs on imports, and various other surcharges. Complex methods were used to establish reference prices ("aforos") which served as the basis upon which import duties were levied.³ Bension and Caumont (1981: Table II.7) estimate that in 1968, for sales on the domestic market, nominal rates of protection averaged 264% and effective rates of protection 384%. For export sales, the corresponding figures were 4% and 37%. Thus the trade regime was heavily biased against exports and towards sales in the domestic market.

The implementation of the commodity market reforms started in July 1974 with the arrival of the new economic team. In the domestic goods markets, the reforms consisted of a progressive removal of price controls. By December 1979, the proportion of agricultural products under price controls had fallen to 14%. Progress was also made in the decontrol of consumer goods prices, including rents. Thus by June 1980, only 16% of the CPI basket was under price control, excluding public utility prices. Concurrently, the share of public sector enterprises in GNP reduced by 3 percentage points, to 18.7% by 1979. Most of the decline was registered in manufacturing where the public sector share fell from 7% to 4% of GNP (Wonsewer and Notaro, 1980).

Tax reforms were also implemented. To combat tax evasion and rationalize the tax system, several reforms were implemented, starting in July 1974. The personal income tax and the inheritance tax were abolished. In 1977 a value added tax was extended to all activities at the flat rate of 18%.

Important reforms also took place in foreign trade. These reforms affected tradable producing activities as a group vis-à-vis

TABLE 2
Price-Level Deflated Exchange Rates

Year	PLD-ER a/	PPP-ER b/
1968	162	109
1969	134	95
1970	115	86
1971	138	108
1972	154	127
1973	100	89
1974	100	100
1975	91	101
1976	88	106
1977	76	99
1978	68	95
1979		75
1980		62
1981		58

a. Nominal exchange rate index deflated by the consumer price index.

b. Nominal exchange rate index times the ratio of world inflation index (from IFS) to the consumer price index.

nontradable producing activities. During the prereform period, the domestic currency was often overvalued, producing a bias against tradable activities. This bias, which increased throughout the 1960s as a result of the stop-go cycles described earlier, was reversed starting around 1972 when the crawling peg was introduced. The crawl essentially was based on differential lagged inflation and lasted until December 1978. Table 2 shows the evolution of two measures of the real exchange rate over the period from 1968 to 1981. Both of these measures exclude the effects of direct incentives to exports discussed below. The price-level-deflated exchange rate (PLD-ER) shows that except between 1970 and 1972, domestic inflation always exceeded the rate of devaluation. When one takes into account world inflation, however, there was little variation in the real exchange rate (PPP-

ER) between 1974 and 1978. The period from 1968 to 1974 displays about the same average real exchange rate but with much greater variation. By contrast, the period from 1979 to 1981 displays a steady fall in the real exchange rate for reasons associated with the stabilization program, as discussed later.

The reforms also affected the relative incentives to exporting versus import competing activities. For traditional exports (meat, unprocessed wool, and raw hides) export taxes were progressively lowered, from 21% of export value in 1973 to 2% by 1976 (Bension and Caumont, 1981: Table 11.5). For nontraditional exports, incentives were provided in the form of financial and fiscal subsidies (tax reimbursements or "reintegros"). The financial subsidies included prepayment of export receipts by the Central Bank. Tax reimbursements were used to compensate exporters for the bias against exporting that resulted from the high levels of protection mentioned earlier. These included, among others, tariff exemptions on imported materials that were used in exports and exemptions from the 25% value added tax. On average, the tax rebates amounted to about 15% of the value of exports. These rebates were always viewed as temporary and were to be progressively removed as import restrictions were eased.⁴

The removal of restrictions on imports started gradually with abolition of import quotas in 1975. Controls on imports of capital goods, which had been prohibited since 1971, were relaxed. Starting in 1974, restrictions on the maximum value allowed for capital goods imports were raised until all such restrictions were abolished in 1977.

In December 1978, the government announced a framework for gradually consolidating all import surcharges, taxes, and tariffs into a uniform rate of 35% to be reached in equal arithmetic cuts by 1985. But, because of an inflation surge in 1979, the government announced additional, selective cuts covering some 500 items. The maximum surcharge on imports was also reduced as part of the effort to control inflation by reducing excess protection.

TABLE 3
Macroeconomic Indicators

	1967-74	1975-81
GDP Growth p.a. <u>a/</u>	1.4	3.8
Exports/GDP <u>a/</u>	14.0	19.0
Non-traditional/Traditional Exports (%) <u>b/</u>	40.0	153.0
Imports/GDP <u>a/</u>	16.0	23.0
Investment/GDP <u>a/</u>	10.0	16.0
Foreign Saving/GDP <u>c/</u>	0.9 <u>d/</u>	4.6
Incremental Output Capital Ratio <u>e/</u>	.18	.25
Inflation p.a.	58.0	56.0
Fiscal Deficit/GDP <u>c/</u>	2.7	1.4
Nation-wide Real Wage Index (1968=100) <u>f/</u>	93.5 (1974)	65.0 (1981)
Employment Growth in Manufacturing p.a. <u>g/</u>	0.8	1.1

SOURCES: BCU (1979-1982).

DGEC (Direccion General de Estadistica y Censos). In 1968, 197,400 persons were employed in manufacturing. Population growth is estimated at less than 1% p.a. in both periods.

- a. Real.
- b. Traditional exports include: metal, textile, products, hides and skins, grains, oilseeds and oils.
- c. Nominal.
- d. Mainly reflects a 4.4% figure in 1974.
- e. Calculated as the change in real output between 1967-74 (1974-81), divided by the total real investment between 1967-73 (1974-80).

The Record: 1975-1981

We begin our evaluation of the Uruguayan reforms by taking a look at the record, then go on to examine the role of trade reforms and critically review the stabilization program that started in December 1978.

During the period from 1974 to 1981 real output expanded by 30%, an average rate of 3.8% p.a. As shown in Table 3, this performance compares favorably with the 1.6% p.a. average growth during the period from 1967 to 1974. Other macroindicators, aside from falling real wages and nearly constant average inflation, also showed signs of improvement. Building upon a substantially increased inflow of foreign capital, the average real

rate of investment increased substantially. The domestic rate of savings also rose 25% compared to the 1967-1974 period. The domestic financial sector expanded rapidly, with real money plus quasi-money doubling between the end of 1974 and the end of 1981, an 11% annual growth rate. The *ex post*, incremental output-capital ratio—a rough measure of investment efficiency—rose nearly 40%.

These aggregate results support McKinnon's hypotheses regarding the beneficial effects of financial liberalization on the volume and efficiency of investment. Moreover, the improvement in the output-capital ratio occurred despite the sharp rise in private apartment construction which marked the building boom from 1978 to 1980. However, the improvement in efficiency probably reflected not only the improved allocation of credit but also (a) the improved utilization of capacity; (b) the rapid growth in less capital intensive industries, which benefited from the goods and financial market reforms, and (c) the easing of restrictions on capital goods imports.

Analyzing the period in more detail, we note that aggregate output expanded at an increasing rate in 1975 despite the problems of 1974, the signing of still another IMF stabilization program, and a sharp fall in the terms of trade caused by declining meat prices and continued high oil prices. A large inflow of capital—the result of the stabilization program, the financial liberalization, and the uncertain situation of Argentina—permitted a large fiscal deficit (4.9% of GDP), a doubling of public investment, and a 20% rise in private investment. Nontraditional exports were stimulated by the combination of a favorable exchange rate and increased export incentives. The resulting increase in international reserves soon permitted Uruguay to dispense with the IMF's program. Although inflation remained high in 1975, to some extent this reflected the deregulation of controlled prices.

For the next couple of years growth continued, based on export expansion and continued growth in investment. The government exerted a contractionary impact on aggregate demand during this period as it gradually closed its fiscal deficit,

attaining a current account surplus in 1977 and an overall surplus in 1979 (World Bank, 1981).⁵ This approach to fiscal policy was undertaken with the objective of slowing inflation by eliminating the domestic source of monetary emission. Monetary aggregates, however, continued to grow much faster than in the period between 1967 and 1974 owing to increasing international reserves. Inflation seemed stuck at roughly 50% p.a., after a drop from the 80% p.a. range of 1974 and 1975.

The peak growth years of the 1974-1982 period were 1979 and 1980 (6.2% and 5.8% respectively). In addition, the unemployment rate, which had remained at relatively high levels, fell and real wages rose slightly. Inflation increased, however, to an average rate of 65% p.a. in two years. The boom had its origins in the increasing overvaluation of the Argentine peso. Its principal manifestation was the rise in private construction, which nearly doubled in real terms between 1978 and 1980, directly accounting for 25% of the growth in expenditures in real GDP. Much of this construction was either for Argentines or financed by Argentines. As long as it lasted, the Argentine exchange rate policy also benefited Uruguayan exports to Argentina—the growth in these exports accounted for 60% of the rise in the dollar value of exports in 1979—and the tourist and service industries. In 1980 problems began to develop, however. Exports to Argentina slowed and limits were placed on tourist purchases in Argentina's boundary countries. Furthermore, an increasingly overvalued Uruguayan peso and a reduction in direct export incentives led to stagnating exports.⁶ Thus only construction and services, reflecting the banking and import booms, remained as engines of growth in 1980.

Worsening external conditions, combined with the anti-inflationary policy, produced a decline in output of about 1.3% in 1981 and a sharp contraction in 1982. Further increases in local prices relative to the exchange rate continued to dampen export growth. At the same time, the sharp rise in world interest rates increased the weight of Uruguay's debt service by about .5% of GDP and, together with the slowdown in international lending, raised real interest rates locally. In addition, the deterioration of the

Argentine economy resulted in successive massive devaluations of the Argentinian peso starting in March 1981; further reducing this source of aggregate demand. At this juncture, expectations developed that the current account deficit was unsustainable and that a devaluation would be necessary to improve the trade balance, which further pushed up the real interest rate. Despite a large increase in social security payments in 1982 that resulted in a fiscal deficit of over 10% of GDP in 1982, output fell by about 6%. Moreover, this fiscal deficit added further doubts about the viability of the anti-inflation program. Faced with a large current account deficit and prospects of a growing fiscal deficit, but unable to continue its 25% p.a. expansion in foreign debt because of world market conditions and foreign banks' limits on country exposure, Uruguay reached a crisis. In November 1982, the authorities floated the peso, thereby ending the anti-inflationary program based on the preannouncement of the exchange rate.

Foreign Trade Reforms and Competitiveness

Aside from deregulation of domestic prices, the main reforms in commodity markets were related to foreign trade. It is evident from Table 3 that these reforms resulted in an opening of the Uruguayan economy to foreign trade: on average, export as a share of GDP increased by 5 percentage points during the period from 1974 to 1981 from their average level of 14% from 1967 to 1974. What is more remarkable, however, is that between the two periods, the average ratios of nontraditional exports to traditional exports rose from 40% to 153%. It should be noted, however, that Uruguay still has a low export : GDP ratio compared to countries of similar size.

There are several reasons for this turnaround. They include the policy of the crawling peg that reduced uncertainty for exporters and prevented drastic swings in the profitability of producing competing tradables. Thus an important element in the improved export performance was the maintenance of a fairly constant value of the real exchange rate (see Table 2). Another reason is the

impact of the trade reforms on incentives, which can be partly judged by comparing incentives for sales in domestic and foreign markets. Bension and Caumont (1981: Table II.6) show that the net taxation on nontraditional and traditional exports was substantially reduced starting around 1973 to 1974. Export tax collections as a percentage of export sales declined to near zero from ranges over 20%, while export subsidies increased from negligible figures in the late 1960s to reach an average rate of 59% of export sales by 1976. Thus the reforms in the foreign trade sector shifted relative prices away from import competing activities and toward exporting activities. The exact extent of this shift is hard to appraise because in some cases adjustments in reference prices continued to provide substantial protection despite the cuts in nominal tariffs. The combination of incentives described above and the stable crawling peg, however, seem to have reduced the bias against exporting which prevailed during the 1968-1972 period.⁷

More detailed information on the impact of the trade reforms is available over the 1975-1980 period for a sample of 15 industries covering approximately two-thirds of total exports. Table 4 reports the detailed computation of incentives for the group of export industries. The first three columns give the components of the real effective exchange rate for supplying on the export market, expressed in terms of the manufacturing wholesale price index (column 4). The index shows that until 1979, incentives to sell in the export market were maintained. However, beginning in 1979, the index starts falling rapidly, reflecting rising earnings from selling in the domestic market. The annual export growth figures (column 7) are consistent with this depreciating real effective exchange rate. Starting in 1979, exports gradually became less profitable and ceased to be a leading factor in growth. Likewise, the growth performance for export manufacturing industries deteriorated vis-à-vis import-competing industries.

Furthermore, tradable-producing activities as a group experienced strong cost increases and a profit squeeze. In spite of rising dollar prices (column 1) and the combination of devaluation and

TABLE 4
Incentives to Export-Oriented Industries and Growth

Year	Dollar Price Index <u>b/</u>	Nominal Effective Exchange Rate <u>c/</u>	Wholesale Price Index	Real Effective Exchange Rate <u>d/</u>	Composite Cost Index <u>e/</u>	Cost-Based Real Effective Exchange Rate <u>f/</u>	Annual Growth Rates		
							Exports for Sample Industries (%)	Gross Output: Exportable Manufactures (%)	Gross-Output: Import Competing Industries (%)
Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1975	100	100	100	100	100	100.0	---	---	---
1976	103	149	150	102	179	85.5	79.0	10.0	0.0
1977	119	207	226	109	301	81.7	21.2	4.0	13.0
1978	139	260	336	197	480	75.2	22.1	3.0	6.2
1979	164	331	607	89	654	56.9	3.4	-1.0	19.2
1980	173	385	860	77	1111	59.9	8.0	3.3	4.2

SOURCE: World Bank (1982: Tables 1.14-1.20). Aggregation of a sample of 15 industries covering approximately two-thirds of total exports.

b. Weighted index of international prices for Uruguayan exports.

c. Nominal peso/U.S. average annual exchange rate adjusted for reintegros.

d. Column (1) × Column (2) ÷ Column (3).

e. The composite cost index includes: labor costs, financial costs, raw materials and non-traded inputs.

f. Column (1) × Column (2) ÷ Column (5).

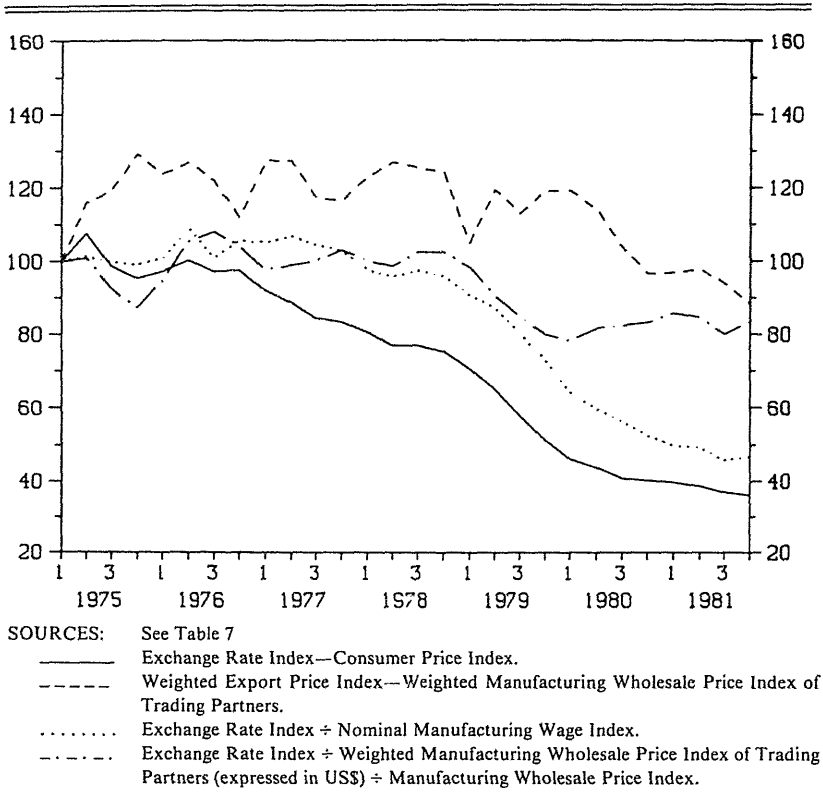


Figure 1 Measures of Competitiveness [1975 (1) = 100]

subsidies which insured a rising nominal effective exchange rate (column 2), the cost-based real effective exchange rate (column 6) fell drastically because of increased costs. Thus, tradable-producing activities as a group were losing competitiveness. Between 50% and 90% of total costs were accounted for by outlays for labor services, financial overhead, and raw materials—all of which outpaced the rise in tradables prices. The increase in financial costs towards the end of the period is further discussed below.

The deteriorating situation facing tradables in general, and exportables in particular, is also indicated by the evolution of several measures of competitiveness shown in Figure 1.⁸ The

general decline in the profitability of tradable activities vis-à-vis nontradable activities after 1978 is indicated by three indices of the real exchange rate: the nominal exchange rate deflated by the nominal manufacturing wage, the nominal exchange rate deflated by the consumer price index, and the nominal exchange rate times the wholesale price index of trading partners divided by the manufacturing wholesale price index. Finally, there was also a decline in the terms of trade between exportables and importables, measured by a weighted export price index divided by the trade-weighted wholesale price index of manufactures, both expressed in U.S. dollars. These declines, and the resulting stagnation of exports, reflect to some degree external factors beyond the control of the government, in particular the economic cycles in Argentina. As described below, however, to a large degree they also reflect the exchange rate policy which was the centerpiece of the stabilization program that started in December 1978.

The Stabilization Program: 1979-1982

One of the most interesting aspects of the Uruguayan experience is the different ways monetary and exchange rate policy were used in an attempt to control inflation. Roughly speaking, between 1974 and 1978 the authorities followed an orthodox approach to fighting inflation in a closed economy. Control of the rate of monetary emission was viewed as the principal anti-inflation weapon. Yet, despite a sharp drop in the principal source of domestic emission—the ratio of the fiscal deficit to GDP was reduced from 4.4% in 1974 to 1.2% in 1977 and in 1978—inflation had fallen to only 45% in 1978. Although the domestic sources of monetary expansion had been curtailed, international reserves flowed into the country and continued to increase the money stock at a rapid rate. The final straw came in 1978 when the Central Bank attempted an open market operation to reduce the money supply and international reserves rose to offset it, with no perceptible effect on inflation.

TABLE 5
Monetary Base Money and Financial Sector Deposits
 (Million \$Nu)

	Monetary Base	International Reserves a/	Domestic Credit	M1	M2
1972	170.3	35.5	134.8	189.6	272.9
1973	314.5	78.2	236.2	331.5	481.7
1974	447.3	-36.4	483.7	540.8	815.0
1975	726.0	80.7	645.3	822.1	1,331.1
1976	1,302.0	428.6	873.8	1,328.7	2,245.4
1977	1,831.9	1,837.3	-5.4	1,857.1	3,196.5
1978	3,211.3	4,276.6	-1,065.3	3,065.0	6,283.6
1979	5,468.2	5,792.5	-324.3	5,796.7	12,857.3
1980	7,873.2	8,058.1	-184.9	8,691.2	23,547.1
1981	8,221.0	9,723.0	-1,502.0	9,705.6	29,960.3

SOURCE: BCU (1982a).

a. Reserves valued in local currency at the end of the year.

Based on this experience, the Uruguayan monetary authorities switched from the orthodox view, in which tighter monetary policy could slow inflation by raising interest rates and reducing demand for goods, to a view in which monetary policy was ineffective in fighting inflation because of the openness of the economy. In particular, it was believed that domestic interest rates were independent of local monetary policy, closely following world interest rates adjusted for devaluation because the removal of controls on capital flows had integrated the domestic and world capital markets. As a result, any attempt to decrease (or increase) local money emission would simply produce an offsetting increase (or decrease) in capital flows and international reserves at the given world interest rate, thereby maintaining aggregate demand and monetary growth while leaving inflation unaffected (Frenkel and Johnson, 1976). This view is consistent with the figures in Table 5 and with the tendency toward offsetting variations in domestic credit and reserves shown in Figure 2. This view was also roughly confirmed by later econometric analysis of the period between 1968 and 1979, where it was estimated that about 75% of a one-shot increase in domestic credit would leak out in a loss of international reserves within one semester. The same estimates show prices would rise by only 20% to 25% of the proportionate increase in domestic credit, and output would not be affected significantly.⁹

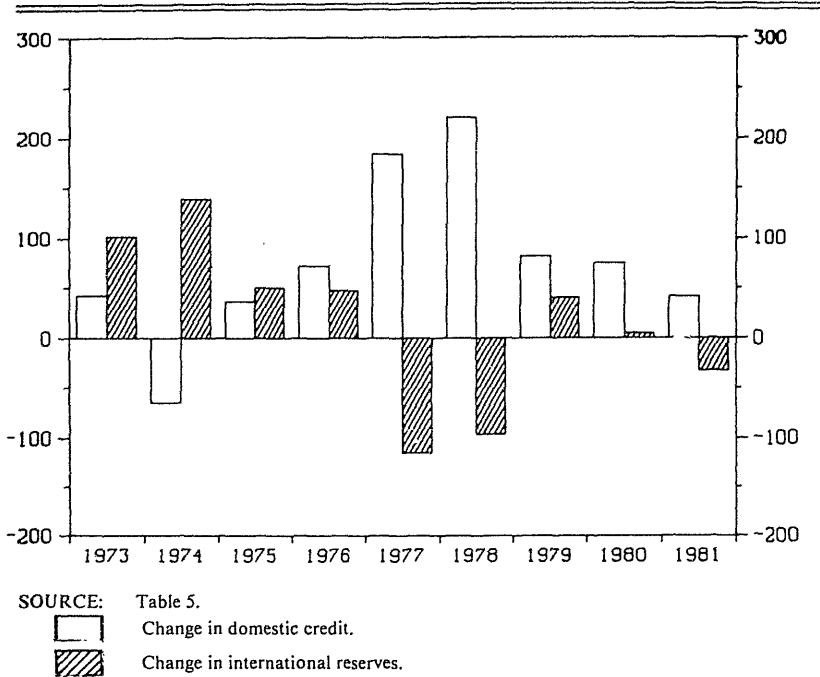


Figure 2 Sources of Change in Money Base (millions Nu\$ 1975 prices)

What determined inflation then, if it was not domestic monetary emission? In the authorities' new view, businessmen were taking advantage of the incomplete liberalization of goods markets to jack-up their prices, based on expectations of devaluation. Since businessmen knew that devaluations were being made with an eye to maintaining competitiveness of local industries in the world market, they felt that their price increases would effectively be validated by the exchange rate policy. For the authorities, the remedy was clear: put a ceiling on what businessmen could expect to get by preannouncing a declining rate of devaluation (a slower crawl).

In the authorities' view, this policy would lower inflation because rapid arbitrage in tradables would keep inflation in their prices in line with world inflation plus the declining crawl. More important, provided that domestic expenditures were kept in line

with output through slow domestic credit creation, potential substitution towards tradables would restrain price increases of nontradables and of goods with excess protection.¹⁰ Although it was expected that the preannouncement policy would produce a temporary current account deficit, the authorities thought that the close adjustment of domestic credit creation to the target inflation rate would soon eliminate any problems in that area. Moreover, the approach theoretically implied that no sacrifice in output was necessary to reduce inflation, since price increases were largely the result of overly optimistic expectations that could be corrected by a clear signal of the authorities' intentions. Finally, the policy would have the additional benefit of reducing the cost of borrowing in local currency because of both a slower rate of devaluation and a decrease in risk. Accordingly, in October 1978 the government began announcing a schedule of monthly devaluations of the peso against the dollar six to nine months in advance, with the understanding that the policy would be maintained during the period of implementation of the reduction in the tariff schedule.¹¹

The stabilization program was viewed as working hand-in-hand with the concurrent liberalization in the goods market, which was intended to make exporting activities more profitable than import-substituting activities. Not only was the price of exportables to rise vis-à-vis that of importables because of the reduction in tariff schedules, but it was also expected to rise vis-à-vis with the price of nontradables. Nontradables, on the other hand, would rise relative to importables.¹² Finally, prefixing of the exchange rate would help exporters by reducing risk. Perhaps more important in the authorities' viewpoint, it would be a step in the direction of a fixed exchange rate, which was necessary if Uruguay were to become a financial center.

How did the stabilization program work? Table 6 shows the behavior of prices and exchange rates for various periods before and during the preannouncement of the exchange rate. Domestic inflation exceeded the rate of devaluation adjusted for international inflation throughout the period, although the gap between

the two did narrow as time went by. In the first twelve months of the policy, however, local inflation actually rose. Thus the stabilization program did not fulfill its intended objective of rapidly bringing down the rate of inflation.

The desired fall in the rate of inflation depended crucially on a number of assumptions that did not appear to hold at the time in Uruguay. First, local prices of tradables continued to rise fairly rapidly despite the slowdown in devaluation, owing to the lack of distribution channels for imports and the continuance of high protection for some goods. Second and more important, the increasingly overvalued Argentine peso (compare Columns 2 and 5 of Table 7) created an increase in demand during 1979 and especially in 1980. As a result, expenditures were increasing more rapidly than income in Uruguay, which put upward pressure on prices, especially in the nontradable sectors of the economy. Finally, as shown in Figure 3, the real interest rate fell at the inception of the preannouncement policy. The fall in the interest rate was due to three factors: a tendency towards convergence with world interest rates; removal of domestic reserve requirements; and a rise in the price of nontradable goods. This fall contributed to a speculative bubble in construction that was further inflated by the easing of rent controls. These speculative tendencies drove up wages and prices in construction, thereby adding to the existing inflationary pressures.

The increased rate of inflation, combined with the slowdown in the rate of devaluation, produced a loss of competitiveness as shown in Table 7, columns 7 and 8. Furthermore, as indicated in column 6, wages started rising faster than the exchange rate, adding further downward pressure on the real exchange rate. The loss in competitiveness resulted in an increasing current account deficit, which was exacerbated by the massive Argentine devaluations of 1981 and the pursuit of the Uruguayan stabilization program.

TABLE 6
Behavior of Prices Before and During the Stabilization Program^a

	Previous 12 months	Previous 3 months	First 3 months	First 6 months	First 12 months	First 18 months	First 24 months
Wholesale Prices <u>b/</u> of Trading Partners	17.5	22.5	18.3	17.5	16.8	14.7	14.4
Exchange Rate <u>b/</u> (Financial)	26.0	27.1	26.0	24.0	18.0	15.8	16.2
Wholesale Prices <u>c/</u>	46.7	65.8	69.1	77.0	57.1	40.8	35.0
Consumer Prices <u>c/</u>	37.9	46.1	61.0	64.2	60.5	47.9	40.1

SOURCES: a. Annualized logarithmic.
b. Computation by authors—see notes, Table 7.
c. BCU (1977-1980).

TABLE 7
Exchange Rates, Prices, and Interest Rates During the Stabilization Program

Year	Rate of Devaluation	Consumer Price Index	Wholesale Price Index	Wholesale Price Index of Trading Partners	Argentine CPI corrected for Exchange Rate Change	Exchange Rate Age Index	Real Exchange Rate (I)	Real Exchange Rate (II)	Nonlial Lending Interest Rate	Real Deposit Interest Rate (Ex-post)
Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1977-1	31.5	49.9	49.4	77.4	32.9	109.9	122.5	95.7	44.0	-19.0
1977-2	39.6	56.0	51.2	78.1	37.3	111.5	117.8	96.7	49.2	-15.0
1977-3	21.3	63.8	58.5	80.3	45.3	110.5	113.6	99.4	49.9	0.9
1977-4	16.3	70.0	64.6	83.9	48.6	106.2	109.5	99.6	58.8	4.0
1978-1	44.0	73.8	69.7	86.1	54.0	98.8	103.9	94.8	67.2	1.0
1978-2	41.0	82.1	78.1	89.3	67.8	100.3	102.4	96.6	63.2	-2.0
1978-3	27.9	90.5	87.7	94.9	83.7	102.1	102.7	100.6	62.0	-7.0
1978-4	28.1	100.0	100.0	100.0	100.0	100.0	100.0	100.0	51.2	-14.0
1979-1	24.1	114.0	115.9	104.4	120.1	93.4	93.3	95.8	51.3	-22.0
1979-2	16.5	130.8	139.0	108.8	141.7	90.6	85.8	87.9	47.7	-27.0
1979-3	11.4	153.5	166.1	116.8	169.0	82.9	76.1	82.1	47.2	-21.0
1979-4	12.5	179.5	184.3	118.2	187.8	75.1	66.8	77.0	49.4	-4.0
1980-1	16.0	204.0	193.0	118.2	211.0	65.0	60.2	75.2	49.0	0.0
1980-2	22.5	222.7	203.3	125.5	243.9	55.8	57.3	78.8	51.2	5.0
1980-3	23.1	249.4	223.3	131.6	281.1	58.7	54.0	80.6	50.2	15.0
1980-4	17.8	268.6	238.4	135.8	338.1	54.2	52.9	80.9	49.1	18.0
1981-1	14.7	286.1	267.4	138.7	360.3	49.3	52.1	82.9	49.6	10.0
1981-2	15.4	303.3	254.0	135.8	226.8	50.3	50.2	81.1	47.5	8.0
1981-3	15.4	330.0	275.1	133.6	236.8	46.6	48.1	77.0	46.5	25.0
1981-4	16.0	349.1	282.5	138.7	240.5	48.2	47.1	80.7	45.9	35.0
1982-1	19.5	355.6	279.4		198.5	44.8	47.9		42.3	21.0
1982-2	22.6	365.3	286.4		173.7	46.6	48.5		44.7	21.0
1982-3		384.5	304.5			52.1	48.9		49.6	

SOURCES:

Columns (1)-(3) BCU (1978-1982).

Column (4): Trade weighted Divisia index of major trading partners: Argentina, Brazil, U.S., U.K., Germany, Italy, Japan, Netherlands.

Column (5): IFS (International Finance Statistics): Index expressed in Uruguayan pesos.

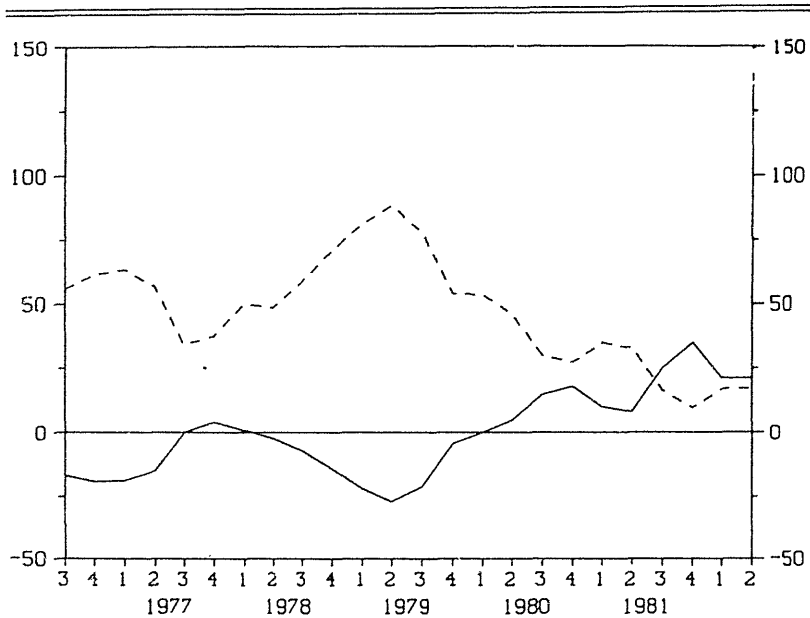
Column (6): BCU (1978-1982).

Column (7): Exchange rate index (1978 - 4 = 100) × Column (4) ÷ Column (2)

Column (8): Exchange rate index (1978 - 4 = 100) × Column (4) ÷ Column (3).

Column (9): BCU (1978-1982).

Column (10): (100 + Column 9) ÷ (100 + Column 9) ÷ (100 = Inflation in Consumer Price Index, 6 months forward).



SOURCE: Table 7.
 — Real Deposit Interest Rate (ex-post).
 - - - - Percentage Change in Consumer Price Index (6 months forward).

Figure 3 Inflation and Real Interest Rates on Deposits (annual rate 1-6 month deposits)

The deteriorating current account had an effect on the domestic financial market through its effect on expectations. As explained above, it was expected that with the removal of restrictions to capital movements, domestic interest rates would follow closely the cost of borrowing in world capital markets. Yet, Figure 4 consistently shows a positive spread between interest rates paid on peso-denominated deposits and dollar-denominated deposits in the banking system. It also is clear that the spread between the peso rate and the dollar rate that was corrected for the preannounced rate of devaluation increased sharply starting around 1980. This spread supports the argument that expectations about the future rate of inflation remained above those consistent with the preannouncement policy. As doubts about the preannouncement policy increased, depositors switched out of

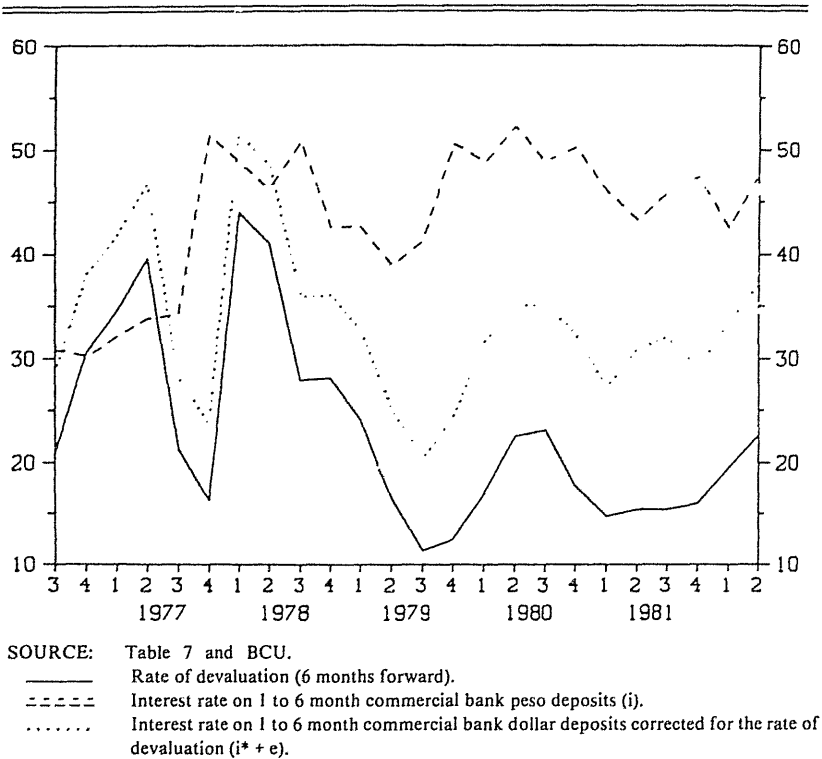


Figure 4 Devaluation and Interest Rates on Peso and Dollar Deposits (annual rates)

domestic currency into dollar deposits. At the same time, debtors sought peso-denominated loans while commercial banks tried to reduce their foreign exchange exposure sharply. The net result was the increase in the spread shown in figure 4. As mentioned in the Reforms in the Commodity Markets section, firms' financial costs rose sharply, leading to bankruptcies and a deep recession.

To summarize, the start of Uruguay's anti-inflationary program coincided with the boom caused by the overvalued Argentine peso. The slowdown in Uruguay's devaluation produced an initial loss in competitiveness, except vis-à-vis Argentina, and a deterioration in the current account. The loss in competitiveness was exacerbated by a declining real interest rate, induced by

continued high inflation and the abolition of reserve requirements in the banking system. The declining real interest rates generated a speculative demand for new construction—which bid up wage costs, further lowering the profitability of exports. Later on, the combination of rising world interest rates and drastic devaluations in Argentina led to an additional deterioration of the current account and ended capital flows from Argentina. At the same time, a sharp increase in transfer payments led to a rising fiscal deficit. Doubts about the schedule of devaluations set in, capital flight developed, and *ex post* real interest rates in pesos started to rise sharply. The rising financial costs contributed further to the profit squeeze induced by the stabilization program (leading the economy into recession), pressure for bailouts, and eventually to the demise of the anti-inflationary program with the devaluation of November 1982.

Conclusion

The Uruguayan program of liberalization cum stabilization resulted in a sharp improvement over the economy's dismal historic trends. The performance was especially impressive in light of the poor initial conditions. Uruguay was the only importer to increase its average growth rate substantially following the oil price shocks. Although reforms in foreign trade proceeded less rapidly than reforms in the financial market, exports were an important engine of growth as long as the real effective exchange rate was maintained. In contrast to trade reforms, financial liberalization proceeded quite far and led to higher domestic savings, increased holdings of real financial assets, sharply increased capital inflows, and improved aggregate efficiency of investment. Finally, the economy benefited from increased aggregate demand associated with the overvaluation of the Argentine peso in 1979 and 1980.

Difficulties began to arise in 1980 in connection with the implementation of the anti-inflationary program that started in October 1978. Based on the preannouncement of the exchange rate, the stabilization program was intended to reduce inflation from its average level of 45% p.a. in 1978—an ambitious goal considering that Argentina had an inflation rate of 175%. Moreover, Argentina's policy of increasing overvaluation produced an inflow of Argentine capital and tourists which exerted inflationary pressure on the Uruguayan economy. Together with the ending of Uruguay's rent control and capital market liberalization, this produced a speculative bubble in construction, spurred by what appeared to be negative real interest rates. The bubble burst when Argentina began devaluing massively in early 1981.

As long as Argentina was pursuing a policy of overvaluation, the Uruguayan policy of slowing the rate of crawl dampened inflationary pressures. However, when Argentina embarked on a series of massive devaluations, Uruguay continued its slow rate of crawl, thereby aggravating the recession. At the same time, a large fiscal deficit developed because of a massive increase in transfer payments. Loss of international reserves was avoided only by increasing foreign debt at an unsustainable rate. The result was a gradual loss of confidence in the schedule of preannounced devaluation, which eventually led to the demise of the stabilization plan and put in jeopardy the liberalization reforms.

Uruguay's experience offers some general lessons for liberalization and stabilization programs. First, financial sector liberalization seems to offer substantial benefits, provided that the real exchange rate and the current account are not allowed to deteriorate too much. If the exchange rate does become overvalued, however, then the openness of financial markets will lead to heavy pressure on international reserves through private capital flight. The ensuing lack of real credit in local currency will manifest itself in either credit rationing or high real interest rates. When public external indebtedness can no longer be used to offset private capital flight, a massive devaluation will be necessary.

Second, stabilization in an economy with a long history of high inflation is a difficult and slow process. In particular, the evidence from Uruguay, and from the Southern Cone in general, suggests that a preannounced exchange rate policy has only a small effect on inflation, and does not avoid the output-inflation trade-off. In particular, this policy is likely to produce a recession through an overvalued exchange rate and high real interest rates. Furthermore, such a policy runs counter to the goal of increased exports, which is the centerpiece of liberalization programs.

NOTES

1. It is worth mentioning here that Uruguayan output statistics suffer from two defects: (a) an underestimate of agricultural output and exports, when increased taxes on the rural sector stimulate contraband, for example, in 1972; and (b) an overestimate of the contribution of industry to GDP, because of the initial inclusion of import substitutes at their protection-inflated domestic values rather than at world prices, for example, between 1951 and 1956.

2. Krueger (1974) provides a theoretical analysis of rent-seeking.

3. For example, around 1968, Bension and Caumont (1981) report "exchange surcharges" ranging up to 225%, and a tariff with five components—general duty plus variable levy plus specific taxes plus port fees totalling 13% to 19% of c.i.f. value plus consular fees amounting to 12% of f.o.b. value.

4. For further description, see Bension and Caumont (1981, especially Table 11.6) and Mezera (1980).

5. Government financing of the deficit through monetary emission also fell as a percentage of the GDP, though not so sharply.

6. The only exception was wool exports, which benefited from a world price rise.

7. The bias against export, however, is understood since taxes on imports include only import duties, while there were many other surcharges also in effect.

8. These indexes do not include export subsidies, import duties, and other surcharges.

9. There are, however, many possible explanations for these results. For example, the policy regime may have increased protection along with domestic credit, or the rise in domestic credit could have fallen mainly on nontradables.

10. Under the (plausible) assumption that tradables and nontradables are gross substitutes.

11. For a short period, the government also preannounced increases in prices of public enterprises and in wages to decrease risk further.

12. Again, under the assumption that tradables and nontradables are gross substitutes.

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James Hanson is an economist with the Industry Division of the World Bank. A former professor of economics at Brown University, he has been Visiting Professor at Georgetown University and at the Universidad de la República del Uruguay. His publications include Short-Term Macroeconomic Policy in Latin America (Ballinger, 1979), coedited with Jere Behrman.

Jaime de Melo is an economist with the Development Research Department at the World Bank. He is coauthor of General Equilibrium Models for Development Policy (Cambridge University Press, 1982) and Professorial Lecturer at Georgetown University. He is codirecting, with Professor Vittorio Corbo, a World Bank research project on the recent liberalization and stabilization experiences in the Southern Cone.

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