Crisis in Uruguay
A snapshot of the country’s international finance policies over the last decade

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Executive Summary:

Nearly a decade after it transitioned from a military regime to a democracy in 1985, Uruguay’s economy appeared to stabilize with regard to GDP, exchange rates, and other key financial indicators. However, over the past ten years, Uruguay suffered severe external shocks to its economy which led to drastic monetary and fiscal changes. These jolts were mostly unavoidable because of Uruguay’s size and geopolitical role.

Uruguay is a small country about a little over three million citizens with one of the highest GDP’s per capita in Latin America ($12,600)\(^1\). Despite this wealth, Uruguay is incredibly dependent on its next door neighbors Brazil and Argentina. With respective GDPs of nearly 50 and 12 times that of Uruguay, the economic size and location of both of these countries enable them to have a strong influence over Uruguay. Therefore, any Uruguayan policy must be taken in the context of its true effect compared to the effect of policies of the neighboring countries.

Consequently, we will look at Uruguay’s economic base and analyze and evaluate its recent fiscal and monetary policies. Some of the fiscal and monetary policies we recommend are not markedly different from the government’s current stated intentions, which are meant to control inflation and stabilize growth; however, we draw attention to potential pitfalls that should influence how the government implements these policies and evaluates their results.

We also provide recommendations that address other problems facing Uruguay’s finances, especially its onerous external debt burden and its heavily limited economic base. Our contributions relate these topics to the demand and asset curves and their role in the finance model as it relates to Uruguay’s recent experiences.

Crisis:

Argentina’s Role

Through the latter half of the 1990s and until the end of 2001, the Uruguayan economy appeared to be stable. GDP held steady, fluctuating at about a $1 billion change each year between 1996 and 2001. (see exhibit 1) As a result of this economic stability the general population appeared to be fairly well off. Private consumption in the country increased between 1995 and 1997 and held steady until 2001 (see exhibit 2). This in turn led to a current account deficit due to the increasing amounts of goods the country was importing (see exhibit 3). In addition, the Uruguayan peso experienced slow growth with respect to the dollar, for an average annual inflation rate between 1995 and 2001 of 13.3% with respect to the dollar\(^2\).

However, this fortune quickly reversed in late 2001 as Argentina was hit by a currency crisis that had ripple affects throughout the region. Prior to this crisis, Uruguay had benefited from trade with Argentina. It was Uruguay’s second largest destination for exports and its largest sender of imports. (see exhibit 4)


In December 2001 when confidence in the Argentine peso ebbed, Uruguay was hit hard. When the crisis struck, Argentine banks froze accounts which led many Argentines to withdraw the large amounts of money they had in Uruguayan banks. This in turn led to a drain in assets and foreign capital from Uruguay. Additionally, because of its close ties to Argentina, Uruguay also suffered a major decline in production. Argentina had been Uruguay’s second largest export destination, but when the crisis hit, Uruguay’s exports to Argentina dropped by 10% between 2001 and 2002. (See exhibit 4) This loss of capital made fruitful investment in Uruguay much tougher which was reflected by significant drops in both private and government consumption 2001 and 2002 (see exhibits 2 and 5). At this point, the smoldering ruin of Uruguay’s financial landscape featured more than 100% interest rates and more than 50% inflation. (see exhibit 6)

**Fiscal and Monetary effects**

In analyzing the effects of the Argentine crisis, it seems that much of the impact can be explained using the AA-DD international finance policy model. As the shocks of this economic disaster spread to Uruguay, between 2001 and 2002, the combination of the decrease in exports, purchases and investment appears to have led to lowered aggregate demand and a 10% drop in GDP growth (See exhibit 1). This caused the aggregate demand (DD) curve to shift inward. At the same time, due to the loss of capital and the withdrawal of money from abroad, overall assets fell sharply. (see exhibit 7) This led to a slight contraction in the money supply, which shifted the AA curve inward, and resulted in a drop in overall domestic investments. (see exhibit 8) These inward shifts of the AA and DD curves not only caused output to drop by about $3 billion, they also led to a sharp increase in the spot rate of the Uruguayan peso (i.e. the peso depreciated against foreign currency). (See exhibit 9).

As a result of this decline in production at home and the rise in the spot rate, the country experienced a downturn in imported goods because they became more expensive for Uruguayans to buy. This in turn boosted Uruguayan exports which were cheaper for other countries to purchase. Immediately after the crisis started, the rise in exports was small compared with the large drop in imports, as Uruguayans curtailed their consumption of luxuries. Thus, while the DD curve shifted in and production decreased, exports increased. (see exhibit 10) As exports outnumbered imports following the crisis, the current account moved from a deficit to a surplus. (see exhibit 3) Thus, Uruguay had gone from a relatively rich country with plentiful imports to a country that could not afford to import as much and relied on exportation for sustainability. Unfortunately for Uruguay, its major exports are non-industrialized goods with little added value on world markets, because Uruguayan heavy industry is so scant.

**Recovery:**

**Monetary Changes:**

In an attempt to reverse the negative effects of Argentina’s declining peso, the Uruguayan Central Bank worked to stabilize its own currency and increase its GDP. In 2003, it increased the money supply by about 35% (see exhibit 9) in hopes that it would shift the AA curve outward and spur output. This effort to increase GDP by the Central Bank was helped by a rise in net exports which shifted out the DD curve. These changes had some positive effects as GDP increased in 2003 and 2004, and while output still remains slightly below pre-crisis levels, this growth can be seen as a sign of recovery. (see exhibits 1 and 11) Additionally, as a result of the outward shifts in both the AA and DD curves, the spot rate went from a high of 28 Uruguayan...
pesos per dollar in 2002 to 25 pesos per dollar in 2005. While this rate is still much greater than the 13 pesos per dollar spot rate in 2001, it serves as yet another indicator that the recovery has started but is far from complete. (see exhibit 9)

As seen at the beginning of the decade, the expansion of the monetary supply had a small effect on the overall output. The effect probably had more to do with increased consumption of Uruguayan goods and the policies of Brazil and Argentina during that period of time. The country also received help from international institutions such as the IMF, IADB and World Bank and direct loans from the U.S. and others. This helps explain an otherwise anomalous-seeming component of Uruguay’s current financial position. Since the crisis, Uruguay’s holdings have increased sharply. This may seem strange in view of the increased money supply; however, it is fairly easy to explain in terms of Uruguay’s intensified debt burden since the crisis. The IMF alone supplied $1.6 billion in 2002, $510 million in 2003 and $717 million in 2004. This has increased Uruguayan holdings in foreign assets, along with efforts to save for repayment of the government’s large foreign debts. External debt was mounting sharply even before the Argentine crisis; now, Uruguayan debt has grown nearly 60% in the last four years3. The sharpest instance of this trend was Uruguay’s 2003 debt transfer program. However, this assumption of additional debt was probably necessary to shift exposure to these external debts further into the future and give Uruguay more time to establish stable growth4.

**Recommendations:**

Since Uruguay is still in the process of recovering from the Argentine crisis, the government and central bank should pursue fiscal and monetary policies that will drive slow and steady growth and enable the country to maintain a relatively stable currency. As a result it should take the following steps to better insulate itself from some of the external shocks it experienced in the last decade:

**Bilateral Trade Agreements and Diversification**

Uruguay should seek more bilateral free trade agreements to provide the government with more flexibility in the markets where it has a comparative advantage. The bloc nature of MERCOSUR limits Uruguay’s financial independence, especially with the history of financial crises in Brazil and Argentina. It might be worth trying to negotiate concessions on the existing MERCOSUR obligations so that Uruguay can respond more rapidly to constraining policy changes by the two regional hegemons.

This hews closely to the separate recommendation that Uruguay needs to diversify its production. Its exports are based on low-cost agricultural production and 36% of its exports have to do with livestock production. These goods do not provide much of an added value to production, and are thus vulnerable to major setbacks which would shift the DD curve in dramatically. Potential changes in production by Brazil and Argentina exacerbate this vulnerability, and if there were to be a major drought, natural disaster, or other blow to the

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ranchers, Uruguay could be severely crippled without much ability to cope on its own. With this type of decline in output and inward shift of the DD curve, the spot rate would increase, and country would see a huge depreciation in its currency. (see exhibit 12) However, if Uruguay could improve its diversification of its production it would provide better insurance that output would remain steady and the spot rate would remain stable.

The manufacturing industry is so sparsely present in Uruguay that it may require some creativity to find a new market opportunity worth pursuing investment. Uruguay counts its coastline and a favorable climate among its natural assets. A robust investment in the tourism industry, combining casinos and entertainment with resorts that take advantage of Uruguay’s natural setting, might have the competitive advantage to take hold for the medium-to-long term and provide the country with better diversification to insulate it from future external shocks.

**Monetary Expansion**
A slow increase of the money supply should continue. If necessary to further reduce inflation, future increases should be even smaller than in the last two years. Production is still lower than what it was from before the crisis. Expanding the money supply will shift the AA curve outward which will lead to an increase in the spot rate. This in turn will lead to a depreciation of the currency which will make Uruguayan products cheaper abroad. As this occurs, the country should see a rise in net exports and a boost in production and GDP. However, this must be done slowly. There should be no dramatic increases in money supply as the severe drop in the value of the peso in 2002 helped feed the crisis in Uruguay. (see exhibit 13)

One means of promoting growth might be a sterilized intervention to pay back foreign debts faster. A sterilized intervention would increase foreign assets without raising the money supply or interest rate too drastically. Eliminating Uruguay’s exposure to debts such as the IMF Brady Bonds would build expectations for the peso and promote investment.

This would be the optimally desired type of growth. In contrast, growth in GDP accompanied by increased inflation could snowball Uruguay into another crisis, because paying off the high debts in dollars and other foreign currency would then be much more difficult. Expectations of Uruguay’s currency could reach dangerously depreciative levels.

**Fiscal Policy**
Government spending should not undergo any marked increase under the newly elected government (this is a concern in some quarters, as the new President presides over a nominally socialist government). Fiscal expansion will not be very effective as Uruguay is a small country; extra spending may have little impact in comparison with the production capabilities of other countries.

**Limitations:**

**Complications with bilateral trade agreements**
Uruguay’s involvement in MERCOSUR and its complicated bloc obligations may make bilateral trade agreements illegal. Even the less ambitious step of negotiating greater latitude within MERCOSUR poses difficulties. Given its size, Uruguay may be unable to deliver attractive enough concessions for such negotiations; its production capacity is improving but still shows
systemic problems from the aftermath of the crisis. Argentina and Brazil may resist any latitude for Uruguay to modify any of its MERCOSUR obligations, as both countries are still restoring their own financial stability post-crisis.

**Increased government costs with development of tourism industry**
While an expansion of the tourism and leisure industry, seems like a good way for Uruguay to diversify its production, it is not clear how much government spending would be required for major development of this industry. This type of industry expansion will require fixed costs such as significant land acquisition. Logistically it may be difficult to identify large enough locations, because even the coastal region that is most promising for our proposal has significant agricultural use to the rice industry. This is just one example of the kind of hurdle that may hamper the willingness of private investors to commit to this opportunity. If the government has to get too involved with startup costs, it might contradict the recommendation to limit increases in government spending.

**Politics of fiscal policy**
For now, the new government is declaring intentions to continue the gradual expansion sought by the previous government. However, if political setbacks occur, the new government may feel obligated to undermine that course of action. There could be a temptation to reward campaign supporters and build a more secure coalition with spending programs that would fly in the face of our proposals without any appreciable gain to Uruguay’s long-term structural position.

**Politics of monetary policy**
Uruguay is small enough that its monetary policies will have little effect on other countries, so it is not enough to simply advise limited money supply increases. Depending on events and actions by Uruguay’s major trading partners, a given level of monetary expansion could run the risk of being either excessive or insufficient. Uruguay’s interest rates are already high, and while inflation is not especially high, even minor reversals in inflation could be destructive in view of the high foreign debt burden.

Too much expansion could lead to runaway inflation, and too little could hinder investment and limit Uruguay’s reviving potential for growth. As a result, Uruguay must closely monitor outside events and walk a tightrope between raising interest rates or inflation.

**Excessive dollarization**
The nature of Uruguay’s growth also must be monitored for the potential harmful effects of excessive dollarization. As mentioned, Uruguay has seen its foreign currency holdings make unusually rapid gains, from $500 million to $2.5 billion almost completely due to their debt transfer program. If future growth and investment does not mitigate the current private proclivity for dollar deposits over pesos, the level of dollarization could reach dangerous levels. It could inhibit Uruguay’s flexibility to respond to events, either by forcing the central bank into an undesirable monetary expansion, or by increasing Uruguay’s vulnerability to the fortunes of the dollar on world currency markets. The latter risk could possibly impose some of the kind of obligations that would obtain under a fixed currency situation.
Exhibits

All data for excel charts are from Economic Intelligence Unit referenced in the footnotes within the paper. The AA-DD curves were created by Matt, Julie and Jeff based on our interpretation of the information studied.
Exhibit 1

GDP 1994-2005
PPP US$ at 1996 Prices

Exhibit 2

Real Private Consumption 1994-2005
US$ at 1996 Prices
Exhibit 3

Current Account Balance
1994-2005

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Exhibit 5

Real Government Consumption
US$ at 1996 Prices

Exhibit 6

Lending Rate
1994-2005
**Exhibit 7**
Change of AA and DD curve at time of crisis. 2000-2001

**Exhibit 8**

Money Supply

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Exhibit 9

Exchange rate

Exchange rate peso/dollar avg. period rate

Year


Exhibit 10

Exports and Imports

US$ at 1996 Prices

US $ (Billions)

Year

**Exhibit 11**
Change of AA and DD curves during recovery starting in 2003-2005

**Exhibit 12**
Setback in Production
**Exhibit 13**
Monetary Expansion

Spot Rate

![Diagram showing monetary expansion](image_url)