The monetary system of Uruguay at the crossroads. What is the best route forward? Lessons from Europe

Lecture for *Academia Nacional de Economía (Uruguay)*

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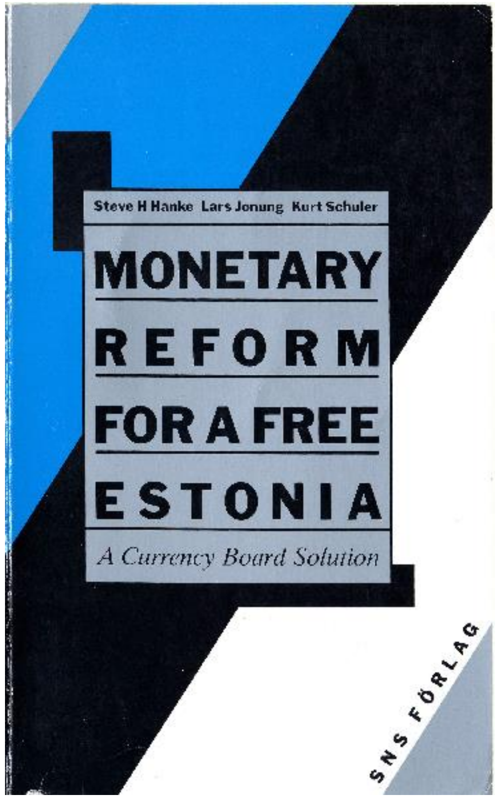
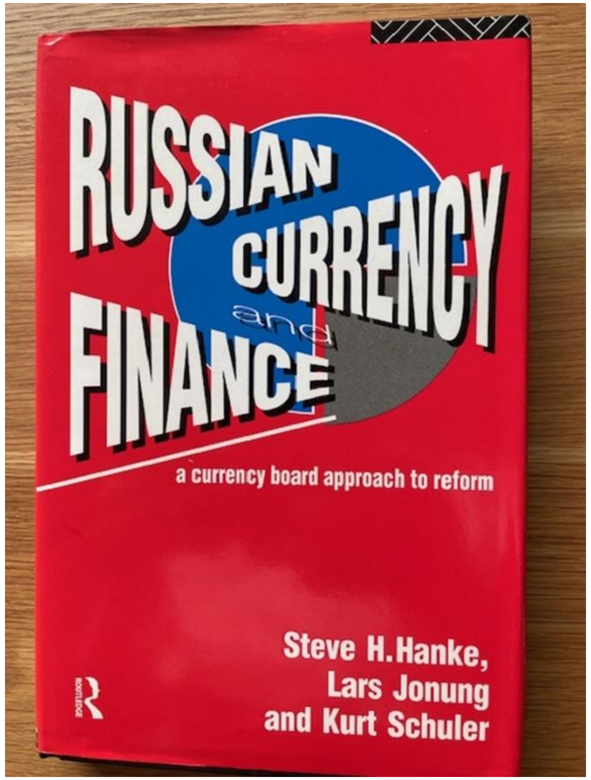
December 5, 2023

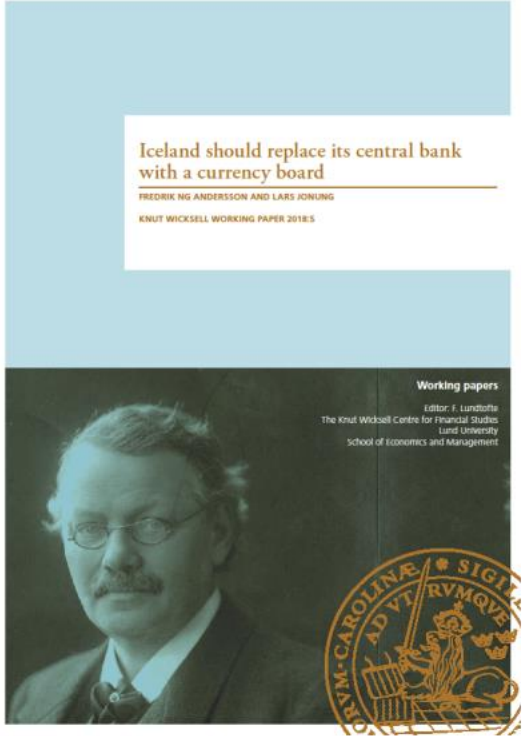
My background

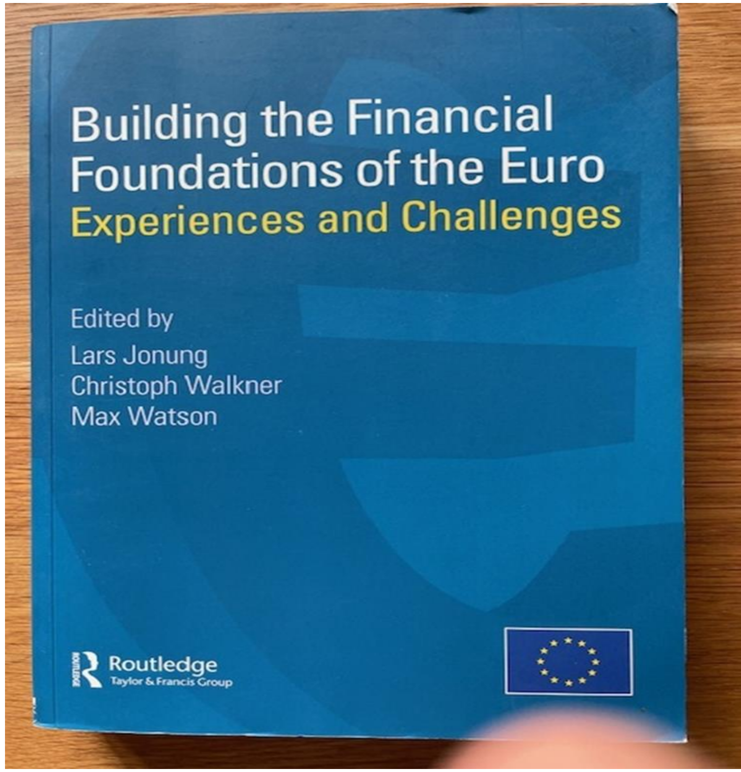
Advisor on the choice of the monetary system for Estonia in 1992 and for Iceland in 2018.





Research advisor at the European Commission 2000-2010. Focus on the euro.

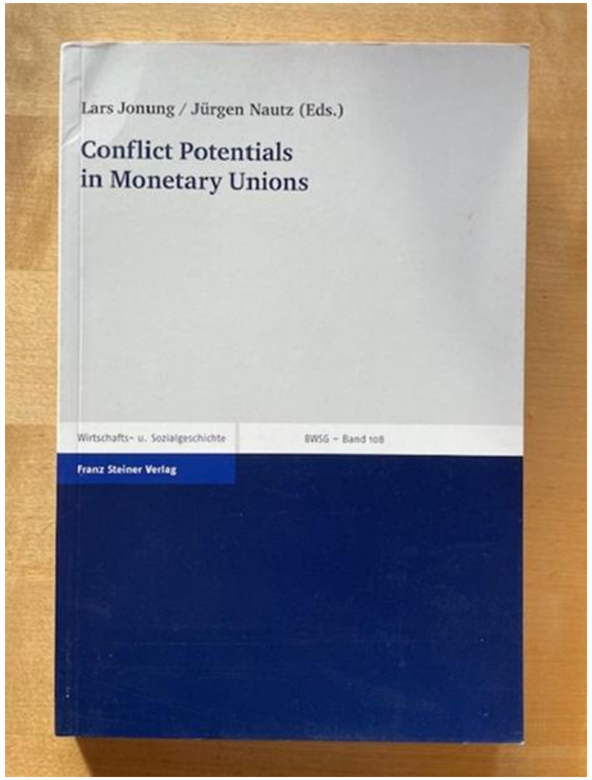


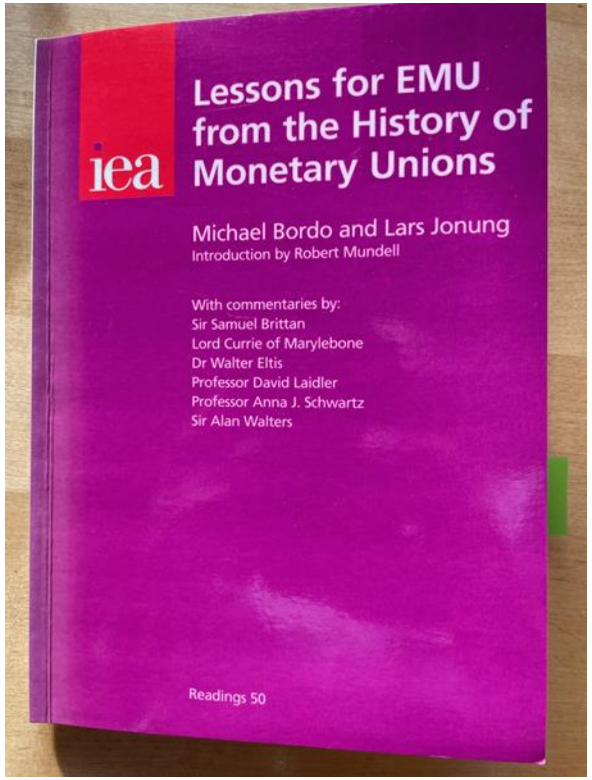


My background

Studies in the history of monetary unions

History is an excellent guide for the choice of the proper monetary system





The monetary options for Uruguay
1.

1**. Truly fixed exchange rate arrangements**

A. Monetary union with a common currency (the U.S. dollar, the euro)

B. Dollarization, euroization (Ecuador, Panama, Montenegro, Monaco, Andorra)

C. Specie standards (the gold standard)

D. Currency boards (Hong Kong, Estonia, Bulgaria)

The monetary options for Uruguay
2.

2. Fixed but adjustable exchange rates (pegged rates)

The Bretton Woods system, currency baskets, the ERM-system

The monetary options for Uruguay 3.

3. Floating exchange rates (”free” national currency)

A. Rules-based systems

Knut Wicksell’s rule of price stability (inflation = zero)

Inflation targeting (inflation commonly = 2 percent)

B. Discretion-based monetary systems (no rules at all)

The monetary options for Uruguay

Financial integration and political developments have reduced the number of options:

Now the choice is between:

1. Truly fixed exchange rate arrangements - including no national currency

2. Floating exchange rates with rules-based frameworks

The size of the economy
Does it matter?

The size of the country is important for the choice of monetary system.

A. Small countries, in particular microstates, tend to adopt the currency of another country. Andorra, Monaco etc. They ”import” the credibility of another currency and they reduce transaction costs in this way.

B. Big countries tend to be monetarily independent with national currencies of their own. USA, China and India.

How big is Uruguay?

Uruguay is inbetween – in the middle – like Sweden

Uruguay: A small open economy with an exports-to-GDP ratio of around 30 percent. Population around 3,4 million. High GDP per capita. Strong democratic tradition for Latin America. Financially open.

Sweden: An export ratio of around 50 percent. Population around 10,6 million. High GDP per capita. Strong democratic tradition. Financially open.

This suggests that a national currency is a viable option for Uruguay.

Lessons from Europe

Fixed exchange rate arrangements:

- A monetary union like the euro area
- A currency board solution like Hong Kong or Bulgaria
- Dollarization or euroization like Ecuador, Montenegro etc.

A floating exchange rate arrangement:

- An inflation targeting regime like Sweden with a floating exchange rate

What are the advantages and disadvantages of these monetary systems?

The euro – a unique experiment

- The euro is a gigantic and unique experiment with no precedent in monetary history.

- Never before has a group of wealthy independent nation states handed over their monetary sovereignty to a central monetary authority, while maintaining fiscal sovereignty – that is the right to tax and spend – within the nation-state.

The euro
An exceptional experiment

This is the view of

The Economist

in 1997.

The advantages of euro membership (a monetary union)

The approach in economics:

The optimum currency area theory of Robert Mundel: The optimal currency area is the area where the benefits of a common currency outweigh the costs.

- Benefits: Transaction costs are reduced through the use of a common currency. Efficiency is improved. Dynamic effects contribute to increased trade and growth.
- Costs: Loss of a national monetary independence. Monetary policy cannot be used to counter asymetric (country-specific) disturbances.

Robert Mundell, Mr. Euro

- Interview I conducted with Mundell in 2009:
- His view: The euro has been an unqualified success!
- This is too optimistic!

Interview with Robert Mundell:

The euro has been an unqualified success

Your famous paper on optimum currency areas (OCA) was five years old when it was published in 1961 in the American Economic Review. Now this article has almost a fifty-year history, but OCA theory is still evolving, inspired by your original ideas. How do you assess the evolution of OCA theory? Does each period have its own OCA criteria?

Mundell: Frankly, I don't think much progress has been made. I think it's because of the overemphasis on money as an asset to the neglect of money as a unit of account, or as Aristotle would say, a measure. OCA theory is only useful as a guide to exchange rate policy if it incorporates money as a unit of account (as the last half of my article did) and also incorporates political considerations.

Already back in the early 1970s, you served as a leading member of the EEC's Study Group on EMU. How much of today's EMU was already anticipated at that time?

Mundell: There was more attention paid then to a monetary union as a multiple-currency union, achieved through the addition of a common parallel currency, than to a single-currency union in which a common currency replaces the national currencies.

Robert A. Mundell (born in Canada in 1932) has worked in academia (e.g. Chicago, Stanford, Geneva, Bologna, Columbia) and as an adviser to international institutions (e.g. European Commission, IMF, World Bank, UN), central banks and governments.

He prepared one of the first plans for a common currency in Europe and is often called the father of the theory of optimum currency areas (OCA). His writings on a broad range of subjects include over a hundred articles in scientific journals. In 1999, he received the Nobel Memorial Prize in Economics.

Paternity of the euro is often ascribed to you, particularly after you received the prize in economic sciences in memory of Alfred Nobel in 1999, while you have been so modest as to call yourself rather as "one of the several godfathers" to the euro. Are you as godfather happy with your child today at the age of ten years? What has surprised, impressed and depressed you the most when you look back at the first decade of the euro?

Mundell: Godfather was not an appropriate word, at least as far as my input was concerned, since a Godfather is someone who concerns himself with the welfare of a child after he has been born. In this sense the Godfathers would be people like Duisenberg and Trichet.

If I have a claim to a role in the founding of the euro it would be because of (1) the theory of Optimum Currency Areas, (2) my 1969 paper, "The Case for a European Currency," which was circulated to the European Monetary Commission in December 1969, (3) my 1970 paper, "A Plan for a European Currency, coining the term EUROPA as the name for the European currency, (4) my work with the European Monetary Commission in June 1970 exploring alternative routes to an optimum currency area, and my contributions to the EEC Study Group in the early 1970s.

I think the euro has been an unqualified success and Europe is better off and more powerful because of it.

Of course, an economist must stand ready to propose better policies and better institutions. What measures would you propose to make the euro work better?

Mundell: I would support institutional developments which would make Europe a less immature capital market. There should be a European bond and a European Treasury Bill

Looking into the future of Europe, where will EMU and the euro be ten years from now when we celebrate the euro at 20?

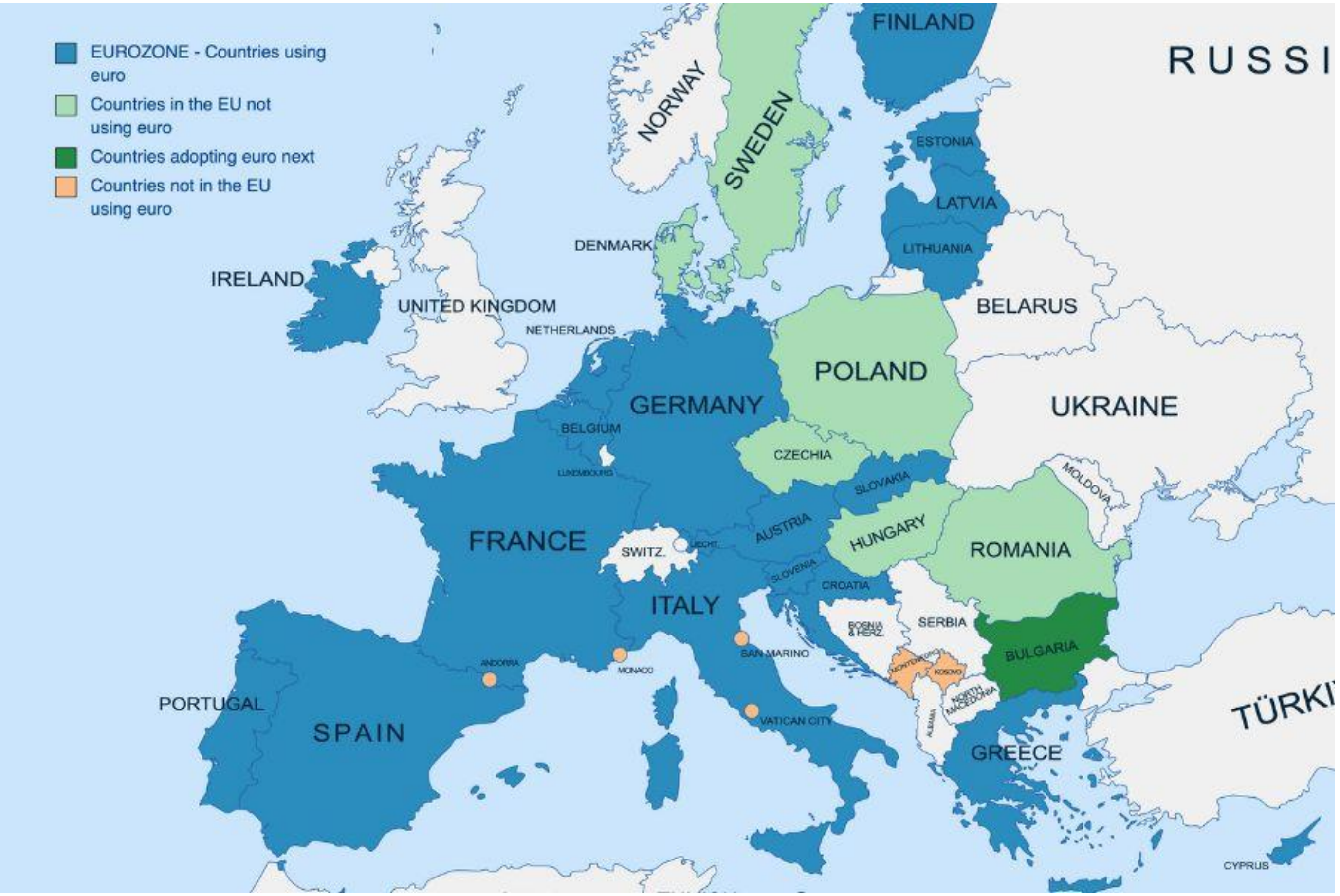
Mundell: I believe that ten years from now there is a good chance that most members of the EU, including the U.K., will be inside the euro zone, and that the euro area will be larger than the dollar area. But in twenty years, I believe the dollar will be back in first place.

Finally, let's look to the future of the euro as an international currency. How do you see its future role as compared to other currencies? Will monetary integration continue on a global scale?

Mundell: The euro is now one of the two top currencies in the world and that will continue to be the case for the next few decades. In the longer term, however, it is likely that China and India will break into the top group as a result of the global spread of the productivity revolution. Within thirty years I would expect there to be a global currency that is used for international transactions.

Interview by Lars Jonung (DG ECFIN).

Today 20 of the 27 EU member countries are part of the Eurosystem



How has the euro evolved?
The first 20 years

Positive result: Price stability has been achieved. Many countries have joined.

Problems facing the euro

- Lack of fiscal discipline

  The rules of the Stability and Growth Pact have not been followed

- Lack of supply-side reforms (Maastricht fatigue). Economic growth is not impressive.

The euro – a unique currency

- We have biannual data on the popular support behind the euro.
- The data show that inflation and unemployment drive the popularity of the euro.
- The importance of successful economic policies.

A major lesson from the euro area on political will (Mario Draghi as head of the ECB)

- Political will holds a monetary union together.
- Political will is the glue behind a stable monetary union
- This is the challenge for the euro – and for any monetary union

Is a monetary union an option for Uruguay?

The political perspective: Is there a political will?

My guess: NO!

The OCA perspective: Is there an optimum currency area around Uruguay?

My guess: No

The fiscal perspective: can fiscal policy among the members of a monetary union in South America be disciplined by any pact/agreement?

My guess: No

Is dollarization an option for Uruguay?

Dollarization is an attractive option when the public has lost complete confidence in the national currency.

Severe monetary mismanagment leads to the view that credibility and stability can best be established through the abolishment of the national currency.

Has Uruguay reached this point?

Is dollarization an option for Uruguay?

Dollarization is an attractive option when the public has lost complete confidence in the national currency.

Has Uruguay reached this point?

My guess: No

But the US dollar is used as a unit of account to measure asset values.

Is a currency board an option for Uruguay?

- A currency board is a form of a monetary union. It is an institution that issues notes and coins convertible into a foreign “reserve” currency at a fixed exchange rate.

- As reserves, a currency board holds high-quality, interest-bearing securities denominated in the reserve currency. A currency board’s reserves are equal to 100 per cent or slightly more of its notes and circulation, as set by law.

- The currency board has no discretion in monetary policy; market forces alone determine the money supply.

Is a currency board an option for Uruguay?

- As a rule, small countries have adopted currency boards. In the 1990s, countries like Estonia and Lithuania adopted currency boards with the euro as the reserve currency. These boards served as stepping-stones to full membership of the euro area, a strategy that worked well.
- Denmark has had a rigid exchange rate to the euro since the start of the euro. Denmark's central bank acts much as a currency board would.
- A currency board for Uruguay based on the U.S. dollar would have a number of advantages. It would immediately establish exchange rate stability between the domestic currency (the peso) and the dollar. Inflation and interest rates in Uruguay would rapidly converge to US inflation and US interest rates.

Is a currency board an option for Uruguay?

- One major drawback of a currency board: Uruguay would give up the monetary autonomy it has. In normal times, this might not come with any major drawbacks. However, it might be a problem if Uruguay were to face an extremely deep economic crisis or shocks in the future. With a traditional currency board, there is no authority to act as a lender of last resort. No floating exchange rate that can absorb disturbances.

- Support may come through fiscal measures instead. The taxpayer serves as the lender of last resort. This is actually the case in many countries with central banks during financial crisis. Sweden is a prime example.

Is inflation targeting an option for Uruguay?

Inflation targeting (IT) is the dominant monetary regime in the world today.

The major central banks base their policy on IT: European Central Bank, Bank of England, Federal Reserve System.

Central banks in smaller economies like Sweden, Norway, Canada, Australia and New Zealand are inflation targeters as well. This is also the case of Uruguay.

Knut Wicksell (1856-1926) is the father of IT. Professor in Lund 1901-1916.

KNUT WICKSELL (1856-1926)

Father of price-level targeting (inflation targeting). Wicksell's *Interest and Prices* is the intellectual foundation of modern central banking.

Is inflation targeting an option for Uruguay?

***Goal of IT*:** Price stability – commonly defined as a rate of inflation around 2 per cent a year.

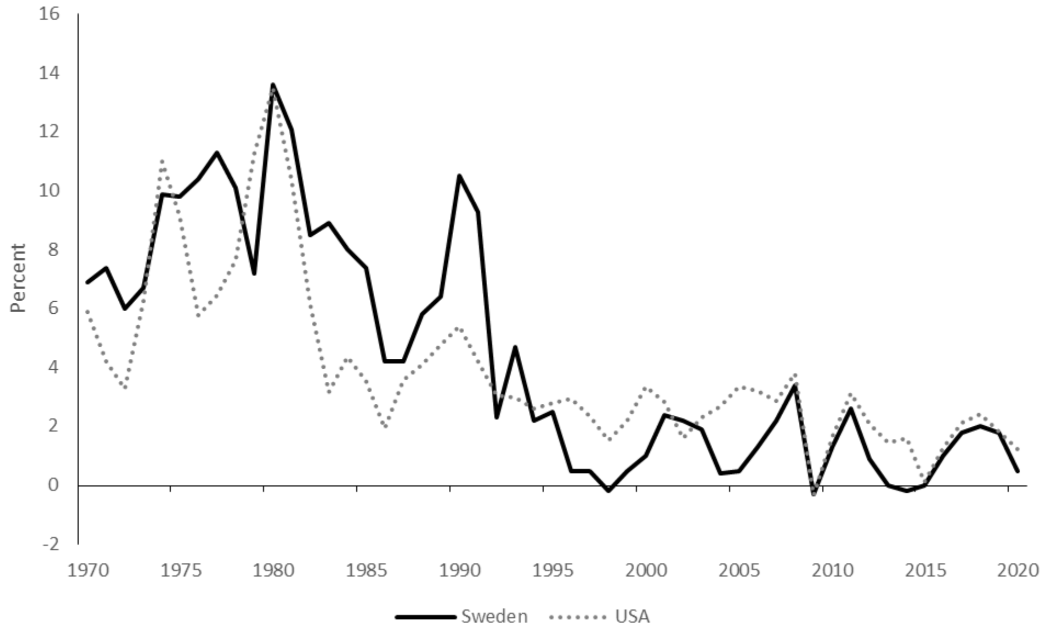
***Instrument of IT*:** The central bank policy rate

***The institutional framework (the monetary system)*:**

- A paper standard (fiat money)
- An independent central bank
- Free exchange rates and unfettered free financial markets

Is inflation targeting an option for Uruguay?

- Inflation targeting has been successful in keeping CPI inflation low across the world.
- Asset price inflation has been a problem ignored by central banks.
- The pandemic contributed to high inflation – overreaction by central banks.



Is inflation targeting an option for Uruguay?

Inflation targeting should be backed by a strong institutional framework.

- An independent central bank.
- A proper fiscal framework supporting fiscal prudence.

  Sweden has a fiscal framework aiming at a government debt to GDP-ratio around 35 per cent.
- A proper financial stability framework.

Is inflation targeting an option for Uruguay?

Does Uruguay have the necessary institutional framework for a successful monetary policy based on inflation targeting?

My guess: Yes

But the IT regime should be a subject of

a) constant debate in order to improve its working and

b) to currency competition

Currency competition – the best option for Uruguay?

Uruguay is interesting case of currency competition between two government-issued monies: the domestic peso and the foreign US dollar.

Economists praise competition – even in the market for money.

More than 70 per cent of bank deposits in Uruguay is dollar denominated.

This puts pressure on the Central Bank of Uruguay to improve its performance. And it makes a conversion to a currency board more attractive in case the peso underperforms.

Let the best money win!

Concluding: Which is the best option for Uruguay?

My conclusions:

An independent central bank based on inflation targeting or a currency board are the best options for Uruguay.

As long as the present inflation targeting regime remains successful it should be maintained. The floating exchange rate of the peso serves to isolate Uruguay from shocks. While the US dollar serves as the store of value.

Let currency competition prevail. It allows the public of Uruguay to choose the money they prefer.

Final conclusion: Growth is the best option for Uruguay

- In the long run, the standard of living in Uruguay depends on high and sustainable economic growth.
- The choice of monetary system is important in the growth process. It can contribute to growth by serving as a stable framework for the actions of the private sector.
- However, growth is ultimately based on an efficient use of resources in the real economy, that is on supply side reforms.
- Such reforms should be given the highest priority to ensure a successful future for Uruguay - regardless of the choice of the monetary system.

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