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Uruguayan Monetary Stabilization 1968-1970:
Experience with a Parallel Credit Market

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Uruguayan Monetary Stabilization 1968-1970: Experience with a Parallel Credit Market.

Recent actions of the Government of Uruguay in the area of money and credit reflect the classic contradiction between economic stability and popular politics. The Government is attempting to continue the 1968 stabilization program essential to the country's development while yielding to popular demands for more and cheaper credit. Actions to relieve credit stringency during the second half of 1970 have caused sizable losses of foreign exchange reserves and eroded confidence in the ability of the Government to prevent a further deterioration in the months leading up to the November 1971 elections. The Government's response to this has been to pyramid exchange controls.

The Uruguayan example in the struggle to maintain financial stability is particularly interesting because of the existence of a large credit market outside the banking system, known in Uruguay as the "parabanking" market. The existence of this market and the desire of the authorities to eliminate it have enormously complicated the task of regulating the amount and cost of internal credit. While such a market also exists in several other Latin American countries, it has developed in Uruguay primarily because of the excessive administrative and personnel costs of the commercial banks and the unrealistic Government regulations imposed on banking operations.

History

In the 1960's the rate of inflation in Uruguay irregularly tended upward. It rose from a low of 10 per cent in 1961 to a startling high of 135 per cent in 1967. The expansion of commercial bank credit to the private sector, which also irregularly tended upward during this period, played an important role in feeding the inflation.

Table 1
Rates of Commercial Bank Credit Expansion to the Private Sector and Inflation--1960-1970.
(per cent)

	Commercial Bank Credit Expansion	Inflation a/
1960	21	36
1961	24	10
1962	14	11
1963	7	44
1964	57	35
1965	16	88
1966	24	50
1967	60	135
1968	66	66
1969	33	14
1970	41	21

a/ Change in the Consumer Price Index.

Sources: Boletín Estadístico Mensual del Banco Central Del Uruguay and International Financial Statistics.

In October 1967 the Uruguayan authorities instituted an orthodox policy of monetary restraint. This restraint, combined with an equally restrictive fiscal and incomes policy, achieved notable success until it began to be relaxed in April 1970. It reduced the annual rate of inflation from 165 per cent for the first half of 1968 to 6 per cent for the second half. Although the rate rose again in 1969 and 1970, it stayed well below the early 1968 rate.

The monetary policies followed were relatively conventional. In 1968, 1969, and the first quarter of 1970, credit to the private sector was tightly controlled. Strict loan ceilings, instituted in late 1967, although relaxed monthly, were set again in June 1968 to accompany fiscal and income stabilization measures. In late 1967, reserve requirements were doubled to 40 per cent on sight deposits and 20 per cent on time deposits.

Table II
Bank Credit Expansion and Rate of Inflation
(per cent)

	Expansion of Peso Loans	Rate of Inflation a/	Expansion of Foreign-Currency Loans
Jan-June 1968	43.8	63	49
July-Dec 1968	2.6	3	45
Jan-June 1969	31.6	9	20
July-Dec 1969	-4.4	6	18

a/ Change in consumer price index.

These measures were exceptionally successful in the first year, although less so afterwards. In 1968, they kept peso loan expansion to the private sector below the rate of inflation. But peso loans increased over three times as fast as prices in the first half of 1969. This was somewhat counteracted in the second half when there was an actual reduction in peso loans. But for the whole year 1969, the peso loan expansion exceeded the inflation rate.

Foreign currency loans and loans for import, pre-export and export financing were exempt initially from the individual ceilings. Consequently foreign currency loans, mainly financed through lines of credit with correspondent banks, more than tripled between December 1967 and December 1969. During the same period, foreign currency deposits in commercial banks increased 83 per cent. But in September 1969, ceilings were placed on foreign currency loans, putting an end to this source of monetary expansion.

In 1970 the rate of inflation accelerated slightly, and the authorities began to ease monetary restraints. But the rate of expansion of total commercial bank loans to the private sector in 1970 only slightly exceeded that of 1969. In both years, the total rate of expansion was well above the rate of inflation.

The stringent monetary restraint of 1968 and 1969 resulted in severe hardships on the business community. Statistics released by the Liga de Defensa Comercial, for example, showed that both the number of companies applying for agreements with their creditors and the total of their liabilities were at an all time high at the end of 1970.

Another consequence was the growth of a large parallel credit market, the so-called parabanking market. This market operates by the sale of promissory notes through the intermediation of notary publics.

The parabanking market developed in part because of regulations limiting interest rates banks could pay for deposits and in part because of the heavy costs incurred by banks forced by union pressure and labor legislation to employ an excessive number of workers. Loans on the parabanking market are also exempt from the 6 per cent annual tax paid on commercial bank loans. Under these circumstances, intermediaries in the parabanking market with lower overhead costs could operate with far smaller profit margins. As they were able to pay more than commercial banks and generally made low risk loans for only three to six months, they were able to attract a growing volume of funds. Borrowers used the parabanking market because of the unavailability of credit from the commercial banks and because they found borrowing costs for such credits actually lower than costs of bank loans. While the true size of the parabanking market is not known, a recent preliminary Government study estimated that outstanding loans in the last few months of 1970 were 30-40 billion pesos, compared with 22 billion pesos from commercial banks. Most of the business done in this market is concentrated in the commercial and industrial sectors.

New directions in monetary policy

The growth of the parabanking market and the difficulties experienced by businesses seeking credit from banks led the authorities to take steps intended to increase the availability of credit at commercial banks and to reduce interest charges on bank loans. These steps were a concession to the business community and, in so far as they increased the overall availability of credit, they were in direct contradiction to the on-going stabilization program. They also signaled that the goal of financial stability was being abandoned, and hence they undermined confidence. This in turn placed foreign exchange reserves under pressure and led to the appearance of a black market exchange rate.

In April 1970, the ceiling on peso loans to the private sector was increased by 2.2 billion pesos, with promises of an additional 1.6 billion peso increase later. It was stipulated that 80 per cent of this increase had to go to industry and agriculture and 20 per cent to commerce. In addition, maximum interest rates on new bank loans were lowered to 24 per cent, and 30 per cent of all outstanding bank loans were required to be at this rate by the end of December 1970. To cushion the impact of the new credit authorizations, marginal reserve requirements of 20 per cent were placed on all bank deposits above the average daily amounts of December 1969. This compared with the 40 per cent reserve requirement previously in effect.

But these concessions were not enough to satisfy the public, and further expansionary concessions were made. The authorities increased the peso loan ceiling by an additional 1.7 billion pesos in July and by 2.7 billion in September. In addition, the 20 per cent marginal reserve requirement imposed in April was removed. Peso loans to the private sector expanded considerably as a result of these ceiling increases. In the first ten months of 1970 the Bank of the Republic (a State owned commercial bank) increased loans to the private sector by 53 per cent. In the first eight months of the year, the private commercial banks increased credit by 25 per cent. In August, for the first time since the last devaluation in April 1968, a black market exchange rate emerged.

In order to attract funds into the official banking market, the Government raised the legal interest payable on time deposits in early October 1970. Interest on one-year deposits of more than 5 million pesos was increased from 14 to 20 per cent. But since the banks were already paying 20 per cent by use of various devices, this measure did not attract substantial quantities of new funds. Furthermore, by this time, confidence in the peso was so shaken that an interest rate of 20 per cent no longer compensated for the anticipated rate of inflation and/or exchange devaluation, if it ever had.

Further direct intervention

Apparently not confident that these measures would achieve the desired goals, the authorities issued regulations to control and reduce the size of the parabanking market, to lower the interest rates there and elsewhere and to channel parabanking funds into the commercial banking system. The first such decree, issued in November 1970, established a three-year minimum term for all parabanking loans of more than 100,000 pesos and provided for the intermediation of the official mortgage bank in all mortgage loans of less than three years duration. Previously in the mortgage market, a market of the parabanking variety, all loans were handled by the notary publics who accepted title to the property from the borrower and held it as collateral against a loan made by them while collecting an interest fee of 24 to 48 per cent. The new decree called for the Banco Hipotecario to hold title and to collect a fee of 2 per cent, and specified that the lender would receive the maximum of 12 per cent interest on mortgage loans plus an inflation correction factor (probably 12 per cent).

The newly stipulated minimum term in the parabanking market was a substantial increase from prevailing three- to six-month period and, in effect, made contracts covering shorter term loans unenforceable. But market uncertainties and the risk of devaluation made loans of three years or more very unattractive to lenders, and many began to refuse to renew their loans at maturity. This put a severe squeeze on many small- and medium-sized firms which had counted on being able to roll over their debts and lacked the cash to liquidate them. Debtors who were able to raise enough cash paid off their creditors who then tried to find new profitable uses for the funds; many of them began to move into dollars. Funds from maturing mortgages must also have begun to move into dollars, for there was no large flow of funds into the official mortgage bank. On the other hand, requests for mortgage funds did not materialize in the volume expected. As a result, the black market rate for the peso rose to 282 pesos per dollar during the third week of November 1970 before settling to 270-275 pesos per dollar at the end of the month. (The official rate was 250 pesos per dollar).

The authorities found it necessary to act to alleviate the exchange pressure stemming from the movement of funds from the parabanking market into dollars and to provide relief from the threat of bankruptcy for the small- and medium-size companies unable to liquidate their parabanking debts. On December 2, they issued a decree which proclaimed a moratorium until December 31, 1971, for all parabanking loans of more than 100,000 pesos and suspended until July 21,1971, judicial proceedings already initiated to collect matured parabanking loans. This decree provided that parabanking borrowers could request a special loan from the Bank of the Republic to cover the principal and all legal interest on the debt, the legal interest rate being 24 per cent. It specified that, should such a loan be granted, the amount would be deposited in a Bank of the Republic time account in the name of the parabanking lender, who would earn 20 per cent per annum interest on it but who could not withdraw the funds until December 31, 1971. This insured that credit outstanding in the economy would be maintained, but at much lower interest rates, and that the movement of funds from the parabanking market into the foreign exchange market would stop. But it created a delayed increase in liquidity which will become available when the lenders' time accounts mature next December 31.

Finally, in a further attempt to lower the interest charges in the economy and expand credit, a November decree reduced from 4 per cent to 2 per cent per month the interest charge allowable on all debts owed to all public offices. This, in effect, would allow businesses and individuals to obtain loans by way of non-payment of taxes at interest rates of 24 per cent per year. There is no doubt that this will have a detrimental effect on tax collections, both by postponed payments and by under-estimation of tax bills which, when discovered, would result only in the low interest charge for back taxes. The Tax Office estimates that this decree will approximately double the percentage of tax collections collected through installment payments and therefore reduce current collections. Anticipating potentially disatrous effects on the already serious operating difficulties of many agencies, the Government exempted the social security bank and the retirement funds from this decree.

Results of parabanking regulations

The results of these attempts to regulate the parabanking market have been disappointing to the authorities. Through the end of 1970, the Bank of the Republic and the private commercial banks had attracted very few long-term peso deposits. Through January 1971 applications for Bank of the Republic loans under the December decree were lower than the most conservative predictions. The levels of mortgage loan requests and of funds flowing into the mortgage bank from the para-mortgage market were below expectations. Of an estimated 16 billion pesos in that market prior to the November decree, only 8 million had entered the Mortgage Bank by the end of 1970. Although the flow has picked up in 1971, by the end of March the Mortgage Bank had not yet reached its original target of 700 million pesos in new deposits. Finally the interest rate on parabanking loans did not fall. In fact, the regulations may have had the effect of raising the interest rate. Those who still need credit beyond what they can get at the banks must continue to borrow from lenders who will only lend for three to six months. But as contracts for such short maturities are no longer enforceable in the courts, the lenders faced with added risk require more interest. Some estimates place the resulting added interest charge at from 10 to 20 per cent.

It is not surprising that these decrees have not succeeded in eliminating the parabanking market. While the size of the parabanking market undoubtedly will be reduced, it can be completely eliminated only when banks are no longer forced to bear excessive costs resulting from employment of redundant workers and when the authorities rely further on free market forces, allowing bank interest rates to rise to levels at which the flow of funds to other intermediaries dries up. Under the present set up, those borrowers who will need more credit in the next year than will be available through the official banking system will probably try to maintain good relations with parabanking institutions rather than take advantage of the moratorium.

The modest increase in the legal interest payable on time deposits at banks, decreed last October, was a move in the right direction, but it was not sufficient to provide a positive return to savers in view of inflationary expectations. In this respect, Uruguay's experience parallels that of other countries which have moved only partially to a realistic interest rate policy.

Other exacerbating developments

All of these actions have cast doubt on the future of the stabilization program and placed mounting pressure on the exchange rate. In addition, several other adverse factors have helped to undermine confidence. In November 1970 the President approved a 21.5 per cent wage increase for the private sector, considerably higher than had been expected. Beginning in August, tax revenues fell below the expected level, increasing the fiscal deficit and requiring increased borrowing from the monetary authorities. A small trade deficit appeared in 1970 after surpluses in the previous two years, as imports rose faster than exports. This occurred even though exports were 16 per cent higher than in 1969 and reached the highest level in 13 years. The deterioration of the trade balance was accompanied by a deterioration of the invisibles account. Uruguayans were also spending an increasingly large amount on foreign travel, a primary channel of capital flight. At the same time, the number of tourists visiting Uruguay after mid-1970 fell off 25-30 per cent from the preceding year mainly as a result of terrorist activities. Although net foreign exchange reserves rose $38 million in the first half of 1970, they fell by over $60 million between June and December. Finally, when the Congress increased the fiscal 1971 deficit early in October, a crisis followed which forced the authorities to close the exchange houses from October 15 to early December. So far in 1971, financing of the Government's cash deficit has required a substantially greater recourse to the monetary authorities than was the case in 1970.

By March 1971 the internal price level had risen 50 per cent since the last devaluation. The rate of inflation for the first quarter of 1971 only slightly exceeded 4 per cent. But this may not be representative of the real inflation to the extent that the index includes tightly controlled prices.

The export boom has continued into 1971 as exports were well above the 1970 levels for the first three months. But the decline of the country's foreign reserves has also continued into 1971, and the parallel exchange rate rose to as high as 350-400 pesos per U.S. dollar in early May. The Government has responded by enacting more direct controls. A central bank regulation reducing the amount of foreign exchange allowed for travel was followed by the imposition of new regulations which allow importers to bring in during the first six months of 1971 only 35 per cent of the amount imported last year. Those importers who bring in more must make a penalty advance deposit. At the end of March, further bureaucratic delays in the purchase of foreign exchange for travel were instituted in the form of requiring proof of payment of income taxes as a prerequisite of the purchase. More intensive surveillance of the exchange houses was begun in an attempt to control the parallel rate. In April, the authorities suspended the sales of foreign exchange by banks and exchange houses except for imports of perishable goods and limited travel fares and allowances. Sales for certain purposes such as travel and tourism, family remittances and consular incomes were resumed later in the month, but these were subject to special commission which were, in effect, partial devaluations.

Conclusion

While the 1968 stabilization program achieved notable success for almost two years, a deterioration began in mid-1970. As a concession to the business community, the Government undertook to lower the cost of credit in the economy by expanding bank credit and attempting to curtail the parallel credit market. These actions, accompanied by several other adverse developments, appear to have severely undermined confidence in the on-going stabilization program and have had the effect of increasing the pressure on Uruguay's foreign reserve position. But the Government has responded to these developments mainly by enacting only short-run measures. Since a presidential election is scheduled for next November, it may be that more decisive action will be put off until after the new Administration takes office in March 1972.