ISSUES IN INTERNATIONAL POLITICAL ECONOMY

February 2000, NUMBER 2

THE DOLLARIZATION DEBATE

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Popular and professional distrust of the durability of established exchange rates contributed to practically all the financial collapses of recent years, from Mexico in 1994-1995 to Brazil in 1998-1999. Capital exited from the hapless nations - these two and others, such as Thailand, Indonesia, Russia, and Ecuador - in dramatic fashion and the end result was a depreciation of the currency accompanied by collapses in real activity (production, sales, salaries, and other income). The extensive human hardships dominated discussion within the affected countries - such as in Ecuador now -whereas the technical financial aspects received the bulk of international media attention at the time the events were unfolding.

Exchange-rate arrangements have been a constant theme for centuries, indeed millennia, ever since countries with different currencies began trading with each other. Many arrangements endured over long periods, only to collapse when faced with unacceptable strains. One rule that most economists now accept is that there is no single exchange-rate arrangement that is optimal for all countries - or for individual countries - at all times. The gold standard gave way in the 1920s and '30s, the adjustable peg structure of the International Monetary Fund in the early 1970s, and more recently so did a crawling peg set in a band around a dominant currency, such as the dollar.

The current wisdom is that only two systems, which on the surface are diametrically opposed, can endure for extended periods in the modern world of growing international trade, investment, and capital movements. These are rigid exchange rates, of which dollarization is one form, and freely floating rates, which permit the currency to roll with shocks without sacrifice of foreign reserves in a way that adjustable or crawling pegs cannot. Mexico and Brazil, while their financial crises played out, had currencies pegged to the dollar in a narrow band which they protected by selling reserves (buying their own currencies) to keep their currencies from depreciating outside the band. In each case, after losing tens of billions of dollars of reserves, they gave up the battle and floated their currencies. So did Chile, more recently, as a prudent measure. In each case the float is working well - at least so far. The currencies are

fluctuating, but not inordinately so, and all three economies are performing well. These are really the first serious experiments with floating rates in major economies of Latin America.

Argentina has a rigid system under which the peso is convertible with the dollar, on demand, at a 1:1 ratio. This system was introduced as a way to eliminate Argentina's habitual inflation and it has accomplished this. The Argentine system removed the monetary policy authority of the central bank and set up a requirement that dollar holdings must equal the full extent of the country's monetary base (the currency in circulation plus the reserves of the banking system).

The system is not foolproof. Argentina had to scramble to line up contingent dollar backing, which it did successfully, after the tequila effect of the Mexican devaluation in 1994. Argentina was hit much harder after Brazil devalued its currency in 1999 because the peso became sharply overvalued in relation to the Brazilian real. About a third of Argentina's exports go to Brazil and the Brazilian financial-economic crisis had more severe effects on Argentina than on Brazil itself. The then president of Argentina, Carlos Menem, suggested that Argentina should become even more rigid in its currency valuation and shift from a currency board to full dollarization. He argued

just this month that all the countries in the Americas should adopt the dollar to avoid devaluations. When the Ecuadorian economy collapsed this year, its president, Jamil Mahuad, proposed that Ecuador should dollarize.

What is meant by dollarization? What are its attractions? Why is dollarization resisted, both popularly (the suggestion of Ecuador's president to do this contributed to his ouster) and technically? The crisis in MERCOSUR this past year was the consequence of incompatible exchange-rate arrangements between the two important trading partners, Brazil and Argentina. Are there options to deal with this inconsistency other than dollarization? Should the United States react to other countries adopting its currency as their official money? So far the U.S. government has been cool to the idea.

The dollar is used for many purposes: it is the most important currency in international trade transactions; dollars are held as foreign reserves more than any other currency; individuals and companies fearful of the stability of their own currency hold dollars to safeguard the real value of their assets. Many contracts in foreign countries - such as leases - are expressed in dollars to protect against national inflation and effective depreciation of the national currency. The argument often made is that many countries - Mexico is an example - are already de facto dollarized and why not take the next step and dollarize de jure.

There is an important difference between official and haphazard dollarization. Under official dollarization, the internal debt of governments and individuals is in dollars, accounting practices will have to change, and dollars cease to be foreign reserves and instead become the national currency. The process of transformation is complex; for example, an exchange rate must be chosen to convert existing contracts, assets, debts, and the like into dollars. The sharp depreciation of the Ecuadorian sucre to a level of 25,000 per dollar has made many Ecuadorians nervous about their president's proposal to dollarize.

Dollarization has both an up- and down-side for foreign countries. The main advantage is that it can give confidence that the value of the currency will be stable, at least more so than most national currencies. Many traders see this as critical. This was evident in Mexico, which experienced sharp currency devaluations roughly every six years from 1976 to 1994, corresponding with national presidential elections. The fear that this will happen again in 2000, an election year, guided much economic policy of the current administration. The past devaluations took place when Mexico tried to protect the value of the peso vis-à-vis the dollar within a narrow band whereas the Mexican peso is now floating more or less freely.

One downside is that the country loses seignorage, which is essentially the interest lost on foreign reserves held in dollars. The seignorage loss can be hundreds of millions of dollars a year, depending on the extent of the reserves. A more serious issue is that a balance-of-payments disequilibrium, such as a large current account deficit, cannot be corrected by a depreciation of the currency - the national currency no longer exists - but must instead be corrected by a contraction of the domestic economy. It was the unwillingness to accept this outcome which eventually did in the gold standard.

Dollarization means that a country gives up an independent monetary policy and relies instead on the policy of the Federal Reserve Board of the United States. This entails a clear loss of economic sovereignty. Many analysts consider this an advantage in that central banks in many developing countries do not have stellar records of promoting monetary stability. They are often under the political control of governments and are ordered to "print" money to finance government deficits, and this will not be possible if dollarization is to succeed.

Indeed, dollarization will not succeed unless fiscal policy is highly disciplined. Financing public sector deficits means taking on dollar debt and there is a limit to the extent this can be done. Many advocates of dollarization also see this as an advantage because it can impose the discipline that might not otherwise exist. Panama, which has been dollarized since early in the 20th century, has shown that fiscal self-restraint is feasible.

Dollarization does not mean absolute stability of the currency in international markets. The dollar itself floats and there have been wide changes in the relationships among the three major world currencies, the dollar, euro, and yen. If the dollar depreciates (appreciates) with respect to either of the other two currencies, this will affect the trade of a dollarized country. There is reasonable certainty of the value of the dollar, but not absolute certainty.

The European Union chose to move to a single currency, the euro, in order to avoid sharp changes in the values of the separate currencies and to reduce transaction costs of changing from one currency to another. There has been talk of potential monetary union (dollarization) in North America - among Canada, Mexico, and the United States, the three members of NAFTA - for the same reason. None of the three countries now supports this, but the idea is in the public domain. Many analysts believe that MERCOSUR, the common market of south - composed of

Argentina, Brazil, Paraguay, and Uruguay - should move toward a monetary union of its own, but Brazil does not support this and the position of the other three countries is uncertain.

One question often asked is whether a dollarized Western Hemisphere is inevitable on the grounds that its economic advantages outweigh the political and symbolic sovereignty disadvantages. The European Union came this conclusion, even though many countries still do not accept this - the United Kingdom, for one, at least for now. Few things other than death merit the descriptor "inevitable." What is clear, however, is that the issue of dollarization is now on the agenda and is unlikely to disappear.