

Monetary Options for the Americas

EXECUTIVE SUMMARY

The financial crises that have hit Latin America and the Caribbean in the past five years have intensified the debate about the most appropriate exchange rate policy for the countries of the region. While some countries have opted to float their currency, others have established a currency board mechanism to closely link it to the US dollar, or have adopted the US dollar as their own national currency. This paper examines the issue by first looking at the situations of some of these countries, i.e. Panama, Argentina, Ecuador, El Salvador and Mexico. It then summarizes the arguments for and against dollarization, outlines some common ground between advocates on both sides, and draws some conclusions about the future of the debate.

Proponents of dollarization argue that this policy would bring financial stability, help boost foreign investment, enhance fiscal discipline and improve the lot of the poor. They also believe that dollarization would foster the creation of a hemispheric bloc. Opponents emphasize that dollarization would represent a loss of sovereignty, of seigniorage (the profit that results from the right a government has to issue legal tender), and of the “shock absorber” role played by a floating currency in times of crisis. Opponents also argue that dollarization would have a negative impact on the poor.

On closer analysis, both sides may agree on more than their sometimes heated rhetoric would lead us to believe. The majority of analysts on both sides believe that dollarization does not constitute a magic bullet for the hemisphere’s ills, and is no substitute for a better regional financial system. They also agree that widespread formal dollarization will not occur in the short term, even though it may become a more viable option in the mid to long term (10 or 20 years). They concur that the US government would need to take a clearer position on the debate. Finally, there is a consensus that the impact of dollarization on smaller economies and the poor needs to be explored more fully.

The paper concludes that the debate around dollarization will likely continue in the coming years. Conducted so far mostly among a small group of economists, business people and academics, it would eventually have to reach the voters who hold the ultimate power for such a momentous decision. Dollarization in its different forms may also have an impact on foreign policy formulation, particularly with regard to sub-regional and hemispheric integration.

RÉSUMÉ

Les crises financières qui ont secoué l’Amérique latine et les Caraïbes depuis les cinq dernières années ont intensifié le débat à propos de la politique du taux de change la plus appropriée aux pays de cette région. Alors que certains pays ont opté de laisser flotter leur devise, d’autres ont établi un mécanisme de caisse

continued on page 2



FOCAL

Canadian Foundation for the Americas
Fondation canadienne pour les Amériques
Fundación Canadiense para las Américas
Fundação Canadense para as Américas

d'émission afin de fixer leur devise au dollar américain ou ont substitué leur devise nationale par ce dernier. Ce document examine cette problématique en observant la situation de plusieurs de ces pays, i.e. le Panama, l'Argentine, l'Équateur, le Salvador et le Mexique. Ensuite, cet article se propose de résumer les arguments pour et contre la « dollarisation », de dégager les points communs entre les partisans et les opposants de cette politique et finalement d'exposer certaines conclusions quant à l'avenir de ce débat.

Selon ses partisans, la « dollarisation » apportera une certaine stabilité financière, stimulera les investissements étrangers, améliorera la discipline fiscale et la situation des pauvres. Ceux-ci pensent également que cette politique favorisera l'émergence d'un bloc hémisphérique. Ceux qui s'opposent à la « dollarisation » mettent l'emphase sur une perte de souveraineté, plus particulièrement en ce qui concerne le droit de seigneurage (c'est-à-dire le profit découlant du droit de battre monnaie), et soulignent le rôle d'« amortisseur » que joue une devise flottante en temps de crise. De plus, ils affirment que cette politique aurait des répercussions préjudiciables à l'égard des pauvres.

Toutefois, à y regarder de plus près, il semble que les deux camps s'entendent plus que ne le laisse croire leur rhétorique parfois enflammée. La majorité des analystes appartenant aux deux camps croient que la « dollarisation » ne constitue pas un remède miracle aux maux de l'hémisphère et que cette politique n'est en rien un substitut pour un meilleur système financier régional. Les deux camps s'entendent également sur le fait qu'une « dollarisation » officielle et généralisée ne se produira pas à court terme, mais qu'elle pourrait devenir une option plus viable à moyen et long terme, c'est-à-dire d'ici 10 à 20 ans. Ils pensent aussi que le gouvernement américain devrait adopter une position plus claire dans le débat. Enfin, il existe un consensus quant à l'impact de la « dollarisation » à l'égard des petites économies et des plus pauvres qui, de l'avis de tous, nécessitera un examen plus approfondi.

Ce document arrive à la conclusion que ce débat va probablement continuer dans les prochaines années. Bien qu'il se soit essentiellement déroulé sous forme de groupuscule entre économistes, gens d'affaires et universitaires, ce débat devra aller chercher l'intérêt des électeurs qui possèdent le pouvoir ultime de prendre les décisions de cette envergure. Sous ses diverses formes, la « dollarisation » pourrait influencer aussi la politique étrangère, notamment sur le plan de l'intégration sous-régionale et hémisphérique.

RESUMEN

Las crisis financieras que han sacudido a América Latina y el Caribe en los últimos cinco años han intensificado el debate sobre cual debe ser la política cambiaria más adecuada para los países de la región. Al tiempo que algunos países han preferido la flotación libre de sus monedas, otros han decidido adoptar tipos de cambio fijos vinculados al dólar estadounidense (*currency board*), o directamente reemplazar sus monedas nacionales por esta. El presente trabajo comienza con un análisis de la situación en países como Panamá, Argentina, Ecuador, El Salvador, y México. Posteriormente, se ofrece un resumen de los criterios a favor y en contra de la dolarización así como los puntos de contacto entre uno y otro. Finalmente, este trabajo brinda algunas conclusiones acerca del rumbo futuro de este debate.

Quienes apoyan el proceso de dolarización arguyen que esta política traería consigo estabilidad financiera, incremento de la inversión extranjera, fortalecimiento de la disciplina fiscal, y un mejoramiento de la situación de los más pobres. Además, aseveran que la dolarización estimularía la creación de un bloque hemisférico. Por otra parte, los que están en contra afirman que la dolarización coadyuvaría al debilitamiento de la soberanía y del señoreaje (las ganancias que se obtienen a partir del derecho de los gobiernos a emitir moneda circulante), así como el papel de "resorte" que tiene el régimen de flotación cambiaria en tiempos de crisis. Asimismo, consideran también que esta política perjudicaría a los pobres.

No obstante, al observar detenidamente notaremos que ambas corrientes pueden ser más coincidentes en un número mayor de cuestiones que lo que aparentan sus intensos debates. La gran parte de los analistas a ambos lados de la discusión concuerdan en que la dolarización no es una fórmula mágica para solucionar los males que aquejan a la región, ni tampoco podrá reemplazar la necesidad de crear un sistema financiero regional más efectivo. Igualmente, convienen en que la generalización de esta política no tendrá lugar en el corto plazo sino que pudiera llegar a ser una alternativa más viable en el mediano o largo plazo (en 10 ó 20 años). Asimismo, concuerdan en que el gobierno de los Estados Unidos deberá asumir una postura más precisa sobre el tema. Por último, todos coinciden en que el debate sobre las consecuencias de esta política para las economías más pequeñas y los países más pobres deberá ser estudiada con mayor profundidad.

Como conclusión, se vaticina que el debate sobre dolarización continuará en los próximos años. Hasta el momento la polémica sobre el tema ha tenido lugar entre un reducido grupo de economistas, hombres de negocios y académicos. En el futuro esta cuestión deberá ser debatida por los votantes, quienes poseen en última instancia la potestad de decidir sobre tan importante cuestión. Además, el proceso de dolarización, en sus diferentes formas, podrá incidir en la formulación de las políticas exteriores, especialmente en lo referente a los procesos de integración subregional y hemisférica.

DEFINING THE PROBLEM

After the "lost decade" of the 1980s, the past decade in Latin America and the Caribbean is viewed generally as one of economic progress. Most countries of the region brought inflation under control, opened up to foreign trade and investment and put in place sound fiscal and macroeconomic policies. The result was renewed growth, albeit at the price of sometimes wrenching strains on the social fabric of these societies. However, despite the success of these first-generation economic reforms (second generation reforms dealing with state reform, education and poverty alleviation are now much needed), the region has been hit by recurring financial crises in the past few years.

The Mexican and Brazilian currency crises of 1994-95 and 1999, as well as the ripple effects of the Asian financial crisis in 1997, had a particularly strong impact. To some, this seemed to prove that the region was at the mercy of outside forces and that little could be done to check the ever-growing power of financial markets. Others, however, saw the crises as an opportunity to renew the search for alternatives to current financial arrangements, or at least for ways to mitigate their impact. Other than controls on external financial flows, which, if applied too rigidly, would shut out much-needed foreign investment, one proposed solution was the

establishment of a new financial architecture, either at the regional or the global level. Involving complex negotiations among governments and private sector actors at the national and multilateral levels, the main purpose of such a financial architecture would be to help insulate otherwise healthy economies from some of the worst swings in investor sentiment. Considerable efforts have been made to reach this goal, but at the same time, the region's relatively rapid recovery from the Brazilian *real* crisis last year seems to have lessened the sense of urgency for putting such an architecture into place.

Another proposed solution was to replace the national with a common currency. Other than the financial crises referred to above and the rapid integration of financial markets and production processes that had been underway for several years, the launch of the euro by the European Union (EU) in January 1999 gave a further push to this idea. Just as the introduction of the euro promised to increase financial stability in the Old Continent, a hemispheric currency would bring stability to the Americas. However, the notion of a common currency for the Americas had obvious drawbacks, such as the lower level of integration among the countries of the hemisphere, the opposition by the US to any form of shared monetary policy, as well as the fact that the US dollar was already a pervasive

presence in the economies of the region. Therefore, the debate turned to a more radical, and possibly more effective way of reaching the goal of a common currency in the Americas: the unilateral adoption of the US dollar by the countries of the hemisphere, replacing their national currencies. This scenario, generally referred to as dollarization, will be the focus of this paper.

COUNTRY CASES

Dollarization is a hotly debated topic among the academic, policy, business and financial circles in most countries of the Americas, but actual monetary policies differ widely. Most of the larger Latin American countries have decided against dollarization.

For example, Mexico, Chile, Peru, Colombia and Brazil have opted to float their currencies and let financial markets decide an appropriate value for them. By contrast, countries such as Argentina, Panama, Ecuador or El Salvador have either embraced dollarization or are actively considering it, sometimes opting for some form of currency board instead of scrapping their national currencies outright. As the following section will show, the motivations behind these policy choices differ and the few cases where dollarization has been tried have yielded inconclusive results.

Panama

Panamanian leaders like to remind everyone that, with the recent exception of Ecuador, Panama is the only country in the Americas that has had first-hand experience with dollarization. Having adopted the US dollar as its national currency as early as 1903, Panama offers lessons for both proponents and opponents of dollarization. On the plus side, the country has largely been insulated from the direct impact of currency crises, and it has been able to develop a buoyant financial services industry. But dollarization has not resulted in a higher standard of living for most Panamanians.

Argentina

Argentina did not opt for full dollarization but chose a close cousin in terms of exchange rate policy, a mechanism resembling a currency board. It did so mainly for reasons of internal monetary stability, as a means to combat chronic inflation fuelled by inadequate monetary policies. Under the 1991 *Ley de convertibilidad*, the state guarantees a one-for-one convertibility between the Argentinean peso and the US dollar. This mechanism means that the Central Bank will issue pesos only when they can be fully backed by an equal value of dollars, gold or other financial instruments linked to a basket of hard currencies. Argentina became a rallying point

The debate turned to a more radical, and possibly more effective way of reaching the goal of a common currency in the Americas: the unilateral adoption of the US dollar by the countries of the hemisphere.

for proponents of dollarization in the weeks following the Brazilian crisis, most notably Argentina's then-President, Carlos Menem. However, Argentina's "silver bullet" lost its sheen when Brazil's economy quickly recovered, while Argentina's sank into recession. As a result of the 37% devaluation of Brazil's currency (the *real*), Argentina's competitiveness vis-à-vis its most important trading partner suddenly was seriously compromised, even if it has since recovered somewhat, due

to the re-appreciation of the *real*. By mid-1999, Argentina had become an example of the potential problems facing countries that dollarize, in the sense that its rigid exchange rate system deprived it from much-needed flexibility to absorb external shocks.

Ecuador

After losing some of its momentum in the second half of 1999, largely because of the economic recession in Argentina, the dollarization debate received a new boost in early 2000 due to the political, economic and financial crisis that was developing in Ecuador. As a last-ditch attempt to save his presidency from impending collapse, then-President Jamil Mahuad announced his government's intention to implement full dollarization. This resulted in massive demonstrations a few days later, and he was toppled by a military coup. However,

his replacement, former Vice-President Gustavo Noboa, renewed his predecessor's commitment to dollarization, and the country has since removed all *sucre*s from circulation. As an example of a "crisis-driven" dollarization, used as a quick fix for seemingly intractable political and social problems, the Ecuadoran case is somewhat untypical and even proponents of dollarization are not completely comfortable with it. Whether or not it will become a success story still remains to be seen.

El Salvador

El Salvador has not formally dollarized, but is considering this option in the short to medium term. Support has come and gone in the past few years. Last year, the government of President Armando Calderón Sol proposed to dollarize, but backed off in the face of business opposition. In March 2000 José Luis Trigueros, the country's finance minister, mentioned that El Salvador might follow Ecuador's example, but opposition from different sectors of society forced him to backtrack. El Salvador would certainly be in a better position to dollarize than other countries, notably Ecuador. It has relatively large hard currency reserves and the *colón*, the country's currency, has been pegged at 8.7 to the dollar since February 1994. However, this lack of flexibility in the exchange rate has also made El Salvador's exports less competitive, particularly in the *maquiladoras* sector, resulting in calls to float the currency instead.

Mexico

An informal debate on dollarization and currency union has been simmering in Mexico for several years, especially since the country joined NAFTA in 1994. This debate was brought into the open following Vicente Fox's victory in the July 2000 presidential elections, when Mr. Fox suggested not dollarizing, but moving towards some form of currency union for NAFTA in the medium to long term (ten to twenty years). Mexico is a very interesting case

in the context of the dollarization debate. On the one hand, the country has opted to float its currency in the wake of the "tequila crisis" of 1994-95, and is now doing very well in terms of financial stability and overall growth. On the other hand, Mexico's economy is increasingly becoming intertwined with that of the US, with close to 85% of its exports going to the US market. More importantly, a growing number of companies in both countries are operating seamlessly across the border and already function in US dollars only. Mexico's macroeconomic indicators and business cycles are also coming into closer alignment with those of the US, making dollarization both easier and more plausible.

Argentina became a rallying point for proponents of dollarization in the weeks following the Brazilian crisis,... [but] Argentina's "silver bullet" lost its sheen when Brazil's economy quickly recovered, while Argentina's sank into recession.

THE CASE FOR AND AGAINST DOLLARIZATION

Sometimes seen as taboo or at least highly sensitive by governments in the hemisphere, the topic of dollarization is gradually being more openly discussed. In economic and financial circles, an in-depth debate is certainly taking place, going much beyond the basic arguments that will be presented here. After doing so below, this paper identifies some of the common ground shared by both sides in this debate.

Dollarization: The "Pros"

Dollarization would bring currency stability. The debate on alternative monetary regimes in the Americas intensified as a result of the repeated financial crises that have hit the region in the past five years. Proponents of dollarization claim that a common currency in the Americas would prevent the kind of speculative attacks on national currencies that triggered the Mexican and Brazilian crises.

Dollarization would help boost foreign investment. The argument here is twofold. First, by bringing stability and predictability to financial markets, dollarization would encourage foreign investment that would otherwise stay away or be pulled out in times of crisis. Second, dollarization would make it

unnecessary for large foreign firms — whose internal accounts are often denominated in US dollars — to hedge against currency fluctuations in the futures market. While providing an effective shield against such fluctuations, hedging and other instruments increase the cost of doing business in the Americas and therefore have a dampening effect on investments.

Dollarization would improve competitiveness.

Of all the ways a country can react to external shocks, proponents of dollarization consider devaluation or depreciation the “lazy way out”

(opponents of dollarization value the “shock absorber” effect of these measures; see below).

Devaluation (where the exchange rate was previously fixed) or depreciation (through the open trade of a floating currency) means that every wage earner or asset owner in the local currency becomes poorer in US dollar terms. A corresponding rise in salaries or prices is out of the question, since it would only reduce competitiveness and fuel inflation. Proponents of dollarization argue that in a dollarized economy, workers and firms have to realize that if they do not improve their competitiveness through more efficient work practices or production processes, they will have to face either salary cuts or loss of profits or market share. The idea is, therefore, that dollarization will bring the responsibility for a lack of competitiveness much closer to home and will generally result in higher levels of productivity.

Dollarization would improve fiscal discipline.

The argument rests on the fact that a dollarized country loses the ability to print money as a way out of economic difficulties. Its government can only spend the dollars it has and cannot engage in the inflationary behaviour so common in Latin America in the 1980s and early 1990s, leading to hyperinflation in some cases and requiring drastic corrective measures. In a dollarized economy, there is little alternative to fiscal discipline, and the government either has to

tax more or spend less (or, of course, opt for a combination of both). This does not mean that the country has to balance its budget at all times, or that it loses the ability to provide an economic stimulus in times of recession. But in order to do so, it would have to borrow on the domestic or international markets and a lack of fiscal discipline would quickly tarnish the country's credibility as a debtor and lessen investors' willingness to buy that country's sovereign bonds at a reasonable price.

Dollarization would foster the creation of a hemispheric bloc.

Proponents of dollarization argue that if the countries of the Americas want to truly integrate into a hemispheric bloc, they will have to adopt a single currency. This argument gives a political cast to the debate around dollarization: if the world is to evolve into three huge trade and currency zones, namely the euro, US dollar and yen areas, then dollarization in the Americas would become essential. Not doing so would leave Latin American and Caribbean countries dangerously out of the great currents of the world economy. In the short term, dollarization would provide a major boost for the negotiations for a Free Trade Area of the Americas (FTAA).

Dollarization is good for the poor. The impact of dollarization on the poor is a hotly debated topic. Advocates of dollarization argue that it is the best guarantee against inflation, considered the worst curse upon the poor. In its absence, devaluation or depreciation of a currency will hit them disproportionately hard. The poor do not have access to tools that could help mitigate the situation, such as inflation-adjusted bank accounts or inflation-adjusted salaries (the poor often work in the informal sector). While many professionals in Latin American countries receive their salaries in US dollars, this is not an option available to the poor. Therefore, dollarization is seen as good for the poor because it is a guarantee of solid money.

Proponents of dollarization argue that in a dollarized economy, workers and firms have to realize that if they do not improve their competitiveness..., they will have to face either salary cuts or loss of profits or market share.

Dollarization: The "Cons"

Dollarization results in a loss of sovereignty.

While in Europe, the adoption of a common currency, the euro, led to an increased pooling of national sovereignty, dollarizing countries in the Americas would see their own sovereignty reduced. At a symbolic level, opponents of dollarization argue, these countries would give up their currencies in favour of that of the United States, a country traditionally viewed as the greatest threat to their political independence. More importantly, they would relinquish control over their monetary policy to the US, and the US authorities have already indicated they would see no need to take the needs of dollarized countries into account. In particular, there are no plans to regionalize or multilateralize the Federal Reserve, and the absence of such a hemispheric central bank makes dollarization very different from the approach adopted in Europe. Furthermore, the Federal Reserve would not act as a lender of last resort for dollarized countries and it would set interest rates without regard for their concerns.

Dollarization entails a loss of

seigniorage. Seigniorage is the profit that results from the right of a national government to issue legal tender, in the sense that its own currency can be seen as a form of non-interest-bearing debt. Opponents of dollarization argue that a country which decides to dollarize unilaterally loses this substantial profit, given that it would have to acquire US dollars through exports of goods and services (US Senator Connie Mack has proposed to share seigniorage with dollarizing countries; see below). For example, if Argentina decided to fully dollarize, it would have to forgo about US\$15 billion from loss of seigniorage.

Dollarization means the loss of a "shock absorber." Opponents of dollarization assert that when a country scraps its national currency, it abandons an essential tool of its economic and monetary policy, using a floating currency as a "shock absorber" in times of crisis (which is considered the

"lazy way out" by advocates of dollarization; see above). For example, if a country is dependent on exports of a few commodities, a sudden drop in the international prices of these commodities will result in the immediate loss of hard currency revenues. Without control of its own monetary policy, the country is unable to quickly adjust through the depreciation of its currency. In that case, there will be little time for short-term improvements in productivity, and the absence of this natural "shock absorber" will result in immediate domestic adjustments through job losses and recession. In addition, the country would have to follow US interest rate policy, even if that

makes its own predicament worse (for example, by having to raise interest rates in times of recession or lowering them when the economy is overheating).

The US dollar may not be the most appropriate hard currency. While dollarization could make sense for countries that have a high percentage of trade with the US, critics point out that for countries with a more balanced distribution of their trade, a basket of hard currencies under a currency board system may be

a more appropriate solution. This would protect them from sudden shifts in the value of the US dollar and give them back some of the autonomy in their monetary policy, which would be completely lost in case of dollarization. After all, a major new world currency was introduced in 1999 with the euro and it may be inappropriate for some South American countries that have a substantial share of their trade with Europe to opt for the US dollar.

Dollarization is bad for the poor. Opponents of dollarization argue it would have a negative impact on the poor, for several reasons. First, the available evidence from countries such as Panama suggests that dollarization did not alleviate the plight of the poor, on the contrary. Second, by taking away one of the main tools at the disposal of governments to help stimulate the economy in times of recession, dollarization would substantially

While in Europe, the adoption of a common currency, the euro, led to an increased pooling of national sovereignty, dollarizing countries in the Americas would see their own sovereignty reduced.

increase unemployment levels and thereby poverty. Finally, the poor are often the least prepared when a country dollarizes, such as most recently in Ecuador. The upper and middle classes often hold US dollar accounts already and are used to dealing with this currency. The poor, on the other hand, do not have this option. Those living in remote regions sometimes have never seen a US dollar and are therefore prime targets for fraudulent schemes and forgery.

SOME COMMON GROUND

On the surface, the debate over dollarization appears to take place between two firmly entrenched camps, leaving little room for compromise. However, on closer analysis, both camps may agree on more than their sometimes heated rhetoric would lead us to believe. Some aspects of the debate where such common ground may be found are examined below.

Dollarization is no magic bullet for the hemisphere's ills. This is a common critique presented by opponents of dollarization. But even some of its most avid proponents are uncomfortable with the extravagant claims that dollarization will bring immediate and substantial benefits, such as responsible government and an end to political deadlock, or vast amounts of new investment.

After all, through most of the last century, Panama has not been a model of good governance and sound economic policy. Brazil, despite its floating exchange rate regime, is currently attracting large amounts of foreign investment, often at the expense of its quasi-dollarized neighbour, Argentina. In Ecuador, dollarization brought no quick solution to the political and economic crisis plaguing the country. In fact, the best candidates for dollarization seem to be those countries that have already put their political and economic house in order and that opt for dollarization to shield themselves from future turbulences.

Dollarization is no substitute for a better financial architecture. As mentioned above, the dollarization debate intensified when Latin America and the Caribbean were hit by two major financial crises over the course of the past five years. Mexico and Brazil, the countries at the centre of these two crises, were able to recover rather quickly, in good part because of the massive financial packages that were put together by multilateral institutions and individual countries, under the leadership of the United States. Unfortunately, because these packages were so effective, the political resolve needed to put into place a more permanent financial architecture for the region quickly waned. Without such an architecture, involving multilateral initiatives as

well as reforms in the banking sectors of individual countries, dollarization remains a second-best option for financial stability, particularly if dollarized countries are in the minority. Argentina was probably the most severely hit by both the Mexican and the Brazilian crises, and being quasi-dollarized provided it with little protection. Dollarization advocates would prefer to see a coordinated move towards dollarization among the larger countries of the region. Uncoordinated decisions may leave dollarized countries out in the cold when their major trading partners continue to experience competitive devaluation or

depreciation of their currencies, as has happened in Argentina vis-à-vis Brazil.

Other options are available besides dollarization or a pure float. Dollarization and a pure float are the two extremes of exchange rate policy. In recent years financial markets have often speculated against the currencies of countries trying to adopt a more middle-of-the-road approach (through the use of a "crawling peg" system for example). However, critics point out that more balanced solutions, such as a managed float or a currency board, may provide more suitable solutions, both economically and politically. Furthermore, a common currency other than the US dollar

Even some of its most avid proponents are uncomfortable with the extravagant claims that dollarization will bring immediate and substantial benefits, such as a responsible government and an end to political deadlock, or vast amounts of new investment.

could eventually emerge in the Americas. Mercosur countries have been discussing this idea for some time, even though the opposing exchange rate policies adopted by its two main members (Argentina and Brazil) seem to render the establishment of a common currency more difficult. In North America, Mexican President-elect Fox has recently floated the idea of a common currency for the NAFTA countries. The US dollar is unlikely to disappear in favour of such a currency anytime soon but if the current pace of integration between the three NAFTA countries is any indication, creative proposals that would prove more politically palatable to all parties may start to emerge.

Dollarization is not a serious option in the short term.

Dollarization advocates naturally seized the moment when the debate on the benefits of a common currency grabbed the headlines following the Brazilian crisis and the successful launch of the euro. However, few proponents of dollarization would seriously propose such an immediate radical change in exchange rate policy for most countries of the hemisphere, particularly the larger ones. Indeed, according to most forecasts, the countries with the best economic prospects for the next two years are those that have decided to float their currencies, such as Mexico and Brazil.

Dollarization may become a more viable option in the mid to long term. Opponents of dollarization would concede that in the mid to long-term (10 or 20 years), the arguments for dollarization may become stronger. First, the financial and business sectors in many countries of the hemisphere are already operating chiefly in US dollars. The rapid rise in international trade and the integration of production processes across borders may reinforce this trend, even though a large share of this trade continues to be conducted with Europe. Also individuals in many countries have bank accounts in US dollars, and conduct everyday transactions, such as buying a house, in this currency. Second, to the extent that countries in the region adopt similar economic

and fiscal policies, their macroeconomic indicators, and possibly their business cycles, may come further into line with those of the US. Finally, if the hemisphere moves toward greater integration with a successful conclusion of the FTAA negotiations in 2005, the move toward a common currency could emerge as a logical next step toward further integration.

The US government cannot stay on the sidelines forever. Up to now, the US government has not taken a position for or against dollarization in the Americas, except to say that its own monetary policy will not change as a result. In

the US Congress, Senator Connie Mack, Chairman of the Joint Economic Committee and the Banking Subcommittee on Economic Policy, proposed to share profits from seigniorage with countries that dollarize. While this is not likely to become official US policy, the US may become more flexible on that point in bilateral talks with countries wishing to dollarize. In any event, the US cannot avoid taking a position on this issue if more and more countries decide to dollarize,

particularly the larger ones, given the likely impact on US monetary policy in the event of a crisis.

The impact of dollarization on smaller economies needs to be explored more fully.

While the arguments for or against dollarization are not fundamentally different when it comes to smaller economies, additional factors need to be taken into account. First, because of their size, smaller economies often have a more limited range of monetary policies available to them. A fully floating currency of a smaller state may be a much easier target for large international investors wishing to speculate against it. Structural costs for maintaining a national currency are also relatively higher for smaller economies, particularly for small island states. This partially explains why the countries of the Organization of Eastern Caribbean States have opted for a common currency (the Eastern Caribbean dollar). Finally, the smaller

Opponents of dollarization would concede that in the mid to long-term (10 or 20 years), the arguments for dollarization may become stronger.

economies in the Americas, generally located in Central America and the Caribbean, may become increasingly integrated into the US economy, particularly following the recent adoption of the US-Caribbean Basin Trade Partnership Act (part of the Trade and Development Act of 2000). It is therefore no surprise that wide-ranging debates on the potential costs and benefits of dollarization are taking place right now in several smaller states.

The social policy implications of dollarization will have to be carefully analyzed. The impact of dollarization on the poor is a controversial topic and needs further in-depth analysis. Both sides of the debate make a strong case for why dollarization would be good or bad for the poor. Therefore, before dollarizing, governments should carefully analyze the likely consequences, particularly regarding issues such as inflation, unemployment or competitiveness. In any case, the more vulnerable segments of the population, particularly those living in remote rural areas or working in the informal economy, will need special assistance. This was overlooked in Ecuador, where confusion surrounding the switch to the US dollar seriously undermined political support for this measure. The impact on the poor is particularly acute in the short term, when a sudden mismatch in prices and salaries can occur and when those least informed are a prime target for fraudulent activities.

Ultimately...it will be up to governments and their electorates to decide whether to dollarize or not. A decision of this magnitude...should be preceded by a wide-ranging national debate.

CONCLUSION

The debate on dollarization is likely to continue, occasionally taking on nationalist flavours and exciting passions on both sides of the divide. Ultimately, however, it will be up to governments and their electorates to decide whether to dollarize or not. A decision of this magnitude, abandoning the national currency, as well as sovereignty over monetary policy, in favour of that of another country, cannot be taken on the basis of technocratic or economic criteria alone, but should be preceded by a wide-ranging national debate. It remains to be seen whether such debates will take place, taking the issue out of the hands of economists, business people and academics and placing it squarely in the public realm.

Common currency regimes may also become an issue for foreign policy formulation, particularly with regard to sub-regional and hemispheric integration. Some governments in favour of such integration may come to the conclusion that a common currency is in their countries' best interest. Of course, as long as the frame of reference remains a free trade area and not a common market, as is the case in NAFTA or the current FTAA negotiations, this question is not on the agenda. But events can run ahead of time, as Vicente Fox's recent remarks on the deepening of NAFTA and the potential benefits of a common currency have shown. The time may not yet be ripe for these ideas, but they will be harder to ignore in the future.

WANT TO KNOW MORE? LOOK FOR:

Andrew Berg and Eduardo Borensztein, *The Pros and Cons of Full Dollarization*, (IMF Working Paper, March 2000); Ricardo Hausmann, *Should There Be Five Currencies or One Hundred and Five?*, (Foreign Policy, Fall 1999); Jeffrey Sachs and Felipe Larrain, *Why Dollarization Is More Straitjacket Than Salvation*, (Foreign Policy, Fall 1999); *Encouraging Official Dollarization in Emerging Markets*, (Joint Economic Committee Staff Report, Office of the Chairman, Senator Connie Mack, US Senate, April 1999); Gary C. Hufbauer and Jeffrey J. Schott, *The Intersection of Trade & Finance: Small Economies in the Western Hemisphere*, (Institute for International Economics, March 1999); Ricardo Hausmann, Michael Gavin, Carmen Pages-Serra and Ernesto Stein, *Financial Turmoil and the Choice of Exchange Rate Regime*, (Inter-American Development Bank, 1999); Eduardo Fernandez-Arias and Ricardo Hausmann, *International Initiatives to Bring Stability to Financial Integration*, (Inter-American Development Bank, March 1999). Also see Nouriel's Roubini's website on *Dollarization: A Solution for Emerging Markets?* at: www.stern.nyu.edu/~nroubini/asia/dollarize.htm

November 2000

ISBN: 1-896301-52-5

Publications Mail Agreement #1606328

The Canadian Foundation for the Americas (FOCAL) is an independent, non-governmental organization that fosters informed and timely debate and dialogue on issues of importance to decision-makers and opinion leaders in Canada and throughout the western Hemisphere. Established in 1990, FOCAL's mission is to develop a greater understanding of important hemispheric issues and help to build a stronger community of the Americas.

An internal version of this paper was prepared by Pierre Bouchard, formerly Senior Analyst, Trade and Economic Policy, FOCAL. Gerd Schönwälder and Nobina Robinson also contributed to this publication. Editorial services were provided by Brian Cameron, Cameron and Associates. FOCAL thanks Roy Culpepper and John Serieux of the North-South Institute for their comments. The preparation and printing of this paper has been made possible thanks to support from the Department of Foreign Affairs and International Trade.

Additional copies of this paper may be obtained from the FOCAL web site (www.focal.ca)



FOCAL

Canadian Foundation for the Americas
Fondation canadienne pour les Amériques
Fundación Canadiense para las Américas
Fundação Canadense para as Américas

1 Nicholas Street, Suite 720
Ottawa, Ontario
K1N 7B7 Canada
Telephone: (613) 562-0005
Fax: (613) 562-2525
E-mail: focal@focal.ca
Web Site: www.focal.ca