Dollarization for Latin America?

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My bottom line on the issue of Latin American dollarization is that (1) the U.S. government should *not* promote a general dollarization of Latin America, and (2) our government *should* accommodate the dollarization of any Latin American country, if requested by their government for their own reasons.

The Case Against an Active U.S. Dollarization Policy

My case against U.S. promotion of Latin American dollarization rests on a judgment that the Western Hemisphere is *not* an optimal currency area, even less so than Europe. The economies of the Western Hemisphere are quite heterogeneous and are likely to be subject to quite different shocks. The United States, for example, is a major net commodity importer, many other countries in the hemisphere are net commodity exporters, and a relative change in commodity prices would thus have quite different effects within the region. Nor is there much mobility of labor within the hemisphere, except across the U.S.-Mexican border, that would ease the effects of a differential shock. A fixed exchange rate or a common currency in the Western Hemisphere, thus, would increase the *variance* of economic growth and the unemployment rate within the region, increasing the incentives for the governments in those countries experiencing a negative shock to withdraw from the currency arrangement.

Creating a dollar area of the Western Hemisphere, moreover, would yield only a small reduction in U.S. transactions costs. The United States has surprisingly little trade with Latin American countries south of Mexico, and much of that trade, such as our imports of oil and illegal drugs, is already conducted in dollars. Most U.S. trade and investment flows, except with our immediate neighbors, are with

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Europe and Asia, not on a north-south orientation. U.S. trade with Argentina, for example, is a fraction of one percent of our exports and imports; Argentina ranks as our 31st largest trading partner, just behind the Dominican Republic. So the United States would save only a trivial amount of transactions costs by an Argentine decision to replace the peso with the dollar.

For these reasons, I suggest, most of the governments of Latin America are best advised to maintain a flexible exchange rate with the dollar *unless* a fixed exchange rate or adopting the dollar is necessary to maintain domestic monetary stability.

The Proper Sequencing of Dollarization

Although I do not advocate U.S. activism in the promotion of Latin American dollarization, I do recognize that many governments in Latin America have a record of domestic monetary *in*stability. If there is no way to sustain responsible central bank policy or no way to protect the central bank against the treasury, a government is best advised to constrain or abolish the central bank. It is important, however, to recognize that a decision to adopt the dollar is the *fourth* in a sequence of decisions, and it is important to understand the implications of each decision in this sequence.

The First Step

The characteristic first decision is to replace a flexible exchange rate with a pegged but adjustable exchange rate with some major external currency. For many governments, this seems like an attractive decision—promising to stabilize domestic demand and reduce short-term exchange risk while maintaining the option of adjusting the exchange rate in response to a major threat to the reserve position. There is increasing recognition, however, that this common type of exchange rate policy may be the worst of the feasible options—increasing the variance of interest rates without proving to be sufficient to protect the central bank against the treasury or to reduce the long-term exchange rate risk. Most governments, however, have to go through one or more exchange rate crises before they abandon this policy.

The Second Step

For some governments, the second decision is part of the first decision—to choose the U.S. dollar as the external currency to which they peg their own currency. The choice among the potential reserve currencies, however, involves several considerations, and the dollar may not be the best reserve currency for many governments. One would prefer a reserve currency of an economy with four characteristics:

1. A record of stable domestic monetary policy and the institutions that promise to sustain this policy.
2. An economy sufficiently like one's own so that there is little prospect of a major differential shock.
3. An economy sufficiently close and open to labor mobility to permit a migration response to a differential shock.
4. An economy that is a major trading partner of one's own, in order to economize on transactions costs.

For any country, no potential reserve currency meets all of these criteria. And the second and fourth criteria are likely to be negatively related. It is interesting to observe that the British pound seems to be the logical reserve currency for Ireland—meeting the first, third, and fourth criteria—but that the Irish, for reasons of their own, chose the German mark. For Argentina, the U.S. dollar meets the first criteria but only weakly the fourth: exports to the United States are only 8 percent of total exports, and imports from the United States are 20 percent of total imports, so that there is little saving in transactions costs. Argentina would be better served by a stable Brazilian currency, but that seems unlikely. Among the major governments of Latin America, Mexico would benefit most from a firm dollar peg; for them, the dollar would meet the first, third, and fourth criteria. My major point here is that the dollar is not the only or logical reserve currency for all of the governments of Latin America, a choice that depends on the balance of the above four criteria.

The Third Step

The third decision is to whether to replace a pegged but adjustable exchange rate with a currency board. Steve Hanke and others have made a compelling case that this would be a wise decision, and I will not elaborate on this case. The currency board advocates, however, have not made a case that a currency board is superior to a flexible exchange rate for every country.

The Final Step

The fourth decision is whether to replace a currency board and the domestic currency by adopting the reserve currency. The case for this decision is much like the case for a currency board—to effectively eliminate the exchange rate risk relative to the reserve currency. Once a government adopted the reserve currency, the probability that it would reinstate the domestic currency would be much lower than the probability that it might abolish the currency board. This would probably also reduce the level and variance of domestic interest rates. The only real cost of this decision would be the loss of seignorage on the domestic currency and the opportunity to feature one's own national heroes on the domestic currency. The United States could offset the loss of seignorage by selling the other government enough dollars to meet the domestic demand at a price that covers only the cost of printing the dollars. Only the government considering this decision can evaluate the loss of opportunity to feature one's own national heroes on the domestic currency.

Recent Developments

Since presenting the above remarks, a number of later related developments merit comment.

The Brazilian Devaluation

The government of Brazil devalued their currency relative to the dollar by over 40 percent in January 1999. This created severe problems for Argentina, which maintained its currency board arrangement with the dollar, making Argentine exports more expensive in Brazil and Brazilian exports cheaper in Argentina. This provoked petitions for protection by several Argentine industries, and the government responded by imposing import restrictions on Brazilian footwear, textiles, pulp, and paper, revealing the lack of an adequate dispute settlement mechanism in the regional trading agreement Mercosur. Argentine exports to Brazil, its major trading partner, declined 28.5 percent in 1999 and the Argentine real GDP declined 3.1 percent, provoking some public debate about whether to maintain the currency board arrangement with the dollar. For the moment, this test of the Argentine currency board seems to be over. The election of a new president in Argentina from the opposition party suggests broad support for the currency board, and real GDP is expected to increase by 3.4 percent in 2000. This episode, however, illustrates the strains on a currency board or full dollarization when major trading partners are subject to a differential shock.

Ecuador's Move toward Dollarization

The government of Ecuador started a process in March 2000, following a political crisis and financial panic, that may lead to adopting the dollar as their domestic currency. This decision was made without much deliberation or public debate and without the prior step of a currency board. This process has not yet been completed, and the future status is uncertain; there continues to be a public debate about dollarization, and the dollar has not yet replaced the sucre as the domestic currency.

Mexico's Political and Financial Stability

Until recently, Mexico seemed to be the most likely next country to adopt the dollar, with its record of financial instability and a moderately open border with its major trading partner, the United States. Developments in Mexico in 2000, however, have been a pleasant surprise. For the first time since 1970, Mexico seems about to complete a presidential election year without a financial crisis. The election of a president from the major opposition party promises continued modernization of Mexican economic policies. And foreign exchange traders have reacted to these developments by bidding up the exchange rate for the peso. If these promises are realized, there is no reason for Mexico to adopt the dollar.

Conclusion

These recent developments confirm my general conclusion that a currency board or full dollarization is best for a nation only as a last resort, an institutional response to despair that the government could ever maintain a responsible domestic monetary policy. For governments that have demonstrated the understanding and discipline necessary for a responsible monetary policy, I continue to conclude that a flexible exchange rate best serves the nation. In any case, the issue of the U.S. response to dollarization by some other country is still open. In July 2000, the Treasury expressed opposition to a bill that would share the seigniorage with those other governments that choose to adopt the dollar.