Official versus Spontaneous Dollarization

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The Superiority of Currency Competition

Dollarization is gaining support in Latin America as the definitive way to leave behind its inflationary past. By dollarization I mean the official demise of a country's currency and its replacement by that issued by another country (the partner), taken here to be the dollar. Dollarization sounds modern, outward looking, truly liberal. But the sweet elixir may conceal a dangerous poison. In my view, far from creating a stable monetary framework, dollarization would aggravate the domestic impact of foreign disturbances, drive the attention of policymakers away from the true sources of instability and could even jeopardize hard efforts to bring free market growth to Latin American economies.

There is, to be sure, an alternative to official dollarization: to allow open and free circulation of foreign moneys within a country, in competition with the local one, on the same legal grounds and under floating exchange rates. I have nothing against this alternative monetary regime; currency competition is a natural extension of individual liberty and a practical way to protect Latin American economies from their central banks' monetary follies. Such an arrangement, which we might call "spontaneous dollarization," would be a positive step toward a Hayekian system of competitive private monies.

Drawbacks of Official Dollarization

Unlike currency competition, in which good monies drive out bad monies via the market process, official dollarization is an act of government intervention that demonetizes the national currency. The working of a dollarized economy is very similar to a currency board

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arrangement, in which the permanent fixing of the nominal exchange rate prevents the government from using monetary policy as a macroeconomic tool. The advantage of dollarization over a currency board is that the former is less reversible and thus more credible. The practical implication of this is that dollarization would do away with the costly spread between local currency and dollar interest rates in a currency board country. But, to me dollarization has essentially the same drawbacks as a currency board system.

The most often mentioned disadvantages of dollarization are (a) the loss of seigniorage and (b) the loss of a domestic lender of last resort. I do not see these as the most serious problems. Regarding (a), dollarization would require the Chilean government, for example, to undertake a one time purchase of dollar coins and bills in the amount of about 3 percent of GDP to replace outstanding local peso coins and bills, plus the yearly growth in currency demand due to economic growth and inflation. Since pesos are produced at essentially zero cost, seigniorage lost would be the opportunity cost of such purchase, equivalent to a flow some 0.2-0.3 percent of GDP every year and forever: not an unbearable fiscal burden, it seems, although because of real GDP growth, the discounted present value of such flow may well amount to same 20 percent of the initial GDP, under plausible assumptions for growth, inflation, and discount rates.

Regarding (b), although having the expediency of a central bank acting as lender of last resort may be helpful during banking crises, financial rescue packages are seldom financed by printing money because it would be highly inflationary. Instead, public debt is issued by the central bank or some other government agency and sold to local or foreign creditors, either voluntarily or with different degrees of "arm twisting." In other words, if you want to do lending of last resort—and face the associated moral hazard and fiscal costs—dollarization is no obstacle.

Therefore, my critique of dollarization and currency boards will not be based on the said disadvantages, but on their inability to create a truly stable monetary framework, except under a set of very stringent conditions that are quite distant from the current Latin American reality.

Dealing with Shocks

The most important benefit of dollarization is eliminating central banks as a source of money supply shocks. The monetary history of most Latin America countries has been really scary, and many see that by getting rid of politically motivated or simply incompetent central bankers, dollarization provides the only way to make sure Latin America will ever get to know price stability.

Unfortunately, dollarization or currency boards do not do away with all monetary shocks. They eliminate domestic money supply shocks but not currencies shocks from the anchor country or real exchange rate movements between the home and anchor countries.

Partner's Money Supply Shocks

Dollarization would make Latin American countries rely fully on U.S. monetary policy. Although the Fed has recently performed exceedingly well, this has not always been the case. And, of course, good future performance is not guaranteed. A well-managed local currency, floating freely, and in open competition with foreign currencies offers I think, better protection against money-issuing sovereigns, national as well as foreign.

Partner's Real Exchange Rate Shocks

In a world of *n* floating exchange rates, to fix one's exchange rate with respect to one currency still leaves you floating with respect to the *n*-1 remaining currencies. Under its currency board, Argentina has been suffering deflationary pressures because of the dollar appreciation vis-à-vis the euro (which makes Argentina's exports to Europe more expensive and its imports from Europe cheaper). Even a dollarized Mexico would be affected indirectly by competition of third countries' exports to the U.S. market. Of course, a well-managed and freely floating local currency would not prevent these shocks from having microeconomic effects, but market-driven local exchange rate adjustments would minimize their macroeconomic consequences.

Own Real Exchange Rate Shocks

Fluctuations of the fundamentals determining one's equilibrium real exchange rate would also cause monetary disturbances under dollarization. Real exchange rates change because of terms of trade shocks (volatile copper, coffee, and oil markets directly affect Latin American exports), natural resource discoveries, relative productivity innovations, economic policy news (changes in import tariffs, taxes, and fiscal spending), changes in business sentiment and sovereign-risk perceptions, political factors (riots, coups, wars), and so on. Some of these shocks may be short-lived and cause no lasting effect. But others are durable and pervasive. In the absence of *nominal* exchange rate movements—definitively ruled out by dollarization—*real* exchange rate equilibrium can only be restored through costly and lengthy domestic price-level adjustments.

Let us pause a moment to think about real exchange shocks. Indeed, what are they? Real exchange rates measure the ratio between two national price levels or, alternatively, between national wages, unit labor costs, or other costs. Equilibrium changes in such ratios are a consequence of changes in country specific economic conditions. Conceivably, in the future, globalization will be so intense that political boundaries will cease to have any economic relevance what so ever. All goods and services will be internationally tradable, as labor and capital are able to move freely across the world and asset portfolios are fully diversified. But we are still a long way from that outcome. Thus, political geography still matters—real exchange rates exist and their equilibrium levels are likely to be affected by a great variety of domestic and foreign circumstances.

The problem with real exchange shocks under dollarization is that with no nominal exchange rate available, adjustment can only occur through changes in national price levels or unit costs. Such movements are fostered by money supply fluctuations. If a real appreciation of the exchange rate is called for, a balance of payment surplus will feed a money supply and credit expansion so as to sustain the needed local price and wage inflation. Conversely, a real depreciation would be preceded by a balance of payments deficit, money supply and credit contraction, and ultimately deflationary pressures. Balance of payments induced monetary fluctuations will not only affect the price level but also real output and employment. Even without legal rigidities, wages and asset prices typically move sluggishly because of coordination costs. Of course this is no other than Milton Friedman's classic argument in favor of flexible exchange rates. It would take, I think, a long and painful time for workers, union leaders, and politicians to learn that, under dollarization, wages are to be rendered fully flexible.

Slow price adjustments are inevitably associated with wide fluctuations in output and employment. In Latin America labor market distortions aggravate wage rigidity, as evidenced by the painful adjustment Argentina is currently undergoing: deep recession, rising unemployment, and almost no variation in nominal (and real) average wages. Chile, is better positioned in this respect due to a visionary labor reform 20 years ago (masterminded by José Piñera), but still unions are entitled to keep—as a minimum—unchanged nominal wages, a distortion that is now becoming relevant when inflation is down to 3 percent per year. Other countries have the "advantage" of low enforcement of labor laws and high informality. However in many of them minimum wages are high relative to average labor productivity. El Salvador, for example, has long been considering moving to dollarization. Minimum wages are equivalent to close to 90 percent of per capita income, thus covering a large share of the Salvadoran labor force. Under dollarization, a drop in coffee export prices may very well call for either cutting in the minimum wage or massive unemployment—not an easy choice, politically speaking.

An often neglected consequence of money supply fluctuations is asset price booms, bubbles, and busts. Asset prices are also sticky in a peculiar way. Although they inflate spectacularly in times of balance of payments surplus and the expansion of money and credit, their ultimate downfall is preceded by a dramatic drop in liquidity, so transactions tend to dry up. This outcome is very harmful for banks which in boom times tend to make loans on the basis of collateral that, at the end of the day, when the credit crunch comes, is worth only a fraction of its original value. Of course, this phenomenon is observed under all monetary arrangements. However, under floating exchange rates, there will be a smooth and faster adjustment of local asset dollar prices than under a regime of rigidly fixed nominal exchange rates. In a dollarized monetary system, asset price cycles will last longer and fluctuations be even more painful. In fact, I am of the view that a false sense of security in real exchange stability (which no monetary regime can possibly achieve) can seriously distort financial decisions, overstimulating capital inflows during boom times. Even the far less credible pegged exchange rate regimes—used in Chile in the early 1980s, Mexico in the early 1990s, and, more recently, in East Asia—had the effect of luring investors with spectacular ex-ante dollar returns, which they lately came to realize were simply too good to be true.

A standard recommendation to a dollarized or fixed exchange rate country is to engage in countercyclical fiscal policy. To check inflationary pressures brought about by balance of payments shocks with budget cuts or ease deflation with fiscal expansion. We all know the pitfalls of countercyclical fiscal policy, most of them stemming from political rigidities and counter incentives. Despite fiscal flexibility being so critical for stability under fixed exchange regimes, it has proved very elusive. Panama, a dollarized economy, has had a fiscal deficit of 4 percent of GDP for 25 years and has been able to finance it only because of the IMF's willingness to act as "Panama's lender of first resort," to put it in Sebastian Edwards's telling words (Edwards 1999). Argentina is following the same path. Although it is trying to cut its fiscal deficit and has passed a law mandating a balanced budget by 2003, the continuing weakness of the economy is turning Argentina into a loan addict.

Building Credible Monetary Institutions

Instead of closing our historically weak or incompetent central banks, why not try to build in Latin America strong, credible, and efficient monetary institutions? Chile's experience with an independent central bank has been encouraging. And, regretfully, Chile has not yet opened fully her capital market or put the peso in free legal competition with foreign currencies. Argentina, Brazil, and Mexico have been less successful during the last decade, but nevertheless their central banks are increasingly independent, fully committed to fight inflation, and well staffed.

When Argentina faced deflationary pressures in 1995, the central bank launched a skillful and ultimately successful bank rescue program, providing liquidity (backed by foreign financing) and cutting bank reserve requirements. In other words, despite the "convertibility law" ruling out discretionary monetary policy, Argentine central bankers applied a good dose of it. If you have a world class team in the central bank, as Argentina certainly does, why not use it to achieve monetary stability directly rather than through the backdoor?

Dangerous Currents

Because of price, wage, and fiscal rigidity, dollarization would not be good for Latin America. But since the required flexibility in labor and asset markets, a sound financial system, and a prudent fiscal policy are all desirable in themselves, would not dollarization be a good way to foster such changes? I cannot exclude the possibility that the political economy of good reform (i.e., market oriented) is stimulated by dollarization or currency boards. One can even think of recent examples of good policy decisions—Brazilian privatization, for instance—made possible only by the hardships of the defense of exchange rate stability. But of course such hardship can also give rise to dangerous currents.

The way all fixed exchange rate regimes work is that when times are good, and the economy is enjoying a cyclical expansion with only mild inflation, governments have no incentives to introduce the right fiscal and structural reforms. On the contrary, with tax revenues being swelled by economic expansion, nothing would preclude politicians to increase spending, adding fiscal fuel to the eventual overheating of the economy. Recall that under fixed exchange rates or dollarization, there is no exchange or interest rate movement, no price signal, to alert the market and the political leaders of the dangerous path being taken.

One may think that a well-informed market, fully aware of the dangers of overheating, would end up increasing country risk spreads, thus causing an automatic contraction. It might. But experience shows such reaction to came late, because markets are prone to be deceived by unrealistic fiscal projections or the likelihood of a timely helping hand by the IMF.

Inevitably, when fortune reverses, or when finally international markets start penalizing an overheated economy, a sharp economic contraction is likely to take place. Interest rates shoot up and credit is squeezed. Governments will be pressed to "do something." They may consider applying a fiscal contraction in order to calm investors, bring down country risk spreads and interest rates, and get the credit supply flowing again. But it is difficult to adjust the fiscal budget during a recession, as Argentina is learning these days. And the failure to convince investors may backlash, causing a further contraction in aggregate demand.

As budget discipline becomes the critical condition for preserving credible dollarized or currency board monetary arrangements, too much comes to be expected from fiscal policy. It would be foolish to argue against fiscal discipline in Latin America, but, in my view, many countries are already being pressed to take an overly restrictive fiscal policy stance in the belief that it would reassure investors and avoid currency depreciation. If the adjustment were made by cutting government spending, I would see no problem. But because of obvious political reasons, the emphasis is rather on the revenue side of the budget. As a consequence, critical structural reforms such as privatizing social security and reducing taxes on savings, investment, and labor are delayed because of their negative initial impact on the fiscal budget.[1] My fear is dollarization would worsen this trend.

The social and political costs of sharp economic fluctuations mandated from time to time by dollarization may give rise to even more dangerous initiatives. An unstable path of economic activity discourages private investment and lends support to increased government intervention. The relative high frequency of financial crises leads to tightly regulated, over capitalized and in the end less efficient banking industries. Lacking exchange rate adjustments, dollarized countries may feel tempted to cut stubborn trade deficits by raising tariff barriers or introducing capital controls. Massive unemployment can discredit free markets and lend ammunition to their everpresent foes. I

[1]The strategy followed by Chile, in the 1980s, was to increase savings by pension and tax reforms, even at a significant short-run fiscal cost, in the belief that the ultimate source of macroeconomic instability is always a lack of savings.

do not think dollarization would really serve the cause of the free market in Latin America.

Conclusion

The argument against dollarization rests on the view that as long as political boundaries matter, national currencies play a useful economic role: their relative prices, or exchange rates, perform the crucial task of conveying information about ever changing country-specific conditions and policies. Markets are the most efficient mechanism yet known to collect, process, and distribute relevant information. A currency market is no exception.

Rejecting official dollarization,, however, does not mean a rejection of spontaneous dollarization via currency competition. People ought to be free to choose their own currencies. If they prefer U.S. dollars to pesos, then the government should recognize that preference and allow good money to take the place of bad money under a regime of floating exchange rates. Spontaneous monetary order may then become a reality as globalization makes national economic boundaries a thing of the past.

Reference

Edwards, S. (1999) "The IMF is Panama's Lender of First Resort." *Wall Street Journal,* 24 September.