Currency Competition and Consumer-Driven Unification

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What is meant by "currency competition?" In Northern Ireland today, most of the paper currency is privately issued. The banknote currency issued by the Ulster Bank competes against the currencies of three other commercial banks (the Northern Bank, the Bank of Ireland, and the First Trust Bank) and against Bank of England notes. All five brands of notes are denominated in pounds sterling. A similar system operates in Scotland. Northern Ireland and Scotland thus have "currency competition" in the same sense that most developed countries have checking-account competition. (England and Wales, by contrast, have "currency unification" in the sense that the Bank of England holds an exclusive legal monopoly of note-issue there.) Although not all economists have recognized it, the same arguments that economists use to defend competition among providers of checking accounts and traveler's checks apply equally to competition among providers of banknotes. As we all know, "*when banks compete, you win!*" (the phrase is a registered service mark of LendingTree.com®). Consumers benefit more from competitive than from monopolistic markets in all types of spendable bank liabilities: not only checking accounts and traveler's checks but also circulating currency.

The usual meaning of "currency competition" is of course something slightly different: rivalry between *monetary standards* (or "units of account"), such as the pound sterling *versus* the euro, the peso *versus* the dollar. The usual sense of "currency unification" is convergence to a single monetary standard, such as the replacement of the pound sterling by the euro, or of the peso by the dollar. The benefits of *this* type of currency competition are also under-

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appreciated. Economists normally take it for granted that the ultimate goal of economic policy is to satisfy the preferences of market participants, and normally recognize that consumers benefit more from competition than from monopoly. Yet some object to allowing competition among monetary standards within a single country. They do not seem to recognize that *when central banks compete, you win!* (I am looking into registering this phrase as my own service mark.) I will consider their objections below.

Spontaneous Currency Unification

The contrast between competition and unification among monetary standards can be overdrawn. From the perspective of a central bank—a producer of fiat money—acting as a rival to other central banks certainly excludes merging with those central banks. But from the perspective of an ordinary market participant—a "consumer" of money—competition and unification are not mutually exclusive. When consumers do not have a single currency imposed on them, but are allowed to choose freely which currency to use, competition can become a route to unification through spontaneous convergence on a preferred standard. For people whose domestic central bank issues low-quality currency, open competition allows them to unify with—by voluntarily adopting—a stronger currency issued by someone else.

This kind of currency unification *from the bottom up* is known as "unofficial dollarization" where the stronger currency adopted is the U.S. dollar. The U.S. dollar has become the currency of choice in most of the Americas (not just Latin America, but also the Caribbean; even Canada is about 10 percent U.S.-dollarized), in Russia and other former Soviet-bloc countries, in much of Africa, and in parts of Asia. A recent careful estimate (Anderson and Rasche 2000, p. 17) places the Federal Reserve notes circulating outside of the United States at around 53 percent of the total. Applying that percentage to the most recent figures, around $342 billion in Federal Reserve notes (out of the $646 billion total) circulates abroad. In Central and Eastern Europe, there is discussion of the present extent and future prospects both of unofficial dollarization and of "euroization." The logic of dollarization applies equally to euroization.

Dollarization becomes "official" or "full" when the national government phases out its own brand of currency and switches to the dollar for its own transactions (taxes, court judgments, public-sector wages, transfer payments). Ecuador (in September 2000) and El Salvador (in January 2001) are the most recent countries whose governments have officially dollarized. In doing so they bowed to the verdict

of the market: their citizens had already largely dollarized their own finances.

A Threshold for Official Dollarization

To respect the preferences of its citizens, a national government should place no barriers in the way of their using whatever currencies they prefer. No authority should have a legislated monopoly on issuing currency. It should be perfectly legal to conduct private spot transactions, and to denominate bank accounts and other financial contracts, in any currency. These contracts should be specifically enforceable in a court of law. If, given the choice, the public holds a large share of its financial assets in dollars, say more than one-third, it seems reasonable that citizens should have the options of paying taxes and receiving public-sector wages and transfers in dollars. Dollars and the domestic central bank's currency—call it the peso—would then circulate jointly as "official" currencies. If the dollar's share rises above some higher threshold, say two-thirds (implying that peso use falls below one-third), the government should retire the peso and officially dollarize. We can quibble about the proper levels of these thresholds, but surely there is *some* level of dollar use above which the dollar should be officially recognized and *some* level of peso use below which the domestic monetary authority should toss in the towel.

Why do some economists object to a country's government adopting the dollar even when its citizens clearly demonstrate a preference for the dollar? They object because they do not think about dollarization as a market phenomenon reflecting consumer preferences that ought to be respected. They instead think about dollarization only as a policy option to be evaluated by expert policy analysts (presumably themselves). They analyze not as if consumer advocates, but as if advisers to an optimizing head of state. From that perspective, dollarization stands at the extreme end of a spectrum of possible exchange rate "pegging" policies. It is the "hardest" of the "hard pegs."[1]

[1]For example, the abstract to Meade, Müller-Plantenberg, and Pisani (2002) states, "Some well-known economists have advocated that countries in eastern Europe adopt the euro now either unilaterally or by prior arrangement with the EU. Such official currency substitution is typically termed 'dollarisation' or 'euroisation', and is the most extreme form of a hard peg currency regime."

Arguments against Dollarization: Are They Valid?

The standard policy-instrument objections to dollarization focus on the domestic government's losing three things: (1) a useful tool for macroeconomic stabilization policy, (2) "sovereignty" or national pride, and (3) seigniorage—the profit from issuing its own currency.

The Macroeconomic Objection

The *macroeconomic tool* objection is at the core of arguments claiming that dollarization (or multilateral unification in the manner of the Euro zone) is a bad idea because a particular set of countries, or the entire world, is not an "optimal currency area." If used as a rationale for legal restrictions against unofficial dollarization, the "optimal currency area" argument adopts a curiously paternalistic attitude toward consumers' choice among currencies. Elsewhere in economics, "optimality" is evaluated in a strictly nonpaternalistic way. Economists do not presume to know the optimal area for the consumption of Toyotas or Levi's jeans. Some *do* presume to know that the network of QWERTY-keyboard or VHS-videocassette users is too large because (supposedly) we got "locked in" to a second-rate standard that predominates for no good reason save its own accidental predominance. But "lock in" problems can only provide a rationale for *easing* entry by a new standard, not for *blocking* entry.

The macroeconomic objection supposes that having the tools of an independent national monetary policy—the ability to expand the money stock ad libitum, to act as a lender of last resort, to devalue the national currency—helps to mitigate business cycles and financial panics. This is largely wishful thinking. In practice, few if any central banks—in developing *or* developed counties—have a successful track record of using discretionary monetary policy to make their economies more stable. The central bank's ability to print money without constraint has instead been a weakness. Especially in the developing world, it has been a source of high inflation.[2] For a central bank pegging to the dollar, the discretion to print money at a rate that would force devaluation is a *source* of weakness and financial panics, not a source of strength, because it invites speculative attack on the domestic currency (now, before the next devaluation). As Chicago Federal Reserve economists François Velde and Marcelo Veracierto

[2]In principle, a central bank's ability to act as a lender of last resort (i.e., to accommodate extraordinary shifts into the narrowest monetary aggregate) is not inconsistent with its being constrained to meet a low-inflation-rate target (or other nominal target). But working examples of such a regime are lacking among developing countries.

(1999) noted even in the case of Argentina's relatively hard currency-board-like peg: "What the repeated speculative attacks on the peso indicate, however, is that retaining the *option* to resume an independent policy has proven expensive for Argentina." It should also be noted that banks in a dollarized economy, without a domestic central bank, have other potential sources of reserves. They can secure credit lines from money-center banks in the United States. Funds will be available for a bank that can sufficiently assure potential lenders of its solvency and intention to repay.

The "Sovereignty" Objection

The *national pride* objection was perceptively criticized by Pedro Pou, when he was the president of the Central Bank of the Republic of Argentina, in remarks to a Federal Reserve of Boston conference:

> We do not suggest that each country should produce every possible good. We are happy with the idea that we should import automobiles or TV sets from the more efficient producers; why should we not apply the same logic to money? Should a small emerging economy produce its own money, or should it buy it from a more efficient producer? … What is so particular about money, that every country wants to have one of its own? [Pou 2000: 244, 246].

Pou's questions refer to choices made by consumers and not only by the government. There is no good case for a government preventing its citizens from choosing whatever currencies, domestic or imported, they may prefer. Once the money issued by a domestic central bank has failed the market test—meaning that it can keep a significant market share only by legal restrictions on private transactions and by the state's own use of it, because market transactors strongly prefer other currencies—it is difficult to see that there is any *additional* loss of honest national pride in giving up its production.

The Seignorage Objection

To answer Pou's last question, we turn to the third standard objection to dollarization. What is so particular about money, such that nearly every national government (clearly not every country's citizens) wants to have one of its own, is that *even a government* can make a profit producing it (as a monopolist). The profit is known as "seigniorage." Economists who cite seigniorage loss as a reason not to dollarize are assuming that dollarization means a wealth transfer from the domestic economy to a foreign currency producer. They view each million dollars in Federal Reserve notes held by domestic consumers as a million-dollar interest-free loan to the Fed that the

domestic government could otherwise have had. But actually the domestic government could *not* have had the entire loan, because by hypothesis the consumers find its currency less attractive. To argue that it is a tragedy for seigniorage to go abroad, when consumers prefer to import foreign currency, is akin to making the protectionist arguments for forced import substitution that economists recognize as anti-consumer rent-seeking in other contexts.

Few analysts have noticed that the seigniorage lost by officially dollarizing *need not* go abroad. As the examples of Northern Ireland and Scotland remind us, there is an alternative to importing foreign currency: allow domestic banks to issue currency notes. Where dollars are popular, consumers will presumably insist on notes that are directly redeemable for dollars. They may or may not prefer the notes to be labeled "dollars." In addition to carrying the face of a local hero (already mitigating the loss of national pride), the notes might even be denominated in a local unit (with the issuer being contractually bound to redeem at a stated rate of so many to the dollar). Domestic banknotes retain the would-be seigniorage locally (except to the extent, small in the absence of reserve requirements, that the banks would hold noninterest-bearing foreign currency as reserves). The transfer does not go the banks' owners. Competition among the banks distributes the gain to their currency-holding customers, typically in the form of unpriced services. For example, to get their notes into circulation, competitive banks of issue will install more ATMs and waive fees for withdrawing their notes from the machines.

The circulation of Federal Reserve notes in Panama, Ecuador, and El Salvador, and the corresponding seigniorage transfer to the Fed, is thus avoidable—if the circulation is due to legal restrictions that prevent domestic banks from issuing notes, rather than due entirely to consumer distrust of private banknotes. It is unlikely that banks trusted with deposits would not be trusted to issue notes. If domestic banks are not sufficiently reputable to gain acceptance for their own notes, local branches of foreign banks may nonetheless be able to do so, with the same benefits to currency-users. In this respect, as in general, we can leave it to the market to sort out which institutions are trustworthy enough to issue currency.

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