TESTIMONY ON FULL DOLLARIZATION

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I will discuss the motivation and potential benefits of full dollarization, namely, abandoning domestic currency (identified with the peso) and adopting a foreign currency (identified with the U.S. dollar), with special reference to emerging-market economies. I will argue, first, that full dollarization is especially advantageous for countries with large dollar debts, and, second, that in these economies standard criticisms against full dollarization are largely unwarranted. (For a more extensive discussion of these issues, see Calvo (1999 b)).

Dollar debt (*liability dollarization*) is an important, and not fully appreciated, phenomenon. A recent IMF study (IMF(1999)) shows that there are a number of countries where dollar deposits exceed 30 percent of the total (e.g., Argentina, Bolivia, Peru and Turkey). Since banks tend to lend in the same currency in which deposits are denominated, this means that a large share of loans is denominated in dollars. In addition, there exists direct foreign borrowing. These loans are also denominated in dollars. Finally, liability dollarization is likely to grow over time in countries that depend on foreign savings (i.e., countries exhibiting current account deficits), which under normal conditions encompass most emerging markets.

Liability-dollarized economies are highly vulnerable to devaluation. Consider a firm or individual who borrows in dollars. If the currency devalues 50 percent, for example, the peso value of dollar debt will increase by 50 percent. If borrowers operate in pesos, they may be unable to repay their debts, possibly leading to a financial debacle. Lenders are aware of these problems and are, therefore, wary about loans to sectors that, in one way or another, operate in pesos. Since domestic producers tend to be financially interconnected, this creates sizable interest premiums on loans to every sector of the economy. This situation gets exacerbated during crisis because fiscal revenue falls and in implementing adjustment programs (as those designed by the IMF) taxes are increased, worsening the financial straits of all sectors in the economy. Consequently, the threat of large devaluations in liability-dollarized economies results in high interest rates, and when devaluation takes place most sectors get hit.

Full dollarization, if credible, eliminates devaluation risk and, consequently, will likely result in interest rates which are both lower and less sensitive to crisis in other countries. In other words, the incidence of *contagion* will diminish. Credibility, in turn, will be enhanced if full dollarization was carried out in the context of a Treaty with the U.S.

I will now turn to answer three important criticisms that have been raised against dollarization, namely, (1) lack of a *lender of last resort,* (2) absence of domestic monetary policy, and (3) loss of seigniorage.

1. <u>Lack of Lender of Last Resort</u>. In a fully dollarized economy the central bank cannot print money. Thus, critics are concerned that the central bank would be unable to stop a financial crisis by injecting liquidity. However, there are alternative ways that can be followed to secure emergency liquidity, even under full dollarization. Argentina, for example, has arranged a facility with several large banks that allows authorities to get sizable instant credit in case of crisis. Moreover, if banks have international connections, banks themselves can get credit lines from headquarters or their external partners.

2. Absence of Monetary Policy. A key concern is that devaluation could no longer be used to improve competitiveness. Instead, prices and wages would have to fall. This is usually a slow process that may lead to unemployment and output loss. However, I have already argued that devaluations could be highly disruptive in liability-dollarized economies. Moreover, empirical evidence overwhelmingly shows that devaluations in Latin America have proved to be contractionary, not expansionary as in advanced countries (Edwards (1989)). Besides, there are many instances in which competitiveness has been partially offset by high interest rates. Thus, devaluation may not be effective to gain competitiveness and could be costly in terms of output loss. Moreover, if lack of competitiveness becomes a serious problem, authorities can always resort to fiscal policy.

3. Seigniorage. In a non dollarized economy, the central bank holds international reserves in, for instance, U.S. Treasury Bills, which earn interest. Under full dollarization, reserves are exchanged for pesos and held by the public mostly in the form of dollar bills (which earn no interest). Thus, the country as a whole suffers a loss on account of foregone interest. In the case of Argentina, this cost has been estimated to be around $750 million per year. However, in Calvo (1999 a) I show that a Seigniorage-Sharing Treaty with the US could allow the country to have the cake and eat it too. Under this arrangement, the U.S. would gain $150 million per year and, in exchange, Argentina would be able to set up a stabilization fund of more than $10 billion, which would go a long way towards deterring financial crisis. Both countries gain.

In summary, there are several countries that are liability-dollarized and could greatly benefit from full dollarization. In particular, under full dollarization those countries are likely to face lower interest rates and be better shielded from contagion. As a result they might enjoy higher and more stable growth. The U.S. has a lot to gain given that these countries are fertile ground for absorbing U.S. exports. Moreover, the U.S. could encourage dollarization at virtually no cost by means of Seigniorage-Sharing Treaties. Problems raised by critics are important but there are instruments that can be used to cushion their negative effects. In closing, it is worth saying that dollarization cannot stand alone, and must be supported by policies that ensure the solidity of the domestic financial sector, and a long maturity structure for the public debt.

References

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