TESTIMONY ON DOLLARIZATION

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I was invited here to explain about Dollarization, the benefits and costs for the US and the countries that adopt it. Before I start my formal presentation, I would like to state, in no uncertain terms, that I am a firm supporter of such system for many Emerging Market economies, EM, especially if it is done within the context of a Treaty with the US (as in Senator Connie Mack's proposal). Moreover, I believe global dollarization will have direct economic benefits for the US, and enhance its role as a worldwide leader.

Dollarization is the decision to abandon the national currency and replace it by the US Dollar (or some other hard currency like the Euro). This is a major economic and political decision. By default, a dollarized country adopts US monetary policy, even though the two countries could be going through different phases of the business cycle. Moreover, a dollarized country gives up the option of assisting banks by printing money in the case of a systemic bank run.

In the first, and more substantive, part of my presentation I will argue that EM have already given up those functions. Therefore, dollarization is a win-win proposition except possibly for some fiscal costs (called ***seigniorage*** in the technical jargon). In the second part of the presentation I will evaluate the advantages of ***regional*** dollarization, and argue that dollarization is a winning proposition for the US.

I will start the discussion by focusing on two key themes: ***Fear of Floating***, and ***Lender***

***of Last Resort*.**

Fear of Floating. Simply put, very few countries really let their currencies float vis-a-vis the Dollar (or other hard currencies). Even countries that are listed as “floaters” by the IMF, do not float or float very little (e.g., El Salvador, Bolivia). Two reasons have been identified for the policymakers’ reluctance to let their currencies float. First, devaluations get quickly transmitted into higher inflation. Second, firms and households in EM have dollar-denominated debts, some of them acquired through domestic transactions like the purchase of a car or a refrigerator. Therefore, fluctuations in the exchange rate run the risk of creating serious financial stress. For example, a wage-earner that has dollar debts could run into bankruptcy simply as a result of a currency devaluation. (We never think about this in the US because wage-earners get their wages in Dollars). If a sizable number of wage-earners are in this situation (as in Argentina, Peru and several other EM), banks will see their loan portfolio deteriorate very sharply after devaluation. Depositors will become aware of the problem and attempt to withdraw their deposits, causing a bank run.[1]

Lender of Last Resort, LOLR. This expression refers to the institution that is able to lend when nobody else is willing to lend, i.e., during a crisis. Typically this is a function undertaken by central banks. As noted before, a dollarized country cannot print money to perform this function. This does not mean, however, that the central bank could not be a LOLR. For example, the central bank could lend to the private sector by selling liquid assets (e.g., international reserves). Or, as in Argentina, it could arrange in advance for contingent credit lines from international

[1] For evidence and discussion, see “Fear of Floating” by Carmen M. Reinhart and myself, available online: www.puaf.umd.edu/papers/reinhart.htm.

banks that could be activated during crisis.

Therefore, a dollarizer only gives up one way of extending credit during a crisis, namely, through the printing press. This is not the way it works in advanced countries. In advanced countries the LOLR is able to ***borrow*** in order to lend. Relying on the money-printing machine results in inflation, usually very large rates of inflation. Moreover, the exchange rate will be the first to rise, causing the kind of financial difficulty that I discussed before. Therefore, ***a LOLR that relies on the printing press could actually magnify the banking problem, not solve it, and cause high inflation***.

In addition, the costs will be felt before a crisis strikes. As individuals become aware that the LOLR will print money in case of crisis, they will anticipate high inflation and demand high interest rates. This is detrimental for growth. Besides, under those conditions inflationary expectations are highly volatile, causing high interest-rate volatility – another factor that is bad for growth.

Summary. EM show a tendency to peg their currencies to a hard currency like the Dollar and the Euro. However, by not making an irrevocable commitment to fix, they generate high and volatile interest rates. This is detrimental for growth. Dollarization – especially, in the context of a Treaty with the US – will lower and stabilize interest rates, stimulating growth.

Why are there so few dollarized countries? One reason is that dollarization involves a fiscal cost. A dollarizer must be prepared to have its central bank swap the entire stock of domestic currency for Dollars at the stipulated exchange rate. To illustrate, suppose that at the stipulated exchange rate currency in circulation is equivalent to US$15 billion and that the central bank has the funds available in the form of US Treasury Bills earning 5 percent per annum. Thus, as the

Treasury Bills are transformed into Dollar Bills, the country loses 5 percent interest rate on US$15 billion, or US$725 million per year. Although these types of costs (***seigniorage***) are often significantly less than 1 percent of GDP, the sums are not to be disregarded. What is important to note, however, is that ***the loss of seigniorage incurred by the dollarizing country is matched, Dollar for Dollar, by gains for the US***. In the previous example, prior to dollarization the US was paying US$725 per annum to the country in question. After dollarization, and since the Treasury Bills were exchanged for non-interest-bearing Dollar Bills, the fiscal cost for the US goes down by exactly the same amount (i.e., US$725 million). Therefore, there is room for the US to ***share seigniorage*** with the dollarizer ***with no fiscal cost***, a fact that is at the core of Senator Mack's proposal.

Another reason for countries' reluctance to dollarize is political. National currency bills carry the images of domestic patriots, scientists or artists. Thus, some people see their national identity threatened by adopting a foreign currency. This was a powerful argument for the period between the Second World War and the ***financial globalization*** that started around 1989. Having a national currency was not very costly because there was little international capital mobility and, therefore, countries were better able to insulate themselves from international financial conditions. This is not true anymore, and it accounts for the fact that these nationalistic considerations are fading into the background.[2]

Benefit for a region like Latin America. Dollarization of several key countries in Latin America (e.g., Argentina, Chile, Brazil, Mexico) would give a tremendous boost to intraregional

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[2] For a more in-depth discussion of these issues, see my article "Capital Markets and the Exchange Rate: With Special Reference to the Dollarization Debate in Latin America," manuscript, April 14, 2000. Available online: www.bsos.umd.edu/econ/ciecalvo.htm.

trade and make the whole region much more attractive to foreign investors.

Is it good for the US? This is a win-win proposition for the US. First, as noted before, it carries fiscal benefits by way of reducing interest payments on the public debt. Second, it will help entire regions to increase growth and stability. This is always good news for the US. Some analysts worry about the extra burden that dollarization may impose on the Fed. I do not see that as a major problem because by fixing their exchange rates against the Dollar, incurring in Dollar debts and holding Dollar assets, many EM are ***already dollarized***. Direct evidence of this is that a large share of the total supply of Dollar bills is held outside the US. By contributing to stability in EM, dollarization generates a more stable demand for Dollars, which helps, not hurts, US monetary policy.

Role of the US. The US plays a pivotal role in inducing global dollarization. The US is, after all, the sole manufacturer of Dollars. Seigniorage sharing can only be implemented through a Treaty with the US. Moreover, dollarization is catching. The larger the number of countries that adopt the Dollar, the more attractive will be for the others to join the club. The US could play a key function in coordinating this process. What's to be done? Seigniorage sharing – Senator Mack's proposal, for example – would be a big step forward. Another is to offer EM a seat at the Federal Reserve Board.[3] First as observers, and eventually – in the context of a Free Trade Agreement, for example – as voting members. I realize that this proposal will make some people wince but, in my view, the benefits of global dollarization amply compensate for the costs that this measure might entail.

Thank you very much.

[3] EM could be clustered in large groups as in the IMF Board.