

Dollarization in Latin America: Solution or Straitjacket?

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Excerpts from: “*No Single Currency Regime is Right for all Countries or at All Times*”

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Many are drawing the lesson from recent exchange rate crises that less-than-absolute pegs are not viable in the presence of integrated financial markets, that they cannot hold up to international currency speculation. Some Latin American countries, notably Argentina, are talking about the possibility of abandoning their own moneys completely, and adopting the dollar as their official currency. Full dollarization may well be a good idea, for a country as small and US-dominated as El Salvador. It might be good even for Argentina, if the political willingness to give up all monetary sovereignty now exists in that country. But a wholesale movement of Latin America to the dollar is not likely and would not be well-advised at this point in history. Intermediate regimes are still advisable for many countries, notwithstanding the new view to the contrary.

I begin with some fundamental observations about fixed vs. floating exchange rate regimes in general.

The Flexibility-continuum of Exchange Rate Regimes

“Fixed vs. floating” is an oversimplified dichotomy. There is in fact a continuum of flexibility, along which it is possible to place most exchange rate arrangements. There are nine regimes, starting with the most rigid arrangement, and becoming increasingly flexible as we go:

1) Currency union: Here the currency that circulates domestically is literally the same as that circulating in one or more major neighbors or partners. Examples include Panama (the dollar); Namibia, Lesotho, and Swaziland (South African rand), and EMU (the euro). Where dollarization has recently been proposed in several Latin American countries, the motivation is to get the maximum credibility for inflation-resistant monetary policy by adopting the strongest commitment. Even a currency union can be reversed if desired (witness the Czech and Slovak korunas, whose separation was velvety smooth, and the Former Soviet Union, whose separation was considerably rougher). But it is the firmest commitment to a fixed exchange rate possible.

2) Currency board. The current fad, sometimes sold as credibility in a bottle. Examples include Argentina, Hong Kong, and some Eastern European countries.

3) “Truly fixed” exchange rate. Members of the francophone West African and Central African currency unions fixing to the French franc.

4) Adjustable peg: “Fixed but adjustable” was the description of exchange rate pegs under the Bretton Woods regime. Most countries that declare themselves fixed, in fact periodically undergo realignments.

5) Crawling peg: In high-inflation countries, the peg can be regularly reset in a series of mini-devaluations, as often as weekly. In one approach, the path is pre-announced. In another approach, the exchange rate is indexed to the price level, in an attempt to keep the real exchange rate steady.

6) Basket peg: The exchange rate is fixed in terms of a weighted basket of currencies.

7) Target Zone: The authorities pledge to intervene when the exchange rate hits pre-announced margins on either side of a central parity. Example: Europe’s Exchange Rate Mechanism, where most members followed a range of plus-or-minus 2 1/4 percent.

8) Managed float: Also known as a “dirty float,” this is the most popular category in the IMF listings. It is defined as a readiness to intervene in the foreign exchange market, without defending any particular parity.

9) Free float: The central bank does not intervene in the foreign exchange market, but rather allows private supply and demand to clear on their own. Example: the United States comes closest.

Reminder of the Advantages of Fixed vs. Floating

This is not the place to enter into an extended discussion of the advantages of fixed and floating exchange rates. The main points can be stated succinctly. The two big advantages of fixing the exchange rate, for any country, are: (1) to reduce transactions costs and exchange rate risk which can discourage trade and investment, and (2) to provide a credible nominal anchor for monetary policy. The big advantage of a floating exchange rate, on the other hand, is the ability to pursue an independent

monetary policy.¹ The choice is generally a trade-off.

Dollarization as an Alternative to a Currency Board

Currency boards, which not long ago appeared a radical straightjacket, are now in some quarters deemed an insufficiently firm commitment. In January 1999, at the request of Argentina's President, the central bank submitted a report spelling out possible ways to complete the dollarization of that country, that is, to replace the peso fully with the dollar as the legal currency. This plan may well never come to fruition. The timing of the initiative -- immediately after the downfall of the real in neighboring Brazil and in advance of a presidential election in Argentina -- suggests possible short-term objectives: impressing contagion-prone speculators and stability-craving voters. Nevertheless, many Latin Americans are suddenly taking the dollarization alternative seriously, and at least one country, El Salvador, may actually go ahead.

The reasons why most countries would not want to adopt the currency of the United States or any other foreign power as its own are clear. It would be a total surrender of monetary independence. Also it would add the insult of surrendering a symbol of national political sovereignty, which is demonstrably important to most people. It is striking that, notwithstanding that in theory the boundaries of political units and optimal currency areas need not coincide, in practice they almost always do. In 1984, Israeli popular reaction to the idea of dollarization was so adverse that the finance minister who had proposed it was forced to resign.

Yet, consider a country that already has demonstrated sufficient political support for monetary discipline to go as far as a currency board, and where the foreign currency already plays a large role in the economy. Is there anything further to be lost by going the rest of the way and giving up its currency altogether, beyond the symbolic loss of sovereignty?

¹ To be sure, other factors enter as well. Another advantage of an independent currency is that the government retains seignorage. Most of the important factors, however, can be lumped into the major arguments presented in the text.

Perhaps the additional loss of discretionary monetary policy is not just small, but zero. Perhaps an emerging-market country under a fixed exchange rate or currency board is in a worse position, as regards having to accept an interest rate that may not be appropriate to its current domestic cyclical conditions, than under dollarization. Under the current regime, when the Federal Reserve Board raises U.S. interest rates, emerging-market interest rates often rise *more than* one-for-one. The differential between Argentine and U.S. interest rates declined after the April 1991 convertibility plan and has been relatively small most of the time since 1993. Nevertheless, the differential is still non-negligible, despite strong economic performance. It shoots up roughly once a year, whenever there is an external disturbance -- whether it is a rise in US interest rates or a crisis in some other emerging market. (A renewed sharp spike following the tequila crisis of December 1994 illustrated the point dramatically.)

The differential consists primarily of a country premium (compensation for perceived risk of default, measured as the Argentine dollar interest rate minus the U.S. treasury bill rate), supplemented by a small currency premium (compensation for perceived risk of change in exchange rate policy, measured as the Argentine peso interest rate minus the dollar rate). The currency premium would by definition vanish if Argentina dollarized.

Sensitivity of Dollar-peggers' Interest-rates to U.S. Interest Rates

The country premium would not vanish. But the country premium is sensitive to U.S. interest rates. Thus when the U.S. interest rate increases, the Argentine interest rate increases more than one-for-one. A statistical analysis (by OLS regression) produces the result that when the U.S. fed funds rate rises 1 basis point, the Argentine dollar interest rate on average rises an estimated 2.7 basis points. The interesting hypothesis is that under dollarization, the statistical fit between local and U.S. interest rates would be tighter, but the coefficient would be smaller. For purposes of comparison, we look at Panama. The hypothesis is borne out. When the U.S. fed funds rate rises 1 basis point, the Panamanian interest rate on average rises by only an estimated .4 basis points. The suggested implication is that, somewhat paradoxically, Argentina might be less at the mercy of the Federal Reserve if it went on the dollar standard than it is now. A drawback would be that increases in Argentine interest rates would bear US fingerprints more visibly from a political standpoint.

The same pattern holds when the tests are extended to two Latin American countries with a less-firm tie to the dollar. When short-term interest rates in Brazil and Mexico are regressed against the US fed funds rate, the estimated coefficients are substantially higher, even, than they were for Argentina. But the standard errors are also larger. Apparently the looser the relationship, the higher the regression coefficient.

Costs and benefits of Argentine dollarization

The blueprint from the Argentine authorities details three possible approaches to dollarization:

bilaterally negotiated (through a “treaty of monetary association” with the United States), unilateral, and regional. There are three things that the Argentines might hope to get out of a negotiated agreement. (They are not expected to ask for a fourth: voting rights on the Federal Reserve Open Market Committee!) First is seignorage, worth about \$600 million in lost interest that the central bank now earns by holding \$14 billion of foreign exchange reserves (U.S. treasury bills) against domestic peso liabilities. Second is access to the Fed discount window by Argentine banks. Third is cooperation regarding bank supervision. The United States is quite unlikely to agree to offer to compensate Argentina for lost seignorage, nor to agree to an open-ended money pot like the discount window, even with the Argentine proposal to use donated seignorage funds to collateralize borrowing by its banks. (Cooperative exchange of information in the area of banking supervision is more likely, especially if U.S. banks continue to play a growing role in the Argentine banking system.) Indeed, the United States is so wary of incurring a contingent liability, that it may refuse to enter even into a symbolic treaty designed to give a stamp of approval to the plan, for fear of being held responsible politically for future economic troubles in Argentina, or of creating implicit expectations of future bailouts.

Argentina could choose to dollarize unilaterally instead. Given the proven historical inability to put monetary policy to good use, this might be advantageous to Argentina even without help on seignorage or lender-of-last resort facilities, provided the loss of sovereignty is politically acceptable.

Would dollarization be beneficial to the United States? To say that the effect would be very small is true, but not helpful; the next step would be to ask what would be the effect if other countries wanted the same. Economic benefits for the United States include seignorage, enhanced ease of transactions in Argentina on the part of U.S. businesses and travelers, and the increased trade that stability and prosperity in the area would bring about. Perhaps there are foreign policy benefits to spreading US influence as well, though imperialism is distinctly out of fashion. The obvious drawback is the danger of implicit bailout liabilities that may be there even without the official sanction provided by a treaty. But the benefits probably outweigh the costs. This is especially true since the United States already bears some responsibility for leadership when international financial crises strike, and the probability of crisis in Argentina would presumably be reduced under a dollarization plan. If this evaluation of U.S. costs and benefits is correct, then the idea may merit American blessing, even if that blessing must be unofficial.

The last question is the costs or benefits of a *regional* move to dollarization. Clearly the failure of Brazil’s link to the dollar has threatened Argentina financially, and the change in the real exchange rate has disrupted trade relations among the Mercosur partners. The benefits to one country of a firmer dollar link are enhanced if others are moving in the same direction. But this externality is a very general aspect of the benefits of money: a given currency is always more convenient to use, the more others use it. There is little reason to forecast a mass regional movement onto the dollar at this point in history merely on the grounds that it would gather steam as it went. Countries with a past history of hyperinflation, political support for renouncing monetary sovereignty, and a recent record of macroeconomic virtue, are in the minority, and are likely to remain so. The United States should not

wish to encourage a premature movement in that direction, but at the same time we can unofficially welcome any country that finds dollarization advantageous.