Dollarization in the Americas: Its Promise and Its Pitfalls

Pamela K. Starr

Instituto Tecnológico Autónomo de México
Departamento de Estudios Internacionales
Río Hondo 1
Colonia Tizapán, San Angel
01000 México, DF
Mexico525-628-40-00 (phone)
525-628-40-92 (fax)

starr@itam.mx

Abstract

A great deal of analytic attention in recent years has been devoted to dollarization as a mechanism to underwrite stable economic growth in Latin America. Yet little of this research has addressed the politics of the issue. This paper attempts to fill this void by looking at both the political and the economic factors which influence the policy effectiveness of dollarization.

The paper illuminates the political and economic variables which influence the viability of dollarization. It concludes that although dollarization may be the correct policy choice for some Latin American countries, it is not the best solution for most Latin American countries.

Introduction: The Political Economy of Dollarization

Dollarization, the use of the US dollar in place of national currencies, has a long history in Latin America. Panama has officially used the dollar as its national currency since 1904, and the dollar has circulated widely in the region alongside national currencies throughout this century, particularly in times of crisis. At the close of the twentieth century, such de facto dollarization is especially evident in countries as diverse as Argentina and Ecuador, Nicaragua and the Dominican Republic, and El Salvador and Peru.

In the wake of the Russian default on its international obligations in August 1998, the question of dollarization took on a new character in Latin America. The wave of financial uncertainty which swept the region in late 1998 and early 1999, including the devaluation of the Brazilian real in the second week of the year, was the final straw for many Latin Americans. After a decade of striving to reestablish economic stability and growth, it seemed to many that this objective was unattainable as long as Latin Americans retained national currencies whose exchange values Wall Street saw as less than 100% credible. As long as investors perceived a significant exchange rate risk, national interest rates would always be higher than in developed regions, and they would always shoot up dramatically in the wake of any disturbance in the international financial system. As a consequence, the region would suffer uncertainty and reduced growth into the foreseeable future, owing to forces outside of Latin America's control.

This line of reasoning led to a spate of proposals for de jure dollarization in a number of Latin American states. In late 1998, in an effort to shore up confidence in its currency board monetary system, the Argentine government announced plans to begin preparations for an imminent dollarization (which actually turned out to be not very imminent). At essentially the same time, private sector actors in El Salvador and Mexico issued public appeals for dollarization in their national economies to tame interest rates increases and/or exchange rate instability. And in early 2000 the Ecuadorian Congress approved legislation to implement dollarization as an emergency measure to shock both the economy and the polity of this Andean country out of crisis and toward stable growth and prosperity.

These proposals awakened analytic interest in the question of dollarization and produced an explosion of research into the strengths and weaknesses of dollarization. Most of these studies approached the subject from a purely economic point of view and attempted to answer a single question: Can dollarization underwrite stable economic growth in the Latin American region? When one approaches dollarization from a political-economy perspective, however, the answer to this question lies in a set of associated queries. As with any economic policy, dollarization will produce winners and losers. Its political viability as an economic strategy therefore depends on how many losers it produces, who they are, and how much influence they have over policy making and implementation. The illumination of these political puzzles, meanwhile, can only be obtained through careful consideration of the structure of a country's economy and its politics, and how each will react to a policy of dollarization.

The Economics of Dollarization

The economics of dollarization measures the extent to which this monetary/ exchange rate policy will promote stable growth in a given national context. The economic structure best suited for dollarization is laid out in the literature on optimal currency areas (Mundell, 1961; McKinnon, 1963). This literature argues first that small, open economies are more likely to benefit from the abandonment of their national currency. Small economies will benefit disproportionately from the elimination of cost of exchanging currencies in trade, and open economies are less able to alter their real exchange rate through devaluations because of the small size of their non-tradable goods sector. Second, economies characterized by a high degree of economic interaction with the United States will benefit disproportionately from the reduction in transaction costs created by dollarization. On this score, El Salvador stands ready to gain much more from dollarization than either Argentina or Mexico.

Third, the greater the symmetry of the economic shocks affecting the US economy and any economy considering dollarization, the smaller the costs of dollarization should be. By contrast, when production in the dollarized economy is concentrated in economic sectors distinct from those that dominate the US economy, operating under the monetary policy decisions of the US Federal Reserve Board in the presence of external shocks will be costly. For example, economies such as Mexico or Ecuador that export petroleum will suffer recessionary pressures from a sudden drop in the international price of oil, and would therefore benefit from the expansive monetary policy produced by reduced interest rates. In the US economy, however, a sudden drop in the price of petroleum will stimulate economic activity and might thereby demand an increase in domestic interest rates to prevent the economy from over-heating. Clearly, rising interest rates would be precisely the wrong monetary policy for Mexico and Ecuador under these circumstances, but as dollarized economies they would have no option other than to accept this pro-cyclical monetary policy.

The benefits accrued to an economy from dollarization also depend on the relative mobility of labor and the flexibility of wages. Whether through legal or illegal means, through formal or informal mechanisms, the mobility of labor from troubled to growing sectors or regions within the currency area is essential to easing the costs of adjustment to the asymmetric shocks noted above. Equally, downwardly flexible wages will better enable an economy to adjust to recessionary shocks in the absence of an expansionary monetary policy and without the option of devaluation. Downwardly flexible wages also operate as an incentive to labor mobility. Although there is significant variance in the degree of labor mobility and labor flexibility within Latin America, reality is much more flexible than established law suggests. Equally important, adjustment in countries geographically close to the United States will also benefit from the illegal mobility of their labor force into and out of the United States.

Finally, a greater degree of industrial competitiveness will help reduce the adjustment costs associated with dollarization in any given Latin American economy. Countries where deep, well-capitalized financial markets help to cushion the economy from external shocks will be better positioned to dollarize than economies in which weak financial sectors magnify the domestic economic costs of external shocks.

The initial implementation of dollarization will also benefit from a high initial degree of de facto dollarization in the domestic economy and an established fiscal discipline. And any country adopting the dollar must obviously have access to a supply of dollars sufficient to purchase the domestic money supply.

This list of economic conditions capable of increasing the benefits and reducing the costs inherent in dollarization should not be interpreted as a list of economic pre-conditions for the adoption of this economic policy. First, some of the factors which promote stable economic growth in a dollarized setting can also emerge as a consequence of dollarization. The health of the banking system, for example, will be promoted by the stable interest and exchange rates created by dollarization. By reducing transaction costs in dollars, dollarization will also tend to increase economic interactions with the US economy. Expanded exchange can also promote increased symmetry in the production structures of the dollarized economy and the US economy. In other words, over time dollarization is itself likely to cut the costs associated with operating under a monetary policy largely determined by the needs of the US economy. Second, the available empirical evidence is simply insufficient to clarify which factors, or which sets of factors, are essential pre-conditions for dollarization.

The conclusion to be drawn from this data is thus more modest and basic. The greater the constellation of economic characteristics which minimize the costs/maximize the benefits of dollarization, the greater the economic gains for the population, and hence the more limited the number of losers in the economy. In these circumstances, fewer actors will have the incentive and ability to pressure their government to abandon dollarization in favor of a policy more beneficial to their particular interests and/or to destabilize a government which does not respond to their demands. By contrast, economies which lack the bulk of the structural factors promoting growth through dollarization will generate fewer beneficiaries and many more losers, and hence greater political pressures for economic and/or political change.

The Politics of Dollarization

It thus seems clear and quite unsurprising that where economic conditions enable dollarization to fulfill its promise of economic growth with monetary stability, people will tend to support it. But it is also possible that dollarization can work well yet encounter strong societal opposition, or work less than perfectly, yet be politically sustainable. The political sustainability of dollarization depends on the willingness of the losers to accept their situation and on the government's capacity to force recalcitrant losers to absorb the costs of adjustment whether they like it or not. Sustaining dollarization thus ultimately depends on three factors: the presence of cushioning institutions, the degree of conflict in society, and the institutional structure of the government.

Cushioning Institutions:

The willingness and ability of society to absorb the costs of adjustment will inevitably increase as the actual costs they must bear decline. Several institutional characteristics of a national economy and polity have the capacity to mitigate the domestic economic consequences of external shocks under a fixed exchange rate and thereby augment the sustainability of dollarization.

Within the economy, a healthy financial system is an essential tool for minimizing the domestic impact of external shocks. An undercapitalized and underdeveloped financial system can quickly fall into crisis following a sudden rise in interest rates, a common characteristic of the adjustment process under a strictly fixed exchange rate. As occurred in Mexico in 1995 and Thailand and Indonesia in 1997, a weak financial system magnifies the domestic costs of adjusting to sudden shifts in the international economy, and thereby greatly increases the socio-political cost associated with sustaining the established monetary regime.[1] By contrast, a financial system that is well capitalized, diversified, and highly integrated into the international financial order is much less prone (although not immune) to crisis following a sudden increase in domestic interest rates. The Argentine financial system thereby provided an effective cushion for the domestic economy following the Russian default of 1998 and the Brazilian devaluation of early 1999. Despite the enormity of these external shocks, the consolidation of the Argentine financial system since 1995, increased foreign ownership, and most particularly the presence of foreign branch banking, produced a banking system sufficiently well-capitalized to weather the financial storm of late 1998 and early 1999.

A system of income transfers from the winners to the losers in an economy also reduces the political costs of sustaining dollarization. Whether through formal government institutions such as unemployment benefits, informal family networks, remittances from migrant workers, or timely funding from international actors such as IMF/World Bank/IDB loans, bilateral aid flows, or even international capital markets, income transfers mitigate the social consequences of recession. If a decline in living

[1] Although the financial system in all three countries was damaged greatly by devaluation, each was already in serious trouble prior to the devaluation because of the rise in domestic interest rates associated

standards produced by the unemployment and bankruptcies inherent to a sharp economic adjustment can be minimized by the presence of social safety nets, the willingness of society to accept the costs of adjustment will inevitably increase. As a consequence, the capacity of government to sustain the economic policy that forced this adjustment on its constituents will also rise.

Two additional important cushioning institutions are the rule of law, specifically an efficient, capable, and non-corrupt judiciary and bureaucracy to ensure the fair application of the law, and a well-functioning democracy. Although these institutions can do little to mitigate the economic impact of external shocks (like sound financial systems and income transfers), they can reduce the incentive of losers to press for changes in the economic order that has undermined their living conditions.

It is common for citizens to conclude that their economic trials are the result of unfairness in the economic or political order. Where the judicial system and the bureaucracy are inept and corrupt or where the political order excludes popular participation, these political institutions can magnify this sense of unfairness. They can thereby reinforce rather than cushion the political effects of hard economic times, and undermine rather than reinforce the sustainability of dollarization. By contrast, a just and efficient judiciary and bureaucracy encourage a sense of fairness in the minds of losers. When citizens have the chance to rectify a perceived unfairness through a non-biased and effective judicial system or bureaucracy, they will be much less likely to demand changes in the economic policies which were the proximate cause of their

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with efforts to sustain a fixed (or effectively fixed in the Mexican case) exchange rate in the face of declining access to international capital markets.

suffering. A well-functioning democracy offers losers another institutionalized means to protect their interests—by voting out the politicians who caused their personal suffering. In either case, the rule of law and democracy can help to insulate dollarization from the political repercussions of recession.

Societal Factors:

The willingness of a society to absorb the costs of adjustment relies on an environment that minimizes the divisions and competing interests within that society. It depends on creating a national preference for dollarization strong enough to relegate other competing societal preferences to second tier status. The competing interests of distinct sectors of society, such as workers' preference for wage and benefit increases versus owners' preference for expanded profits, or exporters' preference for an undervalued exchange rate versus importers' preference for an undervalued rate, must cease to dominate their policy demands. Instead, their policy preferences much be dominated by a single, overriding demand for sustaining a strict fixed exchange rate regime regardless of its short term costs.

In societies split by a deep socio-economic divide, sharp class divisions, or ethnic conflict, the emergence of a single national preference for any economic policy is rare. In such societies, there is a deep-seeded sense that the competition among different societal groups is zero-sum. Any gain for the other is seen to be an inevitable loss for me. In this setting, it is unlikely that any group will be willing to absorb the costs of adjustment even temporarily, considering this an unfair sacrifice they should not be required to make. The consequence, as in Argentina and Chile during the 1970s and in

Ecuador during the 1990s, is persistent fiscal deficits, macroeconomic instability, and devaluation.

Yet even in societies without such deep-seeded conflict, the tendency to advance individual interests even when this undermines the collective interest is commonplace. How might this seemingly natural human tendency be overcome? A review of the experiences of countries that have adopted strict fixed exchange rate regimes in recent years points to the importance of a shared national trauma that a currency board, monetary union, or dollarization promises to help resolve. Each trauma has a distinct origin, but they fall into three basic categories: a hyperinflationary trauma which brought the national economy to its knees (Argentina 1991 and Bulgaria 1997), national survival (Panama 1904, Estonia 1992, Lithuania 1994), or an outside threat to political and economic stability (Hong Kong 1983 and the European Union).

Regardless of its precise origin, such a national trauma enables the adoption of a currency board, monetary union, or dollarization by building a national sentiment in favor of a strict fixed exchange rate regime as a key tool in the resolution of a shared, national crisis. Equally important for the society's willingness to accept the costs of dollarization over time, however, is the duration of this national trauma. Should the exchange rate regime eliminate the source of the trauma (the end of hyperinflation in Argentina and Bulgaria, for example), time will often transform the trauma into a distant memory. As its traumatic quality fades, so will the willingness of the society's losers to continue to absorb the costs associated with a strictly fixed exchange rate.

<u>Government Capacity:</u>

The political capacity of a country to sustain dollarization over time depends not only on the willingness of a society's losers to absorb the costs of adjustment, however. It also relies on the ability of the government[2] to force society to absorb these costs. In the short term, this government capacity can be enhanced by a strong executive and a cohesive governing coalition that dominates the political scene. But these sources of short-term government capacity are insufficient to sustain dollarization in the long-term. The capacity of a government to assure the survivability of dollarization long into the future depends largely on the presence of political institutions capable of extending the time horizons of politicians and their supporters, such as effective constitutions and strong political parties within the context of a well-functioning democracy.

Executive strength governs the ability of the executive branch to dominate the other branches of government and to insulate itself from societal demands. Executive dominance over the legislature is clearly enhanced by presidential decree power and the authority to dissolve congress. It also benefits from the existence of a well-trained and loyal bureaucracy capable of effectively designing and implementing economic policies. Where such a bureaucracy exists, particularly in the absence of similar expertise in the legislature or in society, the executive can often disarm it opposition by virtue of its economic expertise. Finally, executive strength increases relative to the legislature when party practices and a legislative majority enable the executive to determine who the majority of legislators will be. In such a setting, legislators will hesitate to oppose the man to whom they owe their political future.

[2] This section intentionally refers to the capacity of the government and not the state. Its focus is governance—the ability of the actors which run the state to implement public policies.

The ability of a government to withstand societal pressures to modify the exchange rate regime in economic hard times also reflects the membership and cohesion of the government's ruling and electoral coalitions, and their relative dominance of the political scene. Where the allies of the government are concentrated in sectors likely to suffer a significant proportion of the costs associated with the occasional automatic adjustments that affect a dollarized economy, sustaining dollarization will be difficult. This implies that governments that rely on a coalition composed of large internationalized firms and professionals will be better able to sustain dollarization than governments whose allies include workers, non-competitive national firms, and small farmers.

The relative dominance of the government and its allies in national politics is the final factor determining the capacity of the government to force the losers in society to absorb the costs of adopting dollarization. Where the government dominates the legislature, or the opposition is weak and/or divided, the government will have a greater capacity to withstand societal opposition to its economic policy during the periodic, short-term recessions forced on a dollarized economy in the presence of external shocks.

It is somewhat paradoxical, however, that while these authoritarian features of a government can enhance its capacity to implement dollarization, the ability of a government to ensure the compliance of losers over time is promoted by a more democratic setting[3]. The key factor is the presence of institutions which can extend the

[3] A recent article by Joel Hellman argues that in the case of Eastern Europe, democracy actually deepens and improves the efficiency of a broad swath of economic reforms (Hellman, 1998).

time horizons of politicians and their constituents and thereby increase the likelihood of cooperation and compromise.

Where constitutions clearly delineate a balanced separation of powers among the distinct branches of government, politicians know what powers are available to themselves and their adversaries. The resulting certainty about the rules which delineate the political game will reduce the probability of unanticipated and arguably illegal acts by one's adversaries. As uncertainty declines, the tendency of politicians to exploit every short-term opportunity to strike a fatal blow against their opposition, even at the risk of undermining the essential political and economic foundations of dollarization, will decline as well. Time horizons thereby expand, the willingness of politicians to cooperate and compromise grows, and the capacity of the government to pursue a coherent policy in support of dollarization increases. A well-functioning democracy can have a similar impact by creating the perception among opposition politicians that in time they will have the opportunity to govern. In such a setting, the opposition has little interest in generating instability in either the polity or the economy.

Equally important for sustaining dollarization over the long term are institutions which can extend the time horizons of the government's allies and thereby augment the cohesion of the government's political coalitions. The essential institutions for fulfilling this task are well-disciplined political parties. By definition, such parties can exploit internal regulations, formal or informal, to convince or force their members to accept the short term costs associated with sustaining dollarization. When government allies conclude that the costs of abandoning the ruling coalition are greater than the costs of tolerating a recession, the capacity of the government to sustain dollarization while surviving politically rises markedly.

Conclusion

The ability of any government to sustain dollarization in the long-term ultimately depends on reducing the political costs associated with the automatic adjustment to idiosyncratic shocks inherent in this exchange rate/monetary regime. This paper has argued that these costs can be mitigated by four sets of factors: 1) A domestic economy whose structure approximates that of an optimal currency area with the United States, 2) the existence of institutions that either cushion the domestic economy from external shocks or insulate the political order from the costs of a recession in the domestic economy, 3) a society willing to absorb these costs, and 4) a government capable of imposing these costs on the society.

Given this conclusion, what policy options are available to Latin America to help reduce its vulnerability to external shocks and promote stable growth? First, dollarization can be an effective route to stable economic growth for some Latin American countries—those which possess a preponderance of the characteristics which favor its long-term economic efficiency and political sustainability. But dollarization is clearly not the correct solution for every country in the region. On balance, the preceding analysis indicates that dollarization could be a reasonable option for El Salvador, but is quite inappropriate for countries such as Ecuador and Brazil.

Second, proposals inspired by European monetary union calling for "Euroization" in Latin America raise precisely the same policy questions as dollarization. The only difference between the proposals is the reference point for measuring the degree to which an economy possesses the characteristics of an optimal currency area—the European Union rather than the United States. Third, the worst option for Latin America is to look upon dollarization as a miracle cure for long-standing economic and political problems. Dollarization can do little to reduce foreign debt burdens, build effective state institutions, or reduce societal conflict, all essential sources of continuing economic difficulties in much of the region.

Given the uncertainties associated with the effectiveness of dollarization as a means of creating stable growth in most of Latin America, the countries of the region would be well advised to redirect their policy attention toward the basics. They should redouble their efforts to eliminate the sources of the region's economic and political vulnerability to external shocks. Latin America must strive to reduce its dependence on capital inflows by limiting fiscal and current account deficits and by encouraging the development of domestic financial markets capable of financing government deficits. The region must also focus much more attention on the development of essential institutions—institutions capable of cushioning the domestic economy (healthy financial systems and income transfers) and polity (the rule of law and democracy) from the repercussions of external shocks, and institutions (effective constitutions and disciplined political parties) that extend time horizons and thereby strengthen the government's long-term policy capacity.

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