Dollarization: Pros and Cons

Benjamin J. Cohen

Department of Political Science
University of California at Santa Barbara
Santa Barbara, CA 93106
tel: (805) 893-8763
fax: (805) 568-3720
email: cohen@sscf.ucsb.edu
(home page: http://www.polsci.ucsb.edu/faculty/cohen)

Paper prepared for the workshop
"Dollars, Democracy and Trade: External Influences on Economic Integration in the Americas"
Los Angeles, CA May 18, 2000
The Pacific Council on International Policy, Los Angeles
The Center for Applied Policy Research, Munich

Abstract

This paper assesses the case for dollarization in Latin America today. For dollarizing countries, advantages include lower administrative costs, a firm basis for a sounder financial sector, and lower interest rates. Disadvantages include the loss of monetary autonomy, seigniorage, and a vital national symbol as well as greater vulnerability to foreign influence. For the United States, conversely, advantages include gains of seigniorage, prestige, and political authority. Disadvantages include possible constraints on US monetary policy and pressures to accommodate the special needs of dollarizing countries. Among policy options for Washington, the most attractive would be a strategy of active encouragement based on negotiated agreements with dollarizing countries carefully spelling out mutual rights and obligations.

Introduction

In the wake of the recurrent financial crises of the last decade – Mexico in 1994-95, East Asia in 1997-98, Brazil in 1999 – it is not surprising that governments today would look for new ways to cope with the old risks of currency fragility and volatility. The ever-elusive goal is to construct a sustainable regime of exchange-rate stability. The challenge, as always, is to make a commitment to stable exchange rates credible. In 1991 Argentina thought it found the solution in a currency board, an ostensibly permanent peg to the U.S. dollar. But as subsequent developments have demonstrated, not even the guarantees of a Convertibility Law may suffice to convince investors that an exchange-rate peg is truly irrevocable. So now attention has focused on an even more radical solution: dollarization. The idea of dollarization has become a topic of intense public debate throughout Latin America since Argentina's former President, Carlos Menem, spoke out in its favor a year ago.

Dollarization is not new, of course. On an informal basis, America's greenback has long circulated alongside national monies throughout much of the Hemisphere as well as elsewhere. This is the familiar phenomenon of currency substitution. In similar fashion, Germany's Deutsche Mark (DM) is used widely in the Balkans and East-Central Europe. What is new among our southern neighbors today is a growing interest in *formal* dollarization: legal adoption of the dollar as a full *replacement* for local money. Until now, formal dollarization (or its equivalent using some other major currency) was seen as an option limited only to tiny enclaves or micro-states like San Moreno or the Marshall Islands. In all, only some dozen sovereign entities – including only one country (Panama) with a population exceeding 100,000 – currently use the currency of a larger neighbor or patron in lieu of a money of their own. Today, however, even nations as big as Argentina or Mexico are debating the merits of the approach; and one country, Ecuador, has actually gone from talk to action, enacting legislation intended to implement formal dollarization before the end of the year.

The purpose of this paper is to assess the case for dollarization in Latin America today. The general advantages of dollarization are clear. They are the standard economic benefits of financial and monetary integration: reduced transactions costs, reflecting an enhanced usefulness of money for all its basic functions (medium of exchange, unit of account, store of value). With replacement of the local money there is no longer a need to incur the expenses of currency conversion or hedging in trade and investment transactions between the partner economies. Efficiency gains could be considerable and will be shared commensurately by both sides, the United States as well as the country that dollarizes.

In addition to these general benefits, however, there will also be more specific effects – some positive, some negative – for each side. Implications for the partners are as much political as economic. The first section of this paper will examine the pros and cons of dollarization from the point of view of the dollarizing country. The second section will take up the perspective of the United States. For both sides a complex calculus of potential gains and losses is required, leaving much room for disagreement over the underlying issues. The third section of the paper will address the policy questions involved: What, if anything, should the United States do about dollarization, and what policy alternatives might there be? A final section asks what might be learned in this context from Europe's experience with its own form of monetary integration.

Implications for the Dollarizing Country

Advantages of dollarization

From the point of view of the dollarizing country, replacement of the local currency offers three major benefits (apart from the general advantage of reduced transactions costs). First, **administrative expenses** are reduced. No longer must the government incur the cost of maintaining an infrastructure dedicated solely to production and management of a separate national money. Admittedly, such savings are apt to be most attractive to poorer or more diminutive sovereignties because of the diseconomies of small scale involved. But even for bigger and wealthier countries the potential reduction of expenses would not be inconsiderable.

Second, dollarization can also establish a firm basis for a sounder **financial sector**. Dollarization means more than merely the adoption of a foreign currency. It also means financial integration with the United States, which will force domestic financial institutions to improve their efficiency and the quality of their services. Even more, as a supposedly irreversible institutional change, it signals a permanent commitment to low inflation, fiscal responsibility, and transparency. That would be of particular value to countries that previously have not enjoyed much of a reputation for price or fiscal stability.

Also importantly, with dollarization there could be a substantial reduction of **interest rates** for local borrowers. Dollarization establishes a stable relationship with a currency whose reputation is already well established and secure. Instead of investing heavily in efforts to build market confidence in its own monetary policy, a government can achieve instant credibility by "hiring" the respected Federal Reserve instead. Fed policy become the country's policy. With luck, the reduction of interest rates will result in substantially higher levels of domestic investment and future economic growth.

Presently, Latin American countries must pay a considerable premium when borrowing in world capital markets, reflecting two perceived risks for lenders. One is devaluation risk (or currency risk): a fear of depreciation of the local money's exchange rate. The other is default risk (or sovereign risk): a fear of disruption or suspension of a country's payments on foreign debt. Dollarization can do nothing directly to reduce default risk (the "country" premium), which is a reflection of the political reality of national sovereignty. An independent government can always, *in extremis*, suspend or abrogate its external obligations if faced with, say, a fiscal emergency or political turmoil. But dollarization can reasonably be expected to eliminate devaluation risk (the "currency" premium) since the reform, at least in principle, is supposed to be irrevocable. And it might even indirectly reduce default risk, insofar as some part of default risk reflects the possibility of future currency crises. Barring reintroduction of the local money, exchange-rate disturbances should become a thing of the past, making it easier for governments to meet foreign commitments.

Disadvantages of dollarization

Counterbalancing these benefits, however, are several potentially substantial costs. Economists, not surprisingly, tend to focus on disadvantages that are essentially economic in nature. These include forfeiture of national monetary autonomy and prospective losses of both seigniorage and an effective lender of last resort for domestic banks. In reality, however, none of these costs are apt to be as serious as frequently alleged. The more critical disadvantages of dollarization are *political*, not economic, involving losses of a powerful symbol of national identity, an emergency source of state revenue, and an important measure of diplomatic insulation. Though frequently discounted by economists, who are inclined to view political behavior as mostly interest-driven or even "irrational," these are in fact the costs that are likely to matter most in practice.

Economic costs. It is easy to exaggerate the purely economic costs of dollarization. It is certainly true, for example, that in formal terms **monetary autonomy** is forfeited, since the dollarizing country can no longer exercise unilateral control over its own money supply or exchange rate. The relationship is inherently hierarchical. All authority is ceded to the Federal Reserve, with little promise that the dollarizing country's specific circumstances would be taken into account when monetary decisions are made. In practical terms, however, it is likely that much of the country's monetary autonomy has already been greatly eroded. Otherwise, the country would not even be considering dollarization in the first place. In Argentina, the big step was taken when its currency board was established. The Argentines have already lived without an independent monetary policy for most of a decade. And in many other Latin American countries monetary autonomy has long since been compromised by the steady growth of informal dollarization. The greater the degree of currency substitution that has already occurred, reflecting market pressures and preferences, the greater is the degree of constraint imposed even now on a government's ability to manage macroeconomic conditions – and hence the smaller will be the actual loss of monetary autonomy if the local money is eliminated formally in the future.

Likewise, it is true that with dollarization a government forfeits a potentially powerful tool for underwriting public expenditures – the capacity to create money, otherwise known as **seigniorage**. Technically defined as the excess of the nominal value of a currency over its cost of production, seigniorage can be understood as an alternative source of revenue for the state beyond what can be raised via taxation or by borrowing from financial markets at home or abroad. What cannot be paid for with tax receipts or borrowed funds can be paid for, in effect, by using the printing press. Dollarization automatically terminates that revenue unless explicitly offset by some kind of agreed formula for seigniorage-sharing with the United States. But once again, in practical terms, the loss will be smaller, the greater is the degree of prior informal dollarization. For many of the countries of Latin America, where the greenback even now accounts for a large part of local money supply, the privilege of seigniorage has already been greatly diminished.

Finally, it is true that a dollarizing country forfeits a formal **lender of last resort**, since in adopting a foreign currency it also gives up a central bank capable of discounting freely in times of financial crisis. Domestic banks may thus be more exposed to potential liquidity risks. In practical terms, however, this alleged cost can be rather easily offset on a unilateral basis. Dollarization reduces the overall need for international reserves, since a share of external transactions that previously required foreign exchange can now be treated as the equivalent of domestic transactions. A portion of the central bank's dollar assets could therefore be dedicated instead to a public stabilization fund to help out domestic financial institutions under stress. Alternatively a contingency fund could be built up over time from tax revenues, or flexible credit lines with foreign banks or monetary authorities could be negotiated, using future tax revenues or seigniorage-sharing as collateral. A model for a foreign credit line already exists in Argentina where, in support of its currency board, the government has established a Contingent Repurchase Facility allowing it to sell dollar-denominated bonds to selected international banks when needed in exchange for cash dollars.

Political costs. It is more difficult to exaggerate the political costs of dollarization, which are highly visible and could be quite dramatic.

At the **symbolic level**, preservation of a national currency is particularly useful to governments wary of internal division or dissent. Centralization of state authority is facilitated insofar as citizens all feel themselves bound together as members of a single social unit -- all part of the same political and historical community. Cultural anthropologists teach us that states are made not just through force but through loyalty, a voluntary commitment to a joint identity. The critical distinction between "us" (the nation) and "them" (everyone else) can be heightened by all manner of tangible symbols: flags, anthems, postage stamps, public architecture, even national sports teams. And among the most potent of these symbols is money, which serves to enhance a unique sense of national identity in two ways. First, because it is issued by the government or its central bank, a currency acts as a daily reminder to citizens of their connection to the state and oneness with it. Second, by virtue of its universal use on a daily basis, the currency underscores the fact that everyone is part of the same social entity -- a role not unlike that of a single national language, which many governments also actively promote for nationalistic reasons. Both effects are lost when the money of a foreign state is adopted. Insofar as value continues to be attached to loyalty to a distinct political community, it can no longer be promoted through the tangible symbol of a separate national currency.

Similarly, at the level of state policy, preservation of a national currency is useful to governments as a kind of **insurance policy against risk**. This takes us back to seigniorage, which is more than just a marginal source of revenue for the state. More importantly, it can serve as an *emergency* source of revenue – a way of finding needed purchasing power quickly when confronted with unexpected contingencies, up to and including war. As John Maynard Keynes once wrote, "A government can live by this means when it can live by no other." Resources can be mobilized immediately without being forced to wait for tax returns to be filed or loans to be negotiated. That privilege too is lost when the money of another state is adopted.

Finally, at the level of **foreign policy and diplomacy**, preservation of a national currency is useful to governments wary of external dependence or threat. National monetary autonomy enables policymakers to avoid dependence on some other source for this most critical of all economic resources. In effect, a clear economic boundary is drawn between the state and the rest of the world, promoting political authority. This insulation also is lost when a foreign money is adopted. Indeed, with dollarization the United States gains a potentially powerful instrument of influence over the dependent dollarized economy. Hierarchy unavoidably implies vulnerability.

For a case in point consider Panama, which since its independence in 1903 has used the greenback as legal tender for most domestic monetary purposes. Although a national currency, the balboa, notionally exists, only a negligible amount of balboa coins actually circulate in practice. The bulk of local money supply, including all paper notes and most bank deposits, is accounted for by the dollar. In economic terms, most observers have rightly had only praise for Panama's currency dependence. Reliance on the dollar has created an environment of stability that has both suppressed inflation – a bane of most of Panama's hemispheric neighbors – and helped establish the country as an important offshore financial center. In political terms, however, Panama has been extremely vulnerable in its relations with Washington, which of course could sour at any time. In the late 1980s, Panamanians learned just how exposed to external coercion they really were.

The critical moment came in 1988, following accusations of corruption and drug smuggling against General Manuel Noriega, the country's de facto leader. In March 1988, Panamanian assets in U.S. banks were frozen, and all payments and dollar transfers to Panama were prohibited as part of the Reagan administration's determined campaign to force Noriega from power. The impact was swift. Most local banks were forced to close, and the economy was squeezed by a severe liquidity shortage. The effect on the economy was devastating despite rushed efforts by the Panamanian authorities to create a substitute currency, mainly by issuing checks in standardized denominations that they hoped recipients would then treat as cash. The country was effectively demonetized. Over the course of the year, domestic output fell by a fifth.

As it happens, the sanctions turned out to be insufficient to dislodge Noriega on their own. Ultimately, in 1989, Washington felt it necessary to mount a military invasion that led to a temporary occupation of the country until a new, friendlier government could be installed. But there can be no doubt that the liquidity squeeze was painful and contributed greatly to Noriega's downfall. Dollarization clearly makes a country more vulnerable to threats of manipulation or coercion.

Conclusion

So what can we conclude? For Latin Americans the purely economic costs of dollarization, while hardly trivial, nonetheless appear limited in scope and essentially manageable. Overall, on economic grounds alone, dollarization should be attractive to many countries. But governments cannot ignore the fact that there are also potential political costs, which could be substantial and may in fact be far more threatening to a nation's internal cohesion and external independence. The political implications of dollarization go to the heart of the fundamental purpose of the state: to permit a community to live in peace and preserve its own social and cultural heritage. Such matters cannot be lightly dismissed as mere "politics as usual." Latin American governments have real reason to hesitate over such a momentous decision.

Implications for the United States

For the United States too, as for the dollarizing country, there are potential costs as well as benefits associated with dollarization. And for the United States too, the more critical implications are likely to be political rather than economic in nature.

Advantages of dollarization

On the economic side, in addition to the general advantage of reduced transactions costs, the United States would enjoy one major benefit: an increase of **seigniorage**, mirroring the dollarizing country's revenue loss. Dollarization means that a government must give up interest-bearing dollar reserves in order to acquire the greenbacks needed to replace local cash in circulation. The interest payments thus foregone represent a net saving for the United States which, while not large, could cumulate significantly over time. In the case of Argentina, for example, it is estimated that the amount of seigniorage that would be transferred to Washington as a result of formal dollarization might amount to something like $750 million a year. That number helps explain why Argentina has so far hesitated to abandon its own currency irrevocably without first obtaining some agreed formula for seigniorage-sharing with the U.S. Treasury.

On the political side, the United States would enjoy three main benefits, all also mirroring corresponding disadvantages for the dollarizing country. At the symbolic level, for example, the dollarizing country's loss of a vital token of national identity is matched by America's gain in **international status and prestige**. Our money's global circulation is a constant reminder to others of our elevated rank in the community of nations. Certainly foreign publics cannot help but be impressed when the dollar formally takes over the domestic monetary system. "Great powers have great currencies," Robert Mundell once wrote. In effect, the greenback becomes a tangible symbol of American primacy, if not hegemony, on the world stage. Likewise, at the level of state policy, the dollarizing country's loss of seigniorage as an emergency source of revenue is matched by a corresponding increase of **fiscal opportunities** for the United States. Now foreigners as well as Americans can be counted upon to accept new dollars issued to underwrite public expenditures in the event of a sudden crisis or threat to national security. In effect, Washington's tax base is broadened. And finally, at the level of foreign policy and diplomacy, the dollarizing country's increased vulnerability is of course matched by America's enhanced **political authority**. Washington's capacity to exercise influence or coercion is broadened too.

Disadvantages of dollarization

Despite all these benefits, however, the United States too has reasons to hesitate. Dollarization also poses potentially serious risks for U.S. policy in the future.

Economists, again, tend to focus on the economic side, stressing in particular possible disadvantages for the conduct of U.S. **monetary policy**. Dollarization, it is alleged, could impose an awkward constraint on Federal Reserve decisionmakers, since a larger share of greenbacks would now be placed in circulation abroad. Money demand in the dollarizing country could be subject to sudden or frequent shifts, generating net international flows that might increase the short-term volatility of U.S. monetary aggregates. Such liquidity shocks could make it tougher for the Fed to maintain a steady course over time. But this risk is also easy to exaggerate. In fact, a large share of the outstanding stock of U.S. banknotes -- conservatively estimated at some 55-70 percent of the total -- is already in circulation outside the country, with little or no evident impact on policy. The Fed recognizes the phenomenon of informal dollarization and, as part of its daily open-market operations targeting the federal-funds rate, already factors overseas circulation into its behavior. In any event the additional sums involved, even if several governments were to choose formally to dollarize, are unlikely to be great enough to make much practical difference in an economy as large as that of the United States.

More critical, once again, are possible political risks that could ensue from dollarization. By voluntarily adopting the greenback as its own currency, a country makes itself a monetary dependency of the United States. Like it or not, therefore, Washington might find itself under **pressure to accommodate** the country's specific needs or fragilities should conditions warrant. The Fed might be pressured to take explicit account of the priorities of the dollarized economy in setting its policy goals -- especially in the event of asymmetric payments shocks -- or to extend its lender-of-last-resort facilities formally to local financial institutions. In time, the country might even begin to lobby for indirect or even direct representation on the Federal Reserve Board or Federal Open-Market Committee. Likewise, the Treasury might be importuned to come to the country's rescue in the event of financial crisis or instability. Even in the absence of any formal inter-state agreement, dollarization could create an implicit expectation of future monetary bailouts -- a kind of contingent claim on U.S. Government resources. Such an expectation is the flip side of America's enhanced political authority. With primacy comes not only greater influence but also, potentially, greater responsibility.

Conclusion

For the United States too, therefore, political considerations – positive as well as negative – appear to far outweigh purely economic implications. On strictly economic grounds dollarization appears not unattractive, as it should for many Latin American governments. But on the political side the calculus is more uncertain, reflecting risks as well as possible gains that are by definition unknowable *ex ante.* The U.S. Government also, no less than Latin Americans, has reason to hesitate over such a decision.

U.S. Policy Options

What, then, should the United States do? In practical terms, three broad policy strategies suggest themselves: (1) active discouragement of dollarization; (2) passive neutrality; or (3) active encouragement. Each option carries with it its own calculus of potential benefits and risks.

Active discouragement

One strategy would be to actively discourage dollarization by all means possible. Governments considering such a course would be told in no uncertain terms that no help will be forthcoming from Washington – no seigniorage-sharing, no access to the Fed's discount window, no special accommodation of their monetary needs. Dollarize if you will, they would be advised, but you do so only at your own peril.

The main reason for such an uncooperative strategy would be to avoid even a hint of responsibility for backstopping the financial affairs of Latin American economies. Americans have long enjoyed a high degree of insularity in the making of monetary policy and would be unlikely to welcome any obligation, however limited, to compromise domestic priorities for the sake of undisciplined, perhaps even ungrateful, foreigners. Granted, this course would also mean foregoing the acknowledged benefits of dollarization, political as well as economic. But for many U.S. citizens, all that would be a small price to pay to maintain our traditional monetary autonomy.

Much depends, of course, on the historical counterfactual: What will happen in Latin America if the choice of dollarization is foreclosed? Several scenarios are possible. Easiest to imagine is a future in which governments seek to maintain and manage their own independent monies, just as they have done in the past. In that case, however, the risks of currency fragility and volatility would remain as salient as ever. Would the United States really be better off if our southern neighbors continue to suffer periodic bouts of monetary and financial crisis? An alternative possibility is that some Hemispheric governments might consider promoting monetary unification on their own, on the model of Europe's Economic and Monetary Union (EMU). In the southern cone of South America, for example, there has already been discussion of a proposed common currency for Mercosur, which some have suggested might be called the gaucho. In such a case, the United States would avoid any responsibility but would also undoubtedly suffer a decline of status and influence, as well as opportunities for seigniorage, as the new currency matures. Finally, a third possibility is that some Latin American countries might decide to throw in their lot with Europe, adopting the euro ("euroization") in lieu of the dollar as a replacement for their own national monies. In that case, America's status and influence would be even more directly challenged by a strengthened European Union.

Passive neutrality

A second possible strategy would be passive neutrality – a policy of "benign neglect," to borrow a phrase from another era. Governments considering dollarization would be given moral support, and perhaps some technical assistance, but otherwise would be left more or less on their own. No formal bilateral agreement would be offered, along the lines sought by Argentina over the past year, outlining mutual rights and obligations. Adoption of the greenback would have to be entirely unilateral, as is presently happening in Ecuador.

In fact, benign neglect is the best description of U.S. policy today. The main reason for the policy is the same as before: to try to avoid even a hint of responsibility for backstopping Latin American economies. But at the same time, by not discouraging dollarization undertaken on a unilateral basis, the United States can still hope to harvest the potential gains to be derived, including especially seigniorage and enhanced political authority. The main risk of such a course involves an empirical question: How many countries will actually be willing to transform themselves into a monetary dependency, with all the disadvantages implied, without some sort of formal quid pro quo from Washington? The Argentine government has already made plain that it is unlikely to commit itself in the absence of a bilateral treaty. Ecuador proceeded on its own only because of a massive financial collapse that seemed to leave policymakers in Quito no plausible alternative. The reality would appear to be that so long as Washington's current policy persists, the number of countries that finally do choose dollarization will remain comparatively small.

Active encouragement

That leaves one other possibility: active encouragement of dollarization initiatives. Governments would be offered specified incentives and perhaps even the public affirmation of a formal treaty. The element of dependency would be de-emphasized. Instead, dollarizing countries would be welcomed as sovereign partners in a great new monetary enterprise.

The most obvious incentive to offer would, of course, be seigniorage-sharing. From the dollarizing country's point of view, the government's revenue loss is by far the most visible cost involved. It also seems the least equitable since it reverts directly to the U.S. Treasury as a pure windfall gain. Why, Latin Americans are entitled to ask, should the wealthy United States profit at the expense of poorer neighbors? Should they not be entitled to reclaim at least a part of their foregone earnings as compensation for their surrender of monetary autonomy? Seigniorage-sharing can be most easily accomplished simply by giving the dollarizing country the cash greenbacks needed to replace local currency. The greenbacks may be a pure gift or may be offered in exchange for a dollar-denominated, non-interest-bearing government bond (in effect, a currency swap). Either way, the advantage is that the country can retain its existing dollar reserves and thus continue to receive interest in the future. Alternatively, if reserves are used to retire the local currency, the U.S. could make regular transfers to the country calculated to replace some or all of the interest earnings foregone. Precedent for this approach already exists in southern Africa, where South Africa makes annual transfers to two of its neighbors, Lesotho and Namibia, to compensate for their continued use of the South African rand as domestic legal tender.

In fact, legislation to offer a form of seigniorage-sharing has already been proposed by Senator Connie Mack of Florida, chairman of the Joint Economic Committee of the Congress. Entitled the International Monetary Stability Act, the bill would allow rebates to dollarizing countries of up to 85 percent of all lost seigniorage. (The remaining 15 percent would finance rebates to countries that are already dollarized, such as Panama, and to help pay related costs of the Federal Reserve and Treasury.) Seigniorage would be paid in the form of interest on a consol (a perpetual debt instrument) that would be issued to each country as soon as the U.S. Treasury certifies that its money supply is officially dollarized. The measure's purpose, as Senator Mack emphasized, was quite self-consciously to promote adoption of the greenback. "It is time," he declared, "for the U.S. to show leadership and encourage dollarization." Though greeted cautiously by the Fed and Treasury officials, Mack's initiative appears to have drawn some degree of support from legislators on both sides of Capitol Hill.

Is the Mack bill the best way to encourage dollarization? From a strictly U.S. perspective, critics worry about other obligations that may be implicit in the legislation. Explicitly, the act formally provides "that the United States is not obligated to act as a lender of last resort to officially dollarized countries, consider their economic or financial conditions in setting monetary policy, or supervise their financial institutions." Yet not even such blunt wording may be enough to convince skeptics. Once having encouraged countries to adopt the greenback, can Washington really be expected to turn its back if any of them get into serious trouble? Conversely, from the point of view of potential dollarizers, there is much justifiable concern about the uncompromising unilateralism that is built into the bill. Certification of eligibility for seigniorage rebates would be at the sole discretion of the U.S. Treasury and could be withdrawn at any time. Might this privilege become yet one more handy instrument for the exercise of U.S. influence in Latin America?

For Latin Americans, accordingly, dollarization would be more palatable if accomplished through a bilateral or multilateral treaty, as sought by Argentina, rather than exclusively at the pleasure of the United States. Admittedly, any sort of written agreement would only serve to heighten skeptics' concerns about future contingent claims on the U.S. Government. But expectations of an implied commitment, it is evident, are likely to be generated no matter how strong the disclaimers emanating from Washington. If so, denials of responsibility would literally not be worth the paper they were written on. More preferable, it could be argued, would be an agreed contract spelling out mutual rights and obligations in clear and explicit detail. A manageable balance between the sensitivities of the two sides may not be easy to find. But there seems no satisfactory alternative if a strategy of encouraging dollarization is to be made to work effectively.

Conclusion: Lessons from the European Experience

What lessons for dollarization can be learned from Europe's experience with monetary integration? On the face of it, the parallels are weak. EMU, with its newly created currency -- the euro -- and its jointly managed European Central Bank (ECB), is formally a partnership of equals. Everyone has a seat at the table where policy is made. Dollarization, by contrast, is by definition a relationship of unequals: a hierarchical structure with just one country, the United States, firmly in charge. There is one common money, but it is America's currency. There is one central bank, but it is the Federal Reserve, accountable to Americans alone.

Much more germane might seem the CFA Franc Zone in Africa, which has long functioned as a monetary dependency of France. Though officially maintaining their own separate currency (actually a collection of regional currencies all labeled CFA francs), the fourteen members of the Zone – all but two former French colonies – voluntarily subordinate their monetary policies to the Treasury in Paris. The CFA franc has been firmly anchored on the French franc (a role now seamlessly taken over by the euro) and the bulk of the Zone's foreign reserves have been deposited in Paris. In return, the French government enhances the credibility of the CFA franc by guaranteeing its convertibility, with monetary discipline implemented through rules that determine access to Treasury credit. In reality, however, it is difficult to imagine that Latin Americans would view the Zone as an attractive model for their own relations with the United States. Their preference is certain to be for something far less obviously "neo-colonial."

Most relevant is Europe's experience with EMU's predecessor, the European Monetary System, which was de facto (though not formally) a hierarchical relationship centered on Germany. Begun in 1979, the EMS quickly evolved into a pegged-rate arrangement dominated by the policies of the Deutsche Bundesbank. For Germany's partners in the so-called Exchange Rate Mechanism (ERM), the advantage was the monetary stability imported via the DM, not unlike the main economic advantage claimed for dollarization. Policy credibility was instantly attained by "hiring" the highly respected Bundesbank. But there was also a clear disadvantage, which became most evident after German unification in 1990. Unification, a manifestly costly undertaking, brought in its wake extremely high interest rates, to which Germany's partners, being subordinate, felt constrained to adapt until ultimately forced to abandon their pegs under the pressure of speculative currency flows in 1992-93. The lesson, Europeans felt, was that they could not always rely on the good behavior of one dominant country. Hegemony could be abused, unconsciously if not deliberately. Hence the widespread acceptance of the initiative to replace the EMS with EMU, which involves a much more collective decisionmaking process. For Latin Americans, this is undoubtedly the key lesson to be learned from the European experience.

In short, dollarization has its attractions, but not if it means unqualified subordination to the dominant partner. Some countries, like Ecuador, may feel they have no choice. But most, like Argentina, will prefer to look for greater assurances that their monetary subordination, once entered into, will not be exploited by Washington, the long-dreaded colossus of the north. In effect, America's hands must be tied -- albeit not so much that the whole project becomes politically infeasible for the United States. Ultimately, therefore, the debate boils down to one basic question: Can the sovereign rights of both sides be adequately protected? Should dollarization prove more than just a passing fancy, diplomats will surely have their hands full.

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