Full Dollarization: A Last Resort Solution to Financial Instability in Emerging Countries?

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This paper will examine the question of official dollarization. To clarify the discussion, a taxonomy of dollarization regimes is drawn up in order to make an inventory of officially dollarized countries, territories and dependencies. The foundations for adopting full dollarization are analysed through three elements: an account of the limits to corner solutions, the identification of the economic contexts which are favourable to the adoption of foreign currencies and the reasons behind the legitimacy crisis of national currencies. To determine what is at stake in such decisions, cost advantage analysis mentions, first of all, the expected benefits highlighted by the advocates of complete dollarization. A detailed study of its potential impact will then allow us to evaluate the induced costs of the disappearance of national currencies. Finally, by looking at emerging countries which have adopted this exchange regime, the limits of adopting such a solution are underlined, particularly by the fact that the disappearance of national currencies implies an abandonment of monetary sovereignty and a loss of a powerful symbol of national identity.

L’objet de cet article est d’alimenter le débat sur la dollarisation officielle. En raison de son coût d’opportunité, le remplacement d’une monnaie nationale par une devise étrangère constitue une solution de dernier ressort à l’instabilité financière des économies émergentes. Pour éclairer la discussion, une typologie des régimes de dollarisation est dressée afin de recenser les pays, territoires et dépendances officiellement dollarisés. Les fondements du changement de régime monétaire sont présentés à partir de trois éléments: l’analyse des limites des corner solutions, l’identification des contextes économiques favorables à l’introduction d’une devise étrangère et les raisons de la
crise de légitimité de la monnaie nationale. Pour comprendre les enjeux d’une telle décision, l’étude des avantages-coûts souligne en premier les bénéfices espérés mis en valeur par les partisans de la dollarisation intégrale. L’exposé détaillé de son impact potentiel permet ensuite d’estimer les coûts induits par la substitution monétaire. En prenant pour exemple les pays émergents qui ont choisi cette option monétaire, on précise enfin le terrain d’application limité d’une telle mesure, la disparition de la monnaie domestique entraînant l’abandon d’une souveraineté monétaire et la perte d’un puissant symbole d’identité nationale.

The financial crises which have hit emerging economies for the past ten years have intensified the debate on the exchange regimes that would be the most appropriate for developing countries. Whereas some governments have maintained their confidence in floating exchange rates, others have adopted a currency board system in order to peg their currencies to the dollar or have given up their own currencies in favour of the dollar. Until recently, Panama, which has used the dollar as its official currency since 1904, has been the only significantly-sized country that has opted for official dollarization. In 2000, Ecuador and East Timor and, in 2001, El Salvador chose to adopt the dollar as legal tender, thereby renouncing their monetary sovereignty. In the near future, Nicaragua and Costa Rica may also be tempted to join the bandwagon. Argentina, after hesitating, has refused to dollarize but we have to point out that in Guatemala two official currencies including the dollar co-exist.

In the search for a new architecture of international finance, emerging countries’ leaders have been pondering over the nature of exchange regimes that they should follow and the progression of total dollarization is a reflection of this. These questions are legitimate since monetary substitution can carry heavy consequences. Money does not only fulfil an economic function, it is also the expression of a social and collective reality. The decision to abandon a national currency and adopt a foreign currency is virtually an irreversible choice.

This paper will analyse the debate about official dollarization in emerging countries. The literature on the subject has for long been based on cost-advantage analysis of partial dollarization, where a foreign currency circulates along with the national currency. Recent studies have paid much more attention to official dollarization, where the local currency is completely replaced by a foreign currency. Our hypothesis is that in view of the developing countries’ financial instability, complete dollarization can only be a solution of last resort. In spite of a small number of specific advantages, the losses incurred by monetary substitution in terms of monetary sovereignty and national identity are so great that it would be deceptive to think that it would be the miracle solution for
reducing instability in emerging countries or the instability of the international monetary and financial system.

We will start by identifying the main dollarization regimes in order to analyse the foundations of full dollarization. We will then examine the expected benefits of monetary substitution and the inherent criticism of this exchange regime. Finally, looking at emerging countries that have adopted this method of dollarization, we will highlight the extreme aspects of such a solution, notably because of its opportunity cost and the fact that it engenders the loss of a powerful symbol of national identity.

A TAXONOMY OF DOLLARIZATION REGIMES

The term ‘dollarization’ can be ambiguous. First, in the process of dollarization, some authors include the replacement of a domestic currency by a currency other than the dollar. Thus, the use of the South African rand in Austral Africa or the euro in Central and Eastern Europe (‘euroization’) is sometimes assimilated to a regime of dollarization whereas the term ‘xenomonetization’ would be more appropriate. Another ambiguity arises from the different conceptual frameworks used. Whereas some authors give greater importance to the study of partial dollarization, others stress the importance of complete dollarization or even the ‘monetary union’ type of exchange regime. To clarify the debate, we will look at the different meanings of dollarization. We will then identify the different types of dollarization regimes that exist in order to list the countries, territories and dependencies that are officially dollarized.

Dollarization, a Polysemic Concept

In the strict sense of the word, dollarization means giving up a national currency and adopting the US dollar. Salama [1998: 8] defines dollarization as an evolution where ‘the dollar is the predominant store of value, unit of account and medium of exchange for some goods’. Bourguinat and Dohni [2002: 59] have a similar conception as they define dollarization as the ‘the process where national currencies are replaced by the dollar as the unit for the price of goods, the means of payment and the holding of savings’. In its broadest sense, dollarization is a generic term used to characterise countries that use foreign currencies for their financial transactions – the foreign currency does not need to be the US dollar. As Blanc [2000] has underlined, the meaning in this case is misleading because it embraces a comprehensive process that concerns – just to give a few examples – the euro, the sterling pound, the Australian dollar and the New Zealand dollar. It is also misleading because it leads one to believe that only the dollar has been the object of monetary polarisation.

The notion of dollarization can have different meanings; Ponsot [2003] makes a distinction according to two differentiating criteria: the degree to which
a foreign currency is used in the monetary transactions of a country and the degree to which a foreign currency becomes official and receives institutional approval by its authorities. On the basis of the first criterion, we have to differentiate between partial dollarization and complete dollarization. In a partial dollarization regime, there is a phenomenon of monetary plurality where a foreign currency circulates in parallel with the national currency. This is an informal process of monetary substitution, which operates more or less in the underground economy: some of the uses of the domestic currency are replaced by a foreign currency.

On the basis of the second criterion, we can distinguish between unofficial or de facto dollarization and official or de jure dollarization. Unofficial dollarization appears as a spontaneous process that comes from the choice of the residents of a country whose financial assets are, in a large part, in foreign currencies that are not legal tender in their country [Balino et al., 1999]. Official dollarization is an institutional process that is decided by monetary authorities. The use of a foreign currency is officially accepted as legal tender by public authorities.

Four Regimes of Dollarization

Despite the problems of defining dollarization, it is possible to draw up a typology of dollarization regimes. By combining the two differentiating criteria mentioned previously, Ponsot [2003] has isolated four types of regimes (see Table 1). Regime A1 is the most prevalent regime: a foreign currency circulates along with the national currency without any official recognition. Latin America is certainly one of the best examples of unofficial and partial dollarization. Berg et al. [2002] have shown that in 2002, more than 80 per cent of bank deposits in Bolivia and Uruguay were in dollars. In Argentina and Peru, the percentage was smaller but was still high; 64 per cent for the former and 78 per cent for the latter (Table 4).

Regime A2 is a semi-official dollarization regime: public authorities legalise the use of a foreign currency for certain monetary operations but also keep their national currency. Thus, in 2001 Guatemala legalised the use of the dollar for national transactions, the price of financial assets, bank accounts, the drawing up of contracts and the payment of some salaries.

In regime B1, dollarization is complete but remains unofficial. It is associated with periods of conflict and crises where political sovereignty is in jeopardy such as was the case with East Timor and Kosovo before 2000. Regime B2 corresponds to official and complete dollarization and is the most complete process. It is set up indirectly after a period of unofficial dollarization. In this case, public authorities just ratify an accomplished fact. This is what happened in Ecuador in 2000. It can be set up directly with the emergence of new political entities, such as was the case of Montenegro and Kosovo in 2002.
An Account of Officially Dollarized Economies

Table 2 shows that official and complete dollarization is a large myth. Today, there are only 17 independent countries that are officially dollarized or have two currencies. In demographic terms, the population of all of these countries put together (42 million inhabitants) is similar to the population of Spain or Poland. Average GDP does not exceed 3.6 billion dollars. Ecuador, Guatemala, El Salvador and Panama, alone account for 93 per cent of GDP and 88 per cent of the total population.

Dollarization, in the strict sense of the word, concerns an even fewer number of countries because only nine countries have adopted the dollar as legal tender. If we include the number of territories and dependencies that have officially accepted the US dollar, the number of dollarized countries will of course be
**TABLE 2**  
INDEPENDENT COUNTRIES, OFFICIALLY DOLLARIZED OR HAVING A DUAL CURRENCY, MARCH 2005

<table>
<thead>
<tr>
<th>Countries</th>
<th>Population 2002</th>
<th>GDP* 2002</th>
<th>Legal Currency</th>
<th>Local coins</th>
<th>Since</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andorra</td>
<td>73 000</td>
<td>1.2</td>
<td>Spanish peseta and French franc replaced by the euro</td>
<td>2002 (euro) 1278(franc and peseta)</td>
<td>2002</td>
</tr>
<tr>
<td>East Timor</td>
<td>857 000</td>
<td>0.2</td>
<td>US dollar</td>
<td>x</td>
<td>2000</td>
</tr>
<tr>
<td>Ecuador</td>
<td>13 100 000</td>
<td>24.3</td>
<td>US dollar</td>
<td></td>
<td>2001</td>
</tr>
<tr>
<td>El Salvador</td>
<td>6 500 000</td>
<td>13.0</td>
<td>Progressive disappearance of the colón</td>
<td></td>
<td>2001</td>
</tr>
<tr>
<td>Guatemala</td>
<td>12 000 000</td>
<td>23.2</td>
<td>Dual currency: American dollar and the quetzal</td>
<td></td>
<td>2001</td>
</tr>
<tr>
<td>Kiribati (Gilbert Islands)</td>
<td>82 000</td>
<td>0.1</td>
<td>Sterling pound replaced by the Australian dollar</td>
<td></td>
<td>1979</td>
</tr>
<tr>
<td>Liberia</td>
<td>3 300 000</td>
<td>0.5</td>
<td>Dual currency: American dollar and Liberian dollar</td>
<td></td>
<td>1943</td>
</tr>
<tr>
<td>Liechtenstein</td>
<td>31 000</td>
<td>0.7</td>
<td>Suisse Franc</td>
<td>x</td>
<td>1921</td>
</tr>
<tr>
<td>Marshall Islands</td>
<td>61 000</td>
<td>0.1</td>
<td>US dollar</td>
<td></td>
<td>1944</td>
</tr>
<tr>
<td>Micronesia</td>
<td>120 000</td>
<td>0.2</td>
<td>US dollar</td>
<td></td>
<td>1944</td>
</tr>
<tr>
<td>Monaco</td>
<td>32 000</td>
<td>0.8</td>
<td>French franc replaced by the euro</td>
<td>x</td>
<td>2002 (euro) 1865 (franc)</td>
</tr>
<tr>
<td>Nauru</td>
<td>11 000</td>
<td>0.1</td>
<td>Australian dollar</td>
<td></td>
<td>1914</td>
</tr>
<tr>
<td>Palau</td>
<td>19 000</td>
<td>0.2</td>
<td>US dollar</td>
<td></td>
<td>1944</td>
</tr>
<tr>
<td>Panama</td>
<td>2 900 000</td>
<td>9.5</td>
<td>US dollar</td>
<td>x</td>
<td>1904</td>
</tr>
<tr>
<td>San Marino</td>
<td>26 000</td>
<td>0.1</td>
<td>Italian lira replaced by the euro</td>
<td>x</td>
<td>2002 (euro) 1897 (lira)</td>
</tr>
<tr>
<td>Tuvalu (Ellice Islands)</td>
<td>11 000</td>
<td>0.0</td>
<td>Australian dollar</td>
<td></td>
<td>1892</td>
</tr>
<tr>
<td>Vatican City</td>
<td>1000</td>
<td>0.0</td>
<td>Italian lira replaced by the Euro</td>
<td>x</td>
<td>2002 (euro) 1929 (lira)</td>
</tr>
</tbody>
</table>

* In billions of $.  
higher. However, with the exception of Puerto Rico, these areas have a very small number of inhabitants. Partial dollarization is a more profound and diffused regime. Until the last century full dollarization only affected small countries and territories. A large part of these areas are insular (Marshall Islands, Micronesia) and are American dependencies (Guam, Virgin Islands, Puerto Rico). However, the adhesion to this type of regime by bigger countries (Ecuador, El Salvador, Guatemala) has modified the research and investigation field especially for Latin America.

THE FOUNDATIONS OF OFFICIAL DOLLARIZATION

Until the 1980s, dollarization was conceived as being a more or less informal process of monetary substitution. During the first half of the 1990s, the active management of dollarization progressively took over the passive management of dollarization. During this period, official dollarization was still perceived as being a solution in emergency situations. Full dollarization, however, became an object of debate when Carlos Menem, president of Argentina, proposed to officially replace the peso with the US dollar in 1999. As Théret [2003] said, the notion of dollarization ‘is now being discussed and considered as a permanent, definitive and irreversible solution’ (p.66). It is from this viewpoint that Ecuador and El Salvador introduced this exchange regime. To understand the reasons behind this change in attitude, we will start by looking at the debate about dollarization in the context of the more general debate about the exchange regimes of emerging economies. Second, we will identify the favourable economic contexts whereby countries can abandon their national currencies. Finally, we will show that complete dollarization can also be seen as a legitimacy crisis that plagues a domestic currency.

Dollarization and the Debate about Exchange Regimes

The recent financial crises that have hit emerging economies have intensified the debate about the most appropriate exchange regimes for developing countries. Since the end of the 1990s, the IMF differentiated eight exchange regimes grouped under three big categories:

- hard peg, which includes currency boards, and countries that do not have independent currencies;
- intermediate regimes where we find conventional fixed peg arrangements, the commitment to stay between horizontal bands and the different systems of crawling pegs;
- floating, which includes managed floating with no pre-announced path for exchange rates and independent floating.
The Intermediate Regimes' Relative Decline

Fixed peg regimes were prevalent during the 1960s. During the following two decades intermediate regimes were introduced: fluctuating bands and crawling pegs. However, Graph 1 shows that during the 1990s, intermediate regimes declined to the benefit of corner solutions such as hard peg or floating regimes. The number of countries adopting intermediate regimes dropped from about a hundred in 1990 (65.8 per cent of all IMF countries) to only 59 in 2001 (31.9 per cent of all IMF countries). At the same time the number of countries opting for a hard peg regime more than doubled (from 23 to 48) representing more than a quarter of the total and 78 countries (42.2 per cent of all IMF countries) adopted a floating regime in 2001 against 29 in 1990 (19.1 per cent of all IMF countries).

In reality, statistics exaggerate the attractiveness of corner solutions. On the one hand, is a managed floating regime a flexible regime of exchange? Should we not consider it as an intermediate regime? On the other hand, empirical studies on de facto regimes and not de jure regimes show that the decline of intermediate regimes is relative. Bénassy-Quéré and Coeuré [2000] observed that during the second half of the 1990s the proportion of currencies pegged to the dollar (50 per cent) was a lot greater than the proportion of officially pegged currencies (15 per cent in 1999). This discrepancy between the official adoption of an exchange regime and the monetary practices observed in reality also concerns free floating regimes which appear less frequently de facto (4 per cent) than they do de jure (30 per cent). These results are similar to those given by Levy Yeyati and Sturzenegger [2000] who revealed many de facto pegs and the absence of a decline in intermediate systems.

**FIGURE 1**

OFFICIAL EXCHANGE REGIMES OF IMF MEMBER COUNTRIES, 1990 AND 2001
(NUMBER OF COUNTRIES AS A PERCENTAGE OF TOTAL)

The Floating Syndrome

For Berg and Borensztein [2000], full dollarization can be given as a possible answer to the drawbacks of corner solutions. The debate between the advocates of fixed exchange and those favouring free floating systems is long-standing and has produced a wealth of literature. Those who support pure floating regimes say that their advantages are numerous: a better protection against economic shocks (automatic equilibrium of the balance of payments by the adjustment of parities); greater autonomy in monetary policy and a more effective economic policy; a better allocation of financial resources (central banks do not need to hold large exchange reserves); a restriction in speculative movements and the possibility to determine the long-term exchange rate equilibrium.

The facts have not always supported pure flexibility theory. Central banks have maintained their intervention in exchange markets because the floating system has functioned essentially in its 'impure' form. It has not been able to restrict speculation or contain balance of payment deficits. Monetary policy has become more and more dependent on the objectives set by the authorities of big central banks. For all of these reasons, and also because of the fact that such a system is likely to give rise to large exchange rate volatility, the advocates of dollarization believe that total flexibility has no future in the majority of developing countries [Berg and Borensztein, 2000]. Moreover, there are only a few big emerging countries, endowed with a relatively open and developed financial system such as Korea, Brazil and Mexico that have opted for such a regime. Taking the example of Chile and Korea, two countries that let their currency float quite largely during the 1990s, Artus [2000] showed that the shocks absorbed by the variation of exchange rates did not alter the stability of real growth or the pursuit of disinflation. However, this regime brought about high variations in real exchange rates and interest rates and there was also a cost for workers since it implied having a highly flexible labour market to allow monetary depreciation to stimulate growth.

Some authors such as Calvo and Reinhart [2002] point to the fact that, in an economic context of high capital mobility, incomplete information and where debts are in dollars, authorities in emerging countries are exposed to the fear of floating. This syndrome is caused by the fact that monetary depreciation does not have the same impact on emerging economies that it does on developed economies. Calvo and Reinhart have shown that foreign exchange crises occurring at the same time as the transition from a fixed to a floating regime often lead to a harsh slowdown of incoming capital which in turn can lead to a significant drop in exchange reserves and the deterioration of the current accounts balance. Furthermore, the exchange rates volatility caused by the adoption of flexible exchanges is likely to penalise countries that have taken up a strategy of development based on the promotion of exports.
The existence of an ‘original sin’ also casts a doubt on floating regimes. According to Hausmann [2000: 91] a currency suffers from this phenomenon ‘when it is impossible to use the currency to borrow abroad or even to make a long term loan on the domestic market’. The emerging countries majority that has suffered from hyperinflation and political instability experience great difficulties in obtaining foreign loans in their domestic currency and raising long-term funds from their domestic market. Under these conditions, the adoption of a floating regime can bring further problems: some balance sheet items are likely to become more volatile because of the exchange rates’ variations on payments due in dollars.

The Constraints of a Currency Board

A currency board is the most distinct feature for hard peg. It is based on three basic rules: maintaining a fixed exchange rate between the national currency and the currency of reference; automatic convertibility of the national currency; and an obligation to keep on the assets of a currency board, a level of exchange reserves that corresponds to the amount of the money supply in circulation. In such a regime, authorities are not allowed to modify exchange rate parities or to have an autonomous monetary policy. More generally, it helps giving more creditability to policy-mix through the creditability of the exchange rate and contributes towards maintaining the monetary stability because authorities can no longer use devaluation or inflation as a method to demonetize debts [Hanke and Shuler, 1994].

If we take the example of Argentina, which experimented with this system between 1991 and 2002, we can see the pitfalls inherent in currency boards. At first, confidence was regained and there was a better balance in the economic growth. Year-on-year inflation, which had risen above 1000 per cent at the end of the 1980s, dropped to 4.2 per cent in 1994. The currency board was able to reduce transaction costs and exchange risks that penalised investment and consumption: the money supply in pesos grew, exchange reserves and bank deposits increased, there was more inflow of capital, interest rates dropped rapidly and the purchasing power of Argentines increased significantly. The restoration of confidence in Argentina, however, was accompanied by a regular rise in unemployment and a deterioration of the current accounts balance.

During the second half of the 1990s, the economic situation in Argentina became less favourable and the limitations of the currency board clearly became apparent. The rigidity of the exchange rate (1 dollar = 1 peso) deprived authorities of an adjustment variable that can be used during an external shock. The appreciation of the dollar led to a rise in the effective exchange rate of the peso causing a loss of competitiveness that was made even worse by the fact Brazil, Argentina’s main trading partner, was at the same time using ‘competitive depreciation’ as a weapon against the crisis. It is partly for this reason that Argentina did not cross the line into official dollarization. In a context of dollar
appreciation, this measurement would have only accentuated the loss of competitiveness. Moreover, on a geopolitical level, it would undoubtedly have led to the disappearance of Mercosur (the Southern Common Market of Argentina, Brazil, Paraguay and Uruguay). Furthermore, the public deficits monetization should have been carried out with a very rigorous budget. However, the low level of mandatory contributions, tax evasion and administrative squandering led to a deterioration of public finance and an increase in debt, hence the risk of default in payment which hampered the attempt to regain confidence in the currency.

A currency board also reinforces dependency on foreign currencies because it needs an important and regular flow of currencies. Having a current deficit and an insufficient amount of foreign direct investment will make the growth of currency reserves rely on portfolio investment flows, whose volatility is well-known, or debt-generating flows which reinforce the constraints of external debt. In the absence of a flexible exchange rate and a flexible wage system, the adjustment to an exogenous shock will happen through the level of employment. Furthermore, the halt in the depreciation of the peso after 1991 led to an unfavourable inflation differential in comparison to the US and other competitor countries; hence the loss of competitiveness and the emergence of a chronic trade balance deficit.

**The Favourable Contexts for the Adoption of a Foreign Currency**

The official announcement to substitute a domestic currency for a foreign currency is rarely done during untroubled periods. It is generally introduced in an unstable political, social and economic context. Bourguinat and Dohni [2002] interpreted the adoption of a foreign currency as an acknowledgement of the failure of domestic policy and the loss of public authorities’ credibility. The chronic inability of authorities to improve public finance, to bring external accounts into equilibrium, to curb inflation or to contain unemployment amplifies the loss of confidence in the economy. As Arès [2001a] said, a country that decides to unilaterally dollarize is primarily aiming to restore monetary stability and to obtain the credibility of the issuing country central bank.

Blanc [2000] classified three forms of crises that are likely to favour the implementation of a foreign currency: a crisis in the monetary system; a crisis in the production and exchange system; and a crisis of public authorities. A monetary crisis can be caused by many factors: a strong and long-standing depreciation of the national currency, a shortage in the means of payment or a deficiency in the banking system. Models of asset substitution that favour the replacement of a national currency in its function as a reserve value, show that the primary reason for the flight towards a foreign currency is the real depreciation of domestic assets during inflation crises [Calvo and Végh, 1996]. Similarly, models of monetary substitution which analyse the replacement of a national currency in its function as a unit of account and an exchange intermediary, reveal that inflation or hyperinflation raise the cost of the use of the domestic currency for
these functions, thus implicitly encouraging private economic agents to turn away from them [Balino et al., 1999]. Ecuador is a good example of a country that has been a victim of an inflation crisis because its inflation rate rose regularly during the 1990s and topped off at almost 100 per cent in 2000, the year Ecuador abandoned the sucre for the US dollar (Table 3).

Furthermore, the Mexican crisis of 1995 and the financial crises that hit Asia, Russia and Latin America, particularly Brazil and Argentina, triggered the process of dollarization. Antinolfi and Keister [2001] identified the typical ‘anatomy’ of a crisis: first, there is an inflow of foreign capital and a corresponding deficit of the current operations balance; the beginning of the crisis leads to a capital brutal outflow and a strong currency devaluation, which is often accompanied by a crisis in the banking system. At the end, there is a brutal fall in production, investment and consumption. Ecuador gives us again, a good illustration of the problem: the year before it adopted the dollar, economic activity declined by around 5.7 per cent, urban unemployment climbed to 14.4 per cent, gross disposable income fell by 3.1 per cent and GDP per capita decreased by 7.5 per cent in 1999 (Table 3). In this case, dollarization is not just an ‘emergency’ reaction in an uncertain situation. Although a brutal change in an exchange regime is designed to resolve a situation of crisis at a given moment of time, authorities also wish to have long-term protection against future crises.

Periods preceding the adoption of complete dollarization are sometimes marked by high political instability. East Timor and Kosovo lacked political sovereignty, in part due to separatist movements, before they abandoned their monetary sovereignty. According to a study made by the Inter American Bank for Development, quoted by Bréa et al., [2001], the direct and indirect violence costs in El Salvador represented 13 per cent of GDP in 1998. Ecuador, which went through five different heads of state between 1995 and 2000, suffered at the same time from a series of resignations, fraud, corruption, emergency laws, strikes and farmer revolts. Under these conditions, the purpose of dollarization is as much to restore macroeconomic stability as it is to restore the political credibility of leaders [Arès, 2001a].

The Legitimacy Crises of Domestic Currencies

When we look at countries that have recently chosen to dollarize, we observe that their monetary sovereignty had been restricted prior to the decision to dollarize. The Ecuadorian sucre and the Salvadorian colón, which only had a national circulation, were in low esteem and were barely accepted abroad. Since we are dealing here with relatively open economies, we can see that their national currency does not have all the functions of a currency. In a globalised economy it is necessary to have access to all markets including capital markets. Since we do not have a world currency issued by an international authority, we use the
currency of another country, in this case, the country with which there are close trading and financial ties (e.g., the US dollar for Latin America).

Countries that have abandoned their national currency for the dollar are closely linked to the US economy. American exports and imports often represent more than a third of the trade balance. The majority of direct investment flows come from the US and to satisfy their needs for external finance, residents use American banks or capital markets.

In this context, the complete and full adoption of the dollar often reflects a de facto reality. A double circulation of currencies is often tolerated, especially in countries having a developed formal economy, because authorities find it difficult to oppose. The legitimacy crisis of a domestic currency is a return to reality; a distrust of the norm that people had believed until then [Aglietta and Orléan, 1995]. The loss of confidence in a domestic currency becomes apparent when people prefer putting a large part of their savings in dollars. This distrust can result in the flight of capital or the holding of monetary and financial assets in foreign currencies. This spontaneous dollarization is particularly high in Latin America where deposits in dollars can represent as much as two-thirds of bank deposits (Table 4).

The low degree of partial dollarization of certain countries can be explained by the specific way in which they manage macroeconomic instability [Dempere and Quenan, 2000]. In Brazil, the general indexation of the economy and institutional factors, such as limiting the amount of deposits in foreign currencies, served as a defence against dollarization. In Chile, instruments such as derivatives or measures to ensure a high rate of return on deposits in the local currency as well as institutional factors such as the control of the inflow of capital, were used to dissuade people from holding foreign currencies.

### Table 3

Ecuador: Macroeconomic and Socio-Economic Indicators (1980–2002)

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth rate*</th>
<th>Real gross national disposable income*</th>
<th>Inflation rate</th>
<th>Urban unemployment rate</th>
<th>GDP per capita growth rate*</th>
<th>Balance of current operations**</th>
<th>External debt**</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980–90</td>
<td>1.7</td>
<td>0.1</td>
<td>36.4</td>
<td>–</td>
<td>−0.9</td>
<td>−360</td>
<td>−12 222</td>
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<td>1990</td>
<td>2.9</td>
<td>6.2</td>
<td>48.5</td>
<td>6.1</td>
<td>0.5</td>
<td>−2001</td>
<td>16 400</td>
</tr>
<tr>
<td>1998</td>
<td>2.2</td>
<td>−1.8</td>
<td>40.8</td>
<td>11.5</td>
<td>0.2</td>
<td>877</td>
<td>16 282</td>
</tr>
<tr>
<td>1999</td>
<td>−5.7</td>
<td>−3.1</td>
<td>52.2</td>
<td>14.4</td>
<td>−7.5</td>
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<td>−550</td>
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<td>2000</td>
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<td>14.1</td>
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<tr>
<td>2001</td>
<td>5.5</td>
<td>2.6</td>
<td>37.7</td>
<td>10.4</td>
<td>3.5</td>
<td>14 376</td>
<td>16 282</td>
</tr>
<tr>
<td>2002</td>
<td>3.8</td>
<td>4.8</td>
<td>12.5</td>
<td>8.6</td>
<td>2.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

** In millions of dollars.

Source: ECLAC [2003].
COST-ADVANTAGE ANALYSIS OF COMPLETE DOLLARIZATION

The literature on complete dollarization has, over the years, drawn attention to the costs and advantages of adopting such a regime. The result has been a series of recommendations to countries that are likely to adopt a system of complete dollarization. To see what is at stake in such a decision, we will look at the expected benefits that the advocates of complete and official dollarization put forward. A detailed analysis of its potential impact will then allow us to evaluate the induced costs of the disappearance of a domestic currency.

The Expected Benefits of Monetary Substitution

The advocates of complete dollarization underline the following advantages:

- a strengthened credibility of governments in view of exchange crises, hence a drop of interest rates caused by the reduction of the risk premium;
- lower inflation and lower transaction costs, hence greater trading, financial and fiscal integration;
- the elimination of monetary creation to finance the economy, which favours the development of the banking sector.

Some authors also mention a better prevention of debt crises, a deeper financial system or even a strengthening of fiscal discipline. Besides the economic advantages, we will mention the political advantages such as a greater institutional

---

TABLE 4

SPONTANEOUS DOLLARIZATION: DEPOSITS IN DOLLARS AS A PERCENTAGE OF BANK DEPOSITS

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>South America</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>35.1</td>
<td>43.9</td>
<td>64.7</td>
</tr>
<tr>
<td>Bolivia</td>
<td>76.8</td>
<td>82.3</td>
<td>92.5</td>
</tr>
<tr>
<td>Chile</td>
<td>–</td>
<td>–</td>
<td>12.5</td>
</tr>
<tr>
<td>Ecuador</td>
<td>–</td>
<td>13.1</td>
<td>66.7</td>
</tr>
<tr>
<td>Peru</td>
<td>59.9</td>
<td>64.0</td>
<td>78.2</td>
</tr>
<tr>
<td>Uruguay</td>
<td>78.5</td>
<td>76.1</td>
<td>84.2</td>
</tr>
<tr>
<td>Mexico and Central America</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costa Rica</td>
<td>37.7</td>
<td>31.1</td>
<td>45.7</td>
</tr>
<tr>
<td>El Salvador</td>
<td>1.4</td>
<td>1.7</td>
<td>8.2</td>
</tr>
<tr>
<td>Honduras</td>
<td>3.1</td>
<td>13</td>
<td>23.2</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.9</td>
<td>7.2</td>
<td>4.9</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>28.7</td>
<td>54.5</td>
<td>72.8</td>
</tr>
</tbody>
</table>

* Ratio of deposits in dollars on M3, in percentage.
** Deposits in dollars as a percentage of total deposits.

Source: Minda from Arteta [2001], Dempere and Quenan [2000], Berg et al. [2002].
stability that arises from the presupposed return of confidence and monetary stability.

Monetary Credibility and the Fall of Interest Rates

The experience of the 1990s shows that the causes of exchange crises are numerous and that they have disastrous effects. In this context, the full adoption of the dollar is a means to avoid monetary or balance of payment crises [Berg et al., 2002]. The disappearance of a national currency eliminates the exchange risk and devaluation, hence a restriction of speculative attacks and the volatility of capital that occurs with it. The resulting greater monetary stability favours foreign investment, reduces the cost of public debt servicing and raises domestic investment and growth to the extent that monetary substitution also contributes to lowering interest rates.

Dempere and Quenan [2000] isolated two factors that explain why interest rates become lower. On the one hand, the devaluation risk elimination reduces the premium of country risk, which favours the convergence of national interest rates with the lower and less volatile American rates. Bourguinat and Dohni [2002] showed that the average spread (J.P. Morgan EMBI) on Argentine public bonds was over 1000 points at the beginning of the Brazilian crisis (September 1998) against 700 basis points for Panamanian securities. On the other hand, the elimination of exchange risk with regard to the US dollar reduces transaction costs, particularly conversion costs and costs for covering currency operations.

Economic Stability and the Reduction of Inflation

A country that adopts a stable international currency should be able to control inflation because policies aimed at controlling price hikes would then be intrinsically linked to American monetary policy. From this point of view, countries that have suffered from periods of hyperinflation should be the first to benefit because they have paid a large tribute to growth [Fisher, 1993].

Furthermore, a dollarized country benefits from the credibility of the issuing country, which relieves it of the active management of its currency that can be very costly. Even if the risk of external shocks cannot be eliminated, complete dollarization does contribute to diminishing their impact and reducing the contagion risk by eliminating exchange risk. More generally, the decision to opt for complete dollarization can be seen as a message sent to the international financial community by the leaders of a country to show their volition to tend towards economic stability [Arès, 2001b].

Opening Towards the World and Trade Integration

The adoption of a foreign currency would ease further integration into the American economy and the rest of the world economies to the extent that it would bring about a reduction of transaction costs and the stability of prices in dollars.
Research by Frankel and Rose [1998] showed that monetary union increases trade between member countries. According to Frankel and Rose [2002], the dollarization of Latin America has helped Latin American countries to become more open to the world and more open to trade with the US. From this point of view, the advocates of a free trade zone along the entire American continent (‘The Americas Initiative’) consider dollarization as another step aimed at accelerating the realisation of their project.

We can also point out that trade integration has until now been based on an asymmetric relationship. Deblock and Constantin [2000] underlined the fact the trading position of the US on the American continent became stronger throughout the past decade. Thus, American exports and imports rose from 70.1 per cent to 82.7 per cent of total Mexican exports and from 68.2 per cent to 74.3 per cent of total Mexican imports between 1989 and 1999. In other countries of the continent, while American exports rose sharply to Latin American countries and the Caribbean, American imports from these countries declined globally. The renewed development of regionalism (NAFTA, Mercosur) and the implementation of free market economic reforms have certainly increased trade but at the same time they have created a trade diverting effect which has benefited the US more than the counties which signed the agreements.

A Deeper Financial System

The replacement of a domestic currency by a more stable currency should also further the integration of the domestic financial market, to the extent that savings and financial transactions with foreign countries would be in the new currency. The need to artificially diversify, at whatever the cost, portfolios internationally would no longer be of interest [Bourguinat and Dohni, 2002]. As the example of Panama shows us, the country would benefit from a deeper financial market and have greater possibilities to borrow or lend money on international markets.

A change of currency would also have positive consequences for the banking system. Despite the loss of commissions on exchanges, the elimination of devaluation risk, together with less volatile interest rates, reduces the vulnerability of credit establishments. Restoring confidence in a currency will also increase the number of banks per capita and also encourage the return of capital invested abroad. The induced changes of the regime (a rise in resources, the introduction of competition, services offered at a lower cost) will increase the internationalisation of the banking system [Dempere and Quenan, 2000].

Budgetary and Fiscal Discipline

The fact that leaders can no longer resort to expansionist budgetary policies, which create inflation, is often given as an advantage of complete dollarization. By giving up the right to mint coins, the state can no longer run the ‘printing press’ to finance deficits. It will have to reduce public expenditure or increase
receipts (or opt for a combination of the two) or even embark on a privatisation programme. In any case, leaders run the risk of reducing domestic demand and they also deprive themselves of a means to intervene in the economy.

A lack of budgetary rigour would force the government to run into debt because it cannot indefinitely resort to privatisation. Access to international capital markets will certainly be easier if a country benefits from greater foreign credibility but abandoning a domestic currency is not always sufficient. Macroeconomic stability, a firm economic policy, legal security and political stability also play a fundamental role [Herrera Valencia, 2002]. Thus, domestic borrowers may fear a rise of interest rates and economic instability if the public debt burden were to increase.

Stability of the Political Regime
Apart from the economic advantages of dollarization, there is also a political advantage. Full dollarization rules out almost definitely the question of the choice of exchange regimes. ‘Costly controversy over domestic policy’ [Herrero and Glöckler, 2001: 102] would be avoided because the new regime would have to be accepted as an exogenous factor operating independently from the national policy. The restored confidence in the official currency and the monetary stability brought about by complete dollarization would strengthen the legitimacy of leaders. The strengthened legitimacy induced by the monetary credibility would lead to greater political stability [Théret, 2003].

The Complete Dollarization Costs
There are five main arguments against complete dollarization: the loss of an independent monetary policy, the abandonment of exchange policies, the loss of seigniorage rights, the disappearance of the lender of last resort facility and the limits to the use of counter-cyclical instruments.

The Loss of An Independent Monetary Policy
One of the most common objections to complete dollarization is that it leads to the loss of an independent monetary policy since the dollarized country is entirely subordinated to the decisions made by the central bank of the issuing country. This also happens with a common currency but the loss is greater since the country no longer participates in the elaboration of the monetary policy. With a monetary union, ‘each country has the right to sit on the board where economic policy is decided’ [Cohen, 2000b: 99]. Under complete dollarization, the monetary policy resides solely in the hands of the American Federal Reserve, which makes decisions based on the American economy indicators, adjusting interests rates in accordance with inflation pressure or growth prospects. This subordination is all the more harmful since the economic cycles of dollarized
countries and the US can be divergent [Salama, 2000]. Will a rise in American rates to avoid inflation in the US be compatible with an officially dollarized country in recession?

As a response to this criticism, dollarization advocates say that because of increased trade and financial integration the economic situation of countries which abandon their own currency will be more and more in line with the issuing country economic situation. There is therefore no reason to believe that monetary policy will be perpetually inadequate. Larraín and Sachs [1999] believed, on the contrary, that complete dollarization is a kind of ‘straitjacket’ since authorities can no longer use monetary policy instruments to confront eventual external or internal shocks.

The Abandonment of Exchange Policies

Even if monetary policy is not the most appropriate instrument to use to make crucial adjustments, a dollarized country also loses the possibility to employ the exchange rate as an adjustment variable. In the case of a shock, the loss of monetary sovereignty forces authorities into using other instruments such as budgetary policy, labour market flexibility or even the control of capital. The existence of nominal wage and price rigidities makes adjustment even more troublesome since it rests on a more limited number of instruments. Calvo [2001] retorted that when a large part of trade is already done in dollars we can doubt the effectiveness of monetary depreciation.

Although pure dollarization eliminates exchange risk with the issuing country, it does not protect a dollarized country from exchange fluctuations against trading partners which have decided to keep their own currency, or variations of the dollar against other currencies. Thus, a dollar appreciation will reduce the capacity to export of a country that has adopted the dollar and at the same time it will raise the price of goods imported from countries that do not belong to the same monetary zone. As Arès [2001b] observed, the impact of exchange fluctuations on dollarized countries will vary according to the amount of foreign trade done with countries that are out of the dollar zone. In Latin America, the impact will be high in countries such as Argentina, Brazil and Chile because these countries trade more with Europe and Japan than with the US. However, the impact of exchange variations will be lower in countries that trade more with the US (Central America, Colombia, Venezuela, Ecuador).

The Loss of Seigniorage Rights

A country that adopts a foreign currency loses seigniorage, that is to say the revenue derived from the issuing of currency. According to Fisher [1982], the losses can be divided into two categories. On the one hand, there is the ‘gross cost of seigniorage’ or ‘stock cost’ which is the cost of obtaining from the foreign
central bank the notes and coins necessary to replace the national currency in circulation. The new currency is put into circulation by either drawing on exchange reserves or through a foreign loan. The dollarized country thus loses the revenue derived from its exchange reserves or has to support the loan. On the other hand, there is the ‘net cost of seigniorage’ or ‘flow cost’ which corresponds to the losses incurred from the withdrawal of revenue derived from the interest on exchange reserves. This seigniorage revenue is collected through the issuing of the new currency by the central bank of the dollarizing country.

The revenue from seigniorage, which depends on growth and inflation rates, is for some emerging economies not only a regular and substantial source of income but also an exceptional source of revenue in emergency situations [Cohen, 2000a]. According to Bogetic [2000], between 1991 and 1997, the stock and flow costs of official dollarization in selected Latin American countries (Table 5) represented, on average, respectively 4 per cent and 2.3 per cent of total GDP.

The Disappearance of the Lender of Last Resort Facility

Another criticism made against complete dollarization is that the function of the lender of last resort held by the Central Bank during a banking crisis disappears. By abandoning the power to issue money, monetary authorities no longer have the possibility to satisfy the demand for credit of banks lacking liquidity. Since the Central Bank does not have an unlimited amount of money to lend, we can fear that it would not be able to face a bank rush or a general insolvency that occurs with it.

Bourguinat and Dohni [2002] remarked that the disappearance of the lender of last resort facility which eliminates the problem of moral hazard, forces credit establishments to manage their risk better, hence making the banking system less fragile. Moreover, the elimination of exchange risk, less volatile interest rates and the return of capital invested abroad that results from monetary substitution are likely to make banks less vulnerable.

The Limits to the Use of Counter-cyclical Instruments

As we have mentioned, a country that opts for complete dollarization deprives itself of the use of counter-cyclical instruments such as the monetary policy and the exchange policy. This loss of independence is also a disadvantage of currency boards, which also forbid the use of devaluation. The abandonment of this exchange regime by Argentina in 2002 shows us that a country that opts for a currency board provides itself a way out in the event of a financial crisis. To stimulate growth in a dollarized economy, the adjustment to external shocks (a decline of exports, a rise in the cost of raw materials...) or internal shocks (political instability, a fall in production...) rests on instruments which could be socially costly. Thus, because of the lack of wage flexibility in public services, the cost of budgetary adjustment during periods of recession is transferred onto taxpayers.
In general, the instruments that stay in the hands of public authorities are – with the exception of the control of capital – measures to reduce public expenditure, fiscal policy, wage control policies and measures to increase productivity [Herrera Valencia, 2002]. On a social level, these measures are not always easy to implement because the adjustment will operate with the help of variables which are more real than nominal. This limit to the choice of counter-cyclical instruments is all the more penalising when we consider that the elimination of devaluation risk does not eliminate the spectre of external crises, particularly the default on debt payments. This happened precisely to Panama, which benefited from several IMF assistance programmes [Berg and Borensztein, 2000].

FULL DOLLARIZATION: A MONETARY OPTION OF LAST RESORT?

If the objective is to avoid exchange instability and to reinforce the capacity to resist financial crises, other solutions exist apart from full dollarization. By examining emerging countries that have adopted this regime, we will underline the extreme aspects of such a solution, notably because of its limited field of application. We will also ask ourselves if the US will be able to keep its ‘benign neglect’ attitude towards complete dollarization. Finally, we will develop the idea that the disappearance of a national currency leads to the loss of a powerful symbol of national identity.

A Limited Field of Application

The choice of abandoning a national currency and adopting a foreign currency can be envisaged when there is absolutely no doubt that the benefits will outweigh the costs. However, several factors complicate the objective analysis of

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**TABLE 5**

ESTIMATED STOCK AND FLOW COSTS OF OFFICIAL DOLLARIZATION IN SELECTED LATIN AMERICAN COUNTRIES, 1991–97

<table>
<thead>
<tr>
<th>Countries</th>
<th>Period</th>
<th>Stock cost: C/GDP</th>
<th>Flow cost: change in reserve money as a percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>1991–96</td>
<td>3.7</td>
<td>0.5</td>
</tr>
<tr>
<td>Brazil</td>
<td>1994–96</td>
<td>2.1</td>
<td>1.3</td>
</tr>
<tr>
<td>Bolivia</td>
<td>1991–97</td>
<td>4.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Ecuador</td>
<td>1992–97</td>
<td>12.2</td>
<td>7.4</td>
</tr>
<tr>
<td>EL Salvador</td>
<td>1991–96</td>
<td>4.1</td>
<td>2.3</td>
</tr>
<tr>
<td>Mexico</td>
<td>1991–97</td>
<td>3.3</td>
<td>0.8</td>
</tr>
<tr>
<td>Peru</td>
<td>1991–97</td>
<td>2.1</td>
<td>2.5</td>
</tr>
<tr>
<td>Average</td>
<td></td>
<td>4.6</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Source: Bogetic [2000].
complete dollarization costs and benefits. First, there are a very limited number of countries that have made such a decision. Panama would be an interesting country to look at because it has been dollarized for a long time. However, it would be difficult to draw a general conclusion from its experience since it is a small economy, which has been highly dependent on the US, financially, politically and for trade. The dollarization of Ecuador, El Salvador or East Timor are too recent to be able to assess fully.

In order to evaluate the advantages and costs of a complete dollarization, under these conditions, it is essential to take into consideration the economic, social and political structures of countries that wish to dollarize. According to Bourguinat and Dohni [2002], the benefits of adopting a foreign currency could be very different in three cases.

The first case concerns economies that already have a high degree of trade and financial integration with the US (or the country issuing the xenocurrency). Sharing a common currency will increase trade with the issuing country and ease reactions to symmetrical shocks, which will help strive towards an optimal monetary zone. Panama, which is in this category, has had mitigated results since the 1950s: growth rates within the average range of developing countries, a low inflation rate, low interest rates, high unemployment rates, a depreciation of real exchange rates and a deterioration of public finance [Moreno-Villalaz, 1999; Edwards, 2001]. Panama, which has become an important offshore financial centre, suffers, however, from the US’ political domination, as testified by the Noriega affair when the US imposed sanctions such as the freezing of Panamanian assets in American banks and forbidding the transfer of funds in dollars in 1988–89. These sanctions led to a liquidity shortage, a harsh economic crisis and the temporary occupation of Panama by the US to overthrow the unwieldy general.

With the exception of a few Central American countries that have close trading ties with the US, it would be more difficult to adopt the dollar as the official currency in other Latin American countries. An analysis in terms of an optimal monetary zone shows that the insufficient procedures of adjustment (labour factor mobility, wage and price flexibility, integration of capital markets, the existence of financial transfers) and the existence of asymmetrical reactions to external shocks does not favour the complete dollarization of the continent. Furthermore, if Argentina were to dollarize, this would be incompatible with the floating regime of Brazil, which is Argentina’s main trading partner in the Mercosur zone. Similarly the existence of large economic and social asymmetries between Mediterranean countries and the European Union makes the ‘euroization’ of this region difficult to implement, even though the level of trade between these two zones is high.4

The second case concerns countries that are in the throes of disintegration. In this category we can find countries that have lost their monetary credibility after having
experienced a devastating external conflict or after having gone through a period of high economic and social instability. The replacement of a national currency, which has lost its legitimacy, by a foreign currency is often done as a matter of urgency and is considered as being the ultimate way to end the crisis. Ecuador, East Timor and Kosovo are in this category. In 2001, El Salvador replaced the colón with the dollar despite the country’s relative economic stability: contrary to Ecuador, GDP and gross disposable income growth rates remained positive and inflation never went above 4 per cent (Table 6). However, interest rates were high because the civil war of the 1980s increased the country’s risk premium. At the same time, the balance of current operations deteriorated under the triple effect of the rise in oil prices, the fall in the international prices of coffee and the increase in the value of the colón, which had been pegged to the dollar since 1994. All these elements, to which we must add an insecure climate, the persistence of poverty and the relative victory of the opposition in the legislative elections, pushed El Salvador into unilateral dollarization.

The last case groups small economies in which the majority of prices are in an external currency or where capital movements are controlled by foreign financial institutions. Clearance and settlement are carried out in the US or in large European centres. There are only three independent countries in the dollar zone: Marshall Islands, Micronesia and Palau. They are scarcely populated islands (19 000 to 120 000 inhabitants) with a GDP of less than 200 million dollars (Table 2). In all these examples, the adoption of a foreign currency by an independent micro-state is justified on the grounds that it is highly dependent on the country or zone that issues the legal currency.

On the whole, the field of application of the official dollarization is relatively limited. Except for very small economies or those which are already strongly integrated into the transmitting country, monetary substitution could be justified only in the countries in the process of dislocation. In this connection, the first results of Ecuador’s dollarization remain ambiguous. If the rising oil price promoted growth, the initial increase of the dollar handicapped the competitiveness of non-oil exports, from this there was an aggravation of the deficit of the current operations (Table 3). Admittedly, dollarization allowed an important inflation drop. However, the price rises remain still higher than in the majority of the other Latin America countries. In El Salvador, dollarization made it possible to maintain inflation and interest rates at a low level. On the contrary, the GDP per capita stagnates and the growth rate progresses slowly (Table 6). In both cases, dollarization did not reinforce the budgetary discipline, and even less the leaders’ political credibility. A better synchronization between the business cycles of these countries and those of the US would undoubtedly have attenuated the dollarization costs. Is this simultaneity of the rates of growth possible between countries which have modes and development levels so different?
The US Policy of Benign Neglect

American political and monetary authorities have followed the policy of ‘benign neglect’ towards countries that have officially adopted the dollar unilaterally. Alan Greenspan has repeatedly warned countries that wish to opt for complete dollarization, that the Federal Reserve will implement its monetary policy without taking into account the specific situation of each country. The policy of benign neglect will probably continue as long as complete dollarization is confined to micro-states or small countries such as Panama, Ecuador or El Salvador. However, the adoption of complete dollarization by larger countries or the advancement of monetary union projects concerning NAFTA, or even the entire continent in the free trade area of the Americas (FTAA), will force Americans to re-examine their position on the basis of the costs and advantages it will engender for the US.

Legal dollarization on a large scale could give the US four economic advantages. First, it would strengthen the role of the US dollar in international finance and trade. A second advantage would come from the increased seigniorage revenue that the American Central Bank would obtain by becoming the sole issuer of the official currency of the dollarized country. A third advantage would come from the reduction of transaction costs that would arise from the elimination of exchange risk between the dollar and the former currency of the dollarized country. Finally, the creation of a more stable environment would favour trade development and American investment.

Wouldn’t large-scale dollarization stimulate exports and direct foreign investment of American firms to the emerging economies of this region?

There are two kinds of geopolitical advantages. Contrary to monetary union, where sovereignty is shared between partners, complete dollarization implies a hierarchical relationship of domination and dependence, which will be to the

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**TABLE 6**


<table>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth rate*</td>
<td>−0.4</td>
<td>4.8</td>
<td>3.8</td>
<td>3.4</td>
<td>2.0</td>
<td>1.7</td>
<td>2.1</td>
</tr>
<tr>
<td>Real gross national disposable income*</td>
<td>0.2</td>
<td>8.9</td>
<td>5.0</td>
<td>1.1</td>
<td>1.0</td>
<td>1.6</td>
<td>4.0</td>
</tr>
<tr>
<td>Inflation rate</td>
<td>19.0</td>
<td>24.0</td>
<td>2.5</td>
<td>0.5</td>
<td>2.3</td>
<td>3.8</td>
<td>1.8</td>
</tr>
<tr>
<td>Urban unemployment rate</td>
<td>−</td>
<td>10.0</td>
<td>7.6</td>
<td>6.9</td>
<td>6.5</td>
<td>7.0</td>
<td>6.2</td>
</tr>
<tr>
<td>GDP per capita growth rate*</td>
<td>−1.5</td>
<td>3.1</td>
<td>1.6</td>
<td>1.3</td>
<td>0.1</td>
<td>−0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Balance of current operations**</td>
<td>−261</td>
<td>−90.7</td>
<td>−239.2</td>
<td>−430.5</td>
<td>−190.0</td>
<td>−383.6</td>
<td></td>
</tr>
<tr>
<td>External debt**</td>
<td>−2 076</td>
<td>2 632</td>
<td>2 789</td>
<td>2 831</td>
<td>3 148</td>
<td>3 987</td>
<td></td>
</tr>
</tbody>
</table>

** In millions of dollars.

The sanctions taken against Panama in 1988 show that US monetary power can be transformed into a powerful instrument of influence and coercion against a country that has adopted the dollar [Cohen, 2002]. An increased use of the dollar throughout the world also gives more prestige to the US.

The main economic costs stem from the potential constraints imposed on American monetary policy by the greater circulation of the dollar in foreign countries. For example, we can ask ourselves what the attitude of the US would be if a dollarized Mexico went into recession and asked for an easing of monetary policy and at the same time there was a threat of an inflation rise in the US. Ponsot [2003] also expressed concern about what the consequences would be if one or more countries decided to reintroduce their former currency. ‘De-dollarization’ could provoke a monetary shock that could cause the dollar to plunge. Furthermore, we can ask ourselves if the US would be forced to participate more directly in resolving a liquidity crisis in a dollarized economy since it would no longer have a domestic lender of last resort. If it did not do that, would it take the risk of weakening the position of the American banks and having a mass of illegal immigrants? All these questions show that dollarized countries would not necessarily be the only countries to lose their monetary sovereignty. Would the official dollarization of the entire American continent put the autonomy of American monetary policy in jeopardy?6

The US has chosen to adopt a policy of benign neglect because it has given Americans many advantages at a minimum cost. This passive acceptance is all the more comprehensible since recently dollarized countries have decided unilaterally to abandon their monetary sovereignty, thus exempting the US from all formal engagements, notably from playing the role of lender of last resort. If complete dollarization extends to larger countries, the US may well have to re-examine its policy. Furthermore, American authorities will also have to keep watch over the progression of ‘euroization’. The European Central Bank, according to its Statute, is more concerned about prices stability than the international role of the euro. However, the recent entry of ten Central and Eastern European countries into the European Union and the project of pegging southern Mediterranean countries to the euro will strengthen the dynamics of the European monetary system. If the international role of the euro increases, the US may well be tempted to expand the dollar zone to fight against the euro’s growing power [Minda, 2004].

The Loss of a National Identity Symbol

Money is not just a simple economic instrument, a simple means of exchange. It is also a powerful symbol of identity and emblem of belonging to the same political, social and economic entity. It represents a set of rules that determines how human relationships are formed in society [Servet, 1998]. According to Aglietta and
Orléan [2002], money is an expression of a social and collective reality that represents a social totality. For Cohen [2000a], the ‘magical virtues’ of money enables the expression of national identity in two ways. First, the Central Bank’s function of issuing coins and notes acts as a daily reminder to citizens of their belonging to the nation. Furthermore, the daily and universal use of money highlights the fact that each citizen is part of the same social entity. It also upholds national cohesion by making social groups, which are at times in conflict, become more homogenous.

The decision to replace a weak or fragile currency with a ‘good’ or ‘true’ currency should certainly be accepted positively. However, people have to be informed of the reasons why the decision was made and the potential costs and benefits. Recent examples of dollarization show that there is a lack of transparency since in many cases dollarization was established as an accomplished fact. The dollarization of Ecuador was carried out in an ‘atmosphere of economic failure and social discontent’ [Arès, 2001b: 21]. In El Salvador, the legislature approved the government’s proposal to officially dollarize in less than ten days without conducting any thorough economic analysis [Glower, 2001]. Can the decision to abandon monetary sovereignty and relinquish national identity be made so quickly, especially if only the leaders of a country make the decision? Can these important decisions be taken without having a real political debate? Citizens must be able to make a complete evaluation of the costs and benefits and the long-term impact of complete dollarization [Gruben et al., 2001]. It is on this basis that they can make a decision and express their choice directly by referendum or indirectly through their political representatives, just as Europeans did when the euro was adopted.

However, we should not forget that this change in exchange regimes is in fact assimilated as a loss of national sovereignty, in the full sense of the word. The nation, as an independent entity will ‘dilute’ itself. It will lose one of its powers which, limited as it is, could be used to provide a better future. This gives us a feeling of helplessness or failure and foreboding decline. There is also a huge disproportion in power relations with the issuing country, which does not exist with other forms of monetary integration. The situation is very different when countries decide to create a new currency together and abandon at the same time their own currency, as exemplified by the euro creation. In comparison, euroization is the result of cooperative agreement, whereas dollarization means being ‘subordinated and dependent in a hierarchical system’ [Théret, 2003: 77].

The loss of identity is even stronger when emerging economies opt for complete dollarization while having their own particular difficulties. This is particularly the case for Latin American countries such as Ecuador and El Salvador. Their political structures remain fragile and they also have a weak political leadership and deep social inequalities. Under these conditions, dollarization can entail high social risks, since Latin American countries have
a long history of populism which can easily use the sentiment of despair to overthrow power. The opponents to the suppression of the Ecuadorian currency described the government’s project to get the country out of the crisis as 'the dollarization of poverty' [Cohen, 2000a].

CONCLUSION

We will conclude with three remarks. First, complete dollarization is not a miraculous remedy which will cure the emerging countries’ financial instability. Its economic benefits are too uncertain compared to the monetary sovereignty loss and the national identity loss it entails. Then, it can be only considered as an extreme solution that can be applied to a limited number of cases. Finally, although a country can live without using its national currency, we cannot say that it will live better by using a foreign currency, especially when the population sees itself having to live under subordinated relations. The fact that money has a social and political dimension means that there should be more public debate on dollarization and that we should allow citizens to make decisions on such an important issue.

Since the official dollarization future is uncertain, we should explore other alternatives in order to avoid exchange instability and to strengthen the capacity to resist crises. Regional monetary union between countries of different economic strengths which abandon their currencies but are given equal weight in the union is an alternative. In this case, there is a new sovereignty, which is directly shared over the zone by all the countries. This implies a strong economic integration and the desire to strengthen it. In Latin America only Mercosur could go in this direction, but it would need strong political support to do so. However, a strong currency cannot be obtained by putting together weak currencies. This means introducing mechanisms that will create a culture of stability by putting pressure on macroeconomic policy.

NOTES

2. During the 1990s, in Latin America, nominal and real interest rates were the lowest in Panama [Bogetic’, 2000].
3. Expression used by Keynes with regard to the gold standard.
4. In 2002, exports to the European Union represented 80 per cent of total exports for Tunisia, 73 per cent for Morocco and 65 per cent for Algeria.
5. Despite the preference for complete dollarization in the business community, Mexican authorities do not envisage abandoning the floating regime that was introduced after the 1994 crisis. Arès [2001b] has shown that the question of national identity explains the hesitations of the Canadian federal government: 'monetary union is interpreted as an unacceptable abdication of Canadian sovereignty for the benefit of the United States' (pp.41–2).
6. In case of complete dollarization within NAFTA, Bergstein [2000] wonders whether the US should offer Canada and Mexico the possibility to participate in the elaboration of American policy in the FOMC (Federal Open Market Committee).

7. An opinion poll revealed that 73 per cent of the population in Ecuador was against dollarization (The Economist, 19 Feb. 2000).

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