Why Is Latin America Choosing Dollarization?

In practice, dollarization is already a fact in most Latin American countries. However, it is too soon to tell if the process is irreversible or if it marks a true alternative to the financial crisis in the region.

The dollar is legal tender in Argentina, Bolivia, Chile, Paraguay and Peru. It is common currency in Mexico, Uruguay, Costa Rica, most of the rest of Central America and the Caribbean, including Cuba. Complete dollarization of the economy has been adopted in Ecuador (January 1, 2000), El Salvador (January 1, 2001) and Guatemala (May 2001). Commercial transactions and contracts are priced in dollars in all Latin American countries except Brazil, Colombia and Venezuela. Increasingly, individual and company bank deposits and debts are denominated in dollars, at the same time as banking systems have been denationalized. Technically, therefore, the national currencies of most countries in the region do not fulfill their basic monetary functions as a medium of exchange, unit of account and reserve. Latin America's financial systems have undergone a process of transnationalization.

The impact of dollarization may play itself out to the fullest in the Argentine financial crisis. Many analysts have insisted on dollarization as the only way for Argentina to regain the confidence of the international financial system. Their logic is simple: Dollarization is key to restructuring the external debt and implementing a zero deficit plan to avoid a default. Speculators will bet against the Argentine peso as long as the threat of devaluation persists, these supporters argue. Dollarization would be irreversible and close the door to speculation.

Proponents cite other "virtues" of dollarization for Argentina and the rest of Latin America. Depriving the state (central bank) of the ability to issue money, generate credit and manipulate exchange rates leads to more disciplined and orthodox macroeconomic policies, they claim. The political battle then shifts to the elected legislatures and their allotment of spending within a balanced budget. One of the magical effects of this orthodoxy is to avoid inflation, since the amount of money in circulation can increase only if it is based on national competitiveness earnings; that is, a favorable balance of trade between exports and imports. This scenario will attract domestic and foreign investors and wealth will be distributed in textbook fashion, according to productivity.

Other analysts believe just the opposite. If this really were the solution, they say, why wouldn't there be only three or four currencies in the world, instead of around 200? (Perhaps this is where we are heading, their opponents might respond). Dollarization in Latin America and the Caribbean is very different from the adoption of a single common currency, like the euro in the European Union. Latin America is not a currency union in which each country has ceded part of its sovereignty to strengthen a common authority. Instead, it merely involves the

unilateral adoption of the currency of another country, the United States. The US Treasury and Federal Reserve assume no responsibility for the costs and risks their economic and monetary policies have in dollarized countries [1].

The underlying problem in most Latin American countries is the absence of financial systems for long-term, "development" investments. Instead of solid financial institutions, these countries rely on short- and medium-term conveniences that serve the needs of the small circle of interest groups in power. The only options in this situation are to import financial institutions (passing through financial adjustment and external indebtedness to get to dollarization), or create them.

From this perspective, as Paul Krugman has argued, dollarization is not very creative and fails to address the issues at the root of the problem. In the case of Argentina, for example, dollarization could mean a temporary reprieve from currency speculators, but as long as there is no economic growth there will be no fiscal balance, either. Without export earnings there can be no trade surplus or productive investments to help cover external debt payments. And even dollarization will not keep the speculators away forever.

An even more radical view is that stable institutions and trust are possible only through a functioning social contract. The social costs of the macroeconomic adjustment policies associated with dollarization are obstacles to achieving a stable economic environment, which in turn is necessary for building the financial institutions that can bring national development. And dollarization may turn out to be reversible after all if the underlying problem-development-is not addressed.

Latin America is trying dollarization because the region's governments view it as the fastest way to finance development. But nothing can substitute for the establishment of solid financial institutions. Other factors, such as globalization and foreign debt, also come into play, but we cannot afford to confuse the context with the heart of the problem.

For more on this topic, see:
Acosta, Alberto, "El falso dilema de la dolarización"; and Cintra, Marcos and Elsa de Castro, "Internacionalización del sector financiero y dolarización de los países latinoamericanos," both in Revista *NUEVA SOCIEDAD*, no. 172, March-April 2001, Caracas, Venezuela.

Krugman, Paul. 1999. *The Return of Depression Economics*. New York: W.W. Norton & Company.

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[1] The International Monetary Stability Act of 2000 proposed by Senator Connie Mack proposes compensating countries that adopt dollarization for up to 85% of the costs of giving up their own

currencies.