

Dollars and Development: FIU Conference Evaluates Costs and Benefits of Dollarization for Latin American Countries

Financial and economic policy options in Latin America came into focus at a recent Florida International University conference, "Dollarization and Latin America: Quick Cure or Bad Medicine?" Sponsored by the University's Summit of the Americas Center and Latin American and Caribbean Center, with the Centro de Estudios de Integración Económica y Comercio Internacional of Buenos Aires, the March 4 conference addressed an issue that has become increasingly controversial since the financial collapse of Argentina. As the large turnout at the FIU conference made clear, the Argentine debacle has lent new urgency to evaluating the wisdom of the decision of many Latin America and Caribbean countries to link their fortunes to the US dollar.

Political, Economic and Social Impacts

The program began with a discussion of the nature and mechanics of dollarization. Myriam Quispe-Agnoli, an economist with the Latin American Research Group at the Federal Reserve Bank of Atlanta, gave an overview of definitions and objectives, as well as risks. The main goals of full dollarization, she noted, include lower interest rates and devaluation risks, increased capital mobility, a decline in inflation, greater financial intermediation and diversification. But besides currency considerations, political and default risks specific to each country factor in the calculation of interest rates. Dollarization results in a loss of seignorage, the revenue the government receives from printing or coining money. It also ends the Central Bank's role as the lender of last resort, making the financial system more vulnerable to capital flows. In general, Quispe-Agnoli pointed out, dollarization erodes governments' ability to respond to economic shocks. She concluded that while dollarization can help control inflation and increase a government's credibility, its long-term sustainability depends on financial reform and individual country factors.

Manuel Enrique Hinds, former minister of finance of El Salvador and one of the architects of that country's dollarization program, acknowledged many of these problems but presented the Salvadoran experience as a case apart. Unlike other countries in the region, such as Ecuador, El Salvador did not turn to dollarization in a time of crisis, he argued. The decision was not spurred by macroeconomic problems, such as inflation or a lack of credibility-indeed, El Salvador was already one of the few Latin American countries to enjoy an investment grade rating from international ratings agencies. Instead, El Salvador sought to benefit from the microeconomic advantages of integrating the country into the world financial system.

The next panel looked more in detail at the economic policy effects of dollarization. Felipe Larraín of the Pontificia Universidad Católica de Chile identified the biggest drawback of dollarization as limiting governments' ability to respond to real shocks. Since they are no longer able to devalue the currency, policy makers lose exchange rates as an adjustment mechanism, Larraín pointed out. He advocated a combination of floating exchange rate pegs, an independent Central Bank and inflation targeting as a better alternative for most countries.

Liliana Rojas-Suárez, a visiting fellow at the Institute for International Economics in Washington, D.C., agreed with Larraín that most countries do not fulfill the preconditions for sustainable dollarization. Among these, she listed the absence of fiscal liabilities from a weak banking system; low stocks of debt (whether domestic or foreign); export diversification; mechanisms for liquidity support; a reduction of distortions in the allocation of human and

capital resources; and, perhaps most important, adequate mechanisms to minimize the impact of shocks on the poor. Most Latin American countries are highly dependent on commodity exports, she noted, and so need more, not less flexibility in their exchange rate systems. The issue is not whether or not to dollarize, she argued, but rather the sustainability of the exchange rate regime.

The following panel examined dollarization's implications for economic, political and social stability. Professor David Felix of Washington University reviewed the rise and fall of Argentina's convertibility system, which pegged the value of the peso to the dollar. After the system collapsed, he argued, the IMF and the Bush administration left Argentina "twisting in the wind as an object lesson" to other countries that may consider defaulting on their debt payments. Another rationale for this neglect, he suggested, was that Argentina's problems are bound to weaken MERCOSUR, strengthening the prospects of the US-backed Free Trade Area of the Americas (FTAA).

Joyce Higgins de Ginatta, a leading Ecuadorian entrepreneur and head of the Inter-American Business Federation, recounted her campaign in support of dollarization in her country. Ecuador adopted the dollar at a time of severe economic and political crisis. Higgins de Ginatta stressed the close links between economy and psychology, and the ability of a solid currency to shore up people's expectations of the future.

The conference's keynote speech was delivered by Manuel Enrique Hinds, who highlighted some of the points of consensus among the panelists. The issue for developing countries is not so much dollarization, but development, he emphasized. El Salvador enacted dollarization to take advantage of the efficiency gains it offered, with the understanding that it would not mean automatic stability or freedom from debt. The logic pursued in El Salvador, according to Hinds, was development from below: turning citizens into the engine of growth by making it possible for them to save and invest. He acknowledged that dollarization is not the only solution and, as most of the panelists cautioned in their presentations, he stressed that it must be accompanied by the elements to make it sustainable. The key to development does not lie in exchange rate regimes, but in reform, he concluded.

Prospects for Dollarization After Argentina

A series of case studies looked at five countries that have adopted or considered some degree of dollarization. Augusto de la Torre, the former president of Ecuador's Central Bank, argued that dollarization had brought the country rapid financial stabilization and an economic rebound despite ongoing political problems. He also acknowledged the attendant risks, especially the erosion of Ecuador's "competitiveness cushion." Especially important, according to De la Torre, is the debt-to-GDP ratio: Dollarization gives citizens store value, but it can blind authorities to the real worth of income in terms of tradables, leading them to overstate a country's income.

Salvadoran Central Bank President Rafael Barraza put dollarization into the context of overall development policy. Monetary integration was just one part of El Salvador's strategy of geographic (infrastructure), social and economic integration to make globalization work for the Central American country, he explained. The government made the dollar the only unit of account in the financial system, although the colón remains legal tender, and fixed the rate at which the local currency can be exchanged for the dollar. Currently, dollars account for more than 62% of cash in circulation in the country. Barraza characterized the program as a success, responsible for bringing down interest rates and allowing the introduction of a wider variety of financial instruments. He credited it with helping El Salvador weather a series of

crises in 2001, including earthquakes and low coffee prices, by locking in expectations for future growth.

Jorge Sanguinety, president and CEO of the consulting firm DevTech Systems, discussed the case of Cuba, which he presented as "an alternative to full dollarization." Since 1993, the Castro government has authorized certain groups of Cuban citizens, including those working abroad or employed in the tourism industry or joint ventures on the island, to hold US dollars and spend them in foreign currency stores.

Pamela Starr, a professor of international studies at the Instituto Tecnológico Autónomo de México, saw few prospects for dollarization anytime soon in Mexico. The Fox administration, lacking a majority in Congress, is too weak to push through the needed structural reforms, she argued. Mexican nationalism also remains an important force likely to hinder any effort to limit or do away with the sovereignty of the peso.

The Argentine case was again in the spotlight as Andrew Powell, former chief economist of that country's Central Bank, summarized the pitfalls of convertibility. He noted that although this policy was successful for a time, warning signs were present in the form of persistent current account deficits and questionable fiscal discipline. He presented dollarization in Argentina to some extent as a missed opportunity. If enacted in 1999, when the first signs of crisis became apparent, it could have reduced the country's default risk and increased confidence and investment. He was quick to add, however, that it would not have solved problems of competitiveness and fiscal shortcomings unrelated to growth. Some proponents of dollarization argue that it is still a good option for Argentina today, but Powell argued that the first priority is developing an independent monetary policy. The key to overcoming Argentina's many challenges, he stressed, will be political will and skillful management, as well as US and IMF generosity.

The discussion moved on to a consideration of the United States perspective on dollarization, including its impact on US interests. David Altig of the Federal Reserve Bank of Cleveland discounted fears that dollarization will insinuate other countries' problems into US financial decisions. Domestic policy is already influenced by foreign concerns, he noted. At the same time, he cautioned against the potential for too much dollarization, citing the benefits of competition in monetary regimes as in trade.

Benjamin Cohen of the University of California-Santa Barbara argued that official dollarization is not in the interest of the United States. He maintained that a widespread trend toward dollarization in the hemisphere would bring few gains for this country and some potential losses. Informal dollarization already brings the US increased seignorage earnings, fewer balance of payment constraints, increased status and prestige, and political influence in the form of command over purchasing power. Formal dollarization, Cohen argued, would have a minimal effect on seignorage and transaction costs, and if the countries that adopted it were not prepared the currency switch could bring more, not less instability. Increased political influence could also backfire and make the US the focus of economic discontent.

A concluding roundtable brought back selected panelists to sum up and expand on some of the key points reached during the session. Eduardo Gamarra, director of FIU's Latin American and Caribbean Center, moderated the discussion and posed some guiding questions based on the day's proceedings. Among the points he raised were the minimum preconditions for dollarization, its relationship to regional integration, and what it means for the US.

Benjamin Cohen commented that if a country already meets the preconditions for dollarization, it may not even find it necessary to adopt it. He did not see much of a role for the dollar in regional integration, pointing out that currency unions are extremely difficult to negotiate.

Felipe Larraín also discounted the view of a common currency for MERCOSUR, interjecting that if countries do not have credible national institutions, it is hard to see how they could build regional ones. He agreed with Cohen that the US will continue to follow a policy of benign neglect with regard to dollarization, and that it would take a concerted effort on the part of Latin American governments to change this position.

Larraín reiterated his view of floating pegs as a viable alternative to dollarization in developing countries, although Andrew Powell questioned whether the nominal flexibility of floating regimes translates into real flexibility. He stressed that individual countries must focus on their final objectives to determine the appropriate monetary regime. If the final goal is the FTAA, then dollarization might be the best path, he argued, while regional free trade agreements could benefit more from regional currencies. He concluded that given the United States' hands-off policy with regard to dollarization, most countries will turn to it only in times of crisis.

Pamela Starr again emphasized politics as the most important consideration in dollarization; specifically, a government's ability to pass the necessary reforms to create macroeconomic stability. Also important, she added, are a culture of accountability and a society that doesn't see the world as a zero sum game, in which a gain for one group means a loss for another. The panelists cited Argentina as the epitome of this type of society, and the difficulty of reaching popularly supported solutions to fiscal problems.

Ecuador's de la Torre advised policy makers to worry less about ideal solutions and focus instead on what can be done in the context of global economic realities. He held up two models to illustrate the dollarization debate: the ideal or "Blessed Trinity" of an international currency, a flexible exchange rate and strong institutions; and the "Unblessed Trinity" of a weak currency, fear of floating exchange rates and weak institutions. In practice, de la Torre argued, real policy options come down to what he called the "Peso Trinity"-overcoming the fear of floating, introducing flexibility and building institutions-and the "Dollar Trinity"-tackling the currency problem but leaving the question of institutions in doubt. In summary, de la Torre concluded, dollarizers often underestimate the need for institutions and nominal flexibility, while proponents of floating forget the difficulty of establishing long-term financial markets.

As Latin America deals with the fallout from the Argentine default and the effects of the post-September 11 recession, a vigorous debate continues on the best choice of monetary and exchange rate regimes. The speakers at FIU's conference on dollarization helped clarify many of the potential advantages and drawbacks for the region. Dollarization has emerged as one possible path to economic development and stability, but the jury is still out on the question of its long-term utility in Latin America.