

# The Pros and Cons of Dollarization

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# Old Arguments: Pro

- Lower inflation
- Greater credibility
- Lower interest rates
- Lower transaction costs in trade and investment

# Old arguments: Con

- Lack of a lender of last resort
- Seignorage
- More costly adjustment to asymmetric shocks
- Inflation tax (of last resort)
  - save banking systems by eroding real liabilities
  - erode real value of nominal fiscal commitments
  - misaligned wages

# New counter-arguments

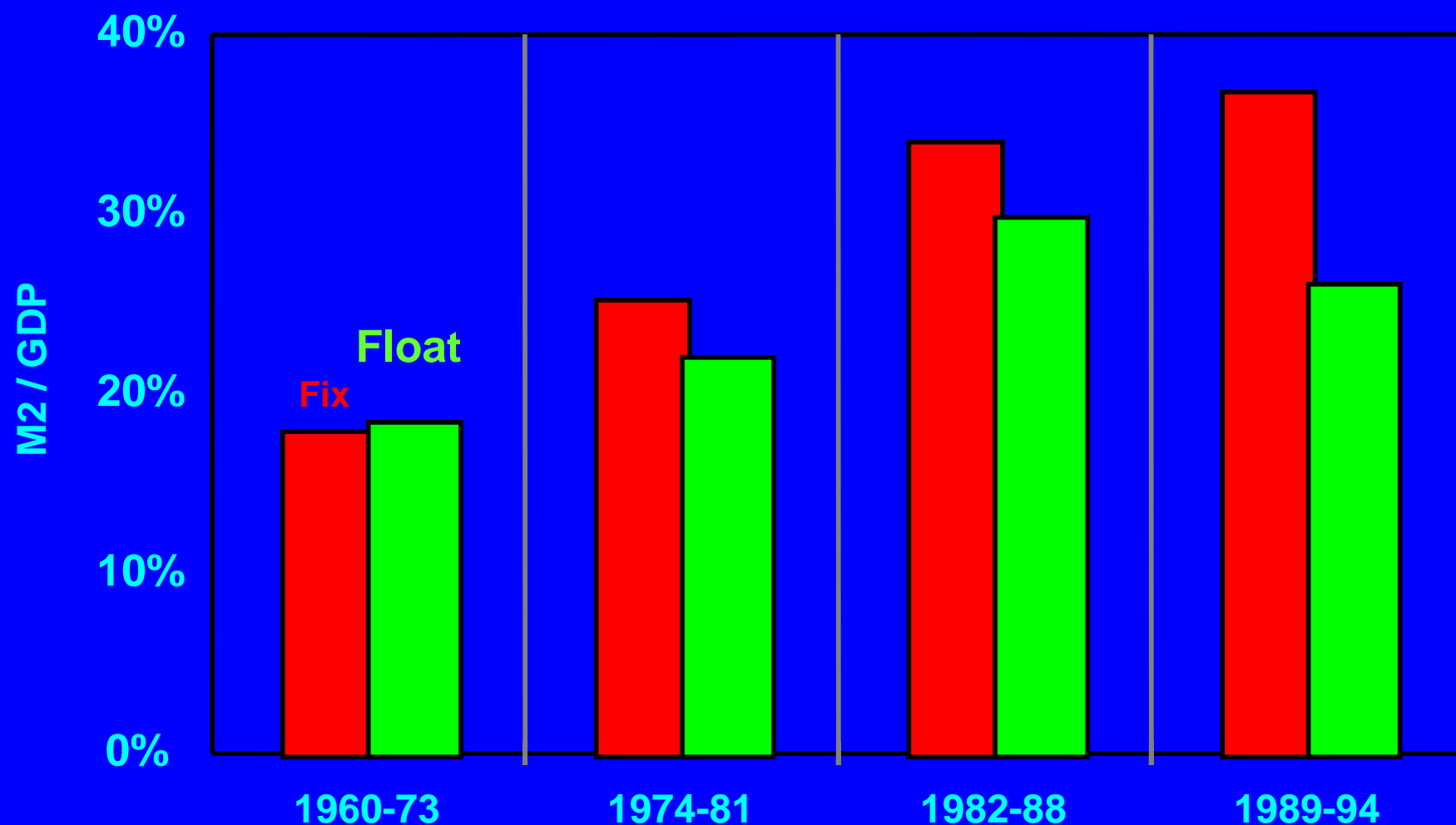
- Lender of last resort vs. borrower of last resort
  - inability to sterilize makes the LOLR destabilizing (e.g. Ecuador 1999, Venezuela 1994, Argentina 1982)
  - destabilizing role when financial system is partly dollarized
- LOLR under dollarization: government borrower of last resort
- Full financial integration (e.g. Panama)

# New counter-arguments

- Adjustment to asymmetric shocks through exchange rate movements has consequences even if shocks are unbiased and unanticipated
- if the expectation is that the currency will depreciate when income is low and appreciate when income is high then correlation of financial returns and income has the wrong sign and people will save in foreign currency

# Flexible regimes generate smaller financial systems

Exchange Regime and Financial Depth



# Does this explain persistent dollarization?

- This may explain why we do not observe de-dollarization in low inflation countries such as Peru, Bolivia, Uruguay and Argentina
- A strategy of sticking to your guns may not do the trick

# New counter-arguments

- The option to inflate must be paid for
- Creates a peso-problem that can become a source of crisis if the stock of debt is sufficiently high
- Can become destabilizing
- The “Orange County” effect

# New arguments

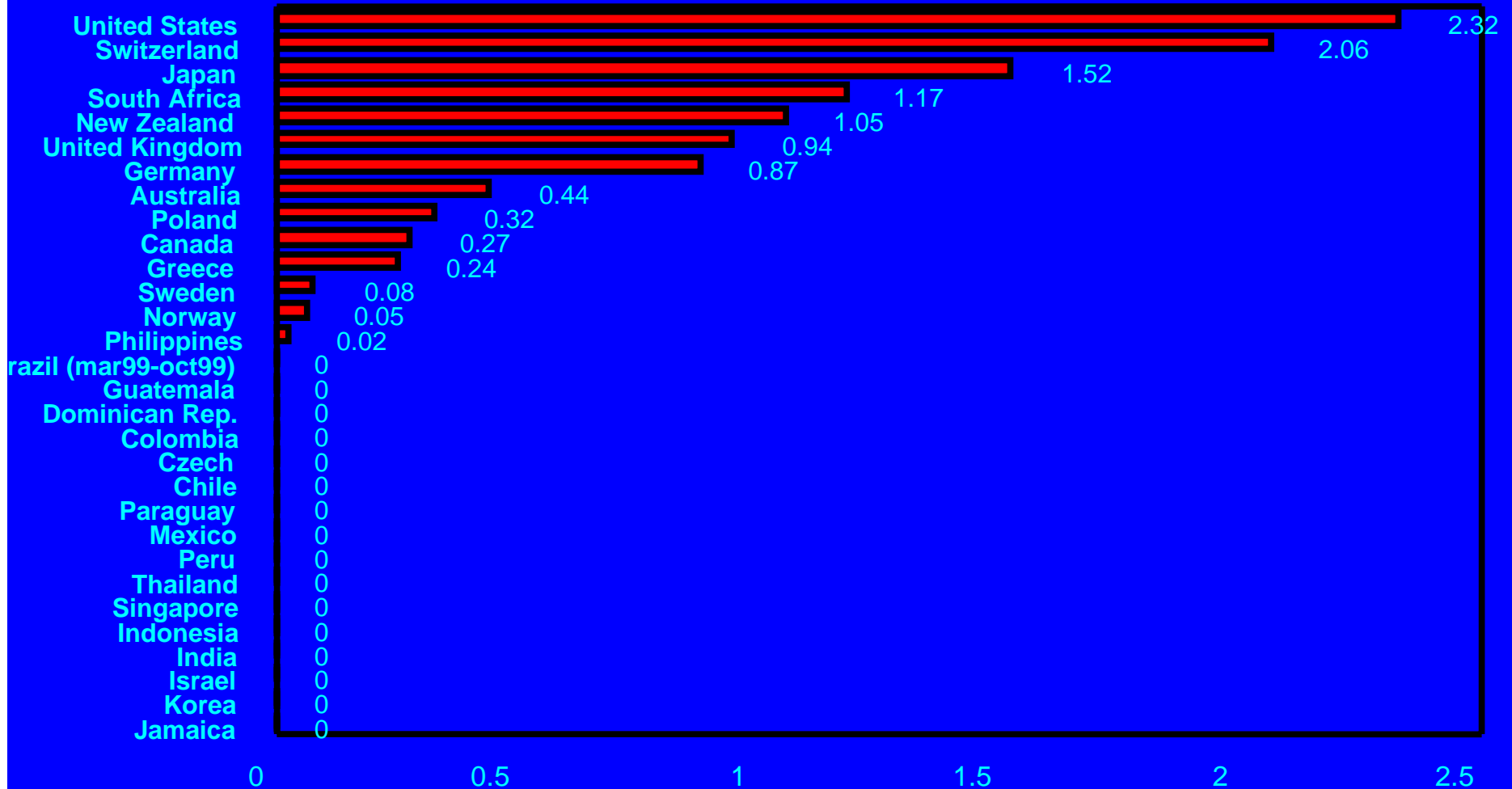
- Avoid financial fragility caused by “original sin”
- Avoid the likely consequences of floating with “original sin”

# Original sin: definition

- A currency has “original sin” when
  - it cannot be used to borrow abroad
  - it cannot be used to borrow long-term even in local market

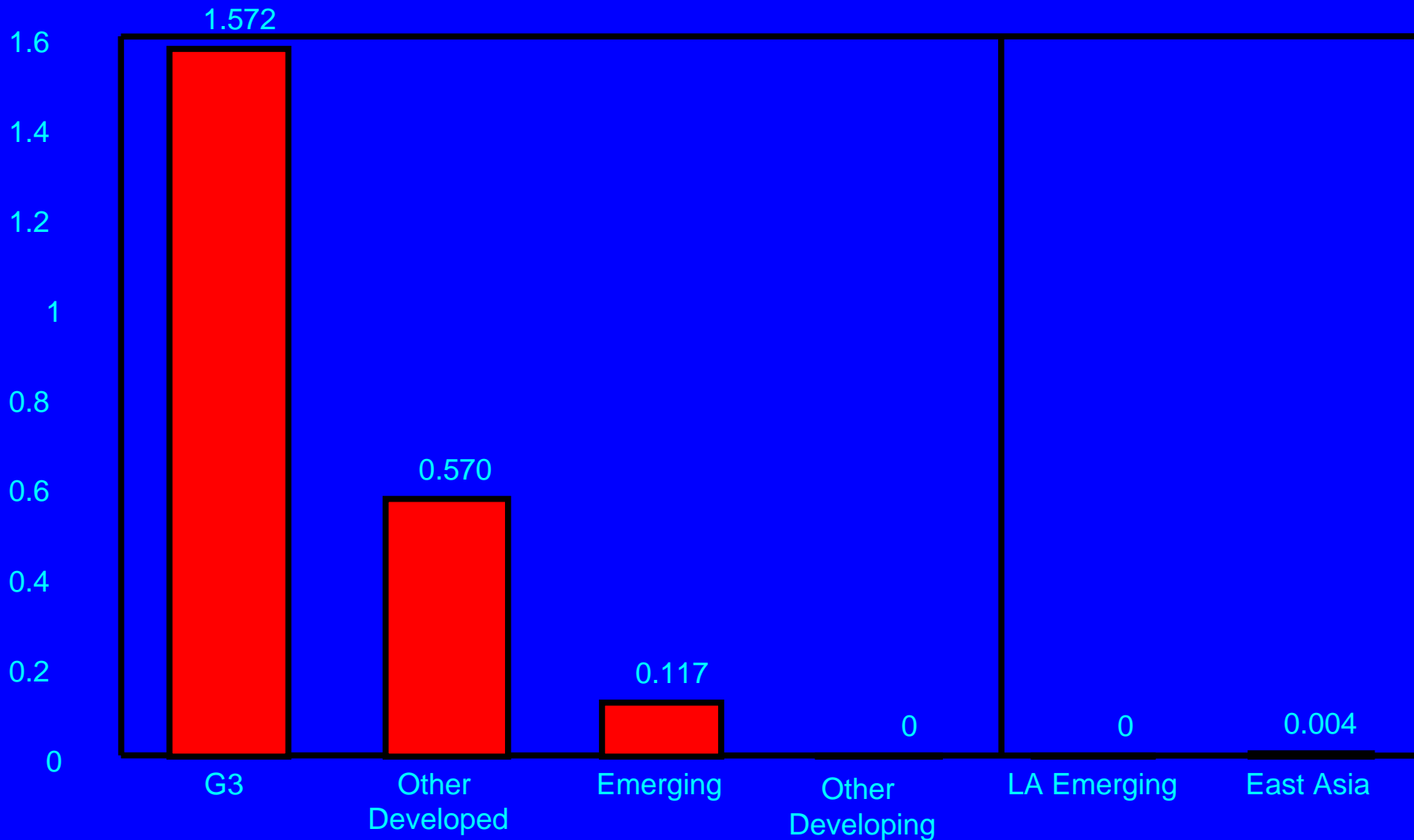
# Very few countries can borrow abroad in their own currency

Index of the ability to borrow in your own currency



# ...and none are in Latin America or East Asia

Index of the ability to borrow in your own currency



# Original sin: implications

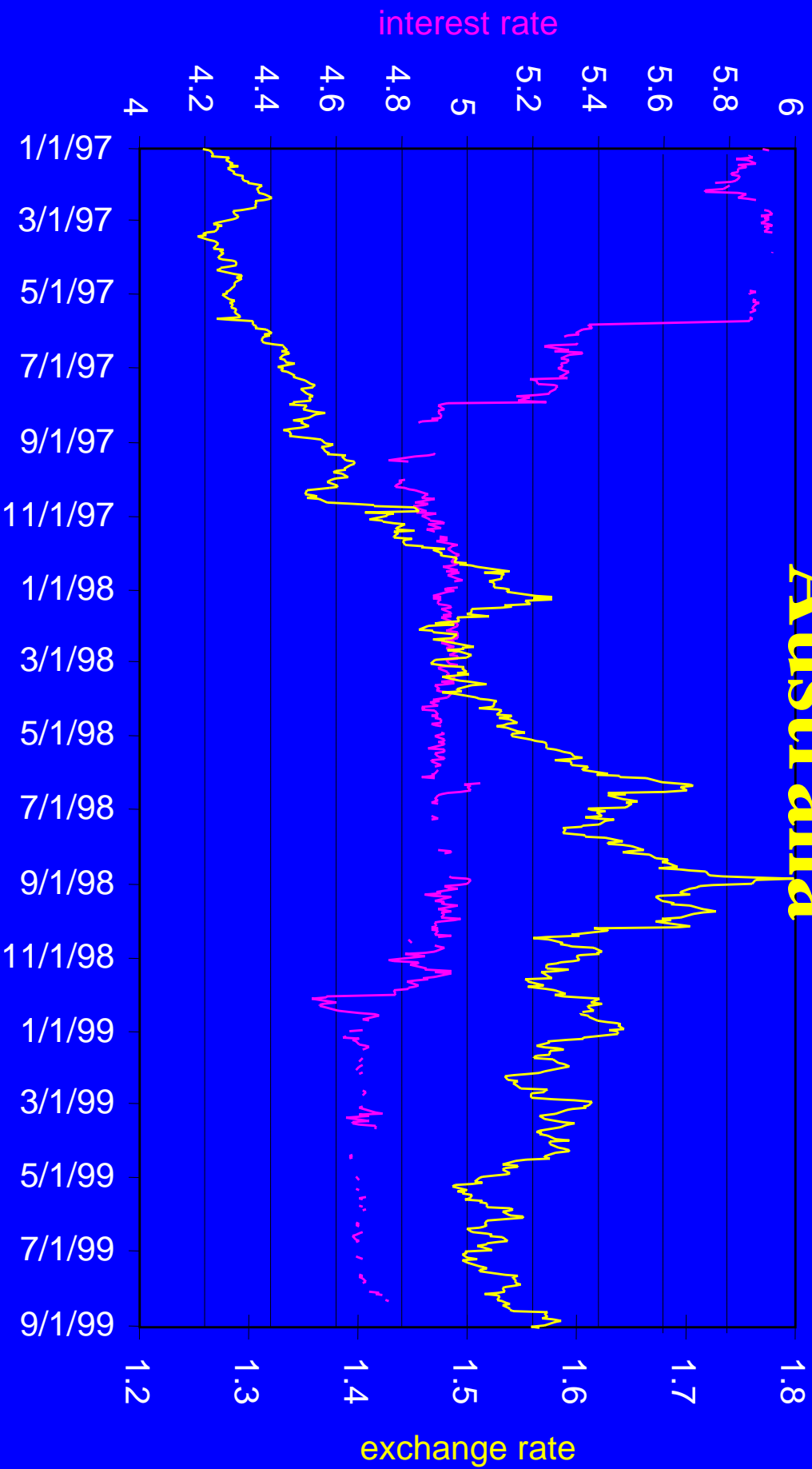
- Dual mismatches: currency or maturity
- Endogenous financial fragility
  - unrelated to moral hazard
- Very limited hedging opportunities
  - why no local currency international lending?
- Fewer opportunities for safe lending

# Floating with original sin is not attractive

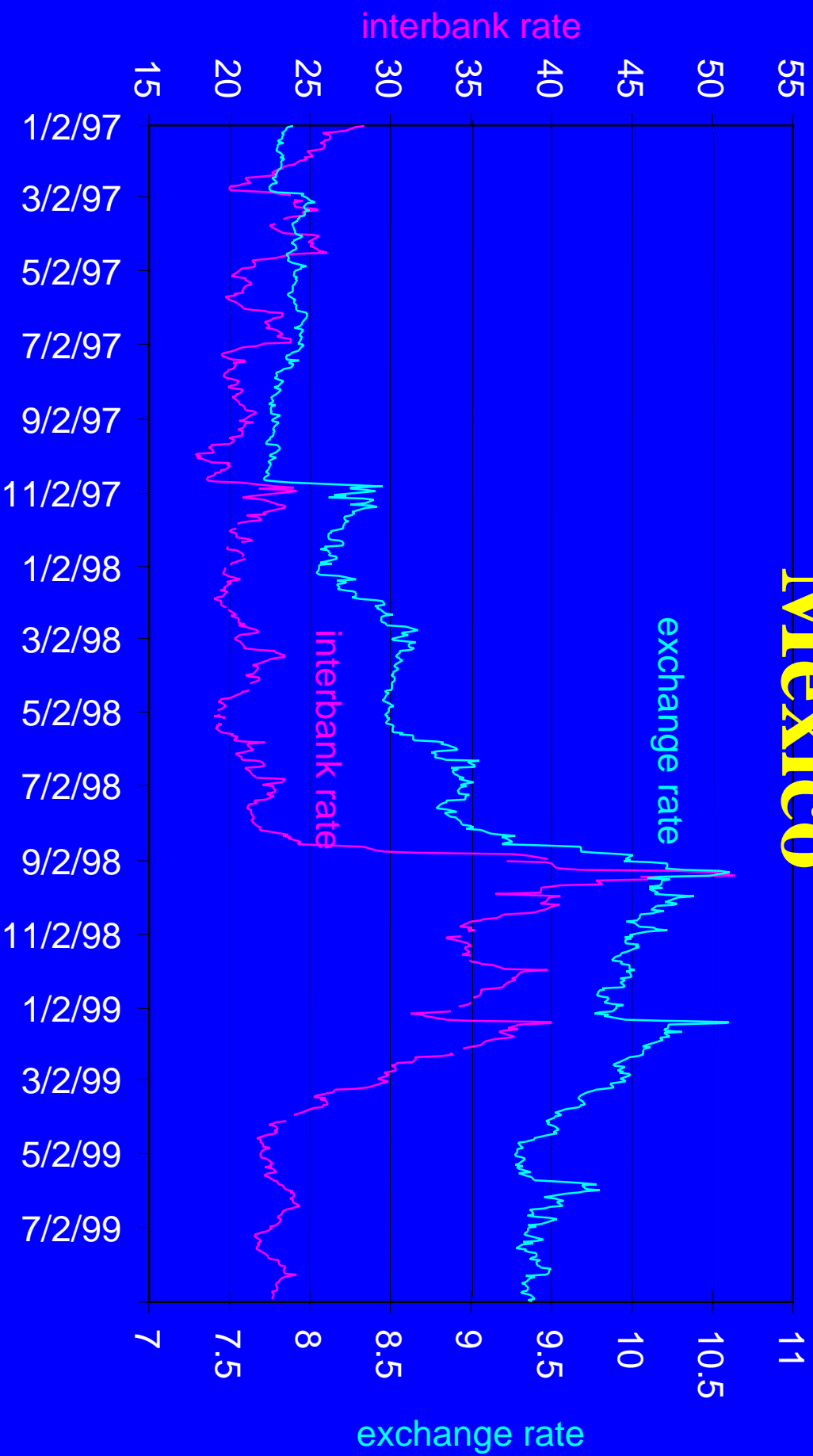
- depreciation, mismatch and balance-sheet effects
  - Peru 1998-99
- monetary tightening, roll-over risk and maturity mismatch

# Floating at its best:

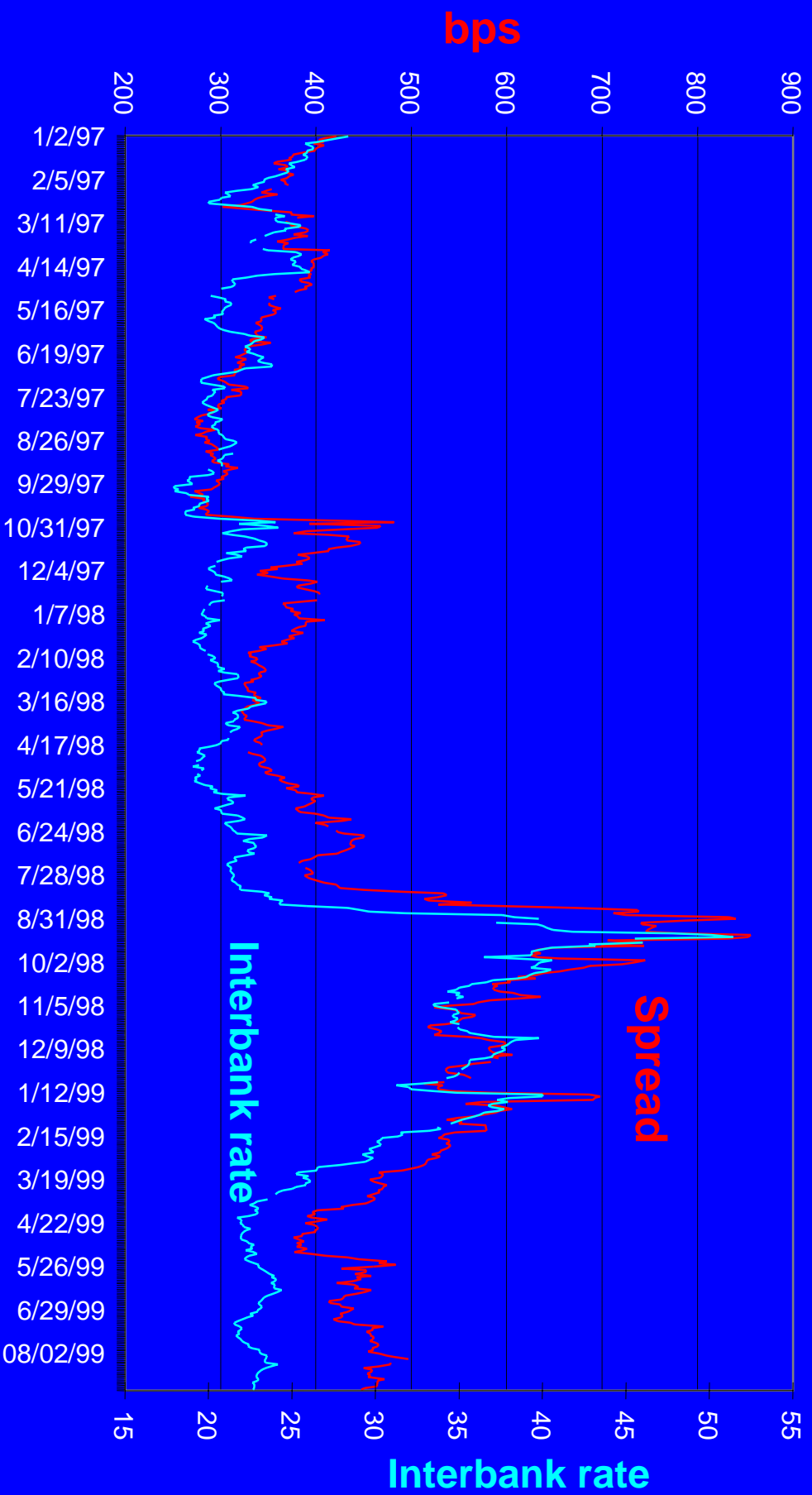
## Australia



# Floating Latin Style: Mexico



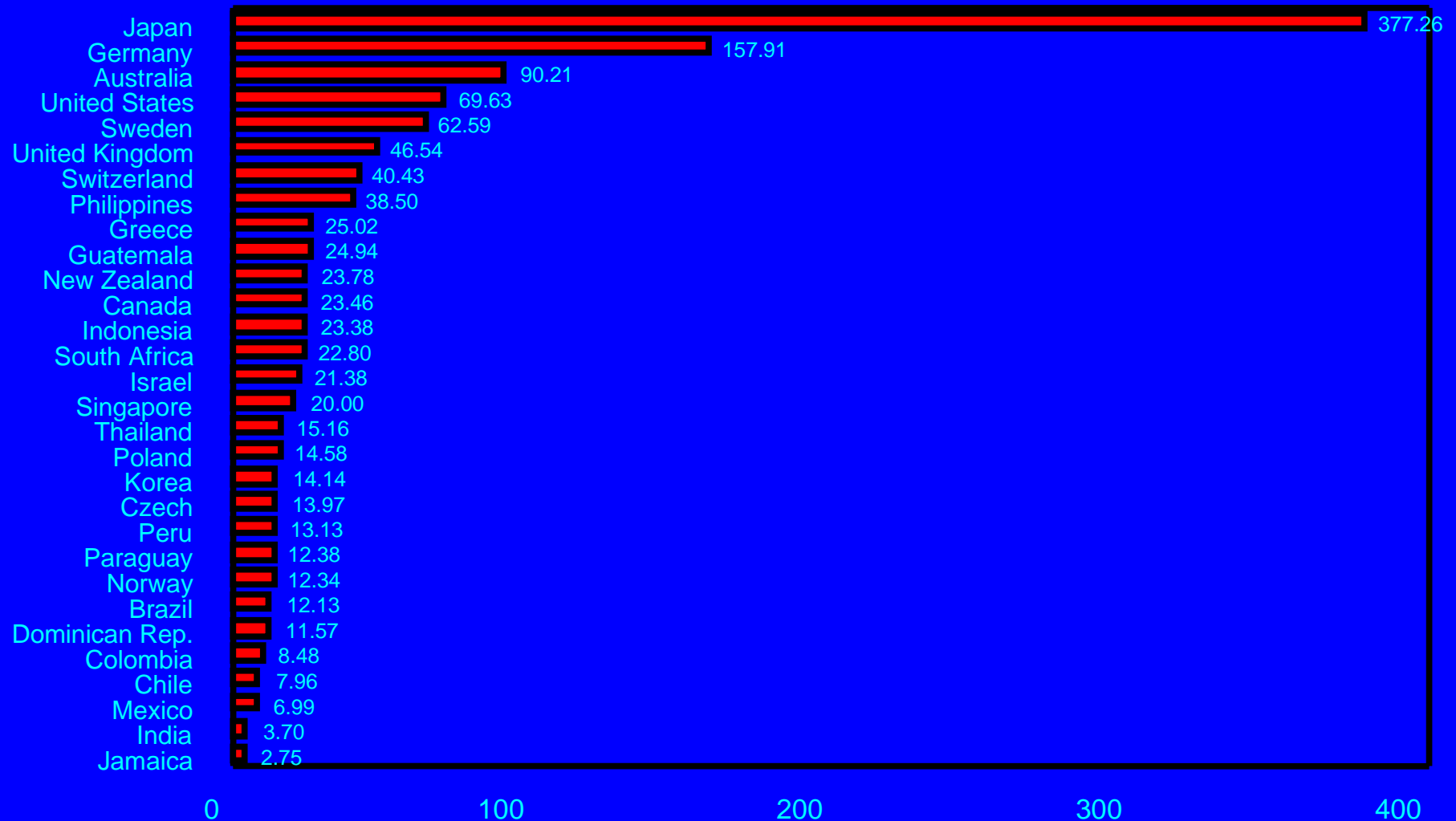
# Country risk gets amplified in the money market in Mexico



# Countries with original sin have large interest rate volatility, low xr volatility

Relative Volatilities: Exchange Rates and Interest Rates

$\text{std}(\text{dev})/\text{std}(\text{ir})$



# Floating with original sin

- Volatile domestic interest rates
- Lower demand for domestic assets and more dollarization of savings
- Riskier banking systems
- Difficulty in developing long-term markets
- Lower dollar borrowing
- Less financial development
- Lower growth

# Lessons from floating in Ecuador

- Self-fulfilling vicious circle
  - In spite of 6% improvement in primary fiscal surplus
  - Massive current account surplus
  - Extremely under-valued currency
- Currency depreciation weakens the fiscal and financial solvency and leads to further attack
- Should Peru watch out? Should it renounce finance?

# Policy options

- Can countries get out of “original sin”?
  - After domestic and capital account liberalization?
- Can countries de-dollarize?
- How long and costly is it?

# Why could monetary association based on the dollar be fast?

- Most Latin American countries are very integrated to the dollar area
- Most trade is denominated in dollars
- Most countries are highly dollarized in deposits and liabilities
- No need to create a new currency

# Political context

- There is no political context for dollarization
- Currencies are still national symbols
  - airlines
  - credit cards
  - money
- Seignorage