Hey, Mr. Greenspan, Can You Spare a Dollar?

THE MEGADEVALUATIONS, banking crises and continent-jumping financial contagions of the past two years have sent policymakers searching for monetary programs to insulate their countries from such problems. In Latin America, the dollarization option is getting considerable attention. It has been the subject of debate in both Mexico and Brazil. And the president of Argentina has been pushing for dollarization there.

When a country officially dollarizes, it uses only U.S. currency. All bank accounts and loans become dollar-denominated. Countries that adopt the dollar cannot print money, so they must rely on taxes to pay their debts.

Dollarization has several benefits. It is one route to fiscal and monetary credibility because it can hold down inflation, maintain price stability and probably lower interest rates. Another benefit is that it enables a country to avoid the large exchange rate devaluations that are possible whether it has flexible or pegged rates or a currency board.

The 1990s have seen a run of collapsed exchange rate regimes (*Chart 1*). Dollarization is not an economic cure-all. But because a country that adopts the dollar cannot devalue U.S. currency, dollarization eliminates the disruptions that can occur both in anticipation of a devaluation and after one.

Devaluations are part of a broader problem—financial contagion, which occurs when one country's problems are at least temporarily transmitted to other countries, regardless of those countries' economic conditions. An example of this is the effect Russia's 1998 financial crisis had on Mexico and Argentina. Although there was little reason to consider either country a candidate for financial meltdown, interest rate increases moved through the financial systems of both. Interest rates may have become unstable because the markets factored in the likelihood of a devaluation.

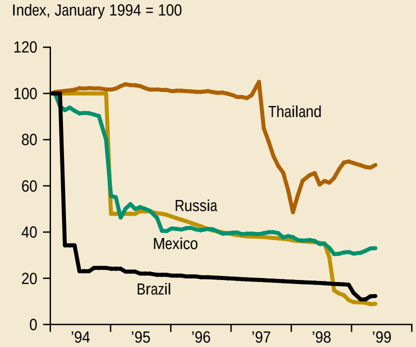
But whether a contagion is irrational or rational, investors' perceptions of policy credibility can trigger capital outflows and exchange rate crises. Investors may anticipate that governments will cheat on their commitments to stable monetary and fiscal policy, and they may fear that other investors share their suspicions. Consequently, investors often pull out en masse, triggering a sharp reduction in demand that can set off a currency crash and a sudden drop in asset prices.

Supporters of dollarization say it is one way to avoid some capital outflows—at least those that occur in anticipation of a currency crash. Dollarization ties policymakers' hands, preventing them from running up deficits that would have to be paid for with inflationary financing.

Dollarization Drawbacks

Dollarization, however, has its costs. A dollarized country cannot conduct its own monetary policy but instead has to follow the Federal Reserve Board's policies. A dollarized currency regime limits a government's ability to serve as a lender of last resort in a banking crisis.

Chart 1
Exchange Rates, 1994–Present



NOTE: 1999 data are through May.

Dollarized countries cannot create money to rescue the banking system because they can't create dollars at all.

A dollarized country also sacrifices its seigniorage, which is the profit a country makes from printing money. It costs three cents to print a $100 bill, but that bill can purchase $100 worth of goods and services. In a nondollarized economy, the central bank holds international reserves in interest-bearing instruments, such as U.S. Treasury bills. Under dollarization, a country loses the interest earned from these types of instruments.

U.S. territories such as Guam and American Samoa are dollarized, as are the Marshall Islands and Micronesia. Panama is the only Latin American country that has officially dollarized, but unofficial dollarization is common. The value of dollar bank deposits is greater than that of domestic currency deposits in Argentina, Bolivia, Peru and Uruguay.

Argentina has all but officially dollarized. In 1991, the country adopted a convertibility plan that would force the government to abandon inflationary spending and convince investors policymakers were committed to this course. Not only is the Argentine peso fixed to the dollar, but bank accounts can be converted to dollars, which can be used to make purchases. (Wages and taxes must still be paid in pesos.) Argentine President Carlos Menem has been pressing for full, official dollarization.

If additional countries opt for official dollarization, the already high foreign demand for dollars would go even higher. The United States would have to print more money but would benefit from the seigniorage.

Dollarization is not the only route to fiscal and monetary credibility, price stability and low inflation. But its supporters argue that it may be a more viable route than others.

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