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Southwest Economy

The New Paradigm in Europe: Is Goldilocks Going Global?

Since the mid-1990s, the U.S. economy has experienced a combination of high growth and low inflation that has made it the envy of the world. Some argue we have entered a new era, one in which the old rules no longer apply. Others argue the country has benefited from a series of favorable supply shocks that have simultaneously lowered inflation and unemployment. While commentators may disagree over what is and isn't new about the New Paradigm, the fact remains that the U.S. economy is experiencing a combination of output growth, inflation and unemployment not seen since the onset of the productivity slowdown in 1973.

What *is* new about the New Paradigm is the proximate cause of the high growth and low inflation experienced over the past five years—rapid technological innovation. But given the ease with which technology can be transferred between nations, the question arises of why only the United States seems to have benefited from the computer revolution. Despite its large domestic market and highly educated workforce, Europe hasn't exhibited the same performance. There's

(continued on page 2)

A Common Currency for the Americas?

As part of the Federal Reserve Bank of Dallas' ongoing efforts to support effective economic policies, the bank hosted a conference in March 2000 entitled *Dollarization: A Common Currency for the Americas?* The question mark in the conference title signaled attendees that both sides of the dollarization debate would be represented.

Dollarization

When a nation officially dollarizes, it abolishes its own currency and formally adopts the U.S. dollar as legal tender. Advocates argue that dollarization helps establish fiscal and monetary credibility because inflating the currency to cover fiscal deficits is no longer an option. For the same reason, dollarization helps maintain price stability. Accordingly, dollarization can lower transaction costs for trade and investments. It also eliminates the devaluation

(continued on page 7)

Special Issue Focusing on International Economics and Monetary Policy

A Common Currency for the Americas?

(Continued from front page)

premium built into many countries' interest rates since the domestic currency cannot be depreciated. Advocates also argue that an increase in credit to small and medium-sized companies and a narrowing of income distribution are likely.

Dollarization opponents point out that the dollarized country loses control of its monetary policy and say that this loss is too costly. Dollarization limits the central bank's ability to serve as lender of last resort to troubled commercial banks during a banking crisis. Critics contend it is often the countries with very weak banking systems that consider dollarization. One of the most common arguments is that it is simply the wrong policy: it delays a country from establishing sound macroeconomic and fiscal policies.

Sen. Connie Mack, chairman of the Joint Economic Committee of the U.S. Congress, opened the conference with a strong affirmation of dollarization. The Florida senator said that dollarization would do more to ensure the long-term economic health of the nations in this hemisphere, more to expand trade, more to enhance economic stability and more to increase standards of living and create jobs than any other single policy shift he is aware of. Mack introduced a related bill taken up by the U.S. Senate Banking Committee: the International Monetary Stability Act (S.1879, Nov. 8, 1999). This bill creates a framework for the United States to compensate dollarizing countries for the seigniorage they lose by abandoning their domestic currencies. Seigniorage is the revenue countries earn from the difference between the cost of printing money and the money's official worth. Responding to criticism that dollarization would undermine a nation's sovereignty, Mack said dollarization would not interfere with a nation's ability to create its own fiscal, regulatory or most other public policies.

Despite Mack's comments, much of the conference focused on debates over what dollarization prevents nations from doing. One of the big questions raised by dollarization opponents was whether the benefits warranted the surrender of monetary sovereignty—especially to a country whose monetary policy would not necessarily be consistent with the interests of the dollarizing country. A Federal Reserve decision to hike interest rates to cool inflationary pressures in the United States might have a deleterious impact on a dollarized country with low inflation, no growth and excess capacity. These issues led some speakers to wonder whether any exchange-rate regime but a flexible one could succeed. Later discussions revealed that dollarization's limit on the central bank's ability to serve as a lender of last resort could be a blessing or a curse.

Hyperactive Central Banks

In responding to concerns about the restrictions that dollarization imposes on the lender of last resort function, Guillermo Calvo, director of the Center for International Economics at the University of Maryland, addressed the issue by characterizing Latin American central banks as hyperactive. Calvo said it is not unusual during financial crises for central banks to print money to create the liquidity required for bailing out commercial banks. Surrendering the freedom to inflate, he argued, is not really surrendering the ability to stabilize, since inflating is not stabilizing. "Power comes from credit and not from printing money," he said. In other words, national creditworthiness is more important than a good printing press.

Continuing on this theme, Inter-American Development Bank chief economist Ricardo Hausmann added that the term *lender of last resort* is a misnomer; the correct phrase would be *borrower of last resort*. According to Hausmann, a serious problem for emerging market countries is "original sin," which he calls the unstable currency history of most emerging-market countries. That history and lenders' fears of it being repeated severely limit borrowing options in emerging-market countries. For example, if a firm in an emerging market needs money, it can only borrow in its local currency for the very short term; for the long term, it can only borrow in dol-

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lars. However, if a company borrows in dollars, it will have a currency mismatch, and if it borrows short-term, it will typically have a maturity mismatch.

When exchange rate pressures materialize under these financial market circumstances, central banks have difficulty adjusting. If the central bank lets the exchange rate go, the consequences for the companies that have currency mismatches are not good. Andrew Powell, chief economist at the Central Bank of Argentina, emphasized that because of the currency mismatches, currency devaluation can dramatically increase the likelihood of defaults. And, if the central bank defends the currency by tightening monetary policy, companies that have maturity mismatches will have trouble rolling over their debts. Any way the central bank moves can trigger a financial crisis. Both Hausmann and Calvo called for dollarization as solutions to these problems.

Pegged or Floating Exchange-Rate Regime?

In the past decade, the six main currency-crisis countries—Brazil, Indonesia, Mexico, Russia, South Korea and Thailand—suffered in varying degrees the short-term borrowing dilemma Hausmann described. Hausmann indicated that this maturity mismatch is aggravated by a pegged exchange-rate regime. Under a pegged regime, a developing country typically fixes its exchange rate by unilaterally pegging its currency to that of an industrialized country. The developing country then buys or sells the foreign money in return for domestic money to maintain the selected exchange rate. The volatile circumstances surrounding small open economies—including terms-of-trade shocks and sudden changes in capital inflows—sometimes push exchange rates toward overvaluation. Then, balance-of-payment pressures materialize. Investors become nervous that when a devaluation occurs, it will be much more severe than if the currency had been allowed to float. The financial crises of the 1990s witnessed such megadevaluations, and as a result, the pegged exchange-rate regime has virtually disappeared as an option.

According to Sebastian Edwards, professor at the University of California at Los Angeles, countries in the region now have two choices: dollarize or freely float. A floating exchange-rate regime is one in which the central bank has no commitment to support a given exchange rate. It sets the money supply and then allows the exchange rate to fluctuate in response to economic conditions that affect supply of and demand for the currencies.

Table 1

Nominal Interest Rate Volatility in Floating Exchange-Rate Regimes

Country	Period	±25 basis points	±50 basis points
United States	2/73–4/99	59.7	80.7
Japan	2/73–4/99	67.9	86.4
Bolivia	9/85–12/97	16.3	25.9
Peru	8/90–4/99	24.8	32.3
Uganda	1/92–4/99	11.6	32.6

SOURCE: Guillermo Calvo and Carmen Reinhart, "Fear of Floating," forthcoming.

Fear of Floating

Edwards pointed out that we lack substantive historical experiences in either floating or dollarization. Panama had been the only dollarized country in Latin America until Ecuador's recent decision to dollarize. Mexico, Brazil, Chile and Colombia have abandoned their pegged regimes in favor of floating. However, Calvo and Edwards questioned whether these countries really float. Calvo explained that emerging-market countries have a "fear of floating." Edwards maintained that instead of floating, developing countries often have pegged regimes in disguise. If these countries float at all, they, in Calvo's words, "float with a life jacket." This means that even though they are operating under flexible rates, or a floating regime, they will from time to time intervene to stabilize the exchange rate. They intervene by buying or selling foreign currency on the foreign exchange market or by manipulating interest rates through open market operations.

The reason for this fear of floating reinforces Hausmann's observation of original sin. These currencies don't have the recognition or the credibility of developed countries' currencies. A developing country fears what might happen if its currency is allowed to float. The resulting volatility of its exchange rate may scare investors into pulling out their capital. Consequently, these countries float with a life jacket.

According to Calvo, while the exchange rate does not move in these so-called floating-rate countries, what does move is the interest rate because interest rate intervention is used to shore up exchange rates. The resulting volatility is especially striking when compared with the low interest rate variances of industrialized countries that actually do have floating exchange rates. Table 1 shows an 81 percent probability that U.S. nominal interest rate changes fall within a plus or minus 50-basis-point band and an 86 percent probability for Japan. In contrast, Bolivia has extremely volatile interest rates and thus only a 26 percent probability that they will stay within the plus or minus 50-basis-point band.

Edwards explained that dollarization makes eminent sense for some countries but perhaps not for all. He expressed concern over the difficulty of relative price adjustments in a dollarized economy. He warned that the dollarized country may be buying higher unemployment and pointed out that the countries with the highest unemployment rates in the 1990s were the superfixers, Argentina and Panama. With dollarization, shocks or sudden unexpected disturbances in the economy are more costly. If you get a real shock, you need a movement in relative prices. Edwards maintained that exchange-rate fluctuations facilitate that movement. Hausmann agreed: "It is easier to change one price, the exchange rate, than it is to change a multitude of labor contracts."

However, Hausmann offered a compelling argument for dollarization by questioning the benefits of floating in economies that are susceptible to shocks.

He used the oil-based Venezuelan economy as an example. If the price of oil goes up, the exchange rate will appreciate and vice versa. Using the connection between exchange rate and oil price movements, Hausmann questioned whether a country's residents would willingly save in their domestic currency if they were allowed to save in another. According to Hausmann, sound risk management requires savings in a currency that has a negative correlation to income. People need to have savings with a maximum buying power when their incomes are low. When their incomes are high, having a maximum buying power is less important. He maintained that if the currency moves up and down with income, it has the wrong correlation. People will want to diversify away from that currency. Floating in an economy suffering real shocks will do away with savings in the national currency. Assuming that the exchange rate can help during the adjustment period is assuming that the financial system and everything else will stay the same, and according to Hausmann, "They simply don't."

Other conference speakers who supported dollarization also saw it as a policy that might bring economic stability. They questioned—along with Hausmann and Calvo—the existence of independent monetary policies in the region. Calvo perhaps expressed this notion most succinctly when he compared an emerging market economy conducting its own monetary policy to a small boat in the middle of the ocean. He said, "One can say to the boat, 'You are free to row.' Yes, the boat is free to row, but it probably is not a good idea."

A Wall Street Perspective

Walter Molano, head of economic and financial research at BCP Securities Inc., disagreed. He said the small boat needs to row in the ocean. The downside of dollarization is that it keeps the boat from rowing, he said, and thereby limits the development process. According to Molano, dollarized governments fail to develop the skills and experience needed to establish macroeconomic policies to deal with various phases of business cycles. Molano maintained that most of Latin America's fiscal problems are the result of institutional flaws, and dollarization does nothing to solve these.

Molano shared a session entitled *A Wall Street Perspective* with two other economists: Michael Gavin, head of economic research for Latin America at the firm Warburg Dillon Read, and John H. Welch, chief economist, Latin America, Barclays Capital. According to Molano and Welch, no country talks about dollarization when things are going well, and they gave Ecuador as an example. In 1999 Ecuador's inflation topped 60 percent, the economy shrank 7 percent, unemployment reached 17 percent, the currency plunged 67 percent against the dollar and the banking system collapsed. Ecuador responded by dollarizing. Molano argued that fiscal reform and privatization were needed—not dollarization.

Gavin countered by emphasizing that the most appropriate question for countries with weak fundamentals is which exchange-rate regime best limits the damage that can be done. Gavin said, "When the fundamentals are weak enough, simply avoiding a hyperinflation is the first imperative of macroeconomic policy. Nothing good has ever happened in an economy that is having a hyperinflation. Monetary integration—dollarization—clearly makes sense for the basket cases." Welch extolled a sound fiscal policy: "Fiscal policies are by far and away the most important. Once you get a reasonable fiscal policy, then you can go about dealing with these other issues."

The Wall Street session built upon a presentation by University of California at Berkeley professor Barry Eichengreen, who introduced the concept of timing. He explained that implicit in the dollarization debate are two very different views of when to dollarize: the dollarize-

Dollarization: A Limerick

There once was a
hyperactive central banker
Whose boat needed
a stronger anchor.
The ocean was big,
The boat was small,
So he tied his anchor
to a tanker.

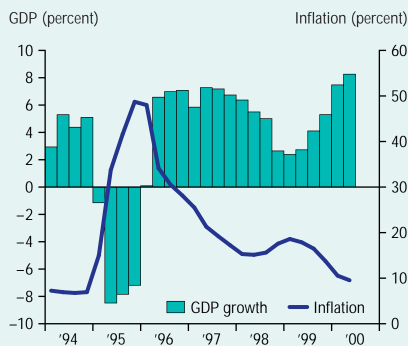
—*Bob McTeer*

The volatile circumstances surrounding small open economies… sometimes push exchange rates toward overvaluation.

Chart 1

Mexico's GDP and Inflation

(Annual growth rates)



SOURCE: Instituto Nacional de Estadística, Geografía e Informática.

last school and the dollarize-first school. The common view is that to work smoothly, dollarization must occur after major economic reforms are in place. This way, dollarization locks in reform. The dollarize-first school takes the opposite position. Since major reforms take time, dollarization should be instituted first, thus initiating reforms. This is Ecuador's approach. Some of Molano's concerns were substantiated by Eichengreen's models and data-based conclusion that reform should precede dollarization—or at least that dollarizing in advance of other fundamental reforms is risky business.

Though dollarizing before reforms might be risky, research by Andrew Rose, professor at the University of California at Berkeley, implies that it is a chance worth taking. In his presentation, Rose concluded, "The best estimate is that countries with the same currency trade over three times as much with each other as countries with different currencies."[1] Rose expounded on this increased trade's impact on growth by referring to the work of Frankel and Romer (1999).[2] They found that when the ratio of trade to GDP increases one percentage point, income per capita increases between 0.5 percent and 2 percent. Rose made a powerful argument for the possible welfare gains through growth via dollarization.

The Importance of Politics

University of California at Santa Barbara professor Benjamin Cohen added another dimension to Rose's argument. Cohen asked, "Why would any rational person oppose anything that might lead to lower interest rates, greater price stability, deeper financial markets, more trade?" His answer was no surprise: "Well, it is politics.…Politics does matter."

Cohen discussed sovereignty concerns, including the loss of seigniorage, which can often be a source of emergency income when other sources are harder to secure. Robert Stein, staff director, U.S. Senate Subcommittee on Economic Policy, and Kurt Schuler, senior economist, Joint Economic Committee, had addressed this issue earlier in the conference while explaining Mack's dollarization bill. The bill would allow the U.S. Treasury secretary to rebate quarterly 85 percent of lost seigniorage, the revenue the dollarized country would have earned by printing its own money. Although governments regain a percentage of their lost seigniorage, they are still limited by the bill's provision of quarterly rebates. Cohen is concerned that the inability to raise money quickly could add to a country's vulnerability, especially in times of national security threats.

Cohen also emphasized the vital role money plays as a national symbol. He said that most nation-states are not natural entities but are created and require nurture. Loyalty is fostered through a variety of national symbols: the flag, the anthem, sports teams, national language and money. Cohen warned that the psychological effects of adopting a foreign currency could include loss of a strong national identity. He cautioned that governments should take this seriously.

As the debate wound down, it became more evident that the obstacles to dollarization are at least as much political as they are economic. Carlos Menem, former president of Argentina, gave a compelling argument for dollarization in his keynote address. But Martín Lagos, vice governor of the Central Bank of Argentina, opened his presentation by saying that "the current Argentine authorities are not seeking any change in the currency arrangements or regime prevailing in Argentina since 1991." Regardless of how much Menem advocates dollarization, he is no longer president, and the current administration is not actively pursuing dollarization. This does not mean the issue is dead in Argentina. Menem quipped that he would be back in 2003 as president.[3]

Guillermo Ortiz, governor of the Bank of Mexico, likewise gave no indication that Mexico would give serious consideration to dollarization any time soon. Mexico began floating at the end of 1994 because it had no more reserves. Ortiz said he is now "convinced that the floating exchange-rate regime has been extremely good for Mexico." He pointed out that floating has not been an impediment to economic recovery or to reduction in inflation (*Chart 1*).

In closing, Dallas Fed President Bob McTeer told the audience dollarization was "about as close to a free lunch as you can get." Emphasizing that he was speaking for himself and not for the Federal Reserve, McTeer said, "Governments could get the benefits of greater price stability cold turkey without having to suffer decades of austerity to reach that point on their own."

—Sherry Kiser

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Copies of the dollarization conference speeches and papers can be found on the Dallas Fed web site at http://www.dallasfed.org/htm/dallas/events/dollarspeech.html

Notes

[1] Andrew K. Rose (Nov. 23, 1999), "Does a Currency Union Boost International Trade?" This paper is a nontechnical version of Rose's working paper, "One Money, One Market: Estimating the Effect of Common Currencies on Trade," which is forthcoming in *Economic Policy*. Rose's model is estimated using a data set with 33,903 bilateral trade observations spanning five different years. His sample contains 320 observations in which two countries trade and use the same currency.

[2] Jeffrey A. Frankel and David Romer (1999), "Does Trade Cause Growth?" *American Economic Review* 89 (June), pp. 379–99.

[3] When Menem was elected president in 1989, Argentina's economy was experiencing hyperinflation. In 1991, the Argentine Congress passed the Convertibility Law, which established a currency board-like system that forbids monetizing government deficits. Under a currency board, the monetary authority issues money against a foreign currency only at a fixed exchange rate. Since Argentina instituted the Convertibility Law, the exchange rate of the U.S. dollar and Argentine peso has remained pegged 1:1, and Argentina's average annual rate of inflation fell from 600 percent (1983–91) to 4.6 percent (1992–98). Menem left office in December 1999.