Why the US should encourage dollarisation

Senator Connie Mack spells out the benefits of official - as distinct from informal - dollarisation.

Until the breakdown of the Bretton Woods system in 1971, most of the world had a common monetary standard - gold. The years since have tested whether national currencies can deliver price stability without a link to gold. The US dollar is one of just a handful of successes.

Most other currencies, especially in developing countries, have performed poorly. Mexico's currency today is worth about a thousandth of its 1971 value in terms of the dollar; Russia's, 1/20,000th; and Brazil's, a trillionth. Unstable currencies have hindered these and other countries from growing as fast as they could have. As a result, their citizens are worse fed, clothed, and housed than they could be.

The complex quilt of monetary policies today is similar to what would happen if each state of the US had a different currency with a different monetary policy. The barriers to trade that currency risk imposes would fragment the nation into 50 separate and far less efficient markets instead of being the dynamic single market it is today.

Argentina's decision altered the political calculus

A way of achieving a similar kind of currency consolidation at the international level is official dollarisation - replacing a country's national currency with the dollar. Until recently, the political obstacles to dollarisation seemed so great even discussion was pointless. That changed in January 1999 when the government of Argentina announced it was actively considering dollarisation. Argentina's action sparked interest in dollarisation throughout the world, especially in Latin America, as a way of ending the currency turmoil affecting so many countries in recent years.

While dollarisation would make it possible for emerging market economies to enjoy the fruits of monetary stability and increased trade, it would also benefit the US. The US would gain from an expansion in trade due to lower transaction costs and fewer disruptions of our markets as the result of exchange rate devaluations by trading partners. By encouraging, though not forcing, official dollarisation, the US has an opportunity to lead the way to a more prosperous and better world.

Connie Mack a chairman of the US Senate's joint economic committee.

Distinction between official and informal dollarisation

Most US dollars already circulate outside the US. Researchers at the Federal Reserve have estimated that foreigners hold 55% to 70% of US dollar notes, mainly as $100 bills. A recent survey of selected developing countries by the International Monetary Fund found 52 countries where foreign-currency deposits were extensive. In most of those countries, the dollar was the foreign currency of choice, particularly in Latin America, the Caribbean, and the former Soviet Union.

Official dollarisation, also called full dollarisation, occurs when the dollar has exclusive or predominant status as legal tender. This means not only is the dollar legal for use in contracts between private parties, but the government uses it in payments. If domestic currency exists, it is confined to a secondary role, such as being issued only in the form of coins having small value.

The key benefits of full dollarisation

Moving from unofficial dollarisation to official dollarisation involves a change in quality, not just quantity. An economy that is 80% unofficially dollarised reaps far less than 80% of the benefits that would accrue from official dollarisation because uncertainty about the status of the dollar remains. Countries that have been unofficially dollarised have at times tried to de-dollarise by forcibly converting dollar bank deposits into domestic currency. Official dollarisation makes the status of the dollar far more certain by removing the domestic currency from the scene.

Only six independent countries are officially dollarised today: East Timor, Ecuador, Panama, the Marshall Islands, Micronesia, and Palau. (The last three are former US trust territories in the Pacific Ocean.) Official dollarisation in Argentina or in another country of similar population and GDP would be a giant leap in scale compared to countries where it now exists. Yet compared to the US, most other economies are small. Argentina's economy is nearly the same size as Michigan's - 3.4% of the US economy. The three largest state economies in the US, California, Texas, and New York, are larger combined than all the economies of Latin America together.

The International Monetary Stability Act

Countries derive a profit from issuing currency. Economists call the profit seigniorage. If a country substitutes the dollar for its domestic currency, the

Informally dollarised countries

Unofficially dollarised: Most of Latin America and the Caribbean, especially Argentina, the Bahamas, Bolivia, Haiti, Mexico, Peru, and Central America; most of the former Soviet Union, especially Armenia, Azerbaijan, Georgia, Russia, and Ukraine; various other countries, including Cambodia, Laos, Liberia, Mongolia, Mozambique, Romania, Turkey, and Vietnam.

Officially dollarised countries

Independent countries - East Timor, Ecuador, Marshall Islands, Micronesia, Palau, Panama; Non-US dependencies—Pitcairn Island (New Zealand), Turks and Caicos Islands (UK), British Virgin Islands (UK); US territories—Guam, Northern Mariana Islands, Puerto Rico, American Samoa, US Virgin Islands.

seigniorage is transferred from the dollarising country to the Federal Reserve System. Loss of revenue from seigniorage is one of the biggest obstacles to dollarisation. Argentina, for example, earns perhaps $750m a year from issuing pesos. Although this is only about one-quarter of one percent of Argentina's GDP, it looms large politically. It is equivalent to one-fifth of Argentina's national budget for education. A similar share of US GDP would be almost $25bn - enough to run the departments of Commerce, Interior, and State combined. Under existing arrangements, a country that officially dollarises loses all its seigniorage.

To remedy this situation, I have introduced the International Monetary Stability Act. Congressman Paul Ryan of Wisconsin has introduced a similar bill in the House of Representatives. My bill would authorise the US government to rebate to dollarising countries 85% of the extra seigniorage that the US would earn. The US would keep the remaining 15% to finance rebates to countries that are already officially dollarised (such as Panama), help pay the costs of operating the Federal Reserve, and leave a profit of perhaps 10%.

If a country chose to become officially dollarised, its central bank would take the assets that back its currency and convert them into assets such as US Treasury securities. The central bank would then sell the Treasury securities to the Federal Reserve in exchange for dollar notes. The country would use the dollar notes and coins to repurchase and retire the domestic currency from circulation. Dollars would entirely replace domestic currency, except to the extent that a country wished to continue issuing its own coins. Dollars would be used for taxes, wages, debts, and bank deposits, just as in the US.

Rebate of seigniorage

Dollarised countries would become eligible for a rebate of seigniorage upon being certified by the Secretary of the US Treasury. The Secretary would consider such factors as whether a country had made the dollar legal tender; whether it ceased issuing a national currency, except perhaps in the form of coins (like Panama); and whether its banking system was open to foreign competition. Certification would not be automatic: if the Secretary did not believe a country would uphold its part of the bargain, or for some other reason thought that certification would not be in the interest of the US, he could withhold certification. Certified countries would continue to receive a rebate of seigniorage as long as they stayed dollarised.

The formula for making rebates, and the other provisions of the bill, would apply uniformly to all certified countries. The provisions of the bill would constitute a standing offer by the US. Countries would decide to accept or decline the offer individually, but uniform provisions would eliminate much of the time and effort that would be involved if everything were a matter for fresh negotiation each time a new country wanted to dollarise.

No access to LOLR facility

The US would assume no responsibility for supervising banks in dollarised countries, their banks would not have access to the Federal Reserve as a lender of last resort, and the Federal Reserve would not be obliged to consider their economic conditions when making monetary policy. These conditions are not as harsh as they may first appear. The first two go together. The Federal Reserve acts as a lender of last resort within a framework of laws and supervisory standards specific to the US. The framework gives it the clout to discipline banks when necessary. Other countries have different frameworks; because of the differences, were the Federal Reserve to extend abroad its role of lender of last resort, it would be unlikely to have success imposing the type of discipline it can in the US. It is more practical for a dollarised country to be responsible for supervising its own banks.

As for the third condition, Federal Reserve Chairman Alan Greenspan has remarked that even when monetary policy in the US is at its tightest, interest rates are lower than the lowest rates that typically prevail in many other countries. The credibility that the Federal Reserve has built up enables the US to have interest rates that are lower, year in and year out, than those of many developing countries.

Advantages for the US

Under the International Monetary Stability Act, official dollarisation would result in a gain of revenue for the US government because more people would use dollars. The gain is one that would not otherwise occur, because the prospect of losing all seigniorage has been a significant deterrent to dollarisation. Until East Timor and Ecuador this year, no independent country had switched from another currency to the dollar since Panama in 1904, although some former US trust territories in the Pacific retained the dollar after becoming independent.

The net gain of revenue to the US government would be relatively small. If Argentina were to dollarise, for instance, the net gain would probably be less than $100m a year initially. Far more important would be the broad long-term political and economic benefits resulting from a more solid international financial system. Because dollarised countries would not devalue against the dollar, dollarisation would reduce political tensions in international trade. Large, unexpected devaluations of other currencies against the dollar give foreign exporters a temporary advantage in the US market, because typically it takes some months for the wages they pay their workers to increase as much as the value of the currency has decreased. In the short term, US manufacturers feel penalised by the policy of a stable dollar, even though they understand its long-term benefits. Some complaints about the “dumping” of foreign goods (selling them at a lower cost than in their home markets) come about because of the effect that devaluations have. Eliminate the devaluations and you eliminate those complaints.

In recent years the US has been an oasis of monetary stability and solid economic growth, but currency crises abroad have affected even our financial markets, causing interest rates at times to be more volatile than they otherwise would have been. Had the crisis countries been dollarised, no currency crises would have happened.

Dollarisation is being most discussed in Latin America, where it has significant long-term implications for international trade. The US is the largest or second-largest trading partner and source of investment for most countries in the region, but the US trades more with Canada’s 31 million people than with Latin America’s 500 million people. The proximity of Canada is important, but at least as important is that the average Canadian can afford to buy far more US goods than the average Latin American. If Latin America would grow more quickly with an assist from dollarisation, becoming closer to the standard of living in Canada or the US, US trade with Latin America could grow by leaps and bounds. That would mean more jobs for Americans to produce the goods Latin Americans could afford to buy.

Advantages for dollarising countries

Official dollarisation offers several broad classes of advantages for dollarising countries. One is lower transaction costs. Official dollarisation would eliminate transaction costs with the US and other countries using the dollar. Businesses would no longer have to hedge against currency risk in trade with those countries. Dollarisation would even reduce the transaction costs with other currencies. Large transactions between, say, the Peruvian sol and the Japanese yen occur in two legs - a sol-dollar trade and a dollar-yen trade - because those markets are so big and efficient that using them costs less than making a direct sol-yen transaction. Dollarisation would reduce the costs of Peru's transactions with Japan because it would eliminate one leg of the trade.

A second class of advantages would come from lower inflation now and lower risk of future inflation. Dollarisation would reduce inflation to single digits from the double-digit levels that many developing countries now have. Because confidence exists that inflation in the dollar will continue to be low, interest rates on loans in dollars are lower and steadier than rates on loans in most other currencies. Lower interest rates would help promote investment and growth in dollarised countries.

Dollarisation may reduce sovereign risk

In many countries that are highly dollarised unofficially, people can make bank deposits and obtain loans in dollars. It has been claimed that dollar interest rates in those countries are already as low as they can go, and that official dollarisation would not reduce them because it would not reduce the country risk of lending. In the absence of a test case we cannot be certain, but it is likely that dollarisation would in fact reduce country risk to some extent because it would make property rights more secure. Money is the most widely held form of property. Inflation is a kind of tax on money, and the lower and less variable inflation is, the more secure property rights are in money. Governments that officially dollarise would be unable to levy the inflation tax. This limit on inflation would encourage saving and long-term lending.

Panama's dollarisation a success

The experience of Panama is consistent with this view. The only country in Latin America that is officially dollarised, Panama has generally had the lowest interest rates in the region. Panama is also the only country in the region where 30-year fixed-rate mortgages are available in the local currency without government subsidies - the local currency there being the US dollar.

Low inflation would help retirees, people on fixed incomes, and people too poor to have bank accounts by assuring that their savings would retain value. Too often, inflation hurts the least well off. Official dollarisation would protect their purchasing power.

A final class of advantages would come from greater economic openness and transparency, especially on the part of the government. Because there would be no domestic currency that needed to be propped up, official dollarisation would eliminate balance of payments crises and the rationale for the exchange controls that many developing countries have. By eliminating the government's power to create inflation, dollarisation would foster budgetary discipline. That need not mean that the government budget must be balanced every year - Panama has run large deficits at times - but deficits would have to be covered by raising taxes or issuing more debt, which are more transparent and more politically accountable methods than printing money.

The disadvantages of full dollarisation

Against these advantages, there are two potential disadvantages. The first is the loss of an independent monetary policy. However, bad independent monetary policies have been one of Latin America's most consistent problems.

The second potential disadvantage of official dollarisation is the loss of a central bank as a lender of last resort to the domestic financial system. However, dollarised countries could undertake substitute measures to strengthen the liquidity of their financial systems. The most important is to open their financial systems to foreign competition. Large international banks are sufficiently diversified that they do not fail if economic conditions are difficult in Argentina or Panama or Mexico. The presence of international banks has made Panama's banking system very stable. Because the banks can lend in dollars and incur no local currency risk, they are willing to lend at relatively low rates to Panamanian banks of suitable quality.

Dollarised countries could also strengthen the liquidity of their financial systems by establishing lender of last resort facilities outside their central banks. For example, Argentina's currency board-like system has a $7bn emergency line of credit with international banks.

The politics of dollarisation

A possible concern about official dollarisation from the standpoint of the US is that dollarised countries might put political pressure on the Federal Reserve to conduct monetary policy in their interests regardless of our economic situation. However, according to Federal Reserve Chairman Alan Greenspan, the Federal Reserve already receives foreign pressure, but the pressure does not influence it to help other countries at the expense of the US. At a hearing of the Senate Banking Committee in April 1999, Greenspan testified that official dollarisation would not make the Federal Reserve more apt to readily take such actions.

The International Monetary Stability Act would leave each country with the choice of whether and when to dollarise. This is as it should be. The US should welcome interest in official dollarisation and cooperate with countries seeking to dollarise. However, no country should be pressured to dollarise, nor should countries desiring to continue with an independent monetary policy be discouraged from doing so.

Enhanced price stability and international liquidity

An attractive feature of dollarisation is that it would enhance price stability and international liquidity without multilateral agreements or grants of power to international organisations. A country could dollarise independently of the choices made by its neighbours and other countries around the world. Of course, the more countries that chose to use the dollar, the greater the benefits would be from joining them. Expansion in the use of the dollar, however, would be achieved in a gradual, evolutionary manner. A gradual approach would enable us to learn whether dollarisation had any unexpected effects and to address them in future cases.

A global currency?

Many commentators perceive a trend toward three large currency blocs, based on the dollar, the euro, and the yen. Dollarisation would allow the consolidation of currencies to happen at a pace compatible with national political readiness to accept a common currency and thereby move further into the mainstream of economic globalisation. Unlike the project of establishing the euro, it would not impose detailed economic targets as conditions nor would it require a march in lockstep to arrive at a common currency. Each country could take its own approach and proceed at its own speed.

Reduced role for the IMF

Widespread dollarisation would largely eliminate currency crises. By eliminating currency crises, widespread dollarisation would also eliminate the need for international institutions to make the detailed and highly controversial interventions in national economies that have been part of recent currency rescue packages.

The currency crises of recent years have generated much debate among economists about whether there is a single best monetary policy for developing countries, and if so, what it is. As a practical matter, it is not necessary for the US government to take any official position on whether official dollarisation is that policy. We can let countries interested in dollarisation decide whether they perceive it as being in their own interest. Under the International Monetary Stability Act, we also would retain the ability of deciding whether dollarisation was in our interest, because the Secretary of the Treasury could refuse to certify a dollarising country if he or she thought that sharing seigniorage might be harmful.

It is noteworthy that so many countries already have extensive unofficial dollarisation. Their citizens have voted with their wallets in favour of the dollar. The idea of monetary sovereignty is a relic of the days when kings were absolute rulers. It does not fit with modern ideas of liberty and the market economy. A market economy emphasises freedom of choice. People should be free to use whatever currency best suits their needs, whether the currency is domestic or foreign. As with the idea of dollarisation, though, the US can espouse freedom of choice in currency while refraining from trying to impose the idea on other countries.

Money as "coined liberty"

It has been said that money is coined liberty. Money gives people freedom of choice, freedom to innovate, freedom to enjoy the fruit of their labours. An untrustworthy currency is a kind of robbery. By limiting the usefulness of money, it limits choice, innovation, and investment.

The US is fortunate to have a currency with one of the best long-term records in the world. We now have the opportunity to share the stability of the dollar with other countries, to our benefit and theirs. The benefits will be measured not just in terms of GDP, but in terms of fulfilling human potential. The accumulation of wealth that a trustworthy currency permits enables children to have better educations, families to take out longer-term mortgages for homeownership, and retirees safety for their accumulated savings. By taking leadership on official dollarisation, the US can advance prosperity and liberty the world over. □