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DOLLARIZATION IN LATIN AMERICA: MUCH ADO ABOUT NOTHING

The 2000-2001 period saw Ecuador and El Salvador adopt the dollar as their national currency. The decision was to trigger much criticism, undermining the enthusiasm of a number of developing countries prepared to relinquish a degree of independence in return for more stability and credibility. But what does the Latin American experience tell us about dollarization? Does the use of another country's currency go hand in hand with additional costs in terms of economic performance? And do these costs outweigh the benefits resulting from greater stability?

Generally speaking, financial crises result in drastic reforms designed to restore market confidence. For example, at beginning of the decade, Ecuador decided to give up its monetary sovereignty and adopt the US dollar as its national currency in an attempt to weather the fallout from a turbulent international environment. Yet urgency is not necessarily a good counselor and it was under a barrage of criticism that Ecuador, followed by El Salvador, opted for dollarization. Sebastien Edwards, for example, asserted that "the recent push for dollarization is a typical case of misleading advertisement"[1]. For his part, Barry Eichengreen considered that "dollarization by countries in the throes of a crisis is a high-stakes gamble"[2]. But there were others who were more than keen to vaunt the merits of such a radical measure. For Alberto Alesina and Robert Barro, in particular, there was an inexorable aspect to dollarization that, in the coming decades, was bound to translate into a "transition toward a world in which the number of currencies is much less than the number of countries"[3]. A few years later, the reality is that the very few countries that have chosen dollarization as the way forward do not appear to want – or be able – to turn back the clock. But other countries have not followed suit. What lessons can we now learn from the Latin American experience of dollarization?

How dollarization came into being in Latin America

Dollarization in Latin America can be traced back a little over a century to Panama and the "dollar diplomacy" driven by the US President Theodore Roosevelt. The secession of the Colombian territory in 1903, effectively gave the USA control over Panama's principal source of wealth, the trans-oceanic canal. It imposed its own currency, the balboa representing nothing more than a division of the American dollar and only circulating in coin form. The massive influx of green dollar bills associated with operating the canal as well as access to international financial markets played a major role in securing the system's long-term future.

1. S. Edwards (2001), "Dollarization: Myths and Realities", UCLA and NBER, mimeo.
2. B. Eichengreen (2002), "When to Dollarize", *Journal of Money, Credit and Banking*, 34(1), pp. 1-24.
3. A. Alesina & R. Barro (2001), "Dollarization", *American Economic Review*, 91(2), pp. 381-385.

Nearly a century later, it was Ecuador's turn to "jump into the abyss", as President Jamil Mahuad described it. 1999 saw the country fall into a deep recession, triggered in particular by tumbling oil prices and the repercussions of the Asian financial crisis. On October 1st, 1999, in the face of crippling deficits, the country's leaders were forced to issue a moratorium on some of its debt payments, leading to a widespread crisis of confidence. Powerless to defend the exchange rate, the monetary authorities decided to allow the national currency – the *sucre* – to float, thereby worsening the devaluation-inflation spiral. In this climate of uncertainty, on January 9th, 2000, President Mahuad presented his dollarization plan, without informing the American monetary authorities beforehand. With the exchange rate established at one dollar to 25,000 *sucres*, the Ecuadorian currency recorded a 400% devaluation compared with August 1998. On March 13th, the Ecuadorian Congress approved the dollarization law and, on September 10th, the sucre ceased to be the official currency (the sucre is now only used for very low-value transactions). Today, the Ecuador Central Bank no longer issues money but it does continue to supervise the banking system. In this capacity, it manages reserve funds fed by a compulsory levy on deposits collected by all of the country's financial institutions; the fund is intended as a source of liquidity should the need arise.

In stark contrast to the case in Panama and Ecuador, the economic environment in El Salvador was relatively healthy when dollarization occurred, with neither excessive public debt, nor spiraling inflation. After the peace agreements were signed in 1992, the country had enjoyed sustained GDP growth: +4.7% on average between 1992 and 2000. However, with a balance of payments deficit amounting to around 14% of GDP, El Salvador was heavily dependent on outside capital, which was reflected in high interest rates. Dollarization was thus seen as a way of reducing the risk premium and attracting foreign capital, particularly from El Salvadorians living abroad. On November 22nd, 2000, El Salvador adopted a law pegging the colon/US dollar exchange rate at 8.75 colons to the dollar and bringing the dollar into general use. On January 1st, 2001, the dollar became the official currency via the "monetary integration law".

The dollarization debate

The daily use of a single currency plays a role in national sentiment: in much the same way as language, it creates a link between different members of society. But beyond national identity, the abandonment of a currency gives rise to a relationship of dependence with the country of attachment. The most striking example of the dangers of this type of relationship is Panama. In 1988, the United States launched a campaign designed to oust General Noriega, who was accused of corruption and drug trafficking. Transfers of dollars to Panama were blocked while Panamanian assets in US banks were frozen. The result was a shortage of US dollars which triggered a serious economic crisis. Although extreme, this example illustrates the political dependence of the dollarized counties. And this comes on top of the loss of strictly monetary independence. Dollarized economies are inevitably linked to US economic cycles: if the United States is at the top of its cycle while Latin America is in the midst of a recession, rising American interest rates can have a detrimental impact on economies that in fact require an accommodating monetary policy.

However, the loss of monetary sovereignty also eliminates the problem of time inconsistency in discretionary policies. More than the "constitutionalization" of an inflation target, the independence of the central bank or the adoption of a currency peg, dollarization may represent an effective means of establishing credibility and accessing the reputational capital of the United States. The confidence associated with the dollar in international markets acts as a magnet for foreign investments. *De facto* adoption of the Fed's monetary policy goes hand in hand with its credibility and promotes – thanks to the removal of the risk premium attached to the national currency – alignment with US interest rates.

In addition, by adopting the dollar, a country puts an end to uncertainties created by exchange rate fluctuations and protects itself from the risk of devaluation. It should also be emphasized that dollarization represents an advantage over a fixed exchange rate, or indeed the existence of a currency board, because it

Box – Dollarization: a many-sided process

Dollarization refers to a situation whereby the national currency of a country is replaced by a foreign currency, and not necessarily the dollar (when talking about the Euro, we could use the term "euroization").

Full dollarization involves the definitive abandonment of the national currency. Prices, wages and contracts, etc. are defined in the foreign currency. And where the local currency subsists, it is only used for very small transactions. Only a very few countries have given up monetary sovereignty in this way. In addition to Ecuador, Panama and El Salvador, Micronesia and East Timor also use the American dollar. In Europe, Kosovo and Montenegro have abandoned their currencies to unilaterally adopt the Euro.

Partial (or informal) *dollarization* is a response to a loss of confidence among economic agents vis-à-vis the national currency. The foreign currency has a refuge value. "Financial" dollarization gives rise to significant asset substitution, either in the form of the purchase of foreign shares, or via the opening of currency bank accounts. The process contributes to the loss of purchasing power of the national currency, which in turn leads to "monetary" dollarization, *i.e.*, the acquisition of foreign currency payment methods: notes and bank accounts in dollars (or in euros). Unlike full dollarization, partial dollarization is very widespread, particularly in developing countries.

eliminates any uncertainty about the ability of the authorities to maintain such a system.

However, adopting the dollar as the national currency has negative implications in terms of competitiveness. The majority of Latin American trade flows towards the United States. Given the technological advance of US producers, the competitiveness of Latin American exporters inevitably boils down to prices. Yet by abandoning exchange rates as an instrument, these countries find themselves on a level playing field – in monetary terms – with US producers. This leads to a real risk of a deflationary bias. This is because when faced with a current account balance of payments deficit, dollarized economies have to turn to wage flexibility – and hence deflation – to re-establish their competitiveness and restore their external trade balance. If the country is faced with excessive wage rigidity, the adjustment variable then becomes unemployment. In this sense, the stability and credibility offered by dollarization may well be obtained at the expense of strong economic growth.

Table 1 – Comparative macro-economic performances (1993-2008) – average annual %

Country	GDP growth		Inflation		Unemployment		Deposit interest rate	
	1993-2000	2001-2008	1993-2000	2001-2008	1995-2000	2005-2008	1993-2000	2001-2008
Central America	40	4.7	10.1	7.4	12.9	8.9	12.4	7.2
Costa Rica	4.8	5.5	13.7	11.3	17.1	12.0	17.6	9.2
Guatemala	4.1	4.0	9.0	7.9	7.2	8.5	10.9	5.4
Honduras	2.5	5.3	17.8	8.0	20.3	8.2	14.6	11.0
Nicaragua	4.9	3.4	12.0	9.6	11.2	12.4	11.4	6.4
Panama	4.0	7.2	1.1	3.2	15.9	7.2	6.9	4.1
El Salvador	4.0	3.0	6.9	4.1	6.0	5.1	13.2	n.d
South America	2.7	4.7	69.7	8.4	9.8	9.1	247.2	9.8
Argentina	2.2	5.5	2.2	11.7	16.3	9.6	151.4	12.2
Bolivia	3.8	4.1	7.3	5.9	5.6	7.9	18.2	6.9
Brazil	2.9	3.9	518.9	7.2	5.9	9.3	1864.6	16.0
Chile	5.3	4.3	7.3	3.7	8.6	7.9	16.9	4.6
Colombia	2.1	4.9	18.0	5.9	13.1	12.4	28.1	8.5
Ecuador	1.6	4.9	41.8	5.6	8.4	7.7	33.6	5.0
Paraguay	1.1	3.9	12.0	9.1	7.7	7.9	19.4	9.6
Peru	4.8	6.7	14.8	2.5	8.4	8.7	250.7	3.6
Uruguay	2.3	4.5	26.3	9.9	12.0	10.3	59.1	16.3
Venezuela	0.8	4.7	48.0	22.1	12.1	9.6	29.7	15.4

Source: CEPAL, author's figures.

Dollarization in practice

Although the theoretical literature clearly highlights the existence of a trade-off between sovereignty and credibility, the economic performances of Latin American countries over the last decade shed little conclusive light on the dollarization debate (tables 1 and 2). The abandonment of the sucre in 2000 enabled Ecuador to bring stability to its economy thanks to a rapid fall in its inflation rate (96% in 2000, 12% in 2002, 2% in 2005), and quickly restore market confidence (direct foreign investments increased by 85% between 2000 and 2001). But over the longer term, Ecuador's results are similar to those of its neighbors. For the period 2001-2008, the inflation rate (5.6%) was below the South American average (8.4%), but other countries fared just as well, if not better (Chile and Peru). Deposit interest rates are also lower in Ecuador than in the majority of other countries in the region, but dollarization does not appear to have had a decisive impact in this respect. Likewise, Ecuador does not seem to have suffered either in terms of economic growth (+4.9% on average between 2001 and 2008), or unemployment (7.7%) since these performances are in fact better than the regional average (4.7% and 9.1% respectively). Yet they are not particularly spectacular performances in the region. As far as the current account balance of payments is concerned, although showing a slight deficit for the period 2001-2008, it has improved considerably in recent years (between 3 and 4 percent of GDP between 2006 and 2008). In this respect, it should be specified that dollarized economies have taken full advantage of a significantly depreciated dollar, making them far more competitive abroad (even in the United States where these economies are competing with non-dollarized economies).

In Central America the situation is one of contrasts. Panama stands out from other countries with respect to its inflation rate (3.2% average between 2001 and 2008) and interest rate (4.1%) – lower than those of its neighbors –, its higher GDP growth (+7.2%) and its lower unemployment (7.2% of the working population). As far as El Salvador is concerned, its inflation rate (4.1%) is below the regional average (7.4%), but its annual growth rate (3%) is below the regional average (4.7%). And

Table 2 – External trade (1993-2008) – in % of GDP

Country	Current account		Net FDI	
	1993-2000	2001-2008	1993-2000	2001-2008
Central America	-7.5	-6.7	3.2	4.3
Costa Rica	-4.2	-4.8	3.2	4.3
Guatemala	-5.3	-5.3	1.2	1.3
Honduras	-5.6	-6.0	2.1	5.3
Nicaragua	-23.6	-16.4	4.6	5.1
Panama	-4.8	-4.2	6.3	7.0
Salvador	-1.6	-3.6	1.8	2.7
South America	-2.7	1.9	3.0	2.5
Argentina	-3.6	3.5	2.5	1.7
Bolivia	-5.8	4.0	7.2	3.1
Brazil	-3.0	0.0	2.1	1.9
Chile	-3.1	1.3	3.8	4.3
Colombia	-3.0	-1.5	1.9	2.7
Ecuador	-1.9	-0.4	3.3	2.8
Paraguay	-2.8	0.9	1.9	0.9
Peru	-5.7	0.0	4.0	3.2
Uruguay	-1.9	-0.5	0.8	3.7
Venezuela	3.6	11.2	2.5	0.4

Source: CEPAL, author's figures.

it is probable that the low rate of unemployment (5.1%) can be explained by a high emigration rate. In terms of external trade, El Salvador and Panama boast the region's best current account performances, partly due, as already mentioned, to the depreciation of the dollar in recent years. Conversely, although FDI accounts for a significant proportion of Panamanian GDP, El Salvador is still struggling to attract foreign capital, thereby endorsing the fact that dollarization is not enough in itself to change a country's international image and that radical reforms of the economic environment are required.

"De-dollarization" unlikely

The current economic crisis seems to add weight to the argument that no real differences exist between dollarized and non-dollarized economies. According to the latest IMF forecasts (October 2009), the GDP of El Salvador is likely to fall by 2.5% in 2009 while that of Panama is set to grow by 1.8%. Economic activity for Central America as a whole is likely to decline by 0.7%. In South America, Ecuador (-1%) falls within the regional average (-0.8%), while Paraguay (-4.5%) and Bolivia (+2.8%) represent the two extremes. Beyond short-term advantages, particularly in terms of emerging from a widespread crisis of confidence, dollarization does not appear to have been either an asset or a handicap.

Other Latin American countries, such as Argentina, Bolivia and Brazil, have also demonstrated that it is possible to tackle financial and exchange rate crises without necessarily having to resort to giving up monetary sovereignty. Hitherto, inflation targeting policies have proved effective in terms not only of tackling inflation, but also – by extension – establishing exchange rate stability. Similarly, financial sector, public finance and job market reforms have contributed more to the economic success of Latin America in recent years than a dollarization process, the potentially damaging effects of which with respect to competitiveness have thus far been limited by the depreciation of the dollar (but what would happen should the trend be reversed?)[4].

And it is on this issue that the current status quo on dollarization is significant: countries that have maintained monetary sovereignty despite the crises they have had to deal with, are reluctant to follow the experience of their neighbors when it comes to dollarization, not so much in terms of the overall cost of such a decision itself as because of the few benefits to be derived from it. However this does not mean that a dollarized country can easily turn the clock back. Movements to defend monetary sovereignty – particularly vehement in a country like Ecuador – have faded away and even the likes of President Rafael Correa, a keen advocate of anti-Americanism, has committed to maintaining the current monetary system. In addition to the costs associated with reintroducing a national currency together with an independent monetary authority, no government would like to risk a "de-dollarization", that would, in all likelihood, go hand in hand with a new period of monetary instability and capital outflow.

David Khoudour-Castéras
david.khoudour@cepii.fr

4. With the continuing economic crisis, most Latin American currencies have appreciated against the dollar in recent months, thereby reinforcing gains in terms of the competitiveness of dollarized economies.

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EDITORIAL OFFICES
Centre d'études prospectives
et d'informations internationales
9, rue Georges-Pitard
75015 Paris
Tél. : 33 (0)1 53 68 55 14
Fax : 33 (0)1 53 68 55 03

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La Documentation française
124, rue Henri Barbusse
93308 Aubervilliers Cedex
Tél. : 01 40 15 70 00

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