

# Why Dollarization Is More Straitjacket Than Salvation

by Jeffrey Sachs and Felipe Larrain

**T**he recent wave of financial crises has prompted some observers to argue that developing countries should abandon their own currencies and instead adopt the U.S. dollar (or perhaps the euro or yen, depending on their location). This conclusion is unwarranted, even reckless. Dollarization is an extreme solution to market instability, applicable in only the most extreme cases. The opposite approach—a flexible exchange rate between the national currency and the dollar—is much more prudent for most developing countries, including those hardest hit by recent crises.

There are two main arguments in favor of flexible exchange rates and two main arguments in favor of fixed ones [for exactly what is meant by flexible and fixed, see “A Guide to Exchange Rate Regimes” pp. 70–71]. The first argument for flexibility is that an exchange rate depreciation (or appreciation) can act like a shock absorber for an economy. Take the case of an oil exporter, faced with declining prices. The drop in oil revenues would lead to weaker demand for a range of domestic goods and services, an overall slowing of the economy, and a rise in unemployment. Under a fixed exchange

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rate system (e.g., dollar-peso) one solution would be for wages to decline, so that non-oil industries would be able to cut prices in world markets and thereby increase sales. But as economist John Maynard Keynes famously pointed out over 70 years ago to Winston Churchill, then chancellor of the exchequer, that would be a messy business. It would require the renegotiations of thousands of separate wage contracts, and any such wholesale drop in wages would likely be accompanied by severe social stress. A much simpler solution would be to allow the peso to depreciate *vis-à-vis* the dollar. By changing just this one price (the number of pesos per dollar), all of the country's export products would suddenly become cheaper in world markets and therefore more attractive to foreign buyers. Increased demand for the country's non-oil exports would compensate for the fall in oil earnings, the shock would be absorbed, and the economy would continue to hum.

The second argument for flexible exchange rates is that what is good for the United States is not necessarily good for other countries. For legitimate reasons of its own (perhaps to lend pesos to the government to cover a budgetary shortfall, or perhaps to spur the domestic economy), country X may need a monetary expansion even if the United States does not. Under a fixed exchange rate system, this policy will lead immediately to a decline in reserves and eventually to a reversal of the monetary expansion itself (since the central bank has to reabsorb the public's increased holdings of pesos, as the counterpart to the sale of its dollar reserves). A country that pegs its currency to the dollar is, in effect, tying its monetary policy wholly to U.S. monetary policy. That decision makes sense only if U.S. monetary policy is wholly appropriate for its national economy, which is rarely the case.

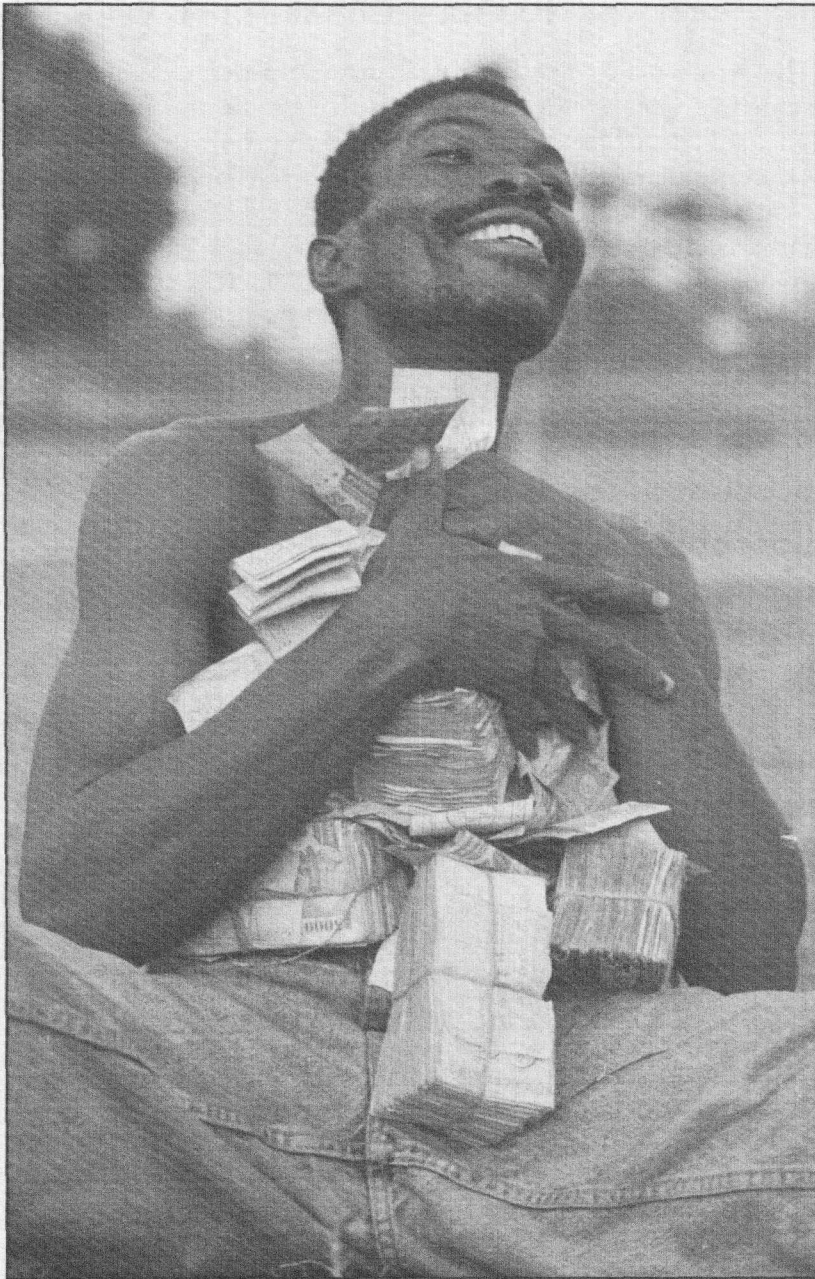
The main argument for a pegged exchange rate system, by contrast, is that it enforces discipline. If an irresponsible central bank is given freedom to issue pesos without worrying about the consequences for the exchange rate, it will simply print pesos to its heart's content to fund a large budget deficit or to provide cheap credits to the banking system. These will be popular moves in the short run, but they will soon lead to inflation and a collapsing exchange rate. All prices, including the price of dollars in terms of pesos, will soar. In this light, a fixed exchange rate system forces the central bank to avoid issuing excessive pesos, since doing so will deplete its reserves. A currency board is an even tighter form of pegged-rate discipline,

since the central bank is not allowed to issue credits to the government or to the private sector.

The second argument for a fixed exchange rate system is equally straightforward: A stable exchange rate reduces business transactions costs. There is no risk in changing currencies if the exchange rate remains stable, and the costs of switching between the peso and the dollar (measured by the difference between the buying and selling price in the currency market) are also likely to be very low. Business executives like the certainty they associate with a pegged rate.

Thus, in theory at least, flexible rates are appropriate in some conditions and fixed rates in others. A flexible rate is probably better if a country is often hit by shocks to its exports—for instance, by sharp price fluctuations. A fixed rate is probably better if shocks to the economy are rare or relatively small, or if the central bank or government either is politically irresponsible or lacks strong institutional controls.

Where you stand on flexible versus fixed rates may depend on where you sit. Businesspeople naturally tend to prefer the predictability promised by stable exchange rates, and it is true that some elements of the Mexican business community have come out in favor of dollarization. But businesspeople may underestimate the indirect costs, such as higher unemployment, which can result when the central bank pursues exchange rate stability to the exclusion of other goals. They also tend to forget that a pegged exchange rate is a conditional promise, not an unconditional guarantee: The exchange rate might still collapse, even if the central bank does everything in its power to prevent that from happening. If enough households and businesses try to convert their pesos to dollars, for example, the central bank will almost surely run out of reserves, since the number of pesos in circulation plus bank deposits is almost always higher than the dollar reserves held at the central bank. If bank depositors and currency holders try to shift out of pesos and into dollars en masse, only one of two things can happen: Either the banks will become illiquid, unable to provide the pesos to households that want to remove their funds, or the central bank will run out of reserves as it sells dollars in return for the public's mass flight from pesos. Of course, both a banking crisis and a currency collapse can occur together. That, indeed, is what has happened in many countries in the last three years. A currency board can help prevent this scenario, but it cannot stave it off altogether if households and businesses are determined to convert their holdings into dollars.



**Fatal embrace? A Zairean truck driver clutches his zaires in 1997.**

## EXPERIENCE FAVORS FLEXIBLE RATES

The arguments against fixed exchange rates were vividly demonstrated 70 years ago by the problems that the nearly universal gold standard created for countries at the onset of the Great Depression. Countries that needed to increase their money supplies in 1929–32 to fight the growing depression—but that found themselves strapped into a gold straitjacket—tightened monetary policy rather than loosening it, despite surging unemployment. Only as countries left the gold standard one by one in the 1930s did their economies begin to recover from the global crash.

Seventy years later, we have again seen many countries bound to the dollar standard undertake extremely contractionary policies to preserve the pegged exchange rate at the cost of high unemployment and falling domestic output. Although in theory fixed exchange rates may be appropriate under some conditions and flexible rates under others, recent practical experience suggests that most emerging markets are better off with the latter.

First, many countries in the last several years have been unable to resist the pressure that builds up when markets come to expect that their exchange rates will depreciate. Mexico in 1994, Thailand and South Korea in 1997, and Russia and Brazil in 1998–99 all experienced the collapse of pegged exchange rates, even though the governments and central banks were committed to defending them to the bitter end of reserve holdings. Expectations of a currency collapse can become a self-fulfilling prophecy. As rumors of a currency depreciation circulate, money holders convert their pesos into dollars, since they do not want to be caught holding pesos that are going to fall in value. The rush out of pesos is often greater than the reserves held by the central bank; the central bank is then unable to mount an effective defense.

Second, a failed defense can be very costly. A country will find itself in serious trouble if its central bank runs out of reserves trying to defend the national currency. In such scenarios, foreign banks often flee, knowing that they will no longer be protected if something goes wrong. If a domestic bank collapses, for example, the central bank will not have the dollars to help that bank meet its foreign obligations. In Mexico in 1994, and in Thailand and South Korea in 1997, the collapse of the pegged exchange rate was followed by a financial panic, in which foreign banks abruptly demanded repayment of loans. Domestic banks could not meet the demands and had to default.

Third, U.S. monetary policy is seldom appropriate for countries whose currencies are pegged to the dollar. For several years, the U.S. economy has been booming. With high rates of return in the United States and the excitement of the information technology (IT) revolution leading to a surge of new IT investments, capital has flowed into the United States from the rest of the world, and the dollar has surged in value relative to the euro and the yen. Therefore, developing countries that pegged their currencies to the U.S. dollar (such as Thailand until July 1997 or Brazil until January 1999) have also seen their currencies soar in value relative to the euro and the yen. But what was good for America was not so good for these other economies. They needed weaker currencies to maintain their export competitiveness. To keep their currencies linked to the

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dollar, they had to tighten their monetary policies, even though that was not called for by their economic conditions. The defense of rates pegged to the dollar helped bring on recessionary conditions in a number of countries, including Brazil, Russia, South Korea, and Thailand.

Fourth, many emerging markets have experienced sharp declines in world prices for their commodity exports. Especially after the start of the Asian Crisis in 1997, countries selling oil, timber, gold, copper, and many other primary commodities experienced a sharp loss of income. They needed either a currency depreciation or a fall in wage levels. The first is typically easier to achieve, but during the Asian Crisis it was often blocked by commitments to maintain a pegged exchange rate. Commodity exporters such as Argentina and Venezuela, which suffered terms-of-trade losses on world markets but whose currencies were pegged to the dollar, ended up with sharp rises in unemployment and sharp declines in real economic output. The case for exchange rate flexibility is even stronger if we look at Australia and New Zealand, which depend to a large extent on commodity exports. When these economies were hit by sharp declines in commodity prices in the wake of the Asian Crisis, their floating exchange rates helped them absorb the shocks without significant damage to domestic output and employment.

A fifth point seals the practical case against fixed exchange rates in most countries. One vigorous argument has been that central banks cannot be trusted with floating exchange rates—that they will simply print too much money if given the chance. Pegged rates, or even dollarization, are seen as the remedy to chronic, irremediable irresponsibility. Although many developing-country governments or central banks are certainly not blameless, their actual practices are much less irresponsible and irremediable than often claimed. Countries with significant degrees of exchange rate flexibility, such as Chile, or Mexico since 1995, have actually behaved responsibly, keeping money growth low and inflation under control, even without the straitjacket of a pegged rate or dollarization.

### **WHAT MAKES DOLLARIZATION DIFFERENT?**

If a country abandons its national currency in favor of the U.S. dollar, the result is very much like a pegged exchange rate, only with less room to maneuver. First, of course, there is no longer the “shock absorber” of exchange rate depreciation. The only alternative is a cut in wage levels, which is likely to be a long, drawn out affair, with lots of interim unemployment. Second, there is no scope for independent monetary policy. Monetary policy would be determined in Washington, by the U.S. Federal Reserve Board. Having the Fed make such decisions is a good thing if the national central bank involved is highly irresponsible. But it is a bad thing if the country needs a more expansionary monetary policy than the Fed wants to provide. (It hardly needs emphasizing that the Fed will choose monetary policies based on U.S. conditions, not on the conditions of the dollarizing country.)

There are, however, some important differences, both positive and negative. One sharp minus to dollarization is its cost. In opting to dollarize, a country would be forgoing its seignorage, the income it receives when the value of its currency exceeds the cost of producing the currency. Instead of making a profit from its national currency, the dollarizing country would be faced with the expense of buying dollars to swap for its national pesos. It would have to pay for these dollars either with its foreign reserves or with money from a large dollar-denominated loan. Either way, the cost in terms of forgone interest payments on its reserves, or new interest payments on its borrowings, would be significant. Argentina, for example, would have to spend \$15 billion initially to swap its peso currency notes for U.S. dollars. As the economy grows and needs more greenbacks, there would be a continuing price to pay. In theory, these costs could be offset if the United

States agreed to share its seignorage with dollarizers, but this seems a particularly distant political prospect.

Another sharp minus is the absence of a lender of last resort to the banking sector. Suppose that households in a country do decide to take their money out of the banks en masse, perhaps because of rumors about the banking sector's lack of safety. When a country has its own currency, the central bank can lend domestic banks the money needed to satisfy the sudden increase in withdrawals by depositors. The depositors can therefore be confident that the banks will have their deposits available for withdrawal. When a country has dollarized, however, there is no longer a national central bank that can make dollars available in the event of a sudden withdrawal of bank deposits. And there is no reason to expect the U.S. Federal Reserve Board to be the lender of last resort for banks in another country, even if that country has adopted the dollar as its currency. Dollarizing countries could try to establish contingent lines of credit, but producing adequate collateral could prove difficult.

A final sharp difference (one that is a plus, but also a significant minus) between dollarization and a pegged exchange rate is that dollarization is nearly irreversible. This factor is good in that it allays any fears of a possible collapse of a pegged rate or even of a currency board. However, it can be equally bad if a country gets hit by a rare but extreme shock and desperately needs a currency depreciation. With a pegged exchange rate, a depreciation would be possible. The government would tell the public that it has to renege on its promise to keep the exchange rate stable, given the extreme circumstances facing the country. If the country has abandoned its own currency, however, this extreme step (meant for extreme emergencies) might not be available. Dollarization does result in certainty—the lack of worry about exchange rate changes—but that certainty comes from strapping the economy into a monetary straitjacket.

## **IS DOLLARIZATION EVER WARRANTED?**

Dollarization only makes sense under the following circumstances:

- A country's economy is very tightly integrated with that of the United States and thus would experience very similar shocks. In such a case, U.S. monetary policy might be a good fit. Commodity exporters whose products are subject to sharp swings in world prices rarely fit this criterion.

- A country has a very small economy in which most prices are set in dollars and most goods are used in international trade. In fact, there are only four independent countries that are currently dollarized: the Marshall Islands, Micronesia, Palau, and Panama. Of these, only Panama is of a significant size in terms of population (2.7 million) and gross domestic product (GDP) (\$8.7 billion). The other three are islands with populations between 17,000 and 120,000 and GDPs of between \$100 million and \$200 million.
- A country has very flexible labor markets. If domestic wages have to decline, they can do so without high levels of labor market strife and without a prolonged period of unemployment.
- A country's central bank cannot be trusted to run its own currency in a stable way, perhaps because local politics is too populist or because social demands are too high to resist pressures for money-financed budget deficits.

Very few countries fit this profile; Mexico and Argentina certainly do not. Both countries have relatively inflexible economies and heavy commodity dependence. They face shocks quite different from those that hit the United States and therefore might need monetary policies quite distinct from those of the United States. Argentina has been on a kind of dollar standard since April 1991, when the Argentine peso was pegged one-to-one with the dollar. In spite of some significant achievements, Argentina experienced a sharp recession in 1995 following the Mexican peso crisis and is currently enduring another one. The objective conditions call for monetary ease, but Argentina's pegged rate will not allow it. Mexico had a pegged rate until December 1994, when the rate was destabilized by a combination of economic shocks and inconsistent monetary policies, which caused the country to run out of foreign exchange reserves. Since 1995, Mexico has operated a floating exchange rate system. In 1999, it was able to absorb shocks in world markets by allowing its currency to depreciate rather than by tightening monetary policy (as Argentina did). The result is that Mexico continues to enjoy economic growth in 1999, even as Argentina sinks deeper into recession.

Halfway around the world, a similar comparison between Hong Kong and Singapore also puts in relief the risks of a dollarized system. When the Asian Crisis hit in 1997, both Hong Kong and Singapore experienced a sharp fall in demand for their exports in the rest of the region. Singapore countered this external shock by allowing its currency to depreciate. Hong Kong, by contrast, maintained a fixed exchange rate

with the U.S. dollar, a rate that has been stable since 1984. Singapore, therefore, escaped recession in 1998 and 1999, while Hong Kong has experienced the sharpest decline in its output in recent history (about an 8 percent drop in real GDP from the peak until mid-1999).

## **ARE REGIONAL CURRENCIES THE ANSWER?**

There may be a golden mean for some countries between the gains from a common currency (reduced transactions costs, depoliticized monetary management) and the gains from flexibility—a shock absorber for terms-of-trade fluctuations or other shifts in world trade patterns. That is the regionalization, rather than dollarization, of national currencies, as in the case of the euro. Suppose countries that are close neighbors have approximately the same economic structure, face the same international shocks, and do a lot of business with one another. They might want to adopt a common currency within the neighborhood, but one that remains flexible vis-à-vis other major currencies such as the U.S. dollar. Many members of the European Union made precisely that choice. Several additional candidate regions around the world come immediately to mind, and two in Latin America especially: MERCOSUR countries in South America and the Central American countries other than Panama (which is already dollarized).

The gains from regionalization of currencies could be quite large. First, there would be the reduction of transactions costs for doing business within the neighborhood. Second, there would be the creation of a supranational central bank run by designated representatives from each of the participating countries, which would take monetary policy out of the domain of populist national politics, while still preserving accountability of the monetary authorities to the political process of the member countries. Third, there would be the great savings of such a scheme compared with dollarization, because the seignorage problem would not be a factor. Suppose the Central American countries, for example, adopted a common currency. Since they would be the issuers, the countries could print the money at low cost and swap it for the outstanding currencies already in circulation. If the countries were to dollarize, by contrast, they would have to sell interest-earning dollar reserves or borrow new dollars at high interest rates in order to swap dollars for the existing currencies.

The obstacles to regionalization of national currencies would of course be significant, even where regionalization might be warranted

by underlying economic realities. Take the case of MERCOSUR, for example. Argentina and Brazil would seem to have a common monetary stake: The depreciation of the Brazilian real early in 1999 threw Argentina into a very deep recession. And yet, Argentina apparently remains wedded to fixed parity with the U.S. dollar, if not outright dollarization. Brazil seems to many Argentines to be an unlikely, and unworthy, monetary partner. The probable result is a floating real in Brazil, an overvalued peso in Argentina, and little movement toward either dollarization or regionalization of the national currencies. In Central America, the situation is similar. Each country looks with doubt at its neighbors as plausible monetary partners. There would need to be considerable economic coordination among the countries to prepare for a common currency. The distinct lack of movement in this direction makes such a currency a distant prospect.

## **REDUCING THE RISKS OF GLOBALIZATION**

The world financial system has become treacherous in recent years, especially since many players have not yet learned the ins and outs of globalization. Emerging markets are whipsawed by huge swings in lending from international banks: Sometimes money floods in; other times it floods out. All countries need to learn how to manage financial risks, and a good exchange rate system is part of good risk management. Under these circumstances, the following three principles can be recommended.

First, except in the extreme cases outlined earlier, flexible exchange rates (either at a national or regional level) are a useful absorber for external shocks. It is not good enough to have a pegged rate that is right most of the time. Countries have to plan for eventualities—natural disasters, collapses in world market prices, abrupt shifts in international capital—that might require the shock absorber role of the exchange rate.

Second, countries should attempt to limit inflows of hot money, especially very short-term loans from international banks. Money that pours into a country can just as easily pour out. Highly volatile short-run capital, often moved by self-fulfilling waves of euphoria or panic, can disrupt economies and cause massive swings in exchange rates. Such flows can be limited through appropriate regulation of the banking system or through some restriction on inflows of short-term capital (once the foreign money has come in, however, it is not a good idea to limit its exit). Countries should also pay close attention to the

ratio of short-term foreign debt to international reserves. Most countries that have recently endured currency crises had more short-term debt than international reserves on the eve of the crisis. Under these conditions, it is rational for foreign investors to try to be first to the door, and a speculative attack against the currency can easily happen.

Finally, countries should strengthen the operating capacity of their central banks and give such banks sufficient independence, so that they can resist political pressures for excessive monetary expansion. Advocates of dollarization are wrong to think that developing countries are congenitally incapable of managing a noninflationary currency. There are many developing countries that maintain good internal discipline without the straitjacket of dollarization. These advocates are correct, however, to warn of the risks and to emphasize the importance of institutional design to ensure the central bank has the professionalism and protection from daily politics that it needs to do a responsible job.

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## WANT TO KNOW MORE?

For a textbook treatment of the basic issues surrounding exchange rate regimes, the authors' favorite source is Jeffrey Sachs and Felipe Larrain's *Macroeconomics in the Global Economy* (Englewood Cliffs: Prentice Hall and Harvester Wheatsheaf, 1993).

A discussion of the pros and cons of different exchange rate regimes for countries in transition to market economies is provided by Sachs in "Exchange Rate Regimes in Transition Economies" (*American Economic Review Papers and Proceedings*, May 1997). The vulnerability of pegged exchange rate regimes in emerging markets—with particular reference to Mexico—is studied in Sachs, Aaron Tornell, and Andres Velasco's "Financial Crises in Emerging Markets: The Lessons from 1995" (*Brookings Papers on Economic Activity*, 1996). The subject of dollarization is discussed by Larrain in "Going Green" (*World Link*, May/June 1999). Larrain and Velasco provide a recent analysis of the pros and cons of fixed and flexible exchange rate schemes in their working paper, "Exchange Rate Policy for Emerging Markets: One Size Does Not Fit All" (Cambridge: Harvard University, August 1999).

John Maynard Keynes's famous attack on the policies of Winston Churchill is in "The Economic Consequences of Mr. Churchill,"

from Keynes' *Essays in Persuasion* (New York: W.W. Norton & Company, 1991).

The "financial panic" of the recent Asian Crisis is discussed in further detail in Sachs and Steve Radelet's "**The East Asian Financial Crisis: Diagnosis, Remedies, Prospects**" (*Brookings Papers on Economic Activity*, 1998) and Sachs' "**Creditor Panics: Causes and Remedies**" (*Cato Journal*, Winter 1999).

A detailed analysis of capital controls is provided in Larrain, ed., ***Capital Flows, Capital Controls and Currency Crises: Latin America in the 1990s*** (Ann Arbor: University of Michigan Press, forthcoming). This volume also contains case studies of how several countries in Latin America—Argentina, Brazil, Chile, Colombia, and Mexico—have dealt with capital flows.

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