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Dollarization in Developing Countries: Official or Spontaneous, Why it Takes Place, Which is Better?

Background: For at least two decades, the U.S dollar has tended to displace the national currency in many developing and transition countries. Residents have been shifting from holding national currency to holding U.S. dollar notes, and from holding national currency-denominated bank deposits to holding dollar-denominated ones. This is known as dollarization. Dollarization refers to the use of any foreign currency, not just the US dollar, as a substitute within a nation's borders for the national currency. Spontaneous, partial dollarization occurs when the foreign currency is not legal tender, but residents still hold a large share of their in-country wealth in financial assets denominated in the foreign currency. Official, full or virtually full, dollarization occurs when a country officially adopts the currency of another country (or a common currency, such as the euro, jointly issued by a number of countries), makes it legal tender for all domestic financial transactions, buys up its own domestic currency offering for it the foreign currency, destroys it and replaces it with the foreign currency. Some small denomination notes and coins, making up a small fraction of money supply, may be left in circulation. Dollarization, how to deal with the spontaneous variety, and whether to dollarize officially, may be live issues for many post-conflict and some other low and medium inflation countries.

Partial, unofficial spontaneous dollarization takes place when domestic residents, to escape real erosion of their financial assets from ongoing or anticipated domestic inflation, shift from holding domestic currency to holding, to some extent, dollars or other similarly trusted foreign currencies, and domestic banks begin to take deposits in dollars and make loans in dollars. It is unofficial, because the foreign currency is not officially treated as legal tender, and partial because domestic currency continues to be issued and not everyone shifts entirely out of domestic currency. Dollarization has occurred in response to high inflation of the domestic currency. As inflation has subsided in many developing countries, the extent and pace of unofficial dollarization might have been expected to moderate, but this, at least in Latin America, seems not to have happened. People may fear the possibility of inflation flaring up at some future time. One can expect some tendency to partial dollarization to persist in countries that issue their own currencies even if they succeed in achieving and maintaining a low and stable rate of inflation.

Full, official dollarization: Official replacement of domestic currency by the U.S. dollar or some other well-managed, strong currency, used by central banks for international reserves, as legal tender has been seen as a way out of the problems leading to macroeconomic instability. In the 1990s currency crises in a number of developing economies triggered interest in moving to full, official dollarization, or to a less drastic solution, a currency board arrangement in which there is a domestic currency issued only in exchange for the dollar and/or other reserve foreign currencies at a pegged rate There was some exploration of why the U.S. might want to encourage other countries dollarize fully and officially and how it might do so. Official dollarization has also been seen, as in the case of El Salvador as a way of "locking in" successful macroeconomic policy that has managed to keep fiscal deficits low and achieve a low and stable rate of inflation for a sustained period of time.

Advantages of full, official dollarization: Among its claimed advantages are avoidance of: currency crises, of exchange rate fluctuations and associated GDP volatility. By dollarizing officially, it is argued, countries eliminate the risk of sudden capital outflows, the possibility of devaluation, and thus of currency crises detrimental to sustained GDP growth. If official dollarization is seen as irreversible, the government's credibility is enhanced: it is seen as committed both to the official dollarization and to the policies making it viable. By making monetary policy passive and unable to accommodate fiscal deficits, official dollarization is expected to help to foster fiscal discipline, lead to expectations of lower inflation and to lower domestic interest rates. The lower transaction costs associated with official dollarization may also hasten deeper integration into global product markets.

Disadvantages of full, official dollarization. If full dollarization doesn't foster fiscal discipline, it will raise interest rates, crowd out private investment, swell the country's external debt and deplete the foreign reserves of the banking system, and lead to crisis. The officially dollarized economy cannot deal with external shocks by devaluing or revaluing the currency, as its currency is not its own. Its trade-weighted exchange rate will tend to vary to the extent it does not trade much with the country issuing the currency it has adopted. As that currency's trade-weighted exchange rate with the rest of the world's currencies varies, countries that have adopted it as their currency will tend to experience balance of payments movements and resource shifts. In practice U.S. monetary and fiscal policies are not constrained by trying to achieve a foreign exchange rate objective. The U.S. dollar and euro effectively float against each other and against other important currencies such as the Japanese yen. As a result trade-

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weighted nominal exchange rates of the euro and the US dollar can be quite volatile and a dollarized economy could experience the same volatility, to its disadvantage.

Adjustment to adverse shocks, such as adverse terms of trade movements causing a balance of payments deficit to emerge, must take place through declines of aggregate expenditure, income and (if wages are rigid downward) employment, brought about by the money supply's being reduced automatically by the balance of payments deficit until lower spending has eliminated the deficit. In some circumstances it may make sense to avoid adjustment by financing the deficit by external borrowing. Adjustment is similar with a currency board system: the board supplies the foreign currency required for international payments in excess of receipts by buying back domestic currency it has issued, until it has shrunk the money supply enough to bring payments into balance. The central bank cannot act as a lender of last resort in the event of a systemic bank run and bank payments crisis except by borrowing from abroad. Officially dollarized post-conflict states most likely would require flexible budget support assistance from donors to stay dollarized. A balance of payments deficit due to purely temporary factors of course can be financed by the government's or commercial banks' taking out external loans on which interest would have to be paid.

The government of a country that issues its own currency can extract a certain amount of "seigniorage revenue" through its ability to issue money (which essentially costs very little at the margin) to buy real resources. The government of an officially dollarized country foregoes seigniorage since it does not produce its own currency. This loss could be quite significant since seigniorage revenue may be sizable. With dollarization of a country's economy, the issuer of the currency adopted by the dollarizing country gets the seigniorage revenue, and there are no arrangements to share it. The officially dollarizing country may have to borrow from abroad to acquire the initial stock of dollars to carry out the dollarization.

Empirical evidence on effects of official dollarization: Interest in dollarization has generated a handful of formal empirical studies on the tiny sample of (primarily small) officially dollarized economies. On average dollarization has been associated with significantly lower inflation, but economic growth results are mixed. These experiences may not be indicative of what results would be for larger, more complex economies. Ecuador officially adopted the U.S. dollar as its currency in 2000 and El Salvador did so in 2001, effectively replacing their own currencies with the U.S. dollar. As of early 2007 both still have the U.S. dollar as their legal tender. Estonia has had a currency board since the early 1990s. Argentina abandoned its currency board arrangement in 2001 as the peso came under attack due to lack of fiscal discipline and further help from the IMF did not materialize (there had been quite a bit of IMF support up to then). Most European Union countries have replaced their national currencies with the Euro. Few additional countries seem likely to opt for full and official dollarization.

Pluses and Minuses of Unofficial Dollarization, i.e. of Tolerating Unofficial Dollarization of the Economy: Permitting partial dollarization increases residents' range of economic choice and allows them to shift out of the national currency if they distrust its stability as a store of value. Partial dollarization carries with it, however, the risk of currency and maturity mismatches between banks' assets and liabilities, as well as between assets and liabilities of nonfinancial businesses and of government,. making devaluation and monetary policy tightening in responses to external shocks more likely to trigger financial crises and disruption of the real economy. To reduce unofficial dollarization, a country's monetary authorities' must refrain from unsound, inflationary monetary policy. But, with part of the money supply effectively consisting of foreign currency, the central bank, because of fragility concerns due to potential currency mismatches, may feel less free to tighten monetary policy when it is needed to bring inflation down and counter external shocks. Stronger supervision of banks is part of the solution. Sound monetary policy that keeps inflation low can reduce incentives to hold liquid foreign currency notes and balances for domestic use or for domestic loans and liabilities to be denominated in foreign currency terms, and thus enforce fiscal discipline. Alternatively, the central bank can make it illegal to hold foreign currency, but this poses an enforcement problem, puts undesirable restrictions on economic freedom of residents of the country, and removes the discipline imposed by the possibility of unofficial dollarization. Acquiring capability to implement sound macroeconomic policy will tend to eliminate problems leading to unofficial dollarization, so that considering official dollarization becomes unnecessary.

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1) Even with zero partial dollarization, however, currency mismatches at the aggregate level would be a concern as Goldstein and Turner explain. The extent to which denomination of liabilities and claims among resident banks and other residents makes matters worse is not clear.

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