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Monetary Instability: Are National Currencies Becoming Obsolete?

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Abstract: Accelerating cross-border competition among currencies is creating increasing turbulence in the international monetary environment. Are national currencies becoming obsolete? Currency competition compels governments to choose from among a limited number of strategies, only one of which involves preservation of a traditional territorial money. Many national currencies will disappear, leading to an increasing number of *regional* currencies of one kind or another – a distinctly new geography of money. But there is no sure way to predict what that new geography of money will ultimately look like. We have a fairly good idea of the principal factors that are likely to influence state preferences, but many configurations are possible and even probable.

Prepared for an edited volume on
Global Instability: Uncertainty and New Visions in Political Economy (eds.
James Busumtwi-Sam, Marjorie Griffin Cohen, Laurent Dobuzinskis, and Stepen McBride)

Nothing signifies the growth of instability in today's international political economy more than the disruptive financial crises that have swept the world in recent years – the speculative attacks on the pound sterling and other European currencies in 1992-93, which broke up the old European Monetary System; the fall of the Mexican peso in 1994, which sparked a worldwide contagion in financial markets that came to be known as the tequila effect; the East Asian crisis of 1997-98, which began with crash of Thailand's currency, the baht, and then spread outward in another contagion, which some this time labeled a case of "bahtulism"; the Russian default of 1998; Brazil in 1999; and the continuing troubles of Argentina, Turkey, and others. In just one decade the world's monetary system has gone to the brink a half dozen times. No wonder there is so much talk – albeit, to date, rather little action – about reform of what we now call the international financial architecture.

Yet in a very real sense, all of these crises may be considered little more than the tip of the iceberg – the outward manifestations of a much more fundamental transformation of the global monetary environment. That transformation, which I wrote about in my recent book *The Geography of Money* (1998), is being driven by a rapid acceleration of cross-border competition among currencies – what in *The Geography of Money* I called the *deterritorialization* of money. Circulation of national currencies no longer coincides with the territorial frontiers of nation-states. A few popular monies, most notably the U.S. dollar and Europe's new euro (succeeding Germany's Deutschmark), have come to be widely used outside their country of origin, competing directly with local rivals for both transactions and investment purposes. Many weaker currencies, conversely, have been reduced to a minority share of the money supply in their own country of issue. All of the crises of the last decade can be understood as instances of national monies that, in this increasingly unstable environment, have lost their market appeal.

This instability, then, raises a truly fascinating question. In all markets, we know, the logic of competition suggests that, ultimately, many weaker rivals will be eliminated. And so, we might think, the same should be true in the market for monies. Does this mean that national currencies are becoming obsolete? Are many of the monies around the globe – the diverse kips (Laos), quetzals (Guatemala), pulas (Botswana), and levs (Bulgaria) – destined to go the way of the Dodo bird? The short answer, for many, is almost certainly Yes. Extinction could be the fate of the currencies of even some of the world's richest economies, such as Canada's beloved loonie.

In this paper, I will make three main points. I start with the transformation of today's global monetary environment. The implications of deterritorialization for the survival of national currencies are only beginning to be understood. My first point is that currency competition compels governments to choose from among a limited number of strategies, only one of which involves preservation of a traditional territorial money. Second, a good number of national monies will indeed disappear, leading to an increasing population of *regional* currencies of one kind or another – a distinctly new geography of money. But, third, there is no sure way to predict what that new geography of money will ultimately look like. We have a fairly good idea of the principal factors that are likely to influence state preferences, but many configurations are possible and even probable.

I. The New Geography of Money

That the global monetary environment has been greatly transformed in recent decades is undeniable. A half century ago, after the ravages of the Great Depression and World War II, national monetary systems -- with the notable exception of the United States -- were generally insular and strictly controlled. Starting in the 1950s, however, barriers separating local currencies began gradually to dissolve, first in the industrial world and then increasingly in many emerging-market economies as well. Partly this was the result of an increased volume of trade, which facilitated monetary flows between states. But even more it was the product of intense market competition which, in combination with technological and institutional innovation, offered an increasingly freer choice among currencies. Currency substitution widened access for a growing number of actors at all levels of society.

Most scholarly attention has been paid to the remarkable growth in recent decades of capital mobility, reflected in a scale of international financial flows unequalled since the glory days of the nineteenth-century gold standard. The high level of capital mobility today is commonly cited as one of the most visible artifacts of contemporary globalization. But these flows are just part of the story of money's growing deterritorialization. A focus on capital mobility, emphasizing integration of financial markets, highlights only one of the standard functions of money: its use as a store of value. In fact, the interpenetration of monetary systems today has come to be far more extensive, involving *all* the functions of currency -- not just money's role as a private investment medium but also its use as a medium of exchange and unit of account for transactions of every kind, domestic as well as international. Cross-border currency competition means much more than capital mobility alone.

Deterritorialization is by no means universal, of course -- at least, not yet. But it is remarkably widespread. Krueger and Ha (1996) estimate that foreign currency notes in the mid-1990s accounted for twenty percent or more of the local money stock in as many as three dozen nations inhabited by at least one-third of the world's population. In all, as much as one-quarter to one-third of the world's paper money supply is now located outside its country of issue. Most currency substitution is concentrated in Latin America, the Middle East, and republics of the former Soviet Union, where the dollar is favored; or in East-Central Europe and the Balkans, where the DM traditionally predominated. By a different measure, focusing on foreign-currency deposits rather than paper money, the International Monetary Fund identifies some eighteen nations where by the mid-1990s another state's money accounted for at least thirty percent of broad money supply.¹ The most extreme cases, with ratios above fifty percent, included Azerbaijan, Bolivia, Croatia, Nicaragua, Peru, and Uruguay. Another thirty-nine economies had ratios approaching thirty percent, indicating "moderate" penetration.

What are the implications of this transformation for the survival of national currencies?

For specialists in open-economy macroeconomics, who typically focus narrowly on capital mobility, the significance of recent developments is restricted mainly to implications for the choice of exchange-rate regime. Traditionally, the exchange-rate issue was cast in simple binary terms: fixed versus flexible rates. A country could adopt some form of peg for its currency or it could float. Pegs might be anchored on a single currency or a basket of currencies; they might be formally irrevocable (as in a currency board) or based on a more contingent rule; they might crawl or even take the form of a target zone. Floating rates, conversely, might be managed or just left to the interplay of market supply and demand. More recently, the issue has

been recast – from fixed versus flexible rates to a choice between, on the one hand, contingent rules of any kind and, on the other, the so-called “corner solutions” of either free floating or some form of monetary union. Today, according to an increasingly fashionable argument known as the bipolar view or two-corner solution, no intermediate regime can be regarded as tenable (Fischer 2001). Owing to the development of huge masses of mobile wealth capable of switching between currencies at a moment’s notice, governments can no longer hope to defend policy rules designed to hit explicit exchange-rate targets. The middle ground of contingent rules has in effect been “hollowed out,” as Barry Eichengreen (1994) memorably put it.

But that too is just part of the story. In reality, much more is involved here than simply a choice of exchange-rate regime. At its most fundamental, what is involved is nothing less than a challenge to the long-standing convention of national monetary sovereignty. Governments have long claimed an absolute monopoly over the issue and circulation of money within their own territory. Currencies were to be *territorial* – exclusive legal tender within the nation’s frontiers – with strict lines separating one monetary domain from another. However, once we look beyond capital mobility alone to the broader phenomenon of currency competition, we see that in many areas of the world the traditional dividing lines between national monies are becoming less and less distinct. No longer are most economic actors restricted to a single currency -- their own home money -- as they go about their business. Cross-border circulation of currencies, which had long been common prior the emergence of the modern state system, has dramatically re-emerged, resulting in a new configuration of currency spaces – a new geography of money. The functional domains of many monies no longer correspond precisely with the formal jurisdiction of their issuing authority.

Currency deterritorialization poses a critical challenge because governments have long relied upon the advantages derived from formal monetary monopoly to promote their conception of state interest. In fact, five main benefits are derived from a strictly territorial currency: first, a potential reduction of domestic transactions costs to promote economic growth; second, a powerful source of revenue (seigniorage) to underwrite public expenditures; third, a possible instrument to manage the macroeconomic performance of the economy; fourth, a potent political symbol to promote a sense of national identity; and finally, a practical means to insulate the nation from foreign influence or constraint. But all these gains are eroded or lost when a government is no longer able to exert the same degree of control over the use of its money, by either its own citizens or others. Instead, in a growing number of countries, policymakers are driven to compete, inside and across borders, for the allegiance of market agents -- in effect, to sustain or cultivate market share for their own brand of currency. The monopoly of monetary sovereignty yields to something more like oligopoly, and monetary governance is reduced to little more than a choice among marketing strategies designed to shape and manage demand.

Broadly speaking, for affected states, four strategies are possible, depending on two key considerations -- first, whether policy is defensive or aggressive, aiming either to preserve or promote market share; and second, whether policy is unilateral or collective. These four strategies are:

- (1) **Market leadership**: an aggressive unilateralist policy intended to maximize use of the national money, analogous to predatory price leadership in an oligopoly.

(2) *Market preservation*: a status-quo policy intended to defend, rather than augment, a previously acquired market position for the home currency.

(3) *Market alliance*: a collusive policy of sharing monetary sovereignty in a monetary union of some kind, analogous to a tacit or explicit cartel.

(4) *Market followership*: an acquiescent policy of subordinating monetary sovereignty to a stronger foreign currency via a currency board or full dollarization, analogous to passive price followership in an oligopoly.

Of these four options, a strategy of market leadership is of course generally available only to governments with the most widely circulated currencies, such as the dollar and euro. For the vast majority of states with less competitive monies, decisionmaking is limited to the remaining three – a tricky tripartite choice. For these states, the very survival of national money is at stake.

II. Currency Regionalization

The basic question for such states is the familiar one of constrained choice. What limits on national policy are they willing to accept? Should governments seek to sustain their traditional monetary sovereignty (market preservation)? Or, alternatively, should they countenance delegating some or all of that authority upward, either to the joint institutions of a monetary union (market alliance) or to a dominant foreign power (market followership)? Involved is what one source² calls a “sovereignty bargain” – a voluntary agreement to accept certain limitations on national authority in exchange for anticipated benefits. Monetary sovereignty is either *pooled* in a partnership of some sort, shifting authority to a joint institution like the European Central Bank (ECB), or else *surrendered* wholly or in part to a dominant foreign power such as the United States.³ The former president of the Argentine central bank put the point bluntly (Pou 1999: 244): “Should a [country] produce its own money, or should it buy it from a more efficient producer?” Buying from a more efficient producer necessarily implies a degree of regionalization in currency relations.

Currency regionalization occurs when two or more states formally share a single money or equivalent. With a strategy of market alliance, governments agree to merge their separate currencies into a wholly new joint money, as members of Europe’s Economic and Monetary Union (EMU) have done with the euro. This is *currency unification*, what the economist George von Furstenberg (2000) calls a “multilateral sharing model of monetary union.” Examples already in existence around the world include, in addition to EMU, the CFA Franc Zone in Africa and the Eastern Caribbean Currency Union (ECCU). A looser version, called the Common Monetary Area (CMA), also exists in southern Africa, encompassing South Africa and three of its smaller neighbors, Lesotho, Namibia, and Swaziland.

Alternatively, with a strategy of market followership, any single government can unilaterally or by agreement replace its own currency with an already existing money of another, an approach typically described as full or formal *dollarization*.⁴ This much more hierarchical variant of regionalization, which von Furstenberg labels an “uncooperative unilateral monetary union,” has long been official policy in a miscellany of tiny enclaves or microstates around the

world, from Monaco and San Marino to the Marshall Islands and Micronesia, as well as in Panama and, for many years, Liberia; and was more recently adopted by Ecuador and El Salvador, each of which now uses America's greenback in place of its own former currency. A near equivalent is a currency board, such as has long existed in Brunei, Djibouti, and Hong Kong. With a currency board the home money continues to account for a large, if not dominant, part of domestic money supply. In principle, though, issue of the local money is firmly tied to the availability of a designated foreign currency -- usually referred to as the anchor currency. The exchange rate between the two monies is rigidly fixed, ostensibly irrevocably; both currencies circulate as legal tender in the dependent country; and any increase in the issue of local money must be fully backed by an equivalent increase of reserve holdings of the anchor currency. Effectively, the home money becomes little more than foreign money by another name -- a proxy for the anchor currency, as it were. During the 1990s new currency boards were established in a number of economies, including most notably Argentina, Bosnia, Bulgaria, Estonia, and Lithuania.

The emergence of regional currencies can be regarded as a logical corollary of the intense competitive contest among monies -- a Darwinian struggle where, ultimately, only the fittest may survive. Among informed observers today it is rapidly becoming conventional wisdom that the number of currencies in the world will soon decline.⁵ Typical is the prediction of Michel Camdessus (2000: 35), former managing director of the IMF, who suggests that "In the long run, we are moving toward a world of fewer currencies." Economist Rudi Dornbusch (2001: 9) is blunter. "Convergence on regional monies," he asserts, "is a no-brainer."

Not all local currencies will disappear, by any means. Even in today's globalizing world, many states remain determined to preserve some semblance of their traditional monetary sovereignty -- to keep their national currency alive, no matter how uncompetitive it may be. Monetary sovereignty can be defended by tactics of either persuasion and coercion. Persuasion entails trying to sustain demand for a currency by buttressing its reputation, above all by a public commitment to credible policies of "sound" monetary management. The idea is to preserve market confidence in the value and usability of the nation's brand of money -- the "confidence game," as Paul Krugman has ironically dubbed it (Krugman 1998). Coercion means applying the formal regulatory powers of the state to avert any significant shift by users to a more popular foreign money. Possible measures range from standard legal-tender laws, which specify what money creditors must accept in payment of a debt, to limitations on foreign-currency deposits in local banks and even to the extremes of capital controls or exchange restrictions. Both floating and contingent exchange-rate rules are consistent with a strategy of market preservation.

A desire to continue producing a national money is understandable, given the historical advantages of a formal monetary monopoly. But at what cost? As currency competition accelerates, tactics of persuasion or coercion become increasingly expensive. Growth and employment may have to be sacrificed, more and more, in order to keep playing the confidence game; widening distortions in the allocation of resources may be introduced by controls or restrictions. The costs of defending currency sovereignty are real, a direct result of the transformation of the global monetary environment. And as they continue to mount, the alternative of buying from a more efficient producer becomes increasingly appealing -- or, at least, less unappealing. Not surprisingly, therefore, in a growing number of countries, more attention is being paid today to the corner solution of monetary union, in the form of either formal dollarization or currency unification.⁶

In the Western Hemisphere, for example, the idea of dollarization has become a topic of intense public debate since Argentina's former President, Carlos Menem, spoke out in its favor in early 1999. Though dollarization by Argentina itself was rejected by Menem's successor, Fernando de la Rúa, the idea was in fact implemented in Ecuador and El Salvador and continues to attract attention elsewhere, including in Mexico and Canada, America's partners in the North American Free Trade Area. Likewise, in East-Central Europe and the Mediterranean, "euroization" increasingly is touted as a natural path for countries with close ties to the European Union (EU) or hopes of one day joining the EU. Should more governments decide to go the dollarization route, it is not too difficult to imagine the gradual emergence of two giant monetary blocs, one centered on the United States and one on EMU's "Euroland." (Eventually a third bloc could also coalesce around the Japanese yen, though not any time soon.) As one observer has predicted:

By 2030 the world will have two major currency zones – one European, the other American. The euro will be used from Brest to Bucharest, and the dollar from Alaska to Argentina – perhaps even in Asia. These regional currencies will form the bedrock of the next century's financial stability.⁷

Much will depend, of course, on the policies adopted by the market leaders, which could significantly alter the relative costs and benefits of followership as contrasted with strategies of either market preservation or alliance. Unfortunately, these policies cannot be easily predicted. On the one hand, monetary leadership can yield substantial benefits, both economic and political. Economic gains include reduced transactions costs and additional opportunities for seigniorage as well as an enhanced degree of macroeconomic flexibility. Politically, an international currency may yield dividends in terms of both power and prestige. The prospect of such benefits could attract the U.S. and Europe (and/or Japan) to offer explicit incentives to potential dollarizers, especially if, as I have suggested elsewhere (Cohen 2000), active competition for market share breaks out among the market leaders. But on the other hand there are also considerable risks in monetary leadership, including in particular policy constraints that could be imposed by pressures to accommodate the needs of followers. Suppose Canada were to adopt America's greenback, for instance. It is not at all difficult to imagine that Canada, a major commodity exporter, might experience an adverse terms-of-trade shock even at a time of boom in the United States. Could the Federal Reserve really ignore declining income north of the border while fighting inflation at home? Such risks might prompt Washington and other market leaders to discourage rather than encourage formal adoption of their currencies.

Absent material incentives to dollarize, some governments might prefer instead to look to the idea of currency unification, a less subordinate form of monetary union on the model of EMU. Prospects for monetary alliances have been discussed in almost every region of the world.⁸ EMU is clearly viewed as a test case for a strategy of pooling rather than surrendering monetary sovereignty. If Europe's experiment comes to be seen as successful, it could have a powerful demonstration effect, encouraging similar initiatives elsewhere. This would be especially likely for groups of states engaged in a common integration project such as Mercosur, in the southern cone of South America, or the Association of Southeast Asian Nations (ASEAN). Alongside two (or three) major currency zones, a variety of new joint currencies could also eventually come into existence in addition to the euro.

Scenarios of currency regionalization, therefore, seem not only plausible but perhaps even likely – indeed, arguably for many states the most reasonable outcome to be expected from today’s accelerating deterritorialization of money. At present there are more than 170 central banks in the world, as compared with fewer than twenty a century ago; and more than one hundred currencies that formally float more or less freely. Can anyone really believe that such a polyglot and turbulent universe represents a stable equilibrium? The logic of competition suggests that a good number of governments could eventually yield to the market power of more efficient producers, replacing national monies with regional currencies of some kind. Regionalization of the world’s monies has happened before, in medieval Europe and again during the nineteenth century, as Eichengreen and Sussman (2000) remind us. Obviously, it could happen again. For Ricardo Hausmann, formerly chief economist of the Inter-American Development Bank, the process has an almost historical inevitability about it: “National currencies are a phenomenon of the twentieth century; supranational currencies are the solution of the future” (Hausmann 1999b: 96). That formulation may be a bit too deterministic. Nonetheless, there is little doubt that alongside national monies a new geography of regional currencies is beginning to emerge.

III. Predicting the Future

Can the shape of that new geography be predicted? How will governments decide among the three broad options of market preservation, alliance, or followership? Clearly, the choice is not an easy one, involving a number of potential benefits and costs, both economic and political. On the economic side, currency regionalization would reduce transactions costs, a distinct advantage, but would also mean a loss of both an autonomous monetary policy and seigniorage revenue. On the political side, regionalization means giving up not only a degree of insulation from foreign influence but also a vital symbol of national identity, a role of money that has been especially emphasized by Eric Helleiner (1998). State choices ultimately will depend on how much importance policymakers attach to particular gains or losses, which in turn will depend on each state’s individual circumstances.

Scholars are just beginning to explore this critical issue. The most ambitious effort to date has been by the economists Alberto Alesina and Robert Barro (2001), who use formal modeling techniques based on deductive reasoning to forecast when governments might be prepared to give up producing their own money. In my own research, which is still at a preliminary stage (Cohen 2001), I take a more inductive approach, concentrating on the empirical record to identify key factors that may be expected to influence state behavior. Significantly, study of the empirical record does reveal some reasonably consistent patterns. Three conditions seem especially influential: (1) country size; (2) economic linkages; and (3) political linkages. In addition, domestic politics must also be assumed to play a key role. But we are still quite a way from anything that might be regarded as a full-scale, positive theory of currency regionalization.

Among the conditions that appear influential, country size clearly does matter -- at least for the world’s smallest states. Of all the economies that were dollarized until recently, the largest was Panama, with a population of less than three million. Most are truly tiny enclaves or microstates. Small size also dominates among nations that have adopted currency boards and is an accurate description of the members of both the ECCU and CFA Franc Zone. One safe bet,

ceteris paribus, is that the smaller an economy's size – whether measured by population, territory, or GDP – the greater is the probability that it will be prepared to surrender the privilege of producing a money of its own. The logic is simple. Smaller states are least able to sustain a competitive national currency. Conversely, these are the economies that stand to gain most from a reduction of transactions costs. Moreover, when considering the option of dollarization, they are least likely to encounter resistance from market leaders because they will have the least impact on the countries whose currencies they adopt.

Next is the intensity of economic linkages between nations. Many of the countries that make use of a popular foreign currency have long been closely tied to a market leader economically. This is especially true of the numerous dollarized systems in the Caribbean and Central America, as well as the several dollarized enclaves of Europe and the Pacific. Likewise, we know that nearly half a century of deepening integration preceded the start of EMU. Another safe bet, *ceteris paribus*, is that closer economic bonds will also increase the probability that a government will be prepared to surrender the privilege of producing its own money. Here again, the logic is simple. Economies that are already closely linked would, because of the efficiency gains involved, appear to be natural candidates for a regional money of some kind.

Third is the intensity of political linkages between nations, whether formal or informal. Ties may take the form of a patron-client relationship, often descended from a previous colonial or trusteeship association; or they may be embodied in a network of cooperative diplomatic arrangements, possibly institutionalized in a formal alliance. Whatever the form, the influence of such ties is unmistakable -- in currency groupings that have failed in the past as well as those that still survive in the present. A third safe bet, *ceteris paribus*, is that closer political bonds too will increase the probability that a government will be prepared to surrender the privilege of a national money. The logic is that political linkages reduce two of the key costs associated with regionalization – the loss of a social symbol and the increase of vulnerability to outside influence.

Finally, there is domestic politics. Unfortunately, no studies yet exist that directly probe the role of domestic interest groups in currency regionalization. But we do know that the material interests of specific constituencies are systematically influenced by what a government decides to do with its money. State strategies, therefore, are bound to be sensitive to the interplay among domestic political forces as well as the institutional structures through which interest-group preferences are mediated. Most influential, it can be assumed, would be the constituencies that can be expected to benefit most from the openness and stability that would be provided by a regional currency. These would include big tradable-goods producers, banks and other financial-services firms, and large private asset-holders – those that Jeffrey Frieden (1991) refers to as “integrationist” interests. Much will depend on the degree of political influence exercised by such groups as compared with other domestic constituencies, such as producers of non-tradables and workers, who might oppose abandoning a national currency – “anti-integrationist” forces who feel they would benefit more from preservation of some measure of monetary autonomy.

Taken together, do these factors suggest that national currencies are indeed becoming obsolete? The answer, regrettably, is unclear. While the deterritorialization of currency is clearly imposing growing constraints on traditional forms of monetary governance, it by no means dictates the choices that governments will eventually make. A good number of countries will consider some form of dollarization or currency unification – but by no means all. The

essential elements of a positive theory of currency regionalization can be identified. What cannot be foretold is how these elements will work out in specific bargaining contexts. At this stage, there is simply still no sure way to predict what the new geography of money will look like. Standard microeconomic theory teaches that when stable monopoly yields to more strategic oligopoly, outcomes become indeterminate and multiple equilibria are possible. So too, it would appear, is that true in matters of money.

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Notes

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1. Baliño *et al.* 1999. Broad money supply (M2) is defined to include all coins and notes in circulation, demand deposits (checking accounts), and all other “reservable” deposits (time deposits).
 2. Litfin 1997. See also Mattli 2000.
 3. The distinction between pooling and surrender of sovereignty, which is generic to the question of how to organize political authority, is of course a familiar one in political science and is used in a variety of contexts – in analyzing differences between confederal states and empires, for instance.
 4. The adjectives “full” or “formal” are frequently added to distinguish this policy choice from the market-driven process of currency substitution, which in the past was also often popularly labeled dollarization (now unofficial or informal dollarization). Dollarization, of course, does not necessarily require the dollar. Some other currency, such as the euro or yen, might also be chosen to replace a country’s currency.
 5. See e.g., Alesina and Barro 2000; Fischer 2001; Rogoff 2001.
 6. In a complementary analysis Helleiner 2001 stresses the declining benefits of monetary sovereignty rather than, as here, the rising costs.
 7. Beddoes 1999: 8. See also Eichengreen 1994; Hausmann 1999a, 1999b; Mundell 2000.
 8. These include prospects in Asia (Eichengreen and Bayoumi 1999), Africa (Honohan and Lane 2001), Latin America (Levy Yeyati and Sturzenegger 2000), Australia-New Zealand (Grimes and Holmes 2000), and even between Canada and the United States (Buiter 1999).