Is A Dollarized Hemisphere in the U.S. interest?

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Prepared for a Conference on Dollarization and Latin America,
Latin American and Caribbean Center, Florida International University,
Miami, March 4, 2002

Is dollarization in the U.S. interest? As more Latin American countries contemplate following the examples of Ecuador and El Salvador, which have dollarized unilaterally, it is natural to ask whether the United States can expect to gain or lose in the process. In my opinion, the answer is clear. Considering political as well as economic implications, there is little doubt that risks and prospective costs far outweigh possible benefits. Unless directly challenged by efforts elsewhere to promote international currency use at the dollar's expense, the United States has no interest in encouraging formal adoption of the greenback by neighboring governments.

The reason is straightforward. Much of Latin America is already extensively dollarized on a de facto basis, as a result of currency substitution – a spontaneous, market-driven process now customarily distinguished as *informal* or unofficial dollarization. Informal dollarization, it may be argued, realizes significant advantages for the United States. As compared with these gains, little would be added by *formal* (official) dollarization and much, conceivably, could be lost.

Benefits of Informal Dollarization

Foreign use of the dollar translates into considerable advantages for the United States, both economic and political. Though minimized by some (e.g., Wyplosz 1999: 97-100), the benefits can in fact be quite substantial. Four distinct gains may be cited.

Most familiar is the potential for seigniorage. Expanded cross-border circulation of a country's money generates the equivalent of a subsidized or interest-free loan from abroad -- an implicit transfer that represents a real-resource gain for the economy as a whole. Consider just the circulation of Federal Reserve notes abroad, which studies by the Federal Reserve (Porter and Judson 1996) and U.S. Treasury (2000) suggest could presently total as much as $375 billion. Updating earlier estimates by Jeffrey A. Frankel (1995) and Alan S. Blinder (1996), current interest savings may be conservatively calculated at some $16-22 billion a year. To this may be added a saving of interest payments on U.S. government securities, which are uniquely attractive to foreign holders because of their greater liquidity. Richard Portes and Hélène Rey (1998: 309) call this an "often neglected source of seigniorage to the issuer of the international currency." In their words (1998: 309): "This international currency effect reduces the real yields that the United States government has to pay" – a "liquidity discount" that they suggest could amount to at least $5-10 billion a year. Put these numbers together and, paraphrasing former Republican Senator Everett Dirksen's celebrated remark about the Federal budget, we are beginning to talk about real money.

A second gain is the increased flexibility of macroeconomic policy that is afforded by the privilege of being able to rely on one's own money to help finance foreign deficits. As in any form of monetary union, expanded cross-border circulation reduces the real cost of adjustment to unanticipated payments shocks by internalizing through credit what otherwise would be external transactions requiring scarce foreign exchange. In effect, it reduces the need to worry about the balance of payments in formulating and implementing domestic policy. Who can remember the last time Washington decision makers actively incorporated concern for our large current deficits

or our exchange rate in debating the course of monetary and fiscal policy?

Third, more psychological in nature, is the gain of status and prestige that goes with market dominance. Money, as I have written elsewhere (Cohen 1998), has long played a key symbolic role for governments, useful – like flags, anthems, and postage stamps -- as a means to cultivate a unique sense of national identity. But that critical role is eroded to the extent that a local currency is displaced by a more popular foreign money, especially a money like the greenback that is so widely used on a daily basis. Foreign publics are constantly reminded of America's elevated rank in the community of nations. "Great powers have great currencies," Robert Mundell once wrote (1993: 10). In effect, the dollar has become a potent symbol of American primacy – an example of what political scientist Joseph S. Nye (1990) has called "soft power," the ability to exercise influence by shaping beliefs and perceptions. Though obviously difficult to quantify, the role of reputation in international affairs should not be underestimated.

Finally, there is the gain of political power that derives from the monetary dependence of others. On the one hand, an issuing country is better insulated from outside influence in the domestic arena. On the other hand, it is also better positioned to pursue foreign objectives without constraint or even to exercise a degree of influence internationally. As political scientist Jonathan Kirshner reminds us: "Monetary power is a remarkably efficient component of state power... the most potent instrument of economic coercion available to states in a position to exercise it" (1995: 29, 31). Money, after all, is simply command over real resources. If another country can be denied access to the means needed to purchases vital goods and services, it is clearly vulnerable in political terms. Kirshner lists four ways in which currency dependence can be exploited: (1) enforcement – manipulation of standing rules or threats of sanctions; (2) expulsion – suspension or termination of privileges; (3) extraction – use of the relationship to extract real resources; and (4) entrapment – transformation of a dependent state's interests. The dollar's widespread use puts all of these possibilities in the hands of Washington policymakers.

The Economics of Formal Dollarization

The question thus is: Given these considerable advantages, what would be added by formal dollarization in one or more countries? To begin, consider the pure economics of the process. Three economic benefits generally are expected -- an increase of seigniorage, a decrease of transactions costs, and an improved environment for foreign trade and investment. Such expectations are not unrealistic. The magnitudes involved, however, can be easily exaggerated. In fact, none of the three is apt to be of more than marginal importance to an economy as large as that of the United States. At the same time there could be a significant cost in terms of possible constraints on the conduct of U.S. monetary policy, which might well be of much more than marginal importance. At best, the balance of economic gains and losses is moot. At worst, the outcome could be seriously negative.

Seigniorage

Formal dollarization, when undertaken unilaterally, means that a government must give up interest-bearing dollar reserves in order to acquire the greenback notes and coins needed to

replace local cash in circulation. The interest payments thus foregone represent an additional flow of seigniorage to the United States – a material gain that comes at the direct expense of the dollarizing country. For Latin American economies, many of which are quite small, these costs would not be inconsiderable – in relative terms, a potentially "very high financial tribute to the United States," as George von Furstenberg (2000: 109) asserts. But for the United States, with its ten-trillion dollar GDP, gains would be barely visible, especially given the sizable amount of seigniorage that Washington already accrues from the circulation of dollars in the Western Hemisphere and elsewhere. According to economists at the International Monetary Fund (Baliño *et al*. 1999), the greenback even now accounts for a substantial portion of the broad money supply of many Latin American economies – more than half in Nicaragua and Peru and as much as 80 per cent in Bolivia and Uruguay. The greater the degree of prior informal dollarization in a country, the smaller will be the additional transfer generated by formal dollarization.

Transactions costs

By eliminating any possibility of exchange-rate change, formal dollarization also reduces transactions costs. This is the standard economic benefit to be expected from monetary integration, an efficiency gain that is shared by both sides, the United States as well as the country that dollarizes. Once a local money is replaced by the dollar, there is no longer a need to incur the expenses of currency conversion or hedging in transactions between the U.S. and its partner economy. The usefulness of money is enhanced for all its basic functions: medium of exchange, unit of account, and store of value. Again, however, benefits for the United States are unlikely to be considerable, since most U.S. trade with Latin America, as well as a good part of the nation's portfolio investment, is already contracted in dollars. Certain specific sectors will profit, of course. Earnings could be increased at U.S. banks, for example, which are naturally advantaged relative to their rivals in dollarized countries by their privileged access to the resources of the Federal Reserve. Economists have long recognized that international use of a currency generates "denomination rents" for financial intermediaries based in the country of issue. Gains should also accrue to other market actors who currently may still be exposed to exchange risk in the Hemisphere. These would include export and import interests and portfolio investors. They would also include American tourists who are fond of travel south of the border. But, overall, additional gains for the U.S. economy will be slight.

Environment for trade and investment

Finally, formal dollarization is widely predicted to benefit the United States by bringing greater stability to the countries of the Hemisphere, creating an improved environment for regional trade and investment. Latin American central banks, with their histories of high inflation and debauched currencies, do not enjoy a great deal of credibility. Adoption of the dollar, by contrast, would mean that loose monetary policy could no longer threaten renewed financial crisis. In the words of investment banker Michael Gavin (2000), monetary regimes would now be "accident-proof," ostensibly removing a key impediment to economic development. Faster and steadier growth, in turn, would mean healthier markets for U.S. exports

and direct investments.

But would monetary regimes really be accident-proof? Dollarization addresses only one among many of the causes of economic instability in Latin America – exchange-rate risk – but offers no direct corrective for other critical deficiencies, such as undisciplined fiscal policy, poor banking supervision, or labor-market rigidities. The hope is that by straitjacketing monetary policy, additional structural reforms will fall into place. But as Walter T. Molano (2000: 52) has warned, this could be "just wishful thinking." Molano continues (2000: 60): "Dollarization is a one-sided look at the problem.... Dollarization is not a solution to the institutional flaws that led to the crisis in the first place. It does nothing to shape the political will needed to sustain the exchange rate regime." A case in point is Argentina, where the discipline of the dollar-based currency board instituted in 1991 sadly failed to bring about any significant reform of fiscal policy. As a result, once foreign creditors lost faith in the government's debt-service capacity, the economy was plunged into deep recession and ultimately, in late 2001, into default and financial chaos. Too much faith, in short, should not be invested in a single institutional innovation like dollarization. In reality, the market environment for U.S. business could turn out to be considerably less stable than suggested.

Policy constraints

Furthermore, there could also be serious disadvantages for the conduct of U.S. monetary policy. The risk is that by placing a larger share of greenbacks in circulation outside the country, formal dollarization could impose an awkward constraint on Federal Reserve decision makers. The problem is already evident with informal dollarization, as recent research demonstrates (Aksoy and Piskorski 2001). Variations in the net flow of dollar bank notes abroad, relative to overall changes in the cash component of broad money supply, have disrupted the historic relationship between U.S. monetary aggregates on the one hand and key macroeconomic variables, such as real output and inflation, on the other, making it more difficult for the Federal Reserve to maintain a steady course over time. The problem will only grow worse to the extent that additional nations adopt America's currency as their own. The more that money demand in dollarizing economies is subject to sudden or frequent shifts, the greater is the risk of liquidity shocks that will increase the short-term volatility of U.S. monetary aggregates.

Admittedly, here too it is easy to exaggerate the magnitudes involved, since the Federal Reserve has long learned to live with the phenomenon of informal dollarization and, as part of its daily operations targeting the federal-funds rate, already factors overseas circulation into its behavior. Nonetheless, the challenge is real and can only intensify as more governments dollarize formally. As compared with the largely modest gains to be expected from the process, the potential constraint on policy could be significant.

The Politics of Formal Dollarization

Nor is that all. It is critical to take note as well of possible *political* impacts, which are even more likely to be negative, on balance, rather than positive. In political terms, two main benefits are expected to accrue to the United States, summarized by the words "power and

prestige." Both effects are undeniably real. Both, however, are also apt to pale in significance in comparison to possible costs in terms of added responsibility for the fate of client states.

Power

In geopolitical terms, preservation of a national currency is useful to governments wary of external dependence or threat. Control over the issue and circulation of money within their own borders enables policymakers to avoid dependence on some other source for this most critical of economic resources, in effect providing a kind of insurance policy against risk. Money creation can serve as an emergency source of revenue – a way of finding needed purchasing power quickly when confronted with unexpected contingencies, up to and including war. Conversely, that same measure of autonomy is lost when a foreign money is formally adopted. The relationship with a dollarized country is clearly hierarchical – a link of dominance and dependence -- and hierarchy unavoidably implies vulnerability.

An apt illustration is provided by Panama, which since its independence in 1903 has always used the greenback as its main legal tender. Although a national currency, the balboa, notionally exists, only a negligible amount of balboa coins actually circulates in practice. The bulk of local money supply, including all paper notes and most bank deposits, is accounted for by the dollar. In economic terms, observers rightly have mostly praise for Panama's currency dependence (e.g., Goldfajn and Olivares 2001). Though reliance on the dollar has by no means induced a high degree of fiscal discipline, it has succeeded in creating an environment of monetary stability, helping both to suppress inflation – a bane of most of Panama's hemispheric neighbors – and to establish the country as an important offshore financial center. In political terms, however, Panama has been especially vulnerable in its relations with Washington, as Panamanians learned in 1998 when the Reagan administration initiated a campaign to force Manuel Noriega, the country's de facto leader, from power. Panamanian assets in U.S. banks were frozen, and all payments and dollar transfers to Panama were prohibited, effectively demonetizing the economy. The effect on the economy was devastating despite rushed efforts by the Panamanian authorities to create a substitute currency, mainly by issuing checks in standardized denominations that they hoped recipients would then treat as cash. Over the course of the year, domestic output fell by a fifth, undoubtedly hastening Noriega's eventual downfall in 1999.

Such vulnerability clearly enhances Washington's political authority: its capacity to exercise influence or threaten coercion. But again, it is crucial not to exaggerate. For many, Panama was a special case, unlikely to be repeated anywhere else in the Hemisphere. In any event, what may work with an economy as small and defenseless as Panama's might be less effective when attempted against a larger and more developed nation. Moreover, the United States has worked long and hard to erase unpleasant memories of dollar diplomacy in Latin America. One may legitimately wonder whether any administration in Washington, Democrat or Republican, would wish to do anything that might revive past resentments of *Yanqui* imperialism. The power derived from dollarization is tangible but, like nuclear arms, may be something of a doomsday weapon – in practice, more or less unusable except *in extremis*.

Prestige

Somewhat less tangibly, the United States could also gain yet greater status and prestige from formal dollarization. Symbols, however, can prove to be a two-edged sword, depending on circumstances. What in prosperous times may be accepted as benign, even natural, might become a focal point for hostility in the event of recession or crisis. Unlike informal currency substitution, formal dollarization creates a convenient target for protest. When the greenback was adopted in Ecuador, demonstrators marched in the streets denouncing what they feared would be the "dollarization of poverty." It is easy to imagine similar manifestations in the future, in Ecuador or elsewhere, blaming the dollar – and thus the United States – for any failures of economic management at home. It is even possible to imagine politicians deliberately fomenting popular protests as a way of diverting attention from their own policy errors. Prestige could come at a very high price, creating an easy target for grievances.

Political Responsibility

Nor is that the only political price that might be exacted from the United States. By adopting the greenback, a government voluntarily surrenders control over its own money supply and exchange rate. All authority is ceded to the Federal Reserve, making the country a monetary dependency, a client of the United States. Formally, there need be no promises of any kind: no assurance that the dollarizing economy's circumstances will be taken into account when monetary decisions are made, nor access to the Fed's lender-of-last resort facilities should the country's banks get into difficulty. Indeed, Washington officials have gone out of their way to deny that U.S. policy or institutions would be adjusted in any way. In reality, however, as frequently noted (e.g., Samuelson 1999), it would be very difficult for the American government to ignore adverse developments in the periphery of its own currency bloc. Even in the absence of any explicit commitment, dollarization would undoubtedly create an implicit expectation of future monetary bailouts -- a kind of contingent claim on U.S. resources. Such an expectation is the flip side of America's enhanced political authority. With primacy comes not only greater influence but also, potentially, the burden of greater responsibility.

Like it or not, therefore, policymakers are likely to find themselves under pressure periodically to accommodate specific needs or fragilities. The Fed might be lobbied to take explicit account of the priorities of dollarized economies in setting its policy goals -- especially in the event of asymmetric payments shocks -- or to open its discount window to local financial institutions. In time, governments might even begin to campaign for indirect or even direct representation on the Federal Reserve Board or Federal Open-Market Committee. Likewise, the Treasury might be importuned to come to some country's rescue in the event of financial crisis. The probabilities involved here are of course unknowable. No one can forecast with assurance how dollarized states will behave in actual practice. But the danger is real and here too will only grow worse to the extent that additional nations adopt America's currency as their own.

Options for U.S. Policy

What, then, should the United States do? Until now, as I note elsewhere (Cohen 2002), U.S. policy has remained cautiously neutral – a strategy of "benign neglect," to borrow a phrase from an earlier era. Governments considering dollarization may be given moral support, and perhaps some technical assistance, but otherwise are left more or less on their own. No formal commitments are offered. Adoption of the greenback must be entirely unilateral, as has already occurred in Ecuador and El Salvador. The question is: Should Washington do more?

The answer follows directly from the analysis. No change of policy is warranted unless present gains appear threatened. Benign neglect makes sense in current circumstances, where the U.S. already derives considerable advantage from the dollar's broad circulation. Why do more if there is so little promise of additional net benefit? Only if the dollar's market dominance is directly challenged, jeopardizing present gains, would a more pro-active policy be called for. Washington has little interest in augmenting the greenback's foreign use but much interest in defending it.

This means that a good deal will depend on what actions are taken on behalf of the greenback's principal rivals, the euro and yen. Europe and Japan too enjoy considerable advantages as a result of the international status of their respective monies, and both Europeans and Japanese have spoken of aspirations for even wider foreign use. Efforts to promote the appeal of the euro and yen are therefore to be expected. Indeed, in a setting that can accurately be described as analogous to an oligopoly (Cohen 2000), competition among the leading currencies for market share must be considered natural. For the moment, as it happens, the dollar still reigns supreme, allowing for a certain degree of complacency in Washington. But that may not always be the case. If initiatives by Europe or Japan were really to begin to bite into the greenback's market share, the benefit-cost calculus for the United States would change dramatically, and formal dollarization would begin to look far more attractive.

Conclusion

The conclusion is evident. America has every interest in preserving and defending the advantages it presently derives from the market leadership of the dollar. But unless directly challenged by Europe or Japan, America has no clear interest in going any further, to promote formal adoption of the greenback by other governments. Benign neglect remains the logical policy choice.

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