MONETARY STABILITY IN LATIN AMERICA: IS DOLLARIZATION THE ANSWER? pdf

1: Responding to Global Crises: Dollarization in Latin America - EconSouth Volume 1 Number 2

Monetary stability in Latin America: is dollarization the answer?: hearing before the Subcommittee on Domestic and International Monetary Policy of the Committee on Banking and Financial Services, U.S. House of Representatives, One Hundred Sixth Congress, second session, June 22,

Federal Reserve prepares to raise policy rates for the first time in almost a decade, Latin America is in the midst of a sharp downturn with unemployment on the rise. In this context, many central banks across the region have kept interest rates low to support economic activity. But can monetary policy stay that way as global rates rise? What will the Fed liftoff imply for the region? Our analysis in the Regional Economic Outlook: Western Hemisphere suggests the effects of the upcoming Fed rate increase should be manageable for the region, although local long-term rates could increase considerably if the U. Countries with flexible exchange rates and credible monetary and fiscal frameworks should be able to continue providing support by keeping short rates low where needed. In the early s, many Latin American central banks adopted inflation targeting regimes featuring exchange rate flexibility, in part to avoid the need to deploy policies that exacerbated economic downturns triggered by large external shocks such as the Tequila and Asian crises of the s. But some argue that because of financial globalization, policymakers in small open economies cannot run independent or autonomous monetary policies, even under flexible exchange rate regimes. Indeed, interest rates around the world have tended to move in tandem, typically following U. But global business cycles also tend to be highly synchronized, so the observed comovement in interest rates may reflect that central banks were reacting to similar conditions, rather than following the Fed. This distinction is particularly relevant in Latin America now, where many business cycles in the region are out of sync with the U. To answer this question, we decompose the movements in domestic interest rates of 46 advanced and emerging countries into two parts. The second is everything else, including other central bank objectivesâ€”such as moderating exchange rate movements due to financial stability or competitiveness concernsâ€”or shocks that affect monetary conditions. We then ask to what extent this residual movement in domestic interest rates can be attributed to spillovers from global financial conditions, such as shifts in U. The answer to this question will suggest how much monetary autonomy central banks really have. We find that once we control for domestic macroeconomic conditions, spillovers from U. But they are still significant for some emerging as well as advanced countries, suggesting they do follow the Fed. The setting around the U. Figure 1 shows the estimated impact of Fed lift-off on long-term interest rates in selected countries after one year. Under the baseline scenario, U. As the market is expecting a very gradual hiking cycle in line with an improving economic outlook, the impact is expected to be small across Latin America. However, certain risk scenarios could cause larger impacts. For instance, the Fed could lift rates faster than markets currently expect. Alternatively, an unusually low term premium reflected in very low long-term U. If this risk materializes, the impact on Latin American interest rates could be substantialâ€”over basis points in some casesâ€—with important implications for government spending on debt service. While these scenarios are considerably less likely than the baseline, they are not unprecedented. Flexible exchange rates and credible policy frameworks are key An increase in domestic long-term rates may be unavoidable, but keeping shorter-term rates aligned with domestic conditions would certainly help. In that sense, our analysis suggests that the difference in spillovers across countries can be linked to policies and other characteristics Figure 2. Exchange rate flexibility plays the key role in ensuring that the central bank can gear monetary policy to a greater degree towards stabilizing the domestic economy. But the strength of policy frameworks is also crucial. Other factors can also help. For instance, financial dollarization substantially increases interest-rate spillovers, while an active use of reserve requirementsâ€”one part of the macroprudential toolboxâ€—can help mitigate them to some extent.

2: Dollarization: The recolonization of Latin America

This is the June 22nd, , hearing on Monetary Stability in Latin America: Is Dollarization The Answer? This is the Domestic and International Monetary Policy Subcommittee of the House Banking Committee.

Chairman thank you for inviting me to testify before this subcommittee hearing on the potential benefits of dollarization in Latin America. This is an under-appreciated topic in policy discussions on structural reform throughout the region, notwithstanding the experiments underway in countries like Argentina and Ecuador, and I congratulate you for organizing this opportunity to exchange views on the rewards and risks of radical monetary reform, both for Latin America and for the U. In the region as a whole, one "d-word" devaluation seems to have been replaced by another "d-word" dollarization. The global financial turbulence in , the exchange-rate collapse in Brazil at the outset of and fears of a traditional collapse and ensuing regional contagion at the end of a presidential term in Mexico in , have sparked popular and political debates about the pros and cons of radical monetary reform. The alternatives include establishment of a currency board, the elimination of legal tender monopoly of domestic currencies as a step towards establishing a regime of monetary competition or "co-habitation," or full unilateral dollarization. A fallout of the sequence of exchange-rate crises that began with the Mexico dramatic peso crash in is that investors focus explicit attention on what David Hale characterizes as the "quality of the monetary institutions," namely, the details of monetary conduct and transparency of monetary institutions. In Mexico, the systematic violation of the monetary contract has engendered a devalued generation, that is, a large group of millions of frustrated citizens who have, in their lifetime, never enjoyed the benefits of a climate of stability. This "monetary cynicism" is the result of historical inertia: In , despite solid macroeconomic fundamentals, fears of a fifth currency collapse reflect a widespread popular distrust with monetary policy and the commitment to preserving the stability of the purchasing power of the peso. In the absence of a credible monetary arrangement, dollarization emerges as a radical but powerful option to rule out currency risk and all the malaise that monetary instability causes in the real economy. Indeed, in the past five years alone, the nation has been unable to free itself from the inflationary ravages of the currency devaluation. In Mexico, the average rate was The idea is not new. Many voices have advocated forms of dollarization, and some officials endorse the proposal, albeit in "politically correct" fashion. The second version, known as "cohabitation," does not necessarily involve dollarization, but rather the more politically palatable option of decentralization: This would enable citizens to have a choice between world currencies in denominating transactions, fixing prices, issuing payroll, formulating contracts or paying taxes. The central bank would have a strong incentive to maintain the value of the domestic monetary unit similar to the strongest competing currencies, lest it loose the benefits of seigniorage. Sebastian Edwards, who is sympathetic to radical monetary reform, nevertheless suggests that the original enthusiasm for dollarization is misplaced. The idea, he claims, "is oversold. Yet, from a theoretical basis, the benefits of dollarization for countries with a weak history of price stability are extremely attractive: Inflation is both a monetary and exchange rate phenomenon in Mexico. The four maxi-devaluations in the period between have been followed by massive price instability. Dollarization would end the inflation-devaluation trap and allow the domestic price level to converge to international or U. The fall in inflation would permit a reduction and a stabilization of interest rates, and thereby stimulate the growth of private credit allocation. The spread between country rates and US rates would no longer be a function of exchange-rate risk, but of institutional or other extra-monetary forms of risk. In this regard, it is interesting to highlight that the Mexican government has no trouble floating financial instruments with a maturity of 20 years when these are dollar-denominated, yet finds it virtually impossible to place medium-term paper in local peso denominations. Despite an investment grade rating, private sector bonds have fallen to pre-investment grade levels, as a result of currency jitters associated with the electoral cycle. The goal of sustained growth, fully divorced from the vicissitudes of the political process, combined with stability in the price system, would then become a realizable alternative. Dollarization would rule out currency confiscation, capital controls, or the use of devaluation as a tool of discretionary public policy. The transparency in the new monetary system would give impetus to fiscal and structural reform, since a policy mistake eg. So dollarization would invite open international scrutiny. The absence of an independent monetary policy would constitute an incentive to move faster in improving other fiscal and structural policies. These potential benefits reflect the macroeconomic gains of prospective monetary reform. Yet, in addition, there are also important entrepreneurial considerations in favour of measures to formalize a dollarized, more integrated monetary system. The objections to dollarization or currency board reform embody three dimensions. A second objection is that dollarization requires relinquishing the flexibility of a floating exchange-rate policy and the "discretionary" use of exchange rates to counteract external shocks. This objection is popular, but begs the crucial question, since the issue is precisely whether discretion is or has been a necessary tool for stability. The third set of objections is pragmatic, that is, the financial or technical obstacles that prevent dollarization from taking place. This set, naturally, varies from country to country: Seigniorage, the earnings a central bank derives from issuing currency, would be foregone under a dollarized economy. In currency board arrangements, seigniorage is accrued via interest earned on hard currency reserves. The supporters of dollarization initiatives claim negotiations can lead to sharing of seigniorage with the Fed, but this is an open question. The cost-benefit equation would have to measure the increase in growth and investment, or the use of another more transparent tax to replace foregone income, in the context of price stability, against the loss of seigniorage. Lender of Last Resort. If the local banking system becomes globally integrated, however, international banks would gradually absorb this facility. Moreover, alternative options for the lender of last resort facility can be developed from the fiscal side. A negative external shock would entail burdening the real economy with the full adjustment, instead of using the exchange rate as shock absorber. A flexible labour market is essential to mitigate the pain occasioned by such shocks. This is a function not of monetary policy, still less of policy designed to protect employment via exchange rate adjustments, but of properly structured labor market reform and greater flexibility in migratory flows. These "objections," to repeat, are not theoretically telling. They represent technical obstacles, not conceptual arguments against a specific monetary view. To be sure, an important issue is whether a wholesale reform of the economy to fulfill the alleged requirements of successful dollarization for instance, healthy banks, sound public finances, flexible labor markets, general deregulation, capital mobility, and the like would render the exchange-rate debate boring and meaningless. If the house is in full order, there might not be a need to fix the exchange-rate roof. Confidence and substantial capital inflows would perform the task. On the other hand, this claim is ambiguous. The use abuse of floating rates as negative shock absorbers transfers the burden of adjustment to real domestic-denominated salaries; and this tends to retard, or mask, the need for structural reform in the real sector of the economy. It is, on the other hand, a crucial alternative in contemplating workable stabilizations policies. As it is, spontaneous dollarization, particularly in the commercially robust US-Mexico border region, constitutes a source of the exchange-rate debate. In the crowded streets of Tijuana, for example, one finds street vendors selling the popular weekly, Zeta, sporting catchy monetary headlines: The exchange is simple, but it is conducted in foreign currency. Indeed, this flight to stability continues, notwithstanding critical structural changes such as public finance reform, wholesale privatization of state owned entities and a policy of open trade. From an entrepreneurial point of view, this means that economic expectations are governed by volatility, or an increasingly speculative scenario wherein the exchange rate becomes subject to strong episodes of revaluation and devaluation. This is exactly the pattern that the peso-dollar exchange rate has followed since As a consequence, the peso is not a reliable store of value, still less a reliable instrument for extended payment. As local businessman Eugenio Clairond has stated, in an open testimony to the Dallas Federal Reserve Board, under a regime of stability "transaction costs would be reduced substantially. In other words, the dollarized Mexico is a much better growth performer than the peso denominated Mexico. In , Mexican Minister of Commerce Jaime Serra noted that trade integration and the gradual hemispheric expansion under NAFTA would enable international investors to focus on a single trade bloc, characterised as a dollar zone. This would force businessmen to maintain concerns within their own purview: There is no basis for patriotic pride in high interest rates and a cumulative inflation rate of , percent in one generation. This is the technocratic argument. Despite the popularity of this argument, this kind of "I-know-so-much-more-than-you-do" policy advice defies the common sense logic of radical currency reform. Businessmen, big and small, support dollarization out of a desire to rule out exchange-rate risk and episodes of unforeseen volatility. For the 70 percent of Mexicans who are under the age of 30, dollarization represents a chance to import monetary credibility. This generation is fundamentally ignorant of the privileges of low inflation and financial stability. To amend the analogy, the arm should be amputated, since it is riddled with the cancer of peso devaluation and persistent inflation. Indeed, many Mexicans already vote with their monetary feet. The newspaper vendors do business in dollars, as do the real estate agents. In the maritime ports almost all transactions are dollar denominated. A good number of businesses calculate projections in dollar terms, or use an exceedingly conservative exchange-rate calculation. The risk of volatility and devaluation imposes a huge cost in terms of time and freedom to plan. The objection that flexibility would be lost begs the very question. We do not see Texas announcing the introduction of a new currency, then devaluing the exchange rate to neutralize an external shock such as a drop in the price of oil. In countries with a sound currency, adjusting to external economic shocks is done by a mixture of workers migrating to another state, an increase in productivity and a helping hand from governments via a reduction in taxes or in red tape. A flexible labor market is essential to mitigate the pain that such shocks inevitably bring. At the current exchange rate, this amount is worth 28 pesos, or 28, old pesos, before the government decided to lop three digits off the currency in This is enough to finance a simple lunch-- a coke and a hamburger. Yet, with 28, pesos, the father of the young vendor would have been able to buy a compact automobile in the early s. Such is the outrageous price of exchange rate intervention. The peso, viewed in this light, is a product of low quality. It is not a reliable store of value and it hardly performs its duty as a unit of account. Of course, dollarization is not a panacea. It is more akin to a monetary straightjacket. In Panama, for example, there is no monetary sovereignty; but by wearing this imported straight jacket, the country enjoys a climate of zero inflation, with a robust banking system capable of extending year mortgages. Thus, it would be a mistake would be to construe dollarization as a guarantee of sound policy. No exchange rate and monetary system is foolproof. The fundamental motive for radical currency reform exploits a central problem with monetary institutions of Latin countries. Governments remain suspect after so many failed plans or "pactos. This is the logic of dollarization: In effect, the construction of a credible and functioning independent monetary policy requires a long well-established track record of stability.

MONETARY STABILITY IN LATIN AMERICA: IS DOLLARIZATION THE ANSWER? pdf

3: Financial Dollarization in Latin America

Summary: This paper tests several explanations for financial dollarization (FD), with an emphasis on Latin America. The results provide evidence that FD is a rational response to inflation uncertainty.

But dollarization usually persists many years after the problems that triggered it are alleviated and limits the effect that central banks can have on economic activity and inflation. As a result, many countries have tried to slowly wean their economies off dollar use see Chart 1. Letting the exchange rate change according to market conditions would help a de-dollarization effort by making it as risky to save as it is to borrow in dollars rather than in the domestic currency. The recent sharp terms-of-trade shock faced by many dollarized emerging markets has added urgency to the issue. The marked decline in export prices has put depreciation pressures on the currencies of commodity producers. Currency depreciation creates winners such as households with savings in foreign currencies and losers such as corporates and households that borrow in foreign currencies because repayments in dollars cost more. As a result, the probability of loan defaults rises as do risks to the financial sector. The question policymakers in highly dollarized economies must confront is whether to allow their exchange rate to adjust fully to the shock of lower commodity prices and expose the financial sector to these negative balance-sheet effects, or to curb exchange-rate flexibility, even if it hinders de-dollarization. In our study , we look at data for 33 emerging-market economies from to and find that greater exchange-rate flexibility reduces incentives to lend in dollars. Effect of exchange rate flexibility on dollarization Our research on the effect of exchange rate flexibility on dollarization reveals the following: First, the exchange rate had moved more in countries that subsequently experienced a significant reduction in dollar loans measured as a reduction of loan dollarization of at least 20 percentage points over the sample period, to below 20 percent. Second, statistical estimates confirm that more exchange-rate flexibility causes more rapid de-dollarization. These estimates hold even after controlling for the differential in domestic and foreign interest rates, the macroeconomic framework in individual countries such as whether the country is an inflation targeter , measures of external volatility, the amount of inflation volatility, and other measures of domestic risks. The analysis also suggests that restoring nearly full exchange-rate flexibilityâ€”and, along with it, the risks of lending and borrowing in foreign currencyâ€"would provide incentives to save and borrow in local currency. Our results suggest that policymakers should allow the exchange rate to adjust fully when facing external shocks if they want to reduce dollarization and gain greater control of monetary policy. However, the question remains of how to manage risks from mismatched balance sheetsâ€"that is, corporations and households who borrow in dollars but whose income is in the now depreciated local currency. A look at Peru Peruâ€"a commodity producerâ€"is a good case study. Following the hyperinflation of the late s and early s, which led to dollarization levels of around 90 percent, Peru embarked upon serious macroeconomic reforms. A new fiscal responsibility law helped keep deficits and debt low, while an inflation-targeting regime, adopted in , bolstered confidence in the local currency. The economic house was put in order and dollarization receded, but it remained at around 40 percent in At this level, dollarization still kept the banking system potentially vulnerable to exchange rate movements. Indeed, to support a strategy of limiting financial risks from dollarization, the central bank curbed exchange rate volatility for many yearsâ€"a decision that could have limited the extent of de-dollarization in the country see Chart 2. However, recently Peru has put in place macroprudential measures i. Among the de-dollarization measures, the Peruvian government made it more expensive for banks to lend in foreign currenciesâ€"taxing foreign exchange lending, imposing stricter requirements such as more stringent loan-to-value ratios on foreign currency loans, and making it less profitable for banks to accept foreign currency deposits by increasing the percentage of those deposits banks must maintain with the central bank that is higher reserve requirements. Moreover, since , the Peruvian government has set explicit de-dollarization targets and raised the costs of dollar lending in banks that failed to comply with them. These strong incentives for lower lending in U. This provides banks the soles they need for local currency lending. As a result of these prudential measures, loan dollarization has declined from 40 percent in to about 29 percent in recent months without a credit crunch, which supported the growth recovery following the economic slowdown.

MONETARY STABILITY IN LATIN AMERICA: IS DOLLARIZATION THE ANSWER? pdf

4: Monetary Stability in Latin America

Dollarization in Latin America: Solution or Straitjacket? Remarks at the International Monetary Fund, June 24, Excerpts from: "No Single Currency Regime is Right for all Countries or at All Times".

The most powerful imperialism on the planet has widened its policies of exploitative expansion to include the entire Latin American continent. In order to achieve its expansionist objectives, it has set as its primary goals the dollarization of the continent and the orchestration of free trade preached by the Free Trade Area of the Americas. External debts, privatizations, flexible labor, and militarization of the region-as in Plan Colombia-are the central elements of its recolonizing policy. Dollarization The process of introducing a single currency in Latin America has fairly distant antecedents, but never has there existed so great a drive as the one being felt today. There are two forms for the implementation of "dollarization. In turn, there are those in the first group that abandon their local currencies in a bilateral way-reaching an agreement with the U. Federal Reserve, which implies sharing control and obtaining a cover for the issue of new dollars according to new demand-and those that opt for doing it unilaterally. There are already four Latin American nations that have formally anchored their economies to the dollar: Ecuador, El Salvador, Guatemala, and Panama. In this last case, the balboa was replaced by the dollar in Dollarization in Ecuador occurred in January ; in El Salvador, a year later January ; and in Guatemala, in May , after the Guatemalan Congress approved last December a law allowing free circulation of the dollar as a currency that, in principle, would coexist with the quetzal. The economy of Costa Rica will soon join them, although at the moment, the results of trial experiences are pending. The rest of the Latin American continent is divided among those that are informally dollarized, those that are on the way there, and those that still have some reservations about joining in. Nations of the size of Argentina, Colombia, Peru, Paraguay, and Honduras are in the process of dollarizing formally. Something similar is happening in Mexico, since its type of exchange is related to "free floating," which has been the rule since the crisis of December and has become known as the "tequila effect. The case of Argentina is the most explicit, since the so-called Convertibility Plan was orchestrated in under the presidency of Carlos Menem and the economic leadership of Domingo Cavallo. With this, they "invented" the one-to-one equivalence of the peso and the dollar. Therein lies the key to informal dollarization. Sixty percent of deposits are held in U. All it would take is the application of the reforms already imposed in Ecuador, and Argentineans would definitively lose their economic sovereignty. Paraguay and Colombia are not much different from the preceding example. Guarani economist Cesar Barreto discovered that "in our country, 65 percent of deposits are in dollars, as are 50 percent of private-sector loans. Paraguay is virtually dollarized and the guaranI has completely lost its role as a valuable reserve currency and accounting unit. This is why he predicts that, "at the right moment," the country can adopt free convertibility as its exchange policy. Economic sovereignty and international monetary stability The total and absolute loss of economic and monetary sovereignty is one of the principle characteristics of dollarization, which undoubtedly brings with it a disaster for the political independence of the dollarized nation. At present, the Latin American countries as a whole are tied to the designs of U. But the adoption of the dollar will intensify their subjugation even more. Any dollarized country will absolutely lose any possibility of designing a politics of growth, of independent development from the United States, or of real and definite attention to the social needs of its inhabitants. Its economic strategy will be completely tied to the U. Federal Reserve, which means that national governments will be converted into mere managers or administrators of the U. Such a policy is a rejection of monetary control, of any monetary policy, and lets prices adjust directly to the dollar. The countries that adopt the dollar are going to be in very serious recessions. But for researcher Ruben Pinero Santana, all of this could lead to a deflation that would be very difficult for the national productive apparatus to assimilate, as a result of its inefficiency and scarce technology. He wrote in his analysis for the Cuban publication El Economista: The result would be the de-capitalization of national enterprises and their eventual replacement by foreign capital. Looking ahead, the

MONETARY STABILITY IN LATIN AMERICA: IS DOLLARIZATION THE ANSWER? pdf

U. Toward this end, U. These include monetary stability, the lowering of inflation and interest rates to U. Ievels, greater economic growth that would stimulate savings and investments, and a strengthening of the financial system. But no one says anything about how a dollarized country could be easily converted into a fiscal paradise for money laundering and counterfeiting. In this same line of argument, IMSA asserts that such changes would help to stabilize export markets and make them grow faster. It also states that it would give U. Because of its contribution to strengthening the international financial system, IMSA claims that it would increase profits in the United States. Meanwhile, Guillermo Gil, a specialist in monetary policy at the Central Bank of Cuba, has offered this interpretation: The total dollarization of Latin America would guarantee the existence, for U. Moreover, it would mean the complete hegemony of the dollar in the region, to the detriment of the euro, from which it is easy to infer that this is the U. And it would constitute the most effective "weapon for destroying regional trade blocs-Mercosur- thus avoiding the emergence of a common currency and the integration of the region outside of U. In conclusion, the perspective is that the Latin American nations that accept this monster-dollarization-will be converted into colonies that are both integral and useful to the Empire. The governments of these nations will be transformed, as far as the United States is concerned, into mere administrators of second-rate provinces.

MONETARY STABILITY IN LATIN AMERICA: IS DOLLARIZATION THE ANSWER? pdf

5: Enhancing Monetary Policy Flexibility Through `De-dollarizationâ€™ | IMF Blog

many countries in Latin America, making it one of the most dollarized regions in the world. Financial dollarization is typically a consequence of past episodes of severe economic crisis and high inflation, which made the U.S. dollar the preferred currency to minimize risks for.

Bretton Woods system After the gold standard was abandoned at the outbreak of World War I and the Bretton Woods Conference following World War II , some countries sought exchange rate regimes to promote global economic stability, and hence their own prosperity. Countries usually peg their currency to a major convertible currency. In all long-standing currency substitution cases, historical and political reasons have been more influential than an evaluation of the economic effects of currency substitution. Measures[edit] There are two common indicators of currency substitution. The first measure is the share of foreign currency deposits FCD in the domestic banking system in the broad money including FCD. The second is the share of all foreign currency deposits held by domestic residents at home and abroad in their total monetary assets. Unofficial currency substitution occurs when residents of a country choose to hold a significant share of their financial assets in foreign currency, even though the foreign currency is not legal tender there. Official currency substitution or full currency substitution happens when a country adopts a foreign currency as its sole legal tender, and ceases to issue the domestic currency. Another effect of a country adopting a foreign currency as its own is that the country gives up all power to vary its exchange rate. There are a small number of countries adopting a foreign currency as legal tender. Full currency substitution has mostly occurred in Latin America, the Caribbean and the Pacific, as many countries in those regions see the United States Dollar as a stable currency compared to the national one. This type of currency substitution is also known as de jure currency substitution. Currency substitution can be used semiofficially or officially bimonetary systems , where the foreign currency is legal tender alongside the domestic currency. External liability currency substitution measures total external debt private and public denominated in foreign currencies of the economy. The first is the significantly negative effect of exchange rate volatility on trade in most cases, and the second is an association between transaction costs and the need to operate with multiple currencies. The elimination of the currency crisis risk due to full currency substitution leads to a reduction of country risk premiums and then to lower interest rates. However, there is a positive association between currency substitution and interest rates in a dual-currency economy. Adopting a strong foreign currency as legal tender will help to "eliminate the inflation-bias problem of discretionary monetary policy". Currency substitution cannot eliminate the risk of an external crisis but provides steadier markets as a result of eliminating fluctuations in exchange rates. Seigniorage revenues are the profits generated when monetary authorities issue currency. When adopting a foreign currency as legal tender , a monetary authority needs to withdraw the domestic currency and give up future seigniorage revenue. The country loses the rights to its autonomous monetary and exchange rate policies, even in times of financial emergency. This cost depends adversely on the correlation between the business cycle of the client country the economy with currency substitution and the business cycle of the anchor country. The alternatives to lending to the bank system may include taxation and issuing government debt. This cost depends on the initial level of unofficial currency substitution before moving to a full currency substituted economy. This relation is negative because in a heavily currency substituted economy, the central bank already fears difficulties in providing liquidity assurance to the banking system. Assets and liabilities on the balance sheets may be in different denominations. This may arise if the bank converts foreign currency deposits into local currency and lends in local currency or vice versa. Arises if the bank uses the foreign currency deposits to lend in foreign currency. Currency substitution may reduce the possibility of systematic liquidity shortages and the optimal reserves in the banking system. This phenomenon is called the "flight from domestic money". It results in a rapid and sizable process of currency substitution. At the beginning of this process, the store-of-value function of the domestic currency is replaced by the foreign currency. Then, the unit-of-account function of the domestic currency is displaced when many prices are quoted in a foreign currency. A prolonged period of high inflation will induce the domestic currency to lose its function as medium of exchange when the public carries out many transactions in foreign currency. Currency substitution increases with inflation volatility and decreases with the volatility of the real exchange rate. The first factor is the level of development of the domestic financial market. An economy with a well-developed financial market can offer a set of alternative financial instruments denominated in domestic currency, reducing the role of foreign currency as an inflation hedge. The pattern of the currency substitution process also varies across countries with different foreign exchange and capital controls. In a country with strict foreign exchange regulations, the demand for foreign currency will be satisfied in the holding of foreign currency assets abroad and outside the domestic banking system.

MONETARY STABILITY IN LATIN AMERICA: IS DOLLARIZATION THE ANSWER? pdf

6: "Dollar Democracy: The Politics of Dollarization in Latin America" by Cori Madrid

The answer is yes and no. Dollarization may promote economic stability in the short term, but structural and institutional problems must also be addressed if a dollarizing country is to achieve long-term economic growth and development.

Responding to Global Crises: Dollarization in Latin America The Latin American region has been the subject of much conversation recently as financial crises spread across the globe. In an effort to provide stability to their economies, several Latin American countries have considered adopting the U. While adopting the dollar has its benefits, it also has potential drawbacks. A s economists struggle to explain the development and the spillover potential of financial crises, policymakers and economic advisers search for ways to protect their economies from the devastating effects these crises can cause. A number of proposals have been put forward. These include creating a new international financial architecture, instituting capital controls, applying stricter monetary and fiscal policy regimes, and implementing outright dollarization of an economy. Recently this last proposition has drawn significant attention as a potential scenario in certain Latin American countries. But there is much to consider before a country dollarizes its economy. In a totally dollarized economy, the U. Today, Panama is the only country in Latin America that is totally dollarized; it has been since A country that has totally dollarized has eliminated the monetary policymaking role of its central bank. Limited dollarization occurs when U. In this arrangement, the domestic currency continues to serve to some degree as a medium of exchange, store of value and unit of account. Limited dollarization exists in many countries throughout the world, notably in Latin America. A recent International Monetary Fund study Occasional Paper estimated that in dollar deposits were at least 50 percent of domestic money supplies in seven countries around the world, between 30 percent and 50 percent in 12 countries, and between 15 percent and 20 percent in several other countries. Outside of Panama, Bolivia is the most significantly dollarized economy in Latin America, with a ratio of 82 percent; Argentina is next with a 44 percent ratio. A de facto dollarization can occur when citizens lose faith in their national currency and turn away from it toward the dollar. This course has occurred in many Latin American countries. Although most Latin economies are making significant attempts to institute and solidify policy credibility and have made impressive headway in limiting inflation, these initiatives are recent, most having been applied over the past decade. In other words, the probability of devaluation rises, and more citizens shun the national currency in favor of the historically more stable U. Another path to dollarization occurs when a foreign government makes a conscious decision to re-place its own currency with the U. In a totally dollarized economy, this replacement affects all transactions. In a country with limited dollarization, this policy shift can take the form of allowing residents to hold dollar-denominated accounts. The benefits of dollarization Total dollarization nearly eliminates the possibility of a currency devaluation. The threat of devaluation has been a major concern for many people and businesses holding assets in Latin American currencies in the wake of recent international financial crises in Asia and Russia. The capital flight from many Latin countries in and early came about because asset holders there appeared to believe that these international crises threatened economic stability. Many of those with access to international financial markets moved to exchange national currencies for dollars or other foreign currencies. By dollarizing, a country adopts U. As long as U. A history of high inflation and policy volatility are often prevalent in countries that are partially dollarized and are main reasons behind their dollarization in the first place. The high interest rates in such countries reflect inflation expectations and, at the same time, restrain real economic activity. By importing benign U. Chart 1 shows that interest rates in Latin America skyrocketed in the wake of the Asian financial crisis in the fall of , again following the Russian default in August , and again in January as Brazil devalued its currency. The chart shows the spread between selected Latin American Brady bond yields and comparable yields on U. An increase in the spread indicates that investors allotted an increased risk to holding Latin American debt. Dollarization arguably could reduce this spread to nearly zero because the threat of devaluation and the resulting pressure on international payments would be significantly diminished. In addition to deterring devaluation and inflation, dollarization reduces the transaction costs associated with international trade and finance with the United States, which is the most important trading partner for Latin America as a whole see Chart 2. Eliminating currency conversion would allow trade to flow more easily. Dollarization should not be viewed as a panacea for an environment created by economic mismanagement, however. Developing policy credibility to a point at which residents have sufficient confidence in the currency takes decades of prudent fiscal and monetary policies, uninterrupted over many administrations and supported by major political parties. Since most Latin American nations are in their first decade of real and sustained economic reform, their policy credibility is still being built. Dollarization in this environment should be viewed on a case-by-case basis. The costs of dollarization Dollarization also implies some costs to the economy of a country that adopts it. A dollarizing country relinquishes several important policy instruments. For one, monetary policy in a dollarized economy is made by the Federal Reserve in the United States. But the policy environment in which we attempt to achieve this mandate is global. No economic condition in any part of the world can be considered exogenous. And any action intended to produce a strictly domestic result is almost instantly transmitted around the globe and may or may not be countervailed by a concomitant change in international economic conditions. But it also presents equally formidable challenges for those of us whose job it is to sort it all out, to take advantage of it or to understand where the policy action is. In the global economy, our policies are more influential than ever, although the equation through which we calculate them is more complex. Understanding that equation is the challenge. But the FOMC bases its decisions on considerations about the welfare of the United States and its citizens, not about the welfare of countries that have dollarized. The role of the Federal Reserve and its domestic mandate in a highly globalized economy remain important issues, issues that Jack Guynn, president and chief executive officer of the Federal Reserve Bank of Atlanta, noted in a speech last year see the sidebar on page But chief policymakers at both the Fed and U. Department of the Treasury have stated that the policies of the United States will not be altered to adapt to the economic considerations of countries that choose to dollarize. So foreign governments that may be considering full dollarization must do so with the understanding that U. Countries debating whether to dollarize should also consider how reversible that policy would be. Although a government can always choose to end its dollarization policies, the risk of financial instability from this move would be a powerful force working against reversing dollarization. There is also a measurable monetary cost, called lost seigniorage, involved with forgoing a national currency. Seigniorage is the revenue gained by issuing currency. Governments that dollarize will give up the benefits of seigniorage, although this total benefit is estimated to be less than 1 percent of gross domestic product GDP in most countries. Adopting the dollar as the official currency has both political and economic ramifications for a nation. The loss of sovereignty that accompanies the surrender of monetary policy control, the national currency and the central bank is likely to spark opposition within a country. Such opposition is evident in some Latin American countries where the dollarization debate is under way. Although the business community in many of these nations appears to back dollarization, other segments of society may view the loss of sovereignty as too great a price despite the economic benefits. The outcome of this debate will be one of the most important economic developments in Latin America in the near term. Dollarization also implies some costs to the economy of a country that adopts it. Although dollarization may not be feasible for all economies, it would seem to benefit some. Small, open economies that are particularly vulnerable to international shocks may find that adopting a high level of dollarization or pegging their currency to the U. Countries with strong international trade and financial ties to the United States are also among those better equipped to seriously consider dollarization. Transaction costs between such countries and the United States should be reduced by dollarization, and this reduction could help develop even stronger ties through other economic arrangements. This advantage is particularly important for Latin America, which has a stronger trade relationship with the United States than with any other country or region. The move toward a Free Trade Area of the Americas has dropped from the headlines because of international financial crises and political developments in the United States. Dollarization could lead to the deepening of trade relationships that may integrate the hemisphere. Latin American countries stand to gain the most from such a development. In Latin America, the cases of Argentina, Mexico and Brazil highlight the current dollarization debate. Argentina has stated officially that it would like to totally dollarize its economy. The country instituted a currency board in in response to hyperinflation and a lack of policy credibility. Despite its fixed exchange rate and constitutionally self-imposed restrictions on issuing currency, Argentina still finds itself buffeted by international shocks. Monetary policy is automatic. If investors switch out of domestic currency into dollars, the supply of domestic currency will automatically shrink. This decline will cause interest rates to rise until it becomes attractive for investors to hold local currency again. Total Dollarization The process involves adopting the U. The national currency unit ceases to exist. Monetary policy is made by the Federal Reserve in the United States with no formal input from officials in the dollarized economy. Monetary Union Members of a monetary union agree on a common currency, either by adopting an existing one or issuing a new currency altogether. Monetary policy is made collectively, with input from each member of the union. The loss of sovereignty that accompanies dollarization is a difficult political hurdle in Mexico at present. Brazil shows no interest in pursuing official dollarization despite its recent economic troubles and hyperinflationary bouts in the s and early s. Its trade and financial ties with the United States are as strong as those of many other South American economies, but its economy remains comparatively closed, with total exports accounting for roughly 7 percent of GDP. Like the dollarizing countries, U. Currency conversion could be eliminated, and the administrative costs associated with international trade and investment would decrease. As long as the U. Businesses in the United States would also benefit from the expected fall in inflation and interest rates in dollarized economies because these developments should, in turn, lead to faster rates of economic growth in these countries. The stronger consumption and increased sales this growth would spark could improve the performance of U. To dollarize or not to dollarize Dollarization is one proposition currently under consideration as a means to prevent, limit or contain the kinds of financial crises that have swept the globe during the past two years. Countries considering dollarization need to undertake a careful cost-benefit debate, weighing the benefits against the resulting loss of sovereignty and the realization that monetary policymakers in the United States have a domestic focus, considering international issues only insofar as they affect U. Not all countries appear suited for dollarization.

MONETARY STABILITY IN LATIN AMERICA: IS DOLLARIZATION THE ANSWER? pdf

7: Currency substitution - Wikipedia

Page 52 Oshkosh Scholar econometric analysis indicates that dollarization has brought greater economic stability (low inflation rates) and economic progress (economic growth) to Latin America.

In the summer of the ratio was Generally the ratio varied near Florida has had senators from opposite parties since December 31, , but Connie Mack III was a Republican senator for two terms from January 3, â€" January 3, He introduced the S. The host country would have some requirement to institute Anti Money Laundering Laws. Dollarization is possible without such an offer, but it is very expensive for the host country since they are acquiring banknotes at face value. Commie Mack noted in that Ecuador is in the process of dollarization right now. El Salvador, Guatemala, and Costa Rica are all considering dollarization. Argentina remains a candidate for dollarization. The bill would encourage countries to consider dollarization during periods of relative stability, when it is most likely to be successful, rather than during periods of economic crisis. The Act talked about "Is official dollarization right for all emerging market countries? The bill merely removes the obstacle of the seigniorage transfer to the United States. Countries would still refrain from official dollarization if they did not think it was in their best interests. In addition, if a country thinks official dollarization is in its best interests but the Secretary disagrees, the Secretary could refuse to rebate seigniorage. The Act talked about "What does the United States gain from the bill? At present the United States exports more to the 31 million people in Canada than to the million people in all of Latin America. Dollarization should result in faster economic growth and more purchasing power in Latin America, thereby creating larger markets for U. In addition, dollarization should reduce currency risk, thereby helping U. And by helping foreign governments strengthen their economies it would reduce the need to use U. Ecuador did dollarize because of financial crisis. El Salvador also dollarized without a financial crisis. But the motivation for El Salvador was simply that so much of the economy was dependent on reparations sent from workers in the USA, that it was actually costing them more to have their own currency, Mexico and Brazil were obviously not mentioned in the Act, because as the two largest economies in Latin America dollarization would likely be a political hotbed. But the impact of Mexico dollarizing could be the most positive. Much of Latin America is already dollarized on an unofficial basis. Unofficial dollarization means that, despite the existence of a national currency, people often use the U. Official dollarization means a country eliminates its own paper currency and adopts the U. Only the and the handful of peso notes would have to be replaced with US banknotes as the pesos banknote represents the majority of the value of currency in circulation. Free flotation warranties that Any difference of productivity will be reflected in the ratio of currency Exchange. If such Free flotation disapears, Wht it comes is what spain suffered, Large portions of people sent to unemployment and rehiring with lowered wages to correct income to productivity.

8: Archives | Financial Services Committee | U.S. House of Representatives

Is dollarization a remedy for economic stability in Latin America? The answer is yes â€" and no. Dollarization may promote economic stability in the short term, but structural and institutional problems must also be addressed if a dollarizing country is to achieve long-term economic benefits.

9: To Hike or Not to Hike? Monetary Policy in Latin America During Fed Liftoff | IMF Blog

How can emerging markets such as those in Latin America solve this fundamental monetary policy dilemma? The answer, according to the report, is central bank independence, low levels of dollarization and credibility in the markets.

MONETARY STABILITY IN LATIN AMERICA: IS DOLLARIZATION THE ANSWER? pdf

The Life of Peace Forecast and fantasy in Little Dorrit Genetic Algorithms Reference Volume 2 Mutation operator for numerical optimization problems Marshall Islands 1996 Economic Report (Pacific Studies Series) Nanostructure control of materials Microsoft project management 2013 Freedom from sinful thoughts: Christ alone breaks the curse. Non-violence and justice as inseparable principles : a Gandhian perspective Veena Rani Howard The Covenant/The Inheritance/The Dream (The White Pines Chronicles 1-3) Folk Literature of the Ge Indians (Ucla Latin American Studies) Credibility as the voice of authority Transfer and diffusion of information technology for organizational resilience Neuroanatomical Techniques HBOs Guide to Movies on Videocassette and Cable TV 1990 Canine rehabilitation and physical therapy Gun Digest 2001 (Gun Digest) Mythology Pictures Mythologische Bilder Motifs Mythologiques On the mathematics lesson Alexander Karp and Leonid Zvavich V. 1. Pages 1-1154 Tcs aptitude questions and answers 2012 Ethical Dilemmas in Modern Medicine Poems of the Great War. Surface treatment VI 426 Observations on Volume Changes of Bunter Vision y Voz Student Text Poppy the puppy (Peek-a-boo pets board books) The youngest kite. Methods of behavior analysis in neuroscience Soul of Adulthood A Commentary on Isaiah EXAMNotes for Psychology An Introduction The Complete Painting Course Regulations of international business Hum[o]r for a w[o]mans heart 2 Hockey Superstars 1998-99 The ex games 1 Lead sheets charts stan getz Sheilas Diary Vol. 3 Np bali solutions The new rolling stone album guide