

<http://news.ft.com/ft/gx.cgi/ftc?pagename=View&c=Article&cid=FT3914MUKMC&live=true>

Financial Times, May 11 2001

The false promise of dollarisation

Emerging countries that give up their currencies do not always reap the intended economic benefits,

Argues,

Sebastian Edwards

Published: May 10 2001 19:08GMT | Last Updated: May 10 2001 19:12GMT

The recent crises in Argentina and Turkey have reignited the debate on exchange rate policies in emerging countries. A small but increasingly vocal group of economists argues that emerging nations should give up their currencies and adopt an advanced nation's currency as legal tender.

What started as an intellectual but impractical idea has become a genuine policy option. In 2000, in the middle of a crisis, Ecuador abolished its currency, the sucre, and adopted the US dollar. On April 30 the dollar became legal tender in Guatemala; and El Salvador recently announced that it planned to adopt the dollar this year. Argentina has recently decided against it but its supporters consider this a temporary setback and expect the troubled South American nation soon to join the ranks of the dollarised.

This rather drastic piece of advice - giving up the national currency - is being dispensed on the basis of limited empirical and historical evidence. It is akin to a physician prescribing a drug without making clear what other steps the patient must take and without explaining the drug's side effects or its rate of success in clinical trials.

The economic record of dollarised nations leaves a lot to be desired and the recent push for dollarisation is a typical case of misleading advertisement. Countries that give up their currencies, we are told, will be unable to engage in macroeconomic mismanagement. Public finances will stay in balance and external accounts will move within reasonable bounds. Dollarisation-imposed macroeconomic stability is purported to bring lower interest rates, higher investment and superior economic performance.

Twelve independent nations used another country's currency between 1970 and 1998 - all very small countries with a median population in 1998 of 45,000. Many are city-states fully integrated into their neighbours' economies, such as Monaco, Liechtenstein and Andorra. The largest dollarised countries in this period were Liberia and Panama. Only the latter, however, remains dollarised; Liberia abandoned the system in the 1980s, when the government of President Samuel Doe decided to issue local currency.

The growth in gross domestic product per capita in these 12 countries has been

significantly lower than in countries that use their own currencies. There is no evidence that nations that use other countries' currencies are more fiscally prudent. And in terms of current account imbalances, their behaviour has been no different from that of countries with their own currencies.

However, countries that have given up their own currencies have had significantly lower inflation.

Supporters of dollarisation point to Panama, which has low inflation, macroeconomic stability and low interest rates.

But Panama has relied heavily on the International Monetary Fund in the past 35 years or so, with 17 IMF programmes since 1973. The most recent was signed in late 2000 and is expected to run until late 2002. The reason for these programmes has been Panama's inability to control its public finances. Between 1973 and 1998 the fiscal deficit averaged 4 per cent of GDP and during 1973-87 - a period of continuous IMF programmes - it exceeded a remarkable 7 per cent of GDP. As recently as 1998 the public sector deficit was still 3 per cent of GDP; the IMF has estimated that during 2000 the deficit declined to a more modest 1 per cent of GDP. Why has the IMF accommodated Panama's repeated macroeconomic transgressions? Considerations of political economy - including the US interest in maintaining the canal zone free of political turmoil - are surely part of the answer.

Contrary to what supporters of dollarisation claim, Panama's cost of capital has not been the lowest in Latin America. The spread over Panamanian bonds has been systematically higher than that over Chile's sovereign bonds of similar maturity. But Chile has followed a different policy: its exchange rate has become more flexible. So dollarisation does not by itself reduce country risk.

Robert Mundell's optimal currency areas analysis is the right approach for dealing with the dollarisation question. Mundell argues that there are good reasons to think that very small countries that are highly integrated in terms of factor mobility and trade will benefit from having a common currency. The benefits could possibly compensate for the costs, including the loss of seignorage.

But dollarisation is not appropriate for all countries. Large countries that face volatile terms of trade and are not deeply integrated into big economies are likely to incur net costs if they dollarise. They will have difficulties in accommodating external shocks while the alleged benefits of low costs of capital, fiscal discipline and stability may continue to be elusive.

The writer is the Henry Ford II professor at UCLA's Anderson Graduate School of Management. Between 1993 and 1996 he was chief economist for Latin America at the World Bank.