XX. De jure dollarization and euroization

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A discussion of de jure dollarization and euroization presumes the presence of two different phenomena. Typically, de jure dollarization refers to the official adoption of a foreign currency – any foreign currency – in lieu of the national currency.[2] It follows that the standard definition of dollarization also comprises the unilateral adoption of the euro as exclusive – or parallel – legal tender. What do we talk about, then, when we talk about euroization?

Taking advantage of the absence of a standard definition of the term, I propose to understand euroization, more specifically, as monetary integration with the euro area. As I will argue below, this entails important differences with dollarization – as well as with monetary unions in general. But in order to frame the discussion, it is useful to revisit first the traditional dollarization debate.

This debate was reheated by the stream of emerging market crises in the late 1990s. The crises revealed the vulnerability of conventional pegs – which had regained popularity in the 1980s and early 1990s as a deflationary device – to self-fulfilling runs and speculative attacks, narrowing down the exchange rate regime debate to a credibility issue: unless a credible commitment device could not be engineered, governments would better avoid any commitment to a fixed exchange rate at all.

For a while, the so-called hard pegs were proposed as a partial solution to this dilemma. In a nutshell, this 'bipolar view' argued that the only alternative to floating was a pegged regime that was irreversible enough to eliminate the standard time inconsistency problem that plagued previous fixed arrangements.[3] If exit costs were enormously high – either due to legal constraints or to deleterious economic consequences – it would be ex-post optimal for a government to ensure the sustainability of the regime – and for market participants to believe in it.

Underlying this view was the belief that, in the absence of a strong national currency (as in most developing economies), the scope for an independent, counter-cyclical monetary policy – and, in general, the benefit of a floating exchange rate – was bound to be rather limited. While there were other aspects that matter in this discussion, the concept of a credible nominal anchor was certainly critical to the debate at the time.

If currency boards were the perfect example of a hard peg,[4] the Argentine crisis provided the perfect counter-example. Argentina not only showed how a long-standing currency board could be easily undone: it showed that this could be was done endogenously while the currency board was still in place, through the printing of money by sub-national governments.[5] At any rate, as currency boards prove to be not hard enough, the bipolar view was left with unilateral de jure dollarization as the only possible (and more extreme) alternative to flexible exchange rates.

With the sole (debatable) exception of Liberia, there is no precedent of de jure de-dollarization: dollarization appears to be, indeed, more difficult to revert than any other fixed arrangement. The assessment of its pros and cons, however, suffers from a severe scarcity of relevant experiments. On the one hand, long-standing dollarized economies are largely due to historical and political reasons rather than economic motivations. More crucially, virtually all of them are very small sub-national economies that are hard to extrapolate in a meaningful way to the case of real countries. Panama, a small country by conventional standards, is a clear outlier within the group. On the other hand, potentially more revealing cases such as El Salvador or Ecuador are still too young to provide usable information.

The dollarization debate

Keeping these caveats in mind, the dollarization debate can be broadly summarized by means of the following stylized trade-offs:

- Reduced transaction costs vs. exchange rate rigidity.
- Enhanced credibility vs. loss of counter-cyclical monetary policy.
- Reduced borrowing costs vs. financial fragility (loss of the lender of last resort).

The first trade-off is associated with the traditional Optimal Currency Area (OCA) theory. On one corner, there is the view that exchange rate volatility introduces transaction costs that reduce the efficiency and intensity of international trade. This popularity of this long-dated idea (of which McKinnon, 1963, is an early reference) peaked with the work of Rose (1999), which estimated the impact of a common currency on trade flows to be up to 300 per cent (based, it has to be noted, on the sample of mostly sub-national entities mentioned above). These controversial results were toned down in subsequent work,[6] until a recent piece by Micco et al. (2003) shed new light on the discussion by working with the more relevant case of industrial economies at the time of the launch of the euro. Their preliminary evidence indicated that the effect of joining the European Economic and Monetary Union (EMU), while positive, was rather smaller than originally thought (of about 15 per cent).

The flipside of these potential trade gains, still under the OCA view, lies in the loss of the exchange rate as an automatic absorber of real shocks. Given that the root of the problem lies in the asymmetries between the countries that share the currency, the cost would be smaller the greater the degree of factor mobility and the correlation of shocks within the region.[7] This concern is supported by the evidence that pegs tend to display greater output volatility (Levy Yeyati and Sturzenegger, 2003b) and greater output sensitivity to real shocks (Edwards and Levy Yeyati, forthcoming) – particularly negative ones, which makes sense given the evidence of that downward price rigidity tend to be greater than upward price rigidity.

The second trade-off is related with the 'modern' approach to the exchange rate debate, which, as noted, is centred on the concept of credibility. In particular, this approach views dollarization (as they viewed pegged regimes before) as a credible nominal anchor for non-credible monetary authorities. The evidence, which pertains almost exclusively to pegs, supports this claim: fixed regimes tend to be correlated with lower inflation – as long as they last.[8]

This inflation gains come at the expense of the loss of monetary policy.[9] In addition, one may argue that dollarization cripples any attempt at institutional building, which would require the successful implementation of a discretionary policy.

The existing evidence on this point is mixed. The fact that capital behaves pro-cyclically for most developing economies provides support for dollarization advocates, to the extent that it helps explain why flexible regimes do not appear to isolate domestic monetary variables from external shocks more effectively than rigid exchange rate arrangements.[10] However, as noted, monetary credibility cannot be achieved overnight, as witness some recent post-crisis success stories such as Chile, Mexico and even Brazil, which are gradually learning to disregard the exchange rate and to use monetary policy more actively.

Unlike the first two, the third trade-off, between reduced borrowing costs and lack of lender of last resort, is specific to de jure dollarization. On the one hand, dollarization eliminates currency risk by definition. If follows that, to the extent that currency risk has an adverse impact on sovereign risk, dollarization should lower the latter.[11] Conversely, inasmuch as the loss of the exchange rate as a shock absorber implies deeper recessions and greater default risk, dollarization may increase country risk premia. Moreover, dollarization makes the banking sector more fragile (or less efficient) due to the absence of a lender of last resort (or a presence of a costly substitute such as the holding of a substantial stock of liquid foreign assets).[12]

Short of testing the long-run effects on real-life dollarized economies, Powell and Sturzenegger (2003) examine the impact on sovereign risk of news that increase the probability of dollarization. Interestingly, they find that country risk in financially dollarized countries fall significantly on these news, while the opposite happens in non-financially dollarized ones.[13]

The incidence of financial dollarization leads directly into the crucial issue of the importance of initial conditions. On the one hand, de facto dollarization reduces the cost of de jure dollarization, since it already imposes many of the constraints associated with the latter. In particular, balance sheet effects reduce the tolerance for exchange rate fluctuations under a flexible regime, and the lender-of-last-resort function is limited to local currency intermediation.[14] Similarly, economic integration with the issuer of the foreign currency (or within the common currency region) increases trade gains, while credibility problems enhance the gains from importing monetary policy from more credible countries.

In short, we could then draw the following identikit of a prospective dollarizer:

- High financial dollarization.
- Important trade links with other users of the foreign currency to be adopted.
- Pervasive credibility problems that result in high country risk and persistent high inflation, or frequent currency collapses whenever they attempt to use an exchange rate anchor.

Euroization

In this light, what can we say about euroization (in the particular definition used here)? The first thing to note is that, in general, there is mixed evidence on the relevance of OCA considerations in the political process that led to the launch of EMU. This is not specific to euroization: as noted, OCA was not relevant in any historical examples of unilateral dollarization – with the sole exception, perhaps, of El Salvador. At any rate, recent experiences show that substantial trade gains can be achieved without a common currency (as witnessed by NAFTA and the EU itself) and that additional gains induced by a common currency are likely to be moderate (as indicated by the preliminary evidence of the euro). More realistically, monetary integration is likely to be driven by credibility issues (for low credibility countries) and 'linkage' politics (for 'anchor' countries).[15]

But perhaps the main distinctive aspect between dollarization and euroization is the combination of a multilateral agreement and the presence of countries with policy credibility to export. Let me be more precise on this.

At the risk of oversimplifying a complex issue, one could summarize the euroization scheme from the perspective of a developing economy in this way: monetary and real integration plus a shared (implicit) lender of last resort that requires upward convergence to the anchor economies, a prerequisite that, in turn, works as a credible commitment mechanism to comply with the convergence criteria.

The exact nature of how this works is still an open question. In particular, European observers may dispute the idea of a regional lender of last resort within the euro area (let alone one that involves accession countries) and emphasize that it is the prize of integration that make credible the commitment of governments to meet the accession criteria. However, besides trade gains (which in any case can be largely achieved through trade agreements), the other potential benefit from integration comes from nominal and financial stability, which hints at the presence of some implicit regional safety net.[16] At any rate, it is generally acknowledged that convergence to an anchor country (or countries) is crucial in this scheme.

Moreover, even in the absence of such a safety net, euroization (unlike dollarization) bring with it the additional benefit of a large degree of real integration, which reduces, through capital and labour mobility, the cost of losing the exchange rate as a mechanism to smooth out business cycle asymmetries between member countries. Indeed, with sufficient factor mobility, asymmetric business cycles may enhance the scope for regional risk sharing.

From the perspective of a small developing country, then, euroization, by replacing the stick of exit costs by the carrot of integration, entails essentially a gentler and more effective version of dollarization that enhances substantially the associated credibility gains while it mitigates the cost of a rigid exchange rate.

In this light, we can address the question of whether euroization a sensible prospect for a developing South-East European Economy. Whereas the answer would still depend on the situation of individual countries, in this case we can afford to be more precise for at least two reasons.

First, a casual look at the identikit outlined above reveals that it matches relatively closely the situation of many of the countries involved. The example of Croatia, analysed at length in chapter XX, is a case in point – it is safe to say that most other economies in the group largely fit the description. Second, as noted, euroization ensures a rapid convergence that goes beyond monetary policy. Indeed, the existing evidence on the process of convergence has been striking by most standards. In particular, the narrowing of the spreads has been often accompanied by increased government efforts to comply with Maastricht conditionality, closing a virtuous circle. As a result, euroization (or, more precisely, its prospect) appears to bring the gains in terms of lower inflation and reduced borrowing costs often attributed (debatably) to unilateral dollarization.

Thus, euroization indeed appears to be a sensible prospect for South-East Europe – and, possibly, for developing economies in general. Ultimately, while unilateral dollarization is still under debate, one might argue that euroization may be indeed the peg pole that the bipolar view has been searching for.

Notes

1. Universidad Torcuato Di Tella, Buenos Aires.
2. See Levy Yeyati and Sturzenegger (2003a), on which the present discussion is based. The definition excludes the use of the foreign currency alongside the domestic currency, typically referred to as de facto or unofficial dollarization.
3. See for instance Fischer (2001).
4. Ghosh et al. (2000) is a good example of the case for currency boards, and the prominent role that Argentina played in this regard.
5. See De la Torre et al. (2003) for a detailed discussion of the collapse of the Argentine currency board.
6. See for instance Rose and Van Wincoop (2001).
7. Standard references on these issues are Mundell (1963) and Kenen (1969), respectively. One qualification may be in order. OCA theory assumes that common currency countries have no 'real risk sharing" mechanism. If, by contrast, a regional transfer scheme is in place such that, whenever the macro context is better in one country than in the region as

a whole, the country receives a subsidy, for a given shock distribution, the more asymmetric the shocks the larger the scope for regional risk sharing.

8. See Ghosh et al. (1997) and Levy Yeyati and Sturzenegger (2001).

9. But, from the perspective of the modern view, this is exactly what dollarization is all about: if the policy maker is the source of the problem (due to lack of political will or mere ineptitude), losing him is more of an advantage than a loss. In the end, dollarization advocates argue, the scope for a non-credible policy maker in a small open economy to run an autonomous monetary policy is bound to be limited anyway.

10. See for instance Frankel (1999), Hausmann et al. (1999) and Borensztein et al. (2001). Indeed, interest rates in Panama appear to be less significantly influenced by external rates than in countries with other, more flexible arrangements.

11. Currency risk may increase sovereign risk through balance sheet effects in de facto dollarized economies or, if a devaluation is successfully avoided, through the cost of the interest rate defence of the currency.

12. Other lender-of-last-resort substitutes are likely to be limited and unreliable (as the contingent credit lines subscribed in the 1990s by Argentina and Mexico with a consortium of international banks), or unpredictable (as the assistance from IMF-led rescue packages). See Broda and Levy Yeyati (2003) for a discussion.

13. Here, following Ize and Levy Yeyati (2003), financial dollarization denotes the holding by residents of foreign currency-denominated assets and liabilites in non-officially dollarized economies.

14. Hence, the different effect of dollarization on borrowing costs across financially dollarized and not financially dollarized economies.
15. Frieden (2002), for example, stresses the role of ‘linkage’ politics by which EMU may have helped Germany to gain European support for its foreign policy initiatives in Eastern Europe.
16. As stated in Levy Yeyati (2004), ‘the perception that accession to EMU may enhance stability beyond what would be achieved by a set of good policies hints … at the presence of some implicit safety net that, at the very least, protects the country against exogenous shocks or liquidity runs, ensuring that these good policies are ultimately rewarded.’

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