

ECON 4311 – Economy of Latin America

Lecture 11A: Dollarization

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Introduction

▶ Previously:

- Macroeconomic imbalances started in the 1950s with ISI policies, and continued well through the 1970s.
- In the 1980s, multiple default episodes and Lost Decade.
- Monetary and fiscal policy historically not very successful in LatAm:
 - ▶ Large fiscal deficits.
 - ▶ Before CB's independence, monetary policy determined by fiscal policy (fiscal deficits typically financed with debt monetization).
 - ▶ Printing money associated with rising inflation.
- Macroeconomic instability, the norm in the region.

▶ Today: Dollarization.

Dollarization

- ▶ **Dollarization/Currency substitution.** Use of foreign currency in parallel to or instead of the domestic currency.
 - Although dollarization is a term most often used to indicate that domestic currency X is substituted by the USD. . .
 - Dollarization not always means substituting domestic currency by USD.
- ▶ **Types of dollarization.**
 - De facto (or unofficial or partial).
 - ▶ Residents' choice.
 - ▶ Insurance against inflation, deflation, confiscation.
 - De jure (or official or full).
 - ▶ Government's choice.
 - ▶ Policy: legal tender.

Dollarization

► Examples.

- **Panama in 1904:** US dollar as legal tender/constitutional outcome.
- **Ecuador in 2000:** USD to deal with political and financial stability.
- **El Salvador in 2001:** long-standing unofficial currency substitution.
- **Zimbabwe in 2009:** USD to deal with macroeconomic instability. (231 million % inflation rate in July 2008).

► **Dollarization vs. Currency Unions** (e.g., Eurozone).

- Many similarities, but not the same thing.
- Adoption of foreign currency vs. common currency.
- Restricted monetary policies.

Dollarization: Anchor Currencies

- ▶ **Anchor currency.** Foreign currency chosen by a particular country to stabilize its exchange rate.
 - In principle, any currency does the work.
 - Historically, the USD has been the world's nominal anchor.
 - ▶ Originally, the term “currency substitution” used to refer to the demand of foreign currency by domestic agents.
 - ▶ In the 1970s and 1980s, due to the (unofficial) substitution of domestic currency for USD in Latin America, people used “dollarization” to refer to the currency substitution that was taking place.
 - ▶ Today, people use “dollarization” and “currency substitution” interchangeably.

USD: The World's Nominal Anchor

Exchange Rate Arrangements of IMF Member Countries, 1960–1997

	Number of IMF member countries											
	1960	1970	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997
Fixed exchange rate arrangement	71	116	94	94	86	81	84	73	71	66	66	66
Pegged to the U.S. dollar	53	65	39	31	25	24	24	21	23	22	21	20
Pegged to the French franc	2	17	14	14	14	14	14	14	14	14	14	15
Pegged to the UK pound sterling	15	30	1	1	0	0	0	0	0	0	0	0
Pegged to the deutsche mark	0	0	0	0	1	1	1	1	1	2	2	3
Pegged to the Russian ruble	0	0	0	0	0	0	6	1	1	0	0	0
Pegged to other currency	1	4	3	4	5	3	5	6	7	6	7	8
Pegged to SDR	—	—	15	12	6	6	5	4	4	3	2	3
Pegged to other currency composite	—	—	22	32	35	33	29	26	21	19	20	17
Limited exchange rate flexibility	—	—	—	13	14	14	13	13	14	14	16	16
Flexibility limited vis-à-vis a single currency	a	b	c	5	4	4	4	4	4	4	4	4
Cooperative arrangements	—	—	8	8	10	10	9	9	10	10	12	12
More flexible exchange rate arrangement	—	—	—	41	53	61	70	89	93	100	99	99
Adjusted according to a set of indicators	a	b	4	5	5	5	3	4	3	2	2	—
Other managed floating	a	b	c	21	23	27	23	29	32	44	45	46
Independently floating	a	b	c	15	25	29	44	56	58	54	52	53
Unclassified	1	1	1	1	1	0	0	0	0	0	0	0
Total	75	120	141	149	154	156	167	175	178	180	181	181

Table Notes. Source: [Kawai and Akiyama \(1998\)](#).

Dollarization: USD as Anchor Currency in LatAm Region

Examples

- ▶ **Argentina**: highly dollarized today.
- ▶ **Belize**: Belize dollar pegged at 2:1 to USD, but USD accepted.
- ▶ **Cuba**: USD used alongside the Cuban peso.
- ▶ **Ecuador**: dollarized since 2000; also uses its own currency.
- ▶ **El Salvador**: both USD and bitcoin are official currencies.
- ▶ **Haiti**: uses both USD and the gourde.
- ▶ **Honduras**: USD used alongside the Honduran lempira.
- ▶ **Mexico**: USD used alongside Mexican peso.
- ▶ **Venezuela**: USD used alongside the Venezuela bolívar.
- ▶ **Uruguay**: USD used to conduct transactions in real estate.

Measuring Dollarization

Measures of Dollarization:

- ▶ Ratio of foreign currency deposits (FCD) to total deposits.
 - 35% dollarization at the end of 2000s in developing economies. (Levy Yeyati, 2006)

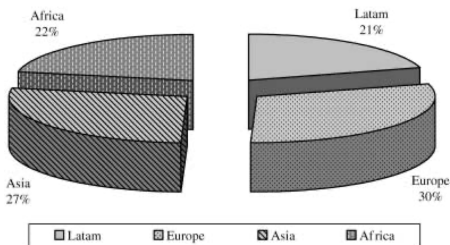
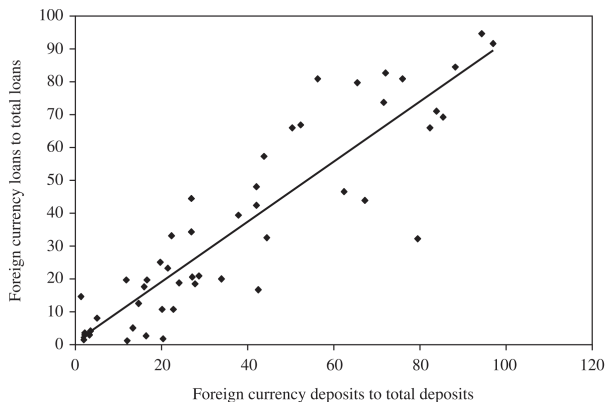


Figure 1. Regional distribution of non-industrial countries with deposit dollarization above 10% in 2000

Measuring Dollarization

Measures of Dollarization:

- ▶ Ratio of foreign currency loans (FCD) to total loans.
 - Deposit dollarization and loan dollarization often mirror each other.



Partial Dollarization: Pros & Cons

Pros & Cons:

- ▶ Advantages for individuals:
 - Safe assets for individuals.

- ▶ Disadvantages for the economy:
 - Pressure on the exchange rate.

Full Dollarization: Pros & Cons

Pros & Cons:

▶ Advantages for the economy:

- **Price stability.** Reduces uncertainty, increases investment.
- **Fiscal discipline** (?).
- **International trade.** Reduction in transaction costs.
- **Borrowing costs.** Avoids currency crises and thus reduces the sovereign risk premium. (↓ risk premium, ↓ interest rates).

▶ Disadvantages for the economy:

- Exposed to real and financial shocks.
- Constrained control over monetary (and even fiscal) policy.

Dollarization in Latin America

Pros & Cons:

- ▶ **Early adopters:** Panama fully dollarized since early 1900s.
- ▶ High degrees of partial dollarization in the region since the 1970s.
- ▶ Most common reason behind dollarization is high inflation rates in domestic country.
- ▶ Examples of full dollarization:
 - Ecuador in 2000.
 - El Salvador.
- ▶ We now discuss in some detail the cases of Panama and Ecuador.

Dollarization in Panama

- ▶ **Background:** Independence from Colombia.
- ▶ **Reason for dollarization:** Legal tender.
- ▶ **Benefits of dollarization:**
 - Trade benefits or natural route for trade?
 - Price stability.

Table: Annual inflation rate (%)

	1960s	1970s	1980s	1990s	2000s
Panama	1.1	6.0	3.2	1.1	2.4
Latin America	8.1	34.6	193.6	136.5	8.3

Dollarization in Ecuador

▶ **Background.**

- Volatile markets for primary commodities (cacao, bananas, oil, . . .).
- Debt accumulation during the 1970s and 1980s.
- Natural disasters:
 - ▶ El Niño (1975, 1983, 1998). Irregular periodic variation in winds and sea surface temperatures over the tropical eastern Pacific ocean.
 - ▶ Earthquakes (1987).
 - ▶ Droughts.
- War against Peru (a border dispute) in 1995.

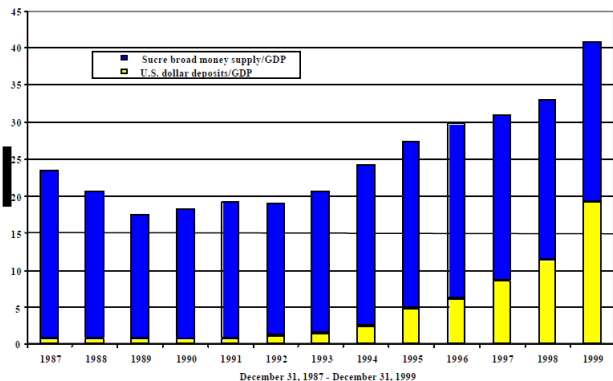
Dollarization in Ecuador

▶ **Background.**

- Banking crisis in the 1998-1999 with large deposit withdrawals.
 - ▶ Bank holiday (1 week).
 - ▶ Government froze deposits for a full year.
 - ▶ Nearly half of the banks were shut down or nationalized in 1999.
- Devaluation of the sucre in 1999, due to:
 - ▶ Pressure on the current account.
 - ▶ Partial dollarization.
- In September 1999, the government defaulted on external debts.

Dollarization in Ecuador

Figure 8. Ecuador: Broad money supply (M2) and its currency composition (per cent of GDP)



Data source: Central Bank of Ecuador.

Dollarization in Ecuador

▶ Dollarization in Ecuador in 2000.

● **Benefits.**

- ▶ Release of frozen deposits, no bank runs.
- ▶ Debt restructuring.
- ▶ Lower inflation.

● **Fiscal responsibility laws:**

- ▶ Privatization of state enterprises.
- ▶ Oil stabilization fund.
- ▶ Liquidity stabilization fund (lender of last resort for banking system).

Dollarization in Ecuador

- ▶ Dollarization in Ecuador in 2000.
 - **Lasting Benefits.**
 - ▶ Low inflation.
 - ▶ Fiscal discipline?
 - + Primary surplus of 2.5% of GDP in the 6 years following dollarization.
 - Default in 2008.

Dollarization and Inflation in Ecuador

Dashed vertical line marks dollarization

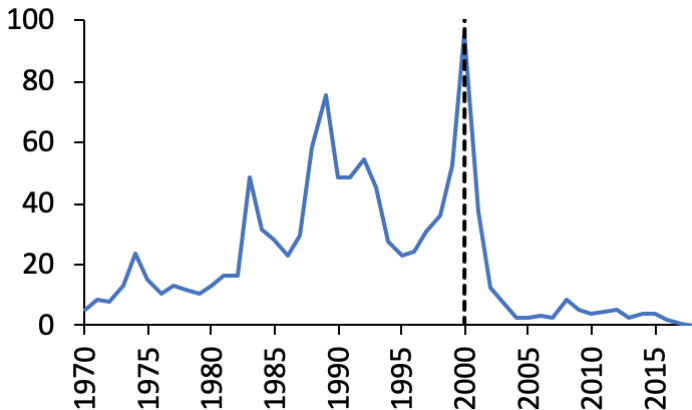


Figure: Inflation rate (%) in Ecuador, 1970–2018.

More on Dollatization

More from your classmates!