

Floating, Fixed, or Super-Fixed? Dollarization Joins the Menu of Exchange-Rate Options

By BLAKE LEBARON AND RACHEL MCCULLOCH*

Debate on relative merits of alternative exchange-rate regimes was revived in the 1990's by a succession of exchange-rate crises and associated global contagion. Despite waning enthusiasm for market-determined rates, most developed countries continued to float with only limited intervention. The major exception is the European Union. After a period of crises that accompanied attempts to keep rates within predefined bands, 11 EU members opted for a common regional currency issued by a regional central bank—a choice not even on the policy menu at the start of the decade. Developing and transition economies were likewise divided between those willing to cope with a market-determined rate and those choosing to fix rates.

The newest twist for countries with fixed rates concerns minimizing the risk of crisis, especially crisis via contagion. Traditional crisis prevention emphasizes sound macroeconomic fundamentals bolstered by adequate international reserves and emergency lines of credit. Indeed, the International Monetary Fund's original mandate was to provide supplementary balance-of-payments finance as needed to maintain official par values, including defense against speculative attack while countries get their fundamentals back in order. But the crises of the 1990's delivered a disheartening message. Neither sound fundamentals nor seemingly adequate reserves and credit lines offered reliable protection against determined specula-

tors. Hence, there has been increased attention to an alternative approach to crisis prevention: making a fixed rate entirely credible, and thus uninteresting to speculators in search of targets for attack, by establishing a currency board or even dollarization (i.e., official adoption of another country's currency).

These options are hardly new. The U.S. dollar has been Panama's official currency since 1904. Unofficial dollarization, also known as currency substitution, is common in developing and transition economies whose national currencies are subject to a high inflation tax. Currency boards were once standard arrangements in British colonies; Mauritius had the first in 1849 (John Williamson, 1995). However, currency boards and dollarization are now increasingly promoted as tools for reducing the risk of exchange-rate crises for countries with fixed exchange rates. Our purpose is to clarify this new role and to recast the familiar fixed versus flexible rate discussion by distinguishing adjustable pegs from rates that are more permanently fixed through a currency board or dollarization. The decision to create the regional Euro raises many of the same issues. However, the Euro is already the subject of an enormous literature. We therefore focus on the considerations most relevant for developing and transition economies.

I. The Post-1973 International Monetary Non-system

The free-for-all approach to exchange-rate regimes that emerged from the collapse of the Bretton Woods system has achieved a mixed record. Confirming predictions of early advocates, most notably Milton Friedman (1953), flexible rates paved the way for elimination of exchange controls and liberalization world-

[†] *Discussants:* Michael D. Bordo, Rutgers University; Jeffrey Frankel, Harvard University; Catherine Mann, Institute of International Economics.

* Department of Economics and Graduate School of International Economics and Finance, Brandeis University, Waltham, MA 02454. We are indebted to Michael Bordo, Jeffrey Frankel, Catherine Mann, Peter Petri, and Olaf Underberdoerster for comments and suggestions.

wide of trade and capital flows. Flexible rates also freed monetary policy from its earlier preoccupation with external balance. But market-driven rates brought unexpected problems of their own. As capital flows reached unprecedented size, corresponding exchange-rate movements created major deviations from purchasing-power parity and disruptive swings in trade competitiveness. Attempts to achieve employment objectives at the expense of higher inflation and increased reliance on seigniorage to finance government spending culminated in an era of global stagflation. Belatedly acknowledging instability of the short-run Phillips curve and surprisingly high economic and political costs of inflation, major central banks reverted to a conservative stance, with promotion of low inflation and exchange-rate stability again paramount (Michael Bordo and Anna Schwartz, 1999).

Associated with renewed macroeconomic conservatism on the domestic side, countries experimented with limits on exchange-rate movements. Opting for a peg was seen not only as a means to promote trade and capital flows, but also as the quickest way for a central bank to commit credibly to an anti-inflation stance. But experiments with pegs and bands soon led to the rediscovery of an old truth from the Bretton Woods era: given highly mobile capital, exchange-rate crises are a fundamental feature of any pegged-rate system. The spectacular development of international capital markets since 1973 further increases the risk of speculative attack as well as its potential damage. Parity changes are rarely achieved without an attending crisis and associated costs; some costs of crisis, particularly very high interest rates, must be borne even by countries that eventually succeed in beating off the speculators.

II. Fixed versus Flexible

We restate the choice between fixed and flexible exchange rates in terms of two related questions. First is the classic question: are there net gains from maintaining the degree of freedom that a flexible exchange rate offers? However, recent experience suggests a second and equally important question: how can a fixed exchange rate be sustained in a world of internationally mobile capital?

Friedman's case for flexible rates rests on the assumption that direct controls are used to sustain inappropriate pegs. The case is thus a negative one; allowing the market to determine exchange rates avoids costs from exchange controls and other distortionary policies. Recognizing efficiency gains from a common currency, Friedman endorses a continued sterling area if fixed rates within the area can be maintained without trade restrictions. In contrast, Robert Mundell's (1961) optimum-currency-area analysis ignores possible costs of maintaining a fixed rate and focuses on the use of exchange-rate adjustments in active macroeconomic management when regions are subject to asymmetric shocks.¹ The first-best response, improving factor-market efficiency, is implicitly ruled out. Moreover, Mundell assumes that a flexible rate will move to restore balanced trade; recent experience underscores that capital, rather than trade flows, is the principal driver of flexible rates. The key role of mobile capital implies that, rather than assuring full employment in the face of asymmetric shocks, flexible rates may themselves be a significant source of such shocks.

Advocates of a common regional currency do not claim that the European Union satisfies the Mundellian criteria for an optimum currency area.² They emphasize instead the efficiency advantages of a single currency over many national currencies in terms of reduced transaction and information costs, and potential scale economies in the financial-services sector. These efficiency benefits are seen to outweigh gains from retaining the option of national exchange-rate realignment as an element of macroeconomic management (Barry Eichengreen, 1997).

Another element of the fixed/flexible question is the need to gain monetary credibility. A central bank may gain needed credibility by pegging to a strong anchor currency.³ In

¹ Mundell (1961) and subsequent authors in this literature ignore the important distinction between fixed exchange rates and a common currency.

² As Ronald McKinnon (1999) emphasizes, these advocates include Mundell himself. Although his 1961 analysis is central to the main academic case against a common European currency, Mundell (1973a, b) was an early supporter for reasons centering on currency speculation and its implications for capital-market development.

³ Future stability of the adopted currency is a central consideration. As Bordo and Schwartz (1999) observe, the Fed has made low inflation its primary goal only since 1979.

principle, adoption of a fixed exchange rate rules out discretionary monetary policy. However, the message is most persuasive when linked to an exchange-rate mechanism such as a currency board, which comes close to adoption of a simple rule for monetary growth.⁴

III. Fixed versus Super-Fixed

Once a country decides against a floating rate, it faces a second choice between some type of fixed-exchange-rate mechanism and the more permanent solution of adopting another country's currency or a common regional currency. The large and highly responsive capital flows in modern markets call into question the stability of any fixed but changeable rate (Maurice Obstfeld and Kenneth Rogoff, 1995; Jeffrey Frankel, 1999). Recent theoretical work surveyed by Robert Flood and Nancy Marion (1999) suggests that speculative attacks on fixed but changeable rates will be difficult to predict. Given the self-fulfilling nature of such attacks, a small country may be unable to avoid them, although this conclusion also depends on the availability and efficacy of policy tools such as capital controls and global lending facilities. The recent examples of Argentina and Hong Kong show that even the rigid rules and reserve requirements of a currency board cannot protect a fixed rate from the attention of speculators. Likewise, as discussed below, even a decades-long record at the same par value did not protect the CFA franc from coming under speculative attack.

Because financial markets recognize the possibility of a parity change, fixed-exchange-rate systems, even those with a currency board, can be subject to dramatically higher interest rates during attacks and also sustain higher interest rates over the long term. At their peak during the 1994–1995 crisis in Mexico, 30–60-day time deposit rates for the Argentine peso were nearly 10 percentage points higher than compa-

rable dollar rates (Francois Velde and Marcelo Veracierto, 1999). From 1997 to 1999, interest rates on Argentine peso-denominated deposits averaged nearly 1.5 percentage points higher than on their dollar-denominated equivalents, with the spread widening to more than 4 percentage points on occasion (Lawrence Summers, 1999).

To avoid the higher cost of capital associated with even the remote possibility of devaluation, a next logical step is to adopt the dollar (or another outside currency). Advocates of dollarization (e.g., Guillermo Calvo and Carmen Reinhart, 1999) put primary stress on implications for capital markets. But lower and less volatile interest rates are not the only likely benefit. Empirical research suggests that trade-enhancing effects of a shared currency are surprisingly large (John McCallum, 1995; Andrew Rose, 1999).

Another potential benefit arises from savings related to the skilled labor otherwise required to manage domestic monetary growth and the exchange-rate mechanism. Relieved of the need to staff these areas, developing and transition countries could deploy their limited supply of appropriately trained personnel to enhancing economic performance through improvements in factor-market, fiscal, and trade policies.

A final consideration is feasibility. Dollarization requires the action of just one (for unilateral) or two (for negotiated bilateral) countries. It is thus an option that can be implemented quickly, in contrast to complex schemes for a "new financial architecture" requiring the assent and ongoing cooperation of many nations with divergent interests.

IV. Costs of Dollarization

Before a country adopts another's currency, such as dollarization in Argentina, policymakers will have to make a strong case. The highly visible sacrifice of national sovereignty is sure to arouse opposition for purely symbolic reasons. Yet the mere fact that the possibility is under active consideration, along with the EU's adoption of a regional currency, suggests that dollarization cannot be written off as a political nonstarter.

Adoption of a foreign currency also raises significant economic issues. The first is lost seigniorage in the absence of a bilateral agree-

In an earlier era, central banks used reestablishment of a link to gold to signal their resolution to end inflationary money growth or even to tighten money enough to reduce the price level.

⁴In practice, countries with currency-board-type arrangements maintain some limited flexibility with regard to monetary policy.

ment for sharing revenues (see U.S. Senate [1999] for a seigniorage-sharing proposal). A second is loss of the lender-of-last-resort function of the domestic central bank, although this is already a consideration for a country adopting a currency board or another restrictive monetary rule. To assure stability of the domestic financial system, the central bank could create a fund to bail out ailing banks or establish international credit lines similar to those Argentina has put in place to defend the peso. Private-sector initiatives to provide lender-of-last-resort function or deposit insurance could perhaps offer adequate protection, especially for smaller countries (Catherine L. Mann, 1999). How significant are these two costs? Willem Buiters (1999) concludes that Canada would benefit, primarily via integration of financial markets, from a symmetric monetary union with the United States. However, he rejects unilateral dollarization because of seigniorage considerations and loss of lender of last resort.

A last issue is the possibility of conflict with the currency-issuing nation (Panama's experience is discussed below). Reliance on another country's currency implies enhanced vulnerability to a type of monetary warfare. A dollarizing country therefore needs safeguards such as holding funds in offshore accounts beyond the reach of the currency-issuing country.

V. Dollarization in Panama⁵

Panama adopted the U.S. dollar as its official currency in 1904. Unlike its neighbors, Panama has maintained low inflation and interest rates; it is the only Latin American country with an active 30-year fixed-rate mortgage market (Summers, 1999). The National Bank of Panama (NBP) has experienced none of the credibility crises that plague other countries in the region. But while dollarization brought monetary stability, it did not prevent poor choices in other policy areas, including import substitution in the 1950's and agrarian "reform" in the 1970's. GDP growth rates have remained in the moderate 3–7-percent range.

⁵ Juan Luis Moreno-Villalaz (1999) summarizes the Panamanian experience. See Andrew Zimbalist and John Weeks (1991) for more details.

Use of the U.S. dollar and relatively flexible banking laws fostered Panama's development as an international banking center—and for the same reasons also as a center for laundering drug money. In the late 1980's U.S. officials began actions against Panama and specifically President Manuel Noriega that included freezing \$50 million of NBP deposits held in New York banks. The objective was literally to starve Panama of cash. Though NBP had large cash reserves due to money-laundering operations, many local banks were forced to close, and general panic ensued. GDP fell by 17 percent in 1988.

Panama's experience demonstrates that the dollar can indeed provide a stable monetary base for a country, giving it a low inflation anchor, but it cannot assure model policies to promote growth and development. Dollarization also puts a country at greater risk for economic sanctions imposed by the United States. While other types of economic sanctions are often ineffective, monetary restrictions on a dollarized economy can disrupt the country's monetary and banking systems. However, a country can reduce its vulnerability to this kind of pressure through safeguards in the form of offshore accounts (i.e., Eurodollar accounts in banks not controlled by U.S. officials), precautions Panamanian officials had not taken prior to 1988.

VI. The Franc Zone

The closest to a permanently fixed rate since World War II is the CFA⁶ franc used by two groups of countries in sub-Saharan Africa. The CFA franc was fixed to the French franc from October 1948 until January 1994. However, even this long-fixed rate ended in a protracted period similar in character and costs to the crises that typically precede devaluations.

Like Panama, members of the franc zone avoided the rampant inflation that plagued most of their neighbors. Perhaps for this reason, until the 1980's they also enjoyed higher average growth rates than similar countries outside the zone. However, CFA members gradually lost international competitiveness

⁶ Communauté Financière Africaine, originally Colonies Françaises Africaines.

due to a combination of adverse terms-of-trade movements, wage increases not matched by productivity gains, and appreciation of the French franc; most CFA countries experienced declining per capita income during the 1980's. Despite the zone's decades-long success in maintaining the peg, capital flight added to members' problems as devaluation became more probable. Consistent with Friedman's (1953) assessment, CFA countries piled on direct controls rather than accepting necessary adjustments such as reduced real wages. A 50-percent devaluation in 1994, along with implementation of structural reforms overseen by the IMF, was followed by much-improved growth performance in the second half of the 1990's.

As with Panama, the CFA experience shows that a firm peg to a low-inflation currency is an effective way to maintain low inflation but is not insurance against poor policy choices. It is notable too that despite its long history at an unchanged peg, the CFA franc devaluation was preceded by a period of turmoil similar to the crises that typically precede changes in par values of much shorter duration. Had the zone been a "frankified" region, would the outcome have been different? The zone might then have avoided the capital flight that began in the late 1980's, but there would have been no way to roll back excessive real wages and to restore international competitiveness in a single stroke.

VII. Conclusions

On the menu of regime choices faced by developing countries, dollarization can be an appealing option, particularly when the need to bolster credibility of an anti-inflation policy is high. For many countries, the value of the active monetary policy permitted by a floating rate is small compared with the enhanced price stability offered by a fixed-rate or common-currency regime. Once a country has chosen a fixed rate or currency board, adopting a foreign currency looks attractive, especially if seigniorage is shared. Intermediate policies are likely to be subject to instabilities and entail extra costs related to these risks.

Although the same logic could perhaps be extended to make a theoretical case for a global currency, it seems unlikely that many countries

would willingly cede sovereignty in this area to an inclusive international organization.⁷ However, the dynamic process we suggest here could lead to a world of a few growing, and perhaps competing, currency blocks. Could this small number of currency blocks eventually find it advantageous to link since they will have greatly surpassed an optimal regional currency area in the Mundellian sense?

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⁷ One parallel is the IMF's ineffective Special Drawing Rights plan to enhance global liquidity.

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