

# **Dollarization: Issues and Implications for Southern Agriculture**

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# What Is Dollarization?

- **Dollarization occurs when another country or a territory outside the United States adopts the U.S. dollar as its official currency.**
- **When a country dollarizes, it adopts U.S. monetary policy.**
- **Countries can dollarize with or without consent of the United States.**



# Why Dollarize?

- **Improve creditability and credit worthiness with international lenders and multilateral donors.**
- **Improve monetary policy discipline.**
- **Greater financial stability and increased economic growth.**
- **Eliminate capital flight.**
- **Eliminate currency risk and lower transaction costs for businesses.**



# Types of Dollarization

- *Official* - formal adoption of the U.S. dollar
- *Semi-official* - domestic currency used for wages, payments, and cash expenses, but U.S. dollar is the legal tender
- *Unofficial* - domestic currency is the legal tender, but part of a country's assets held in U.S. dollars and part in domestic currency  
(Note: 55-70% of U.S. currency held by foreigners)



# Who has Dollarized and Who is Considering Dollarization

- **More than 30 nations and territories have officially dollarized.**
- **Panama is largest economy officially dollarized with any long-term history.**
- **Ecuador most recent country to fully dollarize.**
- **El Salvador, Guatemala, and Mexico currently considering dollarization - Even Argentina and Brazil have expressed interest.**



# **Benefits of Dollarization for Adopting Country**

- **Benefits of U.S. monetary policy**
  - **Lower, More Stable Interest Rates**
  - **Lower, More Stable Inflation Rates**
- **Exchange rates and exchange rate fluctuations eliminated**
- **More confidence in currency transactions in U.S. dollars**



# **Drawbacks of Dollarization for Adopting Country**

- **Increased export and import competition from other countries if currencies depreciate relative to U.S. dollar**
- **Lost Seigniorage to the treasury**
- **Perceived loss of sovereignty, potentially leading to civil unrest**



# **Benefits of Dollarization for the United States**

- **Lower transaction costs when trading with adopting countries**
- **Greater efficiencies for multinational firms**
- **Increased seigniorage**
- **Competitive environment no longer subject to exchange rate fluctuations**





# Possible Drawbacks for the United States

- Attempted influence of adopting country governments on U.S. monetary policy
- Increased value of U.S. dollar due to other countries dollarizing leads to increased competition from third countries that have not dollarized
- Trade retaliation by non-dollarizing countries
- Jeopardize foreign relations
- Abandonment of dollar causing value to fall



# Seigniorage and Dollarization

- **Seigniorage-government revenue collected from issuing coins and currency**
- **The difference between the face value of money, its purchasing power, and the cost of material to coin and print**
- **U.S. Treasury collects \$25 Billion annually in seigniorage**
- **Each U.S. dollar costs about \$.03 to print, so with perpetual circulation, it would net \$.97 in seigniorage**
- **U.S. seigniorage is less since each bill is replaced after 18 months**



# Calculating Real Seigniorage

- **Seigniorage over a selected period of time can be calculated as:**
  - △  $M/P$ , where  $M$  denotes the U.S. monetary base and  $P$  is the price level in the U.S. economy
- **Example:**
  - Extra \$100,000,000 is issued to dollarized countries over a year
  - $DM = \$100,000,000 \times .97 = \$97,000,000$
  - U.S. price level = 1.023 over same time period
  - **Real Seigniorage =  $\$97,000,000/1.023 = \$94,819,159$**



# Dollarization Makes the News

**Salvadoreans Embrace the Dollar (12/29/00)**

**Drowning Ecuador Grasps for the Dollar (1/11/00)**

**Japanese and French Bridle at Dominion of the Dollar (1/16/01)**

**Dollar's Embrace Leaves Ecuadoreans Tender for Passing of their Sucre (9/21/00)**

**Salvador Opposition Calls for Halt to Dollarization (1/17/01)**

**Caribbean's Economies Weigh Option of Embracing the Dollar (1/2/01)**

**Guatemala Set to Allow Use of Foreign Currency (12/20/00)**

Source: *Financial Times*

# **Benefits of Dollarization for Southern Agriculture**

- **Increase U.S. exports due to lower transaction costs on sales to dollarizing economies.**
- **Less competition in U.S. market from imports made cheaper by exchange rate depreciation, ie - wheat, soybeans, beef, shrimp, melons.**
- **Less competition in 3rd country markets from dollarized economies due to depreciation.**  
**Example on next slide.**



# Benefits of Dollarization for Southern Agriculture in 3rd Country Markets

- **Country A and the U.S. each sell wheat to country B.**
- **Country B's currency depreciates relative to \$, but not relative to country A's currency.**
- **Country A exports of wheat to B - , U.S. exports to B - .**
- **If country A had dollarized, no such condition or benefit to country A would exist.**



# **Drawbacks of Dollarization for Southern Agriculture**

- **Cannot take advantage of U.S. dollar depreciation relative to a currency for a country with a competing commodity**
- **For processors, agricultural inputs from dollarizing economies are no longer able to take advantage of depreciation**





# Dollarization: The Case of Ecuador

- Ecuador sucre depreciated from 7,000/\$ in Jan 99 to 29,000/\$ in Jan 00
- Inflation (40%) and interest rates (200%) were running rampant, leading to economic contraction of 7.1% in 1999
- Dollarization decision made Jan 2000, help cost the President his job but Ecuador now has interest and inflation rates closer to U.S. rates



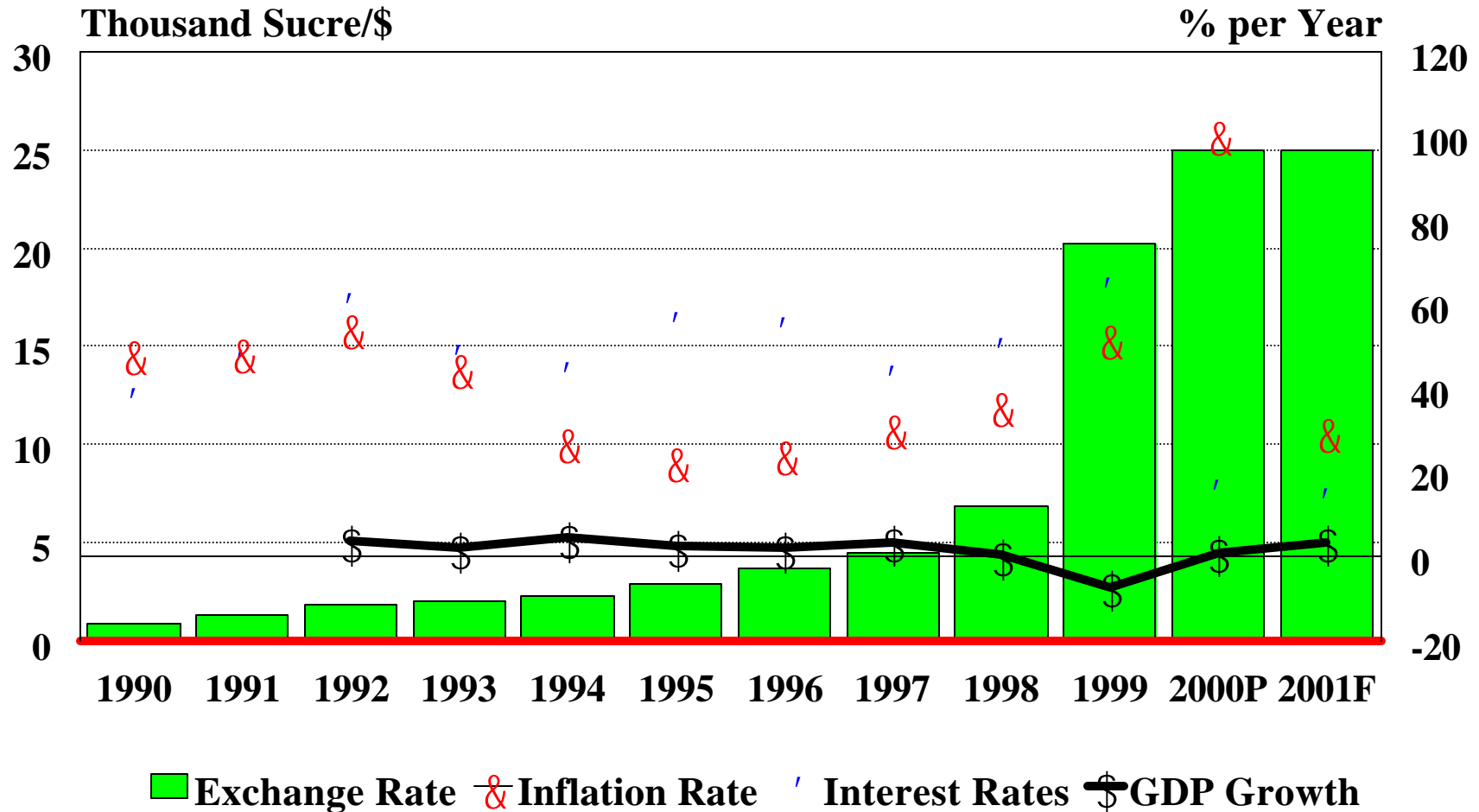


# **Dollarization: Results from Ecuador**

- **Interest rates decreased from near 200% to around 16% in six months**
- **Inflation was near 100% in 2000 due to incorrect conversion rate; now slowing**
- **Other factors include lack of fiscal discipline and ailing bank sector**
- **Price of oil very important factor**



# Ecuadorian Exchange Rate with Dollar, GDP Growth, Interest Rate and Inflation Rate



Source: IMF and LatinWatch; End of Period Rates

# Alternatives to Dollarization?

- **Currency Union - creation of a new currency to be used among countries, such as the euro in the European Union**
- **Currency Board - Pegging the exchange rate of a currency to the currency of another country, ie Argentina Peso pegged to U.S. dollar**

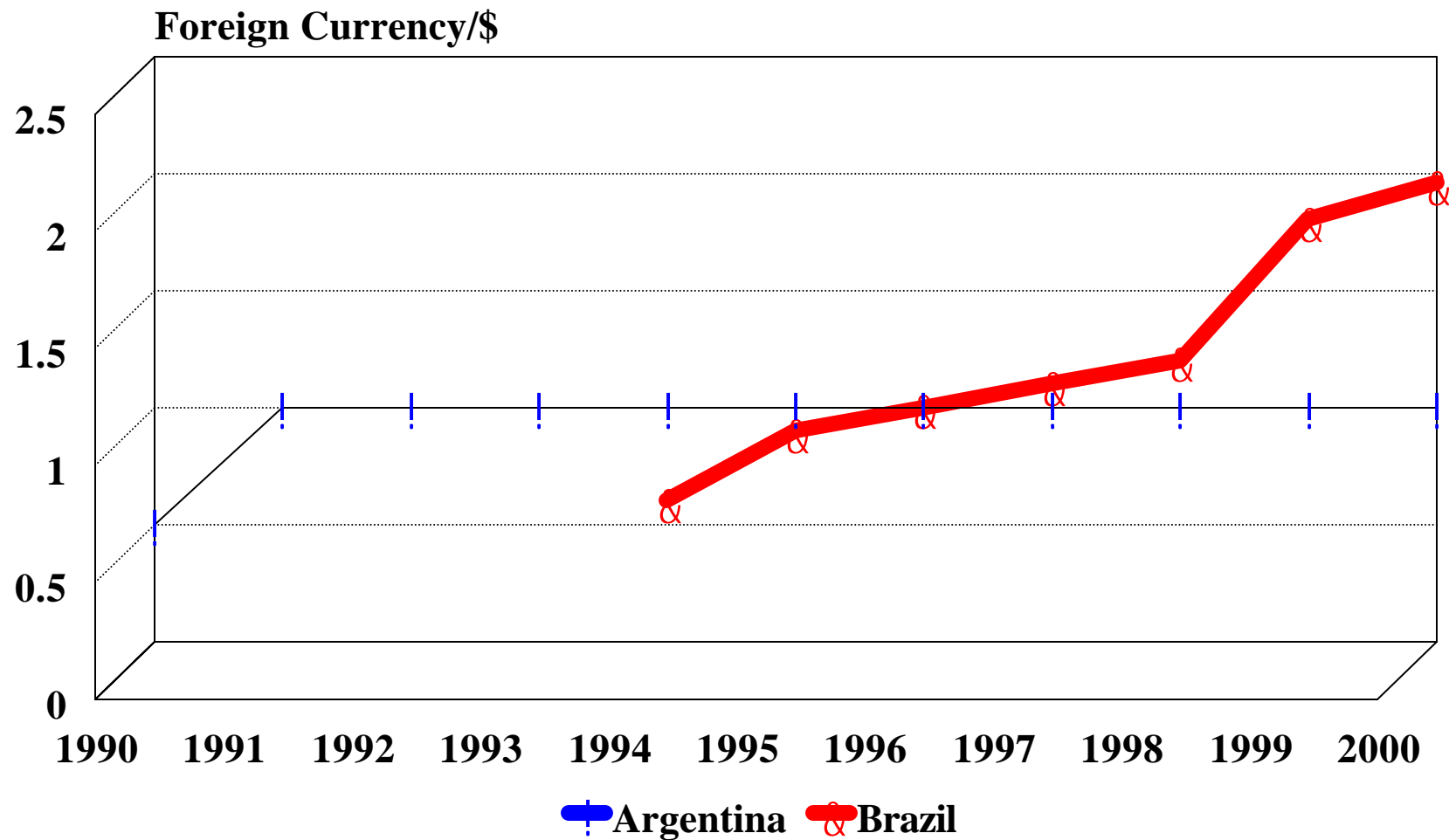


# Argentine Currency Board

- Rampant inflation and depreciation during 1989-90; Per Capita GDP below 1980 levels
- Currency Board created in 1991<sup>o</sup> U.S. style inflation by 1995 (not a “Quick Fix”)
- Comparison of Argentina to Brazil, which has floating rate

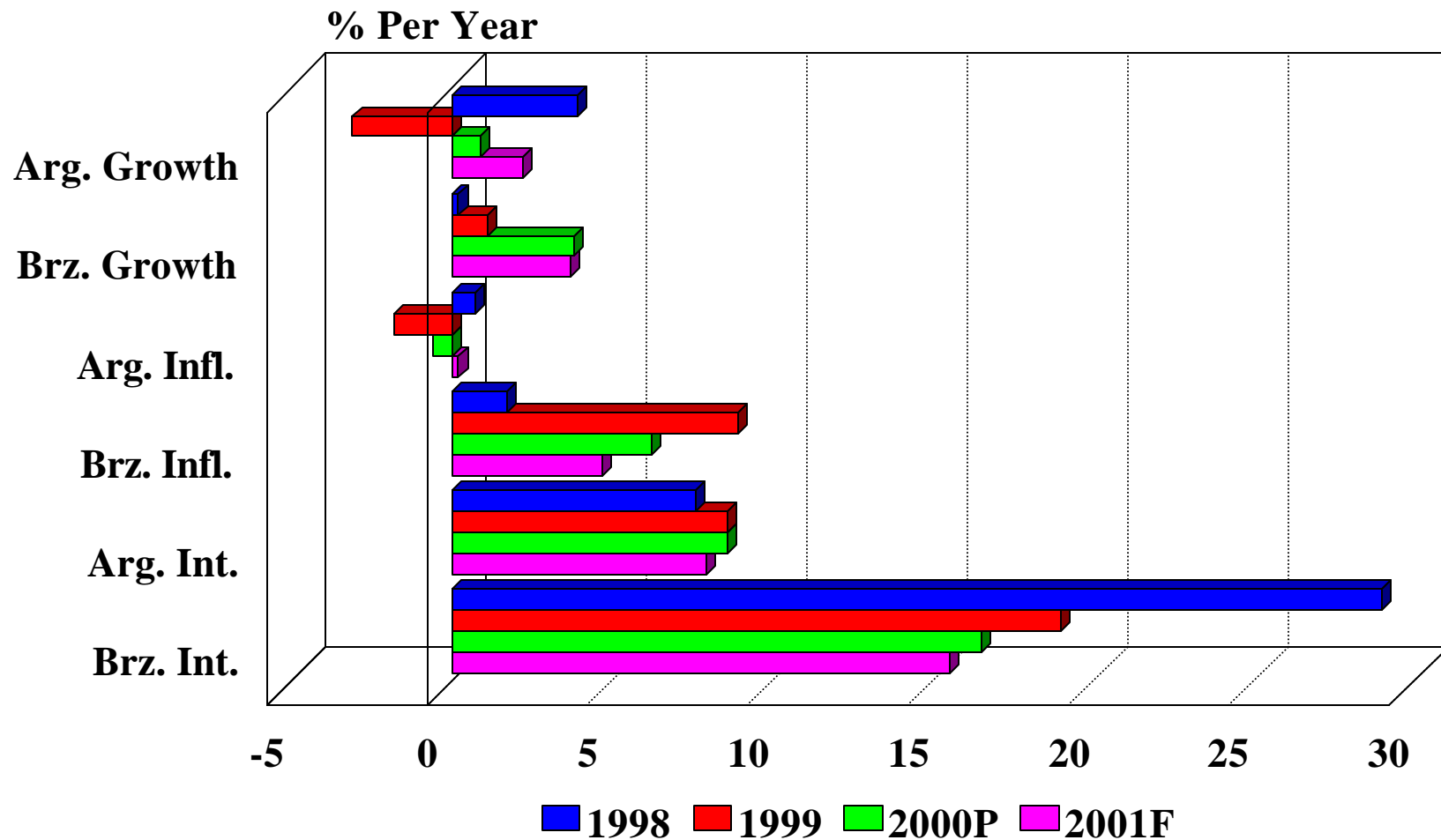


# Argentina and Brazil Exchange Rates with the U.S.



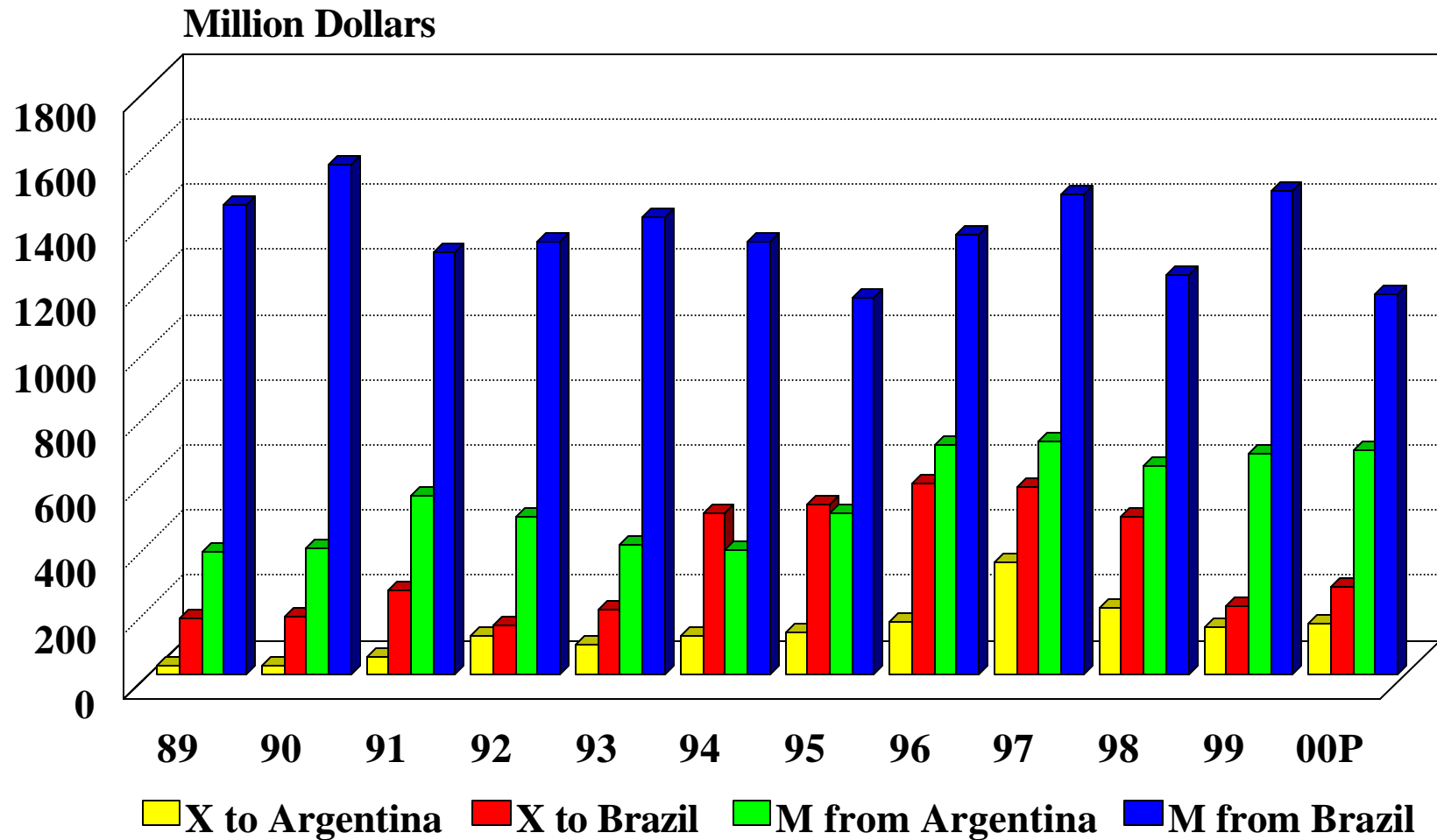
Source: InterAmerica Development Bank; Pre-1994 Rates for Brazil less than 1/2 significant digit

# Argentina and Brazil GDP Growth, Interest and Inflation Rates



Source: LatinWatch

# U.S. Agricultural Trade with Argentina and Brazil



Source: USDA/ERS

# Summary

- **Dollarizing economies may benefit from U.S. monetary policies following domestic/fiscal policy changes during the transition period.**
- **Agricultural trade more stable with dollarized and currency board countries.**
- **Increased dollarization has both benefits and drawbacks for U.S. agriculture.**
- **More applied research needed to assess options and impacts of dollarization.**





# Conclusions

- **Dollarization may be a key policy to promote economic stability.**
- **Dollarization is NOT a panacea.**
- **Fiscal, trade and agricultural policies, and other factors are important.**
- **Corruption, graft, and social unrest can disrupt dollarization benefits.**

