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Dollarisation of an economy

Published On: 29-11-2023

Why is in news? Javier Milei, the recent winner of Argentina's presidential election, has drawn attention for his unconventional policies, one of them being the plan to replace the country's currency of peso with the dollar.

Dollarisation:

Dollarisation is the term for when the **U.S. dollar is used in addition to or instead of the domestic currency** of another country.

It is an example of currency substitution.

Dollarisation usually happens when a country's own currency loses its usefulness as a medium of exchange, due to hyperinflation or instability.

When the foreign currency is the **dollar or the euro**, respectively, the practice is also known as **"dollarisation" or "euroisation".**

Full or partial currency replacement is possible.

Following a severe economic catastrophe, **full currency substitution** can take place, as it did in **Panama, El Salvador, and Ecuador.**

Some smaller economies, for whom maintaining a separate currency is impractical, utilize the currencies of their larger neighbours; Liechtenstein, for instance, uses the Swiss franc.

Types of Dollarisation:

Asset Dollarisation:

The term Asset Dollarization refers to the **use of foreign currency in any of the three functions of money**: unit of account, means of exchange, and store of value

Currency Substitution refers to the use of foreign money only as means of exchange. Thus, an economy can be highly dollarized, but not subject to currency substitution. Domestic currency may still be used for transactions.

Liability Dollarisation:

A key point that has emerged in the recent literature on **currency and banking crises in emerging markets** is that either the domestic banking system or the government can have relatively large foreign currency debt obligations. This concept is called liability dollarization.

Therefore, a country can be scarcely dollarized on the asset side, but the loans made by the banking system can be mostly in foreign currency.

Partial and Full Dollarisation:

Full Dollarisation is a situation in which a country abandons its currency and adopts another country's currency as a means of payment and unit of account e.g., Panama. Few countries in the world have dollarized completely.

Background:

Following the **Bretton Woods Conference after World War II** and the abandonment of the gold standard at the start of World War I, **several nations sought exchange rate regimes** to advance global economic stability and, by extension, their prosperity.

Most nations link their currency to a significant convertible currency. In contrast to "soft pegs," which are more flexible and floating exchange rate regimes, "hard pegs" are exchange rate regimes that show a deeper commitment to a fixed parity (such as currency boards) or give up sovereignty over their currency.

Currency substitution became a significant policy concern in the late 1990s after "soft" pegs in Southeast Asia and Latin America failed.

The decision about which exchange rate system to adopt became more difficult as world trade and capital markets became more integrated.

The **newest of the solutions was full dollarization**, under which a country officially abandons its currency and adopts a more stable currency of another country- most commonly the U.S. dollar -as its legal tender.

The main attraction of full dollarization is **eliminating the risk of a sudden, sharp devaluation** of the country's exchange rate. This may allow the country to **reduce the risk premium attached to its international borrowing**.

Dollarized economies could enjoy a higher level of confidence among international investors, lower interest rate spreads on their international borrowing, reduced fiscal costs, and more investment and growth.

Reasons for Dollarisation:

Economic Stability:

Often, countries resort to dollarization when their domestic currency faces instability due to factors like hyperinflation, rapid devaluation, political turmoil, or economic crises.

Adopting a stable foreign currency can help restore stability.

Credibility and Acceptance:

Foreign currencies like the US dollar are widely accepted in international trade and finance, offering lower transaction costs and reducing exchange rate risks, making them appealing alternatives.

Confidence Building:

Stronger foreign currencies can bolster confidence among investors, consumers, and creditors, enhancing trust in the economic system and potentially attracting investment.

Benefits of Dollarisation:

Dollarization can enforce **greater discipline in monetary and fiscal policies** by limiting the government's ability to print money excessively or finance deficits through money creation.

Tying the domestic economy to a more stable foreign currency can **help reduce inflation rates and stabilize interest rates,** which can contribute to economic stability.

Dollarisation can **act as a solution to hyperinflation** by breaking the feedback link between rising prices and rising money supply.

If the domestic currency is replaced by dollars, the money supply in the economy can no longer be controlled by vested political interests who can increase spending (and hence the money supply) for political ends (such as unsustainable freebies).

The rise of prices would be forced to moderate since consumers would no longer be able to access currency easily, thus slowing down consumption demand.

It **creates positive investor sentiment**, almost extinguishing speculative attacks on the local currency and the exchange rate.

It can **promote trade** by reducing barriers and uncertainties in cross-border transactions, attracting foreign investment due to reduced country risk and currency risk.

Full dollarization can improve the global economy by allowing for **easier integration of economies** into the world's market. The result is a more stable capital market, the end of sudden capital outflows, and a balance of payments less prone to crises.

Challenges:

Monetary Policy Autonomy:

When a country gives up the option to print its own money, it **loses its ability to directly influence its economy**, including its right to administer monetary policy and any exchange rate regime.

Fiscal Policy Constraints:

The Governments lose some flexibility in using fiscal policies, like adjusting taxes or public spending, since they can't print money to finance their expenditures.

No profit from issuing coinage:

The central bank **loses its ability to collect 'seigniorage,'** the profit from issuing coinage.

Instead, the U.S. Federal Reserve collects the seigniorage, and the local government and gross domestic product (GDP) suffer a loss.

Loss of central bank's power:

In a fully dollarized economy, the **central bank also loses its role as the lender of last resort** for its banking system.

While it may still be able to provide short-term emergency funds from held reserves to banks in distress, it cannot provide enough funds to cover the withdrawals in the case of a run on deposits.

On the foreign trade front, countries would no longer be able to take recourse to depreciation to boost exports, focusing only on export promotion to stave off downturns.

Securities in dollars:

Another disadvantage for a country that opts for full dollarization is that its securities must be bought back in U.S. dollars.

Without sufficient reserves, it will either have to borrow the money by running a current account deficit or find a means to accumulate a current account surplus.

Vulnerability to External Factors:

The economy becomes more exposed to external shocks, as it becomes highly dependent on the economic conditions and policies of the foreign currency issuer.

Loss of sense of pride:

Additionally, using foreign currency instead of the local one may damage a nation's sense of pride.

Ecuador's Example of Dollarisation:

The Ecuadorian economy suffered a series of debilitating crises in the late 1990s, with economic output contracting by almost 7%, inflation at roughly 67%, and the domestic currency, the Sucre, depreciating by almost 200% in 1999.

The country **announced the adoption of the dollar in January 2000**.

The economy has shown considerable progress since then, on parameters measuring both economic growth and social welfare.

The achievement of economic prosperity is a complex affair that requires sustained engagement with policy-making and **perhaps a little bit of luck to navigate economic shocks**.

Dollarisation is **not the sole reason for success**. Ecuador is helped by significant **reserves of oil and gas**.

The **commodity price boom** of the 2000s greatly aided the growth of the economy and allowed for a greater inflow of dollars.

Rising oil prices brought windfall gains to the Ecuadorian economy, with a government that ensured these gains were translated into social spending.

Subsequently, the reduction in oil prices after 2014 saw a reduction in economic growth and rising debt and deficit levels, bringing new challenges to the economy.

The economy has shown considerable progress on parameters measuring economic growth and social welfare. The **World Bank** estimates a **growth of 4.5% in real GDP between 2001 to 2014**.

The **poverty rate fell from 36.7% in 2007 to 22.5% in 2014**, with inequality, as measured by the Gini index, falling by 9 percentage points over this period.

Following dollarisation, the inflation rate averaged around 4% between 2003 and 2006, a remarkable achievement for an economy experiencing double-digit inflation rates since the 1970s. The **foreign debt to GDP ratio also reduced from 55% in 2000 to 21.5% in 2006**.

De-dollarisation:

De-dollarisation is a term that refers to the process whereby **countries tend to reduce their reliance on the US dollar** as a reserve currency, medium of exchange, and also a unit of account.

This movement involves **shifting towards bilateral currency agreements**, **using domestic currencies** for trade, and promoting alternatives to the dollar.

The aim is to **achieve greater economic autonomy**, reduce risks associated with dollar fluctuations, and challenge the dominance of the US dollar in the global financial system.

Rupeefication:

Rupeefication refers to the **process of internationalizing the Indian Rupee** (INR) by promoting its use in international trade and financial transactions.

This strategy involves **enabling trade partners to transact in INR**, issuing financial instruments denominated in INR to foreign entities, and facilitating greater access to the INR in global markets.

The objective of rupeefication is to **enhance the INR's status as a global currency**, **reduce dependence on the US dollar,** and strengthen India's economic resilience and autonomy on the global stage.

In India, while a complete overhaul of the trade invoicing system is not feasible, de-dollarisation can be complimented with the internationalisation of the INR—rupeefication.

Rupeefication will require - Complete freedom over buying or selling of the INR by any entity, the ability of the country's exporters to invoice their trade in INR, and holding as well as issuing of the INR and financial instruments denominated in it by foreign entities.

Conclusion:

Dollarization is not an easy decision for any country. It involves weighing the pros and cons of giving up an independent monetary policy and a national currency for greater stability and credibility.

It also requires careful preparation and coordination with the foreign currency issuer and other relevant institutions. Dollarization is not a panacea for economic problems; it is a tool that can help or hinder depending on how it is used.