Dollarization

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Preface

The Russian default in 1998, and the subsequent squeeze in lending to emerging economies, inflicted a significant blow to the growth process in many of these countries. Since then, and in light of the persistent instability in international financial markets, emerging economies have started to explore new alternatives for reducing exposure to capital flow volatility. While many chose to float their formerly pegged exchange rates, others, following the success of the euro, began to consider seriously the possibility of giving up their domestic currencies in favor of using, as legal tender, a hard currency, such as the U.S. dollar or the euro.

In the case of Argentina, during the 1990s and prior to the demise of the fixed exchange rate regime, the Central Bank looked for alternative ways to enhance the credibility of the currency board, in the hope that this would isolate Argentina from the general pattern of capital flows. Following the Brazilian devaluation of January 1999, the Argentine authorities advocated more openly the view that Argentina should move on to a de jure dollarization. To that aim, the Treasury and the Central Bank of Argentina maintained high-level contacts with their counterparts in the United States to explore the possibility of a monetary treaty under which Argentina would become part of the dollar zone. The reaction of the U.S. authorities was receptive from an intellectual point of view but extremely skeptical about the political viability of the proposal. In addition, the U.S. authorities were concerned about the implicit responsibilities they might be taking by signing such a treaty, particularly as a potential lender of last resort of the Argentine financial sector. Furthermore, the proposal received a lukewarm reception in Argentina itself.

These responses convinced the monetary authorities that more had to be learned about dollarization before moving forward with a formal plan. This conclusion, combined with a renewed interest in the topic both in Europe and in the United States, prompted the Central Bank of Argentina and the Konrad Adenauer Foundation to cosponsor the preparation of a comprehensive study that presented and discussed the different issues related to dollarization within an unbiased and rigorous framework. This volume is the result of that study.

Our strategy was to ask renowned academics that had been previously working on the topic to write a piece on specific issues relevant to the dollarization debate in a rigorous yet accessible style. The resulting papers were presented in a closed seminar at Universidad Torcuato Di Tella, Buenos Aires, and were thoroughly revised based on extensive comments by a group of international discussants gathered for the occasion. The result offers, we believe, a broad coverage of all the aspects involved in the dollarization debate, where the adjective *broad* applies both to the perspective of the different pieces (for example, empirical vs. theoretical) as well as to the underlying personal stance of the authors regarding the convenience of dollarization.

The first chapter of the book provides a synthesis of the issues discussed more at length in the remaining chapters, as well as an introduction to the dollarization debate's existing literature. In chapter 2, Roberto Chang and Andrés Velasco present a stylized theoretical model that illustrates the trade-offs involved in the choice of the dollarization alternative vis-à-vis other exchange rate arrangements. In particular, they discuss the implications in terms of the loss of seignorage revenues, the implementation of optimal monetary policy, and the central bank's capacity to function as lender of last resort to the domestic banking sector. In chapter 3, Pablo Andrés Neumeyer and Juan Pablo Nicolini explore the impact of dollarization on the government's budget constraints, as a function of the banking sector balance sheets and the currency denomination of the government's liabilities. The implications of de jure dollarization on the ability of the central bank to operate as lender of last resort is addressed by Christian Broda and Eduardo Levy Yeyati in chapter 4. They also examine alternative insurance mechanisms suggested in the literature to argue that dollarization entails a costly limitation that cannot be fully eliminated by the existence of substitutes. However, they conclude, these limitations are already in place in countries with widespread de facto dollarization. In chapter

5, Ugo Panizza, Ernesto Stein, and Ernesto Talvi assess the costs and benefits of dollarization from an empirical perspective, highlighting the main characteristics that determine the trade-off between dollarization and alternative regimes. One of the most pervasive arguments in favor of de jure dollarization has been the idea that the elimination of currency risk would lead to a decline in sovereign risk and the cost of capital for the dollarizing country. To test this hypothesis, Andrew Powell and Federico Sturzenegger address the link between sovereign risk and currency risk in chapter 6. They find that the relation between the two types of risk depends crucially on the characteristics of the financial sector of the economy, especially regarding the currency of denomination of (private and public) liabilities. A more operational perspective is taken by William Gruben, Mark Wynne, and Carlos Zarazaga in chapter 7 to discuss implementation issues. Should contracts be changed? How can seignorage be salvaged? What are the steps leading up to successful dollarization? The chapter provides a step-by-step guide on how to go from the decision to dollarize to the practical execution of a dollarization plan. Finally, in chapter 8, Jeffry Frieden discusses the political economy of dollarization, assessing the political feasibility of a dollarization plan by characterizing potential winners and losers among the influential groups within a country.

In putting together this book, we received support and aid from many fronts. We are particularly indebted to the Fundación Gobierno y Sociedad of Argentina for its encouragement and logistic assistance. Hildegard Ahumada, Fernando Aportela, Sergio Berenstein, Miguel Angel Broda, Alfredo Canavese, Tito Cordella, Ilan Goldfajn, Miguel Kiguel, Pedro Pou, Klaus Schmidt-Hebbel, and three anonymous referees contributed either by providing useful insights to the authors of the chapters or by offering suggestions that improved the overall quality of the volume. Finally, we benefited from the editing expertise of Elizabeth Murry from MIT Press, who guided us through the finishing touches.

We hope that this book, the result of two intense years of discussion and learning, will help enrich and disseminate the dollarization debate in future years, thus contributing to better and more informed policy decisions on the subject.

Eduardo Levy Yeyati and Federico Sturzenegger
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