Monetary Integration for Latin America: An Unbalanced Perspective

Michael Gavin

I OFTEN FEEL THAT DISCUSSIONS about the optimal exchange-rate regime are a lot like a Rorschach blot test—that psychological test where the doctor shows you an ink blot and if you see a horse's head you're okay, but if you see your mother screaming at you then you need a couple more sessions. Like that test, pronouncements about exchange-rate policy often tell you more about the speaker than they do about some objective reality. And in that spirit, I plan to lay out my own neuroses here, explaining why I think monetary integration in the Americas—preferably including the United States in a scheme that draws upon the strengths of the US dollar as the dominant world currency—is a good idea for Latin America. I trust that the sceptics will lay out the alternative case.

I divide my remarks into four main parts. I begin with several points that need to be understood about dollarisation, including several red herrings that have generated a lot of confusion, at least within Latin America where I have been discussing this topic extensively. Second, I briefly lay out some reasons why official dollarisation, by which we mean the abolition of an existing national currency and its replacement with the US dollar, may make sense for a country in Latin America.

Two Key Points

Official dollarisation is an evolutionary, not a revolutionary, change in Latin America's monetary arrangements. This is not to suggest that official dollarisation would be a minor change in monetary arrangements, it would be very significant. But the fact is that many countries of the region are already heavily (if informally) dollarised, in the sense that US dollars circulate and are used alongside the national currencies, and that much of the banking system already operates in dollars. In Argentina, Peru and Bolivia, for example, most of the private sector deposits in the local banking system are in dollars, and the banks do most of their medium and long-term lending in dollars. Governments often denominate their debt in dollars, whether the debt is issued domestically or internationally, because investors are willing to buy long-term dollar-denominated paper but not long-term peso-denominated paper. In countries where the domestic financial system is not dollarised, governments and corporations have accumulated substantial dollar liabilities because foreign lenders are unwilling to lend in local currency. Even in countries that are currently moving toward more flexible exchange rates, there is "creeping dollarisation" as authorities promote the dollarisation of their debt (as in Colombia recently) or of bank deposits (which has been announced as a possibility in Venezuela) in order to keep local savers at home. The irony is that this creeping dollarisation, prompted by exchange-rate instability, actually increases the costs of exchange-rate flexibility because of the destabilising effects on the value of the private sector's dollar liabilities. Today's flexible exchange-rate regimes may, therefore, be setting in motion forces that will eventually lead to their replacement by credibly fixed exchange-rate regimes.

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Official dollarisation does mean giving up an independent monetary policy, as well as the income that governments receive from printing money. Partial dollarisation of the sort that I have just described can co-exist with floating exchange rates and a discretionary monetary policy, though sharp movements in the exchange rate can be severely destabilising for partially dollarised economies. But a government that abolishes its own money and replaces it with another country's money loses control over the exchange rate, interest rates, and the money supply.

Four Red Herrings

First, dollarisation does not require that the United States changes its monetary policy objectives or procedures. The United States has barely noticed the gradual adoption of the dollar as a means of payment in many Latin American economies, and official dollarisation—which implies that the dollar would become the *only* means of payment—would not change matters much. And let's face it, America already does condition its monetary policy on what's happening abroad; witness the Fed's reaction to the global financial turmoil that followed the 1998 Russian devaluation and default. If, as I believe, dollarisation were to make Latin American economies more robust and "shock proof", then the US monetary authorities might even be better off, since the financial turbulence that has constrained their decisions in the past would appear less frequently.

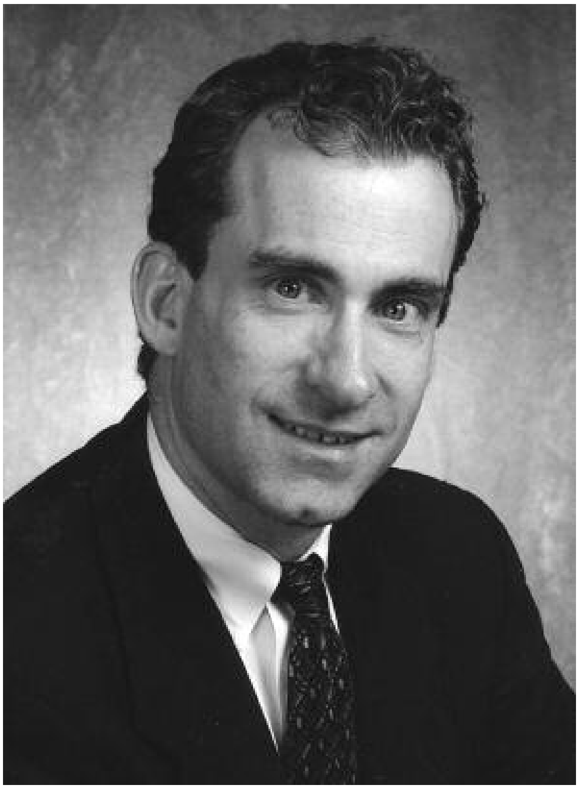
Though not necessary, it would, in my view, be desirable to approach monetary

Head of Latin America Research, UBS Warburg, Stanford, Connecticut, USA. His email address is michael. gavin@ubsw.com.

integration in a more co-operative way, perhaps initially by constructing a consultative group to report on economic and financial conditions in participating economies. But at best, dollarising Latin American economies could expect to exert the kind of weight that a US state of similar economic size now exerts over US monetary policy, which is to say, not much. Countries should not consider dollarisation because they think they will gain influence over US monetary policy, and the United States should not fear dollarisation because they think they may lose control over monetary policy.

Second, dollarisation does not require that the United States become involved in the supervision or regulation of the dollarising economy's financial system. This is often raised as an objection to official dollarisation, even by otherwise economically literate commentators. But there is no logical connection between dollarisation and financial-market regulation. Panama has successfully operated a fully dollarised economy for several decades, and the United States has never involved itself in the supervision or regulation of that country's banks. We also have the example of US states, many of which have long regulated many banks that operate within their borders, without, of course, conducting an independent monetary policy. Dollarisation has nothing to do with prudential supervision and regulation of the financial system.

Third, dollarisation does not mean that the local monetary authority cannot act as lender of last resort. It is true that the central bank of a dollarised economy cannot print dollars, and therefore cannot print money in order to lend it to banks that experience liquidity problems. However, the central bank can easily provide liquidity support to local banks if it keeps on hand excess dollar reserves to use for this purpose. Holding these reserves has a cost, of course, which means that operation of a lender of last resort facility becomes a fiscal problem. But it's a fiscal problem under a discretionary policy regime as well, the main difference being that in a dollarised system, the inflation tax cannot be used as a means of financing lender-of-last-resort operations. This is a good thing, not a bad thing, especially if it makes central banks more discriminating in their lender-of-last-resort operations.



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Finally, dollarisation does not require as a precondition the creation of a pristine banking system. It is sometimes argued that dollarisation cannot or should not be done until weaknesses in the banking system are fully resolved. It's true that you'll have a mess if you try to run a dollarised financial system with a weak banking system. But you'll also have a mess if you try to run a non-dollarised financial system with a weak banking system. I would argue that banks are likely to come under more, not less, stress under a weak monetary regime, and that dollarisation would thus complement, rather than undermine efforts to strengthen the banks. The problem with waiting until all banking problems are resolved before dollarising is that the exchange-rate and interest-rate volatility that is inherent in non-dollarised financial systems may itself weaken the banks, forcing indefinite postponement of the creation of a more stable financial environment. Whatever the monetary regime, if the banks need fixing they should be fixed as rapidly as possible, but weak banks should not be used as an excuse for the perpetuation of a weak monetary system.

Dollarisation Would Promote Integration and Economic Stability

Dollarisation brings with it a loss of monetary autonomy—once an economy has dollarised, it loses the capacity to control the exchange rate, the domestic money supply, or interest rates, all of which would be determined by the US Federal Reserve. In a few moments I will suggest that this loss of monetary policy autonomy is more apparent than real, but at least in theory, one would not want to dollarise unless there were some offsetting advantages to compensate for the loss of control over monetary policy. I think that dollarisation brings with it two key benefits: integration and stability.

Dollarisation would promote economic integration. The evidence is compelling that deepening the economic ties between a developing country and its industrial country counterparts can promote economic development in the less developed economy. Outward-oriented trade policies are consistently associated with economic success. No less important is financial integration, which permits abundant industrial-country capital to work with, and raise the living standards of, workers in emerging markets where capital is scarce.

However, the existence of many different national currencies, fluctuating in value from day to day, impedes this economic integration. Switching to a common currency would reduce both the costs and the risks of international trade, thus promoting trade integration and economic development in Latin America. I suspect that simply switching to a common currency would promote hemispheric integration as effectively as would many thousands of lawyer-hours devoted to the ongoing negotiations over what we cynically call a Free Trade Agreement for the Americas.

More important, I think, would be the impact of dollarisation on domestic financial systems, and their capacity to support deeper financial integration. Under the *status quo*, currency risk segregates national banking systems. It's risky to raise money in Texas and put it to work in Monterrey, because nobody knows where the peso will be ten minutes from now. Foreign lenders have to make their lending decisions on the basis of monetary considerations that have little or nothing to do with the inherent quality of the enterprise that is seeking credit. Industrial country investors do not want to lend very much, even to very sound businesses, in an environment where a monetary accident can suddenly halve the value of even a well-conceived investment. The existence of many national currencies thus curtails the amount and kind of cross-border lending that can be done, to the detriment of capital-hungry businesses in developing economies. And the cost of the resulting shortage of credit and high interest rates is borne, of course, mainly by small and medium-size enterprises whose growth is stunted.

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This point is certainly not lost on businessmen in Latin America. I recently spent four days visiting our clients in Guadalajara, Monterrey and Leon, in the industrial heartland of Mexico. Much of the discussion was about dollarisation, a topic of considerable interest to many Mexicans. They listened patiently to the list of macroeconomic costs and benefits, but the problem that was really on their minds was the constraint that having to borrow in pesos at high interest rates from the Mexican banking system imposed upon their competitiveness and growth. They understood at a deep intuitive level what it would mean for them if they had the same access to the pool of dollar savings that their counterparts in the North now enjoy. Though they did not use these words, dollarisation made sense to these businessmen as a means to promote a deeper integration of credit markets, giving them the opportunity to compete for capital with their industrial-country counterparts on the basis of their business prospects alone, unhampered by barriers to international lending that are created by potentially devastating currency fluctuations.

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In joint work with Ricardo Hausmann, Carmen Pages, and Ernesto Stein from the Inter-American Development Bank, we recently investigated the link between exchange-rate regimes, the depth of local financial markets, and real interest rates in Latin America. This work corroborated these businessmen's insight—we found that fixed exchange rate regimes have in fact been associated with significantly deeper financial markets and lower real interest rates than have flexible exchange rate regimes.

Official dollarisation would promote economic stability. This assertion is counter-intuitive to some economists, and I'm actually staking out a contrarian position here. The conventional wisdom is that, since monetary policy can, in principle, be used to stabilise an economy, the adoption of a currency board or official dollarisation must imply the loss of some capacity to stabilize the economy. But I think this logic is invalid in most of Latin America. The reason is that under any regime that allows for discretion in monetary policy, there is no institutional barrier to devaluation—policymakers retain the option to devalue *whether they intend to use the option or not*. But in most Latin American economies there is a tight link between the exchange rate and inflation and, moreover, the financial system is vulnerable to sharp devaluations because banks, corporations, and in many cases households have important dollar-denominated debt. This option to devalue is therefore tremendously destabilising when economies come under stress.

The year 1998 illustrated this point perfectly. During the summer and fall, the entire region came under stress because of commodity price shocks associated with the Asian crisis, and the world financial panic generated by the Russian devaluation and default. Did the countries operating relatively flexible exchange-rate regimes—Chile, Colombia, Mexico, and Peru—use that exchange-rate flexibility as a "shock absorber"? No. When their currencies came under attack they defended them with very high interest rates. They had to do this because simply allowing their currencies to collapse would have left the countries with unmanageable financial problems, since many corporations and households have substantial dollar debts, and would have left the country with a very costly inflation problem.

The interesting and important point is that all four of these countries were forced to raise interest rates higher, and keep them high for longer, than Argentina, the country in the region with the most rigid and credible commitment to an exchange-rate target. Why? Because even though the authorities in the other countries made clear their intention to defend the currency, and backed up the intention with high interest rates, investors in the country knew that the authorities could change their mind at any time. Much as they might have liked to do so, the central banks could not credibly renounce the option to devalue. But while they did not exercise their option to devalue, they still had to pay for it. Investors, facing the risk that the central bank could at any time change its mind and let the currency go, were willing to keep their money at home only if the central bank compensated them for the risk of devaluation with cripplingly high interest rates. It is these interest rates that lie behind the deep recessions from which Chile, Colombia, and Peru are now emerging.

Of course, Argentina was also thrown into recession by the Russia crisis and the near-collapse of Brazil, its most important trading partner. This proves that credible commitments to an exchange-rate regime are no panacea. Of course they are not—nothing is a panacea. But without the currency board, it is almost certain that fears of devaluation would have forced the central bank to raise interest rates to the level that were reached in Chile, Colombia, and Mexico, worsening the Argentine recession.

Thus, while the credible exchange-rate commitment was no panacea, it provided Argentina with some insulation from the world economic and financial shock. Meanwhile, those countries operating under more flexible exchange rates, who had thought they enjoyed monetary autonomy, found themselves unable to use that autonomy when they needed it.

Of course this is just one episode. But the pattern emerges more generally. In the joint work described above, we also looked at the correlation between real interest rates in Latin American economies and real interest rates in the United States over the past 25 years. We found a strong positive correlation, confirming that when US rates rise, Latin American rates need to follow. Contrary to what one might expect, the correlation was somewhat *higher* under flexible than under fixed rates, suggesting that flexible exchange rates may actually provide less monetary autonomy than is conventionally assumed.

Is Credibility the Key?

Some advocates of monetary disintegration acknowledge these dynamics but argue that they are due to a lack of credibility, which will be eliminated once the public gets used to sound monetary policy that is generated by an independent central bank using the latest and greatest operating procedures, of which inflation targeting is the current rage.

Maybe. But the fact that Chile experienced the same macroeconomically disruptive currency attack suggests that the problems may not be all a matter of credibility, and the destabilising dynamics described above may be a more permanent disadvantage of flexible exchange-rate regimes. After all, Chile is a country that ran over 10 years of budget surpluses. The country that had a 5-year history of meeting its inflation commitments. If that isn't enough to generate credibility, it's hard to know what it will take, and you have to ask yourself how long it will take for this credibility to descend upon Latin currencies.

No Panacea

Monetary integration is no panacea. Neither are flexible exchange rates or inflation targeting or penicillin or anything else for that matter. Argentina's recent experience suggests that exchange-rate rigidity can be costly when a country is dealt strongly negative shocks—in their case, the collapse of agricultural commodity prices, a macroeconomic crisis and associated collapse in demand from their most important trading partner, a mammoth appreciation of the currency to which they peg, and competitive devaluations by their neighbours. A flexible exchange rate could have avoided the deflation that these shocks created. It is less clear that a flexible exchange rate would have eased the overall adjustment.

But the more relevant lesson from Argentina is, like that of the inter-war gold standard, that it can be costly to maintain a credible currency peg when the rest of the world has decided that debasing the currency is the highest economic political virtue, and the anchor currency is adopting a policy of malign neglect of its own exchange rate *vis à vis* other world currencies. All the more reason for businessmen and policymakers in the Americas to see their common interest in promoting monetary integration in the hemisphere, and to approach the question of dollarisation as a co-operative, multilateral rather than a bilateral venture. ◆