6

Official Dollarisation: An Option Generally Rejected by CARICOM Countries

Anton Belgrave, Trevor Campbell, Kevin Greenidge and Ryan Straughn

Introduction

Dollarisation exists when residents of a country extensively use the United States (US) dollar or another foreign currency alongside, or instead of, the domestic currency. In an attempt to shed some light on this debate, this paper assesses the relative advantages and disadvantages of adopting the US dollar as the official currency for the countries of CARICOM by looking at the evolution of exchange rate, inflationary and fiscal issues. Section one addresses the pros and cons of dollarisation. Section two briefly looks at some countries that have adopted or agreed to dollarisation. The third section discusses this topic with respect to CARICOM, a regional grouping comprising both fixed and floating rate currencies. A conclusion follows in Section four.

1. The Pros and Cons of Dollarisation

It is important at the outset to distinguish between policy dollarisation and *de facto* dollarisation. The former occurs when governments replace the domestic currency with a foreign currency, while the latter exists if residents of foreign countries seek refuge in the dollar (or other strong currencies) to hedge against inflation, default or confiscation by their own governments. One new phenomenon in the 1990s is that *de facto* dollarisation has occurred even beyond the point where it is likely to be justified by economic and other risks. This has led in turn to a view, in some quarters, that the costs of maintaining a national currency are outweighed by the benefits of adopting a strong international currency. Hence, Argentina and a few other countries considered, and decided against, a policy of dollarisation. Europe's creation of the euro has also sparked interest in the possible payoff from explicit abandonment of monetary sovereignty (albeit in that case it is for a common currency rather than another country's currency).

As in most aspects of life, decisions have benefits and costs. The decision to or not to dollarise, which involves a complex menu of trade-offs for policy-makers, is no different. The most obvious benefit of dollarisation is that it eliminates transaction costs of exchanging one currency for another. In the view of Berg and Borensztein (2000), dollarisation also reduces the risk of a currency crisis and, in turn, a country's risk premia, with a consequent lowering of interest rates. Furthermore, lower interest rates and more stability in international capital movements are likely to be significant factors in reducing the fiscal cost of servicing public debt. An important caveat is that while dollarisation has the potential to eliminate some currency risk, it is uncertain whether total country risk is removed, since the question remains as to the effects of dollarisation on default risk.

A powerful, but somewhat hypothetical argument raised by Berg and Borensztein (2000) for full legal dollarisation, is that the change in monetary regime may establish a firm basis for a sound financial sector, which would stimulate strong and steady economic growth. The underlying rationale for this argument is that dollarisation signals more than the adoption of a foreign currency; it may be perceived as an irreversible institutional change towards low inflation, fiscal responsibility and transparency.

Countries with weak national economies will be financially fragile, no matter whether they have fixed or floating exchange rates. As emphasised by Hausman (1999), most emerging markets have national currencies that cannot be used by local firms or the government to borrow abroad, or even at home for long-term borrowing. In this case, dollarisation is a preferred option because abandoning the weak currency in favour of a strong international currency eliminates currency mismatches, as debts are denominated in the same unit as a company's cash flow, and also facilitates these countries' efforts to borrow longer-term. Hausman asserts that in spite of its chequered political history, dollarised Panama has the largest domestic credit market in Latin America and is the only Latin American country to offer 30-year fixed rate mortgages.

There are a number of key drawbacks with dollarisation, however, as a policy option. The main one advanced is lost seigniorage. As currency is worth more than its printing costs, printing money generates revenue for whoever owns the printing press. Seigniorage, which represents a form of income, usually accrues to national governments. The annual flow of seigniorage is frequently measured as the increase in base money (the sum of currency plus bank reserves). Governments can use seigniorage to purchase assets (foreign currency reserves, government securities) or finance their fiscal deficits. Under current conditions, any government giving up its currency foregoes this revenue and, indeed, this income is shifted to the issuer of the currency.

Some authors have highlighted the tendency for the dollarisation process to be recessionary (see Molano, 1999). This argument is based on the notion that most developing countries in distress are also facing large fiscal imbalances, and dollarisation tends to trigger a draconian adjustment that involves slashing government spending, which almost inevitably leads to a recession. Moreover, dollarisation is associated with high real interest rates. While it is true that dollarisation lowers nominal interest rates, there is a tendency for real interest rates to spike, as investors demand additional compensation for political and economic risks. Molano (1999) believes that it is, therefore, illogical to think that interest rates in an economy in the midst of an exchange rate crisis can automatically converge to US interest rates.

Another negative view expressed is that dollarisation subordinates external bond-holders. Governments that dollarise transform international reserves into base money. The elimination of international reserves at the conversion date represents the removal of an asset that can be used to repay international creditors. Under the assumption that the fiscal deficit creates an inflation tax on local currency-holders, external bond-holders have a senior claim on the country. Dollarisation bumps local currency- holders up the seniority ladder and allows them to be paid prior to the external creditors.

In addition, dollarisation brings no reasonable exit strategies. If a country successfully dollarises and the results are not beneficial, how then does this country end dollarisation? Governments usually consider dollarisation when there is no confidence in their abilities to implement macroeconomic policies. One, therefore, wonders how can a new regime restore confidence without removing the doubts that existed prior to the dollar initiative?

According to Spiegel (1999), dollarisation implies the reduction or complete elimination of lender of last resort capability. Central bank discount lending to commercial banks is not possible under full dollarisation, as central banks are unable to expand the monetary base to provide commercial banks with additional funds. In this case, the lender-of-last-resort function either has to be provided by private sources, by the Treasury or by some external agent. Initially, there has been some discussion of the possibility of the United States Federal Reserve Bank acting as lender of last resort by providing solvent, but illiquid banks with formal access to its discount window. However, the United States has firmly pledged no assistance to the banking system of dollarised countries, either supervisory or otherwise.

Flawed institutional design has been identified as one of the key components of policy mismanagement (Burhki and Perry, 1998). Molano (1999), for example, argues that the political systems of many Latin American governments lacked feedback mechanisms whereby policy-makers, or political parties, were held accountable for policy actions, while most of these countries lacked an independent central bank. Dollarisation in his view is a shift away from fixing institutional design. While proponents of dollarisation argue that the stabilisation of macroeconomic variables can lead to the emergence of a new institutional framework, this is a backward solution to the problem. It is difficult to see how dollarisation can force a government to repair deep-rooted institutional decay. In addition, dollarised governments fail to develop the skills and experience needed to develop macroeconomic policies to manage the different phases of the business cycles. Dollarisation is a pessimistic view on the capability of society to fully develop.

Perhaps the most significant loss of a dollarised country, however, is its ability to conduct monetary policy. This is especially important as it forces the full burden of combating recession on fiscal policy. This loss of flexibility becomes more evident if the business cycles of the source country and the dollarised economy are asymmetric.

2. The Experiences of Selected Countries That Have Adopted or Considered Dollarisation

Although the dollarisation debate has been relatively topical in the 1990s, this approach has been adopted by various countries for may years. Panama is the longest officially dollarised economy, with almost 100 years of experience with such a system. Since 1904, Panama has used US dollar notes as its domestic currency, issues the *balboa* as coins, and does not have a central bank or any centralised foreign reserves. Therefore, the US collects all seigniorage accrued on the use of US dollars in Panama. Panama only receives a small amount of seigniorage on domestic *balboa* coins that constitute about 9 per cent of total cash and coins in circulation.

In 1970, a banking law liberalised Panama's financial sector and allowed full entry of foreign banks. The capital account is entirely open and banks are free to invest excess funds in Panama or abroad. Because there is no domestic lender of last resort, domestic banks have established lines of credit with foreign-owned banks and have been able to draw on them during liquidity crunches.

Panama's macroeconomic performance has been relatively good. The growth of real gross domestic product (GDP) has averaged 8.1 per cent from 1961 to 1971 and from 1978 to 1981, and 2.5 per cent in the period 1982 to 2000. The inflation rate has been 3 per cent per year on average between 1961 to 1997, with real interest rates in the low to mid-single digits. In addition, the real exchange rate has hardly varied, compared to other Latin American countries, and there have been no systemic banking crises despite the experience of several major shocks. Some of these shocks were the political crisis of 1964, which was caused by riots in the Canal Zone, the oil price shocks of 1973-74 and 1979, the 1982 Latin American debt default and the 1988 to 1989 crisis immediately preceding and during the embargo and the US invasion. These all resulted in the withdrawal of deposits and economic dislocation. However, during the 1964 and 1967 to 1969 crises, several private banks responded by selling their assets abroad and increasing domestic credit, despite the outflow of domestic deposits. These actions helped cushion the adverse impact on the domestic economy.

After the devaluation of the Brazilian *real* in January 1999, the Ecuadorian *sucre* came under increased speculative pressure. Indeed, it was devalued on March 2 of that year. On that same day, eight troubled banks closed, and nine days later, the Government froze deposits in the entire banking system. The level of discontent in the financial system and the state of the economy created interest in the possibility of dollarisation. In January 2000, the President of Ecuador announced official dollarisation to end the rapid depreciation of the *sucre*. The US dollar was declared legal tender and the Central Bank would only issue *sucre* coins. The redemption of *sucre* bank notes was to proceed gradually over six to twelve months.

El Salvador considered dollarisation in 1995, but abandoned the plan amid opposition to the elimination of the currency, a symbol of national identity. However, in November 2000, the decision to dollarise was announced by its President.

In 1999, Argentina's President Carlos Menem declared that the Government was studying the possibility of official dollarisation. He was prompted to do so because of lingering doubts of the credibility of the currency board-like system. Argentina attempted to negotiate a share of seigniorage from the use of the dollar in Argentina, access for Argentine banks to the discount window of the Federal Reserve System, and cooperation on bank supervision. However, while the US did not rule out the possibility of sharing seigniorage with new countries in the Western Hemisphere (see Berg and Borensteinz, 2000), officials of the US Treasury and the Federal Reserve stated that the US would neither grant access to the discount window nor help supervise banks in dollarised economies. President Menem's successor, Fernando de la Rua, took office in December 1999 and although Argentina did not officially dismiss dollarisation, it appeared unlikely given that Argentina created an elaborate system of floating trade tariffs, which essentially devalued the *peso* for foreign trade purposes. Speculation of dollarisation ended in January 2002, after a severe crisis led the Government of Argentina to abandon the fixed exchange rate and to float its currency.

3. Implications for CARICOM

Seigniorage income does not represent a major source of revenue for most CARICOM countries (Table 6.1). For example, in the 1990s, the seigniorage earned by Barbados from its local currency accounted for a very small share (0.5%) of national income. However, seigniorage income for Jamaica and Guyana was significantly higher, 3.7 per cent and 4.1 per cent of GDP, respectively.

Barbados, Belize, The Bahamas and the OECS region all maintain fixed exchange rate regimes. Barbados' and Belize's exchange rates are fixed at 2 local dollars per US dollar, the rate in the Bahamas is fixed at par with the US dollar, and the rate of exchange in the OECS countries is fixed at EC$2.80 per US dollar. Jamaica maintained a fixed exchange rate until 1984, Guyana until 1991 and Trinidad and Tobago until 1993 (Figure 6.1). At the end of 1984, the Jamaican dollar reached J$3.94 per US dollar. By end-1991, it had risen to J$12.1 per US dollar. Three years later, a further increase to J$33 per US dollar was experienced. At the end of 2000, the nominal exchange rate was J$40 per US dollar.

Table 6.1

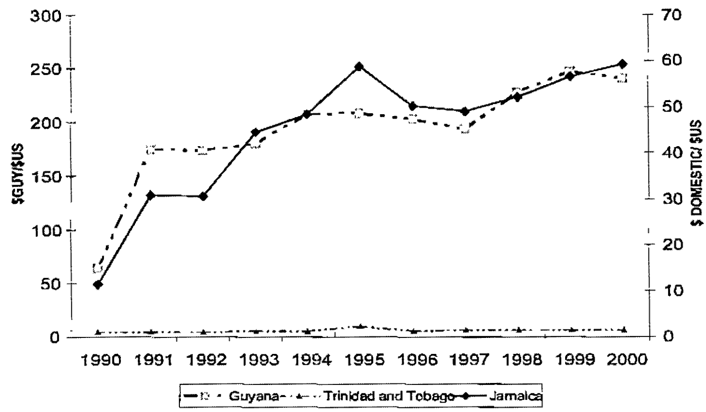
Seigniorage in Selected Caribbean Countries
(% of National Income)

	Barbados	Trinidad and Tobago	Guyana	Jamaica
Averages				
1960s	1.2	0.3	0.7	0.7
1970s	1.6	1.9	2.0	1.3
1980s	0.7	0.3	12.6	3.2
1990s	0.5	1.1	4.1	3.7

Source: International Financial Statistics, International Monetary Fund

Figure 6.1

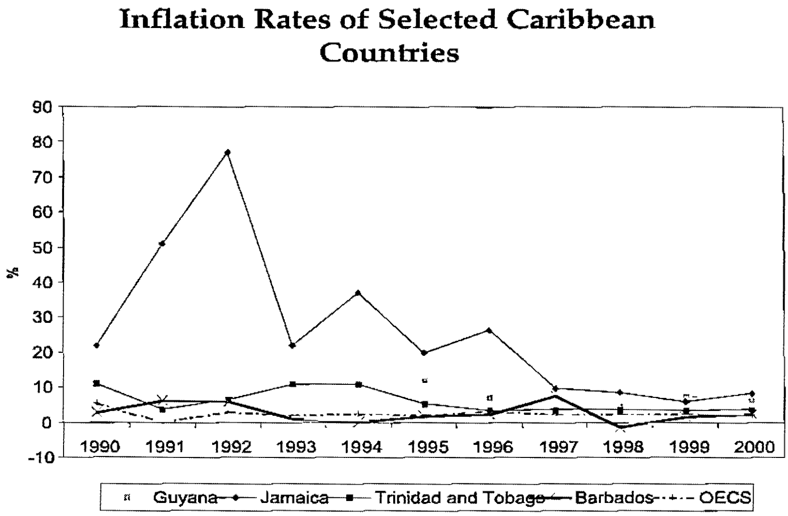
Exchange Rates for Trinidad and Tobago, Guyana and Jamaica



Source: International Financial Statistics, International Monetary Fund

When Guyana announced a floating exchange rate regime in 1991, the rate of exchange was G$111 per US dollar. Three years later, the rate fell to G$138, then to G$150 in 1998, G$178 in 1999 and G$183 in 2000. With the introduction of the floating exchange rate regime by Trinidad and Tobago in 1993, the exchange rate at that time was TT $5.35 per US dollar. The rate moved to TT$6.25 per US dollar by the end of 1997 and has remained relatively stable since then. There have been several interventions by the Central Bank of Trinidad and Tobago over the past few years to maintain this stability. Since December 2000, the exchange rate of the Trinidad and Tobago dollar has remained at $6.26 per US dollar. It is clear that unlike Trinidad and Tobago, both Jamaica and Guyana have experienced exchange rate instability. If this were the only criterion used for judging whether or not a country should dollarise then Guyana and Jamaica qualify. However, there are other factors to be considered.

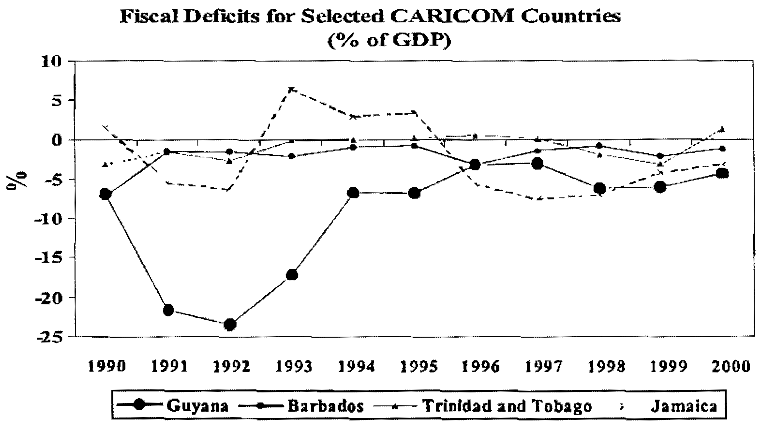
Figure 6.2



Source: International Financial Statistics, International Monetary Fund

The inflation patterns for the CARICOM countries are also worthy of note (Figure 6.2). As expected, those countries with fixed exchange rates have been able to maintain low rates of inflation. For example, since 1995, Barbados has recorded an average inflation rate of approximately 1.5 per cent, with the exception of 1997 when the rate jumped to 7.7 per cent because of the introduction of the value-added tax. The OECS countries have also been able to maintain average annual inflation rates of almost 2 per cent over the past ten years, as well as Belize, with the exception of 1996. However, Guyana's annual rate of inflation averaged around 6 per cent since 1994, Jamaica's was well over 10 per cent, and Trinidad and Tobago recorded average annual inflation of 5 per cent since 1993. If inflation were the only factor to motivate dollarisation, one could argue that both Jamaica and Guyana are possible candidates. However, Jamaica has outright rejected dollarisation and it does not appear that Guyana has ever considered it.

Figure 6.3



Source: International Financial statistics, International Monetary Fund

Figure 6.3 displays the fiscal balance (as a percentage of gross domestic product (GDP)) for Barbados, Guyana, Jamaica and Trinidad and Tobago. In general, Barbados has maintained low fiscal deficits. However, in 1991, when Barbados entered into a stabilisation programme with the International Monetary Fund (IMF), its fiscal deficit was recorded at 7.2 per cent of gross domestic product (GDP). Huge government expenditure was given as one of the reasons for the large reserve loss that was experienced. Indeed, the import reserve cover at end-1991 was equivalent to a mere 2.9 weeks of imports. Ever since then, Barbados has endeavoured to ensure that its fiscal deficit does not exceed 2.5 per cent of GDP. This target has been exceeded only once, that is, in 1996 when the deficit rose to 3.2 per cent of GDP. Data on the Bahamas show that the fiscal deficit averaged annually 3 per cent between 1990 and 1993 and has fallen since that period.

Table 6.2

Ratio of Foreign Currency Deposits to the Money Supply

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Bahamas	1.61	1.90	2.23	1.79	1.32	1.57	1.28	1.65	2.09	1.63
Barbados	0.96	1.22	0.89	1.13	1.40	0.68	1.11	1.19	1.30	1.32
Belize	0.62	0.33	1.48	0.73	1.23	0.77	2.54	1.77	2.01	2.71
Belize*	0.65	0.35	1.48	2.94	5.58	7.38	10.22	7.72	10.99	10.48
Guyana	3.35	2.57	4.30	5.42	6.46	5.28	5.34	6.50	6.10	5.06
Jamaica+	n.a.	n.a.	21.30	19.50	28.10	25.00	25.41	30.45	27.88	26.73
Trinidad & Tobago	n.a.	n.a.	n.a.	8.45	15.20	14.16	18.42	18.52	18.38	17.91
OECS:										
Anguilla	57.56	61.45	63.86	66.72	66.43	70.10	69.47	70.89	73.18	72.49
Antigua & Barbuda	4.29	5.02	4.82	3.36	4.33	3.57	4.02	5.14	5.27	5.36
Dominica	0.17	2.68	3.49	3.19	2.33	1.34	1.02	1.91	2.38	2.76
Grenada	2.04	2.70	2.66	3.03	3.54	3.28	4.71	4.94	3.94	4.95
Montserrat	1.33	5.58	6.92	6.42	4.93	4.78	4.66	2.46	1.97	3.36
St Kitts & Nevis	14.62	12.82	13.59	15.56	14.21	17.70	18.23	23.00	19.08	19.59
St. Lucia	0.18	0.24	0.18	0.31	0.45	0.52	0.42	0.48	0.71	1.92
St. Vincent & The Grenadines	0.49	0.95	0.54	1.00	2.01	1.49	1.09	1.83	2.35	2.85

Source: Research Department, Central Bank of Barbados.

Notes: * Includes Foreign Currency Deposits of both residents and non-residents.

* Data for the period 1992-95 were taken from Issues in Dollarisation, IMF Course on Financial Programming and Policies, Bridgetown, Barbados, Edda Zoli, August 14, 2000.

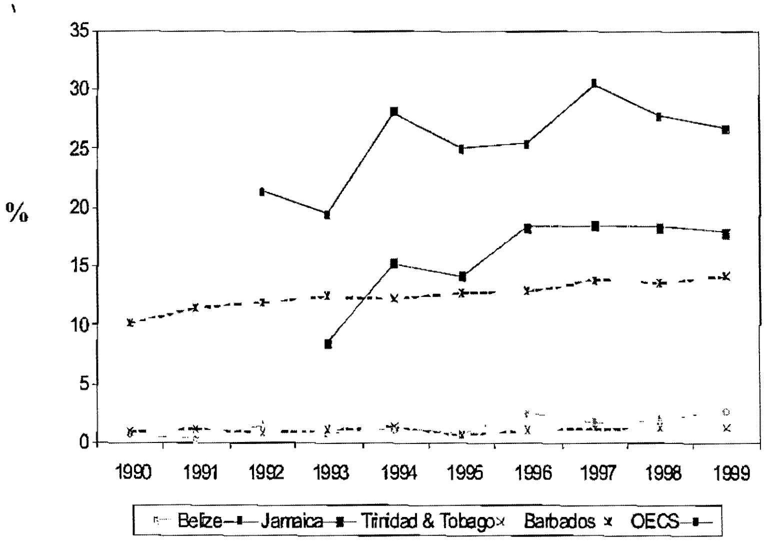
The same argument can be advanced for the OECS countries, as they have managed to keep their deficits within 3 per cent of GDP. In contrast, Guyana's deficit reached 21 per cent of GDP in 1991 and rose to 23.5 per cent of GDP in the following year. Some reduction was experienced in the next six years, with the lowest ratio of 3.1 per cent achieved in 1997. Nevertheless, in 1998, the fiscal deficit grew to 6.2 per cent of GDP. While data on Jamaica's fiscal deficit-to-GDP ratio have been somewhat dubious, during the 1980s, double-digit figures were recorded for this country. In 1999, the Central Bank Annual Report stated that Jamaica's fiscal deficit amounted to US$273.2 million, which would surely have surpassed 3 per cent of GDP. Trinidad and Tobago's fiscal deficit exceeded 4 per cent of GDP in the latter 1980s, but the country actually recorded surpluses from 1993 to 1995, and again in 2000.

The ratio of foreign currency to broad money, which gives the percentage of broad money that constitutes foreign currency deposits held by residents of a country, is presented in Figure 6.4 and Table 6.2. This percentage can be used as a plausible estimate of the degree of dollarisation in an economy. Those countries with a ratio in excess of 30 per cent can be classified as highly dollarised, whereas those with a ratio of less than 30 are moderately dollarised.

Table 6.2 shows that the ratios for Barbados, The Bahamas, Belize, Guyana, Jamaica, Trinidad and Tobago and the OECS countries classify them generally as only mildly dollarised economies. Barbados, The Bahamas and Belize have ratios that have not exceeded 3 per cent of broad money. Indeed, since 1990, Barbados' highest ratio was 1.40 in 1994. The Bahamas' ratio ranged from 1.32 to 2.23, somewhat surprising, considering that The Bahamas dollar is on par with the US dollar. Belize's ratio was at its lowest in 1991 (0.33) and reached its highest in 2000 (2.71). The OECS countries had ratios in the vicinity of 15 per cent since 1990. However, these ratios have been distorted by Anguilla and St. Kitts and Nevis.

Figure 6.4

Foreign Currency Deposits of Residents as a Percentage of Money Supply (M2)



Source: International Financial Statistics, International Monetary Fund

Anguilla's ratio averaged around 60 per cent over the past ten years and would easily qualify as a highly dollarised economy, comparing favourably with Argentina, Bolivia, Uruguay, Peru, Costa Rica and Turkey, to name a few. Its close proximity to the US may be one of the possible reasons for this pattern. St. Kitts and Nevis recorded an average of around 15 per cent. It actually rose as high as 23 per cent in 1997. The average ratio is about five times the ratio of any other OECS country, Anguilla excepted. Guyana's ratio appears to be considerably lower than expected given the history of macroeconomic instability there. The authors suspect that there may be some problems with the data for that particular country.

Excluding Guyana, the foreign currency ratios for the larger CARICOM economies are considerably greater than for the smaller territories. Trinidad and Tobago's ratio increased from 8.5 per cent in 1993 to 17.9 per cent in 1999. It is noteworthy that since 1993, when this country's dollar was floated, there has been a steady rise in the local holdings of foreign currency deposits.

Although Jamaica has been classified as a moderately dollarised economy, its ratios have placed it dangerously close to that of an economy that is highly dollarised. In 1992, the ratio of foreign currency deposits to the money supply was recorded at 21.3 per cent. By 1993, it fell by two percentage points, but in 1994 rose sharply to 28.1 per cent, a mere two percentage points from being classified as a highly-dollarised economy. Three years later, a ratio of 30.4 per cent classified Jamaica as a highly dollarised economy although at the end of 1999, it had declined by four percentage points.

Access to US banks and the income loss of central banks have not so far been dealt with. In a dollarised system, CARICOM countries would not be guaranteed assistance from the US Central Bank. The income loss of central banks would present a number of thorny problems both at the economic and the political levels. Under dollarisation, there is some loss of national sovereignty over the conduct of national macroeconomic affairs. For example, the monetary policies of CARICOM would now coincide with those of the Federal Reserve Bank. Most central banks in the region might agree that this is unacceptable, as domestic decisions might not agree with those of the US.

Table 6.3

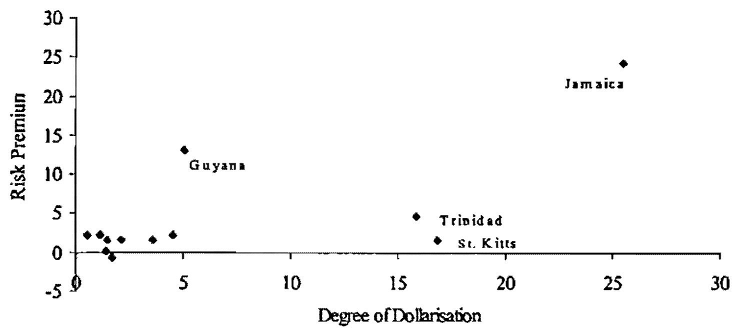
The Risk Premium* versus the Degree of Dollarisation

	Risk Premium	Degree of Dollarisation
Bahamas	-0.76	1.71
Barbados	2.12	1.12
Belize	0.07	1.42
Guyana	12.98	5.04
Jamaica	24.24	25.55
Trinidad & Tobago	4.61	15.86
Antigua	2.13	4.52
Dominica	1.55	2.13
Grenada	1.63	3.58
St. Kitts	1.63	16.84
St. Lucia	2.13	0.54
St. Vincent	1.63	1.46
Correlation Coefficient	0.74	

Source: International Financial Statistics, International Monetary Fund
Note: *The risk premium is calculated as the spread between a country's 3-month Treasury bill rate and the United States Treasury bill rate.

Figure 6.5

The Degree of Dollarisation versus the Risk Premium



Source: International Financial Statistics, International Monetary Fund

Conclusion

This paper has attempted to analyse various aspects of dollarisation in an effort to determine whether the decisions of CARICOM countries failed to consider this option based on persuasive arguments. If one is guided by the individual country data, Barbados, The Bahamas and the OECS countries (despite the performance of Anguilla) are not good candidates for dollarisation. These countries maintained a fixed exchange rate and a low inflation regime and have been able to record small fiscal deficits. In addition, the ratio of their foreign currency deposits to the money supply has been low, suggesting no real need by their citizens to hold foreign currency. With the exception of Trinidad and Tobago, CARICOM countries that have adopted a floating exchange rate regime experienced exchange rate instability, high inflation and fiscal deficits in excess of 3 per cent of GDP. Even in this case, there are serious downside risks. As Table 6.3 and Figure 6.5 show, there exists a positive correlation (0.74) between the degree of dollarisation and the risk premium for CARICOM countries. Dollarisation is not a cure for the problems associated with slow growing or stagnant economies. If, for example, the problems of exchange rate instability and high inflation are caused by high government spending, then dollarisation is not the answer since the fiscal imbalance needs firstly to be addressed. Most Caribbean countries which have considered dollarisation as an alternative measure were facing fiscal problems.

If CARICOM countries should try to successfully tackle their fiscal problems and maintain exchange rate stability, so as to diminish any inducement for dollarisation, the case for dollarisation is weak. It is also doubtful whether CARICOM countries would be willing to give up their implementation of monetary policies and unclear as to how political leaders would respond to the changed role of their respective central banks. These are some of the key issues that would have to be seriously considered. It is clear that regional economies have made their choices otherwise.

References

Anthony, M.L. and A.H. Hallet; Is the Case for Economic and Monetary Union in the Caribbean Realistic?, *The World Economy*, Vol. 23, No.1, January 2000, pp. 119-144.

Berg, A. and E. Borensztein; The Pros and Cons of Full Dollarisation, IMF Working Paper, No. 50, March 2000.

Burki, S.J. and G. Perry; *Beyond the Washington Consensus: Institutions Matter*, World Bank: Washington, D.C., 1998.

Hausmann, R.; Currencies: Should There be Five or One Hundred and Five?, presented at the Inter-American Development Bank Conference - Alternative Exchange Rate Regimes for the Region, July 23 - 24, Panama City, Panama, 1999.

Molano, W.T.; Addressing the Symptoms and Ignoring the Causes: A View from Wall Street on Dollarisation, presented at the Inter-American Development Bank Conference - Alternative Exchange Rate Regimes for the Region, July 23 - 24, Panama City, Panama, 1999.

Spiegel, M.M.; Dollarisation in Argentina, *Federal Reserve Bank of San Francisco Economic Letters*, Vol. 99, No.29, 1999.