

BENJAMIN J. COHEN

Dollarization, Rest in Peace

Remember dollarization? Not so long ago, the issue was being hotly debated in Washington policy circles. Should countries in the Western Hemisphere or elsewhere formally adopt America's greenback in place of their own national currencies? Should they be encouraged to do so? The explosion of interest in dollarization was sudden and dramatic. Reports were written, Congressional hearings were held, and legislation was mooted. Yet just a few years later, who remembers? As a policy issue, dollarization has effectively vanished from Washington's radar screen. The political agenda has moved on to other issues.

What explains the brief life of dollarization as a policy issue? As in most matters of political economy, a monocausal interpretation is hardly possible. In practice, many factors were involved in the birth and death of the issue—political as well as economic, foreign as well as domestic. But above all, this is a story of failed policy entrepreneurship. Strategically placed Washington officials exploited a confluence of events to promote a favored cause but then failed to gain the political support needed to change existing policy. In the absence of a winning coalition, interest in dollarization simply faded away.

Birth

The recent birth of dollarization as a policy issue is usually dated from January 1999, when Carlos Menem, then president of Argentina, suddenly spoke out in favor of replacing his nation's peso with the green-

Benjamin J. Cohen is professor of political science at the University of California at Santa Barbara, Santa Barbara, CA 93106-9420.

back. The idea was hardly novel. Other Latin Americans in positions of authority, from time to time, had also considered the option;¹ and one regional state, Panama, had already long used the dollar in lieu of a currency of its own. But never before had dollarization been publicly endorsed by the head of one of the hemisphere's largest states. With Menem's well-publicized initiative, an idea that previously had been viewed as little more than an intellectual curiosity now suddenly gained real political credence.

Menem's initiative was the product of a confluence of global and regional developments interacting with Argentina's own complex domestic politics. At the global level, the key development was the growing use of the greenback in dozens of countries around the world, part of a spontaneous, market-driven process of currency substitution going back two decades or more. Today, the process is distinguished as *informal* (unofficial) dollarization, in contrast to formal adoption of a popular currency like the dollar, labeled *formal* (official) dollarization. Because of its sad history of hyperinflation during Latin America's "lost decade" of the 1980s, Argentina was particularly susceptible to informal dollarization. By the start of Menem's first term in 1989, the dollar was already circulating widely throughout the economy. Ten years later, as Menem was nearing the end of his second term, the greenback accounted for over half of total bank deposits as well as an unknown, but undoubtedly large, share of paper currency in circulation. To a considerable extent, the stage was already set for formal adoption of the greenback.

At the regional level, the key development was a growing trade imbalance with Brazil, Argentina's principal partner in the Common Market of the Southern Cone, known as Mercosur. In 1991, Menem's government implemented its so-called Convertibility Plan—a currency board arrangement that tied the new peso (the country's fourth currency in less than a decade) firmly to the dollar on a one-to-one basis. In the short term, the program brought quick relief, promoting economic expansion and reducing annual inflation from nearly 5,000 percent in 1989 to less than 5 percent in 1994. But by the middle of the decade, America's greenback was beginning to appreciate sharply, taking Argentina's peso with it and greatly worsening the country's trade competitiveness. By January 1999, when a financial crisis led to a 40 percent devaluation of Brazil's currency, the real pressures on the peso were building remorselessly.

What could Menem do? Faced with the impending end of his second

term and frustrated in his attempts to engineer a third term for himself, he was determined to make a radical gesture that would help consolidate his place in Argentine history. His first sally came as early as April 1997 when, following a summit meeting with Brazil's president Fernando Henrique Cardoso, he floated the idea of a common currency for Mercosur (Giambiagi 1999). Menem's logic was plain. Not only would a monetary union reaffirm national commitments to the region's nascent integration project, but by forestalling any future appreciation of the peso relative to the real, it would also enable Argentina to maintain price competitiveness in relation to its biggest trading partner. It was only when his proposal subsequently received a frosty reception from the Brazilian government that he chose instead to switch the spotlight to dollarization. If monetary stability could not be ensured via a currency merger in Mercosur, then perhaps it could be preserved by adopting the *Yanqui* dollar.

Maturity

With the stimulus provided by Menem's endorsement, interest in dollarization quickly matured in Washington. Within months, formal hearings were convened on Capitol Hill, official statements were being issued, and a lively debate was carried on in the pages of the financial press. Before the end of the year, formal legislation was submitted by Senator Connie Mack (R-FL), then chairman of the Joint Economic Committee (JEC) of Congress, aiming to make dollarization the official policy of the United States.

The proposed legislation was named the International Monetary Stability Act. Informally dubbed the Mack Bill, the Act called for annual rebates to dollarizing countries of up to 85 percent of the seigniorage revenue they would lose by giving up the right to issue their own currencies (with the remaining 15 percent to finance rebates to countries that were already dollarized, such as Panama, and to help pay related costs of the Federal Reserve and the Treasury). Foreign governments would initially use their own dollar reserves, on which they presently earn interest, to acquire the greenback notes and coins needed to replace local currency in circulation. Compensation would then be paid in the form of interest on a consol, a perpetual debt instrument, which would be issued as soon as the U.S. Treasury certified that a country's money supply was officially dollarized.² The measure's purpose, Senator Mack

emphasized, was quite self-consciously to promote widespread adoption of the greenback. “It is time,” he declared, “for the U.S. to show leadership and encourage dollarization.”³

Alternative Explanations

How can we explain such a remarkable explosion of interest? One possibility is that key policy makers determined on the basis of a rational cost-benefit calculus that dollarization would be in the broad strategic interest of the United States—an explanation that in political science terms might be labeled *realist*. Alternatively, dollarization might have been seized upon by powerful domestic constituencies that could expect to profit substantially from the idea—an *interest-group* explanation. In reality, however, little evidence exists to support either conjecture.

The realist explanation is betrayed by the decidedly cool reaction that emanated from the government’s top financial officials at the time, Treasury Secretary Lawrence Summers and Federal Reserve Chairman Alan Greenspan. Both made abundantly clear that they saw little inherent merit in the idea. “It is absolutely not our intention to close the door on consideration of this issue,” Summers said at a Senate subcommittee hearing in April 1999 (Summers 1999: 8). But at the same time, he and Chairman Greenspan made abundantly clear that they had no desire to offer any help to underwrite dollarization efforts. On the contrary, foreign governments were urged to look first to policy reforms at home. “There just is no substitute for sound policies,” Greenspan cautioned (1999: 14). “If you try to create something out of nothing, you will end up not with something, but with nothing.”

Of course, it is possible that the Treasury and Federal Reserve were dissimulating. In the eyes of many Latin Americans, Washington’s underlying ambition has always been clear: to dominate the hemisphere, economically and politically. If Summers and Greenspan publicly resisted the temptation to encourage neighboring governments to adopt the greenback, it was only in order to avoid provoking anti-American reactions and to elude opprobrium should dollarization experiments go awry. Representative of this are the words of one Peruvian commentator: “The U.S. government cannot officially intervene in the initial decision concerning official dollarization . . . That could lead to a series of demands and accusations against the United States, which [it] will want to avoid by all means. . . . We all know that . . . from an official Ameri-

can political perspective [dollarization] seems to be an effective mechanism to fortify their hemispheric and world hegemony” (Schuldt 2003: 244–45). However, no evidence exists to back up suspicions of this sort, which remain essentially a matter of conspiratorial conjecture.

Likewise, the interest-group explanation is betrayed by the decidedly cool reaction emanating from the U.S. private sector at the time. It is clear that a number of groups might have expected to profit from dollarization, in particular, interests who, because of their heavy involvement in cross-border activity, would benefit from the elimination of exchange-rate risk. These would include inter alia U.S. banks and other financial intermediaries, export and import businesses, and portfolio investors. Most positively affected, in all likelihood, would have been commercial banks, because they are naturally advantaged relative to rivals in dollarized countries by their privileged access to the resources of the Federal Reserve. These extra profits are labeled “denomination rents” by economists, who have long recognized that international use of a currency disproportionately benefits financial intermediaries based in the country of issue. Yet no evidence exists of any systematic campaign at the time, by either individual institutions or representative associations, to promote the cause of dollarization. In practice, organized lobbying activity was most conspicuous by its absence.

Policy Entrepreneurs

In fact, the explanation is much simpler. Dollarization got on America’s political agenda because of the determined efforts of a small group of strategically placed Washington officials, who seized upon Menem’s public endorsement to promote long-held private aspirations—a classic case of ambitious policy entrepreneurship.

Central to this effort was Kurt Schuler, then a senior staff economist for the JEC (and presently a senior fellow in the Office of International Affairs, U.S. Treasury). With a Ph.D. in economics from George Mason University, Schuler is a prolific author who has long campaigned against what he regards as the fatal flaws of traditional central-bank practice. Most central banks, in his view, have poor long-term records in preserving the fundamental value of money. As he writes on a Web site he maintains on currency boards and dollarization,⁴ “central banking is central planning in money. . . . The repeated failure of central planning in other areas leads naturally to question why we should want central

planning in money.” His preferred alternative is free banking, a system based on competitive issue of money by private banks as advocated most prominently by the Nobel Prize-winning economist Friedrich Hayek (1990). “Free banking,” Schuler declares, “is in my view the most generally desirable monetary system. . . . the ideal system.” In 1989 he completed a comprehensive history of free banking presuming to demonstrate the inherent superiority of such a system over discretionary central banking (Schuler 1992).

Superior or not, however, free banking is anything but popular with governmental authorities. As Schuler ruefully admits, “trying to discuss it with policy makers remains almost impossible.” Hence, he has also been prepared to turn his attention to other options that might prove more politically feasible, in his words, “useful stepping stones from central banking to free banking.” Throughout the 1990s, working as an independent consultant, he became a tireless advocate of currency boards. An article he wrote on Hong Kong’s successful currency board, following a summer internship in Hong Kong in 1990, led to an extended period of collaboration with Steve Hanke, professor of economics at John Hopkins University, and himself a staunch champion of currency boards since the 1980s. Under Hanke’s mentorship, Schuler completed a doctoral dissertation on currency boards in 1992. The pair also wrote many articles and books together and in collaboration with a varying cast of colleagues, collectively labeled “monetary evangelicals” by John Williamson (1995: 1). The basic idea of a currency board is that a large, if not dominant, part of an economy’s money supply is firmly linked to the availability of a designated foreign currency—in effect, outsourcing monetary policy to a more reliable foreign authority. Currency boards might not be ideal, Schuler and Hancke reasoned. But, at least they tie the hands of some of the worst offenders among the world’s central banks. In part owing to the efforts of the monetary evangelicals, currency boards were established successfully in a number of countries over the course of the decade, including Argentina, as already mentioned, as well as Estonia, Lithuania, Bulgaria, and Bosnia and Herzegovina.

And then came Menem’s endorsement of dollarization in January 1999, just as Schuler was moving to the JEC. Although dollarization had long appealed to Schuler, it had never seemed to hold much promise in political terms. But now, at last, there might be a chance, particularly given the preferences of the JEC chairman, Connie Mack, who also was a long-time critic of discretionary central banking. The oppor-

tunity for policy entrepreneurship was quickly seized. With the chairman's authorization, Schuler swiftly produced a JEC staff report, published in April 1999 with the revealing title, "Encouraging Official Dollarization in Emerging Markets" (Schuler 1999). And within months, Schuler and Mack, together with Robert Stein, who also worked for the Senator, he completed drafting the International Monetary Stability Act, which was formally submitted in November 1999. The issue was now officially on the agenda.

Death

Success, however, proved short-lived. Though reported out by the Senate Banking Committee on a voice vote in July 2000, the Mack Bill was never debated by the full Senate and eventually expired at the end of the legislative session. A companion House version, sponsored by Representative Paul Ryan of Wisconsin, never even made it out of committee; and a successor bill, introduced in the new 107th Congress in 2001, following Senator Mack's retirement, went nowhere. Washington's interest in dollarization died almost as quickly as it was born.

Three countries chose to adopt the greenback during this period—Ecuador (2000), El Salvador (2001), and East Timor (2002)—joining five others that were already formally dollarized: Panama, Liberia, and the Pacific Island states of the Marshall Islands, Micronesia, and Palau. None did so, however, with any overt encouragement from Washington. On the other hand, U.S. policymakers did all they could to discourage Argentina after Menem's endorsement in 1999, even though, with its strong economic and political ties to the United States, Argentina seemed an ideal candidate. The goal in Buenos Aires was to negotiate a bilateral treaty of monetary association. If their nation was to surrender what remained of its historical monetary sovereignty, proud Argentines wanted to be seen as America's partners, not mere dependents. But when Washington politely declined to offer any significant concessions, Buenos Aires chose instead to remain with its troubled currency board, which finally collapsed ignominiously in early 2002.

Why did the idea's success prove so short-lived? Political theory teaches that for policy entrepreneurs to be effective, they must be able to build a winning coalition—a critical mass of supporters numerous and influential enough to "tip" the political process in their favor. That might not have been so difficult to accomplish in many Latin American

countries, where central banks, with their histories of high inflation and debauched currencies, do not enjoy a great deal of credibility. Obviously, these nations were the main objects of the monetary evangelicals' concern. The irony, however, was that policy makers who had to be converted were in Washington, not elsewhere, and that was no easy task.

In fact, considerable effort was devoted to generating support for the Mack Bill. For the uninitiated, a primer on dollarization was produced and widely disseminated (Joint Economic Committee 2000a), along with a more detailed analysis of the Act (Joint Economic Committee 2000b). Supporters were recruited to testify at Congressional hearings, learned articles were published in influential journals (Mack 2000), and papers were prepared for academic conferences (Schuler and Stein 2000). Two parallel strategies were followed: one a realist track, emphasizing broad national interest; and the other a special-interest approach, emphasizing potential gains to key domestic constituencies. In the end, however, backers were unable to make persuasive cases on either ground.

The Realist Case

On realist grounds, backers tried to make the case that formal dollarization would be in the broad strategic interest of the United States. That proved to be a formidable challenge at a time when informal dollarization was already so well advanced around the globe. The greenback is the world's dominant international currency, widely used throughout the Western Hemisphere and elsewhere; and from all this currency substitution, driven by the pressure of market demand, America already derives significant economic and political advantages. Backers were never able to argue convincingly that more was to be gained by formalizing the informal.

The global dominance of the dollar yields four distinct benefits for the United States. Most familiar is the potential for enhanced seigniorage. Cross-border circulation of a country's money generates the equivalent of a subsidized or interest-free loan from abroad—an implicit transfer that represents a real-resource gain for the economy as a whole. Consider just the circulation of Federal Reserve notes, which are a form of noninterest-bearing liability. Authoritative studies by the U.S. Treasury (2000) and Federal Reserve (Judson and Porter 2001) put the value of all notes in circulation abroad at between 50 and 70 percent of the total outstanding stock—equivalent at the turn of the century to roughly \$275 billion to \$375 billion in all. Updating earlier estimates by Jeffrey Frankel

(1995) and Alan Blinder (1996), current interest savings from foreign circulation of the greenback may be conservatively calculated at some \$16–22 billion a year. To this may be added a savings of interest payments on U.S. government securities, which are uniquely attractive to foreign holders because of their greater liquidity. Richard Portes and H el ene Rey call this an “often neglected source of seigniorage to the issuer of the international currency” (Portes and Rey 1998: 309). In their words: “This international currency effect reduces the real yields that the United States government has to pay”—a “liquidity discount” that they suggest could amount to at least \$5–10 billion a year (Portes and Rey 1998: 309).

A second benefit is the increased flexibility of macroeconomic policy that is afforded by the privilege of being able to rely on one’s own money to help finance foreign deficits. Expanded cross-border circulation reduces the real cost of adjustment to unanticipated payments shocks by internalizing through credit what otherwise would be external transactions requiring scarce foreign exchange. In effect, it reduces the need to worry about the balance of payments in formulating and implementing domestic policy. Who can remember the last time Washington decision makers actively incorporated concern for our large current deficits or exchange rate in debating the course of monetary and fiscal policy?

Third, less tangible in nature, is the gain of status and prestige that goes with market dominance. Money, as I have written elsewhere (Cohen 1998, 2004), has long played a key symbolic role for governments, useful—like flags, anthems, and postage stamps—as a means to cultivate a unique sense of national identity. But that critical role is eroded to the extent that a local currency is displaced by a more popular foreign money, especially a money like the greenback that is so widely used on a daily basis. Foreign publics are constantly reminded of America’s elevated rank in the community of nations. “Great powers have great currencies,” Robert Mundell once wrote (1993: 10). In effect, the dollar has become a potent symbol of American primacy—an example of what has come to be called “soft power,” the ability to exercise influence by shaping beliefs, perceptions, and identities. Though obviously difficult to quantify, the role of reputation in international affairs should not be underestimated.

Finally, there is the gain of “hard” political power that derives from the monetary dependence of others. On the one hand, the United States is better insulated from outside influence in the domestic arena. On the

other hand, it is also better positioned to pursue foreign objectives without constraint or even to exercise a degree of coercion internationally. As political scientist Jonathan Kirshner reminded us: "Monetary power is a remarkably efficient component of state power . . . the most potent instrument of economic coercion available to states in a position to exercise it" (Kirshner 1995: 29, 31). Money, after all, is simply command over real resources. If another country can be denied access to the means needed to purchase vital goods and services, it is clearly vulnerable in political terms. Kirshner listed four ways in which currency dependence can be exploited: (1) enforcement—manipulation of standing rules or threats of sanctions; (2) expulsion—suspension or termination of privileges; (3) extraction—use of the relationship to extract real resources; and (4) entrapment—transformation of a dependent state's interests. The dollar's widespread use puts all of these possibilities in the hands of Washington policy makers.

Of course, there are limits to these benefits, particularly if they are abused. At present, the United States is running a current account deficit in excess of \$500 billion a year. To many, this appears to be an overexploitation of privilege that could eventually jeopardize the advantages of widespread use. As America's external liabilities rapidly accumulate, increasing supply relative to demand, foreigners might naturally be expected to worry about the risk of future depreciation or even restrictions on the usability of their holdings. Accordingly, Washington's autonomy could eventually be constrained, to a degree, by a need to discourage sudden or substantial conversions through the exchange market. Both seigniorage income, on a net basis, and macroeconomic flexibility would be reduced if a sustained increase of interest rates is required to preserve the dollar's market share. But at the time the Mack Bill was under consideration, there was, as yet, little sign of any serious threat to the dollar's historic dominance.⁵

As compared with the benefits of informal dollarization, formal dollarization could offer just one unqualified gain for the United States—a reduction of transactions costs. But backers were never able to demonstrate that the improvement would be more than marginal, at best. Certainly, it could be argued that transactions costs would be saved, owing to the elimination of exchange-rate risk. This is the standard economic benefit expected from monetary integration, an efficiency gain that would be shared by both sides, the United States as well as countries that chose to dollarize. Once a local money was replaced by the

dollar, there would no longer be a need to incur the expenses of currency conversion or hedging in mutual transactions. For the United States, however, the saving was unlikely to be considerable, because most U.S. trade with prospective dollarizers in Latin America or elsewhere is already contracted mostly in dollars. From the start, it was clear that it was the potential dollarizers, not Americans, who would benefit most from the anticipated efficiency gain.

Technically, formal dollarization might have also been thought to offer a second advantage—a savings on interest payments that would accrue as soon as foreign government gave up interest-bearing dollar reserves to acquire the greenback notes and coins needed to replace local currency. The United States would enjoy an immediate windfall benefit. But since the Mack Bill was explicitly designed to compensate potential dollarizers for most of their lost seigniorage, in the form of interest on a consol, the outcome would actually be a wash.

On the other hand, as compared with informal dollarization, formal dollarization clearly posed significant risks for the United States. Despite their best efforts, backers were never able to resolve anxieties about looming prospective costs.

First was the risk that technical complications would be introduced into the conduct of monetary policy by the Federal Reserve. Formal dollarization would place a large share of greenbacks in circulation abroad. If money demand in dollarizing countries was subsequently to be subject to sudden or frequent shifts, net flows would be generated that might increase the short-term volatility of U.S. monetary aggregates. Such liquidity shocks could make it tougher for the Federal Reserve to maintain a steady course over time. Backers pointed out that a sizable share of the stock of Federal Reserve notes is already in circulation outside America's borders, with little or no evident impact on policy. The Federal Reserve Board recognizes the phenomenon of informal dollarization and, as part of its daily open-market operations targeting the federal-funds rate, already factors overseas circulation into its behavior. But who could know when the amounts involved might become too large for the Federal Reserve System to manage?

Even more serious was the risk that macroeconomic flexibility might be constrained by demands for accommodations to suit the needs of dollarizers. In adopting the greenback, a government would voluntarily surrender control over its own money supply and exchange rate. All authority would be ceded to the Federal Reserve, making the country, in

effect, a monetary client. Like it or not, therefore, the Federal Reserve might, from time to time, find itself being lobbied to take explicit account of the priorities of dollarized economies in setting its policy goals or to open its discount window to foreign financial intermediaries. Over the longer term, dollarizers might even begin to campaign for observer status or even direct representation on the Federal Reserve Board or Federal Open-Market Committee. Backers pointed out that, in principle, there need be no promises of any kind. To forestall any such risk, the Mack Bill, as drafted, explicitly provided “that the United States is not obligated to act as a lender of last resort to officially dollarized countries, consider their economic or financial conditions in setting monetary policy, or supervise their financial institutions.” Yet, would even such blunt wording have sufficed? Once having encouraged countries to adopt the greenback, could Washington really be expected to turn its back if any got into trouble? In reality, as frequently noted at the time (Samuelson 1999), it might prove difficult for the United States to ignore adverse developments in the periphery of its own currency bloc. Even in the absence of explicit commitments, formal dollarization risked creating an implicit expectation of future monetary bailouts—a kind of contingent claim on America’s resources.

Worst of all was the risk that formal dollarization might lead to increased political tensions with monetary clients, compromising key foreign-policy relationships. In principle, formalization of the informal would enhance both the soft power and the hard power of the U.S. Government. In practice, however, either form of power could turn out to be a double-edged sword, depending on circumstances.

For example, widening a formal dollar bloc might add to America’s prestige around the world (though any gain was unlikely to be considerable unless the new dollarizers turned out to be a good deal bigger than the small, poor economies presently circling in the greenback’s orbit). But what in prosperous times may be accepted as benign, even natural, could become a focal point for hostility in the event of an economic downturn or crisis. Formal dollarization creates a convenient target for protest. When the greenback was adopted in Ecuador, demonstrators marched in the streets denouncing what they feared would be the “dollarization of poverty.” It is easy to imagine similar manifestations in the future, in Ecuador or elsewhere, blaming the dollar—and thus the United States—for any failures of economic management at home. It is even possible to imagine politicians deliberately fomenting popular protests as a way of divert-

ing attention from their own policy errors. Prestige could have come at a very high price, creating an easy target for grievances.

Likewise, formalizing the monetary dependence of client states would make it easier for Washington, if it so chose, to exercise coercion over others—just as the Reagan administration did in 1988 when, in the midst of a political dispute with the government of Panama, it abruptly froze all payments or other dollar transfers to that Central American country. In effect, the United States resorted to what Kirshner calls expulsion, effectively demonetizing the Panamanian economy. The action, which immediately plunged Panama's economy into chaos, was undoubtedly successful in reducing the country's resistance to U.S. pressure, but at what price in terms of the longer-term good will of the Panamanian people? To the extent that the hard power of the greenback is actually used, it simply confirms the suspicions of Latin Americans, like the Peruvian commentator quoted earlier, who see in formal dollarization simply another expression of U.S. imperialism "reinventing colonialism," as one critic put it (D'Arista 2000: 2). Backers were never able to allay fears about the damage that might be done to America's foreign-policy interests.

The Special-Interest Case

Along a parallel track, backers sought to build a case on special-interest grounds. To do so, they had to argue that formal dollarization would materially profit key domestic constituencies, which might then bring their political influence to bear on decision makers in the public sector. That also proved to be a formidable challenge. In practice, as I already indicated, organized lobbying activity turned out to be most conspicuous by its absence. Backers were never able to build a winning coalition of private-sector interests.

Backers could, of course, argue that certain groups, including above all the banking sector, would benefit disproportionately from the anticipated reduction of transactions costs. But given how small the aggregate saving was likely to be, this incentive alone was clearly insufficient to attract active support. More emphasis was placed, therefore, on the potential for creating an improved environment for U.S. trade and investment, particularly in the Western Hemisphere (Barro 1999; Shelton 1999). Adoption of the dollar, backers contended, would mean that flawed monetary policies could no longer threaten periodic

financial crisis. In the words of Michael Gavin (2000), a business economist, the monetary regime would now be “accident-proof,” ostensibly removing a key impediment to development. Steadier growth would mean faster growth; and this, in turn, would mean healthier markets for U.S. exports and investments. As Julie Katzman, another enthusiast, commented:

Dollarization would eliminate the cycle of boom and bust, inflation and recession, and overvaluation and devaluation . . . This would simultaneously create a more secure market for U.S. goods and for U.S. companies who have become substantial players in the domestic economies of Latin America. (Katzman 2000: 208)

But would the monetary regime really be “accident-proof?” Formal dollarization addressed only one among many of the causes of economic instability in Latin America—flawed monetary policy—but offered no direct corrective for other critical deficiencies, such as undisciplined budgetary policy, poor banking supervision, or labor-market rigidities. The hope was that with the straitjacketing of monetary policy, additional structural reforms would fall into place. But as economist Walter Molano warned, that could be “just wishful thinking” (Molano 2000: 62). Molano continued: “Dollarization is a one-sided look at the problem. . . . Dollarization is not a solution to the institutional flaws that led to the crisis in the first place. It does nothing to shape the political will needed to sustain the exchange rate regime” (Molano 2000: 60). In short, too much faith should not be invested in a single institutional innovation. Dollarization, summarized Catherine Mann, “does not produce magic changes” (Mann 1999: 56).

Besides, many experts noted (Sachs and Larrain 1999; Rojas-Suarez 2000), Latin America’s economies are by no means a natural fit for a monetary union with the United States. In more technical language, the Western Hemisphere is not self-evidently an optimum currency area. Apart from Mexico, few of America’s southern neighbors are closely integrated with the U.S. economy or convergent with U.S. macroeconomic performance. All are commodity exporters, subject to wide swings in world demand and prices, whereas the United States is mostly a commodity importer. Moreover, most Latin American economies lack the resource mobility and price flexibility needed to adjust smoothly to terms-of-trade volatility without the “shock absorber” that a flexible exchange

rate can provide. Many, therefore, could find themselves experiencing more rather than less variance of real income over time, making the market environment considerably less healthy than suggested by dollarization's backers. In the end, U.S. business and financial interests remained largely skeptical.

Conclusion

In short, policy entrepreneurship failed. Carlos Menem's endorsement of formal dollarization in January 1999 created an opening for a bold new initiative by a small coterie of strategically placed Washington officials. But then, backers were unable to capitalize on the ensuing explosion of interest to build a political coalition capable of transforming aspiration into legislation. The case was not made on either realist or special-interest grounds. And so, after a brief moment in the limelight, the issue received a decent burial. Dollarization, Rest in Peace.

Notes

1. In the late 1970s, for example, according to one knowledgeable source (Díaz-Alejandro 1988: 371), some economic officials in Chile "dreamed of doing away with the national currency altogether" but were deterred by potential opposition from the military. Similarly, in El Salvador, which did ultimately dollarize in 2001, the idea was first raised by policy makers as early as in 1995, six years earlier.

2. For additional detail, see Joint Economic Committee (2000b) and Schuler and Stein (2000).

3. Joint Economic Committee press release, November 8, 1999.

4. Available at www.dollarization.org. Subsequent quotes from Schuler cited in the text also come from this source.

5. One reason for the dollar's continued dominance is undoubtedly the incumbency advantage that the currency enjoys as a result of network externalities. For more on such inertias in international currency use, see Cohen (2004, chapter 1).

References

- Barro, Robert J. 1999. "Let the Dollar Reign from Seattle to Santiago." *Wall Street Journal*, March 8: A18.
- Blinder, Alan S. 1996. "The Role of the Dollar as an International Currency." *Eastern Economic Journal* 22, no. 2 (spring): 127–36.
- Cohen, Benjamin J. 1998. *The Geography of Money*. Ithaca: Cornell University Press.
- . 2004. *The Future of Money*. Princeton: Princeton University Press.

- D' Arista, Jane. 2000. "Dollarization: Critical U.S. Views." Paper prepared for the conference "To Dollarize or Not to Dollarize: Currency Choices for the Western Hemisphere," Ottawa, Canada, October 4–5.
- Díaz-Alejandro, Carlos F. 1988. *Trade, Development and the World Economy: Selected Essays*. Oxford, UK: Basil Blackwell.
- Frankel, Jeffrey A. 1995. "Still the Lingua Franca: The Exaggerated Death of the Dollar." *Foreign Affairs* 74, no. 4 (July): 9–16.
- Gavin, Michael. 2000. "Official Dollarization in Latin America." *Monetary Stability in Latin America: Is Dollarization the Answer?* Hearings before the Subcommittee on Domestic and International Monetary Policy, Committee on Banking and Financial Services, U.S. House of Representatives, June 22, 45–50.
- Giambiagi, Fabio. 1999. "Mercosur: Why Does Monetary Union Make Sense in the Long-Term?" *Integration and Trade* 3, no. 9 (December): 59–81.
- Greenspan, Alan. 1999. "Remarks." *Official Dollarization in Emerging-Market Countries*. Hearings before the Subcommittee on Economic Policy and Subcommittee on International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 22, 7–23.
- Hayek, Friedrich A. 1990. *Denationalisation of Money—The Argument Refined*. 3d ed. London: Institute of Economic Affairs.
- Joint Economic Committee. 2000a. *Basics of Dollarization*. Staff report. Washington, DC.
- . 2000b. *Dollarization: A Guide to the International Monetary Stability Act*. Staff report; available at www.senate.gov/~jec/dollaract.htm.
- Judson, Ruth A., and Richard D. Porter. 2001. "Overseas Dollar Holdings: What Do We Know?" *Wirtschaftspolitische Blätter* 4 (April): 431–40.
- Katzman, Julie T. 2000. "Dollarization." In *Economic Strategy and National Security: A Next Generation Approach*, ed. Patrick J. DeSouza, 203–15. New York: Council on Foreign Relations.
- Kirshner, Jonathan. 1995. *Currency and Coercion: The Political Economy of International Monetary Power*. Princeton: Princeton University Press.
- Mack, Connie. 2000. "Dollarization." *Central Banking* 11, no. 1: 63–69.
- Mann, Catherine. 1999. "Dollarization." *Official Dollarization in Emerging-Market Countries*. Hearings before the Subcommittee on Economic Policy and Subcommittee on International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 22, 55–57.
- Molano, Walter T. 2000. "Addressing the Symptoms and Ignoring the Causes: A View from Wall Street on Dollarization." *Monetary Stability in Latin America: Is Dollarization the Answer?* Hearings before the Subcommittee on Domestic and International Monetary Policy, Committee on Banking and Financial Services, U.S. House of Representatives, June 22, 51–60.
- Mundell, Robert A. 1993. "EMU and the International Monetary System: A

- Transatlantic Perspective." Working Paper 13, Austrian National Bank, Vienna.
- Portes, Richard, and Hélène Rey. 1998. "The Emergence of the Euro as an International Currency." In *EMU: Prospects and Challenges for the Euro*, ed. David Begg, Jürgen von Hagen, Charles Wyplosz, and Klaus F. Zimmermann, 307–43. Oxford, UK: Blackwell.
- Rojas-Suarez, Liliana. 2000. "What Exchange Rate Arrangement Works Best for Latin America?" Paper prepared for the conference "To Dollarize or Not to Dollarize: Currency Choices for the Western Hemisphere," Ottawa, Canada, October 4–5.
- Sachs, Jeffrey, and Felipe Larrain. 1999. "Why Dollarization is More Straitjacket than Salvation." *Foreign Policy* 116 (Fall): 80–92.
- Samuelson, Robert J. 1999. "Dollarization—A Black Hole." *Washington Post*, May 12: A27.
- Schuldt, Jürgen. 2003. "Latin American Official Dollarization: Political Economy Aspects." In *The Dollarization Debate*, ed. Dominick Salvatore, James W. Dean, and Thomas D. Willett, chapter 14. New York: Oxford University Press.
- Schuler, Kurt. 1992. "The World History of Free Banking: An Overview." In *The Experience of Free Banking*, ed. Kevin Dowd, 4–47. London: Routledge.
- . 1999. *Encouraging Official Dollarization in Emerging Markets*. Staff report. Joint Economic Committee, Washington, DC.
- Schuler, Kurt, and Robert Stein. 2000. "The International Monetary Stability Act: An Analysis." Paper prepared for the conference "To Dollarize or Not to Dollarize: Currency Choices for the Western Hemisphere," Ottawa, Canada, October 4–5.
- Shelton, Judy. 1999. "Prepared Statement." *Official Dollarization in Emerging-Market Countries*. Hearings before the Subcommittee on Economic Policy and Subcommittee on International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 22, 47–53.
- Summers, Lawrence H. 1999b. "Statement." *Official Dollarization in Emerging-Market Countries*. Hearings before the Subcommittee on Economic Policy and Subcommittee on International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 22, 4–7.
- United States Treasury. 2000. *The Use and Counterfeiting of United States Currency Abroad*. Washington, DC.
- Williamson, John. 1995. *What Role for Currency Boards?* Washington, DC: Institute for International Economics.