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Dollarization – A Case Study of Panama, Ecuador, and El Salvador

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Abstract *– This paper observes the effect of dollarization for Panama, Ecuador, and El Salvador. As economists agree that the countries which were facing recession, hyperinflation, and higher interest rates were successful in reducing the interest rates, hyperinflation, and interest rates and successful in increasing foreign investment flow once they go for dollarization.*

Keywords *- Currency Board Arrangement, Dollarization, Hyperinflation, Monetary Policy, Risk Prima,*

Introduction

Dollarization means converting domestic currency with the US dollar. In a broader sense adopting the currency of any other country is also dollarization.

Besides the Commonwealth of Puerto Rico and the US Virgin Islands, Panama has had full or official dollarization since 1904. Ecuador was fully dollarized in 2000 and El Salvador in 2001.

The benefits and costs of dollarization are similar but more pronounced compared to the Currency Board Arrangement (CBAs) because of practically giving up the 'exit option' and independent monetary policy.

The benefits of dollarization are avoidance of hedging risk cover because of reducing the cost of exchanging the domestic currency with the dollar. Avoiding foreign exchange currency crisis and fostering budgetary discipline, and moving towards full international financial integration. Other benefits include more stable international capital movements – so lower spreads on international borrowings, which lower fiscal cost. Reduction in country risk premia and a consequent lowering of interest rates, more investment, and higher economic growth. The inflation rate and interest rate are falling in line with the US except for remaining country risk.

The cost of dollarization includes the cost of replacing the domestic currency with the dollar. This cost is estimated to be 4% to 5 % of GDP for Latin American countries. Dollarized countries will have the same monetary policy as the US despite its domestic cycles. Dollarization is recommended to a small open country with poor monetary performance. Some economists argue that all developing countries also should dollarize. Since the euro is accepted as a common currency, some have suggested that Canada should adopt the US dollar as well.

With dollarization, the country can avoid currency and the BoP crisis. With this, there is no possibility of sharp depreciation and capital outflows because the expectation of devaluation is ruled out. Because of lower transaction cost and assured stability prices in dollar terms leads to closer integration with the US and global economies. It also creates positive sentiments for investors.

Seigniorage would be lost for the countries which go for dollarization. These countries cannot have autonomous monetary and exchange rate policies, including the central bank's credit support to banking.

Dollarization replaces weak currencies. The most important factor of dollarization is credibility, which is attached to it because it is nearly irreversible.

"With dollarization interest premiums owing to devaluation risk would disappear, but the sovereign risk would not."

With dollarization, whether to borrow in the country or abroad is a matter of choice. Full dollarization implies the complete relinquishing of monetary and exchange rate policy.

Panama is the only sizable country using foreign currency as legal tender; the other countries which have done this are mostly tiny economies.

Currency Board Arrangement (CBAs) is the most extreme form of exchange rate peg, which is a fixed exchange rate system, short of adopting a common currency or adopting the US dollar as the nation's currency that is dollarization. Under CBAs, often by law, a nation rigidly fixes the exchange rate of its currency to any foreign currency, SDR or composite, and its central bank ceases to operate as an independent entity. Under CBAs, like the gold standard system, 100 percent international reserve backing is provided to the nation's money supply. Nation gives up its control over its money supply. With a CBAs nation's money supply gets affected only by the balance of payments surplus or deficits. As a result, the nation's inflation rate and interest rate, for the most part, are determined by the condition in the country

against whose currency the nation has fixed the exchange rate or pegged its currency.

CBAs are in operation in many countries viz. Hong Kong, Argentina till the end of 2001.Bulgaria.

A nation generally makes these extreme arrangements when a nation is in a financial crisis. The important condition for the successful operation of CBAs is sound fiscal policy since the central bank cannot lend to the government and a sound banking system since it cannot be the lender of the last resort. The credibility of the country's economic policy is the main advantage of CBAs, which results in a lower interest rate and lower inflation rate. The cost of CBAs is the inability of the nation's central bank to conduct its own monetary policy, collect seignorage from independently issuing its own currency, and to act as a lender of last resort.

"Currency board is at least equivalent to dollarization, in terms of the balance of cost and benefits, then currency board should be the alternative for countries seeking a firmly pegged exchange rate regime as it preserves seigniorage and it is simple to establish." Berg.

Full dollarization implies complete relinquishing of monetary and exchange rate policy. Devaluation is not possible under CBAs and full dollarization. The currency board has some scope of exit of the pegged exchange rate system under extreme circumstances. Full dollarization is much like a currency board with no exit option.

We have other exchange rate arrangements also existing in 2011 56.4 % of the countries operated under hard or soft pegged (some kind of fixed exchange rate) system. Soft pegged countries include Denmark, Jorden. Some countries have stabilized arrangements (also a soft peg) include Iran, Pakistan. The countries which have a crawling peg system are Argentina, Bangladesh, China, and Egypt. The countries which have managed floating exchange rate include Brazil, Hungary, India. The countries which operate under free-floating include the US, Japan, Eurozone countries. The countries with managed floating and free-floating exchange rates constitute 43.6 percent.

Free float or soft peg leads to excessive exchange rate volatility, and the currency boards system is also affected by speculative attacks. Argentina and Hong Kong suffered and resulted in an increase in the interest rate and recessions.

While studying the case of Argentina, though it is not a fully dollarized economy, it is found that there was a difference between the peso interest rate and dollar interest rate. That interest rate in Argentine govt and private securities exceeded those on advanced country's debt reflecting 'sovereign' or default risk of these securities.

Sovereign risk can be measured by spread on the dollar. That is the difference between the interest rate of the Argentinian govt. Bonds and interest rate US treasuries. The spread has come down with time, but still, there is a difference of 3.3 percentage points in 1997/98. Devaluation risk of peso can be measured by the spread between peso and dollar-denominated Euro bonds, which averaged 2.5 percent over the same period.

Panama

Panama was the first fully dollarized economy in Latin America. After the country gained independence from Columbia in 1904, the US dollar became the legal tender for the transaction and the for the domestic currency. The Balboa, Panama's currency, was used for the small transaction as well as for the unit of account.

In the decade of 1990-2000, Panama's growth rate of 4.4% exceeding the average growth rate of Central American countries. The average inflation rate was very low (1.1%). Guldfjan and Olivares (2000) point out that Panama's reliance on the service sector, which is almost 77% of GDP, and openness of its economy are contributing factors to the depreciation of the real exchange rate when there is a gain in productivity in non-tradable goods.

Panama's inflation rate is low to 0.3 % in 2016 and 0.5 % in 2018.The Benchmark interest rate was 7.149 percent, and in the US, it was quite low that is less than 1 %.

Ecuador

Ecuador, in January 2000, announced that it would dollarize fully in response to widespread bank failure, hyperinflation, and recession.

'Global flight to quality' would raise both risk and default and risk of devaluation.' In this case, dollarization did not reduce the dollar spreads very much.

In Ecuador, we find that inflation, which was always in double-digit in the 1980s and 1990s, peaked at 96 % in 2000 reduced drastically after dollarization in 2000 to as low as 0.4 % in 2017. Recession in 1987 and in 1999 changed into high GDP growth of 8.2% in 2004.

Ecuador's GDP growth was not much different before 2000 and after 2000.

"The crisis had intensified since early 1998 when a combination of external and climatic shocks set it off. The economy's partial dollarization made the crisis far worse than it would otherwise have been. The move to full dollarization is perhaps best understood as a structural reform to end unstable, duel currency system".

El Salvador

The exchange rate depreciation that proved necessary to sustain net export surplus and limit external debt accumulation induce Ecuador to dollarize spontaneously.

In January 2001, El Salvador adopted the US dollar as its currency. From 1993 through 2000. El Salvador operated under a pegged exchange rate system. Prior to the 1990s, there was very little foreign investment in El Salvador, in part due to civil war. Annual flows never surpassed $ 30 million, and the country experienced negative net inflows in the 1970s and early 1980s due to a large part of civil war. Between 1970 and 1990, the country attracted cumulative FDI flows of merely $ 254 m. Progressively FDI as a percentage of GFCF has grown from an average of 1.6 % in 1991-95 to 25.9% in 2006-08.

El Salvador's inflation also drastically reduced from as high as 28 % in 1990 to 0.5 % in 2009. The inflation rate was reduced after 2000. Though the recession in 1980 and the high growth rate in 1995 to 6.4% country faced a recession in 2009 and afterward it saw a growth rate around 2% that is the growth rate, which not increased afterward.

The exchange rate depreciation that proved necessary to sustain net export surplus and limit external debt accumulation induce Ecuador to dollarize spontaneously.

Default premiums and expected exchange rate changes are measured by various interest rate changes.

$$d=p(d/cc)*p(cc)+p(d/ncc)* (1-p(cc))$$

Currency crisis term + pure default term

Where d is the total probability default

P(d/cc) is the probability of default given that there is a currency risk

P(cc) is the probability of default given that there is no currency risk

P(d/NCC) is the probability of default given that there is no currency risk.

Conclusion-In case of Panama, the growth rate of the country exceeded 4.4%during a time period and the inflation rate ha drastically reduced in a recent period. But a large spread of interest rate has been found between Panama's interest rate and US interest rate. In the case of Ecuador, through GDP growth rate had increased to 8.2% in 2004, there was no much difference between the GDP growth of the country before dollarization and after dollarization. In this case, also it is found that the inflation rate has drastically reduced after dollarization. In the case of El Salvador, prior to the 1990s, vert little FDI took place, partly because of civil war, but in 2006-08, FDI increased to 25.9% of GFCF. In this case, also it is found that the inflation rate has reduced drastically.

Thus, no conclusion can be made about the interest rate, growth rate, and FDIs. But in all these three countries, it is found that after dollarization inflation rate has reduced drastically.

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