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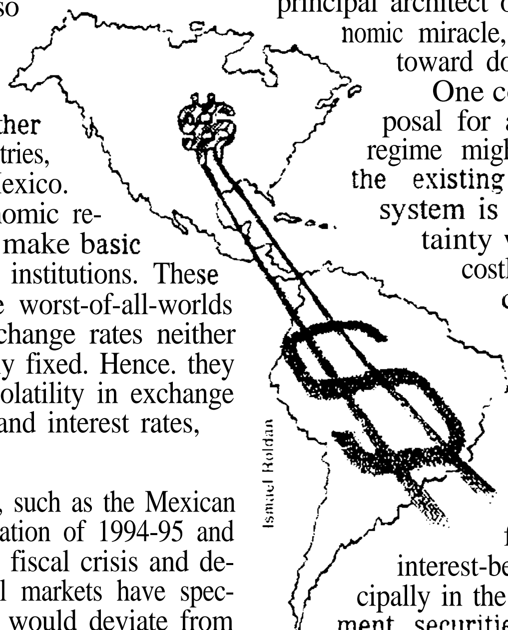
Let the Dollar Reign From Seattle to Santiago

By **ROBERT J. BARRO**

President Carlos Menem of Argentina recently proposed that his country give serious consideration to full dollarization-the abandonment of its own currency, the peso. whose value is already fixed to the U.S. dollar. It's a good idea, not just for Argentina but for other countries in the Western Hemisphere. But the dollarization of the Americas won't happen without U.S. leadership.

Argentina's disciplined monetary policy stands in stark contrast with that of some of its neighbors. At the beginning of the 1990s. Argentina enacted an array of economic reforms, including a currency-board type of monetary system. This regime ensured a fixed exchange rate-one peso to the dollar-and thereby promoted stability in prices and interest rates. Other Latin American countries, such as Brazil and Mexico. instituted some economic reforms but failed to make basic changes in monetary institutions. These countries adopted the worst-of-all-worlds system in which exchange rates neither float nor are genuinely fixed. Hence. they have suffered from volatility in exchange rates, inflation rates and interest rates,



Devaluation

On some occasions, such as the Mexican debt crisis and devaluation of 1994-95 and the ongoing Brazilian fiscal crisis and devaluation, the financial markets have speculated that Argentina would deviate from its peg to the dollar. Argentina has withstood these pressures in the past, notably in 1995. But today's Brazilian situation is especially serious because Brazil is Argentina's largest trading partner. Argentina feels pressure to respond to Brazil's devaluation with a devaluation of its own, Anticipation of a devaluation raises interest rates, because of increases in currency risk and in related default risk. Consequently, the economy tends to contract.

It was to counter this speculation and to reaffirm the commitment to a fixed exchange rate that Mr. Menem floated the idea of full dollarization. Since much of Argentina's financial system already operates in terms of the dollar, the main change would be a switch of the hand-to-hand currency from pesos to dollars. Then, as in Panama. it would be virtually impossible for the government to devalue-in effect. there would be no peso assets whose value could be reset in terms of the dollar. Thus the financial markets would have no currency risk on which to speculate.

In Argentina, the currency board has become highly popular, and a further move toward dollarization might also be popular. Nevertheless. a proposal to dollarize involves political peril. For one thing, Argentina's presidential election this fall makes it difficult for the opposing political parties to agree on a major change in the monetary regime. Domingo Cavallo, the principal architect of the Argentine economic miracle, opposes a move soon toward dollarization.

One concern is that a proposal for a modified monetary regime might foster the idea that the existing fixed-exchange-rate system is fragile. This uncertainty would be especially costly when the economic crisis in Brazil threatens to diminish Argentina's exports. Another issue is the income (known as seigniorage) that the Argentine central bank receives from earnings on its interest-bearing reserves, principally in the form of U.S. government securities. The bank would have to use about $16 billion of its reserves to provide for a circulating stock of U.S. dollar bills. This reduction in reserves means that the bank would lose roughly $750 million in annual interest income.

Because of these concerns, dollarization will likely not happen in Argentina unless the initiative comes from the U.S. But the situation is actually an opportunity for the U.S. to promote a dollar zone throughout the Americas by using Argentina as its first client. Such a move would not eliminate all potential economic problems in the region. But a stable monetary system removes some sources of difficulty, notably those that involve currency speculation.

which tends to generate volatility in interest rates and inflation The benefits would be even greater if the system were extended from Argentina to less reliable countries, such as Brazil and Mexico. Eventually, the monetary union could even encourage extensions of the North American Free Trade Agreement throughout the Americas. Nafta could become AFTA.

There are several ways in which the U.S. could compensate joiners of the dollar zone for the lost seigniorage. It could provide transfer payments each year to make up for the central bank's lost interest revenue. A simpler method, which does not require payments each year, would be to provide a one-time allotment of U.S. dollar bills. For Argentina, this could be accomplished by giving the Argentine central bank $16 billion in newly issued U.S. currency. The Federal Reserve could, for example, exchange this currency for 16 billion non-interest-bearing Argentine pesos, which the Fed would then hold as a form of collateral. The deal is that Argentina would remain on the dollar standard, or else the peso notes would become redeemable one-to-one for U.S. dollars.

This arrangement would cost the U.S. nothing, aside from paper and printing. Moreover, the Fed would enjoy substantial seigniorage income because economic growth in client countries would lead to expansions of desired holdings of U.S. currency. A rough estimate is that the overall value of this flow equals the initial stock of currency-$16 billion in the case of Argentina and much more if the dollar zone were spread throughout the Americas.

More important than the seigniorage revenue would be the U.S. role in promoting economic stability in North and South America. To some extent, the dollar zone would parallel and compete with the recently established euro area. In fact, if the U.S. does not create a dollar zone, some Latin American countries might defect to the euro.

One difference from the euro arrangement, which was roughly a merger of equals, is that the U.S. would be the clear leader of the new zone. The currency ought still to be called the dollar, rather than, say, the america. Also, one concern about the European common currency was that it would encourage the spread of antimarket economic andsocial policies, especially to Britain. The spread of U.S. policies to the rest of the Americas would likely be a plus.

Another issue is whether the U.S. would become the lender of last resort for its dollar-zone clients. A country's use of the dollar would eliminate part of this problem by removing some sources of economic crisis, namely those that relate to actual and potential devaluations of the currency. But possibilities would remain for defaults by banks or governments. The main consequence of a dollarization here is that it would eliminate the potential for a country to deal with problems by devaluing, that is, by engineering a partial and perhaps concealed default on domestically denominated debts of government or banks. Defaults would have to be explicit, but there is no reason to think that open default is worse than hidden default.

Line of Credit

It may be desirable for the U.S. to provide a specified line of credit to countries that are members of the dollar zone. This borrowing potential is not so different from the one that applies less systematically at present. For example, the U.S. and international organizations provided substantial funds to Mexico in 1995, smaller sums to Argentina in 1995, and large amounts to Brazil recently.

In recent years, the U.S. has dealt with international financial crises in a reactive and ad hoc manner, its Treasury responding to crises with bailouts. More constructive, perhaps, have been the policy recommendations and conditionality that accompanied these bailouts. But it would be better if these countries made basic changes in monetary institutions to avert crises in the place. Dollarization in the Americas is one such change.

Washington ought to take the lead in promoting this monetary integration. For the Clinton administration, the improvement in international economic policies would build on the impressive economic record at home. Hence, it is an opportunity for the president to leave a great overall economic legacy.

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