Dollarization: A Guide to the International Monetary Stability Act

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Joint Economic Committee
Staff Report
Office of the Chairman,
Senator Connie Mack

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1. GENERAL EXPLANATION

The U.S. dollar is the world's dominant currency. About two-thirds of all dollars circulate outside the United States. The dollar is the preferred currency for international trade, central bank currency reserves, and transactions on commodity markets and foreign exchange markets. Many countries in Latin America already use dollars on an unofficial basis. Citizens of other countries often keep deposits in dollars and use dollars for large transactions. Foreign banks often lend in dollars and investors prefer to earn profits in dollars.

In the past few years there has been a great deal of discussion about what the appropriate monetary system should be in emerging market countries. One of the options is official dollarization, whereby a country would eliminate its own currency and adopt the U.S. dollar as legal tender. Ecuador and East Timor have recently enacted legislation to officially dollarize and officials in Argentina and El Salvador have shown a great deal of interest in the idea. Panama has been officially dollarized since 1904.

Why are countries considering dollarization? Supporters of official dollarization say it would reduce inflation and interest rates toward the levels of the United States, increase economic growth by encouraging savings and investment, strengthen financial systems, instill fiscal discipline, and eliminate sudden currency-related economic crises. However, critics claim the loss of an independent monetary policy would be too costly and that a country's banking system must be very strong before official dollarization.

Regardless of how countries weigh the relative merits of these economic arguments, official dollarization faces another obstacle. At present, a country that officially dollarizes must forego the profit it earns from issuing a currency. The currency profit B which economists call seigniorage B is the difference between the value of a currency and the cost of printing it. (For example, a $100 bill is worth $100, but only costs several cents to print.) When a country adopts the dollar, it no longer earns currency profit. The currency profit is transferred to the United States. This loss of revenue can be sizeable. For example, Argentina earns about $750 million per year in currency profit. If Argentina were to officially dollarize, this $750 million would flow to the United States rather than Argentina. This transfer in currency profit makes official dollarization difficult.

The International Monetary Stability Act (the "IMSA") addresses the issue of currency profit by letting the Treasury Secretary rebate 85% of the transferred currency profit back to the dollarizing country. The remaining 15% would finance rebates to countries that are already officially dollarized (such as Panama), help pay the costs of operating

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the Federal Reserve, and still leave a net revenue increase for the United States.

The IMSA would not pressure any country into official dollarization. It simply removes the obstacle posed by the transfer of currency profit to the United States. Foreign countries would retain complete discretion over the decision to officially dollarize. In addition, the Treasury Secretary would not be required to automatically rebate currency profit to every country that officially dollarizes. The Secretary would merely have the discretion to do so, thereby encouraging countries to cooperate with the United States.

In addition, The IMSA makes it clear that the United States would not be obligated to act as a lender of last resort to countries that officially dollarize, consider their economic or financial conditions when setting monetary policy, or supervise their financial institutions. U.S. monetary policy would still be made in the United States.

2. ANSWERS TO FREQUENTLY ASKED QUESTIONS

What does the United States gain from this legislation? Dollarization abroad would stabilize and expand export markets, thereby helping U.S. workers and businesses. Dollarization would reduce currency risk, thereby helping U.S. investors. It would strengthen foreign economies, thereby reducing the need to use taxpayers' money to bail out countries due to sudden currency-related economic problems.

Why is this legislation important now? There is growing interest in dollarization, especially in Latin America. The IMSA would let other countries know where they stand with respect to the U.S.

Would the IMSA force countries to officially dollarize? No. The decision to officially dollarize would still be each country's to make for itself.

Is official dollarization right for all emerging market countries? This issue is not addressed by the IMSA. The Act merely removes the obstacle of the currency profit transfer to the United States. Countries would still refrain from official dollarization if they didn't think it was in their best interests. In addition, if a country thinks official dollarization is in its best interests but the Treasury Secretary disagrees, the Secretary could refuse to rebate currency profit.

Wouldn't dollarization eliminate the ability of countries to run an independent monetary policy? Yes. Countries that dollarize would adopt U.S. monetary policy as their own. Independent monetary policies in emerging market countries have often tended to aggravate

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rather than ease economic problems. Historically, the discretionary use of monetary policy has been a major source of instability in many countries.

Would other countries have a say in U.S. monetary policy? No. The IMSA would not alter the structure of the Federal Reserve or the procedures or goals of U.S. monetary policy.

Wouldn't officially dollarized countries put pressure on the Federal Reserve to conduct monetary policy in their interests regardless of the U.S. economic situation? According to Chairman Alan Greenspan, the Federal Reserve is already under foreign pressure, but this pressure does not lead the Federal Reserve to do things that benefit foreign countries to the detriment of the United States. Greenspan testified that official dollarization would not make the Federal Reserve more readily take such actions. He also noted that all of the monetary policy stances the Federal Reserve takes within its ordinary range of looseness to tightness would be improvements compared to what many countries have now.

Official dollarization would leave countries without a central bank that can serve as a lender of last resort during a banking crisis. Wouldn't this pressure the United States to adopt this role for these countries? First, the IMSA explicitly states that the United States is not obligated to serve as a lender of last resort to officially dollarized countries.

Second, before certifying a country as officially dollarized, the IMSA requires the Treasury Secretary to consider whether a country has opened its banking system to foreign competition or met international banking standards. Either of these would greatly diminish the risk of a bank crisis. The presence of international banks has made Panama's banking system very stable.

Third, a country could establish a lender of last resort facility outside its central bank. For example, Argentina has a $7 billion emergency line of credit with international banks. Officially dollarized countries can use rebates of currency profit to collateralize such emergency lines of credit. If concerned about a banking system's stability, the Treasury Secretary may hinge certification on establishment of this kind of line of credit.

How would dollarization affect budget deficits in emerging market countries? Dollarization would mean countries could no longer finance government spending by printing money. Like U.S. states, countries that dollarize would be sensitive to how their fiscal policies influence their credit ratings. This would exert downward pressure on spending, thereby reducing budget deficits.

How would official dollarization be implemented? If a country decides to officially dollarize, its central bank would take the assets

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that back its currency and convert them into U.S. Treasury securities. It could do this in the financial markets. The central bank would then sell the Treasury securities to the Federal Reserve in exchange for dollars. The country would then use the dollars to repurchase and retire the local currency. In the meantime, the country must cease issuing the local currency and cease accepting local currency for payments (except in exchange for dollars). Dollars would be used for taxes, wages, debts, loans, and bank deposits, just like in the United States.

How would the IMSA effect federal revenue? The Federal Reserve controls the amount of dollars in circulation by selling currency in exchange for U.S. Treasury securities. The Fed then earns interest on the securities. The Fed uses a small portion of the interest to finance its operations and sends the rest back to the Treasury Department.

If a country officially dollarizes, the Federal Reserve would issue more dollars in exchange for more Treasury securities, resulting in more interest ultimately handed back to the Treasury Department. This extra revenue will not occur in the absence of official dollarization. The IMSA would rebate 85% of the extra revenue, thereby still leaving the Treasury Department with an extra currency profit.

By making rebates of currency profit to countries that dollarize isn't the United States, in effect, paying twice for the Treasury securities it acquires from the dollarizing country? No. If a country uses the dollars it gets from the Federal Reserve as its currency, the cost to the United States of sending dollars to the country is merely the cost of printing and issuing the money B which is only a few cents per dollar note. For example, if a country gives the Fed $15 billion in Treasury securities and the Fed issues the country $15 billion in dollars, the Fed has made a profit of almost $15 billion, a profit which will be handed over to the U.S. Treasury. The Act would rebate 85% of the profit.

If the country eventually decides it does not want to use these dollars as its currency, the Fed will have to reduce the amount of dollars in circulation by buying dollars and selling Treasury securities. At that point, the U.S. would no longer earn a profit based on the country's currency use, and the rebates would cease.

3. SECTION-BY-SECTION EXPLANATION

Section 1. Short Title. Section 1 provides that the bill may be cited as the "International Monetary Stability Act of 1999."

Section 2. Findings and Statement of Policy. Section 2 sets out the findings and statement of policy of the Act. The "findings" of the Act state the importance of monetary stability to emerging market

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countries, the deficiencies of certain methods of achieving monetary stability, the benefits of official dollarization, and the ability of the United States to encourage official dollarization by offering to share the extra currency profits it would earn with countries that officially dollarize. The "statement of policy" provides 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. It also states that countries are free to officially dollarize unilaterally if they do not want rebates of currency profit from the United States.

Section 3. Certification Section 3 provides the Secretary of the Treasury (the "Secretary") with authority to certify a country as officially dollarized upon the issuance of a written statement explaining why that country has been certified. The Secretary may certify a country as officially dollarized after considering whether it has in fact officially dollarized, opened its banking system to foreign competition or complied with internationally-accepted banking principles, cooperated with the United States on money-laundering and counterfeiting issues, and consulted with the Secretary prior to certification. In addition, the Secretary can consider any other factors he deems relevant.

Section 4. Payments. Section 4 provides that upon certification the Secretary will commence payments to the country every three months. The amount of these payments will depend on the amount of dollars the country purchased from the Federal Reserve in order to officially dollarize (or the dollar value of the local currency in circulation prior to certification, whichever is less), short-term interest rates in the United States, changes in the U.S. price level, using the same inflation-adjustment that is already used to index payments on inflation-indexed Treasury securities. The payments are designed to rebate 85% of the currency profits the country would have earned had it not officially dollarized.

The payments are backed by the full faith of the U.S. Government, and may therefore be paid out of general revenue without being subject to the appropriations process. The Secretary is given the authority to reduce payments to a country is he believes such payments would result in a net revenue loss to the United States.

Section 5. Previously Dollarized Countries. Section 5 provides the circumstances under which countries that were officially dollarized prior to this Act can be certified as officially dollarized and receive payments. Panama, East Timor, the Marshall Islands, Micronesia, Palau, Turks and Caicos, and the British Virgin Islands may not be certified as officially dollarized until 10% of the payments to other countries under this Act equals or exceeds the payments that would be

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made to these countries upon their being certified. Payments to previously- dollarized countries will depend on their nominal dollar gross domestic products in 1997, short-term U.S. interest rates and changes in the U.S. price level.

Section 6. Payment Cancellation . Section 6 provides that the Secretary may cease payments to a country if the U.S. declares war on it or if the Secretary issues a written public statement that the country is no longer officially dollarized.

Section 7. Regulations. Section 7 provides that the Secretary and the Federal Reserve System may issue regulations to carry out this Act.

Section 8. Expenses. Section 8 appropriates to the Secretary the necessary expenses to make payments under this Act.

Prepared by the Joint Economic Committee. For more information, please contact Robert Stein.

This staff report expresses the views of the author only. These views do not necessarily reflect those of the Joint Economic Committee, its Chairman, Vice Chairman, or any of its Members.

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FURTHER READING

The International Monetary Stability Act, S.2101, introduced by Senator Connie Mack, February 24, 1999. <http://thomas.loc.gov>

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