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### What is dollarization?

There are two types of dollarization:-

- informal dollarization: the (increasing) holding of dollar-denominated<sup>1</sup> deposits at domestic banks and/or the use of the dollar *alongside the domestic currency* in transactions. E.g. Zimbabwe, Nicaragua, Democratic Republic of Congo
- official dollarization: the complete abandonment of the domestic currency as legal tender in favour of the dollar. The only substantial economies that are officially dollarized are Ecuador, El Salvador and Panama; Montenegro and Kosovo, meanwhile, are officially 'euroized'.

In your subsequent questions, I have taken it you are referring to official dollarization.

### What are currency boards?

A currency board is an institution responsible for the maintenance of a particular type of currency peg. Currency pegs involve matching the value of the domestic currency to that of another currency, basket of currencies, or other measure of value, such as gold. This can be achieved through buying and selling of the domestic currency on the open market in order to achieve the desired value; alternatively, exchange controls and restrictions on currency trading can 'enforce' the desired rate. A currency board maintains a particularly strict form of peg, under which the domestic currency is backed at least one-for-one by international reserves.<sup>2</sup> The fact that the stock of domestic currency is fully convertible into foreign currency (at the pegged rate) enhances the credibility of the exchange peg and theoretically makes it less vulnerable to speculative attack.

The Irish pound was fixed at parity to sterling under a currency board system from independence to 1979; the Argentine peso was pegged against the dollar by a currency board until 2002; and until joining the single currency in 2011, Estonia's kroon was pegged to the Deutsche Mark, and then to the euro.

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<sup>1</sup> The term 'dollarization' can also be applied to the use of any foreign currency as the national currency

<sup>2</sup> A gold standard is a type of currency board under which the value of currency is linked to the value of gold: the 'full convertibility' of the two is then established by a commitment to exchange a certain quantity of gold per unit of currency.

## Comparison between currency boards and dollarization

There are more similarities than differences between currency boards and dollarization. The principal similarity is that countries adopting either regime must relinquish control over monetary and exchange rate policy: in particular, dollarized countries and those with currency boards cannot control the supply of money, and for this reason interest rates and inflation tend to remain closely aligned with those of the 'host' currency.

The most important difference between the two regimes relates to reversibility. A currency board can be abandoned more easily than dollarization, and hence the authorities retain a limited degree of discretion over the exchange rate. In other words, the risk of devaluation under a currency board is higher because the regime can be abandoned. This credibility issue was highlighted when Argentina and Hong Kong, both successful users of currency boards, suffered sharp increases in interest rates and recessions in the late 1990s as their currencies came under speculative attack. As long as an economy remains officially dollarized, such a situation cannot occur.

While the credibility of full dollarization reduces the vulnerability of a country to devaluation-related crises, it opens up other sources of financial instability. For instance, while the central bank is capable of providing short-term liquidity to individual banks, it would be unable to respond to a crisis affecting the entire banking system because its inability to print money means it cannot guarantee the whole payments system, or fully back bank deposits. In effect, a central bank in a dollarized economy cannot be an unlimited lender of last resort and it can literally 'run out of money' to respond to crises. Indeed, the fact that the authorities are unable to guarantee beyond doubt that all claims in domestic currency will be fully met under any circumstances may in itself make a crisis more likely.

In this context, currency boards have slightly more room for manoeuvre because, in extreme cases, they can temporarily allow the printing of currency that is not fully backed by foreign reserves: both Hong Kong and Argentina did this in the 1990s in response to banking crises.

Finally, there is the issue of *seigniorage*: this is the profit accruing from the rights to issue a currency. This arises because the cost of printing money (especially paper money) is negligible in comparison to its value. A currency board regime enjoys only limited seigniorage because it must acquire foreign reserves to match the currency it issues; these reserves, however, will tend to earn interest while the currency is non interest-bearing, meaning residual revenue can be earned from this channel. By contrast, a dollarized economy does not issue its own currency, so there is no seigniorage income. More importantly, in order to become dollarized in the first place, a country must buy up the stock of domestic currency held by the public and banks, effectively returning to them the seigniorage that had accrued over time. Compared with a currency board, there is thus an up-front cost to dollarizing and an ongoing loss of revenue.<sup>3</sup>

In short, a dollarized economy will tend to have lower interest rates on foreign borrowing since the exchange rate risk (already low under a currency board) is eliminated as the prospect of devaluation is shut off completely. On the other hand, a dollarized economy is arguably less able to respond to systemic banking crises, and incurs upfront costs and ongoing revenue loss from not being able to issue its own currency. It is also more directly and irrevocably exposed to instability in the country whose currency it has adopted.

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<sup>3</sup> It is the US that earns the seigniorage revenue from dollarization in other countries.