

Political Dimensions of Dollarization

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I. Introduction

Economists like to think of money in purely functional terms. Money functions simply as a public good: a medium of exchange, unit of account, and store of value. Its role is essentially neutral -- think of the traditional references in economic theory to the so-called “monetary veil.” Money is viewed as little more than a kind of universal solvent to lubricate the real economy. Its purpose is nothing more than to grease the wheels of commerce. It is a **positive-sum game**: everybody wins.

But this is only part of the truth, certainly not the whole truth. Money is political as well as economic; and there can be losers as well as winners. When we talk about the political dimensions of money, it is more like a **zero-sum game**: *not* everybody wins.

The reason is simple: the essence of money is **purchasing power** – and power is at the heart of politics. Power goes to those who create money (what we call seigniorage), those who receive it, those who spend it, and most of all, those who control it. Money, in other words, is anything but neutral. Money can be controlled or governed in very different ways; these systems of governance are described as **monetary regimes**. And different monetary regimes have very different **distributional consequences** – very different constellations of winners and losers.

Dollarization represents one particular form of monetary regime among many. In strictly **economic terms**, dollarization can indeed be viewed as a positive-sum game. Potentially, there are real mutual benefits to be shared, including *inter alia* lower transactions costs, lower interest rates, more liquid financial markets, and greater macroeconomic stability – all of which should generate higher growth rates and improved living standards, especially on the side of the dollarizing country.

In **political terms**, however, dollarization is closer to a zero-sum game. With dollarization, there will be losers as well as winners – distributional consequences that, for many of those most directly involved, may loom as large as or even more largely than any of the purely economic benefits to be accrued. The political dimensions of dollarization cannot be ignored. At a minimum, they may explain why most countries still hesitate to dollarize, despite all the economic arguments in favor. At worse, the political dimensions could throw up an insurmountable roadblock, making dollarization infeasible in the near term or perhaps even impossible under any circumstances.

My purpose, therefore, is to spell out these political dimensions in some detail – not to make a case against dollarization, but rather simply to make clear what is truly at stake in such a dramatic change of monetary regime. At issue are the distributional consequences of dollarization. **Who wins and who loses?** That is the question I shall address in these remarks.

Winners and losers can be identified both between states and within states. I will address each in turn.

II. Between States

Dollarization is not the same as a monetary union like EMU. EMU is a partnership: a regime that treats all participants, in principle if not always in practice, as equals. Dollarization, by contrast, is not a partnership but a relationship among *unequals*: an essentially **hierarchical regime**. One country (say, Argentina) becomes dependent on another (the US) for its money. Hierarchy naturally implies a redistribution of power from the dependent party to the dominant party (from Argentina to the US).

Some of that redistribution of power is openly acknowledged and well understood. These are the **economic dimensions** of power, which have already been thoroughly aired at this meeting. These include:

(a) The power to make **monetary policy**, which is transferred from the Central Bank of Argentina to the Federal Reserve (to put it in personal terms: from Pedro Pou to Alan Greenspan) – unless Argentina gets a seat on the FOMC (which of course is highly unlikely).

(b) **Seigniorage**, which is transferred from Argentina to the US (unless compensated by mutual agreement or by legislation such as the International Monetary Stability Act, otherwise known as the Mack Bill or Mack Dollarization Plan).

But there is more – the **political dimensions** of power, which are less openly acknowledged and perhaps less well understood. From Argentina's point of view there are three distinct political consequences, all potentially disadvantageous (with counterpart advantages for the US).

A. Loss of emergency revenue.

Seigniorage (also known as the inflation tax), which has already been discussed, is more than just a marginal source of revenue for governments. From a political point of view, it is much more: a kind of insurance policy against risk – **an emergency source of revenue** to cope with unexpected contingencies, up to and including war. The point is well summarized by 3 quotes:

John Maynard Keynes (1924): “A government can live by this means when it can live by no other.”

Barry Eichengreen (1994): “Money can be printed to pay soldiers, to purchase matériel, and to underwrite the other costs of a war of national defense without having to wait for tax returns to be filed or for a foreign loan to be extended.”

Charles Goodhart (1995): seigniorage is the “revenue of last resort” – the single most flexible instrument of taxation available to mobilize resources in the event of a sudden crisis or threat to national security.

Since dollarization means that Argentina no longer has its own currency, Argentina is deprived of this revenue of last resort. For the US there is a corresponding gain: a larger currency domain from which to draw seigniorage in the event of emergency. The more people that use the dollar, the easier it is to extract seigniorage when needed. In short, Argentina loses, the US wins.

B. Political vulnerability.

A national currency (peso) not only offers a source of emergency revenue. It also helps to insulate a country from outside influence or constraint in formulating and implementing policy; in other words, it promotes policy autonomy, which of course is highly valued by sovereign states. With dollarization, that **autonomy is compromised**: the nation's access to purchasing power, the means needed to purchase vital goods and services, can be influenced, limited, or even denied. As a result, the country becomes more vulnerable to the **threat of manipulation or coercion**. This too is, conversely, a gain for the US: a means/opportunity to exert influence when it is deemed necessary or useful. Again, Argentina loses, the US wins. In the words of the *New York Times* (January 18):

In times of conflict the United States might even be able to use **the dollar as an economic weapon**, withholding currency from an intractable government to bend it to Washington's will.

Is this realistic? Consider the case of **Panama**, which since its independence in 1903 has used the U.S. dollar as legal tender for most domestic monetary purposes. Although a national currency, the balboa, exists in principle, only a negligible number of balboa coins actually circulate in practice. The bulk of the money supply, including all paper notes and most bank deposits, is accounted for by the dollar. In the late 1980s, Panamanians learned just how exposed they were to coercion under this monetary regime.

In economic terms, most observers have rightly had only praise for Panama's currency dependence. Reliance on the dollar has created an environment of stability that has both suppressed inflation – note the contrast with most of Panama's hemispheric neighbors – and helped establish the country as an important offshore financial center. But in political terms Panama has been extremely vulnerable in its relations with Washington, which of course could sour at any time.

Such a moment came in 1988, following accusations of corruption and drug smuggling against General Manuel Noriega, the country's de facto leader. In March 1988, Panamanian assets in U.S. banks were frozen, and all payments and dollar transfers to Panama were prohibited as part of the Reagan administration's determined campaign to force Noriega from power. The impact was swift. Most local banks were forced to close, and the economy was squeezed by a severe liquidity shortage. The effect on the economy was devastating despite rushed efforts by the Panamanian authorities to create a substitute currency, mainly by issuing checks in standardized denominations that they hoped recipients would then treat as cash. The country was effectively

demonetized. In the words of one former ambassador to Panama (Ambler H. Moss, Jr.), Washington's coercive actions did the most damage "to the Panamanian economy since Henry Morgan, the pirate, sacked Panama City in 1671." Over the course of 1988, domestic output fell by a fifth.

As it happens, the sanctions turned out to be insufficient to dislodge Noriega on their own. Ultimately, in 1989, Washington felt it necessary to mount a military invasion that led to a temporary occupation of the country until a new, friendlier government could be installed. But there can be no doubt that the liquidity squeeze was painful and contributed greatly to Noriega's downfall. The message is obvious, as economist Lawrence Klein (1993) has prudently suggested:

Panama ... uses U.S. dollars for its monetary units. As long as relations remain cordial, this is not a bad arrangement But for Panama the risk price is very high for having the convenience of U.S. dollars. The small country would be in a better and more independent position if it had not let some of its monetary actions be governed by foreigners.

Of course, Argentina is not Panama. The bigger the dollarized country (or the larger the number of countries that have dollarized), the less likely it is that the US would feel free to exploit its power in this way. The "risk price" is undoubtedly inversely related to the size of the country in question and the number of other dollarized countries. But it is risk nonetheless – a vulnerability that can never be wholly evaded so long as the country remains dependent on the US for its national money supply.

C. Loss of a vital national symbol

A national currency provides a **vital symbol of national identity**. The political significance of that national symbol is not always fully appreciated. Here again, Argentina could lose, the US could win.

Go back to the **nineteenth century**. Prior to the nineteenth century, there was no such thing as an exclusive national currency. Throughout monetary history, in fact, currencies were issued by a variety of authorities and tended to circulate freely across national borders. Governments had currencies of their own, but they were not exclusive. Non-national monies were allowed to circulate freely and frequently were even given privileged status as legal tender. In the US, for example, until as late as 1857, no fewer than five foreign currencies were officially protected as legal tender, alongside the dollar, and circulated freely throughout the Union.

What changed in the nineteenth century was the **rise of the modern nation-state**. First in Europe and then elsewhere, national governments began to consolidate their power – to suppress all threats to their rule, whether from other governments abroad or from rival centers of power at home. This was the era of nationalism. The goal of governments was to build up the nation, as far as possible, as a unified economic and political community led by a strong central authority. An

integral part of this was a movement to assert greater control over the creation and management of money. Control of money was simply a logical part of the process of national consolidation. In the words of one monetary historian (O'Mahony, 1984): "Just as all rivals centers of power were absorbed into one monopoly of power so too all rival sources of money were absorbed into one monopoly of money creation."

Control was implemented in two ways – by restricting the role of foreign currencies (in US, legal-tender status of foreign currencies was withdrawn in 1857) and by building up a robust national money. The practical advantages (seigniorage, autonomy) were obvious. But there was also a more subtle psychological advantage: the vital role that a national money could play in promoting a sense of national identity. This is where the symbolic value of money comes in. The importance of this role of money should not be underestimated.

As a symbol, an exclusive national money is particularly useful to rulers concerned about internal division or dissent. Centralization of political authority is facilitated insofar as citizens all feel themselves bound together as members of a single social unit -- all part of the same **"imagined community,"** in the apt phrase of cultural anthropologist Benedict Anderson (1991). Anderson stresses that states are made not just through force but through loyalty, a voluntary commitment to a joint identity. A nation, someone once quipped, is "a people with a common confusion as to their origins and a common antipathy to their neighbors." The critical distinction between US and Them can be heightened by all manner of tangible symbols: flags, anthems, postage stamps, public architecture, even national sports teams. Among the most potent of these tokens is money, as Italian central banker Tommaso Padoa-Schioppa (1993) has noted:

John Stuart Mill once referred to the existence of a multiplicity of national moneys as a "barbarism"... One could perhaps talk of a tribal system, with each tribe being attached to its own money and attributing it magical virtues... which no other tribe recognizes.

Money's "magical virtues" serve to enhance a sense of national identity in two ways. First, because it is issued by the government or its central bank, a currency acts as a daily reminder to citizens of their connection to the state and oneness with it. Second, by virtue of its universal use on a daily basis, the currency underscores the fact that everyone is part of the same social entity -- a role not unlike that of a single national language, which many governments also actively promote for nationalistic reasons. A common money helps to homogenize diverse and often antagonistic social groups.

Once exclusive national currencies were established, it was not long before they became virtually inseparable from the idea of sovereign statehood -- a vital symbol of national identity. The evidence of this inseparability is everywhere:

– Witness the haste with which nations emerging from the disintegration of the Soviet Union and other Soviet-bloc countries (Czechoslovakia, Yugoslavia) all created separate national

currencies. Clearly, a foremost motivation was to assert a sense of national identity. A national money represented tangible proof of one's rightful place in the family of nations.

– Conversely, witness the widespread resistance in Europe to EMU, which persisted for many years (and in the UK, especially, still persists and is even growing). Much of that resistance was motivated by the prospect of replacing national currencies with the euro. Two quotes are representative:

Archbishop of Canterbury: "I want the Queen's head on the banknotes.... The point about national identity is a very important one. For me, being British is deeply important. I don't want to become French or German."

Hans Tietmeyer: "The German people have a broken – an interrupted – relationship with their own history. They can't parade like others. They can't salute their flag with the same enthusiasm as others. Their only safe symbol is the mark." (The DM was the only symbol of the "good Germany," as another observer put it.)

All of this was in the context of a monetary union – a partnership. So the issue is likely to be even more acute with dollarization, which, as emphasized, is not an alliance of equals but a hierarchical relationship between unequals. National money is not replaced with a *common* currency. It is replaced with a *foreign* currency. This is bound to have important psychological consequences.

– An illustrative precedent was provided back in the early 1980s by Israel, which at the time was suffering from a severe hyperinflation. At one point, the Finance Minister suggested adopting the dollar to replace the unstable national currency. He was widely denounced and ultimately forced to resign. Said one politician: If the idea is implemented, "Israel might as well start flying the American flag and singing the Star Spangled Banner."

Argentina (or any other country) faces the same psychological challenge: In effect, will Argentinians want to start flying the American flag and singing the Star Spangled Banner? For Argentina as a distinct and sovereign community, this is clearly a loss: an erosion of the sense of national identity that, in turn, could potentially weaken loyalty to the "imagined community." Conversely, for the US, there would be a corresponding gain: a rise in America's status and prestige; a psychological boost to pride in America and its leadership role in the world. Again, Argentina loses, the US wins.

To illustrate the point, consider a simple thought experiment. Suppose back in the 1970s, when the dollar seemed in irreversible decline, the US had adopted the DM (or the yen in the 1980s). How do you suppose Americans would have responded to seeing the DM (or the yen) every day instead of the greenback? Would that not be likely to affect our own sense of national identity – our own connection to the state and oneness with it? We might not start singing Deutschland Uber Alles or saluting the Japanese rising-sun flag. But almost certainly we would

feel compelled to revise our sense of who we are and what our relationship is to the outside world. My guess is that not many in this audience would be happy with the loss of that vital national symbol, any more than we would want to lose our flag or our national anthem. So we should not be surprised if some Argentinians might hesitate for the same reason.

D. Summary

In short, in the hierarchical relationship between the country that dollarizes (Argentina) and the country whose currency is used (the US), there may be many economic benefits for both sides (including, especially, lower transactions costs and greater macroeconomic stability). The **economic game** may be positive-sum. But in political terms, there are clear winners and losers. The **political game** is much more zero-sum. Argentina loses not only control of its monetary policy and a regular amount of seigniorage. It also loses (a) a revenue of last resort; (b) insulation from foreign influence or coercion; and (c) a vital symbol of national identity. All of these are disadvantages and thus must be balanced against the advantages of dollarization, which of course are mostly economic. Obviously this is not an easy calculus. For the US, meanwhile, there are of course corresponding gains, though in relative terms of a much lower order of significance.

III. Within States

What about within states? There are likely to be winners and losers within each country as well. Not everyone will be affected in the same way. That means we must look at **domestic politics** too. Again, we can address each side in turn.

A. Argentina.

Within the dollarizing country (Argentina), who are the potential winners and losers?

Winners include all those who would benefit from lower interest rates, macroeconomic stability, a stable exchange rate with the dollar, and freer access to the US capital market, such as:

- larger business enterprises, particularly those that are export-oriented or that enjoy sufficient creditworthiness to borrow internationally.
- international traders and investors (including financial-service firms and high net-worth individuals).

Losers include all those who might benefit from preservation of some degree of national monetary autonomy, to cope with situations where local circumstances differ from those in the US (e.g., recession at home when Fed policy is tight). These would probably include *inter alia* smaller agricultural interests, labor unions (representing workers), producers of non-traded goods and services, and local banks and borrowers.

Does this matter? Of course it matters. Dollarization is a high-profile policy decision. In other than autocratic states, policy decisions like these are unlikely to be successful unless backed by a winning political coalition. And that may not be easy if the losers are numerous and vocal.

Consider **Ecuador**. Despite the recent coup (which resulted in the replacement of President Jamil Mahuad with Gustavo Noboa, formerly vice president), the government remains committed to dollarization. Just last week, the Ecuadorian Congress approved legislation adopting the dollar as the country's official currency (with all sucres to be replaced by dollars within six months). And journalistic sources report strong backing by key domestic constituencies, including banks and many business groups (*New York Times*, January 11; *The Economist*, January 29), just as might be expected. Latest polls, however, found 73% of the population opposed to dollarization (*The Economist*, February 19), and opposition is vocal. Examples:

-- The leader of the Patriotic Front, a trade-union umbrella group: "This is the dollarization of poverty and does not provide a solution to the country's severe economic crisis" (*Financial Times*, January 11).

– A socialist legislator (and rector of the University of Guayaquil): "More than a dollarization of the economy, this measure can be considered the Panamaization of the economy" (*New York Times*, January 16).

-- Most important is the opposition of Antonio Vargas, the leader of the most powerful Indian group in the country, which was at the center of the recent coup. Vargas has publicly stated that the present government is "temporary" and should be replaced by new elections.

Will the opposition prevail? Possibly not, but that is not the point. The point is that such opposition cannot be ignored and must somehow be either overcome or accommodated if dollarization is to be successfully implemented. Domestic politics matters: a winning political coalition is needed. That is a critical issue for Argentina or for any country considering such a high-profile policy option. And it is not entirely clear that such a winning coalition can always be organized.

B. The US

Moreover, even if a winning coalition can be organized, there is the question of winning the political support of the United States. Dollarization of course can be unilateral; it doesn't require formal agreement with the United States. But bilateral agreement with the US (e.g., a treaty of monetary association, which Argentina is seeking) is obviously preferable, to deal with such issues as seigniorage, provision of lender-of-last-resort (LOLR) facilities, and so on; and that means that there must be a winning coalition in the US too. Certainly if the Mack Bill is to pass, there must be substantial political support. So we must look at domestic politics in the US too. Who are the winners and losers in the US?

In reality, there seem to be **no significant losers** in the US; that is, no constituencies

whose material interests would be directly threatened by dollarization. But there seem to be **no significant winners either**, apart from the small number of enterprises that might have direct trade or investment interests in Argentina. This helps explain why, until now, the debate on dollarization has hardly gotten outside the Beltway. So far, it has remained merely a dialogue among specialists. Broader constituencies remain largely indifferent.

In turn, this also explains why there has been little groundswell of support for the Mack Bill or any other overt gesture of support for Argentina, Ecuador, or others. **Current policy** is neutral, at best – a kind of “benign neglect,” neither condemning nor endorsing -- and for good reason. There are obvious benefits to the US, as already indicated: seigniorage; lower transactions costs; greater stability in the region; enhanced US influence and prestige. But there are also obvious risks: (1) possible compromise of US monetary policy, due either to divergent economic performance or destabilizing shifts of demand for dollars, perhaps even demands for a seat on the FOMC; (2) return of lost seigniorage; (3) and the LOLR issue. The biggest risk is that dollarization by Argentina and others, even if unilateral, could create a contingent liability for the US: an implicit expectation of help at times of crisis or perhaps even, in more normal times, pressure on the Fed to adjust policy to accommodate the needs of dollarized countries. In absence of any groundswell of support, the current policy is likely to persist.

Thus if the Mack Bill or anything like it is to get passed, public support will have to be generated, cultivated and actively managed. Advocates of dollarization have their work cut out for them.

Is there any circumstance in which a groundswell of support might emerge? In my opinion, only one: if **the euro** begins to seriously challenge the dollar’s traditional role as the world’s main international currency. The US derives considerable benefits from the pre-eminent role of the dollar: not just seigniorage (and a liquidity premium on foreign liabilities) but prestige, influence, and greater freedom in financing our external deficits. If the euro becomes a significant challenge, many of those benefits would be compromised or lost. And that is a circumstance that could encourage domestic support for formal dollarization, as a way of preserving the benefits of the dollar’s international role. But otherwise it is hard to see how much political enthusiasm can be generated.

IV. Conclusion

The bottom line is clear. Dollarization cannot be evaluated solely in terms of economic costs and benefits. To do so artificially skews the debate, since the **economic game** alone is undoubtedly positive-sum. Both sides benefit from lower transactions costs, greater macroeconomic stability, and all the rest. Focusing on these considerations alone thus makes the case for dollarization seem almost a foregone conclusion. How could any rational being oppose such an obviously good thing? If dollarization is resisted, it could only be because of misinformation or misunderstanding. The question is not *whether* to dollarize but only *when* and *how*. The only issues are technical matters, best handled by the professionals (i.e., economists and central bankers).

In reality, however, the most important issues are anything but technical and involve matters that go to the very heart of what we understand as politics: the distribution of gains and losses. The **political game**, to repeat, is much closer to zero-sum. There are losers as well as winners. And it is not at all irrational for potential losers to raise questions about the case for dollarization and perhaps even to oppose it. At the domestic level, some key constituencies may indeed be critically disadvantaged. Their voices have a right to be heard. Likewise at the international level, there are distinct risks for the sovereign state. These risks deserve to be given a hearing too.

The issue, in short, cannot be defined by strictly economic considerations alone; nor can the value of sovereignty be measured solely by its ability to deliver higher material standards of living (what economists mean by welfare). What is to be optimized is welfare in a much broader sense – in political-economy terms, welfare in the sense of a community's overall sense of identity and control of its own destiny. Even if the economic case for dollarization can be made, policymakers must still ask some very basic political questions: What will be the effect on the "imagined community?" On the government's ability to handle unexpected emergencies? On the society's insulation from external coercion? To omit such critical political concerns is to risk rendering debate seriously deficient if not downright irrelevant. It is my hope that these remarks today may help to heighten awareness of these key political dimensions of dollarization.

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