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Dollars for Pesos? The Political-Economy of Dollarization in Latin America

Dólar por Pesos? A economia política da dolarização na América Latina

PAMELA K. STARR*

RESUMO: A capacidade da dolarização de gerar crescimento estável na América Latina, apesar da instabilidade ocasional no sistema financeiro internacional, foi objeto de significativa análise econômica nos últimos anos. No entanto, pouca atenção foi dada à política dessa questão. Este artigo tenta preencher esse vazio examinando os fatores políticos e econômicos que influenciam a eficácia política da dolarização. O artigo revisa o debate teórico e político no qual a questão da dolarização está situada e, em seguida, desenvolve um modelo informal das variáveis políticas e econômicas que influenciam a viabilidade da dolarização. Conclui que, embora a dolarização possa ser a opção política correta para alguns países da América Latina, é improvável que beneficie a maioria. A maioria dos países latino-americanos se beneficiaria mais ao abordar diretamente as forças conhecidas para promover a instabilidade econômica.
PALAVRAS-CHAVE: Dolarização; sistemas de política monetária

ABSTRACT: The capacity of dollarization to generate stable growth in Latin America despite occasional instability in the international financial system has been the subject of significant economic analysis in recent years. Yet very little attention has been afforded to the politics of the issue. This paper attempts to fill this void by looking at both the political and the economic factors which influence the policy effectiveness of dollarization. The paper reviews the theoretic and policy debate within which the dollarization question is situated and then develops an informal model of the political and economic variables which influence the viability of dollarization. It concludes that although dollarization may be the correct policy choice for some Latin American countries, it is unlikely to benefit the majority. Most Latin American countries would benefit more from directly addressing the forces know to promote economic instability.
KEYWORDS: Dollarization; monetary policy regimes.
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* Instituto Tecnológico Autónomo de México – Departamento de Estudios Internacionales – ITAM, México, DF. E-mail: pkstarr@dornsife.usc.edu.

Dollarization, the use of the US dollar in place of national currencies, has a long history in Latin America. Panama has officially used the dollar at its national currency since 1904, and the dollar as circulated widely in the region alongside national currencies throughout this century, particularly intimes of crisis. At the close of the twentieth century, such de facto dollarization is especially evident in countries as diverse as Argentina and Ecuador, Nicaragua and the Dominican Republic, and El Salvador and Peru.

In the wake of the Russian default on its international obligations in August 1998, the question of dollarization took on a new character in Latin America. The wave of financial uncertainty which swept the region in late 1998 and early 1999, including the devaluation of the Brazilian real in the second week of the year, was the final straw for many Latin Americans. After a decade of striving to reestablish economic stability and growth, it seemed to many that this objective was unattainable as long as Latin Americans retained national currencies whose exchange values Wall Street saw as less than 100% credible. As long as investors perceived a significant exchange rate risk, national interest rates would always be higher than in developed regions, and they would always shoot up dramatically in the weak of any disturbance in the international financial system. As a consequence, the region would suffer uncertainty and reduced growth into the foreseeable future, owing to forces outside of Latin America's control.

This line of reasoning led to a spate of proposals for de jure dollarization in a number of Latin American states. In late 1998, in an effort to shore up confidence in its currency board monetary system, the Argentine government announced plans to begin preparations for an imminent dollarization. At essentially the same time, private sector actors in El Salvador and Mexico issued public appeals for dollarization in their national economies to tame interest rates increases and/or exchange rate instability. And in early 2000 the Ecuadorian Congress approved legislation to implement dollarization as an emergency measure to shock both the economy and the polity of this Andean country out of crisis and toward stable growth and prosperity. These proposals awakened analytic interest in the question of dollarization leading to a rapidly expanding body of research on its viability in Latin America. Yet this literature, much like the broader literature on the choice of monetary policy regimes, has been dominated to date by economists and hence economic questions. Although the literature freely admits that politics matters, there has been precious little research into which political forces matter, how, and under what conditions.

The objective of this paper is to begin to fill this void; to begin to illuminate the politics of dollarization.

The paper undertakes this task by first reviewing the theoretic and policy debate regarding monetary policy arrangements within which the dollarization debate is situated. This section will emphasize both the centrality of politics to this debate and its relative absence from the debate. The paper then develops an informal model of the political variables which influence the viability of dollarization. The final section draws some brief conclusions regarding the policy implications of the relative viability of dollarization in Latin America.

THE DEBATE OVER MONETARY POLICY REGIMES

The current debate over dollarization in Latin America fits neatly into the historie debate over monetary policy arrangements. Analysts and national leaders have long striven to construct a monetary order which affords both national policy autonomy and exchange rate stability. This effort to balance autonomy with interdependence was clearly evident in the gold standard system of the late nineteenth and early twentieth centuries (Eichengreen, 1995; Simmons, 1994). But it was even more essential to the effective functioning of the post-World War II Bretton Woods monetary order. The emergence of democracy and the expansion of unionization in Europe during the 1920s made it essential that any future monetary order offered European governments the national economic policy autonomy needed to respond to the legitimate demands of a society with a newfound capacity to influence policy. No longer would governments be able to sacrifice employment for exchange rate stability. The Bretton Woods system thus actively aimed to balance these two objectives through a system of pegged exchange rates with a limited band of floatation and with the capacity to be "adjusted" (revalued or devalued) when required, and a system of conditional lending to help shore up the balance of payments of deficit countries and thereby reduce the domestic costs of adjustment (Gilpin, 1987; Ilgen, 1985).

The effort to balance autonomy and interdependence evident in the construction of the Bretton Woods system, however, would never have functioned effectively if not for the very reduced level of international capital flows during the 1950s. Yet this circumstance was not a permanent feature of the global economy. The return to convertibility at the end of the 1950s, the elimination of most capital controls beginning in the late 1970s, and advances in computer technology, the creation of new financial instruments, and the emergence of new financial actors led to the reemergence of capital flows beginning in the 1960s and expanding rapidly after the mid-1970s (Helleiner, 1994; Sobe!, 1994).

ln this new setting characterized by increasingly mobile capital, analysts noted that governments could no longer enjoy both domestic policy autonomy and exchange rate stability. Under a fixed exchange rate regime, capital mobility would rapidly transmit interest rate pressures in the international economy directly into the domestic economy, thereby obviating national monetary policy autonomy. Policy autonomy could be sustained, but only through the adoption of a flexible exchange rate monetary system. Fluctuations in the exchange rate would operate as a shockabsorber and thereby insulate the domestic economy from international economic shocks. ln a world of mobile capital, governments would be forced to choose (Mundell, 1963; Flemming, 1962).

The events of the 1990s seemed to demonstrate the validity of the Mundell-Flemming thesis, or as Benjamin Cohen more colorfully dubbed it, the "Unholy Trinity" (Cohen, 1993). Governments which adopted intermediate exchange rate regimes (neither fixed nor floating but something in between such as crawling pegs or exchange rate bands) with the objective of continuing the delicate balancing act

between autonomy and exchange rate stability increasingly met with failure. Doubting the capacity of governments to absorb the domestic economic costs of preserving the value of their currency, markets tested these commitments. They sold the national currencies of England, France, and numerous developing countries on the bet that a devaluation was in the offing, and thereby helped produce the anticipated devaluation.

This experience helped construct a new conventional wisdom among economists and policy-makers about exchange rate policy — the only viable exchange rate policies in the presence of mobile capital are a fully flexible regime or a strictly fixed regime such as that obtained through dollarization or monetary union (Eichengreen, 1994).

ln Latin America, many economists now argue mobile capital has created an even more restrictive policy environment — domestic monetary policy autonomy is simply unattainable even under a fully flexible exchange rate regime (Hausmann, et al., 1999). This conclusion is based on three core arguments. First, given the small size of the Latin American economies relative to international markets, they will always suffer much more in the wake of international shocks (sudden shifts in the terms of trade or in capital flows, for example) than developed economies. The movement required in the exchange rate to absorb these shocks also must be much greater, raising the question of whether the costs to the domestic economic of a highly volatile exchange rate, particularly in the form of inflation and exploding public and private debt payments in economies with a great deal of foreign-denominated debt, could be as bad or worse than allowing the adjustment to occur through sharp interest rate increases.

Second, given the higher level of risk inherent in investing in Latin American markets relative to developed economies, external shocks translate into sharp interest rates increases in Latin America regardless of exchange rate regime. Rising interest rates in the United States will tend to draw money out riskier investments in Latin America with a similar rate of return. To prevent an outflow of capital, Latin American interest rates must therefore rise along with US rates regardless of their exchange rate regime. Since most Latin American countries rely heavily on access to international capital markets to cover current account and budget deficits, adjustment solely through the exchange rate is thus simply not a viable option. Further, there is empirical evidence to suggest that in recent crises interest rates have actually risen more under flexible than under fixed exchange rates (Hausmann, et al., 1999).

Third, there is increasing agreement among economists that there is no trade off between inflation and employment in the medium and long-term. Fiscal and monetary policies are hence neutral beyond the near term. Latin American countries which "abandon" monetary policy autonomy through the adoption of a fixed exchange rate are thus giving up something they never really had.

The desirability of dollarization in the minds of many Latin Americans fits neatly within this academic debate. According to the conventional wisdom, Latin America must choose between policy autonomy and exchange rate stability. Yet the reality of Latin America obviates policy autonomy as a realistic option. Further, in

a region where devaluations have historically been associated with bouts of inflation, exchange rate volatility raises the fear of price increases among economic actors, creating the possibility of a self-fulfilling prophecy. Many economists, policy-makers, bankers, and businessmen have thus concluded that the choice left to Latin America is merely the type of strict fixed exchange rate regime it will employ — currency board, monetary union, or dollarization.

FLAWS IN THE CONVENTIONAL WISDOM

Although there can be little doubt that mobile capital has changed the domestic implications of different monetary regimes, it is less clear that international capital flows have made it impossible to balance autonomy with interdependence through the adoption of an intermediate exchange regime. Of the 185 countries evaluated by the IMF at the beginning of 1999, half (93) were classified as employing an intermediate regime, the majority of those employing a fixed exchange rate had devalued in the last decade, and most using a floating regime commonly intervened in the market to influence the value of their currency (Frankel, 1999). Clearly, capital markets have not completely obviated the utility of the middle ground.

Equally, while the monetary policy autonomy of relatively small developing economies has been reduced significantly by the rise of mobile capital, this does not necessarily mean that Latin America (or the rest of the developing world) is effectively devoid of such policy autonomy.

Theory and evidence (such as the Mexican experience in the wake of the 1998 Russian default) demonstrate clearly that flexible exchange rates are unable to absorb the full brunt of external shocks in Latin American economies. But they also indicate that flexibility in the exchange rate can absorb a significant portion of this shock and thereby mitigate the size and/or the duration of the required interest rate increase, and hence speed the renewal of growth in the economy (Giugale, 1999). ln other words, some flexibility in the exchange rate does not operate as a perfect shock absorber, but neither is it without any merit.

Nor does the argument that any effort today to increase unemployment will be obviated by increased inflation in the medium and long term mean that any effort to effect the macroeconomy through the manipulation of fiscal and monetary policy is futile. Equally, evidence suggests that capital markets do not always castigate a country employing an expansive fiscal or monetary policies in the short term (Garrett, 1998). A great deal of room for policy maneuver thus remains in the near term, and this is the time horizon of greatest importance to most politicians and their constituents, without whose support or acquiescence no economic policy will long survive.

The implication is thus that Latin America has much more freedom to choose an exchange rate regime — to attempt to balance policy autonomy with exchange rate stability — than the regional version of the conventional wisdom suggests. This reality raises an obvious question: What factors influence the choice of exchange

rate regime in Latin America? If it is fact true that "no single currency regime is right for all countries at all times" (Frankel, 1999), what might shape the decision of Latin American countries to adopt a particular regime? More particularly, why might some countries opt for a strict fixed exchange rate such as dollarization?

THE ECONOMICS OF DOLLARIZATION

ln a region such as Latin America where most countries have suffered severe macroeconomic instability in their recent history, there is great appeal in the adoption of a strict fixed exchange rate regime. Where economic history has been characterized by high and hyperinflation, extreme exchange rate instability, and/or an extreme lack of credibility with investors, the promise of macroeconomic stability embodied in a currency board, monetary union, or dollarization is highly attractive. ln countries such as Argentina in 1991 and Ecuador today, a currency board or dollarization promises to operate as an anchor for monetary and fiscal policy in a country historically unable to find the political capacity to discipline itself. ln countries such as Argentina or El Salvador, dollarization promises to increase the credibility of a fixed exchange rate regime by eliminating permanently any possibility of devaluation. Without exchange rate risk, domestic interest rates should decline and become more stable. ln Mexico, dollarization promises to eliminate the volatility which has characterized Mexico's exchange rate for decades, but most particularly since the adoption of a flexible regime in early 1995. Without exchange rate uncertainty, private sector investment should increase. And throughout Latin America, dollarization should reduce transaction costs and thereby increase trade and investment flows with the United States and among dollarized economies.

The appeal of dollarization in Latin America also emanates from the regional fallout from recent instability in the international financial system. The Mexican crisis of 1994/5, the Asian crisis of 1997/8, and the Russian default of 1998 all reverberated through the international financial system with serious consequences for the Latin American region. After each crisis, Latin America witnessed a sudden and significant outflow of capital leading to dramatic interest rate increases and recession. The Brazilian devaluation of early 1999 reinforced Latin fears of the powerfully negative impact that instability in the international financial system can cause in their domestic economies, even though the fallout from this event was limited almost everywhere except in Argentina. ln these circumstances, dollarization is appealing as a mechanism to reduce the negative feedback from international financial crises. By eliminating exchange rate risk, dollarization should reduce investors' sense of risk in Latin America, and thereby reduce their skittishness intimes of international financial instability.

Alongside these potential sources of economic stability and growth, dollarization also carries significant economic costs. First, dollarization implies the loss of seignorage, the income that accrues to a government owing to the difference between the value of its currency and the cost of printing it. This sum can be

significant, as in the case of Central American and the Caribbean where it totais about 1% of GDP (Stein, et al., 1999). Second, dollarized countries lose the power of the lender of last resort — the ability to guarantee the liquidity of the banking system intimes of crisis. Although this capability is never unlimited in any economy, it is sharply reduced in a dollarized setting. Without the ability to print national currency (dollars), the central bank can not come to the rescue of the banking system. As an alternative, countries can contract a contingency facility with private banks to borrow the needed liquidity in hard times, as has Argentina. But the amount of liquidity that this option provides is inevitably limited by the country's capacity to borrow and the banks' willingness to lend.

A dollarized economy also forfeits the ability to implement an independent, counter cyclical monetary policy. With the dollar as national currency, the money supply will increase and decrease automatically with international reserves. When faced with a sudden drop in the terms of trade, or capital outflows driven by instability in the international financial system, or other external shocks, the government will be powerless to mitigate the recessionary consequences of the sharp decline in international reserves. And as noted above, although the capacity of Latin American governments to implement a counter-cyclical monetary policy in the presence of mobile capital is quite limited even with a flexible exchange rate, this capacity is not absent. Abdicating monetary policy autonomy thus entails real costs.

Finally, dollarization is very costly to reverse. This is clearly part of its appeal, as previously noted. Yet the historie vulnerability of developing economies to external shocks suggests that there will be times when the capacity to devalue provided by a flexible exchange rate will be an essential element for recovery in the domestic economy (Corden, 1993). Recent research comparing industrial recovery following external shocks in developing economies under fixed versus flexible exchange rates has reinforced this observation. This work indicates that recovery is much more rapid under flexible than under fixed exchange rate regimes (Giugale, 1999). Permanently foregoing the option to devalue can therefore carry significant future costs.

THE ECONOMIC VIABILITY OF DOLLARIZATION

The debate surrounding fixed versus flexible exchange rates, and of the wisdom of dollarization in particular, will likely rage on unresolved for some time to come. What seems clear from the arguments brought to the table by each side, however, is that there are clear costs and benefits associated with dollarization. The question Latin American policy makers considering dollarization must answer, therefore, is under what circumstances a country will be able to extract the benefits of this policy reform while minimizing its inherent costs? The answer to this question depends on both the structure of a country's economy and of its politics.

The economic structure best suited for monetary union or dollarization is laid out in the literature on optimal currency areas (Mundell, 1961; McKinnon, 1963).

This literature argues first that small, open economies are more likely to benefit from the abandonment of their national currency. Small economies will benefit disproportionately from the elimination of cost of exchanging currencies in trade, and open economies are less able to alter their real exchange rate through devaluations because of the small size of their non-tradable goods sector. Second, economies characterized by a high degree of economic interaction with the United States will benefit disproportionately from the reduction in transaction costs created by dollarization. On this score, El Salvador stands ready to gain much more from dollarization than either Argentina or Mexico.

Third, the greater the symmetry of the economic shocks affecting the US economy and any economy considering dollarization, the smaller the costs of dollarization should be. By contrast, when production in the dollarized economy is concentrated in economic sectors distinct from those which dominate the US economy, operating under the monetary policy decisions of the US Federal Reserve Board in the presence of external shocks will be costly. For example, economies such as Mexico or Ecuador which export petroleum will suffer recessionary pressures from a sudden drop in the international price of oil, and therefore would benefit from the expansive monetary policy produced by reduced interest rates. ln the US economy, however, a sudden drop in the price of petroleum will stimulate economic activity and might thereby demand an increase in domestic interest rates to prevent the economy from overheating. Clearly, rising interest rates would be precisely the wrong monetary policy for Mexico and Ecuador under these circumstances, but as dollarized economies they would have no option other than to accept this pro-cyclical monetary policy. The benefits accruing to an economy from dollarization also depend on the relative mobility of labor and the flexibility of wages. Whether through legal or illegal means, through formal or informal mechanisms, the mobility of labor from troubled to growing sectors or regions within the currency area is essential to easing the costs of adjustment to the asymmetric shocks noted above. Equally, wages which are flexible downward will better enable an economy to adjust to recessionary shocks in the absence of an expansionary monetary policy and without the option of devaluation. Downwardly flexible wages also operate as an incentive to labor mobility. Although there is significam variance on the degree of labor mobility and labor flexibility within Latin America, reality is much more flexible than established law suggests. Equally important, adjustment in countries geographically close to the United States will also benefit from the illegal mobility of their labor force into and out of the United States.

Finally, a greater degree of industrial competitiveness will help reduce the smaller adjustment costs associated with dollarization in any given Latin American economy. And countries where deep, well-capitalized financial markets help to cushion the economy from external shocks will be better positioned to dollarize than economies in which weak financial sectors magnify the domestic economic costs of external shocks.

The initial implementation of dollarization will also benefit from a high initial degree of de facto dollarization in the domestic economy and an established fiscal

discipline. And any country adopting the dollar obviously must have access to a supply of dollars sufficient to purchase the domestic money supply.

This laundry list of the economic conditions capable of reducing the costs inherent to dollarization should not be interpreted as a list of economic pre-conditions for the adoption of this economic policy. First, some of the factors which promote stable economic growth in a dollarized setting can also emerge as a consequence of dollarization. The health of the banking system, for example, will be promoted by the stable interest rates and stable exchange rate created by dollarization. By reducing transaction costs in dollars, dollarization will also tend to increase economic interactions with the US economy. Expanded exchange can also promote increased symmetry in the production structures of the dollarized economy and the US economy. ln other words, over time dollarization is itself likely to cut the costs associated with operating under a monetary policy largely determined by the needs of the US economy.

Second, the available empirical evidence is simply insufficient to clarify which factors, or which sets of factors, are essential pre-conditions for dollarization. The argument therefore is less ambitious. The greater the number of the economic factors capable of minimizing the costs of dollarization that a Latin American economy possesses, the greater will be its capacity to achieve dollarization's promise of stable economic growth.

THE POLITICAL VIABILITY OF DOLLARIZATION

The choice of an exchange rate regime, however, is far from a wholly economic decision. Quite to the contrary, this decision is often based more on political considerations than questions of economic efficiency. This is because dollarization, like any other economic policy, creates winners and losers. The political capacity of any government to adopt this strategy and to sustain it will thus depend on the incentive and the ability of the losers to block or overturn the policy.[1] This raises an essential question: under what conditions will a government be able to withstand the política! costs associated with dollarization? Under what circumstances cana government sharply restrict its capacity to cushion the socio-economic costs of business cycles and external shocks and yet survive politically?

It is patently obvious that the greater the economic benefits accruing to an economy as a consequence of dollarization, the smaller the constellation of losers which will confront the government, and hence the greater the government's capacity to withstand their protests. When dollarization works well, people tend to support it. But it is also possible that dollarization can work well yet encounter strong

[1] This discussion of the incentives and capacity of societal actors to effect a change in a country's economic policy finds its roots in the modern political economy literature, and in particular the work of Jeffry Frieden (Frieden, 1991a, 19916).

societal opposition, or work less than perfectly yet be sustainable politically. The political sustainability of dollarization depends on the willingness of the losers to accept their lot in life and on the government's capacity to force recalcitrant losers to absorb the costs of adjustment whether they like it or not. Sustaining dollarization thus ultimately depends on three factors: the presence of cushioning institutions, the degree of conflict in society, and the institutional structure of the government.

Cushioning Institutions

The willingness and ability of society to absorb the costs of adjustment will inevitably increase as the actual costs they must bear decline. Several institutional characteristics of a national economy and polity have the capacity to mitigate the domestic consequences of external shocks under a fixed exchange rate and thereby augment the sustainability of dollarization.

Within the economy, a healthy financial system is an essential tool for minimizing the domestic impact of external shocks. An undercapitalized and underdeveloped financial system can quickly fall into crisis following a sudden rise in interest rates, a common characteristic of the adjustment process under a strictly fixed exchange rate. As occurred in Mexico in 1995 and Thailand and Indonesia in 1997, a weak financial system magnifies the domestic costs of adjusting to sudden shifts in the international economy, and thereby greatly increases the socio-political cost associated with sustaining the established monetary regime.[2] By contrast, a financial system that is well capitalized, diversified, and highly integrated into the international financial order is much less prone (although not immune) to crisis following a sudden increase in domestic interest rates. The Argentine financial system thereby provided an effective cushion for the domestic economy following the Russian default of 1998 and the Brazilian devaluation of early 1999. Despite the enormity of these external shocks, the consolidation of the Argentine financial system, since 1995, increased foreign ownership, and most particularly the presence of foreign branch banking produced a banking system sufficiently well-capitalized to weather the financial storm of late 1998 and early 1999.

A system of income transfers from the winners to the losers in an economy also reduces the political costs of sustaining dollarization. Whether through formal government institutions such as unemployment benefits, informal family networks, remittances from migrant workers, or timely funding from international actors such as IMF/World Bank/IDB loans, bilateral aid flows, or even international capital markets, income tran.sfers mitigate the social consequences of recession. If a decline

[2] Although the financial system in all three countries was damaged greatly by devaluation, each was already in serious trouble prior to the devaluation because of the rise in domestic interest rates associated with efforts to sustain a fixed (or effectively fixed in the Mexican case) exchange rate in the face of declining access to international capital markets.

in living standards produced by the unemployment and bankruptcies inherent to a sharp economic adjustment can be minimized by the presence of social safety nets, the willingness of society to accept the costs of adjustment will inevitably increase. As a consequence, the capacity of government to sustain the economic policy that forced this adjustment on its constituents will also rise.

Two additional important cushioning institutions are the rule of law, specifically an efficient, capable, and non-corrupt judiciary and bureaucracy to ensure the fair application of the law, and a well-functioning democracy. Although these institutions can do little to mitigate the economic impact of external shocks (like sound financial systems and income transfers), they can reduce the incentive of lasers to agitate for changes in the economic order that has undermined their living conditions.

lt is common for citizens to conclude that their economic triais are the result of unfairness in the economic or political order. Where the judicial system and the bureaucracy are inept and corrupt or where the political order excludes popular participation, these political institutions can magnify this sense of unfairness. They can thereby reinforce rather than cushion the political effects of economic hard times, and undermine rather than reinforce the sustainability of dollarization. By contrast, a just and efficient judiciary and bureaucracy encourages a sense of fairness in the minds of lasers. When citizens have the chance to rectify a perceived unfairness through a non-biased and effective judicial system or bureaucracy, they will be much less likely to demand changes in the economic policies which were the proximate cause of their suffering. A well-functioning democracy offers lasers another institutionalized means to protect their interests — by voting out the politicians who caused their personal suffering. ln either case, the rule of law and democracy can help to insulate a government from the political repercussions of recession.

Societal Factors

The willingness of society to absorb the costs of adjustment relies on an environment that minimizes the divisions and competing interests within society. It depends on creating a national preference for dollarization strong enough to relegate other competing societal preferences to second tier status. The competing interests of distinct sectors of society, such as workers' preference for wage and benefit increases versus owners' preference for expanded profits, or exporters' preference for an undervalued exchange rate versus importers' preference for an undervalued rate, must cease to dominate their policy demands. lnstead, their policy preferences must be dominated by a single, overriding demand for sustaining a strict fixed exchange rate regime regardless of its short-term costs.

ln societies split by a deep socio-economic opposition, sharp class divisions, or ethnic conflict, the emergence of a single national preference for any economic policy will be rare. ln such societies, there is a deep-seeded sense that the competition among different societal groups is zero-sum. Any gain for the other is seen to be an inevitable loss for me. ln this setting, it is unlikely that any group will be

willing to absorb the costs of adjustment even temporarily, considering this an unfair sacrifice they should not be required to make. The consequence, as in Argentina and Chile during the 1970s and in Ecuador during the 1990s, is persistent fiscal deficits, macroeconomic instability, and devaluation.

Yet even in societies without such deep-seeded conflict, the tendency to advance individual interests even when this undermines the collective interest is common place. How might this seemingly natural human tendency be overcome? A review of the experiences of countries that have adopted strict fixed exchange rate regimes in recent years points to the importance of a shared national trauma that a currency board, monetary union, or dollarization promises to help resolve. Each trauma has a distinct origin, but they fall into three basic categories: a hyperinflationary trauma which brought the national economy to its knees (Argentina 1991 and Bulgaria 1997), national survival (Panama 1904, Estonia 1992, Lithuania 1994), or an outside threat to political and economic stability (Hong Kong 1983 and the European Union).

Regardless of its precise origin, such a national trauma enables the adoption of a currency board, monetary union, or dollarization by building a national sentiment in favor of a strict fixed exchange rate regime as a key tool in the resolution of a shared, national crisis. Equally important to the willingness of society to accept the costs of dollarization over time, however, is the duration of this national trauma. Should the exchange rate regime eliminate the source of the trauma (the end of hyperinflation in Argentina and Bulgaria, for example), time will often transform the trauma into a distant memory. As its traumatic quality fades, so will the willingness of society's losers to continue absorbing the costs associated with a strictly fixed exchange rate.

Government Capacity

The political capacity of a country to sustain dollarization over time depends not only on the willingness of society's losers to absorb the costs of adjustment, however. It also relies on the ability of the govern ment[3] to force society to absorb these costs. ln the short-term, this government capacity can be enhanced by a strong executive and a cohesive governing coalition that dominates the political scene. Of even greater importance, however, is the long-term capacity of the government to fulfill this task, given the long-term nature of a policy of dollarization. This depends largely on the presence of political institutions capable of extending the time horizons of politicians and their supporters, such as effective constitutions and strong political parties within the context of a well-functioning democracy.

Executive strength governs the ability of the executive branch to dominate the other branches of government and to insulate itself from societal demands. Executive

[3] This section intentionally refers to the capacity of the government and not the state. lts focus is governance — the ability of the actors which run the state to implement public policies.

dominance over the legislature is clearly enhanced by presidential decree power and the authority to dissolve congress. It also benefits from the existence of a welltrained and loyal bureaucracy capable of effectively designing and implementing economic policies. Where such a bureaucracy exists, particularly in the absence of similar expertise in the legislature or in society, the executive can often disarm it opposition by virtue of its economic expertise. Finally, executive strength increases relative to the legislature when party practices and a legislative majority enable the executive to determine who the majority of legislators will be. ln such a setting, legislators will hesitate to oppose the man to whom they owe their political future.

The ability of a government to withstand societal pressures to modify the exchange rate regime in economic hard times also reflects the membership and cohesion of the government's ruling and electoral coalitions, and their relative dominance of the política! scene. Where the allies of the government are concentrated in sectors likely to suffer a significant proportion of the costs associated with the occasional automatic adjustments that affect a dollarized economy, sustaining dollarization will be difficult. This implies that governments which rely on a coalition composed of large internationalized firms and professionals will be better able to sustain dollarization than governments whose allies include workers, non-competitive national firms, and small farmers.

The relative dominance of the government and its allies in national politics is the final factor determining the capacity of the government to force the lasers in society to absorb the costs of adopting dollarization. Where the government dominates the legislature, or the opposition is weak and/or divided, the government will have a greater capacity to withstand societal opposition to its economic policy during the periodic, short-term recessions forced on a dollarized economy in the presence of external shocks.

It is somewhat paradoxical, however, that while these authoritarian features of a government can enhance its capacity to implement dollarization, the ability of a government to ensure the compliance of lasers over time is promoted by a more democratic setting[4] The key factor is the presence of institutions which can extend the time horizons of politicians and their constituents and thereby increase the likelihood of cooperation and compromise.

Where constitutions clearly delineate a balanced separation of powers among the distinct branches of government, politicians know what powers are available to themselves and their adversaries. The resulting certainty about the mies which delineate the political game will reduce the probability of unanticipated and arguably illegal acts by one's adversaries. As uncertainty declines, the tendency of politicians to exploit every short-term opportunity to strike a fatal blow against their opposition, even at the risk of undermining the essential política! and economic foundations of dollarization, will decline as well. Time horizons thereby expand,

[4] A recent article by Joel Hellman argues that in the case of Eastern Europe, democracy actually deepens and improves the efficiency of a broad swath of economic reforms (Hellman, 1998).

the willingness of politicians to cooperate and compromise grows, and the capacity of the government to pursue a coherent policy in support of dollarization increases. A well-functioning democracy can have a similar impact by creating the perception among opposition politicians that in time they will have the opportunity to govern. ln such a setting, the opposition has little interest in generating instability in either the polity or the economy.

Equally important for sustaining dollarization over the long term are institutions which can extend the time horizons of the government's allies and thereby augment the cohesion of the government's política! coalitions. The essential institutions for fulfilling this task are well-disciplined political parties. By definition, such parties can exploit internal regulations, formal or informal, to convince or force their members to accept the short term costs associated with sustaining dollarization. When government allies conclude that the costs of abandoning the ruling coalition are greater than the costs of tolerating a recession, the capacity of the government to sustain dollarization while surviving politically rises markedly.

CONCLUSION

The ability of any government to sustain dollarization in the long-term ultimately depends on reducing the political costs associated with the automatic adjustment to external shocks inherent in this exchange rate/monetary regime. These costs can be mitigated by 1) a domestic economy whose structure approximates that of an optimal currency area with the United States, 2) the existence of institutions that either cushion the domestic economy from external shocks or insulate the political order from the costs of a recession in the domestic economy, 3) a society willing to absorb these costs, and 4) a government capable of imposing these costs on society. lt is important to emphasize once again that none of these factors can be considered pre-conditions for dollarization. lt is clear that the greater (fewer) the number of these economic and political factors supportive of the successful adoption of dollarization a country possesses, the more (less) probable it is that dollarization will produce stable economic growth. But it unfortunately remains unclear precisely which of these factors constitute both necessary and sufficient conditions for the adoption and sustainability of dollarization.

What policy recommendations can be derived from such nebulous theoretic conclusions? First, dollarization can be an effective route to stable economic growth for some Latin American countries, but it certainly is not the correct solution for every country in the region. On balance, dollarization seems to be reasonable policy option for El Salvador, but a very long shot in Ecuador, and not very feasible in Brazil. Second, the worst option for Latin America is to look upon dollarization as a miracle cure for long-standing economic and political problems. Dollarization can do little to reduce foreign debt burdens, build effective state institutions, or reduce societal conflict, all essential sources of continuing economic difficulties in much of the region.

Third, given the uncertainties associated with the effectiveness of dollarization as a means of creating stable growth in most of Latin America, the countries of the region would be well advised to redirect their policy attention toward the basics. They should redouble their efforts to eliminate the sources of the region's economic and political vulnerability to external shocks. Latin America must strive to reduce its dependence on capital inflows by limiting fiscal and current account deficits and by encouraging the development of domestic financial markets capable of financing government deficits. The region must also focus much more attention on the development of key institutions — institutions capable of cushioning the domestic economy (healthy financial systems and income transfers) and polity (the rule of law and democracy) from the repercussions of external shocks, and institutions (effective constitutions and disciplined political parties) that extend time horizons and thereby strengthen the government's long-term policy capacity.

Finally, given the high costs associated with reversing a policy of dollarization once it has been implemented, countries need to think much more profoundly about the presence and effectiveness of the political and economic factors outlined in this essay that influence their long-term ability to sustain this dollarization. Otherwise, Latin American governments may find themselves shackled to a policy that produces very high economic, social, and political costs whose long-term consequences are not pleasant to ponder.

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