The costs of dollarization; a central banker's view

Speech by Jeanette R. Semeleer, President of the Centrale Bank van Aruba (CBA), at the Symposium on "The advantages and disadvantages of Dollarization", organized by the Council of Advice of St. Maarten, March 26, 2015.

Members of Parliament, Ministers, Members of the Council of Advice and other distinguished guests, good evening.

1. Introduction

First of all, allow me to express words of gratitude to the Council of Advice for the invitation to address you on the topic "The advantages and disadvantages of Dollarization". I am truly honored and privileged to be here on this beautiful island (I should come here more often) and to contribute to the ongoing debate of dollarization in St. Maarten.

We all probably agree that dollarization is not an easy topic to debate on, but I hope when we leave the room tonight that some practical tools have been provided to facilitate the discussions. If this debate moves some time in the future towards a political decision that involves a change in the current exchange rate regime, extensive knowledge and practical experience are needed to choose the best policy for managing the exchange rate, which is a key instrument towards achieving macro-economic goals and maintaining financial stability.

Tonight my speech will primarily focus on the *costs of dollarization* within the context of full dollarization. By full dollarization, I refer to a situation in which a country formally adopts a currency of another country—most commonly the U.S. dollar—as its legal tender.[1]

2. The case of Aruba: benefiting from a single currency peg despite partial dollarization

[1] IMF (2000), Full Dollarization: The Pros and Cons, December 2000.

Within the Dutch Caribbean, we are now familiar with this concept, as the BES islands are fully dollarized, as well as with partial dollarization. Partial dollarization occurs when one or several foreign currencies circulate alongside a national currency.[2] In St. Maarten, Curaçao and Aruba, the dollar has been co-circulating, along with the Netherlands Antillean guilder and the Aruba florin, for many decades already.

In the case of Aruba, the options for adopting a new foreign exchange regime were thoroughly assessed and debated prior to its status aparte in 1986. In spite of the existence of the partial dollarization phenomenon, the practical experience with the Antillean guilder, the economic crisis (due to the closure of the refinery), and the uncertainties related to the new status of Aruba within the Kingdom, only a few months prior to the Status Aparte in 1986, the Island Council of Aruba decided, against most advices, including that of the IMF, to issue its own currency, the Aruban florin

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[2] Occasional Paper 219 (2003), IMF, Economic Policy in a Highly Dollarized Economy: The case of Cambodia, 2003.

pegged to the US dollar (a single currency peg) at a fixed exchange rate, and to institute its own central bank, being the Central Bank of Aruba.

The prime reasons behind this own-currency decision were (i) the perceived complexities within a monetary union with the Netherlands Antilles when adopting the Antillean guilder, and (ii) the loss of monetary independence in a fully dollarized economy. By pegging the florin to the dollar, which is the main trading currency (about 80% percent of total payments to nonresidents are settled in US dollars), confidence in the domestic currency has been maintained. This contained capital flights, facilitated trade and investment as FDI's flourished in the following years, and made access to international capital markets easier.

I would like to point out that the decision of the Aruban Parliament to peg the Aruban florin to the US dollar is a unilateral one. The exchange rate regime and exchange rate policy governing the peg are anchored in the

Central Bank Ordinance, the Ordinance governing foreign exchange transactions, and the State Decree value of the florin.

Many times we hear concerns and speculations about possible devaluation of the Aruban florin. However, this would not happen overnight, even if a crisis of unprecedented proportion, which we did have in the past 30 years, has occurred. Whether to devalue or revalue the Aruban florin vis-à-vis the US dollar, the Minister of Finance in close consultation with his colleagues has to make that decision and adapt the State Decree value of the florin, and not the Central Bank of Aruba or any other institution.

The dollar-pegged florin, which exchange rate has remained unchanged, has worked well for Aruba. In the last three decades, Aruba has made great economic progress, within a relatively low inflation rate environment. The Government of Aruba made a significant push for investment in and promotion of the tourism sector and, currently, Aruba is one of the most popular tourist destinations in the Caribbean.

One out of two of our visitors are Americans, making the US dollar a widely accepted means of payment in Aruba, going way beyond the boundaries set by the State Decree on the Acceptance of Foreign Currency (1992 no. GT 10). US dollars are welcome, although many merchants do not accept the larger bills, because counterfeiting of the US dollar is a serious problem around the world.

Based on deposit dollarization[3], which is the use of foreign-currency-denominated bank deposits, St. Maarten experiences a higher rate of dollarization than Aruba and Curaçao. Residents hold more than 60 percent of their local deposits in US dollars, while in Aruba and Curacao this is 7 and 11 percent, respectively. Should St. Maarten then fully dollarize or not?

3. Economic research

[3] World Bank (2002), Deposit dollarization and the financial sector in emerging economies, 2002.

In the last fifteen years, there has been a steady discussion on the pros and cons of dollarization. Very distinguished economists like Stanley Fischer (who is currently the Vice Chairperson of the Federal Reserve System), Sebastian Edwards, Rudiger Dornbusch, Jeffrey Sachs, and Paul Krugman all made valuable contributions, reaching however different conclusions on the merits of dollarization.

For example, Krugman[4] mentioned that dollarization may leave countries exposed to other difficulties, while Edwards[5], referring to Panama, mentioned that external shocks could result in a greater loss. Dornbusch[6] suggests that dollarizing can help in reducing inflation. These diverging views not only reflect the need for more empirical evidence but also prove that dollarization is not a "one-size fits all."

Amongst the varying opinions on this subject, we can distill the following main arguments against dollarization:

[4] Paul Krugman (2000), Crises: The price of globalization, August 2000.
[5] Sebastian Edwards (2001), Dollarization and economic performance: An empirical investigation, May 2001.
[6] Rudiger Dornbusch, Commentary: How should central banks reduce inflation? – Conceptual issues.

a. The import of the monetary policy of the U.S., being the issuing country of the adopted currency, is unavoidable. This means that local policymakers are no longer in the position of using the exchange rate to absorb external shocks or to finance budget deficits. If there are no dollar buffers and no quick access to dollars, the government would need to reduce its expenditures and/or raise income rapidly to avoid defaulting on its financial commitments. The real sector will be impacted immediately, as wages would have to be reduced, and this would on its turn have a negative effect on consumption, investment, and ultimately economic output.

b. Some of the tasks of the central bank, especially the function of lender of last resort, which is the credit line for local banks when experiencing financial stress, will disappear. If St. Maarten at some point in the future choses to dollarize, I would still strongly recommend the establishment of a monetary authority that will continue to conduct financial regulation, economic research, and monitor the balance of payments and other financial developments within the country.

c. In the process of implementing full dollarization, in which the central bank will have to buy back the local currency, a large portion of the current stock of international reserves could be needed. Although the need for international reserves to support the exchange rate is eliminated, it is still crucial that the local monetary authority retains an adequate level of reserves to help support economic shocks, as well as to finance its operations.

d. Dollarization will eliminate seigniorage earnings, which is the income of the central bank from issuing the local currency minus the cost of printing banknotes and coins. This could lead to reduced income to the government, which usually takes place via dividend payments of the central bank. Ecuador, for example lost seigniorage of about 7 percent[7] [8] of GDP when it adopted the US dollar.

e. Dollarization, in the case of St. Maarten, would also eliminate the license fee revenues currently enjoyed by the government amounting to about NAF 27 million[9] as reported in the 2014 budget of St. Maarten. This represented about 7 percent of the country's tax revenues for that year, and the loss hereof could potentially mean the raising of existing taxes and/or introduction of new taxes to recover the loss in revenues.

4. International experiences

Let me briefly move over to the international experiences with full dollarization. When you examine some of the countries that have dollarized within the past 15 years, one thing is clear, dollarization, in itself, is not the magic wand for a stable economic environment.

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[7] Zeljko Bogetic – Cato Journal (2000), Official dollarization: Current experiences and issues, Fall 2000.
[8] Julian Diaz (PhD student) of the University of Minnesota, Dollarization in Ecuador: A process in progress.
[9] Minister van Financiën Sint Maarten (2014), Vastgestelde begroting 2014, January 21, 2014.

The largest non-US territories/countries that are fully dollarized are Panama (1904), Ecuador (2000), and El Salvador (2001). All other fully dollarized non-US territories/countries are small islands such as Micronesia, the Marshall Islands, Palau, the British Virgin Islands (1959), and the BES islands (2011).

Proponents of dollarization often argue that it will stabilize inflation, lower interest rates, and even stimulate investments, but this was not completely true for the case of El Salvador and others that experienced notable challenges. In the case of Panama, for example, it can be argued that dollarization did not automatically produce a more fiscally disciplined country.[10]

Post-dollarization El Salvador is very different from the widely known success story of Ecuador. It is a testament to the fact that each country must properly assess the factors within its economic climate, and determine potential outcomes for changes within monetary policy. Reporting on El

[10] Federal Reserve Bank of Atlanta (2002), Costs and Benefits of Dollarization, July 2002.

Salvador in its most recent article IV consultation (2013), the IMF stated that "El Salvador's growth has been below that of Central America, Latin America, and world averages for almost two decades (since the Tequila Crisis)—*in particular* the decade that followed the adoption of full dollarization in 2001, with the lowest growth in the Salvadoran economic history excluding the period of civil war during the 1980s[11]." Furthermore, the IMF reported that "Although the financial system has remained sound and inflation low, anchored by full dollarization, the recovery never gained strength."

To bring things a bit closer to home, soon after gaining a new status within the Dutch Kingdom, the BES islands became fully dollarized, and this resulted in a sharp spike in consumer prices. In the first year under this new monetary regime, the BES islands suffered a one-off hike in consumer prices. During the first 2 years under dollarization, Bonaire, St. Eustatius,

[11] IMF (2013), El Salvador: 2013 Article IV Consultation, May 2013.

and Saba noted inflation rates of as high as, respectively, 6, 11, and 7 percent.[12]

In fact, in the case of Bonaire, it wasn't until the fourth quarter of 2013 that it returned to the rate of inflation observed prior to dollarization of below 1.5 percent. The purchasing power report written by Ecorys[13] in 2012 concluded that dollarization did play a role in the price rises. Data on other macro-economic indicators for the BES islands are still not available to determine the economic developments there, but with the recent GDP publication[14] for Bonaire by the Dutch Central Bureau of Statistics, soon we will be able to assess how dollarization contributes to other macro-economic developments there.

I am not saying that dollarization has not had success, but I firmly believe that its success depends heavily upon the favorable economic conditions

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[12] CBS Nederland (2014), Inflatie Bonaire omlaag, op Saba en Sint-Eustatius omhoog, October 9, 2014.
[13] Ecorys en Conconsult (2012), Koopkrachtonderzoek Caribisch Nederland, May 23, 2012.
[14] CBS Nederland (2014), Bruto binnenlands product Bonaire in 2012 bedraagt 372 miljoen dollar, August 22, 2014.

and the existence of credible public institutions with prudent and sound policies that complement this choice of monetary policy. Otherwise the economic and social situation can go from bad to worse.[15]

In the Social Economic Council's report on "Sint Maarten stepping out of the monetary union", the primary argument for recommending dollarization was the threat that the structural current account deficits experienced by Curaçao could potentially lead to a devaluation of the Netherlands Antillean Guilder and inflation.[16]

However, the IMF seems to reflect another point of view in its 2014 article IV consultation report by stating that "Despite double-digit deficits, there have been no pressures on the guilder and the union's international reserves have consistently met the CBCS' objectives in terms of coverage of imports of goods and services, reflecting strong capital inflows."[17]

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[15] Ten Years Later – The impact of dollarization in El Salvador (2011), Voices on the Border, June 8, 2011.
[16] Social Economic Council of St. Maarten (2013), Stepping out of the monetary union, February 28, 2013.
[17] IMF (2014), Kingdom of the Netherlands - Curacao and Sint Maarten: 2014 Article IV Consultation Discussions – staff report and press release, August 2014.

5. Concluding remarks

In view of St. Maarten's impending assessment of its current participation in the monetary union with Curacao, as well as consideration of the options of introducing an own legal tender or the US dollar, I would like to close my presentation with the following statements.

Although our islands are deemed too small to justify the costs associated with maintaining an own currency (i.e., the maintenance of international reserves against very low interest income and the associated opportunity loss), the Aruban experience gives us strong arguments against dollarization.

In choosing a dollar-pegged currency, whether the Caribbean guilder or an own currency, St. Maarten could continue to benefit from the financial soundness of the dollar, while still maintaining a certain degree of monetary independence.

Although in a pegged currency regime, the tools for directly influencing consumer prices and interest rates are limited, you still have tools to work with when facing certain (adverse) economic situations.

After the global economic crisis of 2008, policy makers learned that sometimes it is necessary to use tools, like quantitative easing, to help jumpstart the economy and provide badly needed liquidity that only a central bank has access to.

As I stated earlier, the chosen exchange rate regime, whether an own currency or the US dollar, is only an instrument in support of achieving economic goals. It is not an end by itself. Economic actors, the governments in particular, have the leading role.

However, in the choice for dollarization, the role of the government would become even more prominent. This could mean a significant shift of responsibilities, because dollarization does not automatically create fiscally responsible politicians.

While the starting fiscal position for St. Maarten would be advantageous, meaning a low debt stance, it is critical that the fiscal rules and benchmarks, which are already legally imbedded, are strictly observed, and that transparency and accountability are a normal way of life.

In spite of their openness and low economic diversification, our islands have done relatively well under the pegged currency regime. This brings me to my final statement: “if it aint broke, don’t fix it.”

I thank you for your attention.

Appendix:

Table 1

TOURISM DATA BY TOTAL VISITORS AND MARKET SHARE					
	2010	**2011**	**2012**	**2013**	**2014**
Total visitors					
U.S.A.	535,521	531,130	530,950	556,296	576,800
Venezuela	90,363	117,838	143,201	188,020	249,593
The Netherlands	39,786	40,068	39,973	37,788	36,995
Canada	37,598	40,487	45,887	44,338	43,767
Colombia	14,743	16,703	18,127	19,485	23,836
Brazil	20,222	22,413	21,070	23,293	24,733
Secondary Markets	84,096	100,334	104,726	110,036	116,358
Total	822,329	868,973	903,934	979,256	1,072,082
Market share (in %)					
U.S.A.	65.1	61.1	58.7	56.8	53.8
Venezuela	11.0	13.6	15.8	19.2	23.3
The Netherlands	4.8	4.6	4.4	3.9	3.5
Canada	4.6	4.7	5.1	4.5	4.1
Colombia	1.8	1.9	2.0	2.0	2.2
Brazil	2.5	2.6	2.3	2.4	2.3
Secondary Markets	10.2	11.5	11.6	11.2	10.9
Total	100.0	100.0	100.0	100.0	100.0

Source: Aruba Tourism Authority

Table 2

Cash Component of Tourism Receipts Aruba				
	2010	**2011**	**2012**	**2013**
ANG	0%	0%	0%	0%
AWG	0%	0%	0%	0%
CAD	0%	0%	0%	0%
CHF	0%	0%	0%	0%
EUR	1%	1%	0%	0%
GBP	0%	0%	0%	0%
USD	22%	21%	21%	19%

Source: Centrale Bank van Aruba.

Table 3

Deposit Dollarization				
	Resident		Nonresident	
	Local Currency	Foreign Currency	Local Currency	Foreign Currency
Curaçao	88.2%	11.8%	10.7%	89.3%
Sint Maarten	39.2%	60.8%	2.2%	97.8%
Aruba	92.4%	7.6%	21.2%	78.8%

Source: Centrale Bank van Aruba; Centrale Bank van Curaçao en Sint Maarten

Links considered:

http://www.imf.org/external/pubs/ft/scr/2013/cr13132.pdf
https://www.imf.org/external/pubs/ft/issues/issues24/
http://www.cbs.nl/nl-NL/menu/themas/prijzen/publicaties/artikelen/archief/2014/2014-inflatie-bonaire-omlaag-pub.htm
https://www.bbvaresearch.com/KETD/fbin/mult/WP_0808_tcm348-212939.pdf?ts=15112011
http://www.nber.org/papers/w9820.pdf
http://www.bis.org/review/r091216e.pdf
https://voiceselsalvador.wordpress.com/2011/06/08/ten-years-later-the-impact-of-dollarization-in-el-salvador/
http://www.amcm.gov.mo/publication/quarterly/Apr2003/currency_en.pdf
http://www.anderson.ucla.edu/faculty/sebastian.edwards/MATCH_DOLLAR4.pdf
http://www.cbs.nl/nl-NL/menu/themas/macro-economie/publicaties/artikelen/archief/2014/2014-bbp-bonaire-2e-raming-2012.htm
http://www.bis.org/review/r061221e.pdf
https://www.globalpolicy.org/pmscs/30435.html
https://voiceselsalvador.wordpress.com/2011/06/08/ten-years-later-the-impact-of-dollarization-in-el-salvador/
https://www.imf.org/external/np/sec/pr/2014/pr14393.htm
http://www.banboneirubek.com/content/invoering-us-dollar-op-bonaire-1-januari-2011-0
http://www.kc.frb.org/publicat/sympos/2000/krugman.pdf
http://www.nber.org/papers/w8274.pdf
http://testing.kansascityfed.org/publicat/sympos/1996/pdf/s96dornb.pdf
http://www.econ.umn.edu/~dmiller/Ecuador%20Dollarization.pdf
http://www.cft.cw/jdownloads/Begrotingsstukken/Sint%20Maarten/begroting_2014_sint_maarten.pdf
https://www.nationalchurchillmuseum.org/blog/churchill-quote-history/
http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-2748