To dollarize or not to dollarize: the CBA's point of view

Speech by Jeanette R. Semeleer, President of the Centrale Bank van Aruba (CBA), at the Dollarization conference "Opportunities and Risks of Dollarization for the Dutch Caribbean", organized by the Minister of Finance of the Netherlands Antilles, Curaçao, Bank van de Nederlandse Antillen, August 24, 2009.

Ladies and gentleman, good morning!

1. Introduction

I am truly honored to have been invited to speak to such a distinguished audience on a topic that touches everyone's wallet, and that is dollarization. With dollarization in this context I refer to as the use of the US dollar as the exclusive legal tender in a country.

I must admit that at the Central Bank of Aruba, although we have regular bilateral meetings, we have been quite surprised with the recent consideration of the BNA to replace the Netherlands Antillean guilder for U.S. dollars as the legal tender for the island of Curaçao on a very short term.

In view of the far-reaching consequences of such a change, possibly for Aruba too, I highly applaud Mrs. De Lanooy's initiative to organize a forum of experts, which could enlighten us further on a rather complicated issue. At the end, it is of crucial importance that the required political decision is based on a thorough assessment of the opportunities and risks associated with dollarization.

In the next few minutes I will first clarify my view regarding dollarization in general and, subsequently, I will briefly focus on the special case of small island economies like Aruba and the Netherlands Antilles.

2. Dollarized countries

Countries that have dollarized their economy can broadly be divided into two categories. The first group consists of countries, which are generally small and have strong political and/or economic ties with the country that issues the currency they use.

Various island states in the Caribbean (Virgin Islands) and in the Pacific (Guam, Micronesia) belong to this group, which are in economic size comparable with Aruba, Curaçao and St. Maarten.

Other examples include the mini states in Europe like Andorra and Monaco, which use the euro as legal tender. All in all, some thirty countries or territories can be classified in this category.

The second group of countries is much smaller. It consists of economies that are dollarized because of a former special political event or economic crisis.

Ecuador is a good example of this case. At the end of the 1990's, this country experienced high inflation and depreciation of its local currency (the sucre) when the government suddenly decided to dollarize the economy, even without consulting the IMF.

Mr. Stanley Fischer, at that time Deputy Managing Director of the IMF, later stated that he would have advised against dollarization, as the banking sector in Ecuador was unhealthy and the fiscal position weak. However, in the end, the IMF decided to cooperate with Ecuador in its move towards dollarization of the economy, the latter becoming a success as economic performance in Ecuador has been fairly stable since dollarization was introduced.

The Ecuadorian case proves that it is difficult to assess the merits and the costs of dollarization. In fact, a successfully executed dollarization is not enough to realize a stable economic environment: this process needs to be followed by sound economic and fiscal policies, otherwise the situation will go from bad to worse. In other words: dollarization is not a magic wand!

3. Effects of dollarization

The case of Ecuador illustrates well how hard it is to formulate general conditions for a successful dollarization. It is not only difficult to assess the pros and cons of dollarization, it is also necessary to analyze the country's starting position, assess the political and social willingness to abandon the local currency, and to execute a sound economic policy after dollarization, in order to be able to conclude what the effects of dollarization were or are.

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

I will now briefly elaborate on the pros and cons of dollarization on a macro-economic level, thus not the operational implications. Whether an effect of dollarizing the economy is considered a positive or a negative, it could greatly differ between its advocates and its opponents.

I will now briefly refer to some effects of dollarization:

1. Dollarization could lower transaction costs, especially when most payments to nonresidents are in US dollars.

2. Depending on the capital restrictions in place and the depth of the domestic banking sector, it could lead to reduced interest rates, thereby making it less costly to borrow. This could also be the case when acquiring an international loan, as there will be no exchange devaluation premiums on rates charged to local companies and the government.

3. Because of the elimination of exchange rate risk, dollarization could be beneficial to international trade and foreign investment.

4. 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 to use the exchange rate to absorb external shocks or to finance budget deficits by printing money.

5. 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. This is typically linked to the ability of the central bank to print its country's currency.

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

7. 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 the reduced income to the government.

4. <u>View on dollarization</u>

Particularly the reduction in banking costs and the perspective of low interest rates could make dollarization appear very attractive. However, it seems to me that in a stable economic environment with strong fundamentals, a reliable macroeconomic policy, and a credible central bank, the advantages of dollarization are marginal. The more so when there is a good track record of maintaining a fixed and stable exchange rate with the US dollar.

The goal of maintaining a fixed exchange rate is to be able to benefit from the trade advantages of being anchored to the currency of the country with which there exist strong economical ties, while maintaining some degree of independence in terms of monetary policy.

Furthermore, it cannot be denied that there is a political and social aspect to this. Having one's own central bank and issuing one's own currency not only gives political status, it is often an important element of national identity.

5. <u>With regard to the case of Aruba</u>

Only a few months prior to Status Aparte in 1986, the Island Council of Aruba, after many studies and discussions, decided to institute its own central bank and issue its own currency, the Aruban florin, with the same nominal value as the Antillean guilder, and that is 1.79 florin to one US dollar. The prime reasons behind this decision were the perceived complexities within a monetary union with the Netherlands Antilles when adopting the Antillean guilder and the loss of monetary independence in a fully dollarized economy.

For those who are not fully familiar with these issues, I must point out that the decision of the Aruban authorities to peg the Aruban florin to the US dollar is a unilateral one, and is anchored in the Central Bank Ordinance, the Ordinance governing foreign exchange transactions, and the State Decree value of the florin. In other words, it takes a political decision to change the exchange rate of the Aruban florin vis a vis the US dollar.

Just as the Netherlands Antilles, Aruba has been able to maintain this peg, meaning that we have experienced an unchanged rate of exchange with the US dollar since 1971.

Starting from 1986, our economy has had an average annual per capita real growth rate of 2.3 percent, a moderate inflation (on average 4.0 percent), a debt to GDP ratio of 44.1 percent, which is still manageable, and a level of international reserves that is more than adequate (currently at 8.7 months of import payments).

In the last two decades, Aruba has made great economic progress: we chose to invest in tourism and, currently, Aruba is one of the most popular tourism destinations in the Caribbean. Two out of three of our visitors are Americans, which does not make it strange to hear that the US dollar is a widely accepted means of payment in Aruba.

These economic and institutional developments demonstrate that it is possible to issue and manage a local currency successfully in a small open economy like ours.

6. *The case of the Netherlands Antilles*

Now, I would like to turn to the case of the Netherlands Antilles. I know that dollarization of the Antillean economy has been discussed before. As early as 1986, de Boer and Kamps investigated the possibilities of dollarization in the Netherlands Antilles in a study initiated by the University of the Netherlands Antilles.[1] The authors advocated prudence with respect to dollarization of the Antillean economy, as they thought it sensible to first investigate the situation of similar countries with an experience in dollarization. To my knowledge, no follow-up has been given to this study.

The discussion was again brought up in 2005 when it became clear that Curaçao and St. Maarten would become separate entities within the Kingdom, while the BES-islands (Bonaire, Saba and Statia) elected to become an integral part of the Netherlands. De Nederlandsche Bank (conditionally) advised to form a monetary union between the various islands instead of dollarizing the economy. This was in full conformity with the recommendation made in 2004 by the working group on governmental and financial relations (headed by Mr. Jesurun).[2] De Nederlandsche Bank also mentioned that a credible and independent central bank is important when forming a monetary union and that the BNA has proved to be well-equipped for this task.[3]

7. *Concluding remarks*

In view of the forthcoming changes in the Kingdom's Statutes, Curaçao and St. Maarten will have to decide on a very short term what to do with regard to their legal tender. Although these islands are deemed too small to justify the costs associated with maintaining a local currency, our experience in Aruba, which entails the existence of a local currency linked to the US dollar and a credible central bank, gives us strong arguments to continue with our dollar-linked florin. In choosing for such an option, Curaçao and St. Maarten could continue

[1] J. de Boer / J.A. Kamps – Dollarisatie op de Nederlandse Antillen. Een verkennende studie. UNA Cahier, No. 21, June 1986.
[2] Werkgroep Bestuurlijke en Financiële Verhoudingen Nederlandse Antillen – Nu kan het… nu moet het!, p. 11 (8 October 2004).
[3] H.J. Brouwer (director DNB) – Schuldsanering van het Land Nederlandse Antillen en de afzonderlijke eilanden., Staten-Generaal, vergaderjaar 2005-2006 30 461, D en nr. 4 (Bijlage 4).

to benefit from the financial soundness of the dollar, while still maintaining a certain degree of monetary independence.

Last but not least, I would like to point out that the currency choice, whether at the end it would be a local currency or the US dollar, is purely a stage for an economic act. Depending on the actors, the outcome of the play would be a drama or a happy one. In the choice of a dollarization, the role of the central bank would be limited if not nihil, while that of the government would become even more prominent. There is a significant shift of responsibility.

While the starting fiscal position for both St. Maarten and Curaçao would be advantageous as autonomous countries, meaning a low debt stance, it is critical that fiscal rules and benchmarks are legally imbedded, and that accountability is a normal way of life. This would ensure that internal fiscal discipline is guaranteed, and it does not need to be forced upon by an external party. That is time independence.

I would even go a step further and recommend the creation of special reserves, which would be used to counteract any financial stress. This would provide the necessary confidence to promote financial and economic stability.

There is no doubt that these are exiting times in the Netherlands Antilles. I strongly advice you to learn from the experiences of Aruba, the good but also the bad ones.

I wish you success and thank you for your attention.