Dollarization in El Salvador: Revisited

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February 2012

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ABSTRACT

The economic crisis in different parts of Latin America has given rise to consideration of dollarization as an option for many of these countries. Those countries that seek to replace their domestic currencies with the US dollar do so with the hope of achieving both growth and economic stability. At the beginning of 2001, El Salvador began a bold experiment of with dollarization. According to many economists, dollarization does nothing to resolve structural and institutional problems which, in many cases, give rise to economic problems. The purpose of this paper is to address the dollarization in El Salvador. This paper will address both the costs and benefits facing the path that El Salvador has chosen

INTRODUCTION

The process where residents of a country utilize the US dollar instead of or alongside the domestic currency is called dollarization. Dollarization may be official or unofficial. It is official if the government of the country accepts the US dollar (or another foreign currency) as the predominant or legal tender currency. It is unofficial whenever the residents of that country hold US dollars, whether it is in the form of foreign currency deposits or paper money in order to protect themselves against high domestic inflation.

Recent currency crises have given impetus to dollarization. Both industrialized (Italy and the United Kingdom 1992) and emerging market countries (Brazil in 1997, Mexico in 1994, and East Asia in 1997) have undergone currency crises Currency crises, especially for emerging markets, can be quite costly. Mexico, for example, experienced a 7 percent decline in real GDP in 1995, while prior to the crises it was experiencing growth rates ranging from 3 to 10 percent... In addition, the crisis in Mexico spilled over into Argentina following the Mexican crisis. In addition contagion this phenomenon is known as contagion.

Under official or full dollarization, the U.S. dollar is the legal tender for all transactions in the economy. Several countries have already officially dollarized. Panama adopted the U.S. dollar as its official currency in 1904, Ecuador dollarized in September 2000 and El Salvador dollarized in January 2001. Unofficial or partial dollarization, which is widespread in Latin America, refers to the process where individuals substitute domestic money with foreign money in order to conduct transactions and protect the purchasing power of their income. [5] Those countries choosing to replace their domestic currencies with the US dollar are seeking to obtain economic growth and stability. By replacing their domestic currencies with the U.S. dollar, countries considering dollarization hope to achieve economic stability and growth, which is the case of El Salvador. [5]

The purpose of this paper is to address the dollarization in El Salvador. This paper will address both the costs and facing the path that El Salvador has chosen. Lastly, it will consider whether or not dollarization does not "turn out to be a "dead end" [3]. In other words, will this policy be sustainable

WHY DOLLARIZE?

In January 2001, El Salvador decided to adopt the US dollar as its currency. However, it took this decision from a position of strength, which is different for the case of Ecuador. In 1999, Ecuador dollarized in order to avoid an economic collapse. According to the finance Minister, Juan Jose Daboub, this decision was part and parcel of its economic reforms. Given the country's low fiscal deficits and low debt levels, "dollarization reduces interest rates and increases predictability, which is a boost for investment."[2]

Dollarization appears to make sense. El Salvador relies substantially on remittances sent from Salvadorians living in the US. The US is also El Salvador's principal trading partner. It is estimated that there are about two million Salvadorians in the US. It is also estimated that they remitted about $1.97 billion. This represents approximately 13% of El Salvador's GDP. [2]In order to dollarize, there needs to be a government that is seriously committed to maintaining consistency in its economic policy, and important structural and institutional reforms must be put in place. In the case of El Salvador underwent structural and stabilization reforms in which dollarization were part of the process. This was done on the expectation that foreign investment would be promoted.[5] Included in the reforms were trade liberalization, pension reform, and privatization of the banking, telecommunications and electricity distribution industries.

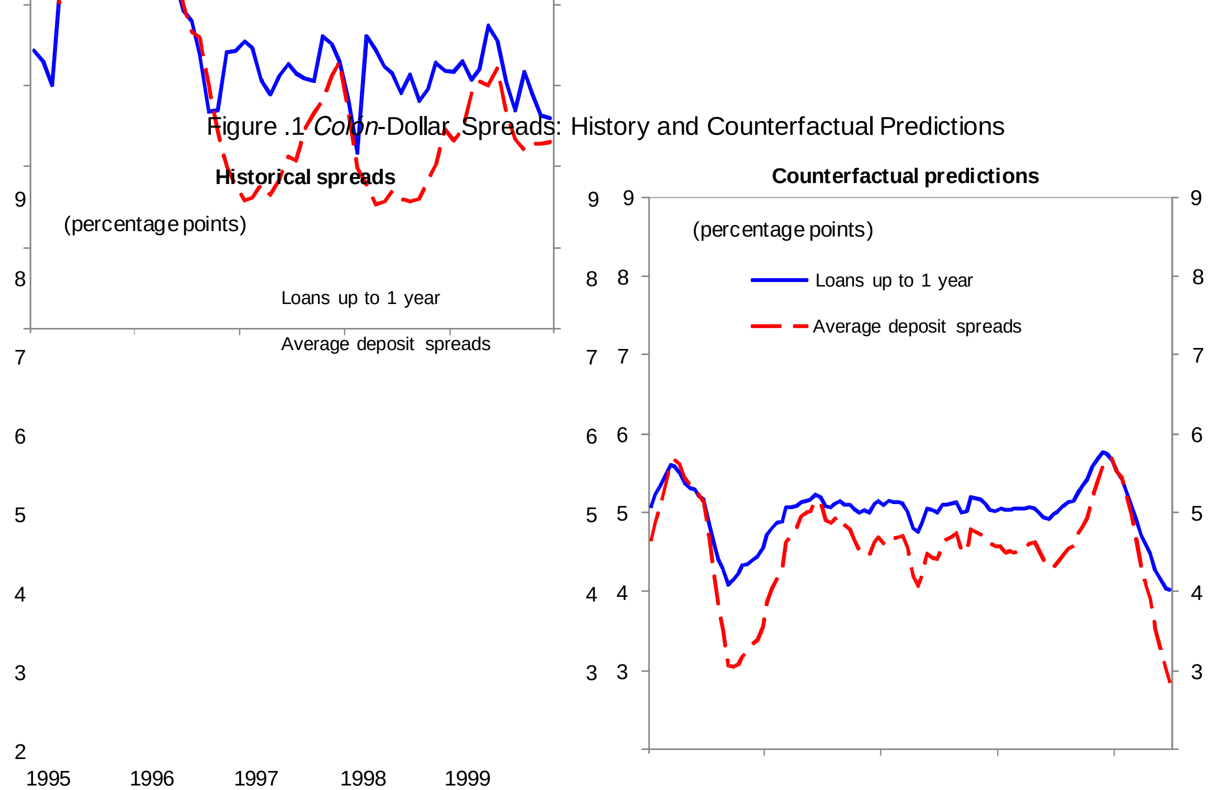
Another important factor is that El Salvador's external-debt –to-GDP ratio is very low (26%) and its total debt ratio of 35% is low. This means that El Salvador needs only a small proportion of its export revenues (10%) to meet its debt obligations. Inflation was 1.4% in 2001, down from as high as 25% in the 1980s. Furthermore, the economy has become more diversified. Coffee accounted for 60% of its exports up until the late 1990's. As a result of maquiladora assembly and export processing plants, that percentage has declined to 8%. These exports have been directed primarily to the US from $790 million in the early 1990's to $2.1 billion in 2001. In addition, El Salvador has attracted foreign investment, which in 2001 rose to $200 million 10% more than in 2000 .[2]

COSTS AND BENEFITS OF DOLLARIZATION

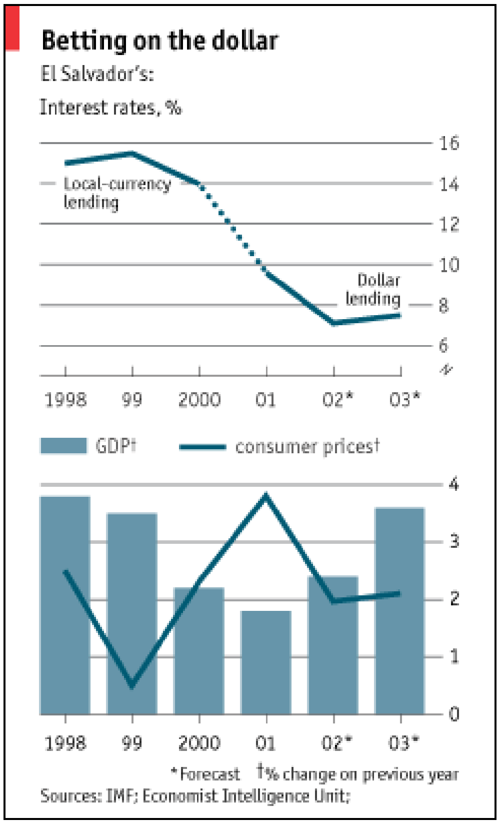
Dollarization has costs and benefits. To begin with, with the money supply will vary with net foreign reserves. This has important economic implications. The central bank cannot serve as "a lender of last resort". Its primary function is relegated to maintaining a sound and efficient financial system. Also, fiscal deficits have to be financed by alternative means as the government is not a position to print money. However, restrictions on monetary and fiscal policy could be seen as a good thing in a region with a past history of hyperinflation. In the event of a recession, if the government tried to institute countercyclical spending, such a move could be interpreted as the loss of the country's commitment to maintaining consistency in its economic policy. Another cost to consider is the loss of seigniorage which is the revenue from issuing currency. "Net seigniorage is the difference between the cost of putting money into circulation and the value of the goods the money will buy which is the revenue that the government receives for creating money."[5] According to Swiston [6, p.11]," the public sector's gains from lower interest rates outweigh the estimated foregone seigniorage revenue by ¼ percent of GDP per year." In addition, seiniorage only transfers resources from the private sector to the public sector. It does not create wealth.

It was expected that interest rates in a fully dollarized economy would decline. This is true for El Salvador as interest rates fell from 14% to 7.5% in 2001. Figure 1 and 2 reveal that since dollarization interest rates have declined. In addition, inflation is relatively low and growth rates have been good. Offsetting the fall in rates could be an increase in country risk or default risk. To date this has not been the case for El Salvador. El Salvador has received investment grade ratings from both Moody's and Fitch ratings. Standard and Poor's has given El Salvador a BB+. It appears that investors find El Salvador as a good investment as it is based on the dollar and they are not subject to currency risk. The present soundness of the economy also makes El Salvador attractive to investors. [2] The ability of a country to meet its debt obligations affects default risk. To avoid default risk, it is imperative that El Salvador continue to maintain its commitment to debt repayment and fiscal discipline.

Figure .1 *Colon*-Dollar Spreads: History and Counterfactual Predictions



Source: Swiston (2011),



2 2 2
2001 2003 2005 2007 2009

However there have been adverse conditions which have negatively impacted on economic growth, such the increase in oil prices, major earthquakes, and political uncertainty. Because of the high oil prices, shows and estimated real GDP growth or approximately 1.5%. Because of high oil prices, inflation is also expected to be around 5.. An important factor that has helped offset the rise in oil imports is family remittances from abroad. These remittances have aided in the decline of the current account deficit. [4]

Another important benefit of dollarization is the opening up of the financial system. The increased capital mobility resulting from dollarization there is greater competition and efficiency. The financial system becomes more integrated with the rest of the world. The risk here is that the country is exposed to "external shocks, and it can make coping with internal shocks more costly." [5] Should a natural disaster occur, the country would have to depend more heavily on external resources for its reconstruction efforts. Monetary and exchange rate policies would not be available to deal with the negative impact of such external shocks.

It should be pointed out that in the 2004 Financial System Stability Assessment, the IMF Executive Board found that the financial sector in El Salvador was "that the financial sector generally is in good health and that dollarization has strengthened financial stability" [4] It has been argued that the costs of dollarization for El Salvador outweigh the benefits. In their analysis, dollarization increases inequality and hence it has a negative effect on the poor. As the poor have no access loans they really cannot benefit from low interest rates.

CONCLUSION

As pointed out above dollarization has provided both costs and benefits. Some of those benefits include closer integration with international markets and exposure to competition from these markets. The costs of dollarization include the loss of seigniorage and a potential for greater fragility of the banking system. Such fragilities can limit the policy options available to the authorities, as well as put an additional burden on the central bank as lender of last resort." [1] As it was pointed out above, there was a substantial saving for the economy with the reduction of currency risk premiums which are found in interest rates in El Salvador. In addition, Swiston [6] estimated "net interest savings of ½ percent of GDP per year for the Salvadoran private sector and ¼ percent of GDP for the public sector, taking into account the opportunity cost of foregone seigniorage under dollarization. "

The key question that arises is whether or not dollarization is sustainable in the long run. A fully dollarized economy has to rely on foreign currency or international reserves to flow on a continuous basis as well on international market conditions. It has to be able to attract foreign investment and net borrowing in order to maintain economic growth. [5] To be sustainable, dollarization requires fiscal discipline and a sound financial system that can respond to financial crises. In essence, dollarization results in the dismantling of both monetary and fiscal policy.

According to Izurieta [3], "…by dismantling the exchange rate and monetary policy, fiscal policy is no longer a policy tool if the financial stability of the system is to be guarded." If that is the case, policymakers do not have the necessary tools to protect employment and generate income. In the case of El Salvador, dollarization could turn out to be a "dead end".

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