# Lecture 9

# Currency Board and Dollarization

Need to import monetary stability, due to either a history of hyperinflation or absence of credible public institutions;

Currency Board: is a monetary institution that only issues domestic currency that is fully backed by foreign assets. The domestic currency is convertible into a foreign anchor currency at a fixed rate and on demand.

-anchor currency: it is a currency chosen for its expected stability and international acceptability

-convertibility: a currency board maintain full and unlimited convertibility between its noted and coins and the anchor currency at a fixed rate.

-foreign reserves are composed by low-risk, interest bearing bonds and other assets denominated in the anchor currency. Currency board reserves are qual to 100 percent or more of its notes and coins in circulations, as set by law.

-currency board generates profits (seignorage) from the difference between interest earned on its reserve assets and expense in maintaining its liabilities (notes and coins in circulation).

-no discretion in monetary policy $\Rightarrow$ market forces determine money supply. The only function of a currency board is to exchange notes and coins for the anchor currency at the fixed rate. It does not lend to domestic banks or to the government.

-fixed rate between the domestic currency and foreign anchor currency tends to keep interest rates and inflation in the currency board country roughly the same as those in the anchor currency country.

-currency board does not act as a lender of last resort to protect domestic banks from losses.

When should a country adopt a currency board?

-currency board are appropriate in countries where national currency has not performed as well in the long term as major internationally traded currencies (this criterion does not consider any dimension like openness of the economy or its dimension).

Today's currency board: Hong-Kong (HK$7.80=US$1). Not truly orthodox system in which Hong Kong Monetary Authority acts like a central bank (1998 bought a massive amount of Hong Kong shares on the stock market). Problem is that there is no law that defines properly the regime.

Argentina had a currency board regime from April 1991 to January 2002 (US$1=1peso)

Estonia from June 1992 (8 kroon=1 German Mark)

Bulgaria from July 1997 (1000 leva=1 German Mark)

In most cases no truly orthodox currency board regime. Central banks retain their old powers and coexist with the currency board regime.

Conditions that are important in order to guarantee the success of a currency board system: currency board is not successful without the solid fundamentals of adequate reserves, fiscal discipline and a strong and well supervised financial system, in addition to the rule of law.

Dollarization: occurs when residents of a country extensively use a foreign currency alongside or instead of the domestic currency. Official dollarization occurs when the government adopts the foreign currency as a legal tender.

Unofficial dollarization: there is no legal element. (different stages: asset substitution (holding foreign bonds and deposits abroad), currency substitution (holding foreign currency deposits in domestic banking system).

Panama is an example of official dollarization;

Andorra had two currencies as legal tender: French franc and Spanish Peseta.

Difficult to assess the performance of dollarized economy: not much evidence.

How does dollarization work?

An officially dollarized country is part of a unified currency zone with the country whose currency it uses, otherwise called issuing country. An officially dollarized country relinquish independent monetary policy and imports monetary policy of the country whose currency it uses.

Within the currency zones, arbitrage tends to keep prices of similar goods within a narrow range $\Rightarrow$ inflation rates tend to be similar throughout the zone.

Interest rates tend also to be equalized across the currency zone (still country risk element might contributing in creating a wedge between interest rates).

Supplied of money is determined by the balance of payment: the monetary base is determined by the issuing country and if people want to acquire more foreign currency notes they have to spend less.

Cost of dollarization for officially dollarized countries:

-lost of seignorage;

-one time cost of converting prices;

-losing central bank as a lender of last resort;

-losing flexibility in monetary and exchange rate policy;

Benefits of dollarization for officially dollarized countries:

-lower transaction costs;

-reducing the country risk premium on foreign borrowing;

-lower inflation and lower risk of future inflation;

-greater economic openness and transparency;

When should countries adopt an official dollarization regime?

a) history of poor monetary performance;

b) many economists have proposed the theory of optimum currency area to judge where official dollarization is desirable.

c) critical role of major trading partners;

d) political considerations;

Dollarization versus currency board: main advantage of dollarization over a currency board is that dollarization is likely to have more credibility because it is harder to reverse. The main advantage of a currency board over dollarization is that a currency board retains seignorage domestically whereas dollarization does not under the current policies of the countries issuing the major international currencies (likely choices for countries interested in dollarizing). But a dollarizing country, by completely eliminating the risk of currency devaluation, gains lower interest rates on foreing borrowing.