

The use of foreign currencies: the United States perspective

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1. Introduction

Several countries have adopted the US dollar as legal tender and their official currency. Such countries are said to have “dollarised”. In many other countries, the US dollar is held as an investment and/or used in market transactions alongside a local currency that serves as legal tender and the official currency. In the past few years, there has been an increase in interest in dollarisation. In 1999, Argentine officials publicly debated dollarising but in the end decided to maintain the country’s currency board arrangement. (The currency board arrangement was abandoned in early 2002.) In 2000, Ecuador and El Salvador unveiled plans to dollarise their economies. Also that year, a bill to share US seigniorage revenues with dollarising countries was approved by the Senate Banking Committee, but was defeated in a House Banking Subcommittee. (Currently, there appears to be little or no interest in the US Congress in legislation for sharing seigniorage revenue.)

2. Economic issues associated with dollarisation

At present, there is no consensus in the economics profession regarding the net benefits that dollarisation might confer on the dollarising economy. Proponents argue that, by irrevocably fixing its exchange rate against the dollar and hence precluding future currency crises, a country will find it easier to contain inflation and inflationary expectations, face lower costs of credit in financial markets, and hence enjoy higher and more stable rates of growth. Dollarisation is viewed as a way of making a strong commitment to macroeconomic stability.

Critics of dollarisation note that adopting the dollar means giving up seigniorage revenues, some degree of political sovereignty and the ability to adjust monetary policy – including the capacity for the authorities to provide a lender of last resort facility – and exchange rates in response to economic shocks. Moreover, dollarisation does not preclude debt crises if a country borrows more than it can repay, nor does it preclude a country’s abandoning dollarisation in favour of its own currency sometime in the future.

The likely effects of dollarisation, were it to become widespread, on the United States are uncertain. To the extent that dollarisation either raised or lowered growth abroad, there would be corresponding indirect effects on US trade and growth, although these effects would probably not be large. Dollarisation would be very likely to increase foreign holdings of dollars, leading the US government’s seigniorage revenues to rise, but probably not by much relative to total US government revenue. Finally, to the extent that dollarisation made the dependence of foreign economies on the US economy more explicit, there is a risk that this could lead to some political and diplomatic pressures on US authorities in an attempt to influence US monetary and financial policies.

In terms of more systemic effects, dollarisation tends to lower the transaction costs of the dollarising economy’s economic and financial dealings with the United States and other dollar markets. It thus tends to promote economic and financial integration with the US economy, although policies regarding trade and capital flows are likely to exert a much greater influence. Dollarisation should also foster enhanced links with the global economy more generally, including access to international financial markets.

3. US policy vis-à-vis dollarising countries

Historically, the US authorities have not objected when foreign countries have adopted the dollar as their official currency, but there has been no attempt to promote the use of the dollar in foreign

countries. During the Clinton Administration, Argentina's interest in dollarisation and some US Senate interest in using seigniorage sharing as an incentive to induce more countries to dollarise occasioned a systematic effort to formulate a US policy on dollarisation. In his 8 February 2000 Senate testimony, then Assistant Secretary of the Treasury for International Affairs Edwin Truman outlined the Clinton Administration's policy clearly:

"We do not have a view on whether dollarisation is advisable in general. Each country, in principle, can dollarise unilaterally, and it must bear the responsibility to decide in light of its own economic and political circumstances if dollarisation is the appropriate policy to pursue.

From the US perspective ... it would not be appropriate for US authorities to adjust the procedures or orientation of US monetary policy in light of another country's adoption of the dollar; to extend banking supervision to that country's banks; or to provide access by those banks to the Federal Reserve's discount window

Obviously, countries can choose to adopt the dollar as legal tender without our assent. However, we hope and expect that countries would consult with us in advance as there are potential benefits as well as costs to the United States from the adoption of such a policy."

There is no reason to think that the Bush Administration has a different view on dollarisation. However, neither the Bush Administration nor Congress is bound to the policy articulated by the Clinton Administration. US policy on dollarisation could very well evolve over time as circumstances change.

4. Federal Reserve policy on dollarisation

In the context of recent discussions about dollarisation, the Federal Reserve has made its policy clear. The Federal Reserve neither encourages nor discourages countries that are considering dollarisation. The decision to dollarise depends on a complex set of factors that may vary significantly across countries. Accordingly, only the national authorities of a given country are in a position to assess adequately the competing considerations. The Federal Reserve considers seigniorage sharing to be a budgetary issue, which should be resolved by the Administration and Congress.

The decision of a country to dollarise creates no obligations on the part of the Federal Reserve towards that country. In particular, the Federal Reserve is not obliged to act as a lender of last resort to financial institutions of officially dollarised countries, supervise their financial institutions or take into account their economic and financial conditions when setting US monetary policy.

In terms of the mechanics and logistics of dollarisation, countries implementing dollarisation regimes are free to purchase the necessary currency through the commercial banking system. In addition, the Federal Reserve has facilities for selling currency directly to central banks and international institutions, provided such entities hold an account at the Federal Reserve Bank of New York. In all cases, those obtaining dollars are responsible for paying shipping, handling and other costs associated with the purchase and transport of the currency. In some foreign countries, the Federal Reserve maintains currency distribution facilities. In general, every effort is made to deliver the currency notes as needed, on a commercial basis.

The Federal Reserve System periodically provides technical assistance in an array of areas to other governments, subject to constraints on its resources. Requests to provide technical assistance to countries in the process of dollarisation will be considered along with other requests, with help given as feasible and appropriate. The Federal Reserve does not provide the equipment required to dollarise (for example, machines for counting currency and checking for counterfeits). However, the Federal Reserve will provide information on what types of equipment are available and where such equipment can be obtained. The US Secret Service stands ready to help foreign entities learn how to distinguish between genuine and counterfeit US currency notes.