



# Pros and cons of dollarisation

## Benefits of exchange rate pegs outweigh drawbacks

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**I**nflation-targeting remains the dominant fad in central banking circles, but that does not make it appropriate for universal use. For monetary policy-makers in small open economies, headline inflation is an unfair metric. A high dependence on imports, especially on volatile items such as food and fuel, highly distorts the influence of the supply of money on inflation, and thus the perception of central bank credibility.

In today's world where most large international transactions are electronically managed, migration is high, remittances are large and financial relationships opaque, central banks in open economies have lost control of the domestic money supply. These linkages offer possibilities for international financial flows about which there may be no reliable information. Exchange controls, once hailed as the way through which central banks could retain control over domestic money, have become an ineffective rationing tool.

### Benefits and costs of dollarisation

The conventional view is that the central bank can retain control of the money supply by allowing the exchange rate to be set by supply and demand for foreign exchange. The problem for small economies is that domestic money is always inferior to the dollar or euro as a store of value, and often as a means of payment as well.

Because of this, the demand for dollars and euros by small economies is limitless, compared to the total of foreign earnings and foreign borrowing in any given period. If the relationship between the local currency and the dollar or euro is not assured, the only people who will do business in local currency are those who have no access to foreign exchange.

These realities were part of the reason behind the adoption of the euro by small open economies in Europe. The question arises whether similar economies elsewhere might find it in their best interest to follow the examples of Panama, Ecuador and El Salvador, and abolish their own currency in favour of the dollar. For countries whose currencies have depreciated rapidly, the case for full dollarisation seems compelling.

The obvious counterargument is that the exchange rate should be retained as a tool for improving competitiveness. But in a world where rate fluctuations are governed by uncertain international financial flows, multinational production and strategic investment planning, that tool is of dubious

effect, even in large economies. In small open economies the effect of the exchange rate on competitiveness is yet lower. Exporters in such economies are price takers in a competitive international market, and exchange rate pass-through tends to be high.

Despite these caveats, the benefits of dollarisation should not be overestimated. Where currencies have a credible track record of stability, particularly against the dollar, there is merit in maintaining exchange rate independence.

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In this case the local currency stands as testament to sound economics. It acts as a powerful motivation for the implementation of economic policies that are appropriate to the country's productive structure and to changing financial circumstances. The challenge has been to find the way to balance the supply and demand of foreign exchange, at an exchange rate which does not change.

### Fiscal tools to support trade

The economic policy framework in use in Barbados is designed to address this challenge. The exchange rate between the Barbados dollar and the US dollar has remained unchanged since 1975, with the help of fiscal tools that are applied to the supply and demand of foreign exchange in the market.

Fiscal incentives of various kinds are used to support tradable activities in which the country has a comparative advantage, such as high-end tourism. The size and financing of the fiscal deficit are calibrated to contain aggregate spending. This limits the demand for foreign exchange to the available supply.

In the short run, any required economic adjustment relies on demand, because it takes time to create new supply capacity. Whenever there is a shock that reduces foreign exchange inflows or increases outflows, expenditure is cut and fiscal policy tightened, whatever the cause. Ideally fiscal tightening should be accompanied by a



twist that provides additional support for building capacity in activities where there is an established or potential comparative advantage. Such a strategy helps to accelerate the building of additional foreign exchange supply capacity, which can bring forward the time when the short-term fiscal limits can be relaxed.

### Currency impact on investment appeal

The benefits of a credible exchange rate anchor include reduced investor uncertainty, reinforcement of domestic savings habits, and a strong, transparent incentive for sound fiscal policy. The international investor in a small open economy which has a floating exchange rate must deal with an additional source of uncertainty, in comparison with investment in a country with a credible peg. All other things equal, the country with the pegged rate will be the preferred destination for that investment.

The erosion of the external purchasing power of domestic money that comes with a large devaluation has a devastating impact on domestic savings habits. The memory of the loss of value of pension benefits, for example, often destroys the domestic currency pensions business for a generation or more.

On the positive side, fear of devaluation has proven to be a powerful motive for fiscal discipline in small open economies, precisely because of awareness of the uncertainty and inflationary consequences of devaluation. ■

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