

Commentary

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1. INTRODUCTION

Dollarization is a complex policy issue with obviously dramatic implications for central banks in countries that choose to dollarize. In analyzing the future of central banking in small, open economies, Alberto Trejos makes at least three contributions to the dollarization literature. First, he provides an excellent review of the standard arguments surrounding dollarization, focusing on seigniorage. Second, the paper stresses that countries are already dollarizing as bank liabilities and assets become increasingly dollar denominated. The paper suggests that dollarization is an inevitable process of openness for many countries. Third, the paper develops a bargaining model between a small country and a big country over the seigniorage revenues lost by the small country to the large country. The paper suggests that coordination can improve welfare in both countries. This coordination involves the small country "dollarizing" more quickly than it would without a bargained outcome, and the large country sharing some of its seigniorage gain with the small country. In my comments, I will briefly discuss each of the three contributions.

2. REVIEW OF THE MAJOR THEMES IN DOLLARIZATION

Trejos does a nice job of reviewing many of the big issues in dollarization, some of which have potentially large macroeconomic implications. Trejos notes that high-inflation countries may dollarize to reap the growth dividends of lower inflation. Some work suggests that inflation has substantial long-run growth effects. In recent work, Levine and Carkovic (2001) find that a substantial reduction in inflation—from, say, 14 percent to 4 percent, would induce an increase in the long-run per capita growth rate of 0.3 percentage point to 0.4 percentage point per year. This is substantial and would increase the actual growth rates that many Latin American countries have experienced in the last 30 years by 50 percent to 100 percent. One may question these estimates. Some researchers suggest the growth effects of inflation are much smaller; others, however, find similarly large growth effects. The point I want to emphasize is that potential growth effects such as these could turn the heads of some policymakers toward dollarization.

Trejos further notes that if inflation reaches 10 percentage points, the real wage falls to a level that is 10 percentage points below the level achieved relatively stable inflation. This is estimated to run around 5 percent of GDP. A 5 percentage point drop in the interest rate on government debt to GDP in interest payments. Inflation reaching 2 percent of GDP. This does not simply represent a level of inflation that is fatal to firms could stimulate long-run growth. It may also be dubious. Again, the evidence suggests that by eliminating inflation and interest rates, dollarization could be a good idea.

Trejos discusses other macroeconomic issues. A reduction in transaction costs could be a good idea. It would eliminate independent banks and the ability of the government to print money. It also force fiscal austerity and a change in monetary policy. Again, the evidence suggests that inflation, currency risk premium, and other issues are very big issues.

This discussion, however, does not address the factors in the dollarization decision. For instance, in a book by Hebbel (1994) show that a 1 percent–2 percent of GDP reduction in seigniorage revenues. I would really like to see the calculations—that suggest that a 1 percent–2 percent of GDP reduction in seigniorage revenues. This is particularly important for developing countries losing seigniorage revenues.

3. THE INEVITABLE

Trejos' paper suggests that dollarization is inevitable and that this trend has been going on for a long time.

If this is the case, then the future shape of central banking is an attractive building block of the future.

Trejos further notes that the currency risk premium reflected in some countries reaches 10 percentage points. Even in Costa Rica, where the central bank has achieved relatively stable inflation rates, the currency risk premium is sometimes estimated to run around 5 percentage points. Because financial intermediary credit to GDP has averaged about 20 percent of GDP in Costa Rica, a 5 percentage point drop in the interest rate would save borrowers approximately 1 percent of GDP in interest payments. In Argentina, the potential savings are larger, perhaps reaching 2 percent of GDP. These numbers are not staggering. However, they might not simply represent a level drop in interest payments. The drop in the cost of capital to firms could stimulate long-run productivity growth increases. These numbers may also be dubious. Again, the point is that some back-of-the-envelope calculations suggest that by eliminating a very costly currency risk premium imbedded in interest rates, dollarization could have large growth effects.

Trejos discusses other major dollarization issues. Dollarization may induce a reduction in transaction costs that eases international integration. Dollarization would eliminate independent monetary policy and, under some circumstances, limit the ability of the government to act as a lender of last resort. Dollarization might also force fiscal austerity and better bank regulation by eliminating discretionary monetary policy. Again, the point is that there are some reasons for believing that inflation, currency risk premiums, and relinquishing control of monetary policy are very big issues.

This discussion, however, raises the following question: Given these important factors in the dollarization debate, is bargaining over seigniorage revenue a critical issue? For instance, in a book on fiscal policy, Easterly, Rodriguez, and Schmidt-Hebbel (1994) show that seigniorage is not huge—perhaps a maximum of 1 percent–2 percent of GDP per year in the long run. They also show that in many developing countries, revenues from the tax on cigarettes are greater than seigniorage revenues. I would really like the current paper to provide evidence—or rough calculations—that suggest that bargaining over seigniorage is a first-order issue. This is particularly important because the paper suggests that many countries are losing seigniorage revenue anyway as residents increasingly move into dollars.

3. THE INEVITABILITY OF DOLLARIZATION

Trejos' paper suggests that many countries are on an inevitable path toward dollarization and that this trend has been increasing and will continue to increase. Maybe.

If this is the case, then the paper has obviously enormous implications for the future shape of central banking. If international integration is a decisively attractive building block of economic success, and if international integration is

leading inexorably to dollarization, then we will end up with the type of world discussed by Alberto Trejos: a world with few currencies. This is important and could change the nature of the discussion about dollarization. If dollarization were an inevitable product of lowering official taxes and limits on transacting with the rest of the world, then this would importantly alter the debate.

This still strikes me as an open question, however: How much confidence should we have in the claim that as countries become increasingly open, they will move persistently toward dollarization? I would like to see more convincing evidence that countries are moving toward dollarization because of openness and not because people have little confidence in the domestic policy regime. In a nice paper, Savastano (1992) shows that dollar-denominated deposits as a share of total deposits vary considerably over time in Latin American countries. How much confidence should we have that recent trends in Latin America are going to continue?

4. BARGAINING OVER SEIGNIORAGE

The paper develops a nice bargaining model based on joint work with Wright. I would simply like to pose a few questions about the focus of the model.

Is the United States really going to bargain over seigniorage revenue with a very small country, especially when (1) the country already holds a substantial portion of its medium of exchange in U.S. dollars; and (2) the model presumes an ongoing process of dollarization, so that the U.S. is going to get all of the seigniorage revenue in the end anyway? I would benefit from additional arguments that bargaining over seigniorage revenue will be a crucial element in shaping central banking over the next 20 years.

This paper made me think, and I urge others to read it. It gave a great review of major policy issues, and it forced me to reconsider where dollarization fits into the literature on international financial liberalization.

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PART III

PRIVATE ALTERNATIVES TO CENTRAL BANKS