Dollarization and Sense[1]

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More than the Big Mac, Coca Cola, or Levi's 501 jeans, the dollar is surely the United States' signature export. Having long had a market among money launderers, drug smugglers and tax evaders, it has now gone up-market. Rather than seeking to produce a stable currency themselves, a growing number of Latin American governments are considering importing it -- that is, giving the U.S. dollar legal tender status. In 1998 there was talk of Argentina adopting the dollar. Now Ecuador seems ready to jump on the bandwagon.

How should U.S. firms considering whether to establish a distribution network or open a branch plant in Latin America regard the news that a country is contemplating dollarization? It would seem, at first blush, that dollarization must be good. Replacing the local currency with the greenback simplifies planning. It eliminates currency risk. It removes the possibility that accounts receivable will be inflated away. Doesn't this necessarily make the country a more attractive place to do business?

The answer, alas, is no. Countries are tempted to adopt the dollar under two very different sets of circumstances. One is that of "Country A," for which dollarization is the culmination of a long process of policy reform. The government first halts inflation. It strengthens the banking system, cuts the budget deficit, and pushes through labor market reform. Only then does it adopt the dollar. The economy having been properly primed, living with the dollar is easy. And by making it all but impossible for the government to revert to its bad old

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inflationary ways, dollarization locks in other policy reforms. One can hardly imagine a better place to invest.

Then there is "Country B," where reform has not yet begun. This country suffers from an unsustainable budget deficit, high inflation, severe banking problems, and political unrest. Dollarization is seen as a way of jump-starting reform and restoring investor confidence. With the adoption of the dollar, inflation will come down at a stroke. Exchange rate instability will disappear. With no central bank to finance the budget deficit, politicians will be forced to find the resources to balance the budget and recapitalize the banks. Previously factious interest groups will have to hammer out an agreement on how to pay the bills.

Note, however, how this process works. Dollarization intensifies the pressure to reach a political consensus by foreclosing other options. It raises the stakes. This, of course, also raises the possibility of another, less happy outcome. If consensus is not achieved, then the government, no longer being able to print money, will have no way of averting the collapse of the banking system. Unable to finance itself with the printing press, it will have to gut public programs. Its fiscal cuts will be seen as arbitrary and inequitable, leading the indigenous peoples to descend from the highlands and call for the president's ouster. Political and financial chaos, not stability, will result. For this country, dollarization is a high-stakes gamble with no guarantee of success. It makes investment there risky business.

"Country A," of course, is Argentina, while "Country B" is Ecuador. Clearly, American managers, when making strategic decisions, need to know more than simply that a country is prepared to dollarize. They need to understand the circumstances that have brought it to this point.

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