

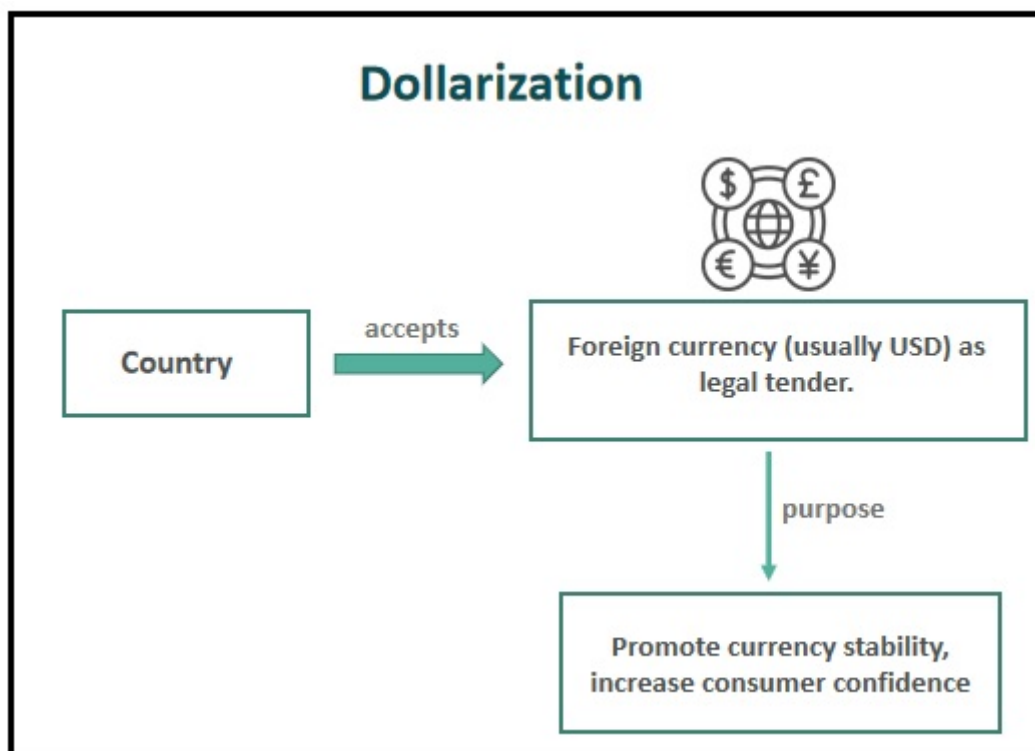
Dollarisation

Why in news?

Javier Milei, the recent winner of Argentina's presidential election, has drawn attention for his plan to replace the country's currency "Peso" with the dollar.

What is dollarisation?

- It is the process by which a country decides to use two currencies the local currency and generally a stronger, more established currency like the US dollar.



- **Occurrence-** It occurs in developing countries with a weak central monetary authority or an unstable economic environment.
- It usually happens when a country's currency becomes unstable or loses its value due to high inflation or other economic problems.
 - **Example-** Zimbabwe ran a dollarization test to see if the adoption of foreign currency could reduce high inflation and stabilize its economy.
- **Types-** There are 4 types of dollarization that countries can adopt.

Types of dollarisation

Complete dollarisation

- It implies that foreign currency is the only legal tender in the country.

Partial dollarisation

- It implies that the foreign and local currencies are accepted as legal tender.

Official dollarisation

- It implies that the country's government and monetary authorities have accepted a foreign currency as its legal tender.

Unofficial dollarisation

- It occurs when the people in the country have their savings in foreign currency in the form of investment instruments.

What is the significance of dollarisation?

- **Economic stability**- It can *lower inflation rates and stabilise prices*, as the dollar is less prone to devaluation and volatility than the domestic currency.
- **Promote investment**- It can *avoid currency crises*, which reduces the sovereign risk premium and *lowers interest rates*, leading to higher investment and growth.
- **Boost trade**- It can *facilitate trade and integration with international markets*, as the dollar is stronger and more widely accepted than the domestic currency.
- **FDI destination**- It can *encourage foreign direct investment (FDI)*, as investors do not need to worry about exchange rate risks or currency fluctuations.
- **Cost effective**- It can *promote fiscal discipline* and a competitive financial system, as the government and the banks cannot rely on printing money to finance their deficits or bailouts.

3 fully dollarised economies - Ecuador, Panama and El Salvador have had successful economic outcomes following dollarisation.

Ecuador model of dollarisation

- **Price stability**- It helped the country to reduce inflation which was over 100% in 2000 to around 4% in following years.
- **Lower interest rate**- Interest rate declined making credit more affordable and encouraging investment and consumption.
- **Fiscal discipline**- It limited government's ability to finance its spending by printing money. This also improved the country's credit rating and reduced its country risk premium.
- The country used the oil revenues to increase social spending and reduce poverty and inequality.

What are the issues of dollarisation?

- **Monetary autonomy**- It can reduce the country's monetary autonomy, which means it cannot adjust its money supply or interest rates according to its economic needs.
 - Greece benefited from using the Euro as a common currency, but lost its policy autonomy.
 - Ecuador's dollarisation led to losing of monetary autonomy and exchange rate policy autonomy.
- **Seigniorage**- It can lose the revenue generated by issuing currency.

Seigniorage is a term that refers to the profit that a government or a central bank makes by issuing money.

- **Country's identity**- The country may face a loss of public support or legitimacy, especially if the decision to dollarise is perceived as imposed by external forces or interests.
- **External factors**- It can increase the country's vulnerability to foreign influence and external shocks, as it depends on the US monetary policy and dollar availability.
- **Liquidity risks**- It can impair the lender-of-last-resort's ability to provide emergency liquidity to the financial system in times of crisis.

What lies ahead?

- Dollarisation is not a silver bullet, but if used well in conjunction with domestic policy, it can offer a route to success.
- Dollarisation should be implemented in a country based on dollar reserves, fiscal policy, trade policy and external shocks to realise its full potential.

De-dollarisation

- It is the process of *reducing the reliance on the US dollar* as a reserve currency, a medium of exchange, or a unit of account in the global economy.
- It gained prominence due to US-China trade war, COVID-19 pandemic, rise of digital currencies and growing multi-polarity in world economy.
- It can increase monetary autonomy, diversify their currency reserves, or challenge the US influence on the world financial system.
- **Global regulatory landscape-**
 - **China-** It is promoting the use of its **Renminbi** in international trade and finance, especially with its [Belt and Road Initiative](#) partners.
 - **Russia-** It promotes the use of **Rouble** after facing US and European Union sanctions over its involvement in [Ukraine](#).
 - **India-** It has released a roadmap for the [internationalisation of the Indian rupee](#) to create broader acceptance for increasing trade and investment ties.
 - **European Union-** It is promoting the use of **Euro** in international currency to reduce its exposure to US sanctions and monetary policy spill overs.

References

1. [The Hindu- Can dollarisation save an economy](#)
2. [Indian Express- Dollarisation in Argentina](#)

