

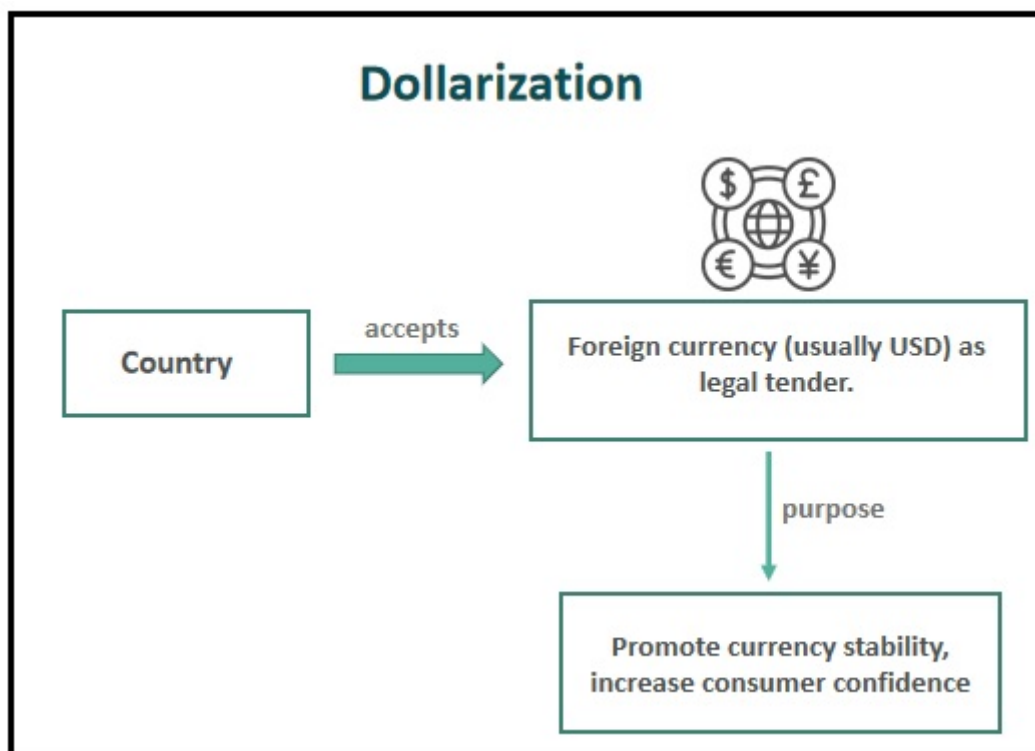
## Dollarisation

### 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](#)

