

**Currency Arrangements**

Currency Unions  
Currency Boards  
Dollarization

---

---

---

---

---

---

---

---

**Currency Arrangements**

- Currently, there are many situations in the world where countries do not use their own currency.
- In some cases, multiple countries use a single currency (currency union), while others have completely adopted another country's currency (Dollarization)

---

---

---

---

---

---

---

---

**Benefits of a Currency Union**

- 1) Transaction Costs Reduction
- 2) No exchange rate uncertainty
- 3) Increased competition –direct comparisons much easier
- 4) Strength of currency
- 5) Single capital market
- 6) No competitive devaluations
- 7) Fiscal Discipline

---

---

---

---

---

---

---

---

**Costs of a Currency Union**

- 1) Introduction Costs
- 2) Non-synchronicity of Business Cycles
- 3) Fiscal Policy Spillovers
- 4) No competitive devaluations
- 5) Central Bank Independence

---

---

---

---

---

---

---

---

**Optimal Currency Areas**

- Is Europe an “optimal currency area”, or should there be several “European” currencies? Should the US have more than 1 currency?
- How does one decide whether or not countries should form a currency union?
- 2 main criteria
  - Synchronicity of business cycles
  - Bilateral-trade intensities

---

---

---

---

---

---

---

---

**European Monetary Union**

- The EU origins are in the Treaty of Rome (1957) –6 original countries: BeNeLux, Italy, France, Germany
  - 1973: UK, Ireland, Denmark
  - 1981: Greece
  - 1986: Spain, Portugal
  - 1995: Austria, Finland, Sweden
- Why form: Post-WWII BoP problems - initiate tariff reduction and aid system

---

---

---

---

---

---

---

---

**EU/EMU**

- Maastricht Summit (1991)
  - Economic and Monetary Union in 1999
  - Goal: Single currency in 2002 (euro)
- Prior to euro – ECU (European Currency Unit)
  - Ecu – artificial “basket” of currencies used by members
  - Created in 1979 when EU was EEC
  - Part of the European Monetary System

---

---

---

---

---

---

---

---

**European Monetary System (Pre-EMU)**

- “Limited Flexible Exchange Rate System”
  - exchange rate bands at 2.25% (wider for Italy)
- Adjustable-Peg system
- Not all European countries participated
- When euro was introduced, ecu:euro exchange rate was set at 1:1.
- Value of ecu: determined by a weighted value of the member countries own currencies

---

---

---

---

---

---

---

---

**European Monetary Union**

- Aspects of the EMU
  - Jan 2, 2002 – banknotes and coins in circulation
  - 11 countries participating
    - UK,Denmark,Sweden,Greece not members
  - European Central Bank created
    - Primary objective: maintain price stability
    - Very independent from member countries

---

---

---

---

---

---

---

---

### Maastricht Criteria

- 5 criteria to meet for EMU membership
- 1) Price stability (low inflation)
  - 2) Fiscal prudence (Deficit and Debt)
  - 3) Maintain stable ER (stay within EMS bounds)
  - 4) Low long-term interest rates

---

---

---

---

---

---

---

---

### Dollarization

- Dollarization occurs when a country adopts the currency of another country as its official currency. Usually, but not always, this is the US\$.
- This may occur as either “total” or as “partial” dollarization
- **Total Dollarization** – the US dollar is made the only medium of exchange, store of value, and unit of account
- **Partial Dollarization** – US dollars circulate alongside domestic currency
- Why Dollarize? Countries are searching for ways to protect their economies from financial crises

---

---

---

---

---

---

---

---

### How Do Countries Dollarize?

- Countries can dollarize in two ways
- 1) The foreign government makes a decision to replace its own currency with the US\$
    - In total dollarization, US\$ used for all transactions
    - In partial dollarization, citizens can hold \$-denominated accounts
  - 2) Citizens lose faith in their own currency and adopt the US\$ as their own currency (de facto dollarization)
    - Inflation/Hyperinflation pressures
    - Political concerns

---

---

---

---

---

---

---

---

**Benefits of Dollarization**

- What are the benefits of dollarization?
  - Eliminates the possibility of currency devaluation
  - Reduced capital flight?
  - Limit inflation
  - Lower interest rates
  - Reduced international transaction costs

---

---

---

---

---

---

---

---

**Costs of Dollarization**

- What are the costs to dollarizing?
  - Dollarizing country relinquishes monetary policy control to US Fed, whose policy mandate is domestic
  - Costly reversibility – can the country go back to its own currency?
  - Lost seigniorage revenue
  - Lost sovereignty

---

---

---

---

---

---

---

---

**Who Should Dollarize?**

- What are the criteria countries should examine when considering dollarization?
  - Is your country a small or large economy?
  - Is your country particularly vulnerable to international shocks?
  - Does your country have strong ties (trade, financial) with the US?

Result: Many Latin and Central American countries have debated dollarization

- Panama: Dollarized since 1904
- Ecuador: Dollarized since 2000

---

---

---

---

---

---

---

---