

THE SUITABILITY OF DOLLARISATION AS AN EXCHANGE RATE REGIME FOR SOUTH AFRICA*

G.M. WESSELS*

Abstract

Countries dollarise because of a lack of policy credibility and to obtain monetary and economic stability by importing it from another country. Although dollarisation may be suitable for some emerging countries, South Africa does not belong to this group. The country suffers neither from hyperinflation or continuous high inflation, nor from policy incredibility. It furthermore has a low inflation pass-through, a high level of integration in world financial markets, but does not have a dominant trading partner or trade block. Furthermore, there is an absence of high levels of unofficial dollarisation and an unwillingness to abandon its central bank and monetary independence.

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The demise of the Bretton Woods system has left countries with a wide choice of exchange rate regimes. The currency crises in Mexico, East Asia, Brazil, Argentina and Russia have kindled renewed interest in the debate on fixed versus floating regimes and the selection of appropriate exchange rate regimes. These crises have revealed the inherent vulnerability of soft pegs and intermediate exchange rate regimes. Even strong pegs or strong fixes such as currency board arrangements did not stand the test of time, as demonstrated by the Argentine crisis of 2001. Emerging countries suffered the most as a result of the crises stemming from the maintenance of pegged exchange rate regimes.

These crises caused huge economic losses in terms of lost employment and prospects for economic growth. Furthermore, rising inflation rates, capital flight, contagion, sharply depreciating exchange rates, severe foreign exchange speculation, social hardship, political instability and generally lowered standards of living followed such exchange rate crises. Many of the emerging economies lost their access to international financial capital resources because of the decline in their credit ratings, depleted reserve levels, and international debts.

An interesting option regarding an exchange rate system for emerging and developing countries is full or official dollarisation. The interest in dollarisation is relatively recent, and has increased since the 1990s. With dollarisation the local or national currency is replaced by the US dollar or other prominent currency

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such as the euro, implying that the latter now serves as medium of exchange, store of value, and standard of value in the local economy. For many countries, dollarisation seems a natural step because of the large amounts of dollars present in their monetary systems (Bergsten, 1999:1-2). The primary intention of dollarisation is to obtain monetary stability by importing it from another country. In view of the considerable exchange rate volatility in South Africa since 1998 (accompanied by sharp interest rate movements with detrimental real economic effects), the question naturally arises whether dollarisation and its propagated advantages may be suitable for the country. Such a step has far-reaching economic, political and social consequences. This paper aims to outline the suitability of such a regime for South Africa.

Section 1 of the paper focuses on the significance and contents of dollarisation, while sections 2 and 3 provide a discussion of the benefits and costs of dollarisation. Section 4 gives a description of the likely candidates for dollarisation, whereas section 5 focuses on the suitability of dollarisation for South Africa. This is followed by a conclusion in section 6.

1. THE SIGNIFICANCE AND CONTENTS OF DOLLARISATION

Full or official dollarisation implies that national economic agents use a foreign currency, most often the US dollar, as legal tender parallel to or instead of their local currency. This happens when a country legally and officially abandons its own currency (except perhaps coins) and adopts that of another country. The latter country's currency then serves as means of payment, unit of account and store of value. The money supply is denominated in dollars and is supported by the balance of payments and by a sufficient amount of foreign currency reserves. Thus, full dollarisation is similar to a complete monetary union with a foreign country whereby the foreign currency becomes the legal tender of the local economy (Bogetic, 2000:18). Several countries, among which Ecuador, El Salvador, Panama, Liberia, Monaco, Puerto Rico, Greenland, Micronesia and others, have adopted dollarisation as their exchange rate regime. By 2000, 28 countries and territories, many of them very small countries or islands, have officially dollarised their economies (Bogetic, 2000b: 182). Approximately 10.5 million people live in officially dollarised countries.

Official dollarisation implies that the dollarised country has relinquished its own independent monetary policy and imported the monetary policy of the issuing nation (Joint Economic Committee, 2000:8). It also means the abolishment of the central bank, since most of its functions, notably the monetary policy function, the note issuing and the lender of last resort function, cease to exist. A few remaining departments will probably be transferred to a government body (e.g. the Treasury) together with the assets and liabilities of the former central bank.

Dollarisation does not necessarily mean that only one foreign currency is introduced, although that is generally the case. *Bimonetary* systems, where a foreign currency dominates bank deposits, but not wages, taxes and everyday transactions, are variants of dollarisation (Bogetic, 2000:18). In this case, the foreign currency plays a subsidiary role, as in Namibia and Lesotho. The latter are independent countries that collect seigniorage according to a specific formula from the South African government. Such countries are usually located close to a dominant economic and trading partner and are tied to it by their heavy reliance on trade and investment with that specific country.

Contrary to this, *unofficial or de facto* dollarisation refers to private economic agents using dollars (notes or foreign currency bank deposits, although this can also include bonds and non-monetary assets) with or without formal legal approval as means of payment or even as a store of value in addition to the local currency. Unofficial dollarisation is also represented in currency substitution, asset substitution and liability

dollarisation. *Semi-official* dollarisation refers to dollars existing legally or illegally parallel to the local currency. However, in most cases the dollarisation has not been legally approved. Unofficial dollarisation is common in various countries in Latin America, Africa and the transition economies (Argentina, Mexico, Bolivia, Peru, Georgia, Russia, Ukraine, Turkey, Romania, Vietnam, Zimbabwe, Mozambique, etc.) and has existed for years. It stems from a loss of confidence by businesses and consumers in the local currency due to high inflation, fears of confiscation and frequent serious depreciations in the exchange rate of the local currency.

Fischer (1982:298) argues that there is nothing particularly strange about an economy that does not use its own money. Government can still use taxes and borrowing to finance the budget, but seigniorage profit and its taxing power is given up. Local banks will hold dollar assets and issue dollar liabilities. The government can still influence wage levels, employment, the balance of payments, as well as investment and consumption by means of fiscal policy.

The reasons why some countries switch to dollarisation is that it replaces the domestic monetary authority's poor policy credibility, which is reflected in violations of exchange rate pegs, a history of easy government finance and large fiscal deficits, as well as high inflation. The latter events cause further expectations of devaluation, inflation and chronic high interest rates, as well as a flight out of local into foreign money and assets.

By dollarising under such conditions, a country imports exchange rate credibility so that financial operators may believe that the country will adhere to it under all circumstances and thus not speculate against the currency*. The fact that many emerging countries suffer from bad government, tax evasion, crony capitalism, non-functioning bankruptcy laws, financial fraud, corrupt judiciary systems, political strife, etc., also favours dollarisation as an exchange rate regime. At the core of the vulnerability of some emerging economies lies a lack of credibility of domestic policy-making bodies, and imperfections in the globalised capital markets (Mendoza, 2002:1).

2. THE BENEFITS OF DOLLARISATION

A brief overview of the benefits and costs of dollarisation follows below and does not include a detailed discussion of their manifold qualifications and criticism.

a. Increased credibility, less exchange rate volatility, lower interest rates and lower inflation

Some of the frequently mentioned benefits of dollarisation are the “imported” increased policy credibility of the dollarising country (Visser, 2000: 158) and an ensuing reduction in exchange rate volatility, a reduction in the risk of currency crises and its accompanying devaluation, as well as the averting of capital flight with its concomitant financial crisis. Dollarisation will mitigate these and also reduce the need for exchange controls (Schuler and Stein, 2000:5). Other important benefits of dollarisation are the welfare gains of eliminating policy uncertainty as well as the distortions due to the uncertainty regarding exchange rates.

* An important warning regarding dollarisation must be sounded since it is embedded in an unmentioned assumption – that of the prudence and stability of US economic policy. It should be remembered that dollarisation would not have been such a good idea in the late 1970s and early 1980s. At that stage the dollar was under attack, reflecting significant weakness and volatility in terms of inflation and its exchange rate. The choice to dollarise therefore depends heavily on the current and future expected stability and prudence of the internal economic policy of the US.

Dollarisation implies that there is now *per se* no possibility of devaluation, and this immediately decreases the currency risk and its accompanying risk premium. These benefits in turn will stabilise inflation (see Edwards and Magendzo, 2001:13) and (more importantly) inflation *expectations* at lower levels, thereby promoting economic growth and employment. Dollarisation also deprives the government of its power to create inflation at will, thereby fostering sounder fiscal policy (Joint Economic Committee, 2000:13). Dollarisation improves the transparency of the government's tax and general budgetary policy and contributes to the prevention of a monetisation of the government debt.

Dollarisation may also cause a drop in real interest rates following a lower expected inflation, reduced fear of devaluation, and smaller country risk. This leads to a reduction in the risk premia on foreign loans, and therefore to cheaper foreign bank loans and general credit. However, dollarisation cannot eliminate sovereign risk stemming from fiscal or political troubles. The remaining risk premia may also stem from the other structural features present in emerging countries (Mann, 1999:2). In addition, dollarisation will also increase the availability of long-term credit as it will expand the horizons of economic agents following greater certainty concerning inflation and increased economic stability. This is beneficial for investment and risk-taking, which may be conducive to economic growth and employment.

Dollarisation can also enhance the internationalisation of the financial system, whereas beneficial influences may flow from the diminished possibility of financial contagion and the increased predictability of economic policy and general economic developments.

b. Lower transaction cost, improved information, and increased international integration

It is suggested that dollarisation will lower the transaction costs related to the converting of different national currencies (Alesina and Barro, 2001:381). The use of the same money or a common currency enhances trade in goods and services (see Rose, 2000:31). There is also the benefit that the hedging costs of currency risk will be eliminated. As an outflow of the above, dollarisation also lowers information costs. Many random shocks are not exogenous, but rather endogenous – such as imperfect and asymmetric information. But dollarisation decreases the need for information, alleviates the information problem and therefore lowers the incidence of contagion (Calvo, 2001:319).

In addition to the aforementioned, dollarisation can also promote integration with the economic activity of the U.S (Antinolfi and Keister, 2001:30). Financial integration links a dollarising country's financial system to a huge, liquid global market for lending and borrowing in dollars (Schuler and Stein, 2000:5).

Dollarisation also increases the cost of turning back or renegeing on the exchange rate regime. It therefore harbours more credibility than other less fixed exchange rate regimes. Increased stability and credibility following the dollarisation of a specific country will lead to increased regional stability and less regional contagion, especially if the dollarising country is a significant one in the region that was prone to instability in the past.

3. THE COSTS OF DOLLARISATION

a. Political costs

An obvious cost for a dollarising country is the loss of an important national political symbol - its national currency. Together with other national emblems and patriotic symbols, the local currency (which usually depicts important historical persons and events) also forms part of its national pride. Dollarisation also

constitutes a loss of political autonomy since the foreign power whose currency is used can stop supplying it, and threaten or coerce the dollarised country by means of such a liquidity squeeze (Cohen, 2000:5).

b. The loss of seigniorage

One of the costs of dollarisation that is of major concern is the loss of seigniorage for the dollarising country*. Seigniorage profit is the result of the power accorded to government to print fiat money. By creating base money the central bank can buy real resources almost costless, except for the cost of printing the money and the interest on bank reserves.

Seigniorage can firstly be measured as a *stock* (Joint Economic Committee, 2000:9). The stock cost of seigniorage is the cost of adopting the dollar (notes and coins) to replace and withdraw the stock of domestic money from circulation and exchange it for US dollars. The central bank has to repurchase the local stock of money and thereby return all the accumulated seigniorage of the past. Moreover, the central bank has to sacrifice future earnings of seigniorage that could have been obtained from the annual *flow* of new currency to satisfy the demand for currency. Bogetic (2000:29) has calculated the average flow cost of dollarisation as 2,3 per cent of GDP for selected Latin American countries. The amount of lost seigniorage depends on the rate of growth in production on the one hand, and the rate of inflation on the other.

c. The loss of the lender of last resort (LOLR) function

One argument frequently raised against dollarisation is that it will either eliminate or severely constrain the LOLR function of the central bank. Since many of the countries considering dollarisation are those in which banking crises were part of national and international turmoil and contagion, this loss may raise crucial questions. Dollarisation leaves the central bank with only limited resources. The absence of a LOLR may therefore impart a sense of insecurity into the financial system (Antinolfi and Keister, 2001: 34).

d. The problem of dealing with asymmetric shocks and business cycles

Another consideration regarding dollarisation is the harmonisation of the two countries' business cycles. Dollarisation will link the dollarising country to the business cycle of the anchor country more intimately. With a floating exchange rate a country can adjust differently, act counter-cyclically, and devalue to adjust its economy. This is not possible under dollarisation. The absence of devaluation implies that the country cannot react to asymmetric shocks, which may result in more debt and increased social conflict. Neither can the country use depreciation in the exchange rate to stimulate internal demand or improve competitiveness, or use interest rate policy as an instrument to deal with a recession.

e. The loss of an independent monetary policy

This cost must be seen in conjunction with the previous one. A country with its own national currency follows its own monetary policy, although within certain constraints. However, since full dollarisation of a

* Kurt Schuler (Joint Economic Committee Staff Report, 1999) forwards many ways of calculating seigniorage and also the basis of calculating the sharing of it between US and the dollarisation country. Gruben *et al* (p. 25-27) also suggest various models for calculating, sharing, and alleviating the loss of seigniorage.

country eliminates its national monetary and exchange rate policy, the central bank cannot independently control its money supply, interest rates and exchange rate to influence its internal economy. Not having an independent monetary policy means that a dollarised country adjusts to external shocks via factor and product markets, rather than adjusting exchange rates. If the labour and goods markets are inflexible, it may necessitate a deep recession with an associated decline in economic growth, output and unemployment which may result in higher real interest rates and large transfers from debtors to creditors (Berg and Borensztein, 2000:18).

f. Other costs

Dollarisation also entails a one-off cost of converting all prices, price labels, cash registers, computer programmes, banking details etc., from local currency to foreign currency. Where inflation is high, this conversion may be cheaper than the frequent changes in local currency. In addition, there is also the cost of legal and financial activities in revising contracts and financing arrangements.

The aforementioned benefits and costs will of course be difficult to quantify and will also differ from country to country. Despite the various costs mentioned in respect of dollarisation, they are, according to Dornbush (2001:238), on the face of it persuasive, but on closer inspection none really is. Because developing countries sometimes seem to be better off without a central bank, the benefits may outweigh the cost of dollarisation.

4. WHICH COUNTRIES ARE CANDIDATES FOR DOLLARISATION

Briefly stated, countries with volatile exchange rates, high inflation rates, and whose trade and financial flows are integrated with the dominant country, will benefit the most from dollarisation. These can be extended to those countries with a track record of poor macroeconomic instability, resulting in high inflation rates and high inflationary expectations. They also experience a lack of credibility regarding sustainable stabilisation programmes, and have poorly developed financial markets. Countries with high levels of unofficial dollarisation must also contemplate dollarisation because of the relatively small loss of seigniorage involved in such cases.

The dollarisation debate does not entail pure economic considerations alone. Frieden (2002:1) is of the opinion that dollarisation is basically a *political* decision entailing political trade-offs. Dollarisation has different distributional interest and pressure effects on the economy and politicians will endeavour to have the best trade-off for their specific interest. Openness and the size of the manufacturing sector are therefore major determinants of the propensity to dollarise (Frieden, 2002: 31).

Those countries whose citizens do not attach a strong value to political autonomy and in which the national currency is not deemed as part of national symbolism and national pride, may find it easier to dollarise. In cases where the previous monetary and exchange rate policy of a central bank that lacks independence have caused hyperinflation and waning levels of respect for political and monetary authorities, the institution of dollarisation will also encounter less opposition.

On the *economic* front inspection of the relevance of the classical criteria for an optimum currency area (OCA) to dollarisation renders many of them so. Although OCA issues were not instrumental in the increased interest in dollarisation (the interest stemmed primarily from banking and exchange rate crises), these aspects are important. OCA criteria contain many applicable considerations such as factor mobility, the openness of the economy, product diversification, financial integration, similarity in inflation rates, etc.

Some of these criteria are highlighted below. Hawkins and Masson (2003:1) correctly pointed out that dollarisation may be considered for small open economies, which at least to some approximate extent resemble the OCA criteria. However, they also noted that there is a poverty in the applicability of OCA considerations (labour mobility, the existence of fiscal transfers, symmetry of shocks, diversified industrial structure, etc.) as a predictor of the formation of currency areas. This follows from what has been mentioned in respect of the fact that political and institutional considerations, as well as foreign policy, also play major roles in the process. In addition to these, care should be taken that the unique characteristics of emerging countries as well as the specific point of departure for a country are taken into account when considering the relevance of OCA criteria for dollarisation.

One criterion which receives only scant if any treatment in the OCA literature, but which crucially affects the relevance of dollarisation for a country, is the extent to which the country is already *unofficially* dollarised (Bogetic, 2000b:204). Countries whose assets and liabilities are mostly denominated in dollars/euro's, especially if they have a short-term duration, are subject to sudden stops and reversal in their capital flows (Calvo and Reinhart, 1999:13). This, together with a currency crisis, can push the country into bankruptcy or a banking crisis much faster and with devastating consequences for the real economy. It takes several years to overcome these and is often accompanied by social and political upheaval. *Official* dollarisation can prevent this as unofficial dollarisation would in any event have increased further because of the dependence of emerging countries on external saving stemming from the deficits on their current accounts (Calvo, 1999:15).

OCA criteria point towards a relatively high degree of *trade integration* as a factor conducive to official dollarisation (or other forms of a common currency). An OCA as well as a currency area normally occur in the presence of a large dominant country, such as the USA, with a dominant currency and where considerable trade and a deep economic integration exist between it and the dollarising country. Not many countries satisfy this criterion for dollarisation (Bergsten, 1999:3). Moreover, the search for credibility is given a higher priority over the trade-gains and shock-insulation trade-off in the classic OCA literature (Levy-Yeyati and Sturzenegger, 2002:6). Countries considering dollarisation are doing so more because of the need to reduce vulnerability to financial shocks rather than for trade reasons (as in OCA).

Asymmetry of *external shocks* between the dollarising country and the dominant country also deserves attention, but only where shocks are permanent since temporary ones can be financed. Business cycles and shocks that co-vary substantially between a potential anchor country and the dollarising country, favour dollarisation (Mussa *et al*, 2000:23). (In this instance, as mentioned before, one key issue is whether or not there is a substantial benefit of having an independent monetary policy to accommodate asymmetric shocks to the economies (Antinolfi and Keister, 2001: 34)). Although traditional economic theory advances that the type of exchange rate regime is a function of the type of shock experienced by a country (if shocks are mostly real, than float, otherwise fix), the recent crises occurred in the capital account and had both real and nominal effects, complicating the exchange rate choice.

Similar industrial structures, high labour mobility as well as wage and price flexibility are also important when considering dollarisation. If the latter flexibilities do not exist, adjustment in a dollarised country can take the undesirable form of unemployment and a recession.

The case for dollarisation is also determined by *policy constraints* and *objectives* (Bogetic, 2000b: 205). A country lacking monetary and fiscal discipline and wanting to eliminate poor discretionary policy and its concomitant lack of *credibility*, can contemplate dollarisation. The latter will also depend on whether the country needs to escape from a history of persistent high or hyperinflation. Where there is serious distrust in the ability of the monetary authorities to maintain a stable currency, floating will trigger a currency crisis.

Defending an adjustable peg can become disastrously expensive. In this case, dollarisation may come to the rescue.

When the *internal banking system is fragile* and prone to crisis (partly due to unofficial dollarisation), it strengthens the argument for dollarisation even further. The history of banking crises and inflation in certain Central and South American countries could make them possible candidates according to this criterion. In these cases dollarisation has to be balanced with the loss of national sovereignty and governments' views on policy constraints.

Dollarisation also obtains increased relevance in countries where *devaluation* may invoke a damaging effect on a country's economy. Most emerging countries start from a position of highly dollarised liabilities and therefore have a fear of floating because it will increase the danger of a sharp increase in the outstanding value of these liabilities if the exchange rate were to depreciate. They then "fix" the latter, thereby increasing the liability dollarisation, which aggravates the crisis potential of the situation (Calvo and Reinhart, 1999:15).

Another predictor of which type of country should dollarise concerns the *availability of information*. Contagion is explained mainly (see Calvo, 1999:6) by imperfect information concerning especially the macroeconomic and financial sectors. This lack of information stems from the short track records of the countries, as well as high government intervention that create uncertainty and a lack of belief in the sustainability of its stabilisation efforts. Furthermore, it is also more costly to evaluate and monitor smaller countries. In such cases, dollarisation can lower the degree of uncertainty.

In addition to the aforementioned, the *sustainability* of an exchange rate regime also matters for the choice of dollarisation as an exchange rate regime. The so-called **peso problem** aptly describes the problem that, despite exchange rate pegging by government, economic agents do not regard the regime as sustainable and thus expect a fundamental regime change, which involves premiums on interest rates and lack of credibility in policy-making. Moreover, even if the current policy regime reflects low exchange rate volatility and even if confidence is currently high, expectations concerning the expected monetary policy in the face of a possible (even remote) crisis in future will play a preponderant role in determining the extent of dollarisation* (Ize and Parrado, 2001:26).

In summary, the following country features point towards the consideration of dollarisation as an exchange rate regime:

- the smaller the country's size and the more open its economy;
- a low involvement with international capital markets;
- a high share of trade with the anchor country to which its currency will be pegged;
- existing trade concentrated in dollar terms;

*It should be noted that dollarisation has an *endogenous* content. Therefore, account has to be taken of not only the current values of variables, but also of what they are probably going to become once the exchange rate is fixed. Dollarisation will for example increase fiscal discipline and price and wage flexibility. Joining such an area may also change the characteristics of an economy, such as an increase in the correlation between the economic performances of the relevant countries.

- similar shocks in the dollarising country as in the anchor country;
- an already high level of liability dollarisation (high domestic borrowing levels denominated in terms of the dollar);
- volatile capital flows where devaluation is risky and wages and prices are sticky so that the devaluation may have more disadvantages;
- a willingness to sacrifice its monetary independence for its partner's monetary credibility;
- a lack of policy credibility and central bank independence;
- a political and social environment favourable to dollarisation;
- a willingness to abandon local money as part of its national pride and symbols;
- a history of hyperinflation or continuously high inflation that does not allow an exchange rate-based stabilisation policy;
- relatively high international reserves;
- a fragile and crisis-prone internal banking system where a currency crisis easily develops into a banking crisis, and
- imperfect and costly market information.

In ending this section, the following cautions should be acknowledged, however (see e.g. Edwards, 2001:1). Dollarisation can be dangerous because there is not yet sufficient empirical and historical evidence to support it. Many of the so-called benefits are uncertain and may not follow dollarisation. In the same vein, Ize and Parrado (2002:27) point out that dollarisation may be validated by policies that are short-term desirable but long-term sub-optimal. They correctly argue that crisis factors may prescribe dollarisation, but that their passing may make a more unconstrained policy more appropriate after a transition phase. A dollarisation trap can occur as increasing dollarisation and an increasingly constrained policy regime feed back on each other. Agents may borrow in dollars expecting that this will tie the hands of the authorities. This trap will be difficult to solve and may take a long time.

5. IS DOLLARISATION AN OPTION FOR SOUTH AFRICA?

It appears from the above discussion that dollarisation, except for the other mentioned considerations, is especially suitable for small, open economies with a dominant trading partner where the latter has a stable inflation and sound macroeconomic policy. For such countries, it is not worthwhile to try and run their own independent monetary policy. Lesotho, Namibia and Swaziland belong to this category because of the dominating presence of the adjacent South African economy. The question is whether South Africa itself is a candidate for dollarisation.

Although the major international market-related crises since 1994 to some extent involved a fixed or pegged exchange rate regime, countries such as Mexico, Turkey, South Africa and Israel avoided crises of the type experienced by emerging market countries with pegged rates (Fischer, 2001:1). South Africa has successfully maintained floating exchange rates during the latest crises, suggesting that floating are often the most workable regimes for many emerging countries (see Mussa *et al*, 2000:34). South Africa's flexible exchange rate regime not only absorbed large, detrimental shocks on its economy more readily during the 1990s, but also avoided the accompanying cost of a breakdown in the exchange rate regime. During the Asian crisis, in particular, those countries that followed pegged regimes were hit hardest, whereas other emerging countries such as South Africa that were following flexible regimes fared better and appear to have benefited from the flexibility (Mussa *et al*, 2000:21). Fischer (2001:2) is of the opinion that adjustable pegs have not proved to be viable over the long term for emerging countries and should not be expected to be viable.

For a country such as South Africa with a substantial re-entry into and growing participation in global trade and financial markets, floating may be more relevant and advisable. In view of the increased capital mobility since the 1990s, together with the considerable independence of the South African Reserve Bank, it seems more appropriate for the country not to dollarise. This is also suggested by the so-called impossible trinity advanced by Frankel (1999), according to which a country with an independent monetary policy, increased financial integration, as well as accompanying high capital flows, can do better if it accepts a flexible exchange rate.

Output correlation is helpful in indicating OCA applicability, but for South Africa the correlation with Western Europe and the US is 0.42 and 0.16, respectively (Hawkins and Masson, 2003: 8). Also relevant for the consideration of dollarisation, is that countries subjected to similar shocks need roughly similar monetary policies. This will be the case if they have similar trading partners or similar industrial structures. However, the South African economy is not nearly as integrated to that of the US as that of countries that have dollarised. Trade patterns also affect regional currency (and dollarisation) decisions. For South Africa, the destination of exports/origin of imports to and from the Euro area and the US for 2003 (May) are 37/44 and 12/10, respectively (see table 1). This is relatively low and does not support dollarisation as an exchange rate regime. Europe is in any event South Africa's biggest trading partner and its share in South Africa's trade exceeds that of the US considerably. This means that even if South Africa were contemplating the adoption of another country's currency, it would be the euro rather than the dollar.

Emerging countries such as South Africa can benefit from a floating exchange rate in order to better adjust to especially terms-of-trade shocks than those that have dollarised. Berg and Borensztein (2002:30) cite countries where world real commodity prices have strong and fairly stable relationships with the real exchange rate of the countries. In the absence of a floating exchange rate, a country such as South Africa, which also has a substantial commodity export basis, would consequently have had to experience deflation if exchange rates were not floating.

Contrary to what would have been the case under dollarisation, South Africa can currently respond differently to external economic shocks *vis à vis* the USA (or Europe), or react to differences in domestic economic policies. The US, e.g., is a net importer of commodities. The drop in commodity prices in the wake of the Asian crisis of 1997-98 therefore benefited the US, but caused a decline in the commodity prices of products exported by South Africa. But the drop in the rand following the Asian crisis led to a depreciation in the rand against the US dollar, thereby helping manufacturing and mining companies to increase their exports. Thus, the adjustment in the exchange rate of the rand acted as a shock absorber, helping to enact the needed adjustment in response to differing shocks and policy objectives and policy requirements. Retaining some independence for its monetary policy tool and leaving the movements in the exchange rate to market forces appears to be a better alternative than dollarisation for a commodity-exporting country such as South Africa.

Furthermore, South Africa may need to depreciate because price and wages do not reveal sufficient downward flexibility. If the country's exchange rate is fixed via dollarisation, much higher interest rates will be required. This will lead to a serious economic slowdown to bring wages and prices down to levels that make industry more competitive. Since wages and prices are sticky, the brunt of the adjustment to shocks will fall on the labour market under dollarisation.

Another argument against the dollarisation of South Africa, is that the country has not suffered from hyperinflations similar to those suffered by Latin American countries. The pass-through effect of exchange rate movements to inflation in South Africa is moreover also relatively low (Bhundia, 2002).

There is a 78 percent pass-through elasticity in South Africa for import prices. This means that a 10 percent depreciation in the nominal effective rate leads to 7.8 per cent increase in import prices in the long run (Bhundia, 2002: 4-8). Bhundia finds a pass-through to the CPIX of 12 per cent after two years, which is low. Hausmann *et al* (2000) furthermore point out that in South Africa the pass-through rate of devaluation to inflation is much lower than in other countries in the same emerging category, indicating that exchange rate movements do not command the same intensity of attention. This supports the view that dollarisation is not a suitable exchange rate regime for South Africa.

The improving country risk rating and stable monetary and fiscal policy stance do not point towards such a drastic interference as dollarisation. Indeed, maintaining the current stability of monetary policy will mean that floating exchange rates will not negatively affect inflationary expectations, implying that the pass-through effect will remain relatively small. In any event, at present South Africa does not suffer from periodic lack of policy credibility necessitating the importation of an external locus of discipline.

In an interesting contribution to the debate on dollarisation which is also relevant for South Africa, Krugman (2003:2) argues that resource-rich countries, far from anywhere, and without a dominant trading partner (either US or Europe), if they can contain inflation, do not have to adopt the currency of a distant country which will not take their interests into account. When two countries are subject to strong asymmetric shocks, there is a good case for having separate currencies whose values are allowed to fluctuate. The risks under such a system of exchange rate volatility can be hedged away, and in South Africa such hedge instruments and markets do exist. There remains the risk of speculation against the currency, but depreciating the currency by means of speculation is often what is needed, according to Krugman.

The absence of a large liability dollarisation in South Africa also argues against the introduction of dollarisation for the country. This is supported by a negligible degree of unofficial dollarisation, rendering one of the motivations for dollarisation ineffective. Countries such as South Africa can better afford "benign neglect" regarding the behaviour of exchange rates, but other emerging countries with high levels of unofficial dollarisation will have to internalise the negative impact of a depreciation due to mismatches.

Another argument against dollarisation as an option for South Africa is the fact that market information is not as costly and imperfect as is the case in other emerging countries. Due to the country's transparent and well-developed financial markets with their high levels of liquidity and turnover, information is generally accessible and obtainable. This is related to the fact that the country has sound banking supervision and does not have a crisis-prone and fragile banking system where a banking crisis will follow a currency crisis, as was the case in other emerging countries during recent crises.

At its current stage of democratisation and political development, South Africa will moreover not be willing to sacrifice its own money because of the importance attached to its national symbols and national pride. In future the looks of the country's money will probably change in line with the changes observed in many other national emblems and symbols that took place and are still taking place. There is therefore almost no possibility of the country abandoning its currency for that of a dominant trading partner (dollar or euro) from a political point of view. This point ties in with the fact that the independence of the South African Reserve Bank was and is still viewed as a plus point and an important attribute of the Bank during the past decade and more. The independence is indeed reflected in the Constitution of the country and was practically demonstrated by the independent policy conduct of the Bank during the past decade. Contrary to a dollarisation regime that requires the abandonment of a central bank as it is normally perceived, the South African Reserve Bank stands no chance to be abolished for the reasons mentioned in the motivations for dollarisation, especially those referring to a lack of credibility and policy independence.

The necessary socio-political environment for dollarisation also does not currently exist in South Africa, and it is hard to imagine that it will in the near future.

In summary, the following characteristics of the South African economy point towards a decision *against* dollarisation as an exchange rate regime for South Africa:

- a high degree of nominal rigidity in prices and wages;
- an unwillingness to abandon its local money as part of its national symbols and emblems;
- a high level of involvement in international financial markets reflected in increased capital flows;
- the presence of policy credibility and central bank independence;
- a relatively low share of trade with any potential anchor country for whose currency the rand could be substituted;
- the absence of a history of hyperinflation;
- a low inflation pass-through (depreciations will therefore have lower inflationary effects);
- the absence of financial fragility and a crisis-prone banking system (depreciations will not have adverse effects on the balance sheets of banks and firms that cause bankruptcies);
- the occurrence of asymmetric shocks and dissimilarities in national economic structures;
- the availability of market information;
- the absence of a high level of liability dollarisation; and
- an unwillingness and needlessness to sacrifice its monetary independence for the anchor's monetary credibility.

Choosing an exchange rate regime of a floating variety for South Africa is of course accompanied by disadvantages such as disturbing noise and ungrounded and overshooting movements in the exchange rate that can impart major unnecessary real adjustments on the rest of the real economy. It may also cause speculation and a vulnerability to exchange rate shocks for the country. This was indeed the case for South Africa. Nevertheless, in view of the above-mentioned disadvantages and unsuitability of dollarisation for South Africa, it appears that a regime of floating exchange rates seems more appropriate than dollarisation. On the other hand, care must be taken that South African firms do not rely on a continuous depreciation of the currency to stay competitive in their exports. They must still contribute to creativity, productivity and innovation for success.

6. CONCLUSION

The dollarisation debate is relatively new. As recent as 2000 and 2001, countries such as Ecuador and El Salvador moved to dollarisation. The increased interest in and research concerning dollarisation shows that it is not a fad, but an exchange rate system that must be taken seriously. However, the multiple costs and benefits of dollarisation vary from country to country and some are difficult to calculate and compare. Some of them are not quantifiable at all - e.g. the importance of having and keeping an exit option open. Decisions on dollarisation entail more than merely comparing its costs with the benefits. It basically concerns the issue of credibility.

Dollarisation, if it is not supported by the political, social, institutional and economic reforms necessary to create a conducive economic environment, will not suffice. Dollarisation is not a solitary monetary panacea to solve all current economic problems in a country. It can never be a soft substitute for other important reforms that may be unpopular but necessary to implement. Indeed, one of the vexing uncertainties regarding dollarisation is whether governments, not known for maintaining discipline but

rather for renegeing on their promises, can be compelled by an external disciplinary force such as dollarisation to permanently abandon their old ways and habits.

In view of South Africa's current economic and political features, recommending dollarisation as a suitable exchange rate system for the country would be misplaced. The current social and political conditions do not favour such a decision, but neither do they necessitate such a drastic step. The country will certainly resist abandoning its local currency and central bank. In the case of South Africa, dollarisation would amount to an acknowledgement that the government needs to import fiscal and monetary prudence and discipline from an external power or a foreign source. This is unthinkable at present.

Economic conditions also do not favour the implementation of dollarisation. The country is not plagued by a hyperinflation or an unacceptable and continuous high inflation with its roots in a lack of fiscal and monetary policy credibility. In addition, the degree of inflation pass-through resulting from a depreciation in the currency is low. South Africa's high level of involvement in international trade and international financial markets, its openness to capital flows and increased capital mobility, together with the importance of its commodity exports, do not fit the conditions and specifications of a dollarised dispensation. This follows even more from the fact that the country does not have a single dominant trading partner, does not reflect the price and wage flexibility required by dollarisation, and does not have symmetric shocks and structural similarities in relation to its dominant trading partners. Contrary to emerging countries with crisis-prone and fragile banking and financial systems for which dollarisation may bring financial order, South Africa does not fit this description.

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Table 1: South Africa's Trading Partners

Imports: 2000 and (Jan - May) 2003

Source of imports*	2000	(Jan.-May) 2003
Germany	13,37%	15,64%
U.S.A.	11,90%	9,90%
U.K.	8,65%	9,30%
Japan	7,97%	7,75%
France	4,24%	6,53%
E.U. as % of total	40,04%	44,41%

* Ranked in terms of 2003 imports.

Source: DTI

Exports: 2000 and (Jan. - May) 2003

Destination of exports*	2000	(Jan.-May)2003
U.S.A.	14,26%	12,29%
Japan	9,38%	10,31%
U.K.	10,54%	9,97%
Germany	9,15%	7,88%
Netherlands	3,91%	5,02%
E.U. as % of total	36,86%	36,76%

*Ranked in terms of 2003 exports.

Source: DTI