



**Time: 10 min**

**Date: 28-11-2023**

### Can dollarisation save an economy?

**Syllabus: GS3/ Indian Economy & Related Issues**

#### In Context

- Argentina's newly elected President had pledged in his campaign to replace the Argentinian currency — the **peso** — with the **dollar**.

#### What Is Dollarization?

- Dollarization is the term for when the U.S. dollar is used in addition to or instead of the domestic currency of another country.
  - It is an example of **currency substitution**.
- Dollarization usually happens when a country's own currency loses its usefulness as a medium of exchange, due to hyperinflation or instability.

#### Significance of Dollarisation

- **Solution to hyperinflation:**
  - Dollarisation can act as a solution to hyperinflation by **breaking the feedback link** between **rising prices** and **rising money supply**.
  - **How?** If the domestic currency is replaced by dollars, money supply can no longer be controlled by vested political interests who can increase spending for political ends.
    - The incessant rise of prices would be forced to moderate since consumers would no longer be able to access currency easily, thus slowing down consumption demand.
- **Positive effects on growth:**
  - Since a **small economy** can only access dollars through **foreign trade and/or capital inflows**, it would incentivise the economy to focus on **export successes** and easing conditions for **foreign capital**, who would be more willing to invest in an economy with a **stable currency**.
  - It creates positive investor sentiment, almost extinguishing speculative attacks on the local currency and the exchange rate.
- **Stability:**

- The stable value of the dollar would ensure that economic agents —both foreign and domestic — would be able to make **long-term plans** regarding economic activity, plans that would otherwise not be possible under a currency that rapidly lost value.
- **Integration into global economy:**
  - Full dollarization can improve the global economy by allowing for easier integration of economies into the world's market.
  - The result is a more stable capital market, the end of sudden capital outflows, and a balance of payments less prone to crises.
- **Recent examples:**
  - Three fully dollarised economies — Ecuador, Panama and El Salvador — have had successful economic outcomes following dollarisation.

### Ecuador's example of dollarization

- **Precursor:**
  - The Ecuadorian economy suffered a series of debilitating crises in the late 1990s, with economic output contracting by almost 7%, inflation at roughly 67%, and the domestic currency, the Sucre, depreciating by almost 200% in 1999.
- **Dollarisation:**
  - The country announced the **adoption of the dollar in January 2000**.
  - The economy has **shown considerable progress** since then, on parameters measuring both economic growth and social welfare.
  - Dollarisation is not, however, the sole reason for success. Ecuador is helped by significant reserves of oil and gas.
- **Challenge:**
  - The commodity price boom of the 2000s greatly aided the growth of the economy and allowed for a greater inflow of dollars.
  - Subsequently, the reduction in oil prices after 2014 saw a reduction in economic growth and rising debt and deficit levels, bringing new challenges to the economy.

## Challenges

- **No influence on Economy:**
  - When a country gives up the option to print its own money, it loses its ability to directly influence its economy, including its right to administer monetary policy and any exchange rate regime.
- **No profit from issuing coinage:**
  - The central bank loses its ability to collect 'seigniorage,' the profit from issuing coinage.
  - Instead, the U.S. Federal Reserve collects the seigniorage, and the local government and gross domestic product (GDP) suffer a loss.
- **Loss of central bank's power:**
  - In a fully dollarized economy, the central bank also loses its role as the lender of last resort for its banking system.
  - While it may still be able to provide short-term emergency funds from held reserves to banks in distress, it cannot provide enough funds to cover the withdrawals in the case of a run on deposits.
  - On the foreign trade front, countries would no longer be able to take recourse to depreciation to boost exports, focusing only on export promotion to stave off downturns.
- **Securities in dollars:**
  - Another disadvantage for a country that opts for full dollarization is that its securities must be bought back in U.S. dollars.
  - Without sufficient reserves, it will either have to borrow the money by running a current account deficit or find a means to accumulate a current account surplus.
- **Loss of sense of pride:**
  - Additionally, using foreign currency instead of the local one may damage a nation's sense of pride.

## De-dollarisation

- De-dollarisation is a term that refers to the process whereby countries tend to reduce their reliance on the US dollar as a reserve currency, medium of exchange, and also a unit of account.

## Potential of Rupeefication

- In India, while a complete overhaul of the trade invoicing system is not feasible, **de-dollarisation can be complemented with the internationalisation of the INR—rupeefication.**
- Rupeefication will require
  - **Complete freedom over buying or selling of the INR** by any entity,
  - The ability of the country's exporters to invoice their trade in INR, and
  - Holding as well as issuing of the INR and financial instruments denominated in it by foreign entities.

### **Way ahead**

- Dollarisation is not a silver bullet, but if used well in conjunction with nimble domestic policy, can offer a route to success.
- The achievement of economic prosperity is a complex affair that requires sustained engagement with policy-making and perhaps a little bit of luck to navigate economic shocks.

### **Daily Mains Question**

**[Q]** What is the significance of dollarization? Examine the challenges. Analyse the potential of Rupeefication & its advantages for the Indian economy.