



**OFFICIAL DOLLARISATION: A REALISTIC
OPTION FOR CARICOM?**

by

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Introduction

Dollarisation occurs when residents of a country extensively use the US dollar or another foreign currency alongside or instead of the domestic currency. The paper attempts to assess the relative advantages and disadvantages of the adopting the US dollar as the official currency for the countries of the Caribbean Community and Common Market (CARICOM). The implementation of a single currency for this regional grouping has proven to be especially difficult and at present the grouping can be divided into those countries that float their currencies and those whose currencies are fixed against the US dollar. Among CARICOM member countries, domestic currency is used as legal tender while foreign currency is required for settling overseas transactions. Dollarisation has been mooted as an alternative to the establishment of a common Caribbean currency. Indeed, some authors have argued that dollarisation may be a preferred option (Anthony and Hallett(2000)). As a result, some attempt will be made in this paper to analyse whether the US dollar is a realistic option as the official currency of CARICOM. Section one will address the pros and cons of dollarisation. Section two will briefly look at some countries that have adopted or agreed to dollarisation. The third section will attempt to discuss this topic with respect to CARICOM. A conclusion will then follow.

1. The Pros and Cons of Dollarisation

It is important at the outset to distinguish between policy dollarisation and de facto dollarisation. The former occurs when governments replace the domestic currency with a foreign one while the latter occurs when residents of foreign countries seek refuge in the dollar (or other strong currencies) to hedge against inflation, default or confiscation by their own governments. One new phenomenon in the 1990s is that de facto dollarisation has occurred even beyond the point where it is likely to be justified by economic and other risk.

This has led in turn to a view, in some quarters, that the costs of maintaining a national currency are outweighed by the benefits of adopting a strong international currency. Hence Argentina, and a few other countries have begun to consider policy dollarisation. Europe's creation of the euro has also sparked interest in the possible payoff from explicit abandonment of monetary sovereignty (albeit in that case this is for a common currency rather than someone else's).

As is the case with most aspects of life, decisions taken result in benefits in some cases and costs in other instances. The situation is no different when it comes to dollarisation, which presents a complex menu of tradeoffs for policy makers. The most obvious benefit of dollarisation is that it eliminates transaction costs of exchanging one currency for another. However, there are other important economic benefits. Berg and Borensztein (1998) have argued that an immediate benefit of dollarisation is the elimination of the risk of currency crisis, which leads in turn to a reduction in the country risk premia and a consequent lowering of interest rates. Lower interest rates and more stability in international capital movements would result in a significantly lower fiscal cost of servicing the public debt. It should be noted that while dollarisation would eliminate the currency risk, it is uncertain whether total country risk would be reduced since the question remains as to the effects of dollarisation on default risk.

Another powerful, but somewhat hypothetical argument raised by Berg et al (1988) for full legal dollarisation is that the change in monetary regime may establish a firm basis for a sound financial sector, which would provide the basis for strong and steady economic growth. The argument here is that dollarisation would signal more than the adoption of foreign currency; it may be perceived as an irreversible institutional change towards low inflation, fiscal responsibility and transparency.

Countries with weak national economies will be financially fragile, no matter whether they have fixed or floating exchange rates. As emphasized by Hausman(1999), most emerging markets have a national currency which cannot be used by local firms or the government to borrow abroad, and cannot be used, even at home for long term-borrowing – a weakness, or “sin”, shared by the currencies of almost all emerging market economies. His argument favours dollarisation because abandoning the weak currency in favour of a strong international currency would eliminate currency and maturity mismatches, as debts would be denominated in the same unit as a company's cash flow. It would also allow these countries to borrow longer-term. Hausman argues that in spite of its chequered political history, for example, dollarised Panama has the largest domestic credit market in Latin America and is also the only Latin American country to offer 30-year fixed rate mortgages.

There are a number of key drawbacks with dollarisation as a policy option. One of the key drawbacks that have been emphasized by many authors is the issue of lost seigniorage. Because currency is worth more than its printing costs, printing money generates revenue for whoever owns the printing press. Seigniorage, which represents a form of income, usually accrues to national governments. The annual flow of seigniorage is frequently measured as the increase in base money (the sum of currency plus bank reserves). The government can use seigniorage to purchase assets (foreign currency reserves, government securities) or consume it by financing a fiscal deficit. Under current conditions, any government giving up its currency would forego this revenue and indeed this income would be shifted to the issuer of the currency.

Some authors have highlighted the tendency for the dollarisation process to be recessionary (Molano(1999)). Given that most developing countries in distress are also facing large fiscal imbalances, dollarisation tends to trigger a draconian adjustment. Such an adjustment will almost inevitably lead to recession as government spending is slashed. Moreover, dollarisation -according to the authors- will lead to high real interest rates. While it is true that dollarisation lowers nominal interest rates, real interest rates will spike as investors demand compensation for political and economic risks. Molano argued that it is therefore illogical to think that interest rates in an economy that is in the midst of an exchange rate crisis can automatically converge to US interest rates.

Another view expressed by the authors is that dollarisation subordinates bondholders. Governments that dollarise transform international reserves into the monetary base. However, the elimination of international reserves is the removal of an asset that can be used to pay off international creditors. Under the assumption that the fiscal deficit creates an inflation tax on local currency holders, then external bondholders have a senior claim on the country. Dollarisation bumps local currency holders up the seniority ladder and allows them to be paid prior to the external creditors.

Finally, the above authors argue that there are no reasonable exit strategies. If a country successfully dollarises and the results are not to its liking, how does it then end dollarisation? Governments dollarise when their societies have lost all confidence in their ability to implement macroeconomic policies. One therefore wonders how do they move into a new regime without renewing the doubts that existed prior to the dollar initiative.

For other authors, including Spiegel(1999), dollarisation implies the reduction or complete elimination of lender of last resort capability. Central bank discount window activities would not be possible under full dollarisation as central banks would be unable to expand the monetary base to provide commercial banks with additional funds. In this case, lender-of-last resort functions would either have to be provided by private sources

or by the Treasury. Initially, there has been some discussion of the possibility of the United States acting as lender-of-last resort by providing solvent but illiquid banks with formal discount window access. However, the United States has unconditionally stated that it will not be providing any assistance to the banking system of dollarised countries, either supervisory or otherwise.

Flawed institutional design has been identified as one of the key components of policy mismanagement (Burhki et al (1998)). Molano(1999) for example, argues that the political systems of many Latin American governments lacked feedback mechanisms whereby policymakers, or political parties, were held accountable for policy actions, while most of these countries lacked an independent central bank. Dollarisation in his view is a shift away from fixing institutional design. While proponents of dollarisation argue that the stabilization of macroeconomic variables can lead to the emergence of a new institutional framework, this is a backward solution to the problem. It is hard to see how dollarisation can force a government to repair deep-rooted institutional decay. In addition, dollarised governments fail to develop the skills and experience needed to develop macroeconomic policies to manage the different phases of the business cycles. Dollarisation is a pessimistic view on the capability of society to fully develop.

Perhaps the most significant loss however, is that the dollarising country also loses its ability to conduct monetary policy. This would be especially important as it forces the full burden of combating recession on fiscal policy. This loss of flexibility would become especially evident if the business cycles of the source country and the dollarised economy are asymmetric.

2. A Look at Some Countries That Have Adopted Or Considered Dollarisation As An Option

While dollarisation can be seen as a relatively new policy option in the Caribbean, this approach has been adopted by various countries around the globe for many years.

Panama is the largest officially dollarised economy with an almost 100 years of experience with such a system. Since 1904, Panama has used US dollar notes as domestic currency. It issues a domestic currency, the balboa, but it only circulates as coins. There is neither a central bank nor any centralised foreign reserves.

In 1970, a banking law liberalised Panama's financial markets and allowed full entry of foreign banks. The capital account is entirely open and banks are free to invest excess funds in Panama or abroad. Panama's macroeconomic performance has been relatively good. Inflation has averaged 3% per year in the 1961-97 period. Growth averaged 8.1% from 1961 to 1971 and again from 1978-81 and has averaged 2.5% in other years. Real interest rates have remained in low to mid-single digits. The real exchange has hardly varied compared to other Latin American countries. There are no systemic banking crises. Panama has no domestic lender of last resort. Domestic banks have established lines of credit with foreign banks with branches in Panama and have been able to draw on them during liquidity crunches.

Panama has experienced several major shocks that caused economic disruption, but the banking system has held up well. Some of these included the political crises of 1964 due to riots in the Canal Zone, the oil shocks of 1973 and 1979, the 1982 Latin American debt default and the 1988-89 crisis immediately preceding and during the embargo and the US invasion. These all resulted in withdrawal of deposits and economic dislocation. However during the 1964 and 1967-69 crises, several private banks responded by selling their assets abroad and increasing domestic credit, despite the outflow of domestic deposits. This cushioned the adverse impact on the domestic economy.

Nominal interest rates in Panama have persistently been the lowest or nearly the lowest in Latin America. Real interest rates have also been relatively low and steady, avoiding the swings from negative to positive double digits that have occurred elsewhere in North America.

As far as seigniorage is concerned, the USA collects all seigniorage on the use of the US dollar in Panama and there is no seigniorage sharing. Panama collects a small amount of seigniorage on domestic balboa coins that constitute about 9 percent of total cash and coins in circulation.

After the devaluation by Brazil in January 1999, the Ecuadorian sucre came under increased speculative pressure. Indeed it was devalued on March 2 of that year. On that same day, eight troubled banks closed and nine days later, the Government froze deposits in the entire banking system. The level of discontent shown in the financial system and the state of the economy created interest in the possibility of dollarisation. In January 2000, the President of that country announced official dollarisation to end the rapid depreciation of the sucre. The US dollar was declared legal tender and the Central Bank would only issue sucre coins. The redemption of sucre bank notes was to proceed gradually over six to twelve months.

El Salvador had considered dollarisation in 1995 but had dropped the plan in the face of opposition at home to eliminating a symbol of national identity. However, in November 2000, the decision to dollarise was announced by its President.

In 1999, Argentina's President Carlos Menem announced that the Government was studying the possibility of official dollarisation. He was prompted to do so by lingering doubts about the credibility of the currency board-like system. Argentina has attempted to negotiate a share of seigniorage from the use of the dollar in Argentina, access for Argentine banks to the discount window of the Federal Reserve System, and cooperation on bank supervision. However while the US have not ruled the possibility of sharing seigniorage with new countries in the Western Hemisphere (see Berg and Borensteinz), officials of the US Treasury and the Federal Reserve have stated that the USA will not grant access to the discount window nor will it help supervise banks in dollarised economies. President Menem's successor, Fernando de la Rúa took office in December 1999 and although Argentina has not become officially ruled out dollarisation it appears unlikely given that Argentina has created an elaborate system of floating trade tariffs

which have essentially devalued the peso for foreign trade purposes. (Financial Times, June 28 2001)

3. Implications for CARICOM

CARICOM is a regional integration movement, the ultimate goal of which is the improvement of the standard of living of the population of the Community. The Community embraces the following countries: Barbados, Trinidad and Tobago, Jamaica, Guyana, Belize, Bahamas and the OECS countries, comprising Antigua and Barbuda, Dominica, St. Lucia, St. Vincent and the Grenadines, St. Kitts and Nevis, Anguilla, Grenada and Montserrat. Seignorage income does not represent major revenue for most of the smaller territories in the Caribbean (Table 1). For example, the seignorage extracted by Barbados from its local currency accounts for a very small portion (0.5% of GDP) of income. However, seignorage income for Jamaica and Guyana are significantly higher accounting for 3.7% and 4.1% of GDP respectively.

Table 1: Seignorage in Selected Caribbean Countries

	Barbados	Trinidad	Guyana	Jamaica
Averages				
1960's	1.2	0.3	0.7	0.7
1970's	1.6	1.9	2.0	1.3
1980's	0.7	0.3	12.6	3.2
1990's	0.5	1.1	4.1	3.7

Barbados, Belize, the Bahamas and the OECS region all maintain fixed exchange rate regimes. Barbados and Belize's exchange rates are fixed each at \$2 dollars per US dollar, the rate in the Bahamas is fixed on par with the US dollar while the rate of the OECS countries is fixed at \$2.80 per US dollar. Jamaica maintained a fixed exchange rate until 1984, Guyana until 1991 and Trinidad and Tobago until 1993 (*Chart 1*). At the end of 1984, the Jamaican dollar reached J\$3.94 per US dollar. By end-1991, it had risen to

J\$12.1 per US dollar. Three years later, a further increase was experienced, to J\$33 per US dollar. At the end of the year 2000, the rate had reached J\$40 per US dollar.

When Guyana announced a floating exchange rate regime in 1991, its rate of exchange was recorded at G\$111 per US dollar. The rate fell to G \$138 three years later, declined further to G\$150 in 1998, G\$178 in 1999 and G\$183 in 2000. With the introduction of the floating exchange rate regime by Trinidad and Tobago in 1993, the exchange rate at that time was TT \$5.35 per US dollar. The rate moved to TT\$6.25 per US dollar by the end of 1997 and has remained relatively constant since that year. There have been several interventions by the Central Bank of Trinidad and Tobago over the past few years to maintain this parity. At present, the exchange rate of Trinidad and Tobago dollar stands at \$6.21 per US dollar. It is clear that unlike Trinidad and Tobago, both Jamaica and Guyana have experienced exchange rate instability. If this is one of the criterion used for judging whether or not there is a country should dollarise then Guyana and Jamaica qualify.

The inflation patterns for the Caribbean countries are also worthy of note (*Chart 2*). As expected, those countries with fixed exchange rates have been able to maintain low inflation rate regimes. For example, since 1995 Barbados recorded an average inflation rate of approximately 1.5% with the exception of 1997, when the rate jumped to 7.7% due to the introduction of the value added tax. The OECS countries have also been able to maintain average annual inflation rates of almost 2% over the past ten years. The same can be said for Belize with the exception of 1996. However, Guyana's annual rate of inflation averaged around 6% since 1994, Jamaica's was well over 10% while Trinidad and Tobago recorded average annual inflation of some 5% since 1993. Once again, one could argue that based on the inflation criteria, both Jamaica and Guyana are candidates for dollarisation.

Up until now, no mention has been made of the fiscal balance (*Chart 3*), but these also make interesting reading. Barbados and the OECS countries have managed generally to maintain low fiscal deficits. In 1991, when Barbados entered into a structural adjustment

programme with the International Monetary Fund (IMF), its fiscal deficit was recorded at 7.2% of GDP. Huge government expenditure was given as one of the reasons for the large reserve loss which was experienced. Indeed, the import reserve cover at end-1991 was equivalent to a mere 2.9 weeks of imports. Ever since then, Barbados has tried to ensure that its fiscal deficit does not exceed 2.5% of GDP. This target has been exceeded only once, that is in 1996 when the deficit rose to 3.2% of GDP. Data on the Bahamas show that the fiscal deficit averaged annually some 3% between 1990 and 1993 and has fallen since that period. The same argument can be advanced for the OECS countries that have managed to keep their deficits within 3% of GDP. However, the same cannot be said for Guyana and Jamaica. Information to 1998 suggests that Guyana deficit reached 21% of GDP in 1991 and rose to 23.5% of GDP in the following year. Some reduction was experienced in the next six years, with the lowest ratio of 3.1% achieved in 1997. Nevertheless in 1998, the fiscal deficit grew to 6.2% of GDP. While data on Jamaica's fiscal deficit to GDP ratio have been sketchy, during the 1980's, double-digit figures were recorded for this country. In 1999, the Central Bank Report stated that Jamaica's fiscal deficit amounted to \$273.2 million, which would surely have surpassed 3% of GDP. Trinidad and Tobago's fiscal deficit exceeded 4% of GDP in the latter 1980's but had actually recorded surpluses from 1993 to 1995.

We turn our attention to the ratios of foreign currency to broad money (M2) (*Chart 4 and Table 2*). This informs us of the percentage of broad money that constitutes foreign currency deposits held by residents of a country. The percentage determines whether countries can be classified as highly dollarised economies or moderately dollarised economies. Any country with a ratio in excess of 30 will meet the first classification whereas a country with a ratio of less than 30 will meet the second.

The table shows that the ratios for Barbados, the Bahamas, Belize, Guyana, Jamaica, Trinidad and Tobago and the OECS countries all classify these countries in most cases as moderately dollarised economies. However a more detailed analysis shows the following. Barbados, the Bahamas and Belize have ratios that have not exceeded three percent of broad money. Indeed since 1990, Barbados' highest ratio was 1.40 in 1994. Bahamas'

ratio ranged from 1.32 to 2.23, somewhat surprising considering that the Bahamas dollar is on par with the US dollar. Belize's ratio was at its lowest in 1991 (0.33) and reached its highest in 2000 (2.71). Despite this, Belize has adopted the US dollar as its currency. It is felt that this decision was influenced by similar actions by its neighbours, Guatemala and El Salvador. The OECS countries carried ratios in the vicinity of 15% since 1990. However this ratio has been distorted by Anguilla and St. Kitts and Nevis. Anguilla's ratio averaged around 60% over the past ten years and would easily qualify it as a highly dollarised economy, comparing favourably with Argentina, Bolivia, Uruguay, Peru, Costa Rica and Turkey, to name a few. Its close proximity to the US may be one of the possible reasons for this pattern. St. Kitts and Nevis, while being nowhere as high as Anguilla, recorded an average of around 15%. It actually rose as high as 23% in 1997. The average ratio is about five times the ratio of any other OECS country, Anguilla excepted. Guyana's ratio appears to be considerably lower than expected given the history of macroeconomic instability in Guyana. The authors suspect that there may be some problems with the data for that particular country.

Excluding Guyana the larger CARICOM the foreign currency ratios for the larger CARICOM economies-Jamaica and Trinidad- are considerably greater than for the smaller territories. Trinidad and Tobago's ratio increased from 8.5% to 17.9% in 1999. The important thing to note here is that since 1993, when this country's dollar was floated, there has a steady increase in the local holdings of foreign currency deposits.

Although Jamaica has been classified as a moderately dollarised economy, its ratios have placed it dangerously close to that of an economy that is highly dollarised. In 1992, the ratio of foreign currency deposits to the money supply was recorded at 21.3%. By 1993, it fell by two percentage points but in 1994 but rose sharply to 28.1%. A mere two percentage points from being classified as a highly dollarised economy. Three years later, the ratio of 30.4% classified Jamaica as a highly dollarised economy and at the end of 1999, it had declined by four percentage points.

Access to US banks and the loss of the Central banks have not been dealt with so far in this paper. CARICOM countries are not guaranteed assistance from the US central bank under a policy of official dollarisation. The loss of central banks could be a tricky issue, even at the political level. Under dollarisation, there is some loss of national sovereignty over macroeconomic affairs. For example the monetary policies of CARICOM will now coincide with the Federal Reserve Bank, hence no need for central banks any longer. This has implications for employment since it may not be easy to absorb these workers into different sectors locally or regionally.

Conclusion

This paper has attempted to analyse various aspects of dollarisation in an effort to see whether it is a viable option for CARICOM. For CARICOM as a whole the answer is not obvious. However, if one is guided by the data provided then, Barbados, the Bahamas and the OECS countries (despite the performance of Anguilla) do not need to officially dollarise. These countries maintain a fixed exchange rate and a low inflation regime and have been able to record small deficits. In addition, the ratio of their foreign currency deposits to the money supply, M2, has been low, suggesting no real need by their citizens to hold foreign currency. With the exception of Trinidad and Tobago, CARICOM countries which have adopted a floating exchange rate regime have also experienced exchange rate instability, high inflation and fiscal deficits in excess of 3% of GDP. Even in this case, the decision to officially dollarise is no straightforward. For example, if the problems of exchange rate instability and high inflation are caused by high government spending, then dollarisation is not the answer since the fiscal imbalance needs firstly to be addressed. Most Caribbean countries that are considering dollarisation as an alternative measure are facing fiscal problems.

If CARICOM countries are able to successfully tackle their fiscal problems and maintain exchange rate stability, then the case for dollarisation is quite weak. Would CARICOM countries be willing to give up its implementation of monetary policies? How would

political leaders respond to the abolition of their respective central banks? These are some of the main issues that would have to be seriously considered.

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Table 2: The Degree of Unofficial Dollarisation in Caricom Ratio of Foreign Currency Deposits and Money Supply (M2)

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Bahamas, The	1.61	1.90	2.23	1.79	1.32	1.57	1.28	1.65	2.09	1.63
Barbados	0.96	1.22	0.89	1.13	1.40	0.68	1.11	1.19	1.30	1.32
Belize	0.62	0.33	1.48	0.73	1.23	0.77	2.54	1.77	2.01	2.71
Belize*	0.65	0.35	1.48	2.94	5.58	7.38	10.22	7.72	10.99	10.48
Guyana	3.35	2.57	4.30	5.42	6.46	5.28	5.34	6.50	6.10	5.06
Jamaica	n.a.	n.a.	21.30	19.50	28.10	25.00	25.41	30.45	27.88	26.73
Trinidad & Tobago	n.a.	n.a.	n.a.	8.45	15.20	14.16	18.42	18.52	18.38	17.91
OECS:										
Anguilla	57.56	61.45	63.86	66.72	66.43	70.10	69.47	70.89	73.18	72.49
Antigua & Barbuda	4.29	5.02	4.82	3.36	4.33	3.57	4.02	5.14	5.27	5.36
Dominica	0.17	2.68	3.49	3.19	2.33	1.34	1.02	1.91	2.38	2.76
Grenada	2.04	2.70	2.66	3.03	3.54	3.28	4.71	4.94	3.94	4.95
Montserrat	1.33	5.58	6.92	6.42	4.93	4.78	4.66	2.46	1.97	3.36
St Kitts & Nevis	14.62	12.82	13.59	15.56	14.21	17.70	18.23	23.00	19.08	19.59
St. Lucia	0.18	0.24	0.18	0.31	0.45	0.52	0.42	0.48	0.71	1.92
St. Vincent & The Grenadines	0.49	0.95	0.54	1.00	2.01	1.49	1.09	1.83	2.35	2.85

Notes:

1. The table now includes data on the Foreign Currency Deposits for Guyana and is therefore now complete.
2. Belize* Includes Foreign Currency Deposits of both residents and non-residents.
3. Jamaica: Data for the period 1992-95 were taken from issues in Dollarisation, IMF Course on Financial Programming and Policies, Bridgetown, Barbados, Edda Zoli, August 14, 2000.

Source: Research Department, Central Bank of Barbados.

Chart 1

Exchange Rates for Guyana, Jamaica and T&T

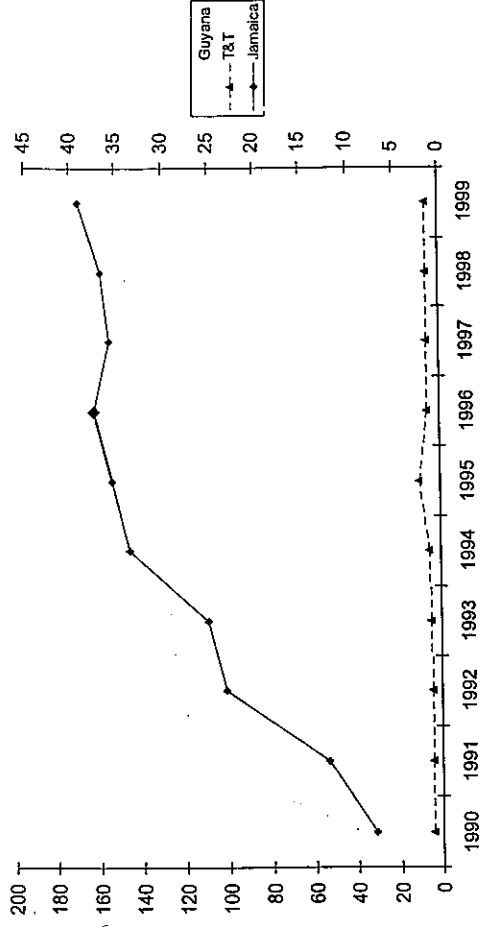


Chart 2

Inflation Rates

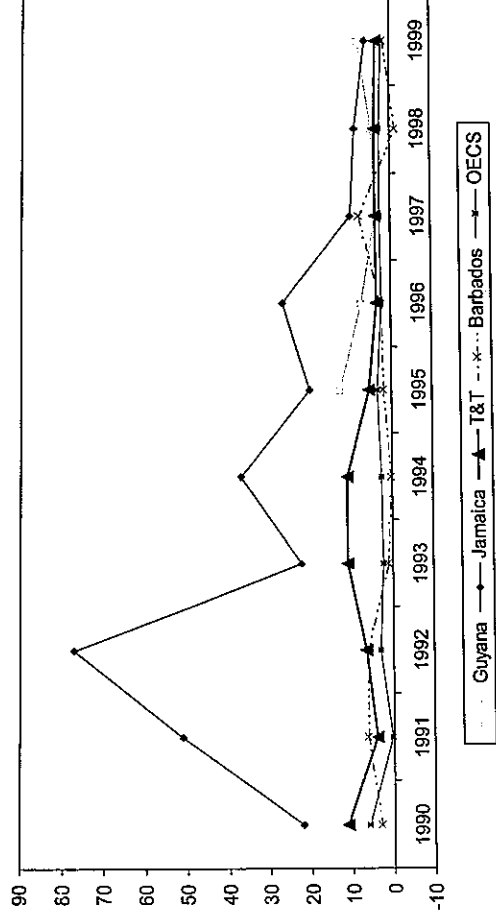


Chart 3
Fiscal Deficit as a % of GDP

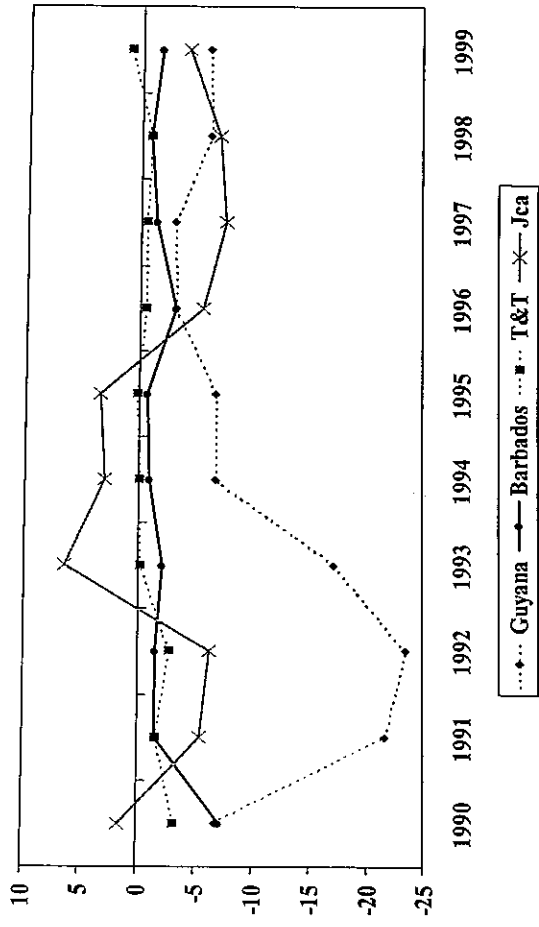
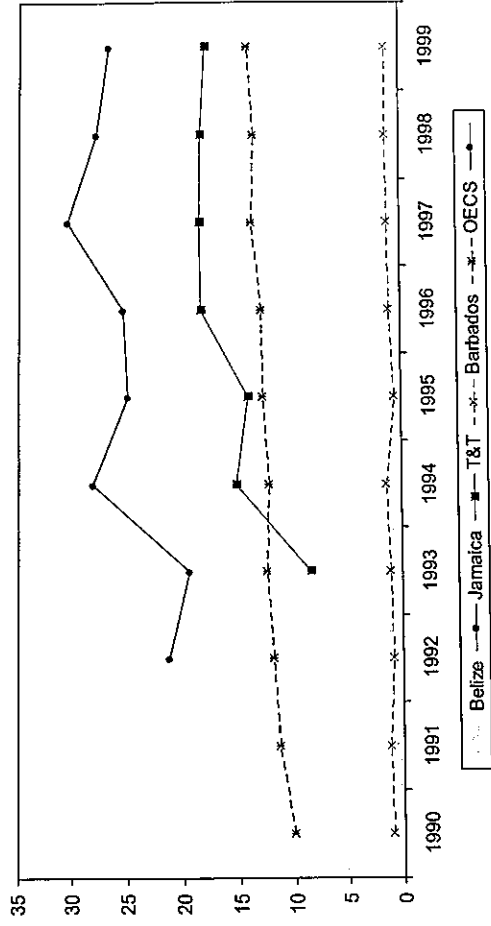


Chart 4
Foreign Currency Deposits of Residents as a % of
Money Supply (M2)



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