Dollarization, Currency Board or Common Currency: Towards a New Monetary Order in North America?

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Introduction

The recent world money crisis and the advent of the euro as the new common currency for 11 nations in Europe, make it necessary for the signatory nations of the North American Free Trade Agreement --that links Canada, the United States and Mexico into a tariff-free common market for goods and services-- to consider the plausibility of launching an initiative for a North American common currency that could provide the monetary stability necessary for the development of financial markets, economic recovery, and the fully realization of the economic returns from the tariff-free common market. Furthermore, it becomes necessary for them to look at the implications of a possible single currency that could serve the needs for the Americas in the future, as a Free Trade Agreement of the Americas --that would extend from Alaska to Cape Horn encompassing 34 countries-- is likely to come into effect by the year 2005.

In this essay I would explore the desirability --and potential benefits and costs-- of the adoption by Canada and Mexico, of a currency board system in contrast to dollarization (namely, the abandonment of domestic currency and the adoption of the U.S. dollar) as a necessary precondition towards a euro-like North American Common Currency.

I would argue that, for the time being, the currency board system is the preferred alternative, as it fosters Monetary as well as Fiscal Policy discipline --with its associated benefits in terms of price stability and higher economic growth-- at the time it definitely avoids the major problems that rise with dollarization, that is, the problem of giving up seigniorage to the United States, the problem of loss of sovereignty in the dollarizing country, and the problem implied for the United States (of) when acting as lender of last resort, and having to assume the responsibility of regulating and supervising the banking system of the dollarizing economy. I suggest that a common currency for North America --and eventually for all of the Americas in the future-- is a necessary development in the evolution of the global economy, and that the currency board constitutes the ideal previous condition to achieve that goal. The implied common currency does not necessarily has to be an euro-like common currency; actually it could be the case that the U.S. dollar acting as a common currency, in the event that certain necessary conditions for an euro-like common currency could not be attained, and assuming that the participant countries --including the United States-- were willing to negotiate an agreement that might address the problems derived from dollarization.

The essay is organized as follows. The first three sections offer a description of each of the alternatives that Canada and Mexico would face if they were to formally link their currency to the U.S. currency --dollarization, currency board and (euro-like) common currency-- and present a general overview of its implications in terms of economic policy, as well as its advantages and disadvantages regarding growth, stability and other related issues. The last section (section IV) explores the desirability and readiness of these countries to opt for either one of the alternatives.

I. Dollarization

A. Overview on the recent discussion in dollarization

The financial crisis that struck Mexico in 1994-95, and the Asian currency crisis with its repercussions in Russia during 1998 and Brazil in 1999, coupled with the advent of European economic and monetary union (EMU), have sparked renewed discussion of a possible reduction in the number of the world's currencies.

On the one hand, the countries that have suffered most from the crises have been developing countries with central banks maintaining pegged exchange rates to the U.S. dollar.

These countries are very interested in a policy that could offer them a way of achieving a truly fixed exchange rate that might contribute to prevent future currency crises as well as sustained economic stabilization, lower inflation, and greater long-term economic growth. Dollarization has emerged as an option, in particular in Latin America; the issue has been raised recently in a number countries within the hemisphere, causing significant debate. The outgoing president of Argentina and the just-departed president of El Salvador, have called for official dollarization. Actually, Argentina's President Menem has already taken one step further proposing a dollarization plan that includes setting up an agreement with the United States[1]. Advocates of dollarization are also making some inroads in Mexico. Mexico's business executives as well as a number of well-known economists speak for Mexico's emulation of Argentina's monetary reforms, suggesting that the country should abandon the peso and go on a dollar-based system. Mexican officials began exploring the idea of taking steps toward some sort of eventual monetary union with the United States. The dollarization option has also been discussed in Canada, where the idea of the U.S. dollar as a common currency for the signatory nations to NAFTA is being seriously considered. Additionally, the influential Inter-American Development Bank has also triggered Latin American developing countries to dollarize, or even create a new regional dollar-linked currency.

On the other hand, the introduction and apparent success of the euro in establishing a common currency in Europe, has encouraged discussions involving the use of the dollar for a similar role in all of the Americas. The introduction of the euro had brought up questions regarding the role that the U.S. dollar will play in the international monetary and financial system when competing with the euro and the Japanese yen. There is a fear that the U.S. dollar could lose its dominant role as trade vehicle currency after the European changeover, moving to a second position followed by the Japanese yen. It has been argued that due to network effects,

[1] For a description on Argentina's dollarization project see: Calvo (1999a).

the euro might gradually expand its share in global trade invoicing thereafter, primarily at the expense of the dollar in Central and Eastern Europe, the Mediterranean, and, perhaps, also in Asia[2].

B. Basics on dollarization: *What* dollarization is, *How* it works, and *Where* it exists.

Dollarization occurs when a country *officially* abandons its domestic currency and adopts the U.S. dollar, so that the latter serves the classical roles of money, that is, as means of exchange, as unit of account, and as store of value[3]. This implies that in a dollarized economy saving holdings, goods pricing, and payments are all determined in U.S. dollars. This particular case is known as *complete* or *full dollarization*, to distinguish it from *partial dollarization*, in which case, the dollar circulates along with the domestic currency, and is used in any of the previously mentioned roles of money. Typically, partial dollarization is *unofficial* and it happens as consumers and business in an economy choose to hold dollars as a store of value --keeping large bank deposits abroad or dollar notes as "mattress money"-- and/or to price products and write contracts on the basis of dollars, or to use them as means of exchange for transactions[4]. This situation usually arises as a result of a lack of confidence of the economic agents, as they perceive that the domestic inflation rate will continue to rise followed by a subsequent depreciation of the domestic currency on international markets.

A recent IMF Occasional Paper dealing with dollarization (Baliño, Bennett and

[2] This fear is not without foundation. The European Monetary Union's economic and commercial weight will be comparable to that of the United States and larger than that of Japan. In 1996 the European Union's share of the GDP in the OECD amounted to 38.3%, as against 32.5% for the United States and 20.5% for Japan. If intra-Community trade is excluded, the European Union accounts for 20.9% of world trade, as compared with 19.6% for the United States and 10.5% for Japan. For a recent discussion on this topic see: Hartmann (1999).

[3] Frequently *dollarization* is used in a generic way to refer to any foreign currency that replaces the domestic currency, not only the dollar.

[4] When in addition to domestic currency, foreign currency is used as means of payments, , the case is commonly denominated "currency substitution"; see Baliño, Bennett and Borensztein (1999).

Borensztein 1999), indicates that partial dollarization is relatively widespread. The paper reports that in 7 countries, dollars circulate about equally with the national currency, account for about 30 to 50 percent in some 12 other countries, and account for about 50 to 20 percent of currency in many other countries. Examples are Bolivia, Peru, and Turkey. In Bolivia, for instance, although individuals are paid in bolivianos, they use them mostly for small transactions, numerous expensive goods are priced in and paid for in dollars. Bolivian people hold most of bank deposits in dollars (as much as 80 percent) and many bank loans are denominated in U.S. currency.

Official full dollarization is less widespread. The best-known case is Panama, a country that has used the U.S. dollar as its official currency since its creation as a nation in 1904[5]. In addition, other 11 countries officially use the U.S. dollar, like Guam, Micronesia, Puerto Rico, Virgin Islands (U.S. and UK), Marshall Islands, Palau, Pitcairn Island, Turks, and Caicos Islands, some of which are U.S. possessions. A few other small economies officially use foreign currencies other than the U.S. dollar, such as the French frank and the Australian dollar. There are various other countries, like Liberia, that confer the U.S. dollar or another foreign currency status as a “parallel legal tender” (Schuler 1999).

A country can choose to dollarize its economy without any special agreement with the United States, as Panama and Liberia did; however, a country may consider establishing a monetary treaty with the U.S., as Argentina has recently proposed. Besides that, a dollarizing country must have to consider several issues: whether to discontinue the use and making of domestic coins; the exchange rate to use for exchanging domestic currency into dollars; the existence and possible acquisition of foreign reserves necessary for dollarization; how to handle legal aspects of changing currencies; and aspects related to the reorganization of the domestic banking system.

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[5] For a recent study on the monetary experience of Panama, see Moreno-Villalaz (1999).

C. Economic Policy implications

A country that ceases to issue its own currency abandons its independent monetary policy, which enables it to manipulate the money supply, exchange rates and interest rates, all of which can be use to speed up or slow down an economy[6]. In a dollarizing country, the function of making monetary policy is transferred directly to the Federal Reserve System of the United States. Additionally, as the country replaces domestic currency with the dollar, it loses *seignorage* to the United States, which implies a change in direction for fiscal policy --since any attempt to increase government income must necessarily be done through taxation or public debt[7].

D. Advantages and disadvantages for the dollarizing economy as well as for the United States

Dollarization in any country, nearly eliminates the risk of devaluation and removes the threat of high inflation, which results in the elimination of inflation and exchange rate devaluation premia, leading to lower domestic interest rates and the reduction of the cost of credit, which in turn encourages domestic productive investment[8]. Price stability reduces volatility in domestic prices which helps reducing uncertainty in the economic environment, further encouraging productive investment --particularly foreign investment-- all of which lead to faster economic growth and presumably to higher employment. Additionally, Guillermo Calvo (1999b) has argued for the advantages in terms of higher and stable growth that result from the diminishing on the incidence of *contagion* --in emerging markets-- as credible dollarization results in lower interest rates that are less sensitive to crisis in other countries; this is basically because

[6] This is referred to as discretionary monetary policy.

[7] Seignorage is the revenue a government gains from its monopoly power of issuing currency, as the purchasing power of the currency issued exceeds the cost of producing it.

[8] Risk premia cannot be completely eliminated, because it depends on other factors such as the performance of the fiscal authority, the quality of the financial system, and the flexibility of labor and product markets. However, dollarization substantially reduces risk premia.

dollarization increases the predictability and credibility of monetary policy[9]. Other advantages are the encouragement of fiscal discipline, and the prevention of "brain drain" from the dollarizing economy --since stability makes it easier to attract and retain talent-- and its associated benefits in terms of higher innovation and its incidence on economic growth.

An evident disadvantage for a dollarizing economy is the loss of the ability to use discretionary monetary policy, which means that only one policy tool --fiscal policy-- is available to deal with all kinds of economic shocks that could hit the country. If an economic shock occurs, the effects would fall entirely on the real side of the economy creating distortions on the labor market and affecting employment. Another disadvantage is the loss by the domestic government of the profit derived from issuing money, that is, seigniorage. These policy related disadvantages are associated with the loss of national sovereignty since the function of making monetary policy, as well as the revenues derived from issuing currency, are transferred directly to the Federal Reserve System of the United States. The latter could make monetary policy decisions that are inappropriate for the particular economic situation of the dollarized country if its level of development is too different from that of the United States. Additionally, in numerous countries a domestically issued currency is seen as a symbol of national identity and political pride. Finally, a dollarized country could have to devise substitutes for a central bank as a lender of last resort.

The advantages and disadvantages for the United States derived from dollarization of another country, can be easily summarized. An advantage for the U.S. is the gain on seigniorage from increases in the dollar monetary base, partly at the expense of the dollarizing economy. Some other advantages are associated to the benefits that dollarization brings in terms of international trade --the dollarizing economy could no longer deliberately depreciate its currency

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[9] An example of the phenomenon of *contagion* is the "efecto Tequila" associated with Mexico's 1994/5 balance of payment crisis. For further discussion on this topic see: Calvo and Reinhart (1996).

to gain price advantage on exports, and dollarization would reduce the cost of doing business with the dollarizing country-- and those associated with the stability of international financial markets --elimination of possible currency turmoil in the future could be expected as more and more unstable economies choose to dollarize. Additionally, an extension of the dollar area would be desirable for the United States in order to prevent the U.S. dollar to be displaced by the euro as the major global reserve currency.[10]

Possible disadvantages could emerge in the event that the dollarizing economy attempts to exert political pressure on the U.S. Federal Reserve System to pursue monetary policies that are not consistent with U.S. objectives. Or in case it demands access to the Fed discount window, that is, if the central bank of the United States is required to serve as lender of last resort, and to assume regulatory and supervising responsibility over the banking system of the dollarizing country.

II. Currency Board

A. Basics on currency board system: *What* a currency board is, *How* it works, *Where* it exists

A currency board system is a system of fixed exchange rates. The currency board is an institution --within a monetary system of a country that has banks and other financial institutions-- that issues notes and coins convertible into a foreign anchor currency --or reserve currency-- at a fix (permanent) rate and on demand[11]. In general, a currency board: holds as reserves low-risk interest-bearing bonds and other assets denominated in the reserve currency, in

[10] The success of the euro is the more likely if the Eastern European countries decide to tie their currencies to the euro by say, establishing a euro-based currency board system, as they wait to be admitted to the Union; see. Courchene (1999).

[11] The anchor currency must be a stable currency with wide international acceptability, the U.S. dollar, the German mark or the British pound had typically been used as reserve currencies in currency board systems throughout the world. Gold can also be used as the anchor currency or a basket of foreign-currency securities could serve as reserve assets as well.

an amount equal to 100 percent or slightly more of its notes and coins in circulation[12]; maintains full unlimited convertibility between its notes and coins and the reserve currency at a fix rate of exchange, which implies that no restrictions exist on current-account or capital-account transactions; does not accept deposits; does not convert local deposits denominated in its currency into the reserve currency (banks must keep on hand adequate reserves of currency board notes and coins to satisfy customers' demands to liquidate deposits); it generates seigniorage from the difference between the interest earned on its reserve assets and the expense of maintaining its notes and coins in circulation, and remits to the domestic government all profits beyond what it needs to cover its expenses and to maintain its reserves at the level set by law; and does not act as a lender of last resort. (Hanke and Schuler 1993)

A country adopting a currency board system must have to consider several issues: whether to maintain a “central bank” existing alongside the currency board[13]; the exchange rate to use for fixing the parity; the existence and possible acquisition of foreign reserves necessary to maintain convertibility; aspects related to the constitution of the currency board[14]; devise substitutes for a central bank as a lender of last resort[15]; and aspects related to the reorganization of the domestic banking system.

The currency board monetary system existed in several countries in the past, particularly during the 1950s when it reached its greatest extent, but most of them disappeared as intellectuals started favoring central banking during that decade and the next. At the present time, currency

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[12] That is, only the monetary base (M0) has 100 percent foreign reserves, broader measures of money supply do not have 100 percent reserves; reserve requirements against commercial bank deposits are not necessarily enforced.

[13] In such a case, the central bank will have no effective powers; it would be restricted to perform supervising functions over commercial banks and other financial institutions.

[14] The board of directors must be appointed by foreign institutions in order to adequately insulate the currency board from government manipulation and the threat of conversion to a central bank.

[15] The government may provide lender of last resort facilities through deposit insurance, though other options could be devised.

board systems exist in a few countries such as Argentina, Hong Kong and Lithuania, whose currencies are tied to the U.S. dollar. Other places with currency board systems are tied to the German mark (and consequently to the euro) such as Bulgaria and Estonia.

B. Economic Policy implications

If a country establishes a currency board system, its domestic monetary policy automatically becomes subject to the monetary policy in the United States. Consequently, it does not permit discretionary monetary policy and prevents the printing of currency either to subsidize government spending or to assist of the banking system, enforcing a hard budget constraint on the domestic government. Nevertheless, under this system the government retains the ability to earn seigniorage and may use its proceeds to finance public expenditure.

C. Advantages and disadvantages of the establishment of a currency board system

Since official dollarization has much in common with currency board systems the perceived advantages and disadvantages of both are mostly the same. One major difference is that under a currency board system and not requiring the elimination of national currency, the domestic government retains the ability to earn seigniorage. Additionally, nationalistic sentiments for a locally issued currency are duly satisfied.

As for the United States the advantages are the same except for the fact that this country wont gain seigniorage from increasing the dollar monetary base, and disadvantages are almost non existent since, under this option, there is no reason to fear that the foreign country could exert political pressure on the Fed with regard to its monetary policy or to require the Fed to serve as lender of last resort, neither to assume regulatory and supervising responsibility over its banking system.

III. Common Currency

A. The European Common Currency: general aspects.

The euro stands alone as a unique case of common currency among independent nation states[16]. It is the result of the ongoing process of economic integration within the European Union single market in which people, goods, services and capital move without restrictions. In Europe, the introduction of the euro is seen as a way to complete the integration because it would guarantee the establishment of sound and transparent competition among the member nations. The common currency is regarded as a way to overcome currency disturbances, and conflicts between budgetary policy and the stability objective assigned to monetary policy, which have limited economic growth in Europe over the last twenty years.

The history of the European monetary integration began in 1968 with the Warner report, which set up an outline for a stage-by-stage realization for the achievement of economic and monetary union over ten years[17]. In 1979 the European Monetary System (EMS) was established as a reply to an unstable international environment. The EMS centered on the self imposed discipline of national policies in a setting of fixed exchange rates, supported by an emerging policy consensus on stability-oriented policies. As a consequence bilateral rates --which were allowed to fluctuate within preset margins around these rates-- were determined between all currencies in the System. At the center of the EMS was the ecu, a basket currency, made up of fixed percentages of the participating national currencies.

In 1989 the Delos report laid the foundations for the euro and the Maastricht Treaty of 1992 provided the economic policy architecture for EMU and the single currency. The main institutional change brought about by the treaty was the establishment of the European

[16] The euro came into being --among the European Union Member States adopting it-- in paper form, and as a unit of account on January 1999. The actual notes and coins will start circulating from January 1st 2002.

[17] However, due to the oil crises, divergences between economic policies and the weakness of the US dollar, early moves to tie currencies together were reduced to an arrangement involving only Germany, Denmark and the Benelux countries.

Monetary Institute (EMI) as the precursor of the European Central Bank (ECB)[18]. Starting January 1st 1999, the ECB is responsible for the definition and the conduct of a single monetary policy for all of the European Union Member States adopting the euro. The Maastricht Treaty also established a convergence criteria for these countries: a rate of inflation not exceeding 1.5 percentage points of the average rate of the three best performing Member States in terms of price stability; a government deficit which does not exceed 3% of GDP in normal circumstances; a ratio of public debt to GDP which does not exceed 60%; and long term interest rates not exceeding 2 percentage points of the average rate of the three Member States with the lowest inflation[19]. These criteria ensure that European Union Member States' economies are sufficiently similar to make a common currency feasible.

B. Economic Policy implications

EMU implies an economic policy regime change for the participating countries in terms of both, fiscal and monetary policy.

Membership of the common currency restricts the freedom of the national state's economic authorities with regard to monetary policy because they can no longer set interest rates and devaluate the currency to jump-start the economy; however, the Member States get to participate in monetary policy making for the Union as a whole, since they all have representation in the European System of Central Banks and in the Council of Economic and Finance Ministers --which brings together the Ministers for Economic Affairs and Finance of the

[18] Other important developments include the adoption of legislation prohibiting: monetary financing of public sector activities; privileged access by public sector entities to financial institutions; the appropriation of the public sector liabilities of a Member State by the Community or by another Member State.

[19] Only 11 of the EU Member States are participating in the single currency at this stage: Austria, Belgium, Germany, Spain, France, Ireland, Luxembourg, Italy, The Netherlands, Portugal and Finland; Sweden and Greece do not meet the convergence requirements at the present time, and The United Kingdom and Denmark decided not to join yet. For more information look at the official web site run by the European Commission: <http://europa.eu.int/euro/html/entry.html>

Member States-- sharing the responsibility of defining the major orientations of economic policy.

With regard to fiscal policy, this would mainly be decided at national level, but it will be set in the framework based in both the Maastricht Treaty and in the Stability and Growth Pact approved by the European Council (Europe's heads of state or government) in 1997[20]. The Treaty established obligations to avoid excessive deficits and an obligation to submit stability and growth programs designed to maintain a budgetary situation close to balance or in surplus in the medium term.

C. Advantages and disadvantages

The major advantages regarding the economic and monetary union is its promise to ensure sustained growth and stability, mainly through the advantages brought about by the elimination of currency disturbances and the assurance of fiscal discipline.

The adoption of a common currency would completely eliminate, within the Union, exchange rate risks -- which are costly in growth and employment terms-- and the economic performance of euro-area will be less sensitive to exchange-rate fluctuations in the currencies of third countries (particularly the U.S. dollar) or shocks outside the European Union[21].

Fiscal and monetary discipline coupled with the elimination of exchange rate risk would ensure low inflation. Additionally, the control of government debt, the elimination of risk premiums on long-term interest rates --linked to inflation expectations and exchange-rate risk-- and the size of the euro securities markets --that is expected to attract new financial investors

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[20] The Stability and Growth Pact follows an approach that goes in two directions: a *preventive, early-warning system* and a *dissuasive set of rules*. The first would help identifying and correcting budgetary problems, within a Member State, before they bring the deficit above the 3% of GDP ceiling. The second is intended to put pressure on Member States to avoid excessive deficits or to take measures to correct them quickly if they do occur.

[21] The most recent turmoil that had affected Europe (1992 and 1995) caused a loss of two to three percentage points of GDP growth and more than 1_ million jobs in the Community economy in the last five years. The last turmoil was not European in origin, it happened as a consequence of the Mexican debt crisis which triggered excessive weakness in the dollar in early 1995.

because its liquidity-- will bring about a fall in the interest rates, which would lead to more investment, more growth and more employment.

It has also been argued that the restriction on public debt ratios and the consequent reduction of the interest burden on public debt, will allow government spending to be restructured towards devoting a higher share of public money to priorities which are important to build long-run growth and employment.

Another benefit derived from the implementation of a single monetary and exchange-rate policy, the increase in economic interdependence and the likely intensification of economic-policy coordination, would be the synchronization of the economic cycles in the different Member States. And greater cyclical synchronization, combined with the size of EMU, will make economic developments in the euro area more important to the world.

It is expected that the euro's arrival will constitute a major change in the international monetary system currently dominated by the U.S. dollar, and will give Europe a monetary importance consistent with its economic and commercial role. The size of the euro area and its attractiveness to investors will mean that a significant proportion of transactions currently carried out in foreign currencies should gradually switch to the euro.

The euro would bring advantages to the European firms: they will not have to bear an exchange-rate risk in future; they will be able to invoice in the currency in which their costs are expressed --thus be better placed to face world competition; firms will make direct savings in terms of foreign exchange conversion costs, and would benefit from the considerable simplification of cash management and in particular, from a higher confidence in investment decisions. These benefits will be connected with firms' European activities but they will also reinforce their competitive position in the world export market. According to the "One Market, One Money" studies, the euro would also bring efficiency gains as well as cost reductions for consumers and non-financial firms.

Finally, a common currency would ensure transparency of pricing, the differences on prices would reflect differences on productivity.

Some of the disadvantages are related to the unavailability of monetary policy for the purpose of country-specific stabilization in the event of a external shock; Member States will have to rely on their own budgetary policy --to absorb part of the shocks that are not smoothed by markets-- and this could intensify the pressure to adopt tough structural reforms, such as cutting back on their welfare states. Related to this issue, is the perceived short and mid term inability of the EMU to cope with the problem of having one of its member countries suffering an asymmetric shock --that can no longer be corrected by exchange-rate changes at the national level. Despite the fact that there are several adjustment mechanisms (labor and product markets, capital and credit markets, budgetary policy) by which EMU could cope with asymmetrical shocks, it may take a few years for these mechanisms to be fully operational.

Another disadvantage is that the conduct of a single monetary policy --that by itself will imply a regime change for the Member States-- will require enhanced coordination in other areas of economic policy, and this could take time and cause conflicts between participating Member States that have different concerns and priorities.[22]

Some EMU Member States, like the United Kingdom, had pointed out the disadvantage of the EMU of further weakening of national sovereignty to the benefit of remote and undemocratic bankers and bureaucrats.

IV. New Monetary Order within NAFTA

A. A North American Euro-like Common Currency

[22] Actually, some conflicts have already arisen between Member States with regard to the decision to locate the ECB in Frankfurt. The United Kingdom had argued that the Bank should be sited in London, and that its establishment in the German city is a great advantage for that country and a great loss for London, Paris and other European cities; see: Oliver (1999)

In light of the most recent developments in the global economy and within the framework of NAFTA, a common currency for North America stands as an appealing option, if not as a necessary development, to enhance stability and economic growth, and to fully realize the economic returns from the tariff-free common market. The common currency for North America could take two forms: it could either consist of the creation and adoption of a euro-like common currency or it could comprise the adoption of the currency of one of the parties involved --the U.S. dollar in this case.

A euro-like common currency for the signatory nations to NAFTA, though advantageous, is not subject to implementation in the short run; a move on this direction would require, in addition to policies to enhance efficiency and guarantee monetary and financial stability, policies aimed at improving equity among the richer countries --the United States and Canada --and the poorer country --Mexico. Mexico's divergence with respect to income, unemployment, and inflation, when compared to that of the U.S. and Canada, is very high. Within the richer countries, economic integration is already well advanced and production methods are similar**.** The same types of goods, but different brands and qualities, are traded between them. The nature and quality of infrastructure, technology, training levels and access to funding are relatively comparable. The United States and Canada are in a stronger position to benefit from a greater market by an expansion of their output of goods and services -- already growing fast at the domestic level-- and from the efficiency gains and cost reductions derived from the adoption of the common currency.

If the adoption of a euro-like common currency among NAFTA participating countries was to be done relatively soon, it would be necessary to design an appropriate mix of catching-up strategies for Mexico that could be implemented in the short run. This might require, among other things --such as further reduction on trade and capital barriers-- some sort of transfers --as it has been done in Europe-- from the Northern Nation States to Mexico, which would undoubtedly encounter serious political obstacles among the Northern States. Even if an agreement could be reached, Mexico would have to insure transparency on the administration of funds and to agree on being subject to ex-ante evaluations and permanent monitoring, and even to some kind of positive economic and political conditionality, requiring sound public finances and low inflation and interest rates, as well as a real democratization of the political system and decentralization of political power. In addition, it could further require some kind of coordination among Nation States on other policy issues such as labor, taxation, and business regulation. The necessary adjustments within Mexico would take time, and strong cooperation among Nation States would be needed.

The transition time then would probably be very long --at least a decade-- and it would have to incorporate an extended period of intense negotiations that could culminate in some version of the Maastricht Treaty and the European Stability and Growth Pact.

Considering the impossibility of implementing a euro-like common currency within a short time period, Canada and Mexico are left with two options for ensuring economic stability and for successfully achieving sustained growth; these are dollarization and currency board system.

B. Dollarization vs. Currency Board

As I pointed out earlier, currency board systems have much in common with official dollarization in terms of their perceived advantages and disadvantages --which are mostly the same. They both foster Monetary as well as Fiscal Policy discipline --with its associated benefits in terms of price stability, economic growth and employment-- but the former avoids the major problems encountered by the dollarizing economy --the problems of giving up seigniorage and the loss of sovereignty-- and the problems for the United States --the expectation of this country to act as lender of last resort, and to assume the responsibility of regulating and supervising the banking system of the dollarizing economy.

Dollarization advocates have argued that a dollarizing economy and the United States could reach an agreement and conceive of mechanisms that could allow the latter to share the seigniorage from dollarization, to the advantage of both countries.

In a recent report dealing with this issue, Kurt Schuler (1999) has offered specific ideas concerning both, a possible agreement and the basis and methods for calculating shares of seigniorage. He argues that official dollarization has significant benefits not only for the dollarizing economies but also for the United States and that this country should promote official dollarization by offering to share seigniorage; this he says, would promote growth and financial stability both at home and abroad. Nonetheless, the mechanisms that he has thought of are still more economically advantageous for the United States, and the proposed arrangements would require the dollarizing economies to accept the conditions imposed by the United States with regard to economic, legal and political issues. This would obviously make the implementation of Kurt's plan difficult to attain.

Robert Barro (1999) has also suggested a mechanism for sharing seigniorage, taking Argentina as a specific example. His plan does not involve the imposition of economic, political or legal conditions by the United States, but it leaves Argentina with the option of defaulting on its commitments and "defrauding" the United States. Once again, this plan would be difficult to implement, unless some specific device --agreeable upon by both countries-- is created to deal with the problem.

From this discussion it becomes evident that the idea of sharing seigniorage --that could solve the "seigniorage problem" that rises from official dollarization-- is highly questionable and does not provide with an adequate solution.

On this basis, and having seen that the currency board system does not pose the problem of seigniorage and satisfies national sentiments of sovereignty --that are very strong throughout the American countries (including Canada)-- and frees the United States from undesirable responsibilities, it may be argued that this system is a better option for the Americas --for the time being-- than official dollarization. The United States would definitely benefit from the elimination of the risk of devaluation and the higher growth of the American countries, because it would make U.S. investment more secure and would generate a greater demand for American (U.S.) goods, boosting U.S. economic growth as well. However, if one thinks of the currency board system as an option for North America (Canada and Mexico) within the NAFTA, one must have to take into consideration Canada's particular economic situation, which is entirely different from that of Mexico and other emerging countries.

Recently several Canadian scholars have come to the conclusion that some kind of fixity of the Canadian dollar to the U.S. dollar is necessary, a few of them have favored dollarization while others have regarded it as the least preferable option.[23]

In a recent study Thomas Courchene (1999) has argued that Canada's economic situation is different from that of the emerging countries in terms of development and economic achievement. After a thorough examination of Canada's options --flexible and fixed exchange rates, currency board, euro-like common currency with the United States, and dollarization-- and an in depth analysis of Canada's current economic situation, Courchene has concluded that dollarization is the least appealing alternative and that fixed exchange rate to the U.S. dollar the most preferred one. He acknowledges that a currency board system, that will also deliver fixed exchange rate, will be the option that will make more sense ". . .in the event that we cannot adhere to a fixed-rate regime." (29) The author points out the probability of having a Quebec-U.S. currency board emerging in the event of Quebec's sovereignty, and the problems that this would generate for Canada, in which case a Canadian currency board would definitely be the best alternative. Courchene maintains that Canada needs not to resort to other mechanisms in order to attach to the commitment of a fixed exchange rate --which must be considered the cornerstone of

[23] See: McCallum, John (1998)

Canada's policy under NAFTA.

Nonetheless, it could be argued that the implementation of a currency board system --which is almost costless-- in Canada would ensure fixity and at the same time prepare Canada for the eventuality of Quebec's sovereignty. Consequently, the currency board option seems to stand as a better alternative for Mexico and Canada as well.

C. Currency Board a Previous Step Towards Common Currency

One additional advantage of the currency board systems, pertinent to the discussion, is that they facilitate the move towards a common currency for North American --or even for the western hemisphere-- whichever the option we think of --the euro-like or the dollar option.

It might be wise to wait and see how the euro evolves before embarking on official dollarization. There is much to be learned from the European experience and from the mistakes that Europe is still in the process of making while laying out the proposals for future monetary policy. On this side of the Atlantic a regional accord --similar to that of the European Nations-- is not feasible yet and while it continues to be out of the reach, the founding of currency board systems throughout the Americas would ensure stability and greater economic prosperity for the western hemisphere, making it easier to jump into dollarization if the euro success begins to challenge the U.S. dollar as the world's reserve currency. Otherwise, the North American Nations, could start taking the necessary steps towards greater integration that would lead eventually to the implementation of a euro-like common currency --that may well be regarded as an ideal future development. The adoption of currency board systems is an excellent policy route to begin with. The euro-like common currency area could extend in the future to include the rest of the American countries depending on the evolution of the Free Trade Agreement of the Americas, and this would be easier if these countries implemented a currency board system as well.

Final Comment

Much research should be conducted in the near future in order to move towards the implementation of either of the options discussed above; the task is not an easy one and it requires an attentive look at its impact on the micro level. At the same time, the countries involved should re-think their position with regard to sovereignty. Canada, Mexico, and eventually all of the American countries, would have much to gain in terms of economic growth and stability if they were to acknowledge that, if dollarization turns out to be the best alternative, their decision to adopt the US currency does not necessarily imply a loss of sovereignty. On the contrary, it is precisely on the grounds of sovereignty that they are free to choose the best for their country and their citizens. The countries can choose to continue producing inflation made at home, and to be subject to economic crisis every now and then, but would have to consider that in the global economic environment that we live on today, their decisions affect others as well.

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