12-14-2000

El Salvador Adopts Dollarization Scheme to Boost Economy

LADB Staff

LADB Article Id: 53629
ISSN: 1089-1560

El Salvador Adopts Dollarization Scheme to Boost Economy

by LADB Staff
Category/Department: El Salvador
Published: 2000-12-14

The Salvadoran legislature approved a bill proposed in November by President Francisco Flores to allow the free circulation of the US dollar alongside the national currency, the colon. Most of the private sector approved of the measure as did the US government and major international financial institutions. The move has stimulated renewed interest in dollarization elsewhere in Central America.

Flores proposed the monetary reform (Ley de Integracion Monetaria) on Nov. 22 as part of an economic-revitalization and poverty-eradication plan the Plan de la Nacion. He stressed the value of a stable currency in attracting foreign investment but said the greatest impact of the dollarization scheme would be felt in middle- and low-income housing, where mortgage seekers would now have access to affordable interest rates and longer periods of repayment.

Until now, he said, only large businesses with access to foreign credit have had that advantage. Consumers paying off car loans or credit-card debt would find their interest rates and monthly payments immediately reduced, Flores said. Along with the expected boost in investment, the government will pump its own funds into the economy.

In addition to regular budget allocations for such investments, the government plans to spend more than US$418 million in infrastructure improvements during the remainder of Flores' term. The funds will go to highway construction. Flores also plans to modernize the educational system, opening new schools that focus on information and other developing technologies. Also in the works are plans for streamlining the justice system, protecting the environment, and investing in the coffee industry.

Measure receives international support

Flores' announcement came after consultations with representatives of the International Monetary Fund (IMF), the World Bank, and the Inter-American Development Bank (IDB) in Washington, DC. Juan Jose Daboub, technical secretary of the presidency, said the plan was not "pulled out of a sleeve," but had been under study for five years.

During the administration of President Armando Calderon Sol (1994-1999), then Treasury Minister Enrique Hinds proposed studying dollarization. He said the large quantity of dollars circulating in El Salvador mostly from remittances from Salvadorans living in the US gave El Salvador a special advantage. Dollarization would stabilize prices during economic crises and attract foreign capital, he said.

In 1999, much of the private sector, including manufacturing and agriculture, rejected dollarization, as did a former economy minister, Arturo Zablah, who called the idea "irresponsible." Until now, neither the US nor the IMF encouraged dollarization in Latin America. When the subject came up in

ISSN: 1089-1560

Argentina in 1999, Michel Camdessus, then director of the IMF, said the possibility of dollarization in Latin America was "far off."

Likewise, both US Federal Reserve Board Chairman Alan Greenspan and Treasury Secretary Lawrence Summers discouraged dollarization. By contrast, within hours after Flores made his announcement, Summers said he welcomed dollarization in El Salvador. "Combined with a strong economic-policy framework, this step should help contribute to financial stability and economic growth in El Salvador and its further integration into the global economy," Summers said.

The IMF also backed the idea. IMF managing director Horst Koehler said the plan could "build on El Salvador's solid track record of economic reforms and promote more rapid economic growth." He said the IMF might offer a loan to help El Salvador in the shift to a dual system.

President says economy cannot go on without reform

In announcing his plan, Flores said bankers would be pleased with dollarization because "the economy can't go on this way." He expects his monetary reform and other measures to revive the flagging economy, end poverty, promote foreign investment, and lower interest rates. He said the step would "open us to the rest of the world," and "integrate us into a society without privileges."

Central bank (Banco Central de Reserva, BCR) president Rafael Barraza said he expected GDP to grow by 5% next year. It has been growing at about 2.5% in 2000. And inflation, which should be between 3.5% and 4% this year, would drop in 2001 to between 2% and 3.5%, he said.

The law will go into effect Jan. 1, 2001. It will set the rate of exchange in a narrow band of 8.72 to 8.75 colones to the dollar and allow free circulation of the US currency for all exchanges. Salaries may be paid in either currency at the discretion of the employee. All businesses must accept both currencies interchangeably at the fixed rate and banks must use dollars in all transactions. No fees may be charged for exchanging one currency for another.

As a byproduct of the dollarization, currency-exchange houses will go out of business. The law also permits the free use of other hard currencies the euro, pound sterling, and yen. The BCR will no longer have control of interest rates or the volume of currency in circulation. The seigniorage the bank's usual transaction fee for exchanging colones for dollars will also disappear as bank customers receive the highest exchange rate for their colones.

Officials say the administration is ready to handle practical problems such as unfair price hikes by retailers trying to take advantage of the confusion arising from the dual currencies. Economy Minister Miguel Lacayo said the consumer- protection agency (Direccion de Proteccion al Consumidor, DPC) will monitor consumer prices and may require retailers to price goods in both dollars and colones. Salvadoran state banks have already begun reducing their interest rates.

The Banco Multisectorial de Inversiones (BMI) dropped its rates by three points and opened new lines of credit to small and medium-size businesses and offered borrowing rates of up to 7%. To guarantee liquidity in the new system, the BCR will set aside US$1.3 billion of its US$2

LADB Article Id: 53629
ISSN: 1089-1560

billion reserves, leaving the remainder to exchange for colones. As backup, the administration is negotiating with the IMF for a standby credit to cover any monetary emergencies. The Legislative Assembly took only a few days to pass the reform, which needed only a simple majority. The Assembly approved the measure Dec.1 by a 50-31 vote.

Governing Alianza Republicana Nacionalista (ARENA) deputies were joined by deputies from the Partido Democrata Cristiano (PDC) and the Partido Conciliacion Nacional (PCN) to put the bill across. Deputies of the Farabundo Marti para la Liberacion Nacional (FMLN) cast all 31 votes against the bill.

Opposition says measure is unconstitutional

Opponents of the bill, led by the FMLN, objected to the hurried pace of the agenda. They wanted the bill to go back to the Assembly's Treasury Committee for closer examination. In debate on the bill, the FMLN argued that a dual currency was unconstitutional and violated national sovereignty because it would place the nation's currency in the hands of the US Federal Reserve Bank. Centro Democratico Unido (CDU) Deputy Jorge Villacorta worried that it would leave the country "without the possibility of making decisions on monetary policy."

ARENA Deputy Norman Quijano brushed aside the constitutional problem saying that the measure was not dollarization, but rather "an opening." The greatest benefit would fall to consumers, he said, because banks would not charge exchange fees. ARENA leaders said the new law was "the best defense of salaries, pensions, and investments." For the moment, the administration is calling the new monetary system bimonitarism not dollarization because both currencies will circulate. However, based on how the system works, officials are saying the colon could be retired in favor of the dollar sometime in the future.

Daboub suggested that El Salvador might even displace Panama as the regional financial center. "Panama has high costs and the political risk from its neighbor Colombia," he said. Asociacion Nacional de la Empresa Privada (ANEP) president Ricardo Simon said 80% of the association's members approved of the change. The major doubts came from the construction industry, manufacturing, and small businesses. They are concerned that the lower interest rates might not go into effect soon enough.

But Mario Molina, president of the Corporacion de Exportadores de El Salvador (COEXPORT), predicted that the fixed exchange rate would make exporters less competitive. COEXPORT wants collateral legislation to ensure that the sector has easy access to credit. COEXPORT, like other business associations, sees the need for lowered costs, especially lower electricity rates and improved port facilities. The organization's executive director Silvia Cuellar said she was not asking for devaluation to aid exporters. "We are aware that devaluation would not bring benefits to the country," said Cuellar.

As the Assembly debated the bill, a protest movement emerged, led by the Movimiento de Organizaciones Laborales Integradas (MOLI), which includes labor, student, campesino, religious, and other groups. On Nov. 29, MOLI, supported by the FMLN, staged a demonstration against the bill, claiming that dollarization would hurt the less privileged.

LADB Article Id: 53629
ISSN: 1089-1560

During the protest, FMLN leader Jorge Schafik Handal said the conservative ARENA was imposing the bill. He claimed that in six months, all colones in circulation would end up in the central bank and disappear.

Other regional countries consider dollarization

With El Salvador's surprise announcement and swift adoption of dollarization, the rest of Central America began reexamining the issue. Banco Central Hondureno (BCH) president Victoria Asfura said dollarization was "not possible in Honduras." Citing differences with El Salvador in Honduras' macroeconomic picture, she said the dislocations caused by dollarization would be too great. Asfura warned that countries attempting to dollarize face a loss of export earnings as the high price of the dollar might reduce competitiveness.

But Armando Urtecho, executive director of the Consejo Hondureno de la Empresa Privada (COHEP), said, "The Salvadoran decision pressures the whole region because if we wish to compete efficiently, we must place ourselves on the same plane."

In Guatemala, which seems the most likely to follow the Salvadoran example, the Congress is studying a bill for partial dollarization. The bill (Ley de Libre Negociacion de Divisas) would permit bank accounts in dollars and use of the dollar in sales transactions but would not establish the dollar as the national currency. At present, use of the dollar is illegal, although sales are often priced in dollar equivalents of the local currency, the quetzal.

The governing Frente Republicano Guatemalteco (FRG) introduced the bill after Flores announced his dollarization plan in El Salvador. One of the bill's sponsors, FRG Deputy Leonel Soto Arango, said that Guatemala could not afford to fall behind El Salvador, which is the country's major trading partner. The bill was reported out of the Finance Committee in early December and backers expect it to be approved this month and go into effect in early 2001. However, the bill faces a possible veto since President Alfonso Portillo, backed by Finance Minister Manuel Maza Castellanos, says Guatemala will not be ready to dollarize until it has improved its financial balance sheet. Portillo also says he wants to see salaries rise before dollarization is considered.

In Nicaragua, the issue has been discussed, but the administration of President Arnoldo Aleman has decided not to act on the matter. The central bank is said not to favor losing control of monetary policy. Noel Ramirez, president of the Banco Central de Nicaragua, says dollarization would increase costs for industry and agriculture. Costa Rica has discussed dollarization but has not acted, primarily because of its high fiscal deficit and low hard-currency reserves.

Eduardo Lizano, president of the Banco Central de Costa Rica, said dollarization was not likely during the present administration but might happen in the next one. Alvaro Ramirez, director of the Union Costarricense de Camaras y Asociaciones de la Empresa Privada, said Costa Rica's policy of minidevaluations is now in question and that dollarization might happen in two years. He also predicted that in five years, all Central American currencies would have to be unified to attract foreign investment. [Sources: El Diario de Hoy (El Salvador), 04/19/99, 10/04/00; La Nacion (Costa Rica), La Prensa (Honduras), 11/28/00; The New York Times, Associated Press, 11/23/00; Prensa

LADB Article Id: 53629
ISSN: 1089-1560

Libre (Guatemala), 12/03/00; Notimex, 04/04/99, 04/12/99, 04/21/99, 11/23/00, 11/29/00, 11/30/00, 12/01/00, 12/06/00; La Prensa Grafica (El Salvador), 11/20/00, 11/22/00, 11/23/00, 11/26/00, 11/30/00, 12/01/00, 12/02/00, 12/12/00]

-- End --