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LATIN AMERICA IN THE 1980s:
A NEW DOLLAR BLOC?

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ABSTRACT

Efforts to understand the international financial turmoil undermining Latin American development have not succeeded in linking international financial changes with the domestic financial systems of the Latin American countries. The starting point of the paper is the role in Latin America of "dollarization," the increased use of dollars in the domestic economies and its attendant detrimental effects on economic policy. The paper claims that the international financial system operates as a "dollar bloc," analogous to the earlier sterling bloc and the contemporary franc bloc. However, the benefits of such blocs, which placed certain obligations on the center country, are not present under current arrangements.

RESUMEN

Los esfuerzos para entender el desorden del sistema financiero internacional que socava el desarrollo de América Latina no han tenido éxito en relacionar los cambios financieros internacionales con los sistemas financieros internos de América Latina. El punto de partida del artículo es el papel de la "dolarización" en América Latina, el creciente uso de dólares en las economías domésticas y sus consecuentes efectos perjudiciales en la política económica. El artículo argumenta que el sistema financiero internacional opera como un "bloque del dólar," análago al anterior bloque de la libra esterlina y al contemporáneo bloque del franco. Sin embargo, los beneficios de tales bloques, los cuales fijaron ciertas obligaciones al país central, no existen bajo los actuales acuerdos.

I. INTRODUCTION

The traditional issues of long run economic development in Latin America have been largely overshadowed by the short run considerations of stabilization and adjustment to the external pressures faced by virtually every Latin American country. The burden of the debt, the decimation of commodity prices, or the instability of exchange rates are the Latin American concerns, rather than human resource formation, infrastructure provision, technological progress, or other central issues of development.

As a result there has been a tremendous outpouring of academic and policy research on the technical elements of these financial relations, on the additional resources needed to maintain payments, on the costs to particular countries of defaults, or on the conditions under which rescheduling should take place. However, efforts to formulate a broader political economic understanding of these changes and their implications for Latin America and for development are only just beginning. MacEwan (1986) placed the debt developments in the broader context of a crisis which he has long been analyzing, and Aronson (1985) surveyed the responses to the debt pressures. Ruccio (1987) examined the class nature of debt relations in the spirit of Resnick, Sinisi and Wolff (1985). Wachtel (1986) analyzed international financial arrangements in terms of a process of "supranationalization," the development of institutions and operations outside of national control. Finally, Griffith-Jones and Sunkel (1986) provided an historical context and a perspective on future developments.

One weakness in the previous political economic treatments is the failure to link international financial changes with the domestic financial systems in the Latin American countries. One of the undeniable realities of the contemporary political economy is that countries' financial markets are now tightly intertwined and so international changes have important ramifications for the structure and functioning of domestic financial markets. This reflects in part the internationalization of banking and of financial markets and in part the attack on the system of capital controls which had stabilized financial and foreign exchange markets in many countries. A synchronous development has been the increase in domestic financial instability manifested in many ways in Latin America: the Bolivian hyperinflation of 1985, the frequent maxi-devaluations in many countries, the strains on domestic financial institutions as seen in the insolvency of the major Chilean banks in 1981 or the Mexican and Peruvian bank nationalizations.

One of the clearest manifestations of these changes is the notable increase in the desire of Latin Americans to use the dollar for some or all monetary purposes, often in strong preference to their own domestic currency. The extent of this phenomenon in particular countries and its extension to virtually every Latin American country suggest that there is a broad political economic process occurring, which can be termed "dollarization."

This paper will focus on dollarization as the key political economic effect of the developments in international and domestic financial markets. The survey of the meaning and reality of dollarization in Latin America suggests that a better understanding of this change and its implications can be gained by examining it in the historical context of the "sterling bloc" of the 1930s through the 1960s, and of the "franc bloc" which continues today. There are strong parallels which can be detailed and which suggest that dollar-ization might well be forming a new "dollar area." Section IV details the elements of this claim and Section V examines its implications and possible developments in the future.

II. DOLLARIZATION IN LATIN AMERICA

Dollarization in its broadest sense is the decision by citizens of other countries to hold dollars and dollar denominated assets as a store of value or to use dollars as a medium of exchange. The dollar can also act as a standard of value in another country. Panama is Latin America's most dollarized economy because the dollar circulates as its official currency. Brazil was among the least dollarized because the dollar was neither widely held nor used in the domestic economy, and overseas holdings of dollars by Brazilians have not been large by Latin American standards, though this has changed to a degree since 1982.

There has long been some element of dollarization in Latin America. The education of the Latin American elite in the U.S. required dollars, capital flight has been a periodic reality, and governments have traditionally held dollars as part of their inter-national reserves.

In addition, under certain circumstances private individuals have been able to hold dollars physically or through the domestic banking system. For example, Ortiz (1983) found that up to 35% of the deposits in Mexican banks during the 1930s were denominated in dollars because of the difficulty the government and the Banco de México had in issuing a paper money which would be accepted by the public. At that time the dollar took on elements of the role of a national currency. After those difficulties were overcome, the share of dollar denominated deposits fell to around 6%.

Mexico was at the extreme; nonetheless holding dollars inside and outside of the home country has grown rapidly in most countries since the oil price increases and the consequent recycling of petrodollars through the international financial system. Dollars have taken on a series of new and unaccustomed roles in many countries, and the desire and ability to hold dollars has been extended to sectors of the population that had previously been excluded. A few examples can show the magnitude of dollarization.

Many countries have allowed dollar denominated deposits in their banking system, and these have often grown dramatically. For example in Peru they reached 73.7% of the total time deposits in the banking system in 1984. In Uruguay foreign currency deposits as a share of the total money stock increased from 5% in 1973 to 45% by 1977, with later periods showing a high degree of instability (Ramirez-Rojas, 1985). And in a survey of the empirical evidence on dollarization (Jameson, 1986), every study but one finds statistical confirmation of the hypothesis that dollarization is a significant phenomenon in Latin America.[1]

Less systematic information corroborates the claim: apartment rents are quoted in dollars in Peru, as are home prices, and often the actual sale takes place in dollars; a large percentage of the transactions in Santa Cruz, Bolivia take place in dollars, much as has been the case in the Bahamas or Bermuda; and informal curbside dollar markets have sprung up in sites as different as La Paz, Bolivia and Santo Domingo, the Dominican Republic.

Information on the holding of dollars outside of the domestic financial system has become more available in recent years, and it again indicates a substantial increase in dollarization. Table 1 presents information on the deposits of non-banks in 31 banking centers, by nationality. The Western Hemisphere developing countries account for over 20% of such deposits, exceeded only by the industrial countries. The magnitude of the deposits is large, $79 billion by 1981, and in five years they increased by a further $57 billion, despite the economic depression which beset most of Latin America. Holdings of Brazilians, Chileans, Dominicans, Ecuadorians, Mexicans, Nicaraguans, Peruvians, and Uruguayans all more than doubled over this period. It is likely that a significant portion of the Unallocated Deposits belong to the Latin Americans, so the actual magnitudes are greater. Also the figures do not include holdings of physical assets, so they are a substantial underestimate of the amount of dollar denominated assets held out of the home country; and if they could be extended back to the late 1970s, they would probably show that much of the $79 billion of deposits in 1981 had been made in those years. In any case the picture of dramatic increases in dollar holdings by Latin Americans is highlighted.

This is further reinforced by the World Bank estimates of capital flight between 1974 and 1982 from six major Latin American countries. The first figure in Table 2 is based on short term outflows plus errors and omissions, the second includes an estimate of the stock of capital held outside of the country. As can be seen, this source of dollarization has been quite substantial in all of the countries except Chile.[2]

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[1] Many of the studies deal with the question in terms of currency substitution which means that citizens of a country are able to choose between one or more currencies and their choices are affected by economic variables. Concentration is on the significance of these variables.

[2] Such magnitudes of capital flight led David Felix (1985) to suggest that the solution of the Latin American debt crisis should be the forced nationalization or repatriation of these overseas holdings, much as the British and French did during WWI and the British during WW II.

These examples should document the central point: there has been an increase in the holding of dollars--both in the domestic economies and their financial systems and outside of the countries--in the international financial institutions. The reality of dollar-ization is undeniable.

What is unclear, however, is how to understand the phenomenon and its effects, and how it might be dealt with. A variety of explanations are possible.

1. Neoclassical Tales

A neoclassical analysis would see dollarization as the result of the inexorable push of the market into all spheres of all economies, and in recent years of the internationalization of markets, including financial markets. According to McKinnon (1982) this has led to the reality of a "world money supply."

The increased use of dollars in the Latin American economies reflects rational calculation of the benefits to be gained by holding dollars as opposed to other currencies. It also reflects on the misguided Latin American efforts to maintain capital controls and restrictions on financial markets. The earlier experiences of Mexico and Canada, where the dollar has long played a significant role in the currency in circulation, simply showed the rest of the Western Hemisphere its future at a time when international barriers have been lowered by transportation and communication developments.

2. Political Economy Tales

A variety of political economy tales are possible--dollarization is simply the newest form of dependency; dollarization results from the changing nature of international class relations; or it is a reflection of world system developments. The strength of observing the phenomenon through the eyes of one of these traditions is their ability to bring to bear a set of analytical categories and to fit the phenomenon into a coherent analytical framework. The disadvantage is that there is inevitably a forcing of the categories onto the empirical phenomena which then must involve the many debates surrounding the tradition. If I were to choose an approach, I would use dependency theory, for it seems to relate well to the observed dollarization, but that would involve dollarization in an evaluation of dependency such as that undertaken by Nitsch (1986).

In order to focus on dollarization and its effects, the paper takes an historico-institutional approach. It will suggest that dollarization and its effects can be best under-stood by using the construct of a "currency bloc." First the historical experience of two formal currency blocs will be examined; then the actual functioning of the dollarized Latin American economy will be measured against those systems. The basic stance will parallel Wachtel's (1986), that there has been a supranationalization of the world economy, that institutional developments have severely eroded the ability of national governments to control their domestic economies, and that this is most clearly the case in the financial sphere, with the reality of dollarization and the implied formation of a dollar bloc.

Let us turn then to a treatment of the history and workings of the sterling and franc blocs.

III. THE STERLING AND FRANC CURRENCY AREAS

The "sterling bloc" began as an effort to deal with the currency difficulties occasioned by the Depression and by the British decision to leave the gold standard in 1931 (Conan, 1952). Included in the bloc were all of the Commonwealth countries (except Canada), and Burma, Iraq, Iceland, and Jordan, though the degree of adhesion to the group varied among countries and over time. The final demise of the sterling bloc was signalled most clearly by the Basle Credit of 1968 which froze the balances of the overseas countries' sterling deposits in Britain, though guaranteeing their value in terms of dollars (Strange, 1971).

The first effort to deal with the 1930s financial disorder was the establishment of Central Banks in the countries of the Commonwealth and the colonies. The sterling bloc then grew to include "a group of currencies based on sterling because of trading or financial relationships" (Conan, 1952, p. 148) or, as described by The Economist (November 23, 1946):

> Then, and especially after 1931, the more homely phase 'sterling bloc' had for many years described the loose informal and wholly voluntary association which was all that the ill-defined 'area' then comprised--a concept without any substance in law and carrying with it no legal implications whatever. It was a club in which custom and habit took the place of rules...
> (cited in Conan, 1952, p. 148)

World War II led to a more formal definition of the bloc and to more clearly defined mutual obligations. First, currency movements outside of the area were strictly controlled, although movements were free within the bloc. This in effect meant that there was one currency within the bloc and exchange controls ruled the relations with countries outside. The system generated sterling deposits in the London financial system by the partic-ipating countries, and eventually the United Kingdom Treasury exerted increasing control over the movement of these balances.

The second development was the formation of a "dollar pool" of the other major international currency. Allocations to countries were made from the pool according to "need," which was effectively determined by the U.K. Some countries, e.g. Ceylon which generated large dollar surpluses, remained outside of the latter facility.

The actual operation of the sterling bloc in effect allowed the British to determine macroeconomic policy for the bloc. Economic and financial policies were coordinated, with the goals of keeping sterling in surplus with the rest of the world to maintain its value against the dollar, and of keeping Britain in surplus with the other members of the bloc so as to preserve the bloc's stability.

On the one hand this required trade restrictions on capital goods from outside the bloc and on bloc imports of consumer goods from Britain. Domestic macroeconomic policy in the other bloc countries was determined by interest rate policy in Britain, e.g. whenever Britain was in deficit with the bloc, sterling balances would be attracted to London by setting higher interest rates. To offset the cost of these balances, Britain allocated purchases of raw materials and shipping services among bloc members during the war and then of commodity purchases after the war. British investment and capital goods were also to be provided to bloc countries to aid their growth.

A key decision for the bloc was the overall alignment of its currencies against the rest of the world. This was effectively determined by the British, as seen most clearly in October 1949 when Britain devalued with respect to the dollar, with virtually no notice to the other bloc members. They could devalue along with Britain or could maintain their previous exchange rate (Conan, 1952, Ch. V).

The bloc finally foundered along with the British dominance of the world economy. This eclipse fostered resentment at British control over the key policy decisions and a sense that Britain's interests were always given precedence. At that point the costs of maintaining the bloc outweighed the advantages of a stable trading group with agreed upon financial mechanisms, and the bloc had disappeared by the 1970s.

The French franc bloc was developed as a direct result of 19th century French colonialism in Africa and the effort to bind the countries to France even after colonialism. Its thirteen African members are former colonies of France. The Coopération Financière en Afrique (CFA) is now divided into two groups, each with its own Central Bank. The West African Monetary Area comprises Benin, the Ivory Coast, Burkina Faso, Mali, Niger, Senegal, and Togo, while the Central African Customs Union comprises Cameroon, the Central African Republic, the Congo, Equatorial Guinea, Gabon, and Chad.[3] The CFA's operations are quite similar to the sterling bloc, though they are guaranteed by treaties among the members and between each member and France (Onoh, 1982). All of the decision-making bodies include representatives from the African countries and from France.

The CFA franc is accepted throughout the region and has been fully convertible with the French franc at 50 CFA francs=1 French franc since 1948. The French franc of course fluctuates as a constituent of the European Monetary System. International reserves of the countries are pooled in the central banks, and 65% of these reserves must be deposited in France. Stability is

[3]Equatorial Guinea had pegged its currency to the Spanish peseta but joined the CFA in 1985. Mali rejoined in 1984, having left the union in 1962. In addition the Comoros have a settlement account with France that operates in a similar fashion.

maintained by monitoring the reserves of each country and forcing adjustment if they decline. If a region as a whole moves into deficit, sanctions are imposed on the whole region, generally forcing a reduction in imports. The dominant macroeconomic tool is credit creation, which had been rigidly determined by France until the Central Banks gained somewhat greater latitude in credit and interest rate policies with a set of 1973 reforms (Devarajan and de Melo, 1987). But strict bounds on credit creation remain, tied to the performance of government revenues. Credit creation is also tied to a program of growth targetting. Under these arrangements, France continues to exert a strong influence on policy decisions.

The benefits of the currency bloc are its commitment to stable exchange rates and thus to stable trading relations among the African countries and with France, some preferential access of the former colonies to the French market, and a conservative management of the money supply which has generally kept inflation rates at relatively low and stable levels. The costs are the restrictions on access to the world market, the potential loss of growth from the monetary controls, and the inability to use the exchange rate as a policy tool. Devarajan and de Melo (1987) compared the growth performance of the franc bloc with other developing countries and concluded that the CFA compared quite favorably, especially after 1973, which would imply that the franc bloc has certainly been a viable institutional mechanism for macroeconomic management in these countries.[4]

With this historicoinstitutional background, we can turn to the Latin American situation and to the claim that its international and domestic financial arrangements, resulting in the high degree of dollarization noted above, can be usefully understood by treating them as functionally a new dollar bloc.

IV. THE CASE FOR THE DOLLAR BLOC

The institutional arrangement of the dollar bloc of the Western Hemisphere resembles the early years of the sterling bloc, a "loose, informal and wholly voluntary association," much more than the formal and codified arrangements of the contemporary franc bloc in Africa. It has developed through the interplay of three key economic actors: the nation states, the private sectors, and international organizations. Just as the colonial heritage and the institutional arrangements of colonialism set the outlines of the sterling and the franc blocs, so postwar institutional developments have provided the outlines of the dollar bloc. On the one hand are the nation states which balance conflicting internal and external demands with some vision of

[4] A close examination of the empirical results shows them to be far weaker than the authors suggest. A conclusion that the CFA countries grew more slowly than most groups of developing countries could not be altogether dismissed.

national destiny in sight. Domestic monetary and fiscal policies are set in this light, as is the country's stance toward international financial arrangements.

The growth of the dollar bloc is partly a reflection of the increasing dominance of the other two international actors. On the one hand is the private sector: the multinational banks of the advanced countries and their multinational corporations, along with the elites of the Latin American countries. The elites exert significant control over a country's dynamic economic sectors, but their orientation is supranational and they have the ability to move their resources rapidly among nation states. On the other hand are the international organizations: the International Monetary Fund, the World Bank, the Interamerican Development Bank, the Bank for International Settlements, institutions who have come to be the enforcers of the regulations of the international financial system, and therefore of the dollar area. They have the sanctions as well as the bribes to keep countries within the bounds required to keep the system functioning.

Since there is no formal adherence to a dollar bloc, the linkage between the dollar and the domestic currency and between international economic policy and domestic policy varies from country to country. There are some indications of formalization in the arrangement. However such trends are only beginning, so our approach will rely on a functional analysis of the system, using its analogues with other currency blocs. The conclusion of this functional analysis is that Latin American financial developments, especially the widely observed dollarization, can best be understood as manifestations of the functioning of a dollar bloc. There are three elements to the argument.

A. <u>The Centrality of the Dollar for the Latin American Countries</u>

The starting point for understanding the dollar bloc is the exchange regime of the South American countries. An important institutional change in the international financial sphere since 1973 has been the weakening of the Bretton Woods system of predominantly fixed exchange rates, with the commitment to maintain balance by a variety of trade and capital flow restrictions. Since current IMF arrangements allow floating exchange rates--indeed encourage them--the existence of a currency bloc would seem unlikely. The sterling and franc areas were predicated upon maintaining the stability of exchange rates within the bloc. Nonetheless, a closer examination of the actual exchange rate regimes in Latin America shows that the central concern of Latin American governments is the relation between their national currency and the dollar.

All of the Latin American and Caribbean currencies are closely linked to the dollar. Twenty countries of Latin America and the Caribbean had fixed their currency to the dollar in 1985. For the most part these were the small countries, although Paraguay, Bolivia and Venezuela were also in this category. Only one country, Guyana, fixed to another currency. Only three countries, the Dominican Republic, Jamaica, and Uruguay, operated with a floating exchange rate in this post Bretton Woods era. The other eight larger Latin American countries either had a managed float against the dollar or adjusted their currency against the dollar according to a set of indicators (IMF, 1986). That the dollar plays a central role in the exchange rate regimes of all of these countries is a starting point for the currency bloc analysis.

As is the case in other currency blocs, these currency arrangements are encouraged by the concentration of other economic relations among the same countries. For example the United States accounted for 35% of the exports of Latin America (1979-81), with all of the European countries summing to 20% and Japan to 4%. Imports are similarly concentrated, with 33% coming from the U.S., 21% from all of Europe combined, and 7% from Japan (Hopkins, 1985, Tables 5,8).

So the importance of the dollar for these countries is quite similar to the importance of the franc or of sterling for the members of the other currency blocs.

B. The Effect of the Currency Bloc on Domestic Economic Policy

The second element of the argument, and the most important, is that the operation of this system has an effect on domestic economic policy which is quite similar to the effect of the franc or sterling blocs on the policies of their member countries. This argument rests on the economic analysis of currency substitution or dollarization, and on the empirical studies which have almost uniformly found evidence of currency substitution throughout Latin America. This may vary in degree from country to country, but it is a reality in all of them. The implication of significant currency substitution, of being part of a dollar bloc, is that domestic economic policies are severely hampered and their independence severely curtailed. Let us examine the theoretical effects of currency substitution on domestic economic policy.

1. Control of the Money Supply

One of the key variables in any domestic economic policy is the control of the domestic money supply by a monetary authority in order to affect the domestic price level and/or the rate of output and/or the exchange rate.[5]

In the presence of currency substitution or dollarization, the control of the monetary authority over the domestic money supply is greatly eroded (Girton and Roper, 1981). For example, when the dollar is a substitute for the domestic currency in virtually all transactions, any effort on the part of the monetary authority to slow the growth of the money supply could be

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[5] In Chile under Gen. Pinochet and the "Chicago boys," the monetarist model led to an effort to prevent discretionary domestic monetary policy by fixing the exchange rate to the dollar and allowing interest rates and resultant capital flows to determine the money supply. Thus U.S. monetary policy in effect determined the money supply of Chile, the extreme result of membership in a currency bloc (Foxley, 1983).

completely frustrated by changes in the availability of dollars. Similarly, any of a variety of factors could lead the private sector to change its demand for domestic currency, given the substitutability of the dollar; so the domestic monetary authority faces an unstable money demand function and domestic monetary policy becomes ineffective, exactly the effect of the agreements of the franc bloc.

2. Indeterminacy of the Exchange Rate

Under a high degree of currency substitution, a country's exchange rate may become highly unstable, i.e. become indeterminate. The influence of relative prices in determining the exchange rate must now be modified by the decisions of individuals to hold dollars or domestic currency, and to hold them at home or overseas. The exchange markets cannot take all of these factors into account and thus the exchange rate becomes highly unstable.

Marquez (1985) investigated the case of Venezuela which had had an exchange rate fixed to the dollar for more than twenty years. After February 1983 a newly established free market exchange rate depreciated by more than 400% in less than three months. His evidence suggested that currency substitution was an essential element in this event. The massive, frequent, and recurring devaluations in other Latin America countries in recent years become more understandable if the countries are seen as participants in a new dollar bloc which is characterized by substitution between the domestic currency and the dollar, and as a result by instability and indeterminacy of exchange rates.

Recall that the inability to use the exchange rate as a tool for domestic stabilization is a characteristic of a currency bloc. In the franc and sterling cases, adjustment of exchange rates was prohibited by the bloc agreement. In this case, the effectiveness of efforts to use exchange rate policy to enhance domestic economic performance is vitiated by the reality of currency substitution, by the existence of the new and informal dollar area.

3. Loss of Seigniorage

Another effect of dollarization is the loss to the domestic government of seigniorage, the increase in its resources from minting or printing the domestic currency. The revenues of the government can be increased by more rapid money creation which will lead to inflation and a depreciation of the value of the money held by its citizens. This is usually termed the inflation tax.

As foreign currency substitutes for domestic currency, the ability of the government to exact the inflation tax is constrained because its citizens will opt to hold their money in dollars, insulating themselves from the inflation tax. In the extreme, an extreme which Bolivia in its hyperinflation phase may have approached, the government can gain no additional revenues through printing money, because there is immediate flight into the foreign currency. Fischer's (1982) rough estimates of the loss of seigniorage in moving from a fixed exchange rate to the use of dollars were from .5% to 1.8% of GNP, with the estimates for Latin America around .5% of GNP.

An additional loss of seigniorage in the dollar bloc is occasioned by the central role that dollar reserves play in exchange rate determination. Any decrease in a country's dollar reserves is interpreted by the private sector as an indicator of impending exchange rate adjustment, and so leads to pressure on the exchange rate. Thus governments are obliged to maintain large dollar reserves in the hope of stabilizing the exchange rate. Such reserves cause a loss of seigniorage as well, for they generally provide the government with lower returns.

The franc and sterling blocs had occasioned a loss of seigniorage for the participating governments in quite the same way as the dollar bloc. Thus again there is a functional equivalence.

4. Limits on Capital Controls

The sterling and franc blocs incorporated a set of stringent capital and trade controls, designed to maintain the internal stability of the system. At the same time the individual governments could not unilaterally utilize such controls for the benefit of their own economy. That domestic policy choice was severely limited.

Capital controls have a long history in Latin America, and every financial crisis results in another set of controls which can stabilize the financial market until the next crisis. However, one of the central realities of the 1970s is that the integration of international markets has attenuated the effectiveness of most such controls. More particularly, in a process of dollarization, capital controls are rendered far less effective because the benefits of capital flight are far greater and the facilities for transfer of dollars out of the domestic economy are expanded. A higher degree of dollarization makes any set of capital controls much less effective, and in this sense dollarization may have been one of the most important manners of enforcing financial liberalization, i.e. the removal of financial controls, on Latin America. Dollarization makes it very difficult to limit any flows of dollars, short of a policy such as Mexico's which saw the nationalization of the entire banking system. Few countries will go that far, though President Alan García of Peru proposed it in July 1987 as a means of stemming capital flight.

The sum of these four effects of dollarization is to make domestic economic policy much more difficult and much less effective, in a form quite similar to the effects of a formal currency bloc.

C. The Mechanisms of the Currency Bloc

The final element of the argument is to specify more clearly the mechanisms which operate within the dollar bloc and which characterize its functioning. This of course is more easily done with a formal currency area which has a set of treaties to describe and regulate the mechanisms. In the case of the dollar area, they are less formal and thus more difficult to isolate. Nonetheless, we will be able to show that they exist and they function in quite the same way as the mechanisms of a formal currency bloc.

At this point in time, the central cog in the mechanism of the dollar area is the whole structure of the international debt of the Latin American countries which now sums to over $1 trillion, including both public and private debt. The growth of the debt during the 1970s was a major factor in creating the dollar area, but it is in fulfilling the obligations entailed that the functioning of the dollar area is determined. Let us look at them by analogy with the other currency areas.

1. <u>External Control of Macro Policy</u>

The end result of the system is that the macroeconomic policies of the U.S. have a tremendous impact on the Latin American economies through their effect on dollar availability while, as noted above, independent macro policy is made quite difficult.

For example, Brazil was able to stimulate its economy and attain rapid rates of growth in recent years because the U.S. undertook a program of fiscal and monetary stimulation which showed up in tremendous balance of payments deficits and allowed Brazil to increase its exports to the U.S. until it ran a trade surplus to the tune of $12 billion in 1984 and 1985. Similarly, when the U.S. and the European countries and Japan decided in September 1985 that the dollar was overvalued and that they should encourage its depreciation, they were also deciding on a depreciation of the Latin American currencies which are tied so closely to the dollar. Or when U.S. monetary policy becomes tight and drives up interest rates, the floating interest rates on the Latin American debt increase the required Latin American interest payments and force domestic adjustments in order to satisfy those demands. So again the key macroeconomic decisions are made in the central country of the currency area.

2. <u>External Claim on Reserves of Members</u>

Another analogy is to the ability of Britain or France to draw capital into their own economies when they wished, in the British case by attracting sterling deposits through higher interest rates and in the French by forcing contraction and reserve accumulation. In Latin America the debt obligations incurred in earlier years are forcing a transfer of capital to the exterior, estimated at $24 and $30 billion per year since 1983 (IDB, 1985). The mechanism is the payment of interest, e.g. $37 billion from the seven major debtors in 1984, not offset by capital inflows of loans or foreign investment. Rather than reflecting the decisions of the Bank of England, the net flow of dollars to the region is largely determined by contractual agreements which were reached years before and which are continually rescheduled or renegotiated when the country cannot comply with the agreement.

3. <u>Existence of a Dollar Pool</u>

There is also an analogue to the dollar pool, the pool of funds that can be used by countries according to "need." In this case the funds of the IMF, of the Bank for Inter-national Settlements, and indeed of the U.S. Federal Reserve act as a pool of international exchange which can be used by countries under stipulated conditions. Mexico, Brazil and a variety of other countries have made use of this pool of funds. The individual country's standing in the overall currency bloc is a key element in the decision whether to free the funds or not. When Mexico was unable to meet its obligations in 1982, almost overnight the international system was able to put together a $2.5 billion "bridge loan" to allow it to continue in the bloc; and then over time additional funds were obtained from the IMF and the international banks as a longer term infusion. The frequent reschedulings and the infusion of new funds through efforts such as the Baker Plan can best be understood as mechanisms to establish, maintain, and allocate a dollar pool to participants in the dollar bloc. And access to this dollar pool is one factor which maintains the participation of the Latin American countries.

To sum up to this point, the financial relations between the Latin American countries and the international financial system can be understood as a currency bloc much as the sterling bloc and the franc bloc. The structure of the world economy has changed since colonialism, and the structural elements in this currency area differ as well. But the functional equivalents are of such importance to the economies of Latin America that it is both useful and correct to treat the relationship as a "dollar bloc." It is possible that the relationship will change radically in the future and perhaps the informal arrangements which have grown and have maintained it to date may become more codified and binding with time. The dollar bloc has been created in the Western Hemisphere as a result of international conditions of the 1970s and their interaction with domestic economic policy in Latin America. Its clearest manifestation is the "dollarization" of Latin America. It certainly has not reached the formality of the British or the French control over the monetary systems of their ex-colonies, but its effects on the economies involved and their policies are quite profound.

V. CURRENT ISSUES OF THE DOLLAR BLOC

Acceptance of the existence of a dollar bloc leaves three questions for inves-tigation: what has been the overall effect of the dollar area on these economies; what are the current pressures that will influence the evolution of the dollar area; and what changes might occur which could improve the functioning of the dollar area. Let us take each in turn.

The effects on the Latin American economies of participating in a dollar area are quite significant, as was made clear above. At the same time, not all of Latin American economic performance can be reduced to a result of the formation of the dollar area. The oil price shocks, the collapse of commodity prices, and even weather related changes have had important influences on the economic behavior of the area. Nonetheless the general direction of effect of the dollar area can be isolated.

The overall influence has been to engender instability in macroeconomic performance in the area. During the 1970s, as the dollar area was forming, the recycling of petrodollars and the extension of substantial private bank loans to the Latin American countries offset a generally deflationary tendency and resulted in debt-led growth during the latter part of the decade. Thus the excellent performance of the period was built upon an infusion of financial resources which in many cases created no base of production. Despite the significant shift of world resources to the OPEC countries, in which Mexico and Ecuador participated, growth of per capita GNP during the 1970s was more rapid than during the halcyon days of the 1960s, 34% over the decade as compared to 32% before (IDB, 1985).

However the obligations incurred during the debt-led growth phase became a constraint during the 1980s and were a major factor in the 10% decline in per capita GNP by 1984. Even more startling from a long run perspective was the 33% decline in Gross Domestic Investment between 1981 and 1984, implying that the stagnation was likely to be a long lived phenomenon. A major factor in this performance was the interest and principal drain of dollars away from most of the Latin American countries and the resultant domestic economic adjustments that were forced upon them.

An underlying cause of this instability, and a clear contrast with the CFA, is the absence of any coherent mechanism for macroeconomic discipline within the dollar area. In the earlier growth period, the reserves of the area were fed directly into the individual countries and there were no limits placed on the credit creation resulting from them. Also there were no demands for a system-wide sterilization through deposit of reserves in the U.S. or another central site. So there was ample stimulation which resulted in good growth performance, as well as inflation and other distortions whose effect would be seen later.

In the recession phase there was also no mechanism to limit the damage being done, with the exception of the dollar pool of rolled-over bank loans. The contractual obligations for debt repayment took center stage, and so the individual countries had to make all of the adjustments. The U.S. was able to continue its policy of high interest rates and price deflation, as well as its double deficits, in trade with the rest of the world and on the fiscal side. Indeed the continued debt repayment was predicated in debtor countries such as Brazil on a substantial trade surplus with the U.S.

In addition there was no way for the bloc to demand a coherent U.S. response to the Latin American dollar drain. While new loans were being provided to allow the countries to maintain the fiction of repayment, the benefits of the Generalized System of Preferences were being reduced in 1986, and countervailing duties were either put in place or threatened on goods from Mexico, Peru, Brazil and a number of other countries. Foreign assistance to Peru was suspended. And tax changes affecting the viability of foreign investments were incorporated into the tax code.

So the system operated in a fashion which encouraged instability and did not force upon the U.S. the role of disciplinarian, either of its own behavior or that of other countries. In this way the benefits of the CFA were not obtained. Similarly, there were no obligations placed directly on the U.S. to develop a coherent policy which would take the Latin American countries into account and to make domestic adjustments to facilitate this. There were no benefits such as the allocation of British purchases among the sterling bloc countries. So the bloc did not perform in a positive manner for the Latin American countries, especially in the difficult times of the 1980s.

Add on to these problems the weakening of domestic economic policy, and the scene is even less positive. When a weak government attempted to assert some independence from the bloc, chaos resulted, as seen most clearly in the three years leading up to the Bolivian hyperinflation of 1985. Even stronger governments faced major constraints on their policy-making ability and were forced to undertake dramatic steps to control their domestic economy; e.g. the Mexican bank nationalization of 1982 was a result in large measure of dollarization in the economy and the inability of the government to influence the behavior of the banking system (Tello, 1984).

So in many ways the dollar bloc has given Latin America the worst of all worlds: it has not provided the economic stability which is often seen as a requirement for growth and which the CFA provided; it has not generated any claims on real resources as a result of the bloc's operation such as was the case in the sterling bloc; and it has served to undercut the power of domestic economic policy. Either a formalization of the bloc or a weakening of its influence must occur for the effect on the Latin countries be improved.

This raises the question of the pressures which are affecting current develop-ments in the bloc and the indications they provide for the direction in which it might go.

To this point the realm of negotiation has been access to the dollar pool. A continued infusion of dollars has been an essential element in the macroeconomic performance of all of the countries in the 1980s. The ticket to the dollar pool since 1982 has been the status of negotiations with the IMF and with the World Bank, for their approval has generally been the prerequisite for renegotiations and new subscriptions by the private banks. The reschedulings of public loans have operated on a parallel track that was more accommodating. The strategies involved and the outlines of the agreements have evolved over time, with every Latin country except Colombia involved in these operations. At best the countries have been able to ensure their access even in the face of negative external economic trends. The best example was

Mexico's 1986 agreement that provided increases in dollar flows if growth slowed or if the oil price fell, as well as giving a narrower interest rate spread than had previously been offered.

However the vulnerability of the Latin American economies has led the IMF and World Bank to take a more active role in determining domestic economic policy, moving beyond the traditional macroeconomic concerns. Not only are they pressing for accep-tance of the international constraints of domestic economic policy, they have also been pressing structural adjustments on the economies, i.e. attempting to expand the role of markets and prices. The mechanism is through "structural adjustment loans" which provide access to the dollar pool only if domestic structures are reformed. For example, the new government of Bolivia adopted what appeared to be a far-reaching Fund type program in August 1985, but a new infusion of dollars was not forthcoming until the following June after a tax reform had been forced through Congress in an effort to change the tax structure of the country.[6]

In any case the quid pro quo for access to the dollar pool on better terms has been an increase in the external influence on economic policy.

Nonetheless there have been several attempts to redefine the rules of participation in the dollar area. The first was the unilateral decision of the Alan García government of Peru to limit interest payments to 10% of export proceeds. García was telling the other members that there were limits to the adjustment that could be forced on the Peruvian economy by the earlier agreements, and that the costs would have to be shared more widely within the area. The response has not been favorable and Peru has become almost a pariah, experiencing great difficulty in obtaining additional dollar inflows. Domestic adjustments and García's continuing popularity have kept the economy functioning, though with very high rates of inflation and with growing problems.[7] The system of the dollar bloc has not been accommodating.

A more fundamental challenge has been proffered by Brazil and its former Finance Minister, Dilson Funaro. In February 1987 Brazil declared a moratorium on interest payments on its bank debt and indicated that it did not want to talk to the banks but would deal with governments and international agencies. Brazil was accused of attempting to politicize the issue, which completely overlooks the reality that the dollar area is a political arrangement. Brazil was clearly attempting a direct attack on the system as it had operated, with the goal of forcing adjustments so that the costs of its continued operation would be more evenly shared. Brazil's unwillingness to reach an agreement with the IMF which would place the burden squarely on the Brazilian economy was another element in the bargaining stance. Again the dollar area was not

[6] A treatment of the evolution of structuralism in this direction is presented in K. Jameson (1986) and the evolution of the IMF programs is dealt with in P. Henriot and K. Jameson (1988).

[7] The most recent evidence of these difficulties was García's call for bank nationalizations in the face of continuing capital flight and dwindling reserves.

accommodating and Funaro was finally forced to resign, in large measure because of his failure to generate any international flexibility in dealing with the Brazilian debt.

One result of the Brazilian stance has been to force the U.S. banks to begin to shoulder some of the costs of keeping the bloc in operation, in this case by setting aside massive loan loss reserves of over $17 billion which generated accounting losses of over $7 billion during the second quarter of 1987. The banks saw this as softening the threat which Brazil represented; however it also makes it more likely that they will "take a hit" and end up writing down, or off, portions of these loans. The end result will be a more even sharing within the dollar bloc of the costs of keeping the bloc in operation. An agreement to allow Bolivia to buy back its debt at its market value, which may be only 30% of its face value, is another step in the growing willingness to reassess the arrangements that have developed.

Such adjustments are likely to stabilize the dollar bloc and may allow it to remain viable for the coming years. But they are far from changing the generally mediocre performance which has been characteristic in recent years. This raises the final question, whether there are adjustments which could make its operation more successful, assuming as is likely that dissolution of the bloc will not occur in the near future and that the Latin American countries will remain under its influence.

Technocratic fixes such as the formation of a "Latin American monetary system" seem unlikely to work, given the major internal political differences which have caused all of the common market efforts to founder. So adjustments to the existing bloc arrangements through political processes seem more likely to improve its functioning.

The first step might be to develop a system in which the mutual needs of all participants were acknowledged--to formalize the bloc. This would require the develop-ment of a coherent U.S. economic policy toward Latin America which would realize that trade and investment flows are integrally linked to the financial flows that have been driving the bloc, and that improvements in Latin American economic performance will be beneficial to all members of the dollar bloc. This would require affirmation that there is a special relationship between the U.S. and Latin America, much the same as the special relationship of Japan, Korea, and Taiwan.

Secondly it would require that the U.S. acknowledge the effect which its own domestic policies have on the Latin American countries, that the tight money policies and overvalued dollar of the early 1980s and the huge trade and fiscal deficits of the mid-1980s have allowed the U.S. to live beyond its means at some significant cost to the Latin American countries. U.S. policy adjustments such as the depreciation of the dollar will be helpful to other members of the dollar bloc. These adjustments should be much more a part of the decision-making process, and improved performance of the whole bloc should be a goal of economic policy.

There will have to be major changes in the operation of the international economy to bring these adjustments to the dollar bloc. Short of that, steps should be taken to restore some of the autonomy of domestic economic policy in the Latin American countries. This really requires the restoration of the countries' ability to implement capital controls, and to resist the financial liberalization of recent years. This takes us back to a debate after WWII and to Keynes' thinking about how to organize a viable world economy. A key construct was the role of capital flight. James Crotty (1983) in an excellent exchange on Keynes' work pointed to the role which capital flight played in Keynes' thinking on how to reconstruct Britain after the Depression and then after WWII. Keynes wanted government control over the investment process, with a substantial increase in investment which would push the rate of interest down to zero and result in the euthanasia of the rentier class. The issue is whether he realized and accepted the possibility that these same rentiers would move their capital abroad, thus avoiding euthanasia. Crotty claims that he did, that this is why he advocated rigid capital controls by government, and thus hoped to avoid the situation where interest rates adjust to bring about international balance at the cost of domestic growth and employment. Crotty also points to the consistency between this view and Keynes' desire for an International Clearing Union which would force adjustment on surplus countries, making them expand their economies rather than forcing the deficit countries to contract. This of course is the type of policy which the Reagan administration is attempting to force on Japan and Germany, while at the same time forcing contraction on the Latin American economies.

So Keynes focused on the real question of the dollar bloc, the effect which it has on domestic investment and accumulation. It is clear that traditional capital flight has a detrimental impact, as resources which could be used for domestic investment have gone overseas. The same argument can be made about the other components of dollarization.[8] So one viable step to improve the functioning of the dollar bloc would be to develop mechanisms to control capital movements within the bloc, to allow governments to trace and indeed control the dollars that leave their country through private capital flight. This would facilitate capital formation in all of the countries and would benefit the whole bloc.

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[8]For example, with financial liberalization and integration into international capital markets, the domestic interest rate under many circumstances is set internationally and independently of domestic economic policy. So capital accumulation is reduced. If there is a substantial growth in dollar deposits in the domestic financial structure, domestic capital formation will be further lowered. Such deposits will earn a higher rate of interest than domestic deposits simply to take into account the possibility of non-convertibility. In addition, the drain of financial resources out of the domestic financial structure will force higher rates of interest in order to attract deposits. Thus again the effect is the same as capital flight even though the mechanism be different.

VI. CONCLUSIONS

The U.S. and the Latin American countries are linked together into a dollar bloc which has evolved informally over time, with very real implications for economic performance. The challenge now is to deal with it in a creative manner and to turn it into an instrument for better performance for all members of the bloc.

The case can be made that the economic chaos of recent years might have been far less in the absence of the dollarization process. Exchange rates might have been far less unstable and the maxi-depreciations which seem to be commonplace would be much less so. Also the ability to stabilize the domestic price level and rate of inflation might have been far higher had there been greater stability in the money market in these countries. Add on the loss of seigniorage, the effect on expectations, and it is clear that the dollarization process has changed the entire economic policy context in Latin America.

There are pressures to alter the arrangements of the dollar bloc, to share the costs of its maintenance more evenly. This is crucial for any type of recovery in Latin America. And any long term view on the part of the United States would see it in its interests as well. It remains to be seen whether the current disarray and the pressures being applied from Latin America can serve to adjust the dollar bloc so that it contributes more positively to Latin American development.

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TABLE 2

Capital Flight, 1974-82 (Billions of $)

	Capital Flight-- Simple Estimate	Capital Flight-- Complete Estimate
Argentina	15.3	31.3
Brazil	-0.2	3.9
Chile	-1.9	-0.7
Mexico	32.7	29.4
Peru	1.2	3.8
Venezuela	10.8	15.6

Sources: Khan, Mohsin and Nadeem U.L. Haque, "Capital Flight from Developing Countries," Finance and Development 24 #1 (March, 1987), pp. 2-5.