Is the US Interested in Exercising Dollar Diplomacy?

(abridged)

Jeffrey Frankel
Harpel Chair, Harvard University, and
Former Member, U.S. President=s Council of Economic Advisers

Luncheon address
Conference on Dollarization
InterAmerican Development Bank
Panama City, July 1999.

Ricardo Hausmann suggested I might talk about American politics and the US Congress, partly with an eye toward any inferences that could be drawn for congressional attitudes toward possible dollarization in any Latin American countries.

30 years ago, if a Latin American country had wanted to dollarize, I think the USG might have seized the opportunity to spread the blessings of the dollar over a wider area, including agreeing to share the seignorage. We might have called it dollar diplomacy ; the left might have called it imperialism. But in any case, I think the US would have supported it. Indeed, most Latin American countries were among the 80+ who remained pegged to the dollar after 1973. Today, one has to say it looks unlikely that the US Congress will go along with such a scheme if it costs anything (even if the only monetary cost is sharing seignorage that the US Treasury would not otherwise have had).

I say this because of the wider reluctance on the part of the US to pay the price for regional global leadership, even when the price is small. There is a lack of interest in internationalism. We have won the cold war, as well as the international economic competition, but we may not be sufficiently interested in collect our winnings to put down the small deposit required for the job of hegemon.

Examples come readily to mind. 30 years ago we criticized the Russians for neglecting to pay their UN dues; in this decade we have been the ones chronically in arrears. 30 years ago, it would have seemed a great Adeal@ for us to be able to exercise influence in the IMF that is more than proportionate to the size of our quota; last year Congress was very reluctant to approve our share of the quota increases. Ever since 1974 Congress has given presidents authority to negotiate trade agreements on a fast-track basis B until the present, when Congress has denied this authority to President Clinton, thus side-tracking progress on the Free Trade Area of the Americas. I think of the trade agreements of the early 1990s as among President Clinton=s great accomplishments, whether regional (NAFTA) or multilateral (Uruguay Round). But there are those in Congress who think they were a mistake and don=t want more of the same. They claim that trade liberalization is bad for the US because we open wider than do our trading partners.

Ten years ago, much of this reluctance on the part of the American congress and public to play an active role in the world had already become evident. But in the 1980s the fear was that the US economy was in decline, particularly compared to Japan and other East Asian countries. People said that we could no longer afford the cost of leadership as we could when we had the world=s strongest economy. Even at the time, there were several serious flaws in this argument. First the decline in US economic performance was only relative to others B perhaps the natural result of gradual [conditional] economic convergence across countries in GDP per capita. If in the immediate postwar period we could afford the vast sums involved in the Marshall Plan, it is hard to see why we could not afford to remain the leading aid-giver (for example) at a time when our income was considerably higher than in the 1950s. Second, the US economy all along had some fundamental underlying strengths, and by the 1980s we had already begun to build on those strengths by undertaking structural changes such as dereulation (airlines, trucking, banking, telecommunications) and innovation (information technology, corporate restructuring). Third, from an economist=s viewpoint, it is of course a mistake to think that maintaining low trade barriers is a cost that a country pays in order to confer a benefit on a political ally.   Rather, openness is good for growth, in theory and in practice. Indeed, US openness is one of those fundamental underlying strengths of the US economy.

But it is perhaps more surprising that the reluctance of the US Congress to exercise global leadership has continued, even deepened, in the 1990s B surprising because US economic performance has been so spectacular, whether measured by the length of the expansion (8 years, a peacetime record, and approaching an all-time record), the average growth rate (4 percent in recent years), the swing from budget deficit to surplus or the low rates of unemployment and inflation (to the levels of the 1950s).   The situation has changed even more dramatically relative to other countries, because simultaneously with the US renaissance, much of the rest of the world has of course stagnated, especially East Asia, which was the supposed source of competition in the 1980s.

Can the U.S. Lead? Our greatest strength is the US domestic political and social system and culture.   American values are democratic, even though US-style democracy is not the only legitimate kind.

Are they consistent with economic liberalization and market orientation?
I believe political liberalization can support economic liberalization.

Not long ago, it would be said that political freedom (democracy and human rights) was in conflict with economic freedom (the basically free-market approach that is best suited to development). Countries that became democracies before attaining industrialization would face excessive pressure for redistribution from rich to poor. One needed a dictator like Pinochet to enforce property rights, and put in place other unpopular but necessary economic policies. Russia's failure at transition as compared to China=s success was attributed to the improper sequencing of political vs. economic reform. Asia's lack of democratic institutions and freedoms was said by some to be a key to its economic success -- and indeed to reflect fundamental Asian values.

Political liberalization and economic liberalization are such sweeping historical forces that they are unlikely to obey a simple correlation or universal causal relationship with each other. Nonetheless, developments associated with the Asian financial crisis show that the two forces can be in alignment more positively than most had assumed.

We were told in the past that Asian values did not place as high weight as did Westerners on democracy, free speech and other civil freedoms. I would guess that many Asians believe (now, if not before) that there are financial advantages to the rule of law, transparency, freedom of expression, and clearly-established procedures for government succession -- even leaving aside the non-economic benefits of such rights. Kim Dae Jung, for example, has blamed the economic crisis on authoritarianism.[i]

Consider the several lessons that one might draw from recent events:
· Lack of rule of law and unclear presidential succession undermine investment (Indonesia).
· Relationship banking turns out to be crony capitalism (Japan and Korea).
· Corruption deters foreign investment and slows growth (Indonesia and many others).[ii]
· A country aspiring to become a major financial center needs freedom of the press (Singapore).
· Persecution of racial minorities can lead to capital flight (the Chinese in Indonesia & Malaysia)
· The legitimacy of a democratically elected leader allows painful reforms (Korea & Thailand).[iii]

Linda Tsao Yang (U.S. Executive Director to the Asian Development Bank) has said: AYou look at country after country, from Thailand to South Korea, and you find governments that are more accountable to the people, with more rule of law, with less rule by man or connections…If the region can survive the major, major changes and have a peaceful transition period, then the Asia that emerges will be much stronger for the exercise."[iv] If this pattern indeed continues to hold up, it will to some degree replicate what happened in Latin America in the 1980s. When the international debt crisis surfaced in Mexico in 1982, the conventional wisdom was that if Latin America were put through a long and deep reduction in its standard of living, the resulting social unrest would set back progress toward both economic and political liberalization. The reduction in living standards turned out to be as long and deep as anyone=s worst fears -- the Alost decade@ of growth. Yet there followed a decade of unprecedented progress toward liberalization, both political (as almost every country in Latin America moved toward democracy and human rights) and economic (as they privatized state-owned sectors, opened their economies to domestic and international competition, and adopted fiscal and monetary discipline). Perhaps the same will happen in Asia.

A serious minus for US leadership is lack of domestic support for internationalism. Poll results from the Chicago Council on Foreign Relations show 61% of public (and 96% of leaders) support an active US role in world. 54% think globalization has been good for America. This does not translate into sufficiently high support for internationalist programs in the Congress.

Conclusion: Dollarization

Would dollarization be beneficial to the United States? To say that the effect of such a move by a single country would be very small is true, but not helpful; the next step would be to ask what would be the effect if other countries wanted the same. Economic benefits for the United States include seignorage, enhanced ease of transactions in the region on the part of U.S. businesses and travelers, and the increased trade that stability and prosperity in the area would bring about. Perhaps there are foreign policy benefits to spreading US influence as well, though imperialism is distinctly out of fashion and I never heard anyone suggest this viewpoint within the Administration. The drawback is the danger of implicit bailout liabilities, which may be there even without the official sanction provided by a treaty. But the benefits probably outweigh the costs. This is especially true since the United States already bears some responsibility for leadership when international financial crises strike, and the probability of crisis in Argentina would presumably be reduced under a dollarization plan. If this evaluation of U.S. costs and benefits is correct, then the idea may merit American blessing, even if that blessing must be unofficial.

Many of those in Congress who are most isolationist in their attitudes consider themselves strong free-marketers. Indeed one of the reasons they might give to justify lack of interest in what goes on in other countries is the belief that problems in those places stem from insufficiently free markets.

Incidentally there is usually an element of hypocrisy to Congressmen's support of free markets, as Congressman Barney Frank pointed out during a hearing in May of the House Committee on Banking and Financial Services where I testified on dollarization. I was explaining that the monetarist disciples of Milton Friedman think that the exchange rate is a price that should be determined freely in the private market without influence by government purchases or sales of foreign exchange, just like the price of wheat. The congressman pointed out that his colleagues on the committee from farm states in fact somehow think that the laws of the marketplace don't apply to wheat.

Free-market principles do not tell one how to choose between free-floating exchange rates and a gold standard, currency board or monetary union. Balancing the monetarists' belief that free-market ideology implies exchange rates should float is the supply-siders' belief that free-market ideology says governments make an implicit promise when they print money that it will maintain its value, and says that the government should honor that commitment. Nevertheless it is these adherents of fixed exchange rates and currency boards, who, for whatever reason, are surprisingly well-represented in Congress, perhaps because they read the Wall Street Journal editorial page. They are a possible constituency of support for dollarization. Thus dollar diplomacy might not be dead yet.

---

i. AIn every country in Asia, including Korea, the major reason for [economic] failure was lack of democracy.@ Emmerson (1998, p.52).

ii. Corruption, while long neglected by empirical researchers, is now the subject of some interesting statistical studies: Paolo Mauro (IMF, 1995) finds that corruption reduces investment and growth (a country that improves its standing on the 0-10 uncorruption scale from 6 to 8 will enjoy an increase of 4 percentage points in investment as a share of GDP, and in the growth rate by roughly half a percentage point; and government spending on education increases by half a percentage point of GDP). Shang-Jin Wei (NBER, 1997) finds: (1) an increase in corruption from the level of Singapore to that of Mexico is equivalent to raising the tax rate by over 20 percentage points [a corresponding increase in uncertainty is equivalent to raising the tax rate by 32 points]; (2) (May 1998) Aif Pakistan were able to reduce its corruption to Singapore=s level, its average annual per capital GDP growth rate over 1960-85 would have been higher by 1.8 percentage points….[I]ts per capita income by 1985 could have been more than 50% higher [p/9];@ and (3) Asia is no better able to withstand the negative effects of corruption than are other countries.

iii. In Korea the crisis has had the effect, under Kim=s leadership, of breaking the political log-jam that blocked needed economic reform, giving firms the freedom to lay off workers, while reining in the excesses of the chaebol in other dimensions (e.g., suppression of union organizing, and unaccountable corporate governance).

iv. Quoted NYT 5/20/98.