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Discussion of "Inflation Targeting in Latin America: Toward a Monetary Union?"

Marc Hofstetter has performed a skillful and innovative analysis of a major policy question: should Latin American countries retain independent monetary policy, form a currency union, or dollarize? One technical advance is to measure the costs and benefits of a regime change in comparable units, using survey evidence on the determinants of life satisfaction. The paper reaches the provocative conclusion that either a currency union or dollarization would increase economic welfare in Latin America.

While I admire Marc's technical accomplishment, I disagree with his conclusions. I think a currency union is probably a bad idea for Latin America, and dollarization is *definitely* a bad idea. I held these views both before and after reading Marc's paper. Let me first discuss my prior opposition to dollarization and currency union, and then the reasons why the paper does not change my mind.

The history of the last twenty years shows that a hard currency peg–either dollarization or a currency board--is a dangerous policy. The emerging-market economies that have adopted hard pegs have typically experienced periods of strong capital inflows that ended in a "sudden stop." This capital flight has produced severe slumps because the economies lacked the shock absorber of depreciation.

We can see the costs of a hard peg by comparing the effects of capital flight on countries with pegs and on neighboring countries with flexible exchange rates. As documented in Ball (2010), Hong Kong, with a currency board, was hit much harder than its neighbors during the East Asian financial crisis of 1997-98. Argentina was the country hit hardest by the Tequila crisis of 1994 (except for Mexico, where the crisis originated). The Baltic countries and Bulgaria suffered more than other countries in Eastern Europe during the world financial crisis of 2008-09.

Ironically, Marc is one researcher who has documented the costs of hard pegs. Ball, deRoux, and Hofstetter (2011) find that inflexible exchange rates contributed to large, persistent increases in unemployment in Argentina, Panama, and Paraguay.

A common currency is not as obviously dangerous as

dollarization. A regional currency union can allow its currency to depreciate if capital flight hits the region, dampening the effect on output. Hong Kong would have suffered less in 1997-98 if it used an Asian currency, which would have depreciated, rather than pegging to the dollar. Argentina and Panama would have suffered less from capital flight if they used a Latin American currency.

Yet we have learned a lesson from the current Greek crisis: a sudden stop can occur for one country within a currency union. When that happens, the country's plight is the same as under a hard peg. Greece's lack of competitiveness has produced steadily rising unemployment—rates of 11% in mid-2011 and 16% in mid-2012. Greece badly needs a devaluation against the currencies of other European countries, which is impossible as long as it retains the euro. A monetary union in Latin America could help one of its members become the next Greece.

Thus the history of hard pegs and currency unions makes me a skeptical reader of Marc's paper. However, Marc offers estimates of the costs and benefits of these regimes and finds that the benefits are higher. Why aren't these calculations persuasive? The answer is that, in my view, the estimates both overstate the benefits and understate the costs.

The primary benefit of dollarization or a currency board is an increase in trade among the countries that share a currency. Thus a key parameter for Marc's cost-benefit analysis is the proportion by which a common currency increases trade. As Marc discusses, research on the euro suggests that it has increased intra-European trade by something on the order of 10%. In my view, this European precedent is the most reliable guide to the effects of new Latin American currencies. Some researchers find larger effects of common currencies, but their estimates are based on the less relevant experiences of tiny countries.

Marc argues that dollarization has substantial benefits even if we assume 10% for the trade effect. But I believe there is an error in his calculations. In Table 3, he estimates the effect on trade by multiplying current trade with the U.S. by 1.1. He should multiply instead by 0.1: that number gives the increase in trade resulting from dollarization, while multiplying by 1.1 gives total trade with the U.S. after dollarization. If I am correct, then all the benefits of dollarization in Table 3 should be divided by 11 (which is (1.1)/(0.1)), and this adjustment makes the benefits very small. A similar point applies to the benefits of currency union.

Turning to the costs of dollarization or currency union, my main concern is an issue that Marc points out in his conclusion.

The paper's estimates of costs assume that a monetary regime can influence the variability of output but not its average level. In effect, Marc assumes that any output loss that dollarization or currency union causes in one period is balanced by higher output in another period. If this assumption is wrong, the costs of a regime are likely to be much higher than Marc estimates.

In reality, it appears that hard pegs and currency unions cause output and employment losses that do not come with offsetting gains. In Argentina, over the decade from 1991 to 2001, the combination of capital flight and a hard peg raised unemployment by 12 percentage points–from 6% to 18%. Obviously an offsetting decrease in unemployment would be impossible: regardless of the monetary regime, no shock could push unemployment from 6% to -6%.

Summing up: Marc has taken a promising first step in quantifying the costs and benefits of alternative monetary regimes. For the results to be plausible, however, he must address the problem with measuring trade effects that I have highlighted, and account for the effects of policies on average output and employment. These modifications of Marc's analysis are likely to yield more negative results about dollarization and currency unions.