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Countries struggle to deal with global markets: Dollarization, eh?

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Countries struggle to deal with global markets: Dollarization, eh?

By Louis D. Johnston | 03/07/12

REUTERS/Shaun Best

Can the mighty loonie save Iceland?

"Step one in Canada's quest for world domination… is to take over Iceland."

I chuckled when I read this headline and thought it came from the humor site The Onion, along the lines of "Road-Kill Squirrel Remembered As Frantic, Indecisive." Yet when I clicked on the link, I found it was a real story in The Washington Post.

An article in Toronto's Globe and Mail, "Canadian envoy to Iceland sparks loonie controversy," put the matter succinctly: "Tiny Iceland, still reeling from the aftershocks of the devastating collapse of its banks in 2008, is looking longingly to the loonie as the salvation from wild economic gyrations and suffocating capital controls." ("Loonie" comes from the fact that a loon is on one side of the Canadian one-dollar coin.)

Countries throughout history have faced exactly the same situation as Iceland's, and more nations will confront it in the future as they try to integrate their domestic economies with international markets. To understand what this means, let's look at how the U.S. situation played out in the 19th century and how other countries have dealt with this problem.

Pounds, continentals and dollars

U.S. history provides a nice example of how a country made this journey. The pound-sterling served as the official currency for British colonies of North America. The colonists never had enough British money to carry out trade, so they used a variety of foreign coins and commodities. This meant that merchants had to keep careful track of the exchange rates between Spanish reals, British pounds and a variety of paper monies issued by colonial governments.

During the American Revolution, the Continental Congress lacked the power to directly tax citizens to pay for the war. They resorted to the printing press, creating "continental bills," or simply continentals, to finance war expenses. As you can imagine, the value of these bills plummeted as the government printed more and more of them, creating a hyperinflation and making continentals worthless. Most businesses went back to using Spanish coins and other forms of commodity money such as tobacco, corn and wheat. Monitoring exchange rates remained an essential part of everyday business life.

Barry Eichengreen, in his book "Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System," describes what happened next: "It took the leaders of the new nation some time to regularize this irregular situation. In 1785 the Congress passed a resolution declaring that the 'money unit of the United States of America be one dollar' and that the dollar should be divided according to the decimal system.

By 1789, the Constitution authorized the Congress "To coin Money, regulate the Value thereof" (Article I, Section 8) and Congress codified this power in the Coinage Act of 1792. In particular, the Act specified that the dollar coin would be composed of 371.25 grains of silver or 24.75 grains of gold.

The dollar and international trade

The dollar coin immediately gained acceptance within the United States. However, as Eichengreen points out, "Whether an American merchant needed credit to purchase imports or to extend credit to a foreign purchaser of American goods, he secured it not in New York but in London or, less frequently, Paris or Berlin. It followed that this credit was denominated not in dollars but in pounds, francs, or marks."

Why? Eichengreen explains: "By the nineteenth century, London had become the premier financial center. Because it was where members of the British Empire serviced their debts, London had developed efficient clearing mechanisms that could also be used by other countries. Britain was the leading foreign investor. And when one of its banks made a loan to a foreign borrower, that loan was naturally in the form of its own currency, the pound sterling. With so many loans denominated in sterling, it became natural for governments, when borrowing in London, to maintain accounts there in order to conveniently service their debts. These accounts were what subsequently came to known as 'reserves.'"

Eichengreen continues: "Because Britain was the leading importer of industrial raw materials and food, the most important commodity exchanges -- the Manchester Cotton Exchange, the Liverpool Corn Market, and of course the London Gold Market -- were located there. Britain was also an efficient provider of trade-related services such as shipping and insurance. All this made London an obvious place to obtain credit for those engaged in international trade. And for reasons of their own convenience, the credit provided by British banks was denominated in sterling. It followed that upwards of 60 percent of world trade was invoiced and settled in British pounds."

This put the 19th century United States in a position similar to Iceland today. In order to conduct international trade, American companies had to convert their dollars into pounds, francs or marks, carry out their transactions, and then convert their profits back into dollars. This took considerable time and resources.

Thus, it wasn't until the 1920s that the dollar became accepted in international transactions. As Eichengreen points out, this was due to a number of factors, the two most important of which were the lack of a U.S. central bank before 1914 and the steep financial cost of World War I to the British.

Dollarization and common currencies

Icelandic exporters and importers must engage in the same types of trades today, only they must convert their króna into dollars or euros. It took the United States over 100 years to get around this problem. Wouldn't it be easier if Iceland just adopted the dollar or the euro or the loonie as its currency?

A number of countries have taken this step. Ecuador and El Salvador did this in the 1990s and early 2000s when they adopted the U.S. dollar as legal tender. This idea came to be known as *dollarization*, and the term is now used to refer to any country that adopts another country's currency as its own.

Another strategy is for two or more countries to give up their individual currencies and create a common currency for the group. This is what the European Union did when it created the euro (and which I discussed here).

There is a big downside to either dollarization or a common currency: Each country must give up the ability to control its monetary policy. For example, Greece is in trouble today not only because of excessive borrowing but also because it was not able to pursue a low-interest rate policy to cushion the blow of the 2007-2009 recession. Monetary policy was set through the European Central, which is dominated by the German and French governments. Neither Germany nor France opted to cut interest rates rapidly, which led to problems not only in Greece but in Ireland, Spain, Portugal and Italy.

Iceland and Canada: world domination?

This is where the loonie comes into the picture. Iceland wants the advantages of a stable, internationally traded currency, but is starting to balk at entering the European Union and adopting the euro. (The Washington Post provides a good summary here.) The alternatives are to continue with an independent currency, and the costs associated with it, or try to find another country's money to which it can link its fortunes.

Enter friendly Canada. The Canadian dollar has done well in international markets over the past 20 years, with its exchange rate less volatile relative to the U.S. dollar than has been the euro. Iceland is cold and exports lots of natural resources; Canada is cold and exports lots of natural resources. Why not team up?

It's interesting to think about this possibility, but I doubt it will happen. In general, countries need deep trade and financial ties in order to function smoothly using the same money, either through dollarization or a common currency. (Economists call a group of countries that have these characteristics an optimum currency area.) When two economies differ, the monetary policies that are appropriate for one country will not be right for the other and the arrangement will fall apart.

It turns out that neither Iceland nor Canada is an important trading partner with the other. The same is true with regard to their financial markets. So there just isn't enough in common between these countries to make dollarization work.

But that's not the end of the story, only the latest chapter. Iceland in particular, and countries all over the world, in general, will continue searching for ways to create stable exchange rates that allow them to easily trade with other nations. Perhaps Iceland should talk with Norway...