



Dollarisation and Economic Shifts

For Prelims: [Dollarisation](#), [Inflation](#), [Exchange rates](#), [Monetary policy](#), [De-dollarisation](#), [India's Trade agreements](#), Special Vostro Rupee Accounts

For Mains: Major Challenges Related to Dollarisation, Reasons for Rise in De-dollarisation Practices.

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Why in News?

Argentina, plagued by **severe inflation** and **widespread poverty**, faces a pivotal moment. **Dollarisation** is seen as a **potential remedy for the country's economic challenges**.

- The recently elected President of Argentina promises to replace the **Argentine Peso with the dollar**. **However**, the immediate implementation of dollarisation seems unlikely due to the scarcity of dollar reserves in Argentina.
- **Dollarization** is the **use or adoption of the United States Dollar** as the primary currency in a country, **replacing or supplementing the local currency**.

How Dollarisation can Save an Economy?

- **Stabilizing Inflation:** Dollarisation can potentially **curb hyperinflation** by **introducing a stable currency, breaking the cycle of rising prices** fueled by uncontrolled money supply. This stabilization fosters confidence in the economy, encouraging investment and consumer spending.
- **Enhanced Trade Opportunities:** A dollarized economy incentivizes **a focus on export-oriented strategies**.
 - With a stable currency, **foreign investors are more inclined to engage**, fostering foreign trade. This orientation towards exports can bolster economic growth and stability.
- **Long-Term Planning:** A stable dollar value allows for better long-term economic planning. Businesses, **both local and international, can make more accurate forecasts** and investments without being hindered by the volatility of a depreciating domestic currency.
- **Reduced Speculative Risks:** Dollarisation can **mitigate speculative risks associated with fluctuating exchange rates**.
 - This stability can attract foreign investors, as they perceive reduced risks, ultimately promoting capital inflow and economic growth.
- **Financial Discipline:** By **relinquishing control of monetary policy**, dollarisation forces governments to rely on fiscal policies for economic stability.
 - This shift **may encourage more prudent fiscal management**, potentially curbing government overspending and promoting **economic discipline**.

Experience of a Fully Dollarized Economy: Ecuador

- Ecuador's journey provides valuable insights. Despite **initial political upheaval** following dollarisation in **2000**, the **nation experienced significant economic progress**. Reduced

inflation rates, lowered debt ratios, and improved social welfare showcased the potential benefits of such a move.

- However, **Ecuador's success was not solely due to dollarisation.** Booming oil and gas reserves during the 2000s contributed significantly to economic growth. Furthermore, expanded government intervention and social spending played a crucial role in sustaining prosperity.

What are the Major Challenges Related to Dollarisation?

- **Policy Constraints:** Dollarisation significantly **limits a country's ability to independently manage monetary policy.**
 - Loss of **control over [money supply](#)** and interest rates can hamper the government's capacity to respond to economic downturns.
- **Economic Shock Vulnerability:** With a fixed currency, **dollarized economies might become more vulnerable to external economic shocks.**
 - They lack the flexibility of adjusting exchange rates to counterbalance sudden changes in the global economic environment.
 - The situation in Greece is a warning example of issues associated with adopting a foreign currency.
 - Although there was some **growth after Greece started using the euro**, the **Eurozone crisis** showed the problems of using a currency without having control over its policies.
 - Greece had to accept **strict budget cuts** and financial help in return for using the euro.
- **Limited Export Competitiveness:** **Loss of control over the exchange rate** can restrict a country's ability to **use currency devaluation as a tool to enhance export competitiveness.**
- **Inability to Address Internal Imbalances:** Dollarisation **may not address internal structural issues within the economy.**
 - Dependency on a foreign currency might **overshadow the need for internal reforms**, such as **productivity improvements or addressing income inequality**, crucial for sustained economic development.

Note

In 2022, the IMF observed that central banks around the globe **were not maintaining the same levels of reserves in the US dollar**, as they had done in the past.

What is De-dollarisation?

- **About:** [De-dollarisation](#) refers to a **deliberate or unintentional process** undertaken by a country or region to **reduce reliance on the US dollar** in its financial system or economy.
 - This can involve various measures aimed at decreasing the use of the dollar in **transactions, reserves, trade**, or as a standard for pricing goods and services.
- **Reasons Associated:** Governments might **pursue de-dollarisation for several reasons**, such as reducing **exposure to the impact of [US monetary policy](#)**, **asserting economic sovereignty**, **mitigating the effects of dollar fluctuations**, or seeking greater independence in global finance.
- **Strategies for De-dollarisation:** It can include diversifying currency reserves, promoting the use of alternative currencies in [trade agreements](#), **establishing currency swap agreements**, or **encouraging the use of regional currencies** in financial transactions.
 - For instance, **in March 2023**, the RBI put in place the mechanism for rupee trade settlement with as many as 18 countries.
 - Banks from these countries have been allowed to open [Special Vostro Rupee Accounts \(SVRAs\)](#) for settling payments in Indian Rupees.

Conclusion

Dollarisation, when **coupled with effective domestic policies**, can pave the **way for economic success**. However, its efficacy **hinges on nuanced policy execution**, balancing the advantages of **stability** with the need for independent economic strategies.

UPSC Civil Services Examination Previous Year Question (PYQ)

Q. Recently, which one of the following currencies has been proposed to be added to the basket of IMF's SDR? (2016)

- (a) Rouble
- (b) Rand
- (c) Indian Rupee
- (d) Renminbi

Ans: (d)

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