

Which currency for East Timor?

Ross H. McLeod

Fellow, Indonesia Project, The Australian National University and
Editor, *Bulletin of Indonesian Economic Studies*

The temporary United Nations administration in East Timor has decided to use the US dollar as official currency *ad interim*. This may pre-empt the eventual decision as to the most appropriate currency for the new nation. East Timor would certainly be better off using the US dollar than introducing its own national currency, because of the avoidable dangers and costs countries face if they have their own central banks. But there may be some further advantage in using the Australian dollar rather than the US dollar or other possible candidates such as the yen or the euro.

One of the most important decisions that will need to be made as East Timor edges towards becoming an independent nation is whether to have its own currency—and, if not, which currency to adopt as legal tender. It is usually taken for granted that sovereign nations must have their own unique currencies—almost as if having a national currency is one of the defining characteristics of nationhood—but the issue is much too important to be determined by default. This note argues strongly against the introduction of a new national currency for East Timor, and briefly canvasses the options as to which other currency it might adopt.

It is helpful to begin by recognising that there are already a significant number of countries and mini-economies that do not have their own distinct currencies. Several of these are in the Western Pacific region: Kiribati, Nauru and Tuvalu use the Australian dollar; the Cook Islands and Niue use the New Zealand dollar; American Samoa and Micronesia use the US dollar. Elsewhere, Panama has for long used the US

dollar as its currency, and both Hong Kong and Argentina have a currency board arrangement, under which there is a fixed rate of exchange between their currencies and the US dollar—very similar to simply adopting the dollar itself as legal tender. East Timor will have much in common with the island nations of the Pacific—small population, predominantly agricultural economy, large distance from major markets, and relatively low skill base—suggesting that there may be something to be gained by East Timor also adopting an existing well managed currency as its own.

This issue arises at a time when there is some rethinking of the role of currencies worldwide. At present, eleven countries in western Europe are engaged in the process of switching to a supranational currency—the euro—which is to become the common single currency in use throughout this region, steadily replacing the individual participant country currencies in day-to-day commerce (Antweiler 2000). Closer to home, this has been a catalyst for recent discussion of the

Policy dialogue

possibility of Australia and New Zealand going down a similar road, replacing their individual currencies with a single 'Anzac dollar', or some such (Grimes et al. 2000). Ecuador is currently in the process of dispensing with its own currency and replacing it with the US dollar (Dow Jones Newswires 2000) and, in the wake of Indonesia's current crisis, it has been argued that Indonesia would do well to consider dollarisation of its economy (Schuler 1999).

Competition in the supply of media of exchange

What is at issue is the same in principle as the provision of a domestic payments mechanism by the commercial banking system. Banks compete amongst themselves to persuade individuals and organisations to use their demand deposit services for transactions with each other, and earn profits by virtue of being able to lend the deposits held with them to third parties at interest. The better the deposit service offered, the greater the profit the bank can make.

It is rarely noted, however, that commercial banks do not only compete amongst themselves, but also with the central banks in their own country, since demand deposits are close substitutes for cash as a medium of exchange. This is reflected in our measure of the narrow money supply (M1), which is simply the sum of cash in the hands of the public plus demand deposits it holds with the banking system. Thus we can monitor the relative shares of cash and demand deposits in M1 over time to provide an indication of who is winning the battle for market share.¹

If commercial banks compete with central banks, and if the former compete amongst themselves, why should central banks not compete with other central banks? To some extent, in fact, they do—though probably not consciously. In most gangster movies involving multinational criminal enterprise, the money in the suitcase is US

dollars, no matter in which country the action is taking place. And the bulk of licit international transactions are denominated in US dollars, regardless of the countries involved. It seems, in other words, that the US Federal Reserve is by far the most successful competitor in the business of supplying money to the world economy. And US commercial banks benefit from this since their deposits are easily interchangeable for this money.

This competitive game has been played out entirely passively on the supply side until now: one is not aware that the US government, or the Fed, has ever consciously adopted a policy of trying to win an increasing share of the world market for media of exchange. Rather, the action is on the demand side. Users of the payments mechanism have various choices open to them, and they choose currencies that seem most useful to themselves, regardless of whether the central banks concerned are actively marketing their products. Outside the realm of international transactions, US money is often adopted for purely domestic use in other countries, both as a preferred store of value and as a medium of exchange. Typically this occurs in countries that are experiencing, or have experienced, very high inflation and depreciation, with consequent loss of purchasing power on the part of holders of domestic money. In some countries the central bank responds not by trying to match the competition, but by making it illegal for citizens to hold and use the money produced by other central banks.²

It would seem, however, that the process of globalisation will inevitably result in the emergence of active competition between central banks. International competition in the private sector has always been taken for granted, of course, notwithstanding that it often has been subjected to restrictions. Barriers to trade in goods have already been significantly reduced, and it is now the turn of barriers to trade in services to be removed. This will see, for example, world class banks extending their operations into economies less

Policy dialogue

well served by currently protected domestic institutions, as has already happened in New Zealand and, to a lesser extent, in Australia.

But in this global era government agencies of many kinds are also beginning to think of themselves as potential competitors on the world stage. Thus in countries where government agencies are particularly competent in certain fields, they are moving towards selling their services in other countries as well: examples include water supply authorities and other public utilities. There is no reason why central banks should not begin thinking along similar lines.

Arguments for national currencies

Seigniorage

Why do most countries choose to have their own currency? Feelings of national pride have much to do with it, much like the desire to have a national airline and a national automobile industry (seemingly regardless of the cost), and this is perhaps the major political obstacle to a nation giving up its own currency and adopting that of another. But there is also an important economic justification: namely, that the monopoly right to provide cash to the economy is valuable. Cash issued by central banks is in effect an interest free loan to them from the public, the proceeds of which can be invested in earning assets (or used to finance government consumption).³ Thus if a country with its own currency were to adopt US dollars, say, as legal tender, it would need to convert all of the cash in circulation into dollars, thereby running down the country's international reserves by the equivalent amount. This would result in the loss of interest earnings on these foreign assets. Alternatively, if the country had no foreign reserves to begin with, its government would need to borrow dollars to buy back the central bank's cash liabilities, thus incurring the cost of servicing these borrowings. At perhaps 0.4 per cent of annual GDP, the cost of transferring this seigniorage

to another country's central bank would not be trivial.⁴ This and the national pride factor are the main reasons why the idea of 'dollarisation' has not been taken seriously by many countries hitherto.

Independent monetary policy

A second economic argument often raised in favour of nations having their own currencies and central banks is that this gives governments the option of operating an activist monetary policy for the purpose of macroeconomic stabilisation. That is, if the government (through the central bank) is able to expand or contract the money supply, it will be able to use this policy from time to time to offset cyclical fluctuations in private sector demand on output and employment.

In this view, monetary policy is seen as analogous to the cruise control on a motor car, keeping speed constant as the car goes up and down hills. In reality, however, the ability of economists in developing countries (and perhaps in the industrial economies as well) to operate such fine-tuning policies effectively is greatly overrated. They do not have available to them reliable data on even the current state of economic activity, let alone information that would enable them to anticipate a downturn (or upswing) in economic activity and then act to offset it. Rather, they only get to know the state of the economy with a lag of several months, and even then the data are likely to be of dubious quality. Moreover, there is in fact no simple, direct link between what happens to the money supply (or interest rates) and the level of private sector demand, so that the impact of an adjustment to monetary policy is very uncertain as to both magnitude and timing. In terms of the cruise control analogy, the driver cannot see the hills and valleys until he is past them, and the accelerator mechanism has a mind of its own.

Perhaps more importantly, it needs to be recognised that having an independent monetary policy is a double-edged sword. On the one hand it holds out the utopian

Policy dialogue

promise of being able to fine tune the macroeconomy. On the other, however, it brings with it the very real prospect of gross errors of policymaking, with potentially disastrous consequences.

These kinds of errors, and their costs, have been readily apparent in neighbouring Indonesia from time to time over the last four decades. In the mid 1960s, the central bank lost control of its monetary liabilities, resulting in a lengthy bout of hyperinflation: at its peak in August 1966, prices had risen by some 1,500 per cent from a year earlier. In the mid 1970s, inflation averaged 18 per cent per annum, and there were devaluations of the order of 30 per cent on three separate occasions from the late 1970s to the mid 1980s. During the present crisis, the central bank has had a very poor run, first squeezing the money supply drastically, then allowing it to double in the space of a few months (McLeod forthcoming). The rupiah has depreciated by two-thirds since mid 1997, and there was a burst of inflation in the ten months from November 1997 during which prices increased by almost 80 per cent.

Violent fluctuations in monetary growth are very likely to result in the disruption of normal economic activity. The economy certainly went backward during the 1960s, and the present crisis has resulted in GDP now running at some 27 per cent below what it would have been if the 7.5 per cent per annum growth of the early and mid 1990s had been maintained.⁵ A large part of this can be traced to mismanagement of the central bank function of supplying money to the economy: during the nine months from September 1997 it loaned some Rp165 trillion to banks (Pardede 1999:26)—thus injecting an amount almost five times as large as the stock of base money at the beginning of this period. This is not necessarily to say that the blame should all be laid at the feet of the central bank itself, however. Undoubtedly there have been strong pressures on it to do what powerful figures within the government of the day wanted it to do: indeed, the ability literally to create money provides a

temptation that is often too great for those in power to resist.⁶

Thus the desirability of having an independent monetary policy is best considered in light of the experience of other countries, rather than in the abstract. In the context of East Timor, its giant next door neighbour is a very poor advertisement for a country having its own currency. On the other hand, the small island nations of the Western Pacific that have adopted other countries' currencies have been free of debilitating monetary convulsions. Certainly none of them has ever suffered a balance of payments crisis—any more than has, say, the Australian state of New South Wales, which uses the same currency as the rest of the country. The idea of NSW running out of international reserves (which is what a balance of payments crisis amounts to) simply has no meaning, since there is no need to hold any such reserves, and no central bank to do so.

Of course it can be argued that provided East Timor's new leaders are aware of these dangers they will be able to avoid them, but that is wishful thinking. Amongst the things the new nation is likely to lack is a legal system that poses a credible threat of punishment for those who act corruptly or illegally, a democratic system with a sophisticated electorate under which government officials can be held accountable for their actions, and a cadre of well trained professionals capable of formulating and implementing sound monetary policy and administering a complex institution such as a central bank. The option of taking the dangerous instrument of monetary policy out of play altogether is available, and it seems good sense to do just that. In other words, the arguments against having an independent monetary policy seem considerably stronger than those in favour of it.

Arguments against national currencies

There are two main potential benefits from giving up the monopoly right to supply legal

Policy dialogue

tender. The first, just discussed, is that it avoids the risk of incurring extremely high costs if monetary policy is poorly managed—a strong possibility in a fledgling democracy with weak mechanisms for ensuring accountability of policymakers, and in which the skill base is very limited. The second is that the day-to-day costs of running a central bank can be entirely avoided if another country's currency is used. This is immensely important in a country in which the skills of highly trained economists, accountants, auditors, managers and information technology specialists are in short supply. There are, quite simply, much more useful things that these kinds of people can do with their time—especially if one subscribes to the view that economists in developing countries are deluding themselves if they imagine they are able successfully to fine-tune the economy.

The realisation is starting to dawn, therefore, that using another nation's currency can be beneficial to both the supplying and adopting countries, which increases the prospects for active competition amongst central banks to induce other countries' governments to adopt their currencies. Legislation has been introduced already to the US Senate by the Chairman of the Joint Economic Committee, Senator Connie Mack, that would enable the US government to compensate governments deciding to adopt the US dollar as legal tender for loss of seigniorage (in other words, to share some of the seigniorage that the US government would gain from such a policy) (Mack 2000). This would be effected by the US government simply issuing appropriate quantities of consols (government bonds with infinite maturity) free of charge to adopting governments. The interest payments on these consols would go some way to compensating the country in question for lost seigniorage. If this proposal comes to be adopted in the US, other countries with a comparative advantage in supplying currency can be expected to follow this lead, and it would then make sense for other countries to 'shop

around' for the best combination of quality and seigniorage-sharing arrangements.

Which currency?

For a brief period after Indonesia gave up control of East Timor, there was no official currency in its former province. Presumably the public continued to use the Indonesian rupiah, but they also began to rely on Australian dollars (brought in by Australian troops, businesses and NGOs) and US dollars as well. This period of competition between currencies was formally brought to an end with the advent of the temporary United Nations administration (UNTAET), which decided to use the US dollar as official currency *ad interim*. This raises the possibility that the eventual decision as to the most appropriate currency for the new nation will be pre-empted. In the view of the writer, East Timor would certainly be better off using the US dollar than introducing its own national currency, but there may be some further advantage in using the Australian dollar, rather than the US dollar or other possible candidates such as the yen or the euro.

A practical consideration is the transportation cost involved in supplying currency. The stock of cash will need to be built up steadily as the economy grows and becomes more monetised, and old notes (and to a lesser extent, old coins) will need to be replaced from time to time with new. In practice, commercial banks would take on most of the responsibility for this function. The Australian banks already have branches in nearby Darwin (which, of course, is far closer to East Timor than the United States, Japan or Europe), and the cost of bringing cash from Darwin to Dili would be small, thanks in part to direct air services between the two cities. Moreover, it may turn out to be the case that US banks will not think it worth their while to establish operations in such a small economy, so far from home.

Finally it should be mentioned that the literature on optimum currency areas

Policy dialogue

(Mundell 1961, McKinnon 1963) places heavy weight on the possibility that changes in the adopted currency's rate of exchange with other currencies should not destabilise the economy of the adopting country. This is unlikely to be a problem in a country such as the new East Timor, however, in which prices are highly flexible, so this would not appear to be a matter of much importance in the choice of a suitable currency.

References

- Antweiler, W., 2000. *The Euro: Europe's New Currency*, <http://pacific.commerce.ubc.ca/xr/euro/>, accessed 7 May 2000.
- Dow Jones Newswires, 2000. 'IMF mission in Ecuador trumpets dollarization drive', 24 April.
- Grimes, A. and Holmes, F., with R. Bowden, 2000. *An ANZAC Dollar? Currency Union and Business Development*, Institute of Policy Studies, Victoria University, Wellington.
- Mack, C., 2000. *International Monetary Stability Act of 2000*, introduced to the US Senate on 24 February, <http://thomas.loc.gov>, accessed 7 May 2000.
- McKinnon, R.I., 1963. 'Optimum currency areas', *American Economic Review*, 53:717–24.
- McLeod, R.H. (forthcoming), 'Lessons from Indonesia's Crisis', in D. Dasgupta, D. Wilson and M. Uzan (eds), *Reinventing Bretton Woods*, Routledge, London and New York.
- Mundell, R.A., 1961. 'A theory of optimum currency areas', *American Economic Review*, 51:657–64.
- Pardede, R., 1999. 'Survey of recent developments', *Bulletin of Indonesian Economic Studies*, 35(2):3–39.
- Schuler, K., 1999. 'Dollarising Indonesia', *Bulletin of Indonesian Economic Studies*, 35(3):97–113.

Notes

- ¹ Banks also compete with central bank cash by supplying credit card services. These permit the public to economise on holding both cash and demand deposits by being able, in effect, to borrow from the bank at exactly the time funds are needed in order to make some purchase. Thus the relative shares of cash and demand deposits in M1 does not tell the whole story.
- ² This is exactly analogous to bans on imports in the field of international trade and, as is invariably the case, the restriction on competition benefits the protected supplier at the expense of buyers or users.
- ³ This 'seigniorage' is analogous to the profit earned by commercial banks from collecting low or zero interest demand deposits that are then used to make loans, except that central banks have a monopoly position as suppliers of cash to the domestic economy.
- ⁴ This very rough estimate is based on Indonesia's ratio of base money to annual GDP at the beginning of the 1970s, when its economy was much more like that of East Timor today. This ratio was around 0.06; assuming potential interest earnings of 6 per cent per annum on assets financed by the issue of base money, the implied value of seigniorage is 0.36 per cent of annual GDP.
- ⁵ Pardede (1999) put GDP at 28 per cent below trend in mid 1999. Extending his analysis with GDP data through the December 1999 quarter results in the 27 per cent figure.
- ⁶ Ecuador's decision to dollarise was driven by a similar failure of monetary policy making in the recent past, resulting in very high inflation and massive depreciation of the national currency.