Statement of Juan Luis Moreno-Villalaz

to the House Committee on Banking and Financial Services,

Subcommittee on Domestic and International Monetary Policy

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Mr. Chairman and distinguished members of the Subcommittee: My name is Juan Luis Moreno-Villalaz. I am an adviser in Panama's Ministry of Economy and Finance and I have extensively studied Panama's experience with dollarization. I thank you for the invitation to testify about it today. Besides my spoken testimony, I have written remarks that I request you include in the record.

Panama has used the U.S. dollar as currency since 1904, shortly after becoming independent from Colombia. An important part of our success with dollarization is our "financial integration" into world markets. This results from the participation of a large number of international banks in our banking system; extensive competition between banks; and no government intervention in financial markets, especially no restrictions on buying or selling foreign currency, or on capital mobility by banks.

The facts of Panama's experience with dollarization speaks for themselves. Inflation over the last three decades has averaged 1.7% per year – even less than in the United States. Interest rates are low, and are set by international markets. Credit conditions are favorable: commercial lending rates are less than 1.0 percentage points above U.S. prime rate, and 30-year mortgages are readily available at 9 percent a year, which is very unusual for a developing country. Low interest rates in Panama are the result of the lack of exchange risk, low risk of financial crises, low spreads charged by banks due to competition, ample flows of funds from abroad, and absence of legal reserve requirements on deposits.

The economy is very stable. Economic growth has been 4 to 5 percent a year. The economy was largely insulated from the Asian currency crisis, and government and private bank bonds are classified Ba1 or better. Panama has never had a systemic banking crisis, even though it has no deposit insurance or government guarantees to banks. The stability of Panama's banks compares favorably with the experience of other Latin American countries, where losses from bank failures have been as high as 40 percent of GDP, much of that borne by taxpayers. When needed, international banks have acted as lenders of last resort to Panama's banking system.

Panama epitomizes the operation of a pure competitive-market monetary system. The system has three main characteristics.

First, Panama money supply is endogenous, demand-determined by the actions of economic agents and banks, instead of being supply-determined by government policy.

Second, financial prices, such as interest rates and asset prices, are the result of a competitive market working without government intervention.

Third, banks play an essential role in balancing the monetary system and making it more stable. They do so by continuously adjusting their local and foreign portfolios in response to market forces. Full capital mobility permits them to get rid of any excess supply of funds -- by placing them offshore -- without creating excess demand for goods or large changes in prices within Panama. The same as the U.S. banking system does across state borders.

Most Latin American countries liberalized their financial markets in the 1980s and 1990s, but to protect local banks they restricted the freedom of entry by international banks. However, the infant industry argument did not work in the financial sector, as it did not work in international trade where free trade is known to be better. Because in developing countries the financial system is in large extent dominated by banks, a competitive and open banking organization is necessary for a stable, efficient banking system.

A popular view holds that a developing country surrenders its ability to "fine tune" its economy by dollarizing. But no one in Panama advocates such powers for our government. Also, it is not correct to say that the Federal Reserve "runs" Panama's monetary policy. The policies of the Federal Reserve affect Panama only inasmuch as it affects *all* countries by altering the global supply of dollars, the international reserve currency, and global interest rates.

In many developing countries, price distortions in financial markets give false signals, creating perverse incentives that induce excessive external borrowing and high risk-taking. These were factors behind behind macroeconomic crises in several places, including Mexico in 1994/5 and Asia in 1997/98. In Panama, on the other hand, the absence of distortions in financial prices leads to "correct," market-based financial decisions. This is an experience which supports a systemic or market solution to macroeconomic problem.

For other Latin American countries to achieve financial integration with global markets, I believe most will need to dollarize. Without dollarization there will not be sufficient confidence to attract capital flows, or international banks. As an exchange rate regime, dollarization has many advantages for the stability and efficiency of capital markets. When you add the advantages of financial integration to the advantages of dollarization, as Panama has done, you help preclude distortions in financial markets and thereby contribute to a stable financial order.

The discussion about improving the "international financial architecture" has emphasized strengthening international institutions, to provide better response to crises. However, improving the performance of private capital markets in emerging economies reduces the likelihood of recurrent financial crises, and should be an important complement to a better international financial system.

Further points about dollarization that Panama's experience clarifies

Capital mobility by individuals and firms is necessary but not sufficient for smooth adjustment of interest rates and flows of funds. This is confirmed by the case of Hong Kong, which is not fully integrated with world financial markets even though it allows complete freedom in buying and selling foreign currency. Despite having a modified currency board that maintains a rigid exchange rate of 7.80 Hong Kong dollars per U.S dollar, interest rates in Hong Kong dollars are higher than the comparable rates in U.S. dollars. Some doubts remain about the government's commitment to the currency board system, and Hong Kong is not fully financially integrated because the government restricts competition to existing banks (though it plans to relax the restrictions).

So, financial integration is not achieved by capital mobility alone. Nor is it achieved by a common currency alone. In the 1800s, there were substantial differences in interest rates between regions in the United States because many states and later the federal government prohibited banks chartered by them from establishing any branches.

Dollarization plus financial integration tend to reduce the country risk premium in interest rates. Around the time of the Russian financial crisis of 1998, the interest-rate spread of Latin American dollar-denominated bonds over comparable U.S. Treasury securities increased by 800 basis points. The interest-rate spread of Panamanian bonds, in contrast, increased by only 200 basis points. This stability is the result both of Panama's financial system and its economy, whose main export is services rather than more volatile manufactured goods or commodities.

Panama's experience shows that the way most economists think about international flows of capital is flawed. One of the main propositions of the so-called open-economy approach to macroeconomics is that, no matter what type of exchange rate a country has, a big inflow of capital creates excess demand for goods and a significant change in the real exchange rate (which measures the competitiveness of exports). This has not been the experience of Panama under full financial integration, which suggests that the open-economy approach implicitly assumes incomplete financial integration that distorts interest rates and other prices.

Dollarization is not a panacea that solves all problems of economic development. A competitive economy needs a competitive microeconomic environment, elimination of trade barriers, prudent fiscal management, minimal government ownership, and significant investment in human capital. However, dollarization and the open banking system necessary to foster full financial integration provide an excellent way of providing a sound currency and a solid, competitive financial system.

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References

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The paper is available at <http://www.cato.org/pubs/journal/cj18n3/cj18n3_12.pdf> or in http://www.sinfo.net/juanluismoreno.

A longer version was published in Spanish as *La experiencia monetaria de Panamá: lecciones de una economía dolarizada, con una banca internacional.* Panama City: Banco Nacional de Panamá, 1997.