



## 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.

**Source:** TH

### 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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