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# GRAN COLOMBIA REVISITED: SPONTANEOUS CURRENCY UNION IN CENTRAL AMERICA

David S. Bloch<sup>†</sup>

## I. Introduction

Panamanians celebrate their independence twice. November 28th commemorates Simon Bolivar's 1819 revolution against Spain and the formation of *Gran Colombia*, consisting of modern-day Peru, Venezuela, Bolivia, Ecuador, Colombia, and Panama. November 3rd celebrates Panama's independence from the rest of *Gran Colombia* some eighty years later.<sup>1</sup> Bolivar's Pan-American revolution was only partially successful. Though he managed to gain political independence for the people of Latin America, the great nation he expected to lead fragmented in less than a century.<sup>2</sup> But now, the region is beginning to coalesce once more into a single economic unit—a process driven indirectly by the gravitational pull of the United States.

Trade with the United States is critical to the economic success of the Central American region. For that reason, regional leaders have long pursued preferential access to U.S. markets through vehicles like the recently-ratified multilateral Dominican Republic-Central America Free Trade Agreement with the United States ("DR-CAFTA").<sup>3</sup> DR-CAFTA is primarily intended to foster trade with the United States and, eventually, the other members of NAFTA. This article will focus instead on the regional effect of the treaty because DR-CAFTA also hopes to promote trade amongst the nations of Central America.<sup>4</sup>

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<sup>1</sup> MARC RIGOLE & CLAUDE-VICTOR LANGLOIS, PANAMÁ 23–24, 62 (4th ed. 2004).

<sup>2</sup> See J. Steven Jarreau, *Negotiating Trade Liberalization in the Western Hemisphere: The Free Trade Area of the Americas*, 13 TEMP. INT'L & COMP. L.J. 57, 57 (1999); Paul A. O'Hop, Jr., *Hemispheric Integration and the Elimination of Legal Obstacles Under a NAFTA-Based System*, 36 HARV. INT'L L.J. 127, 130 (1995).

<sup>3</sup> The six Latin American participants are Nicaragua, Dominican Republic, Honduras, El Salvador, Costa Rica, and Guatemala. Similar negotiations with Panama and the Andean region [Peru, Colombia, Bolivia, and Ecuador] also are underway. See Office of the United States Trade Representative, *Dominican Republic Joins Five Central American Countries in Historic FTA with U.S.* (Aug. 4, 2004), [http://www.ustr.gov/Document\\_Library/PressReleases/2004/August/DominicanRepublic\\_Joins\\_Five\\_Central\\_American\\_Countries\\_in\\_Historic\\_FTA\\_with\\_U.S.html](http://www.ustr.gov/Document_Library/PressReleases/2004/August/DominicanRepublic_Joins_Five_Central_American_Countries_in_Historic_FTA_with_U.S.html). The United States signed the DR-CAFTA on August 2, 2005. See Rob Portman, USTR, Remarks at the signing of U.S.-Central American-Dominican Republic Free Trade Agreement (Aug. 2, 2005), [http://www.ustr.gov/Document\\_Library/Press\\_Releases/2005/August/Statement\\_of\\_UTSRRob\\_Portman\\_on\\_Signing\\_of\\_U.S.-Central\\_American-Dominican\\_Republic\\_Free\\_TradeAgreement](http://www.ustr.gov/Document_Library/Press_Releases/2005/August/Statement_of_UTSRRob_Portman_on_Signing_of_U.S.-Central_American-Dominican_Republic_Free_TradeAgreement).

<sup>4</sup> M. Ayhan Kose, Alessandro Rebucci & Alfred Schipke, *Macroeconomic Implications of CAFTA-DR*, in INTERNATIONAL MONETARY FUND OCCASIONAL PAPER NO. 243: CENTRAL AMERICA: GLOBAL INTEGRATION AND REGIONAL COOPERATION 7, 7 (Markus Rodlauer & Alfred Schipke eds., 2005) [hereinafter IMF PAPER].

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With increased reliance on the U.S. market comes increased vulnerability to American fiscal policy. Because the United States is the dominant trading partner in the region, states throughout Central America are—sometimes de facto and sometimes by law—adopting the U.S. dollar as legal tender. Thus, a little-remarked side effect of Central America's efforts to trade with the United States is the spontaneous creation of a Central American regional currency union with almost fifty million people, all sharing a common history and a common tongue.<sup>5</sup> Much more so than the disparate countries of Europe, the dollarized countries of Central America could plausibly evolve into a single federal state.

Part II of this article will define dollarization with respect to Central America and present examples of the success of such dollarization. Part III will discuss the advantages of currency integration within the region. Part IV will present how the current trends in the region point toward the possibility of further integration, and Part V will briefly outline current and potential obstacles to such currency integration. The article concludes by realizing that present currency integration is more prevalent than some observers concede, and further currency integration is not only possible and likely, but also worthy of North American support.

### II. Dollarization in Central America

Central American countries are adopting the U.S. dollar at a rapid clip. This phenomenon—known colloquially as “dollarization”—correlates strongly with fiscal stability, lowered interest rates, and economic growth. Ecuador and the Latin American nations south of Mexico now form an incipient Central American Dollar Zone with likely benefits to the people of the region.

#### A. What Is Dollarization?

“Dollarization” refers generically to the process by which one country adopts the currency of another.<sup>6</sup> Dollarization does not necessarily require the replacement of local currencies, but the modern trend is toward replacement rather than coexistence.<sup>7</sup> There are three basic forms of dollarization:

Unofficial Dollarization occurs when residents of a country, in the absence of formal government approval of the practice, retain a large share

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<sup>5</sup> UNITED STATES CENTRAL INTELLIGENCE AGENCY, THE WORLD FACTBOOK 2004, available at <http://www.cia.gov/cia/publications/factbook/index.html> (on file with author) [hereinafter FACTBOOK]. Writing about the entire region (including Brazil, Argentina, Chile, and other large South American countries), one commentator notes that “Latin America, with a population of 435.5 million people rich in language and diverse culture, represents an imposing emerging market of vast opportunity where growing international computer access and increasing consumerism are rapidly converging and propagating.” Luz E. Nagle, *E-Commerce in Latin America: Legal and Business Challenges for Developing Enterprise*, 50 AM. U. L. REV. 859, 860 (2001); see also IMF PAPER, *supra* note 4, at 1 (noting “a shared history and a common language,” as well as various macroeconomic similarities, among Central American countries).

<sup>6</sup> See, e.g., David S. Bloch & William Robert Nelson Jr., *Dollarization in El Salvador*, LATIN AM. FIN. & CAP. MKT., Mar. 15, 2003 at 1.

<sup>7</sup> *Id.*

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of financial wealth in assets denominated in dollars. . . . The second category is known as Semi-Official Dollarization, which is another name for a bi-monetary system wherein two distinct currencies (*i.e.*, the dollar and the local currency) are both legally recognized and circulate simultaneously. . . . The third category, Official Dollarization, contemplates an absolute monetary union between at least two nations.<sup>8</sup>

It remains true today that “Central and South America are natural laboratories for dollarization and its alternatives, with several nations trying different ways to deal with the overwhelming economic influence of their northern neighbor.”<sup>9</sup> Before diverging in the 1980s, all Central American currencies were somehow pegged to the U.S. dollar.<sup>10</sup> Following that “lost decade,” Guatemala, Panama, El Salvador, and neighboring Ecuador have all dollarized in one way or another.

This last statement may be viewed as somewhat controversial. On the one hand, some scholars contend that Central American exchange rate regimes “cover the whole spectrum” from floating regimes to crawling pegs to dollarization.<sup>11</sup> While this is true, strictly speaking, it ignores the reality on the ground. Others are instead more bullish, referring to the region as “a dollarized American ‘Union,’”<sup>12</sup> suggesting the appropriate direction for future regional economic efforts but substantially overstating the current reality.

However, despite these disagreements, Panama, El Salvador, and Ecuador use the U.S. dollar. Guatemala has legalized the U.S. dollar, along with any other form of legal tender, but with the United States dominating the region, it seems highly unlikely that other foreign currencies like the Euro will supplant the U.S. dollar as the hard currency of choice for Guatemalans. The Belizean dollar is pegged to the U.S. dollar at a 2:1 ratio,<sup>13</sup> and U.S. dollars are widely accepted in Belize. Furthermore, while Costa Rica, Nicaragua, and Honduras maintain their own currencies, they are effectively dollarized as a consequence of U.S. tourism, participation in DR-CAFTA, and the increasing interdependence of Central American financial institutions.<sup>14</sup> Lastly, there is a general scholarly consensus that Central America is increasingly suited to dollarization.<sup>15</sup>

For purposes of this paper, the countries listed in Table 1 may be grouped into an incipient Central American Dollar Zone:

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<sup>8</sup> Hale E. Sheppard, *The International Monetary Stability Act: Recognizing the “Ripeness” of This Economic Legislation’s Benefits for the United States and Mexico*, 32 U. MIAMI INTER-AM. L. REV. 375, 379–80 (2001).

<sup>9</sup> Bloch & Nelson, *supra* note 6, at 12.

<sup>10</sup> Jun Il Kim & Laura Papi, *Regional Integration and Exchange Rate Arrangements*, in IMF PAPER, *supra* note 4, at 72.

<sup>11</sup> *Id.* at 69.

<sup>12</sup> Susan Bibler Coutin, Bill Maurer & Barbara Yngvesson, *In The Mirror: The Legitimation Work of Globalization*, 27 L. & SOC. INQUIRY 801, 816 (2002).

<sup>13</sup> Kim & Papi, *supra* note 10, at 82.

<sup>14</sup> R. Armando Morales & Alfred Schipke, *Regional Integration and Financial System Issues*, in IMF PAPER, *supra* note 4, at 103.

<sup>15</sup> *Id.*

**Table 1: Currency Status and Rough Per Capita Income.**

Country	Currency Status <sup>16</sup>	Per Capita Income <sup>17</sup>
Belize	Fixed exchange rate <sup>18</sup>	\$4900
Costa Rica	De facto dollarized <sup>19</sup>	\$9100
Ecuador <sup>20</sup>	Dollarized <sup>21</sup>	\$3300
El Salvador	Dollarized <sup>22</sup>	\$4800
Guatemala	Dollarized <sup>23</sup>	\$4100
Honduras	De facto dollarized <sup>24</sup>	\$2600
Nicaragua	De facto dollarized <sup>25</sup>	\$2300
Panama	Dollarized (since 1903) <sup>26</sup>	\$6300

Various Caribbean countries also allow the use of U.S. dollars, and a few—Puerto Rico, Turks & Caicos, the U.S. and U.K. Virgin Islands—have officially

<sup>16</sup> I have visited each listed country over the last five years, most of them more than once, and can confirm anecdotally that the dollar is a viable currency in all of them.

<sup>17</sup> FACTBOOK, *supra* note 5.

<sup>18</sup> Walter H. Diamond & Dorothy B. Diamond, TAX HAVENS OF THE WORLD: BELIZE 5 (2005).

<sup>19</sup> “In Central America, the expansion of financial dollarization has been particularly high in Costa Rica and Nicaragua.” By “financial dollarization,” Ize means “the residents’ holding of financial assets or liabilities in foreign currency”—what we have elsewhere defined as “de facto dollarization.” Alain Ize, *Financial Dollarization: What to Do About It?*, in THE MACROECONOMY OF CENTRAL AMERICA 195, 96 (Robert Rennhack & Erik Offerdal, eds., 2004).

<sup>20</sup> It is fair to question the inclusion of Ecuador on this list. Ecuador is part of The Andean Community, not the Central American Common Market. Nor does Ecuador border on any Central American nation. But its adoption of the dollar should increase its affinity for fellow dollar-using countries in the region, to the detriment of adjacent states like Bolivia and Peru. And it is reasonably proximate to Central America, particularly by sea. In light of its participation in the de facto currency union underway in Central America, it seems fair to include Ecuador here.

<sup>21</sup> Economic Transformation Law (Mar. 13, 2000), R.O. No. 34. See generally Lic. Josemaria Bustamante, *Ecuador’s Economic Transformation Law*, (Mar. 13, 2000), available at <http://www.bomchilgroup.org/ecudec00.html>.

<sup>22</sup> Decreto No. 201, Ley de Integración Monetaria (“Monetary Integration Law”) (12/22/2000) (El Sal.), Diario Oficial Tomo No. 349 at 35–46, available at <http://www.bcr.gob.sv/ingles/integracion/ley.html> (describing the law’s effect from the Central Bank of El Salvador).

<sup>23</sup> Decree No. 94-2000 (Guatemala), Law of Free Negotiation of Foreign Currency (pub. Jan. 17, 2001), available at <http://www.banguat.gob.gt/en/docs/laws/lawOfFreeNegotiationOfForeignCurrency.pdf>. This law “allows the use of any world currency for all transactions.” In essence, however, the economy was dollarized well prior to the law’s passage. Andrew Bounds, *Guatemala Allows Use of Dollar*, FIN. TIMES, May 4, 2001 at Americas, 3.

<sup>24</sup> Technically, the Honduran lempira is the only legal tender in Honduras. Decreto No. 51, Ley Monetaria (“Monetary Law”) (2/1/1950), as amended by Decreto No. 128 (11/22/1966) (Honduras); available at <http://www.law.nyu.edu/centralbankscenter/texts/Honduras-Ley%20Monetaria.html>; see also Reed Elsevier, MARTINDALE-HUBBELL INTERNATIONAL LAW DIGEST HONDURAS LAW DIGEST, 1 (Lexis 2006). But in my experience, dollars are widely circulated, particularly in the Bay Islands.

<sup>25</sup> “A key characteristic of the Nicaraguan banking system is its substantial dollarization.” U.S. Embassy in Nicaragua, *Nicaraguan Financial System, December 24, 2002*, <http://Managua.usembassy.gov/wwwhe38.html>. 71% of deposits are in U.S. dollars. *Id.*

<sup>26</sup> See *Panama Law Digest*, MARTINDALE-HUBBELL INTERNATIONAL LAW DIGEST PAN-1 (2002).

dollarized.<sup>27</sup> Even Cuba has embraced “the bifurcation of the Cuban monetary system,” albeit as a last resort and a stopgap to rescue its socialist economy.<sup>28</sup> On the other hand, French Guyana, technically a *département* of France despite its location in the northeast corner of South America, uses the Euro.<sup>29</sup>

### B. Recent Experiences with Dollarization

A free-market economic system dictates that lower tariffs and trade barriers should lead to enhanced overall wealth for all trading partners. This enhanced wealth will only occur, however, if a nation’s currency is stable. Dollarization is the surest route to monetary stability. The case of Ecuador—the most recent nation to dollarize—is instructive: “[t]he plan has not been in vain as it has successfully ushered in a new era of economic prosperity. Two significant factors signaling a successful turnaround in Ecuador’s economy are a prospective 26% cut in inflation and 3.8% annual growth over the 2001–2006 forecast period.”<sup>30</sup>

El Salvador, whose dollarization likely inspired Ecuador, boasts similar successes:

Despite a number of economic difficulties faced in the international domain during these last four years, and bearing in mind recent natural disasters . . . El Salvador’s macroeconomic performance has outstripped that of other Latin American countries. While its real GDP grew by an average of 2.5% between 1999 and 2001, the region-wide figure amounted to just 1.6%.<sup>31</sup>

In addition, Salvadorean interest rates “have fallen substantially since the start of monetary integration, and are currently the lowest in the region.”<sup>32</sup> It seems reasonably clear that dollarized economies outperform similarly-situated nations pursuing other monetary policies.

### III. The Virtues of Currency Union

Currency unions are superior to fixed exchange rate systems because they eliminate the ability to manipulate the “local” currency in times of fiscal crisis. Economic data bear this out: dollarized countries consistently outperform coun-

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<sup>27</sup> KURT SCHULER, JOINT ECONOMIC COMMITTEE STAFF REPORT, ENCOURAGING OFFICIAL DOLLARIZATION IN EMERGING MARKETS 8 (1999), available at <http://www.geocities.com/Eureka/Concourse/8751/edisi04/dolriz1.htm>.

<sup>28</sup> Christine Zack, *Globalization’s Unlikely Opportunist: Castro’s Cuba Shapes the Paradigm for Economic and Political Stability in Latin America*, 11 TUL. J. INT’L & COMP. L. 355, 376 (2003).

<sup>29</sup> HARRY ADES ET AL., THE ROUGH GUIDE TO SOUTH AMERICA 797 (2004).

<sup>30</sup> Caroline R. Hurtado, *Notes & Comments: Fiscal Policies as Decisive Solutions for Troubled Economies: Differing Legislative Enactments in Argentina and Ecuador*, 24 LOY. L.A. INT’L & COMP. L. REV. 391, 405–06 (2002).

<sup>31</sup> Trade Policy Review, *El Salvador*, 19, WT/TPR/G/111 at 7–8 (Jan. 6, 2003).

<sup>32</sup> *Id.* at 26.

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tries in fixed-exchange regimes, and periodic shocks (most recently in Argentina) underscore the inherent instability of a fixed peg.

As a region, Central America is a strong candidate for economic integration. The disparities in wealth among countries in the Central American Dollar Zone are greater than the disparity among different members of the United States, but substantially smaller than among members of the European Union. Moreover, the gravitational pull of trade with the United States creates a nearly unstoppable incentive in favor of using U.S. dollars, and thus de facto currency union.

### A. Currency Unions Versus Fixed Exchange Rate Regimes

Having briefly considered dollarization in various Central American countries, we turn to the implications of dollarization for the region as a whole. In his *Principles of Political Economy*, John Stuart Mill offered a short thought experiment:

Let us suppose that all countries had the same currency, as in the progress of political improvement they one day will have. . . . So much of barbarism, however, still remains in the transactions of the most civilized nations that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own.<sup>33</sup>

This is the fundamental case for dollarization: it eliminates a source of friction, an opportunity for arbitrage, currency speculation, and graft, and at the same time encourages cross-border exchange.<sup>34</sup> Though dollarization is not without its critics,<sup>35</sup> mainstream economic opinion agrees that sound money is preferable to rampant inflation and holds that dollarization can be an effective stabilizing force as well as an engine of trade-promoting economic growth.<sup>36</sup> It reflects an “irrevocable commitment” to currency stability.<sup>37</sup>

Many of the same arguments can be made in favor of fixed exchange rates (i.e. the 2:1 peg in Belize). Countries with fixed exchange rates exhibit close to 50% greater growth and lower, more predictable inflation rates than those with varia-

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<sup>33</sup> JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY* 572–73 (Prometheus ed. 2004) (1848).

<sup>34</sup> Erik Offerdal, *Fiscal Sustainability*, in *THE MACROECONOMY OF CENTRAL AMERICA*, *supra* note 19, at 19.

<sup>35</sup> “Full dollarization (defined as the use of a foreign currency by another country) is just such a form of snake oil cure that may be worse than the disease.” Myron Frankman, *Beyond the Tobin Tax: Global Democracy and a Global Currency*, 581 *ANNALS AM. ACAD. POL. & SOC. SCI.* 62, 69 (2002). *But see* Kim & Papi, *supra* note 10, at 71 (providing a more temperate overview of the economic literature discussing the virtues and drawbacks of dollarization in Latin America).

<sup>36</sup> *See, e.g.*, George M. Von Furstenberg, *One Region, One Money?*, 579 *ANNALS AM. ACAD. POL. & SOC. SCI.* 106, 110–11 (2002); William A. Lovett, *Reflections on the WTO Doha Ministerial: Bargaining Challenges and Conflicting Interests: Implementing the Doha Round*, 17 *AM. U. INT’L L. REV.* 951, 994 (2002) (“Adoption of a major country’s currency can work for such nearby satellite states”); Kim & Papi, *supra* note 10, at 70 (“The main advantages of fixed exchange rate regimes and currency unions are the promotion of trade and financial flows”).

<sup>37</sup> Kim & Papi, *supra* note 10, at 74.

ble exchange rates, without any greater vulnerability to economic shocks.<sup>38</sup> But there is reason to think that fixed exchange currency regimes are unstable, at least in the absence of capital controls, and thus will evolve into true dollarization.<sup>39</sup> According to Professor Joseph Stiglitz, this result is driven by the fact that a credible fixed exchange mechanism operates, in effect, to eliminate fiat money from a country's fiscal arsenal.<sup>40</sup> The case of Argentina—whose dollar-based currency board collapsed in 2000—seems to bear out Professor Stiglitz's argument.<sup>41</sup>

In any event, currency unions outperform fixed exchange rate regimes in terms of trade promotion and co-movement of prices, and hence economic growth.<sup>42</sup> Partially for these reasons, the U.S. government has considered formal programs to encourage official dollarization.<sup>43</sup>

## B. Is Central America Ready for a Currency Union?

The salient characteristics of Central America, “[s]mall countries heavily dependent on trade and financial transactions with a single large partner,”<sup>44</sup> indicate that the nations of the region are ripe for a currency union.<sup>45</sup> The theory of optimum currency areas strongly suggests that Central America is positioned for rapid integration, presumably on dollarized lines.<sup>46</sup>

Yet integration is not the central focus of Central American trade and foreign policies. Because the United States is the region's largest trading partner,<sup>47</sup> Central American countries tend instead to focus first and foremost on bilateral trade with the United States, rather than intraregional trade with one another. Thus, Ambassador Jett asks, “[b]y and large, dollarization would probably have a posi-

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<sup>38</sup> Steve H. Hanke, *The Derivatives and Risk Management Symposium on Stability in World Financial Markets: Reflections on Exchange Rates and Dollarization*, 4 *FORDHAM FIN. SEC. & TAX. L.F.* 63, 74 (1999). On the latter point, Professor Hanke writes that “fixed rates have proved far superior to pegged rates, with average inflation rates being 4.9 times higher in countries with pegged rates and 4.2 times more variable.” *Id.*

<sup>39</sup> Joseph E. Stiglitz, *Capital Market Liberalization and Exchange Rate Regimes: Risk Without Reward*, 579 *ANNALS AM. ACAD. POL. & SOC. SCI.* 219, 236 (2002) (“In the absence of capital controls, the only exchange rate regimes that, in practice, can work effectively are floating exchange rates or dollarization”).

<sup>40</sup> *Id.* at 237.

<sup>41</sup> See Barry Eichengreen, *International Monetary Options for the Twenty-First Century*, 579 *ANNALS AM. ACAD. POL. & SOC. SCI.* 11, 17 (2002) (“a soft commitment to peg the exchange rate is the worst of all arrangements”); Ize, *supra* note 19, at 198–200 (discussing the drawbacks of de facto dollarization).

<sup>42</sup> Kim & Papi, *supra* note 10, at 70.

<sup>43</sup> See SCHULER, *supra* note 26. Schuler proposes that the United States share seigniorage revenue (the amount generated by the difference between the value of currency and the costs of manufacturing it) to encourage official dollarization in developing countries, especially in Latin America.

<sup>44</sup> Eichengreen, *supra* note 41, at 21.

<sup>45</sup> Kim & Papi, *supra* note 10, at 77 (“The smaller the economy, the greater the benefits of a currency union”).

<sup>46</sup> Guillermo Perry, Daniel Lederman & Rodrigo Suescun, *Trade Structure and Policy, in THE MACROECONOMY OF CENTRAL AMERICA*, *supra* note 19, at 159.

<sup>47</sup> Kose, Rebucci & Schipke, *supra* note 4, at 9.

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tive effect, but the question that remains is how do you harmonize economies that are very different?"<sup>48</sup> Indeed, harmonizing the economies of, say, Ecuador and the United States is a daunting task,<sup>49</sup> and in the near term, it is probably impossible, both politically and economically. The difference in economic performance within the Central American Dollar Zone is a cause for some concern over the ability of the region to integrate. Thus, some scholars believe that currency-integration regimes "will vary not by region but with the characteristics of individual countries."<sup>50</sup> It is hard to argue with this common sense point, and it is true that the Central American countries display a fairly substantial disparity in wealth.<sup>51</sup>

But the regional disparity in income needs to be understood in context. As set forth in Table 1, the adjusted per capita income of Costa Rica, the Dollar Zone's richest country in per capita terms at \$11,100, is almost four times that of the poorest country, Nicaragua (\$2,900).<sup>52</sup> This is greater than the 1.75 difference between the richest and poorest U.S. states, New Hampshire versus West Virginia, as measured by median household income.<sup>53</sup> It is easily comparable, however, with the difference between the richest and poorest European Union member states: Luxembourg is more than five times as wealthy, in per capita terms, as Latvia, and 2.75 times as wealthy as Greece.<sup>54</sup> Even excluding Luxembourg, approximate per capita income in Europe varies by a factor of almost

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<sup>48</sup> Dennis C. Jett, *Proceedings of the Second Annual Legal & Policy Issues in the Americas, 2001: IV. The Essential Elements of a Functioning Democracy*, 14 FLA. J. INT'L L. 71, 76 (2001) (Jett was U.S. ambassador to Peru and Mozambique from 1993 to 1996).

<sup>49</sup> "Under standard criteria . . . Ecuador and the United States, do not constitute an optimal currency area . . . . The shocks facing Ecuador and the United States are markedly different." Stiglitz, *supra* note 39, at 239. *But see* John Williamson, *Dollarization Does Not Make Sense Everywhere*, revised outline of remarks on *To Dollarize or not to Dollarize: Exchange Rate Choices for the Western Hemisphere*, North-South Institute, Ottawa, Canada, Oct. 4-5, 2000, available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=386> ("The small countries of Central America and the Caribbean have all the characteristics of being part of a dollar OCA [optimum currency area]").

<sup>50</sup> Eichengreen, *supra* note 41, at 21.

<sup>51</sup> Ana Corbacho & Hamid R. Davoodi, *Public Expenditure and Governance, in THE MACROECONOMY OF CENTRAL AMERICA*, *supra* note 19, at 87, 88.

<sup>52</sup> FACTBOOK, *supra* note 5.

<sup>53</sup> \$57,352 and \$32,589, respectively. U.S. Census Bureau, *Income 2004: Three-Year-Average Median Household Income by State: 2001-2004*, available at <http://www.census.gov/hhes/www/income/income04/statemhi.html>. The three-year average median household income is not, of course, the only way to measure a state's wealth, and the data are not strictly comparable to the per capita information used in connection with the Central American Dollar Zone. But as the goal here is merely to illustrate orders of magnitude, the income comparisons should suffice.

<sup>54</sup> Luxembourg's per capita income is \$55,100; Latvia's is \$10,200; and Greece's is \$20,000. FACTBOOK, *supra* note 5. In order to compare apples to apples, my calculations here use the 2004 CIA estimates of purchasing power parity and are based on simple division: \$55,100 is 5.4 times \$10,200, and 2.75 times as great as \$20,000. Note that, with the European Union's eastward expansion in 2007, these disparities have become even more dramatic. Using 2005 numbers from the current edition of the CIA World Factbook, per capita income in Romania is only \$8,100 and Bulgaria's is \$9,600. Luxembourg's 2005 estimated per capita income of \$65,900 exceeds these figures by a factor of more than 8 and a factor of 6.8, respectively. The current edition of the CIA World Factbook is available at <https://www.cia.gov/cia/publications/factbook/index.html> (last visited January 17, 2007).

three.<sup>55</sup> In either event, the Dollar Zone is roughly as economically homogeneous as the European Union, which has successfully transformed itself into a single-currency zone.

The empirical underpinnings of the above analysis are not susceptible to reasonable dispute, but the conclusion nevertheless does not reflect a universal consensus. Kim and Papi, for example, contend that Central America is less suited to a common currency than Western Europe was in the 1970s, and conclude that “there is still a large distance before a common currency would be a realistic option for the region.”<sup>56</sup> As discussed above, however, this ignores the reality that the region already possesses and uses a common currency—the U.S. dollar. Kim and Papi acknowledge elsewhere that the de facto financial dollarization of non-dollarized Central American countries (that is, excluding El Salvador and Panama, whose deposits are entirely dollar-denominated) “amounts to almost 40% of total banking system assets, much greater than in Europe in 1979 and 1989.”<sup>57</sup> Moreover, if the Central American nations concentrate on regional, rather than hemispheric, integration, the problem of harmonizing massively disparate economies disappears.

Finally, the logic of free-trade areas may, in the long term, mandate currency integration, because “[l]arge exchange-rate movements between the partners in an economically integrated region almost inevitably threaten stability.”<sup>58</sup> In this context, DR-CAFTA may be decisive. An International Monetary Fund report written before DR-CAFTA’s ratification notes:

In the medium and long term, full dollarization, preferably under a monetary arrangement with the United States, is an initiative to be considered seriously, as both the trade structure and the financial monetary structure are already closely tied to the dollar and such links would be furthered by a bilateral trade agreement.<sup>59</sup>

Competing successfully in the global economy requires further regional collaboration to maximize the benefits offered by economic integration while minimizing the attendant risks.<sup>60</sup>

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<sup>55</sup> Denmark, the second-wealthiest nation per capita in the European Union after Luxembourg, has a per capita income of \$34,600. *FACTBOOK*, *supra* note 5.

<sup>56</sup> Kim & Papi, *supra* note 10, at 69.

<sup>57</sup> *Id.* at 79.

<sup>58</sup> Furstenberg, *supra* note 36, at 108.

<sup>59</sup> Perry, Lederman & Suescun, *supra* note 46, at 165.

<sup>60</sup> Rodlauer & Schipke, *supra* note 5, at 5.

#### IV. The Drive toward Regional Integration

Dollarization is commonly seen as a vehicle for hemispheric integration,<sup>61</sup> and hemispheric economic integration would be a boon for the involved economies.<sup>62</sup> DR-CAFTA already points strongly in that direction, and it is not the first such effort. In the early 1960s, Guatemala, El Salvador, Honduras, Nicaragua, and later Costa Rica, signed the General Treaty on Central American Economic Integration.<sup>63</sup> This treaty was intended “to unify the economies of the four countries and jointly to promote the development of Central America in order to improve the living conditions of their peoples.”<sup>64</sup> For many reasons—chiefly economic mismanagement, internal strife, differential economic performance (in part due to differences in currency and central banking regimes), and the distorting effects of the Cold War—this grand idea never developed into the common market its framers intended.<sup>65</sup> Instead, Central American “economic integration” consisted mostly of lowered tariffs coupled with cultural exchange.<sup>66</sup>

These measures gained steam after the war-torn “lost decade” of the 1980s with the 1991 creation of the Central American Integration System, a nascent effort to pursue “political, economic, social, cultural, and ecological integration.”<sup>67</sup> Mexico’s stalled Pueblo-to-Panama Plan, which would create a communication and transportation network stretching from the border of Colombia to the Mexican state of Puebla, is another attempt at strengthening regional ties.<sup>68</sup> But none of these attempts have achieved their goal of a united Central America. Now, however, true economic integration could well be at hand.

Full regional integration can be broken into five distinct phases: the creation of a free-trade zone, a customs union, a common market, economic union, and, lastly, full economic integration.<sup>69</sup> Using this typology, Central America already is more than halfway there. Most of the nations in the Central American Dollar

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<sup>61</sup> See, e.g., Jett, *supra* note 48, at 76 (“To the extent that economies are dollarized, it advances the process of hemispheric integration as foreseen in the trade agreement you mentioned”).

<sup>62</sup> See, e.g., Hale E. Sheppard, *Dollarization of Ecuador: Sound Policy Dictates U.S. Assistance to This Economic Guinea Pig of Latin America*, 11 *IND. INT’L & COMP. L. REV.* 79, 101 (2000) (“the stability generated by dollarization will continue to facilitate Ecuador’s exports to the United States and other destinations”).

<sup>63</sup> See generally LOUIS HENKIN, RICHARD CRAWFORD PUGH, OSCAR SCHACHTER, & HANS SMIT, *INTERNATIONAL LAW* 1549–51 (3rd ed. 1993).

<sup>64</sup> General Treaty on Central American Economic Integration Between Guatemala, El Salvador, Honduras and Nicaragua, preamble, Dec. 13, 1960, 455 U.N.T.S. 3; see also Multilateral Treaty on Free Trade and Central American Economic Integration, June 10, 1958, 454 U.N.T.S. 6539.

<sup>65</sup> See O’Hop, *supra* note 2, at 131–133; Jarreau, *supra* note 2, at 78–79 (“Political differences and civil strife in Central America from the 1970s to the 1990s negatively impacted the integration process”); Kenneth W. Abbott & Gregory W. Bowman, *Economic Integration in the Americas: “A Work in Progress,”* 14 *Nw. J. INT’L L. & BUS.* 493, 504 (1994) (“indeed, the Common Market essentially collapsed near the end of the 1970s”).

<sup>66</sup> See O’Hop, *supra* note 2, at 138–41; Abbott & Bowman, *supra* note 65, at 504 (“Progress in implementing this vision has been rather slow”).

<sup>67</sup> Jorge D. Calvo-Drago, *Regional Integration of Central American Countries and Opportunities for Internetworking*, (1997), [http://www.isoc.org/inet97/proceedings/E5/E5\\_1.HTM](http://www.isoc.org/inet97/proceedings/E5/E5_1.HTM).

<sup>68</sup> See *Plan que?*, *Developing Southern Mexico*, *ECONOMIST*, Apr. 10, 2004, at 28–29.

<sup>69</sup> O’Hop, *supra* note 2, at 129.

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Zone are members of the Central American Common Market, which creates a functioning free-trade zone, customs union, and common market.<sup>70</sup>

### A. Effects on Intraregional Trade and Finance

This thesis may be criticized on the grounds that there is little overt movement toward regional integration. But a careful look at available economic data suggests that such movements are indeed taking place. Internal Central American trade is rising, albeit slowly.<sup>71</sup> Trade, however, is not the strongest indicator. Rather, the most compelling evidence of integration is the consolidation of the Central American financial sector.

The Central American financial system is relatively well developed—Panama has been a banking power since the early 1900s. Driven in part by Panama, “there has been a significant increase in intraregional financial sector linkages.”<sup>72</sup> Financial sector integration and consolidation are efficiency-enhancing and should thus allow the merged financial institutions to take advantage of economies of scale.<sup>73</sup> Dollar-denominated loans are common throughout the region, particularly for large purchases, and scholars predict bank consolidations as constituent nations become more economically integrated.<sup>74</sup> Excluding Panama, Ecuador, and El Salvador, financial dollarization amounts to 40% of the total assets of the Central American banking system.<sup>75</sup>

But the financial dollarization of non-dollarized economies (as noted, some 40% of Central American financial holdings are in dollars<sup>76</sup>) involves substantial risk: “Although banks are broadly hedged—foreign currency assets are broadly matched by foreign currency liabilities—lending to unhedged private sector entities leaves the banks exposed to credit risk, and borrowers are exposed to exchange rate risk. Large devaluations could therefore adversely affect banks’ capital positions.”<sup>77</sup> The high degree of dollarization simultaneously limits the ability of national fiscal authorities to engage in currency-based economic interventions.<sup>78</sup> Thus, the economically safer course is to move toward true dollarization—and a *de facto* currency union.

Similarly, the Central American nations, excluding Ecuador, have modern tax systems. They have already harmonized external tariffs and eliminated taxes on intraregional trade.<sup>79</sup> Convergence of Central American value-added and income

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<sup>70</sup> Jarreau, *supra* note 2, at 78–79.

<sup>71</sup> Rodlauer & Schipke, *supra* note 4, at 3.

<sup>72</sup> *Id.*

<sup>73</sup> Morales & Schipke, *supra* note 4, at 111.

<sup>74</sup> *Id.* at 101, n. 4.

<sup>75</sup> Kim & Papi, *supra* note 10, at 79.

<sup>76</sup> Morales & Schipke, *supra* note 4, at 101.

<sup>77</sup> *Id.* at 103.

<sup>78</sup> *Id.* at 103, n.6.

<sup>79</sup> Chiara Bronchi & Dale Chua, *Trade Liberalization and Tax Coordination*, in IMF Paper, *supra* note 4, at 42–43.

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tax rates has been underway for some time.<sup>80</sup> With harmonized tax laws and unified cross-border banking systems, more comprehensive political and economic unification should be relatively easy to achieve.

### B. Likely Benefits of Further Integration and Full Regional Dollarization

As the above suggests, the nations of Central America may be forced to integrate and dollarize whether they like it or not.<sup>81</sup> After all, “the U.S. dollar has served as a shadow currency in the informal economy for decades.”<sup>82</sup> But this ought to be a cause for celebration, not alarm. There are very real benefits to dollarization and integration. Chief among these are the reduction of transaction costs, the transregional improvement of international competitiveness, and the likely increase of much-needed tourist revenues.

#### *1. Encouraging Regional Integration and Dollarization Will Reduce Transactional Costs*

Regional dollarization will reduce transaction costs because Central American payments typically are made in cash rather than via credit card.<sup>83</sup> While examining Ecuador, Hale Sheppard suggests that “as a member of a unified currency zone in which the sometimes onerous step of currency conversion is absent, Ecuador and American businesses alike will enjoy lower transaction costs.”<sup>84</sup> And certainly, the elimination of currency risks will help entice U.S. businesses to invest in the region.

#### *2. Encouraging Regional Integration and Dollarization Will Enhance Regional Competitiveness*

Globalization prompts both the consolidation of currencies and increasing integration within monetary unions.<sup>85</sup> “The prerequisite for liberalized market access, now clearly in view, is that individual and corporate citizens in many small countries will be able to choose to make payments in more than one acceptable currency and freely incur debts and acquire assets denominated in different currencies.”<sup>86</sup> The Central American Dollar Zone has already progressed beyond this point: nearly everyone in the region can transact using the same currency. It remains only for the regional governments to take full advantage of the opportu-

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<sup>80</sup> Janet G. Stotsky & Aseggedech WoldeMariam, *Tax Reform: Trends and Possibilities*, in *THE MACROECONOMY OF CENTRAL AMERICA*, *supra* note 19, at 83–84.

<sup>81</sup> “[C]ertain experts have recognized the true benefits and inevitability of dollarization in Latin American countries.” Sheppard, *supra* note 8, at 376.

<sup>82</sup> Coutin, Maurer & Yngvesson, *supra* note 12, at 833.

<sup>83</sup> Nagle, *supra* note 5, at 871.

<sup>84</sup> Sheppard, *supra* note 62, at 101.

<sup>85</sup> See Furstenberg, *supra* note 36, at 107–08 (using the European Monetary Union as an example and discussing the move from the use of fixed and adjustable exchange rates to monetary unification within trade areas).

<sup>86</sup> *Id.* at 110.

nities this provides. The economy-wide benefits of a currency union can also help encourage other forms of regional economic cooperation, such as the harmonization of tax regimes, allowing the Dollar Zone countries to compete more effectively with larger economies like Mexico or Colombia.<sup>87</sup>

### 3. *Encouraging Regional Integration and Dollarization Will Encourage U.S. Tourism*

Lastly, integration accompanied by a dollarized currency union seems likely to increase economic activity for the simple reason that it will render the region more attractive to U.S. tourists. Tourism is an important source of funds in both developed<sup>88</sup> and underdeveloped<sup>89</sup> countries. Panama, Costa Rica, Belize, and Ecuador (the Galapagos Islands) already are targeting eco-tourist dollars.<sup>90</sup> The Dollar Zone boasts some of the world's most impressive archaeological complexes, Mayan sites at Tikal, Copan, and Ceren,<sup>91</sup> as well as some fine Incan sites, principally Ingapirca in Ecuador, and well-preserved colonial centers throughout the region. A stable and familiar currency, coupled with increased political stability, should combine to drive increasing U.S. tourist revenues to these nearby Central American nations.

## V. Obstacles to Further Integration

Converting to another currency can be a wrenching task for a country's monetary authority. Consider, for example, Ecuador's initial experience with dollarization: the move caused "significant upheaval in the retail sector" because, lacking coins in U.S. currency, merchants were "rounding off prices at the dollar level—a sore point in a poor country where more than two-thirds of workers earn less than \$30 per month."<sup>92</sup> But this is atypical. After all, Ecuador is the largest of the world's officially dollarized countries, and started from a very low eco-

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<sup>87</sup> Stotsky & WoldeMariam, *supra* note 19, at 41–42 (suggesting that the European Union model "could usefully be adapted to Central America").

<sup>88</sup> See generally World Tourism Organization, *International Tourism Receipts 2004*, WTO WORLD TOURISM BAROMETER 2 (in 2004, almost 53% of world tourism revenues were expended in Europe—\$326.3 billion out of a total \$622 billion spent). The "WTO" in this title does not stand for "World Trade Organization," but rather for "World Tourism Organization," an unfortunately-named intergovernmental organization serving as a global forum for tourism policy and issues.

<sup>89</sup> See, e.g., John Murphy, *Gaza Sets Its Sights On Tourist Dollars*, BALTIMORE SUN, Oct. 11, 2005, available at <http://www.baltimoresun.com/news/nationworld/bal-te.gaza11oct11,1.4631433.story?page=1&coll=bal-nationworld-utility>; Meity Robot, *RI's Tourism Development, Challenges in 2005*, JAKARTA POST, Nov. 1, 2005, available at <http://www.thejakartapost.com/oulook/eco09b.asp>.

<sup>90</sup> See, e.g., RIGOLE & LANGLOIS, *supra* note 1; PETER ELTRINGHAM, *THE ROUGH GUIDE TO BELIZE* (3d ed. 2004); HARRY ADES & MELISSA GRAHAM, *THE ROUGH GUIDE TO ECUADOR* (2d ed. 2003); PETER ELTRINGHAM, JEAN McNEIL, JAMES READ & IAIN STEWART, *THE ROUGH GUIDE TO CENTRAL AMERICA* (2001).

<sup>91</sup> Ceren, in El Salvador, is the Mayan Pompeii or Herculaneum, buried by a volcanic eruption in the 6th century A.D. DAVID WEBSTER, *THE FALL OF THE ANCIENT MAYA* 140–42 (2002).

<sup>92</sup> Nagle, *supra* note 5, at 863; see also, *Not So Loco: Ecuador*, ECONOMIST, Apr. 24, 2004, at 38 ("GDP grew by an estimated 2.7% last year [2003]. The public finances were in the black; inflation dropped to a record low of 6%; foreign investment reached a record high; the trade account was almost in balance").

conomic baseline.<sup>93</sup> Four years later, Ecuador's economy has stabilized and the supply of coinage is no longer a serious concern. Moreover, the costs of dollarization should drop as more countries adopt the dollar.<sup>94</sup>

Trust in the central banking system, however, remains weak, and the initial dislocation should not be underestimated.<sup>95</sup> Distrust of local financial institutions manifests in part due to a distrust of the currency itself:

[T]he paper dollars in circulation in dollarized economies become a site of concern over jurisdictional origins. In El Salvador, shortly after dollarization was implemented, all dollar bills were considered suspect and were scrutinized carefully. Shopkeepers only accepted new bills, not dirty or crumpled ones. Because the Salvadoran [sic] government had just purchased brand new U.S. currency from the Federal Reserve, the origin of the crumpled currency was suspect. People said that since banks wouldn't accept it, they wouldn't accept it.<sup>96</sup>

This anecdote highlights the need for public acceptance of dollars—the “normalization” of the currency in everyday use. Such normalization may run up against thorny questions of national pride. “Abandoning the national currency for the dollar (or the euro) is a symbolic sacrifice, as acknowledged even by those who believe that dollarization . . . has more benefits than costs.”<sup>97</sup> While such practical problems may discourage further dollarization, they do not necessarily militate against regional integration of already-dollarized economies.

Lastly, external stresses—like the Venezuela of Hugo Chavez—also could interfere with the progress of regional integration, and Mexico may have some incentive to discourage regional integration, lest it be trapped between two dollar zones.<sup>98</sup> U.S. foreign policy ought decisively to discourage such interference in the process of regional Central American integration.

## VI. Conclusion

Modern efforts to unify Central America began as early as 1960. In that year, most South American nations formed the Latin American Free Trade Association, but it never resulted in a free-trade zone.<sup>99</sup> The Central American Common Market was created in the same year with many of the same goals,<sup>100</sup> and these agreements envisioned a customs union, macroeconomic coordination, and an internal free-trade zone. Political and economic instability, however, stymied

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<sup>93</sup> Hurtado, *supra* note 30, at 399.

<sup>94</sup> Kim & Papi, *supra* note 10, at 74.

<sup>95</sup> Hurtado, *supra* note 30, at 402.

<sup>96</sup> Coutin, Maurer & Yngvesson, *supra* note 12, at 812.

<sup>97</sup> Eichengreen, *supra* note 41, at 13.

<sup>98</sup> Sheppard, *supra* note 8, at 377–378. Of course, Mexico could just as easily dollarize, a move that would be very much to its benefit—and ours.

<sup>99</sup> Abbott & Bowman, *supra* note 66, at 497.

<sup>100</sup> O'Hop, *supra* note 2, at 138.

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any significant headway on this project until the 1990s, when integration began anew.<sup>101</sup>

Intra-Central American trade flows are presently very modest. They account for no more than 18% of total exports, and this figure includes Mexico, which for the moment is not a dollarization candidate.<sup>102</sup> Nevertheless, in a groundbreaking work on regional integration, the International Monetary Fund's Robert Rennhack wrote that "[t]he countries of Central America have a long tradition of regional cooperation, with the oldest tradition of regional integration in Latin America. These ties have been growing closer each year, as trade among the countries expands and banks engage in more cross-border lending within the region."<sup>103</sup>

Thus, the spontaneous currency union described above breathes new life into longstanding efforts at greater regional integration. Such cross-border coordination clearly is gaining momentum,<sup>104</sup> and is increasing throughout the region.<sup>105</sup> These twin phenomena—dollarization and integration—should be viewed not as a novel development, but rather as the resumption of efforts whose pedigree dates back to Bolivar himself. Those efforts are eminently worthy of North American support.

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<sup>101</sup> Abbott & Bowman, *supra* note 99, at 503–05.

<sup>102</sup> Perry, Lederman, & Suescun, *supra* note 46, at 145.

<sup>103</sup> Robert Rennhack, *Foreword*, in *THE MACROECONOMY OF CENTRAL AMERICA*, *supra* note 19, at xii.

<sup>104</sup> Rodlauer & Schipke, *supra* note 4, at 3.

<sup>105</sup> Kim & Papi, *supra* note 10, at 69.