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Book Guide

Playing Monopoly with the Devil

In this book, Manuel Hinds explores the currency problems that developing countries face and offers sound, practical advice for policymakers on how to deal with them. Teaching notes by the author.

Summary

The book discusses a single question from multiple economic points of view: should developing countries have their own currencies, or should they adopt the dollar or another international currency as their own?

This is a deceptively simple question. Answering it requires a complete revision of most of the international economic issues of our time, including the monetary, trade, and financial dimensions of economic policy. This book reviews all these dimensions, starting with an analysis of each of the aspects of currency choice and ending with an alternative conception of the Optimal Currency Area Theory.

The book provides an unusual teaching value added because, while it was designed with collegiate teaching in mind (the discussion of the issues were split in accordance with academic fields), the overall point of view is that of policymaking, which looks at problems in terms of the issues involved in a decision rather than in terms of the academic boundaries of a specialty. In other words, the focus on reality is not faked for teaching purposes. The analysis contained in the book was thought through by the author to propose the dollarization of El Salvador and to design the process through which it was carried out.

Applications

Given the wide scope of the book, it is appropriate for several courses in economics and business administration, including macroeconomics, money and banking and monetary theory, financial economics, economic development, international finance, trade, and seminars on globalization and specific issues.

The following sections pose a sample of theoretically and pragmatically interesting issues that can be discussed in the classroom using the book as reference. The book discusses all of them in depth using extensive evidence from all developing countries.

Essay and Discussion Questions

I. Macroeconomic Theory, Money And Banking And Monetary Theory

A. Currency choice in developing countries

This is the main subject of the book. The book covers all the dimensions of currency choice from multiple economic points of view.

- According to Lawrence Summers, "This book... should be read by all who wish to act or opine on the critical question of whether one country, one currency is right for the twenty-first century."
- According to Robert Litan, "For a watertight explanation of how and why dollarization makes eminent sense, one couldn't do better than read this book."

Reading: The entire book.

B. People's monetary behavior under currencies of different quality

The book argues that people's monetary behavior in countries where the currency is the standard of value of the population is essentially different from that observable in countries where the standard of value is a foreign currency.

Is this true? Does dollar depreciation cause the same effect in the United States as the depreciation of a local currency in a developing country? In terms of prices? In terms of interest rates? Why?

Reading: Chapters 1–2.

C. Income and substitution effects caused by exchange rate movements

All price changes cause income and substitution effects. Are these the same in countries with an international currency as in countries where the currency is used only locally? Why? What are the factors determining the mix of effects? What are the implications for currency choice? For macro-economic policy?

Reading: Chapters 1–3.

D. Sterilization as a policy to reduce inflation and reallocate resources

This is a subject that is only rarely treated in the academic literature. The book discusses the costs and benefits of this policy applied to the case of Brazil.

Reading: Chapter 4.

II. Currency Competition

A. How do you explain spontaneous dollarization?

Spontaneous dollarization is the use of international currencies (mainly the dollar) in domestic transactions. According to an IMF report, the share of foreign currency deposits in total domestic deposits is more than 25% in all the developing regions in the world, reaching more than 45% in some of them. Why should people choose to use a foreign currency instead of their own? What are the implications for the power of the central bank? Why should central banks allow people to keep those deposits?

Reading: Chapters 1 and 11–13.

B. How powerful are central banks in setting the interest rates in developing countries?

Is it asymmetrical that central banks can increase the rate as much as they want but cannot reduce it below the dollar rate plus their currency and country risks? What is the implication for the ability of central banks to carry out an independent monetary policy?

Reading: Chapters 1–2.

III. Financial And Currency Crises In Developing Countries

A. The study of crises

Financial and currency crises are themes that recur throughout the book. In addition, there are five chapters specifically devoted to financial crises in developing countries, including Chile in the early 1980s; Venezuela in the early 1990s; the Tequila crisis in Mexico in 1994; Thailand, Korea and Indonesia in 1998; Ecuador in 2000; Argentina in 2001; and Dominican Republic in the early 2000s. In addition, it examines near crashes such as that of Brazil in the late 1990s. Through the discussion of each crisis, the book finds general patterns that are observable in all of them and identify clearly the measures that have resolved them.

Reading: The entire book; particularly chapters 6–10.

B. Do liquidity traps work differently in developing countries?

The book shows that in countries where the standard of value is a foreign currency, resolving a liquidity trap requires issuing less, not more, of the local currency (or, alternatively, receiving international currency from the IMF and the international community). Does this happen in reality? Can central banks of developing countries solve financial crises on their own? Or do they need dollars? Why?

The book deals with this issue in depth, examining evidence from all the major financial crises that have taken place in developing countries.

Reading: Chapters 6–10.

C. Are the central banks of developing countries lenders of last resort?

If they are, why do they need dollars to resolve their crises?

Reading: Chapter 8.

D. Do currency crises cause banking crises? or is it the other way around?

All banking crises in developing countries have been mixed with currency crises. Which comes first, the currency crisis or the banking crisis? Which was the cause of the combined crisis? Why? This book uses evidence from all the major financial crises in the developing world.

Reading: Chapter 7.

E. The dormant crises

Why is it that, after a financial crisis has erupted in a developing country, it is frequently revealed that the financial institutions of the country in question had long been insolvent but had not declared bankruptcy? Why would some insolvent banks go bankrupt while others survive for decades (Japanese banks, for example)?

Reading: Chapter 6.

IV. International Economics, Economic Development

A. The long-term effects of currency depreciations

Is it true that countries that devalue their currency the most experience the highest rates of growth of exports? What are the mechanisms through which currency depreciations could reduce exports?

Reading: Chapters 3 and 5.

B. What determines the competitiveness of a country?

Is it having the lowest wage? Or the highest level of education? Or the lowest interest rates? Or the smoothest bureaucratic procedures? How do currencies interact with all these factors, mainly the cost of capital and the cost of labor in developing countries?

Reading: Chapters 3 and 5.

C. What is the impact of the real value of a currency on successful exporting?

Successful exports tend to appreciate the currency. Should countries devalue it again to keep their "competitive edge"?

Reading: Chapter 3.

V. On The Optimal Currency Area

A. Can the conventional optimal currency area explain the international monetary markets and monetary globalization?

The conventional optimal currency area says that the optimal area is one that is homogeneous in terms of the business cycles and of its reaction to external shocks. The theory was developed using a two-sector model. How do you explain the development of international currencies in such a world. How is it that, say, Uruguay and Libya settle their accounts in a third country's currency, the dollar?

Reading: Chapters 11-13.

B. Why do people demand a currency that is supposedly not optimal for them?

How is it that people use dollars or euros for domestic transactions in most developing countries, even if those currencies have nothing to do with their business cycles? Is it precisely because of this that people use them?

Reading: Chapters 11–13.

C. Floating and fear of floating

The conventional optimal currency area theory was focused on trade. The model on which it was based did not have a financial system. For this reason, the financial effects of exchange rate movements were not taken into account. In reality, there were frequent contradictions between the expected results of these movements and the actual results. For example, in some cases economists have recommended devaluation to spur exports. However, central banks are unwilling to devalue because this would send many companies into bankruptcy—those which have borrowed in dollars. This is the cause of "fear of floating." How could a system be devised that would eliminate this contradiction?

Reading: Chapters 11–13.

D. Separating and unifying

The conventional optimal currency area theory aims to determine the conditions under which a region should establish its own currency to separate itself from the vagaries of the international monetary and financial markets. This separation is what would allow the central bank to create its own monetary policy.

Do you think that aiming at separating from the international markets is a good idea in an increasingly globalized world, in which global resources are increasingly allocated through the global financial markets?

Reading: Chapters 5 and 11–13.

E. What would be a true optimal monetary area in our globalized world?

Reading: Chapters 11–13.

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