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Dollarization and Its Impact on U.S. Law

THOMAS C. BAXTER, JR.*

I. Introduction

Thank you very much. It is an honor to be at SMU today to participate in the dedication of the Sir Joseph Gold Library Collection and to discuss International Monetary and Financial Law in the New Millennium. Sir Joseph is an impressive and remarkable role model to which all of us in the public and academic sectors should aspire. At the outset, I need to tell you that the opinions I will express are my own, and do not necessarily reflect the views of the Federal Reserve.

II. Dollarization

Today, I am going to talk about dollarization and its possible implications for U.S. law and U.S. lawyers. At the very beginning, let me share a basic premise: law reform is driven by changing business conditions. Dollarization is the adoption of U.S. money as the money of another country. This, in my view, is a dramatic change in a business condition. Given how interconnected our U.S. economy is with our neighbors in this hemisphere – and I'm sure I don't have to emphasize this to an audience in Dallas – it's safe to say that dollarization is an issue that cuts across geographical boundaries both outside and inside the United States. I predict that dollarization will have a significant effect on the development of U.S. law, and on those who practice it, whether they are here or abroad. This is the theme of my remarks today.

There are examples of countries that have been “dollarized” for some time. Most notably, U.S. dollar bills have been used exclusively in Panama for much of this century, as an outgrowth of U.S. involvement in Panama from the time of the Panama Canal. More recently, both Ecuador and now El Salvador have enacted legislation adopting the dollar as their currency and sanctioning its use as legal tender in their countries.

There are other numerous examples of countries where the dollar has – by law, policy, or necessity – become widely used and accepted. After the Soviet Union's break-up, dollars

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began to be used widely in Russia and the former Soviet Republics as a safe currency; in these and many more jurisdictions, people want dollars because their own currencies are so volatile. In Argentina, when the peso was introduced after a long period of hyperinflation, the domestic currency was pegged on a one-to-one basis with the U.S. dollar. As a result, the dollar is used virtually interchangeably with the peso today in Buenos Aires.

I do not intend to state any position on whether the United States – or, indeed, any country or region – should encourage or discourage the use of its currency as legal tender in another country. But it is important to note that the policy and mechanics of dollarization are subjects of legislation in the U.S. Congress and have initiated an interesting debate over how our country, and particularly those of us who help implement U.S. monetary policy, should react.

When countries dollarize, whether unofficially or officially, their banks and populations need physical currency – Federal Reserve notes. To bring it down to the most obvious level, the head of a household purchasing vegetables from the greengrocer needs to pay with money. Institutions and people need to convert their old money into dollars. Banks tend to obtain dollars in one of three ways: (1) directly from Federal Reserve Banks in the United States (transporting the currency by courier across borders); (2) from Extended Custodial Inventories (ECI), which are currency vaults that are operated for the Federal Reserve in foreign countries by private entities; or (3) from commercial depository institutions who provide money services.

When U.S. dollars are obtained, they will be exchanged with the local currency being replaced by the dollars. Over time – and there is significant debate now as to how much time is reasonable – the local currency will be completely displaced by the dollar. We have an interesting experiment along these lines that will soon take place in the European Community, where local currencies (such as deutsche marks or French franc) will be displaced by the euro note. This is scheduled to take no longer than eight weeks. For the sake of our discussion, we may use this eight-week period as a rule of thumb.

III. Banking and Payments Infrastructure

Once the dollar has displaced the local currency, it will be freely used in the local economy. As dollars pass from individuals to the greengrocers, there will come a point when people will wish to store those dollars, not in the proverbial mattress, but in the safety and security of the local bank. This will inevitably lead to the creation of dollar-denominated bank balances in bank accounts outside of the United States.

It is a fact of modern life that people soon come to realize that “payment” in its most basic form consists of a delivery of legal tender “on the barrelhead.” In fact, this is perhaps one of the finest icons of the law merchant, the vision of legal tender being passed on the barrelhead from consumer to merchant. If you close your eyes, you can actually see that taking place in a small country store in Laredo.

But in the modern day, we know that this type of payment is unwise. First, it is just not safe to walk around with legal tender in your pocket, either in Laredo, New York City, or Quito. It invites all the wrong sorts of attention. Second, it is expensive to deal in currency. Shop owners around the world know that some part of the currency being passed across that barrelhead never actually makes it into the till because the shop workers have an altogether human tendency to put some of it in their own pockets. Third, money in the bank tends to earn interest. By comparison, money in the till is simply a risk with no return.

Why do I digress along these lines? To make the point that it is only a matter of time before people in a dollarized economy start to think about how to effect “payment” by transferring a dollar-denominated bank balance from the buyer’s bank to the seller’s bank, instead of passing cash across the barrelhead. This is probably not a startling observation to anyone here; and isn’t it characteristic of a lawyer to think that it is profound to discover that rain is wet? But what is much less clear today is what legal infrastructure will govern dollar-denominated payments outside of the United States. If we all agree that these payments are just around the corner, isn’t this an important question?

IV. Legal Infrastructure

In the United States, we have a very elaborate set of laws that constitutes our legal infrastructure for payments. We have Articles 3 and 4 of the Uniform Commercial Code (UCC) for checks, supplemented by the federal Expedited Funds Availability Act.¹ We have Article 4A of the UCC for funds transfers, which works in conjunction with two Federal laws – the Expedited Funds Availability Act and the Electronic Funds Transfer Act.² I would be inexcusably incomplete if I failed to mention the alphabet soup of Federal Reserve regulations. We have Regulations J³ and CC⁴ for checks. Regulation E⁵ exists for consumer electronic funds transfers. Finally, we have credit cards, which are governed by the Truth in Lending Act⁶ and the Federal Reserve’s Regulation Z.⁷

Trust me – this is a pretty elaborate legal infrastructure. What often surprises me is that people take legal infrastructure for granted in the United States. It is one of those many things that work so well that you can freely ignore it. Like turning on the television set, it works – so who cares how? But when we have dollar-denominated payments outside of the United States, will they work well without the legal infrastructure that we all take for granted?

Some of my monetary legal colleagues will take solace in the Latin expression *lex monitae*. They will invoke that concept like an amulet that will fend off the evil law god who might strike at the dollarized sovereign who establishes a payment system without a proper legal infrastructure. *Lex monitae* is a principle that says you apply the law of the jurisdiction issuing the currency to resolve any payment-related legal question. So, if you have a check denominated in U.S. dollars, you apply U.S. payment law to resolve a legal question about handling the check. The utility of the concept is that it answers all “which payment law applies” questions. But some answers are just too simple. I am not particularly confident that *lex monitae* is the answer to legal issues related to payment in dollarized jurisdictions. I think it is politically naive and practically unworkable to expect foreign countries to slavishly convert to U.S. law. Can you imagine how some of the finer textual points in the beautifully written Regulation Z will translate into Spanish and Portuguese? I suspect that you see this point. I also think that it is unrealistic to expect foreign judges to apply U.S. law regularly

1. 12 U.S.C. §§ 4001–4010 (1991).

2. 15 U.S.C. § 1693 (1996).

3. 12 C.F.R. § 210 (2001).

4. *Id.* § 229.

5. *Id.* § 205.

6. Pub. L. 90–321 (West 2000).

7. 12 C.F.R. § 226.

to payment disputes if they are uncomfortable with the outcome produced by the application.

But I cannot stop with that, because it is absolutely clear to me that you cannot have two incompatible legal infrastructures for the transfer of dollar-denominated bank balances. Why? To give you an answer, I want you to think not about payments, but about driving an automobile. Now, when you drive an automobile you need to follow certain rules of the road. One of those rules in the United States is that you drive your car on the right-hand side of the road. In the island nations of Great Britain and Ireland, you know that they drive on the left-hand side of the road. The different rules work well so long as no driver crosses a border at high speed. Imagine if you will, what might happen if Canada followed the British rule. We would undoubtedly have multi-car pile-ups routinely along our northern border. I submit the same principle is true with respect to cross-border payment flows. Dollar-denominated bank balances may pass across national borders, but there must be harmony in the rules of the road that exist in the respective localities.

V. Areas for Harmonization

Assuming you are with me on the need for some harmonization, I will now turn to what I believe are two very fertile areas for study of, and coordination with, foreign legal systems: dollar payment systems and criminal law.

A. DOLLAR-PAYMENT SYSTEMS

As payment systems for dollar-denominated balances emerge in places like Ecuador, El Salvador, and Argentina, there will also be a need to transfer these balances to, through, and from the United States. Commerce will push for links among dollar-payment systems in these jurisdictions. Different legal rules create uncertainties about the rights and obligations of parties wishing to engage in cross-border activities – even if they involve a single currency. The reason is that payment systems operate most safely and efficiently within a clear legal framework, and having two or three, or even four legal frameworks apply to a funds transfer within a linked payment system invites a high degree of legal uncertainty. To return to my driving metaphor, the risk of colliding cross-border funds transfers rises with the number of dollarized jurisdictions.

For example, consider a dollar transfer involving an Originator in Country A and a Beneficiary in Country B. A dispute over the payment arises. What law governs the rights and obligations of the Originator and Beneficiary (not to mention the banks used to carry out the transfer)? If, say, the Originator obtains a judgment against the Beneficiary in Country A under Country A's law, but the Beneficiary's assets are held in Country B, will a court in Country B enforce the Country A judgment?

As we can see, even with the widespread use of a single currency, it is easy to crash into familiar choice-of-law and enforceability questions. The dilemma worsens if one or both of the countries do not have the legal rules or infrastructure capable of resolving payment-system disputes rapidly and predictably. If that is the case, then the participants in the payment systems, their banks, and the payment systems themselves will suffer as a result of a lack of legal certainty and confidence in adjudication.

In this regard, there is a very interesting comparison to make between dollarization and the introduction of the euro in the European Community. In the European Community, there have been euro bank balances long before the distribution of a common, physical

currency, which enabled the creation of their “Target” payment system before any euro was ever printed. In contrast, in the United States and dollarized countries, a common, physical currency will predate linked payment systems for transferring dollar-denominated bank balances. But this difference will not last for long. I predict there will be pressure to link these new, offshore payment systems to our long-established payment systems here in this country – with the goal of enabling borderless dollar-denominated payments.

What do I think will happen in dollarized countries? Some basic principles of U.S. payments law will end up in these nations, as a result of the United States “pushing” our legal framework and/or dollarized countries “pulling in” U.S. law to meet the demands of commerce. I doubt that the flow of U.S. law to dollarized countries – either as a result of our exporting it or their importing it – will extend to laws that commercial lawyers would regard as consumer-protection measures. So, I could see the United States exporting UCC Article 4A with respect to funds transfer, but probably not Regulation Z with respect to credit cards. In this regard, the European Community has already adopted some principles of Article 4A in its Directives on Cross-Border Credit Transfers and Settlement Finality in Payment & Securities Settlement Systems.

How is this likely to happen? My sense is that it will happen because business people will ask their lawyers to make it happen. In this regard, we are just starting to see groups of lawyers from countries in North and South America getting together to consider the legal issues associated with dollarization, and the various ways in which they might be resolved. Later this year, the Mexican Central Bank, together with the Monetary Law Committee of the International Law Association, will hold a conference in Mexico City dealing with this very topic.

B. CRIMINAL LAW

While I believe that dollarization will drive the development of payment law – and I hope my example convinces you of that – it will also pressure other law reform efforts. Consider what might be the area of law that is most territorial – criminal law. Dollarization increases the use of the dollar. As dollars are used by more people, the temptation to counterfeit and the harmful effects of counterfeiting also will increase. Dollarization might put pressure on U.S. law enforcement agencies to export their technology and techniques to stop counterfeiters abroad.

Is it against U.S. law to counterfeit U.S. banknotes in a dollarized country like Ecuador or El Salvador? Yes. But absent close international law enforcement cooperation, it may be difficult for U.S. authorities to apprehend, extradite, and punish perpetrators in addition to preventing counterfeiters from quickly moving their operations elsewhere.

Perhaps we should be focusing just as intently on whether it is illegal under Ecuadorian or El Salvadoran law to counterfeit U.S. currency and on what motivation and resources dollarized countries have to prevent and catch counterfeiters. Already this country devotes substantial resources to helping foreign law enforcement officials eradicate illegal drugs grown in South America: are we willing to devote resources to, say, the eradication of counterfeiting U.S. currency outside the United States? Just as dollarization might cause exporting U.S. payment law to foreign dollar-payment systems, it may also “push” our law enforcement infrastructure offshore, into unknown and uncomfortable territory. Does it strike you as strange to contemplate an Ecuadorian prosecution of an Ecuadorian national for violating an Ecuadorian criminal law by counterfeiting Federal Reserve notes?

VI. Potential Problems from Dollarization

These payment system and criminal law issues raised by the trend toward dollarization should, and in fact do, pose real concerns for central bankers like me. After all, it is part of our job to worry about what my former colleague Jerry Corrigan, who was President of the Federal Reserve Bank of New York, called financial “plumbing.” Moreover, as a lawyer for the U.S. central bank, I fear that an increase in unresolved commercial disputes or uncertainty involving this country’s currency, even if they occur outside our borders, could adversely affect us.

But that is just one possible problem. Payment system problems will probably have the worst effect on emerging-market countries that adopt the dollar in a rush to stabilize their economies and make themselves competitive in an increasingly global economy, but without the necessary legal infrastructure. We commonly worry about financial “contagion”: for example, the possibility that economic troubles in Turkey will spill over into Argentina, which has been in the headlines just recently. I am no economist, but there is a risk that dollarization will not mitigate contagion. In fact, without a protective legal infrastructure, it might hasten the spread of liquidity crises across borders and into economies that investors have not perceived as shaky.

I have also said nothing about operations risk and information technology. For example, the computer systems that drive our wholesale payment systems in the United States are highly sophisticated and robust. What do we expect will happen in poorer countries like Ecuador? If their systems ultimately link to ours in the United States, will there be possible technological fallout? Similarly, on the law enforcement front, if dollarization leads to greater corruption and other criminal activities, then that will detract from any economic benefit derived from the use of a common currency by the United States and other dollarized countries.

VII. Possible Solutions

So how can we – and by that I mean academics, financial institutions, central banks, international financial institutions like the IMF and the World Bank, and the public at large – best grapple with these concerns? Well, for one, our best protection is to anticipate these problems rather than merely react to them. I believe that central banks in particular need to be involved as developers of payments law and payment systems rather than as passive observers so that we can design a sound legal infrastructure that will allow them to flourish. I hope that we can all agree on the importance of successfully linking payment systems and law enforcement initiatives focused on the dollar in order to sustain and improve legitimate trade and economic development, as well as – dare I say it – international harmony.

VIII. Conclusion

In closing, let me return to my premise, that changing business conditions drive law reform. Dollarization is a business condition that will turn the attention of American lawyers outward, whether they are payment lawyers or criminal lawyers. Regrettably, I never had the opportunity to study with, or ever meet, Sir Joseph Gold. However, from what I know about him, I am confident he would urge us to look outwardly and embrace change. I can think of no better way to memorialize Sir Joseph than to pledge my intention to aggressively study the legal issues associated with dollarization, and to try to resolve them.