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Growing Dollarization in Business Banking: Congruous or Ironic?

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Abstract

Over the last few years, international banking has distinctively expanded in the rapidly sweeping global business environment. It has been an important component of a broader process of financial globalization and integration of business. Historically, it has expanded in concert with international trade and has performed key functions for the business of international firms. The role of international banks in the global economy is closely related to that of international financial markets. As they perform complementary functions, forms of financial intermediation are indispensable, together with a resilient market infrastructure, for the healthy functioning of the financial system. Dollarization is one of the major determinants in circumscribing the banking sector networks. The World Bank defines it as the use of foreign currency as a unit of account, means of exchange and store of value or abandonment of country's own currency and adoption of other's. The major effects of dollarization include the monetary authorities' inefficiency to act as lender of last resort to commercial banks by the printing of money. However, is it beneficial or harmful has to be pondered upon. The paper focuses on three aspects: first it briefly highlights the issues that warrant attention in the emerging global environment. The second elucidates on how dollarization affects the business scenario and the third part focuses upon the stabilization strategies which can be followed in the purview of the changing global milieu.

Keywords: *International Business, Dollarization*

1. Introduction

Dollarization occurs when the inhabitants of a country use foreign currency in parallel to or instead of the domestic currency as a store of value, unit of account, and/or medium of exchange within the domestic economy.¹ The term is not only applied to usage of the United States dollar, but generally to the use of any foreign currency as the national currency. There are two common indicators of dollarization. The first one is the share of foreign currency deposits (FCD) in the domestic banking system in the broad money including of FCD. The second measure is the share

¹ Savastano, Miguel (1996). "Dollarization in Latin America: Recent Evidence and Some Policy Issues". *IMF Working Paper* WP/96/4: iii.

of all foreign currency deposits held by domestic residents at home and abroad in their total monetary assets.²

In a fully dollarized economy, monetary authorities cannot act as lender of last resort to commercial banks by printing money. The alternatives to lending to the bank system may include taxation and issuing government debt.³ The loss of the lender of last resort is considered a cost of full dollarization. This cost depends on the initial level of unofficial dollarization before moving to a full dollarized economy. This relation is negative because in a heavily dollarized economy, the central bank already fears difficulties in providing liquidity assurance to the banking system.⁴ However, literature points out the existence of alternative mechanisms to provide liquidity insurance to banks, such as a scheme by which the international financial community charges an insurance fee in exchange for a commitment to lend to a domestic bank.⁵

Commercial banks in countries where saving accounts and loans in foreign currency are allowed may face two types of risks:

1. Currency mismatch risk: Assets and liabilities on the balance sheets may be in different denominations. This may arise if the bank converts foreign currency deposits into local currency and lends in local currency, or vice versa.
2. Default risk: Arises if the bank uses the foreign currency deposits to lend in foreign currency.⁶

However, dollarization eliminates the probability of a currency crisis that impacts negatively on the banking system through the balance sheet channel. Dollarization may reduce the possibility of systematic liquidity shortages and the optimal reserves in the banking system.⁷ Research has shown that official dollarization has played a significant role in improving bank liquidity and asset quality in Ecuador and El Salvador.⁸

2. Dollarization and the Banking System

Three effects on the banking system under dollarization are considered in this article:

- Restrictions on the central bank as lender of last resort,
- The effect of economic stability on the performance of banks, and
- The promotion of financial integration with the world economy.

² Savastano, Miguel (1996). "Dollarization in Latin America: Recent Evidence and Some Policy Issues". *IMF Working Paper* WP/96/4: 7.

³ Bencivenga, Valerie; Huybens, Smith (2001). "Dollarization and the Integration of International Capital Markets: a Contribution to the Theory of Optimal Currency Areas". *Journal of Money, Credit and Banking* 33 (2, Part 2): 548–589. JSTOR 2673916

⁴ Broda, Christian; Yeyati (2001). "Dollarization and the Lender of Last Resort". *Book: Dollarization*: 100–131

⁵ Yeyati, Eduardo (2003). *Dollarization*. London: The MIT Press. pp. 31.

⁶ Kutan, Rengifo, Ozsoz, Ali, Erick, Emre. "Evaluating the Effects of Deposit Dollarization in Bank Profitability". Fordham University Economics Department.

⁷ Yeyati, Eduardo (2003). *Dollarization*. London: The MIT Press. pp. 34.

⁸ Federal Reserve Bank of Atlanta, *Official Dollarization and the Banking System in Ecuador and El Salvador*, 2006

The restriction on the role of the monetary authority as lender of last resort is one of the costs of dollarization. Central banks provide loans to banks facing liquidity problems. Under dollarization, printing money is no longer a feasible source of liquidity, and the central bank needs to look for alternative responses to episodes of financial distress.⁹ Under a fixed exchange rate regime with a central bank that does not act as a lender of last resort, concluding that this regime is more prone to bank runs than a currency board. In this case, the liabilities of the banking system as a whole are, implicitly, obligations in international currency. Consequently, a bank run is possible if the banking system's implicit liabilities are greater than its liquid assets (in foreign currency).¹⁰

Under dollarization, the economy is shielded from a currency or balance-of payments crisis, but the risk of a banking crisis is real. Financial instability is endemic to this regimen. The solution includes external lines of credit with banks from abroad and reserve funds from taxes or other revenues.¹¹ The policy of high bank reserve requirements dominates over a policy of large international reserves. "The intuition is that increasing the international liquidity of the banking system has a social opportunity cost. Under a policy of high reserve requirements, banks internalize this cost; under a policy of large international reserves, they do not".¹²

3. REASONS BEHIND DOLLARIZATION OF AN ECONOMY

There are two potential benefits to opt for hard peg option:

- To provide a nominal anchor for macroeconomic stability, and
- To foster trade integration between countries that have dollarized its economy and the country to which it links its currency.¹³

So the main motivation to dollarize an economy is to achieve economic stability. Many developing countries believe that pegging the domestic currency to the US dollar or using the US dollar as a medium of exchange is better than floating exchange rate regime that might put a country into a severe economic situation. A believe which might not be there in the following years.¹⁴

There is disagreement on the effect of dollarization on actual economic variables of growth, employment and volatility¹⁵. Supporters of dollarization argue that it really affects growth through two ways:

⁹ Official Dollarization and the Banking System in Ecuador and El Salvador By Myriam Quispe- Agnoli & Elenna Whisler.

¹⁰ Chang, Roberto, and Andrés Velasco. 2000. Financial fragility and the exchange rate regime. *Journal of Economic Theory* 92, no. 1:1–34.

¹¹ Berg, Andrew and Eduardo Borensztein, 2000. "The Choice of Exchange Rate Regime and Monetary Target in Highly Dollarized Economies," *Journal of Applied Economics*, Vol. 3, No. 2, pp. 285-324.

¹² Liquidity of the banking system has a social opportunity cost. Under a policy of high reserve requirements, banks internalize this cost; under a policy of large international reserves, they do not" (2000, 3).

¹³ Klein MW. Dollarization and trade. *Journal of International Money and Finance*, 2005.

¹⁴ Burnside, Craig, Barry Eichengreen, and Sergio Rebelo, 2001. "Hedging and Financial Fragility in Fixed Exchange Rate Regimes," *European Economic Review* 45 (June): 1151-1193.

¹⁵ Edwards, Sebastian ;Magendzo, I. Igal Dollarization. *Journal of Money, Credit & Banking*, 2006

- Firstly, it tends to produce higher investment, lower interest rates, and faster growth.
- Secondly, dollarization will encourage international trade particularly between the two countries; the country that adopted dollarization policy and the senior country to which it links its monetary policy¹⁶.

A view which indicates that economies with a hard peg will have troubles accommodating external shocks, which may be translated into greater volatility and might sometimes lead to lower economic growth¹⁷. Another substantial drawback to adopting a foreign currency is that a dollarized nation cannot influence its economy directly. The right to administer monetary policy and any forms of exchange rate regime will be sacrificed for the benefits of using the US dollar¹⁸.

4. Pros & Cons of Dollarization

The Pros. of dollarization at the right conversion rate is likely to¹⁹:

- Ensure low inflation²⁰ (an inflation rate close to U.S. inflation);
- Lower the level and volatility of domestic interest rates (real and nominal interest rates) by eliminating the risk of devaluation and thus eliminating the devaluation-risk premium in local currency interest rates;²¹
- Spur the development of domestic long-term capital markets by eliminating the risk of high inflation and devaluation;²²
- Lower transactions costs in international trade and investment;
- Reduce financial fragility by eliminating currency mismatches and by promoting integration of domestic financial firms into world markets;
- Spur substantially greater international trade.

The Cons. of dollarization means that a country:

- Becomes unable to adjust its exchange rate when that might be helpful;
- Loses the ability to run an independent monetary policy;
- Loses the seignorage²³ from issuing its own money

¹⁶ Rose AK, van Wincoop, E., National money as a barrier to international trade: the real case for currency union, 2001.

¹⁷ Magendzo, I. Igal Dollarization. *Journal of Money, Credit & Banking*, 2006.

¹⁸ Heakal R. Dollarization Explained.

¹⁹ Arteta, Carlos, 2003. "Are Financially Dollarized Countries More Prone to Costly Crises?" *International Finance Discussion Paper 763*, Board of Governors of the Federal Reserve System, March 2003.

²⁰ Boyd, John H., Ross Levine, and Bruce D. Smith, 2001. "The Impact of Inflation on Financial Sector Performance," *Journal of Monetary Economics*, Vol. 47, No. 2, pp. 221-48.

²¹ Garber, Peter, 1996. "Managing Risks to Financial Markets from Volatile Capital Flows: The Role of Prudential Regulation," *International Journal of Finance and Economics*, Vol. 1, pp. 183-95.

²² P., Zaman, J., and Zephirin, M., 2003. "Bank Consolidation, Internationalization and Conglomeration: Trends and Implications for Financial Risk," (forthcoming IMF Working Paper).

²³ Seignorage is the interest income a central bank earns by issuing non-interest bearing money to buy interestbearing assets. A country's central bank is part of its government, so that income is part of the government's revenues. When a country dollarizes, its central bank has to withdraw the local currency from circulation and replace it with dollars.

- Loses the possibility of using the inflation tax (“revenue of last resort”) by printing money in a national emergency;²⁴
- Loses a lender of last resort that can lend by creating its own money;
- Loses political sovereignty.

5. Conclusion

In spite of major disinflation and a shift toward sound policy fundamentals, dollarization has remained very high. Although the authorities in the region have become increasingly aware that high dollarization carries considerable risks and can exacerbate a typical Latin American economy’s vulnerability to adverse shocks, there are no current direct policy initiatives to reduce the level of dollarization. The latter is seen more as a side effect of sound policies and fundamentals than as a policy objective. Among all economic risks or concerns about high financial dollarization is the perverse debt dynamic that can arise in response to adverse shocks in economies with a high degree of public and private sector dollarized indebtedness and where derivatives markets remain underdeveloped. In only a very few cases does prudential regulation directly address the foregoing key risks. It is in this context that we believe tighter prudential requirements on foreign-currency loans as well as enhanced local markets in financial derivatives should be considered. Although policymakers in some countries are currently considering a shift to CPI-indexed financial instruments as a means of attenuating the degree of dollarization, the existence of sound fundamentals and of low and stable inflation in many countries allows them to consider instead a shift to domestic nominal financial assets, similar to those which prevail in advanced economies.

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To get those dollars, the central bank will have to sell some of its assets normally interest-bearing, dollar-denominated assets. The result is that the central bank’s interest income declines.

²⁴ A government levies an implicit inflation tax when it issues so much new money that it generates inflation. (This is the basic “too much money chasing too few goods” story.) Inflation reduces the real value of money over time; thus inflation is like a tax levied on those who hold the local money. When a country officially dollarizes, its government can no longer issue new money, so it can no longer use the inflation tax.

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