

Financial Dollarization: Help or Hindrance in Maintaining Stability?

Using the experience of Latin America to answer this question for Kazakhstan

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Financial Crises in highly dollarized emerging economies and in several countries of the Eurozone has generated conflicting opinions regarding the desirability of allowing local financial assets to be denominated in currencies that the Central Bank cannot control. Several very influential economic experts have advocated compulsory conversion of those financial assets into local currencies like Argentina did in 2002.

The purpose of this paper is to evaluate this proposal based on the experience of some Latin American countries, namely Argentina, Brazil and Perú. Does Financial Dollarization help or hindrance anti-inflationary programs that pretend to deliver sustainable price and financial stability? This is the central question to be discussed.

This is a relevant subject for CIS economies, particularly Kazakhstan's, because most of these economies have become highly dollarized during the late 90's and early 2000's and, in addition, they are discussing the possibility of creating a common currency. Now that the Tenge is twenty years old, should it become the only accepted currency for domestic financial intermediation? Should it eventually surrender to a common currency that would replace not only the Tenge but also the Dollar?

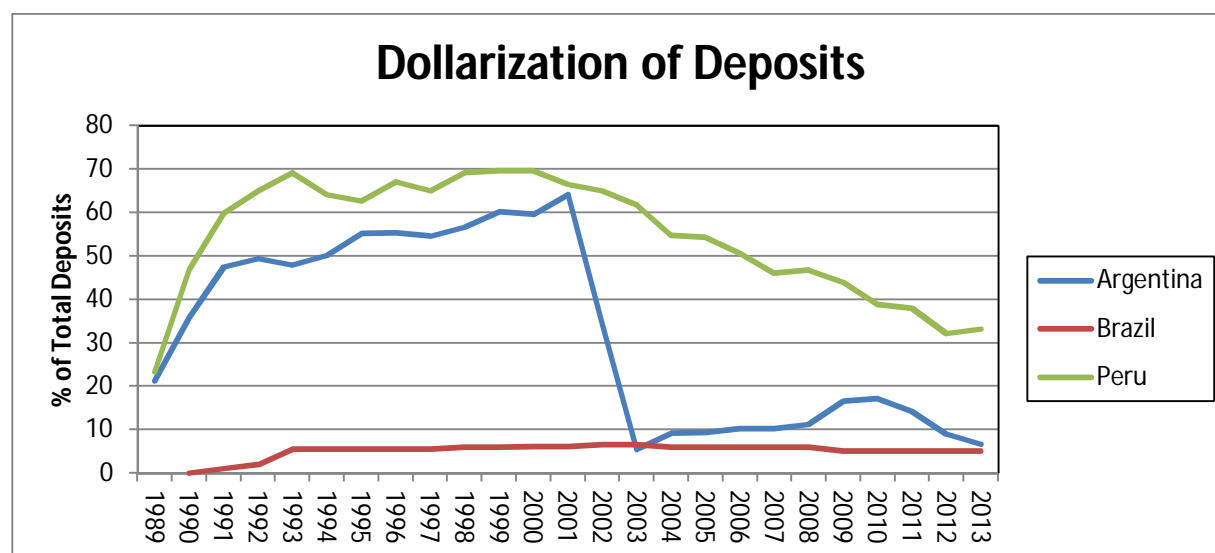
The experience of Latin America

In emerging economies, financial dollarization is normally a consequence of extreme price and exchange rate instability associated with hyperinflation. In Latin America the best example of a country that became largely dollarized is Perú.

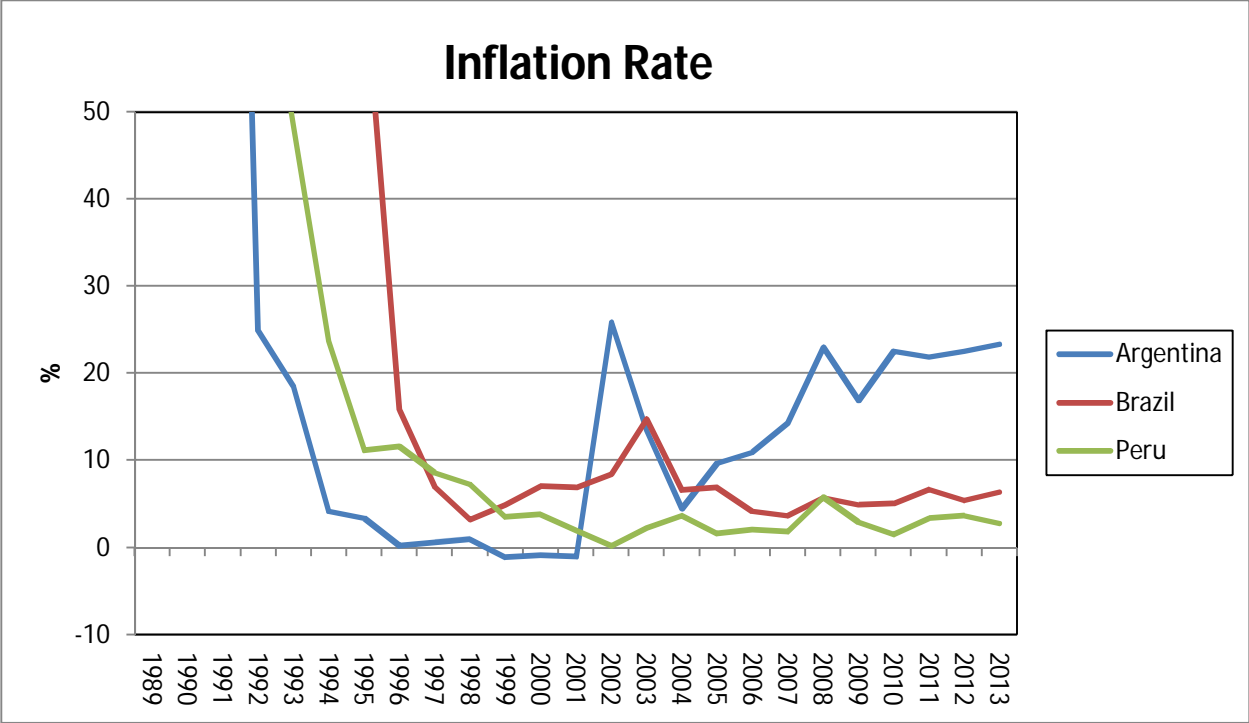
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Argentina was largely dollarized since it suffered hyperinflation. But in 2002 the Government imposed a compulsory conversion into pesos of dollar denominated deposits and financial assets under Argentinean law.

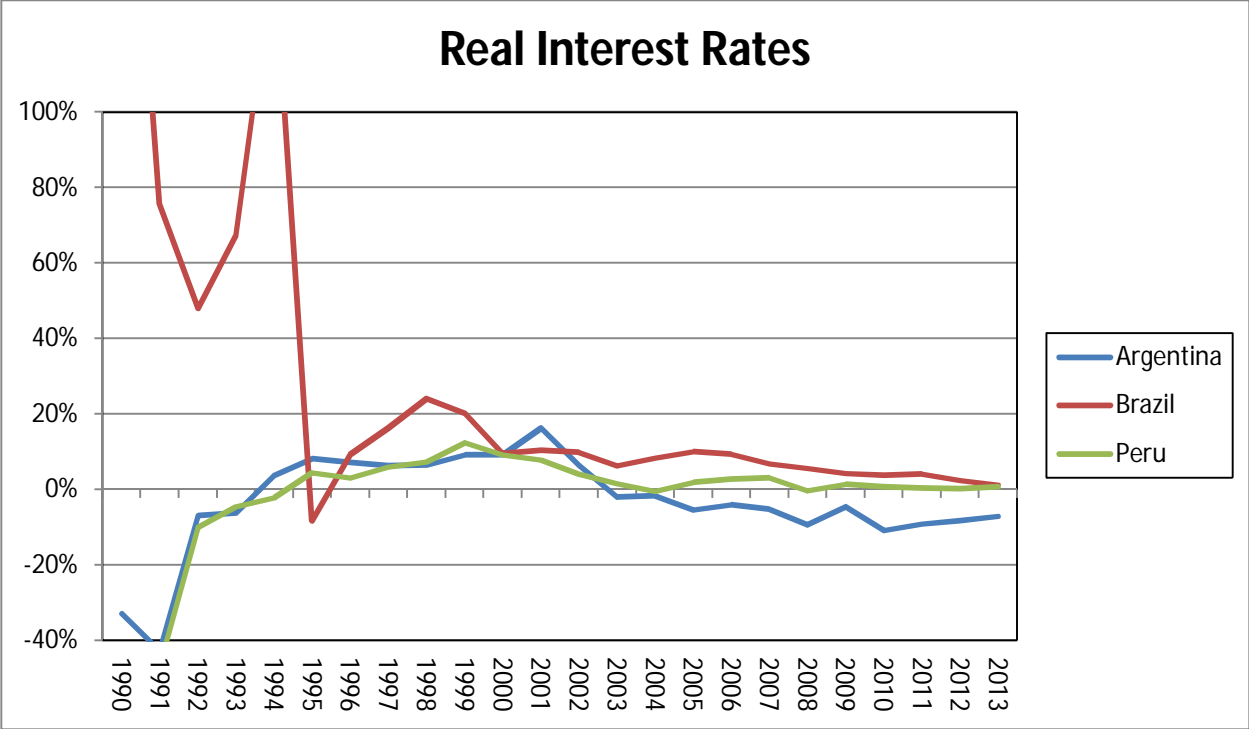
Only a few countries that went through large periods of hyperinflation managed to avoid dollarization. They did so, through a combination of a ban on use of foreign currencies for domestic financial transactions, widespread price indexation of domestic financial assets and high real interest rates. Brazil is the best example of these kinds of countries.



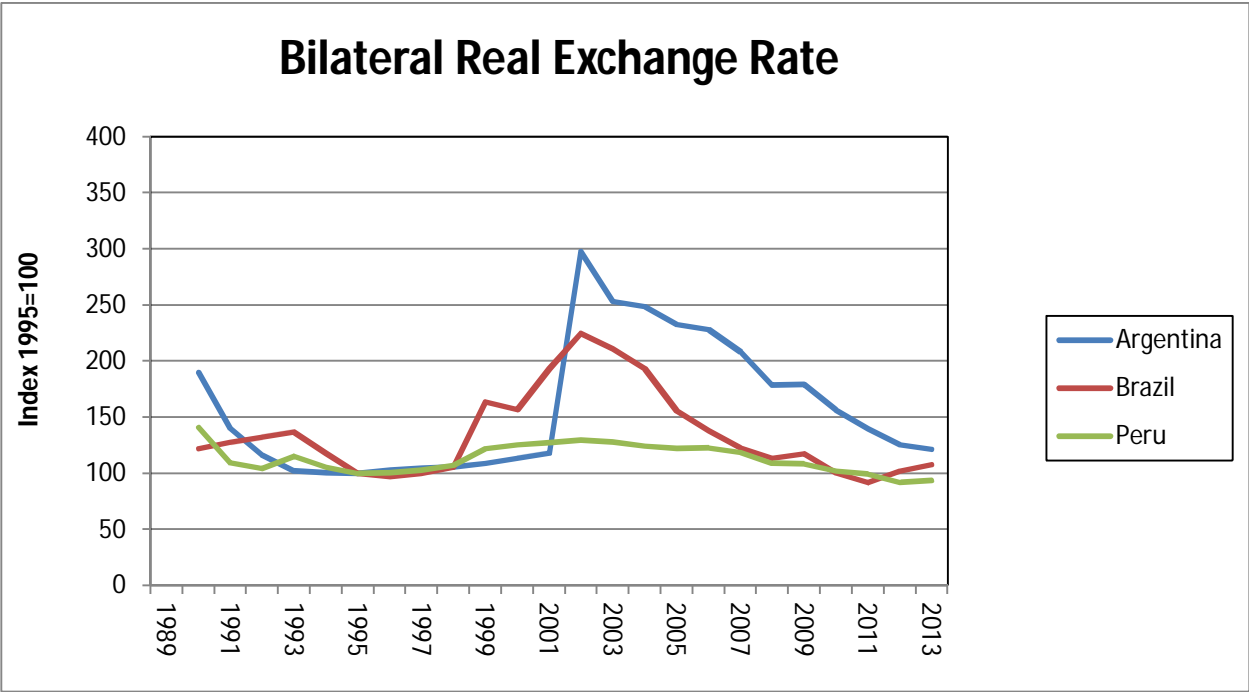
The experience of these three Latin American countries shows that Dollarization can be very helpful to implement an effective stabilization program. The key to achieve price stabilization is finding effective ways to stabilize the exchange rate. Any commitment to a monetary policy that pursue exchange rate stabilization is much more credible if local people are allowed to keep their savings in dollar denominated financial assets because it means the government accepts severe limits to collect the inflationary tax. This point is clearly seen in a comparison of the experience of Brazil and that of Argentina (until 2001) and Perú (all along). Higher inflation in Argentina after 2002 is related to the compulsory de-dollarization decided that year by the Government.



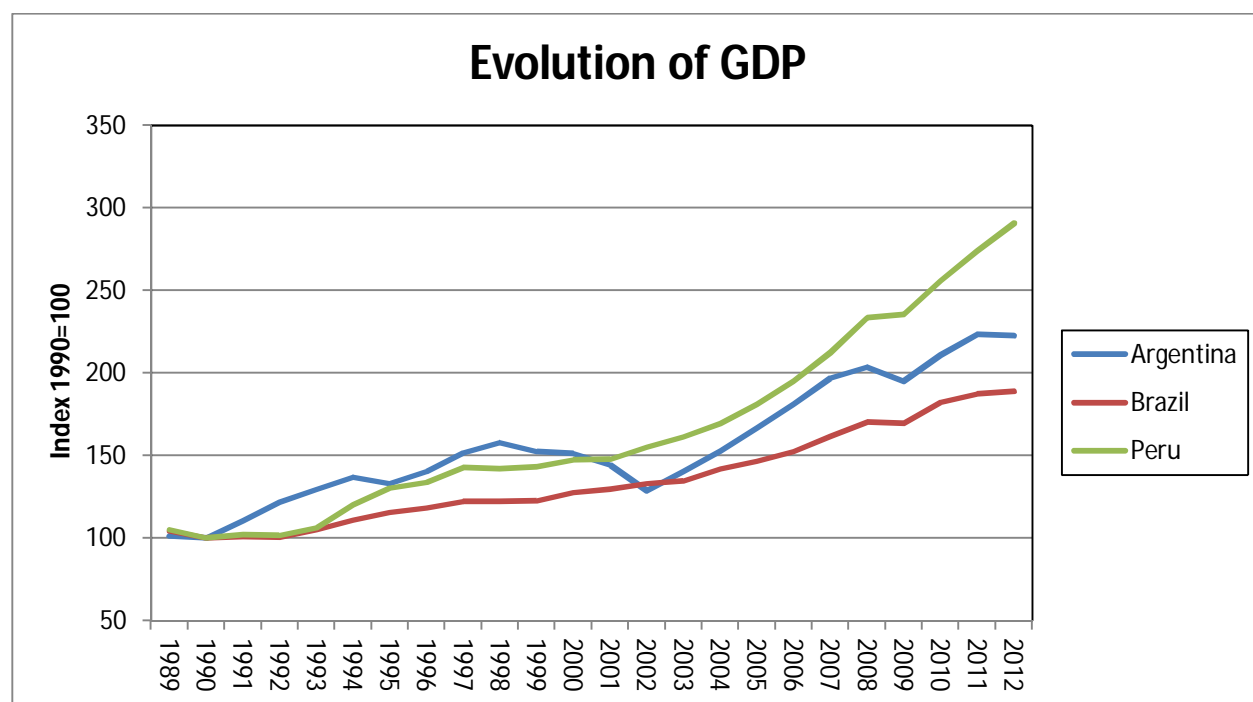
Brazil needed to maintain much higher real interest rates than Perú and Argentina to achieve stabilization and keep inflation low. Largely dollarized economies can stabilize their price levels and keep inflation low with lower real interest rates.



The real exchange rate was much more stable in largely dollarized economies (Perú all along, Argentina until 2001) than in non-dollarized economies (Brazil all along and Argentina since 2002).



Growth performance was superior in highly dollarized economies. This may be related, among other things, to the fact that real interest rates can be kept lower in dollarized economies.



So far, the description of the experience of Argentina, Brazil and Perú suggests that there are advantages in having a high degree of dollarization in an emerging economy. But then, why do many monetary experts consider a high degree of dollarization as a problem?

Higher risk of financial crises

The reason is that there are also wide evidence that largely dollarized economies are prone to financial crisis due to currency mismatches and balance sheet imbalances. To make things worse, large financial dollarization restricts the ability of the central bank to act as lender of last resort when a dollar liquidity crisis arises. This became very clear at the time of the Argentine Crisis in 2001.

At the same time, the experience of Argentina 2002 shows that compulsory de-dollarization to cope with financial crisis is very costly in terms of future inflation. After compulsory de-dollarization, Argentina, that had outperformed Brazil in terms of price stability before 2002, became again a two digit inflationary economy.

During the 1990's, Argentina had defeated hyperinflation and inaugurated a period of stability and growth of a market economy, well integrated into the global trade and capital flows, with a very strict monetary rule that was strengthened allowing the people of Argentina to save and conduct every kind of transaction not only in Pesos but also in Dollars. The economy had been highly dollarized "de facto" during hyperinflation but as a deliberate stabilization strategy, dollarization was allowed "de jure". At the time of a sharp deterioration in terms of trade, between 1999 and 2001, this strategy did not help to prevent recession turning into deflation and fed a debt problem.

Unfortunately, instead of fixing the debt problem in an orderly way and changing the monetary rule to allow for a more flexible inflation targeting, the new authorities that emerged from the political crisis of December 2001 opted for a disorderly debt default and a change in the monetary regime. The new monetary regime started with the destruction of the contractual base of the economy by forcing the conversion into Pesos of all contracts that had been written in US dollars.

The default and forced conversion of contracts provoked an extreme devaluation of the Peso and opened the door for a very damaging freezing of public utility rates, price controls, distortionary taxes and all sort of administrative interventions thought as substitutes for an inflation targeting monetary rule.

An expansionary fiscal policy was, at the beginning, very useful to reactivate the economy and resume growth, even without significant investment in key sectors of the economy that had been very well capitalized during the previous decade. But with the significant improvement in terms of trade since 2003, the government found in the distortionary taxes introduced during the emergency period, particularly in export taxes, a politically very useful instrument to finance populist policies and accumulate political power. The external bonanza allowed the government to finance policies that are in sharp contrast with the basic principle of good economic management. There is no doubt that in the long run these policies are non-sustainable.

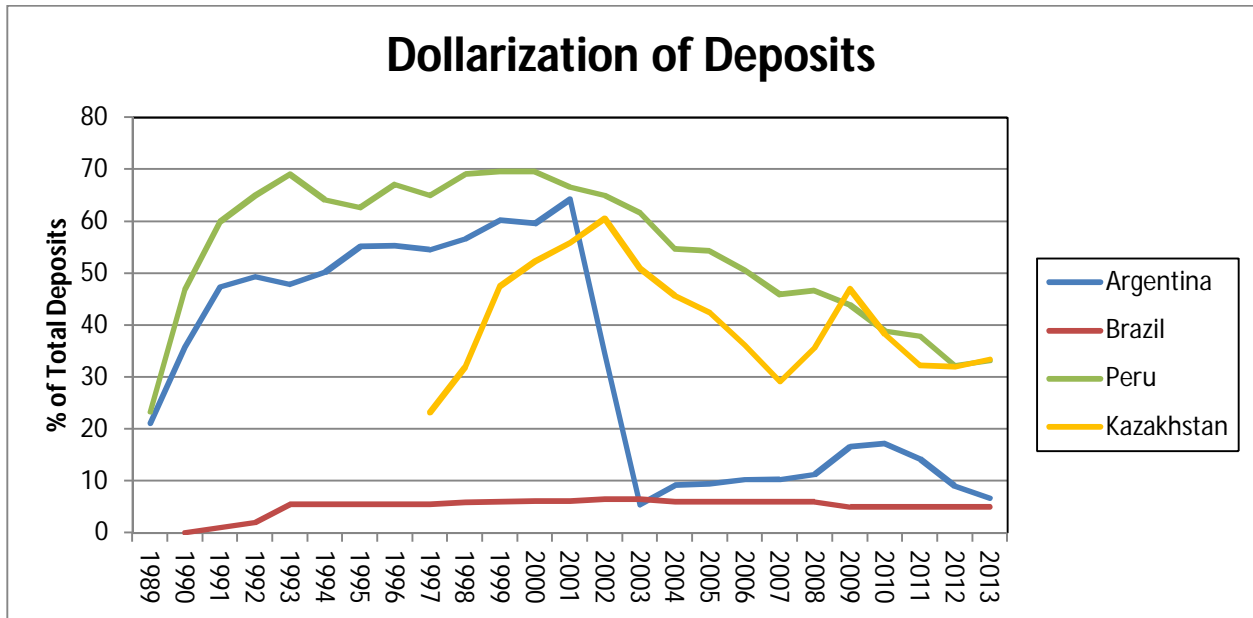
Latin American Lessons on Dollarization relevant for Kazakhstan

The experience of Latin America suggests that the best course of action for an economy that became highly dollarized at time of hyperinflation is to take advantage of large dollarization to stabilize the economy, as Argentina and Perú did in the early 90's, and afterwards, to pursue prudent macroeconomic and regulatory policies to prevent financial crises. And, if the financial crisis eventually comes, compulsory de-dollarization should be avoided. The experience of Perú demonstrates that this is a feasible course of action.

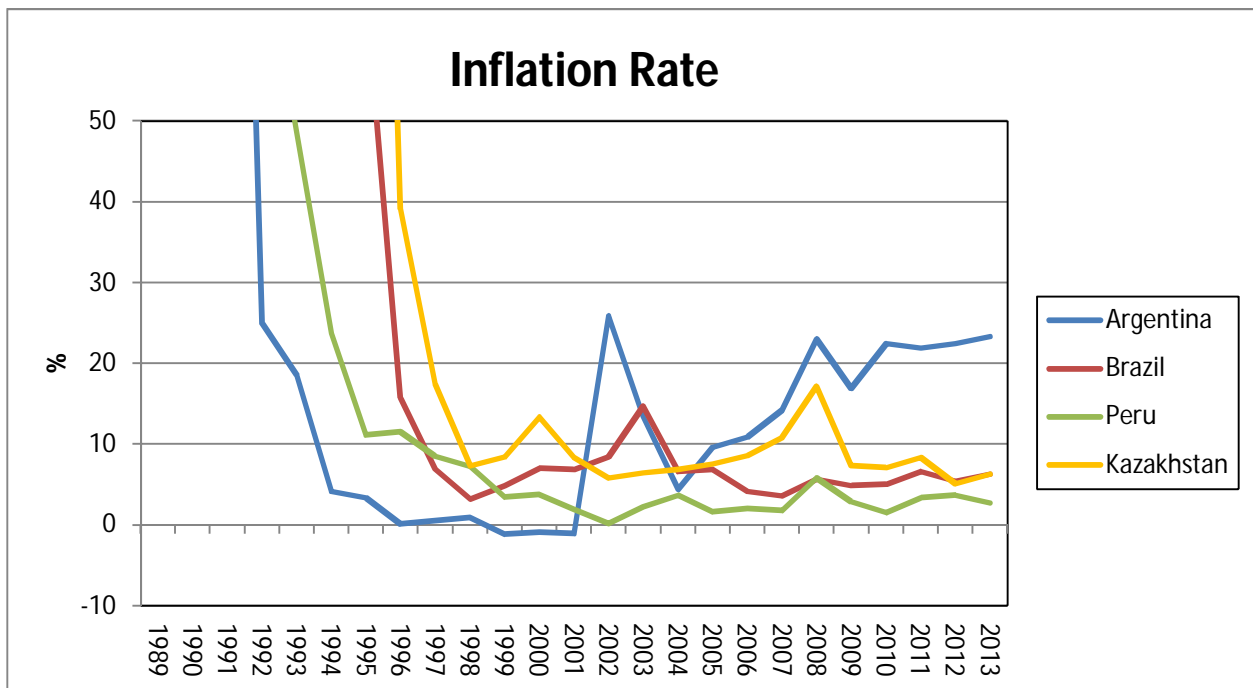
The lessons learned from the experience of Argentina, Brazil and Perú in relation to financial dollarization and stabilization may become very relevant for Kazakhstan. Fortunately, so far, Kazakhstan resembles much more Perú than Argentina and Brazil. This can be seen in the same graphs with the figures for Kazakhstan.

Dollarization in Kazakhstan became a widespread phenomenon as a consequence of the Russian Crisis in 1998 and its aftermath. By 2002 the economy of Kazakhstan was as dollarized as those of Argentina and

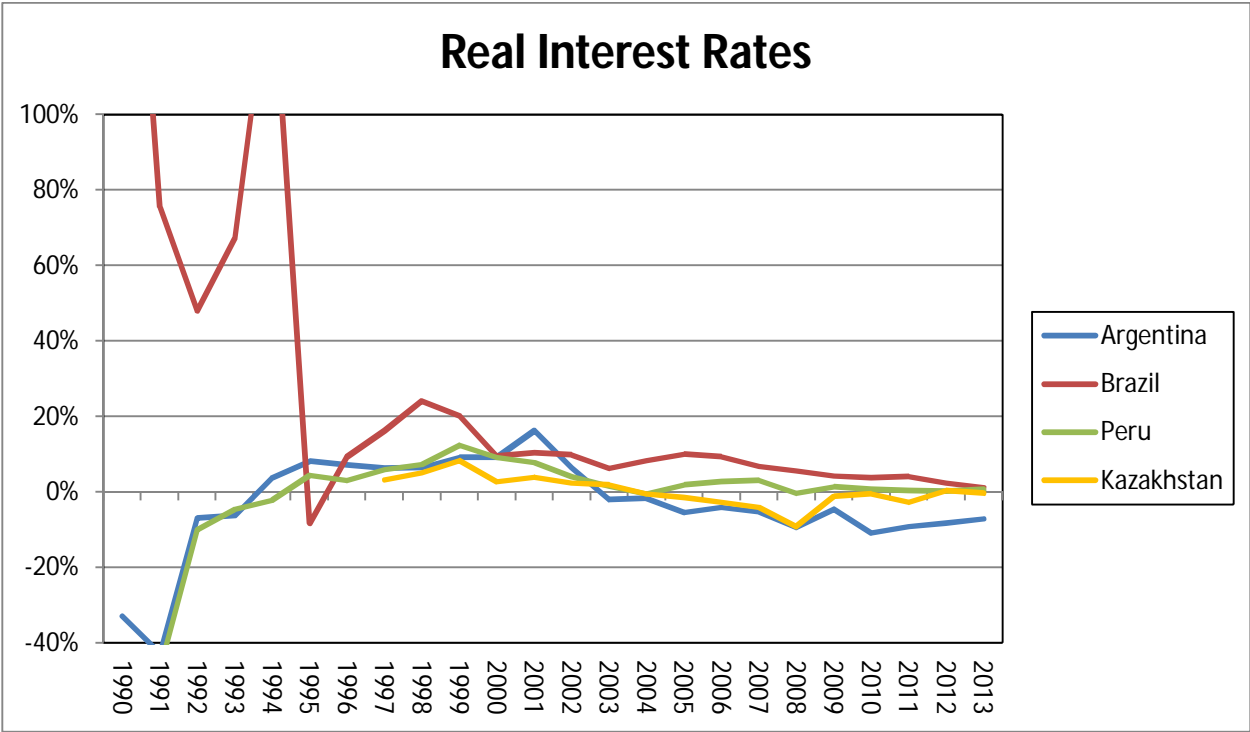
Perú during the 90's. From 2003 onwards, the dollarization of deposits has tended to decline as in Perú. When Kazakhstan went through a financial crisis in 2008 avoided doing what Argentina did in 2002, and the economy continued dollarized in a magnitude similar to that of Perú.



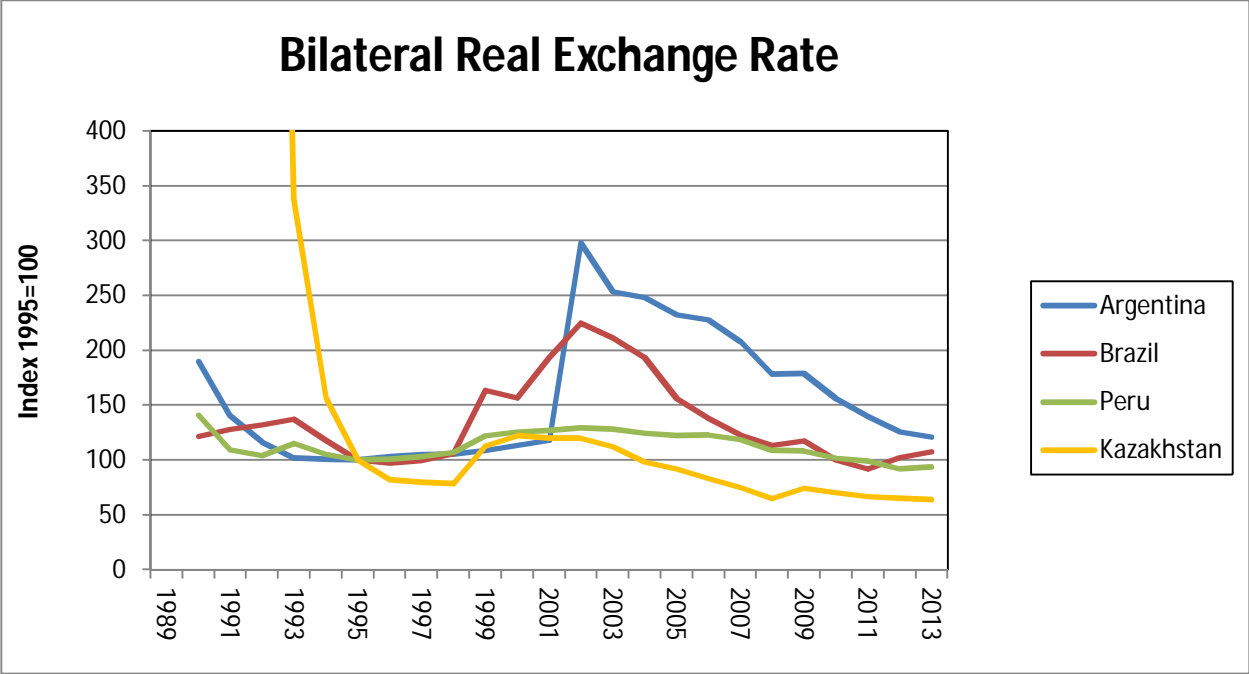
Dollarization in Kazakhstan helped to make the stabilization strategy credible as it did in Argentina and Perú and, thanks to the fact that Kazakhstan avoided compulsory de-dollarization at time of the 2008 crisis, it did not reintroduce double-digit inflation. On the contrary, after the crisis the inflation rate went down to levels similar to those prevailing before the crisis.



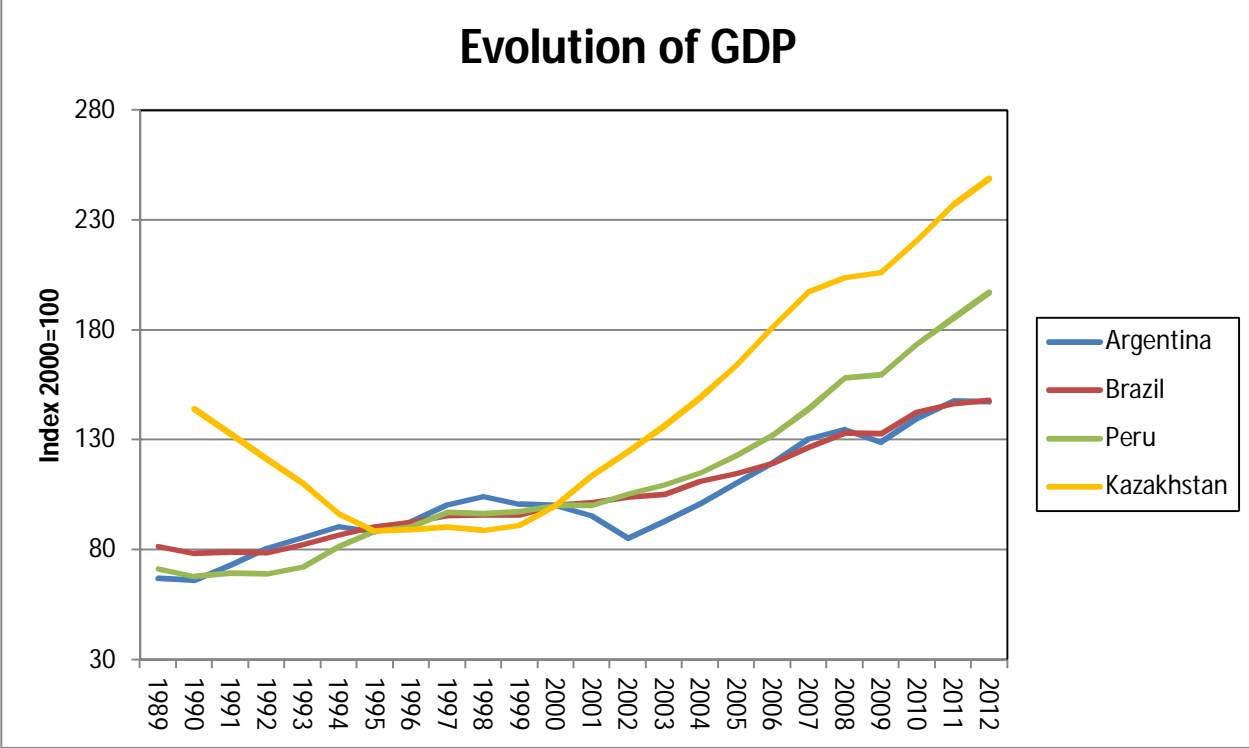
Real interest rates in Kazakhstan were similar to those of Perú and lower than those of Brazil. This was one of the benefits of dollarization.



The real rate of exchange has been almost as stable as that of Perú and, of course, much more stable than in Brazil and Argentina.



The growth performance has been impressive, especially during the 2000's. This can be clearly seen in the graph that shows the GDP index with base 2000=100



Conclusion

Dollarization should not be seen as a problem in Kazakhstan. On the contrary, dollarization will help the Tenge to become a much more credible currency over time. And, whilst happens, the use of the US Dollar will be marginalized in a natural way. The trend towards a naturally reduction in the degree of Dollarization is already evident in Kazakhstan as it has been happening since the mid 90's in Perú.

Prudent macroeconomic policies and efficient regulations should continue to be implemented as to avoid the re-emergence of financial crises but even if a financial crisis happens, Kazakhstan should avoid compulsory conversion of dollar denominated financial assets into Tenge's.

The creation of a common currency for the Custom Union could replace the Tenge but not the Dollar, at least until the moment in which the Ruble becomes a currency as credible as the Dollar. Being that the case, it is not evident that there are significant advantages in the creation of a common currency. The way to detect when the Ruble will become a convertible currency as credible as the Dollar would be to encourage the domestic use of the Ruble, not only the Dollar, in domestic financial intermediation of Kazakhstan and other highly dollarized CIS economies.