Forced de-dollarization is not a good option to speed up growth

Using the experience of Latin America to discuss this question for Turkey

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Motivation

This paper compares Turkish experience on financial dollarization and exchange rate policies with that of Latin American countries, mainly Brazil, Argentina and Peru. I came to the conclusion that this comparison can be useful, because I found in discussions on Turkish growth strategy the implicit suggestion that Turkey should imitate Argentina's decision in 2002 to encourage a large devaluation of its currency and, subsequently, to conduct monetary policy as to keep the currency undervalued for a long period of time.

In an article entitled "The Turkish economy after the Crisis"[2] Dani Rodrick, after emphasizing the importance of reducing the fiscal deficit, concludes that: *"If a shift in fiscal policy provides the first plank of the new growth strategy, a second would be the signaling of a new policy attitude towards the exchange rate. Currently, the official line is that the Central Bank intervenes in currency markets only to smooth short-term fluctuations, without taking a stand on the medium-term level of the exchange rate.*[3] *This has to be replaced with a clear statement of preference in favor of preventing overvaluation. The Central Bank, the Treasury and the Finance Ministry need to cooperate and coordinate when capital inflows threaten to push the value of the currency up."*

"The key point is that private sector saving and investment behavior is unlikely be transformed unless there is a credible shift in the policy regime with regard to both the fiscal stance and the exchange rate."

To support this conclusion, Rodrick presents "*two growth narratives which differ with respect to the nature of binding constraints faced by the Turkish economy and have conflicting implications for policy. The first narrative views financing as the key constraint while the second narrative emphasizes a profit squeeze in tradables. Depending on which of these one views as the dominant narrative, the approach to the external accounts and exchange-rate policy would take very different forms."*
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[1] Prepared for the 13th Forum Istanbul Annual Conference. The topic is "New Growth Strategies and Resources" and will be held in May 13-14, 2014 in Istanbul, Turkey.

[2] Dani Rodrik, "The Turkish economy after the crisis", Harvard Kennedy School, November 27, 2009

[3] See also: Ahmet Benlialper and Hasan Cömert, "Implicit Asymmetric Exchange Rate Peg under Inflation Targeting: the case of Turkey", Discussion paper 2013/11, http ://www.tek. org.tr; and Frenkel, R. and Rapetti, M. (2008), "Five years of competitive and stable exchange rate in Argentina, 2002-2007", International Review of Applied Economics Vol. 22, No. 2, March 2008, 215–226.

"As real-world counterparts to these two prototype economies, think of Brazil and Argentina. In Brazil, private entrepreneurs have no shortage of investment ideas and even with real interest rates at double-digit levels until recently, the investment rate stood relatively high. When the finance constraint is relaxed in Brazil, either because interest rates fall or foreign finance becomes more plentiful, domestic investment rises. Argentina is somewhat different. In that country, there is much greater uncertainty about the credibility of government policies and the stability of the rules of the game, so the tendency is for private investment to remain low, even when finance is plentiful and cheap. What fosters private investment in the Argentinean economic environment is a big boost in the relative profitability of tradables, which offsets these other distortions. So when the government actively managed the exchange rate in recent years to maintain an undervalued peso, the private sector responded with an investment boom in tradables—despite the continued lack of credibility in government policies. The Argentinean economy grew rapidly—more rapidly in fact than Brazil's economy."

"As these examples illustrate, identifying desirable economic policies requires taking a stand on the nature of the binding constraint. If the binding constraint is finance, we should look kindly on capital inflows and moderately large current account deficits, even though they are likely to produce currency appreciation and overvaluation. The costs of overvaluation are likely to be more than offset in this instance by the benefits in the form of increased availability of investible funds. For an economy like Brazil, it is more important to stimulate finance than it is to enhance returns. But the same set of policies would be disastrous in Argentina. Capital inflows and currency appreciation would not spur domestic investment (at least not in tradables); they would instead lower domestic saving and boost consumption (as they did indeed in the 1990s).The question that faces Turkey, then, is essentially this: Is Turkey more like Brazil or more like Argentina?"

Even though Rodrick does not say explicitly that the case of Turkey resembles more that of Argentina, its main conclusions suggests that that is what he really thinks.

Everybody agrees that it is important for a country like Turkey to eliminate the fiscal deficit. That, by itself, will help to generate significant public sector savings and to avoid overvaluation of the currency.

What worries me about the second part of the advice is that in a highly dollarized economy, like Turkey still is and as Argentina was until 2001, the only way to generate a large devaluation of the domestic currency is through a forced de-dollarization of the economy. So, even though nobody explicitly says it, if Turkey were to suffer a sudden stop and a new financial crisis, the advice to look for and maintain a "competitive exchange rate", would be read as advocating forced de-dollarization 'a la Argentina 2002'.

This evolution of the advice should not surprise the economic profession. Financial crises in highly dollarized emerging economies and in several countries of the Eurozone have 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[4].

In Turkey, like in Argentina in 2002, the political justification for a forced de-dollarization may also come from the many evidences that a large devaluation of the Turkish Lira aggravates financial crisis due to

[4] See, for example, Nouriel Roubini, "Greece should default and abandon the euro", http://blogs.ft.com/the-a-list/2011/09/19/greece-should-default-and-abandon-the-euro/

the high degree of liability dollarization of the non-financial corporate sector[5]. So if financial assets and liabilities are converted from dollar into liras at the exchange rate pre devaluation, the government would be killing two birds with one shot: it would alleviate the financial crisis and it would be inaugurating a growth strategy based upon a “competitive exchange rate”.

The purpose of this paper is to evaluate such a growth strategy for Turkey based on the experience of Latin American countries. Does Financial Dollarization help or hindrance anti-inflationary programs that pretend to deliver sustainable price stability? Could a financial crisis be solved by a forced de-dollarization of financial contracts? Would that contribute to the inauguration of a successful growth strategy? These are the central questions to be discussed.

The conclusion of this paper is that forced financial de-dollarization would create in Turkey, like it did in Argentina, many more problems than those that it would solve.

Dollarization in Latin America

In emerging economies, financial dollarization is normally a consequence of extreme price and exchange rate instability associated with hyperinflation. In Latin America several countries became and remained largely dollarized. They are Bolivia, Paraguay, Peru, Uruguay and, more extremely, Ecuador that has become a fully dollarized economy.

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.

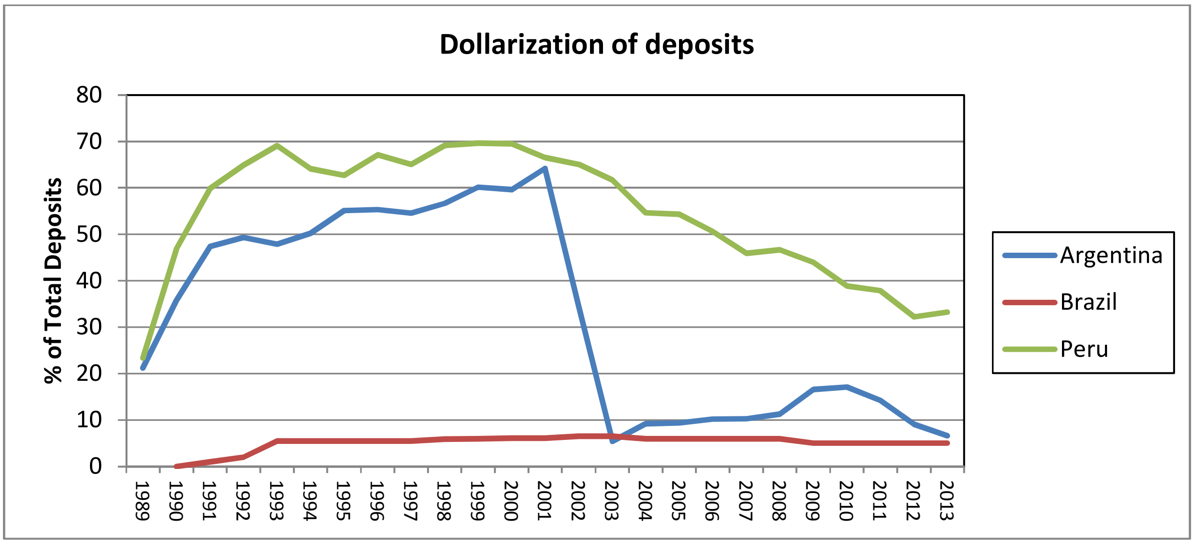
Brazil is the only country that went through large periods of hyperinflation and managed to avoid dollarization. It did so, through a combination of an early ban on use of foreign currencies for domestic financial transactions, widespread price indexation of domestic financial assets and high real interest rates. Chile, Colombia and Venezuela never suffered hyperinflation[6] and, particularly in Chile, that did have high inflation until the mid-70, an efficient financial indexation system, the UFO (“Unidad de Fomento”), helped to protect the savings of its people kept in the local currency.

The experience of Argentina, Brazil and Peru

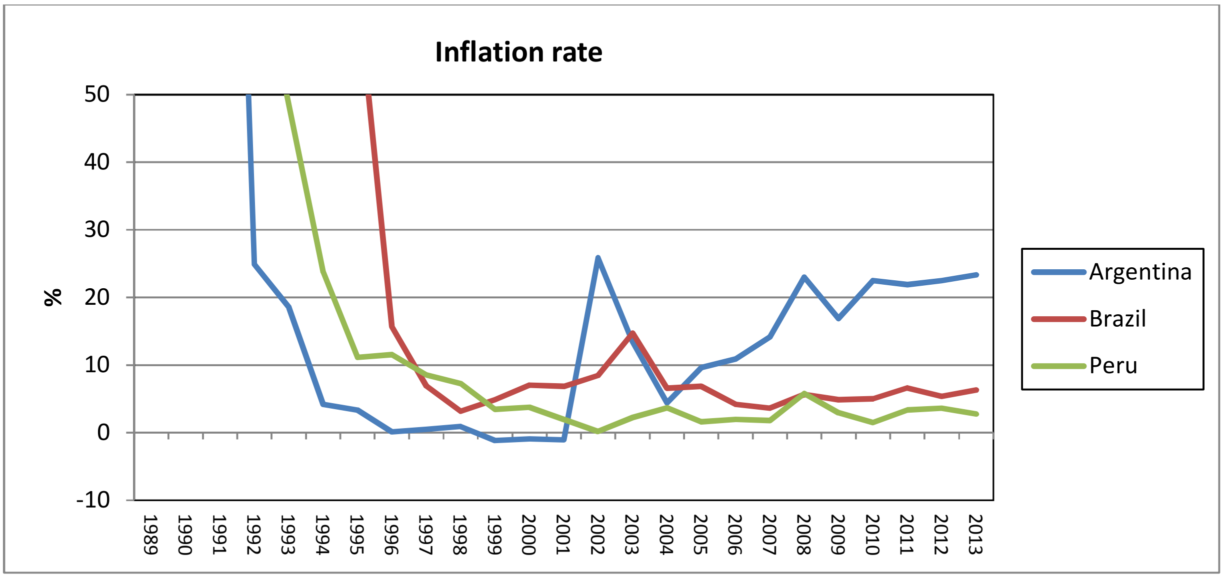
We will start analyzing the experience of Argentina, Brazil and Peru, and then we will add additional information from the experiences of Bolivia, Ecuador, Paraguay and Uruguay.

[5] See, for example Mehtap Kesriyeli a , Erdal Özmen b & Serkan Yigit, “Corporate sector liability dollarization and exchange rate balance sheet effect in Turkey”, http://www.tandfonline.com/loi/raec20

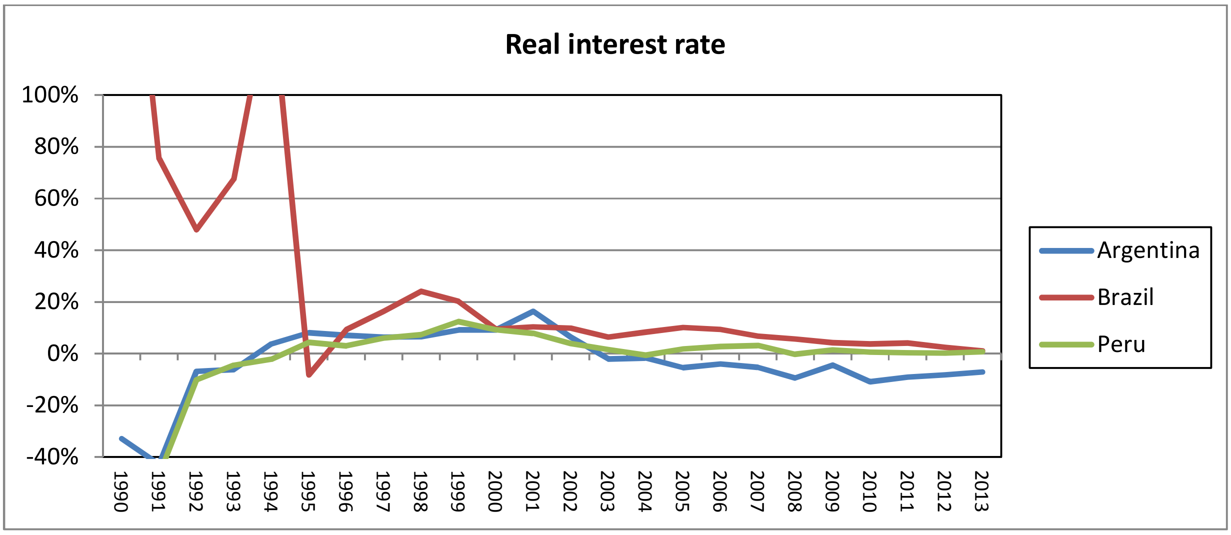
[6] Venezuela may suffer hyperinflation in the near future as a consequence of the mismanagement of it economy during the last 15 years.



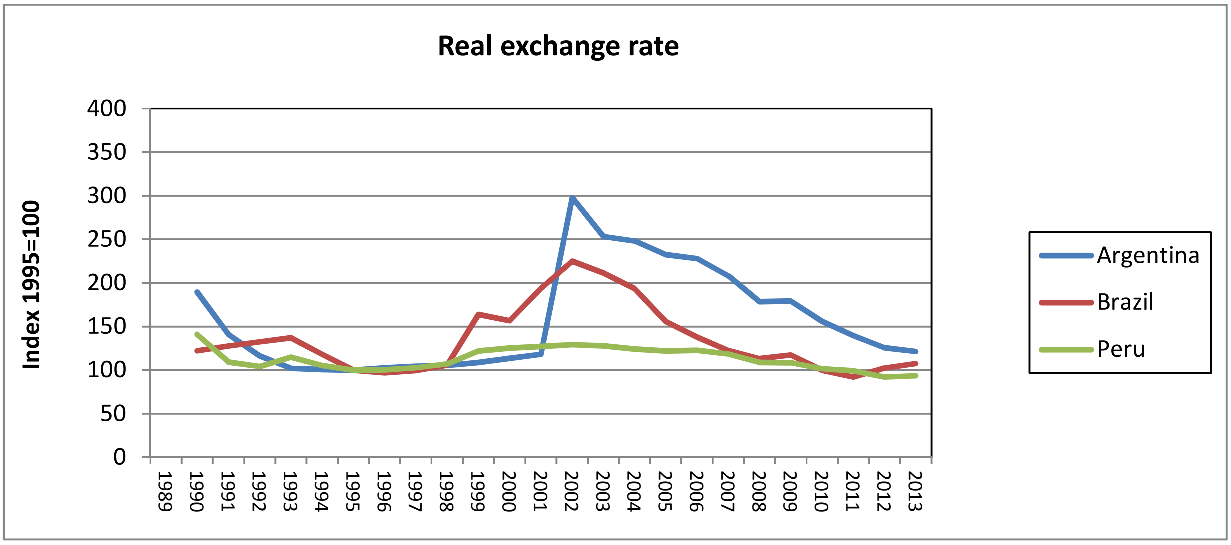
The experience of Argentina, Brazil and Peru shows that Dollarization can be very helpful to implement a stabilization program. In economies with very high inflation, the key to achieve price stabilization is finding effective ways to stabilize the exchange rate. Any commitment to a monetary policy that 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 Peru (all along). Higher inflation in Argentina after 2002 is related to the compulsory de-dollarization decided that year by the Government.



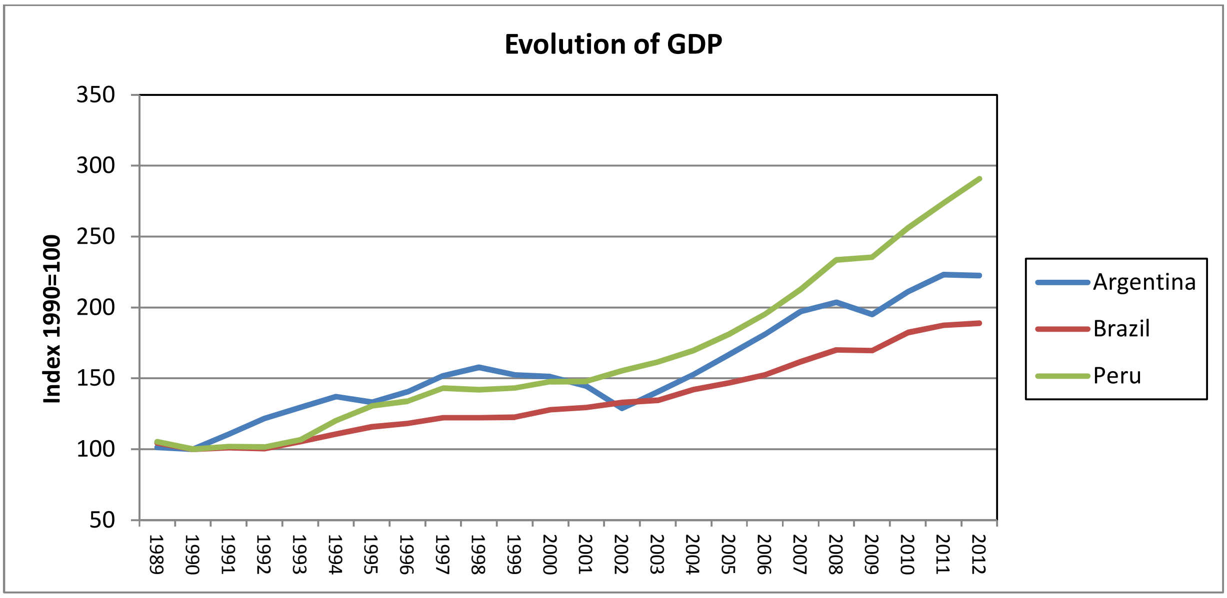
Brazil needed to maintain much higher real interest rates than Peru and Argentina to achieve stabilization and keep inflation low. Largely dollarized economies can stabilize their price levels and keep inflation low with lower real interest rates.



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

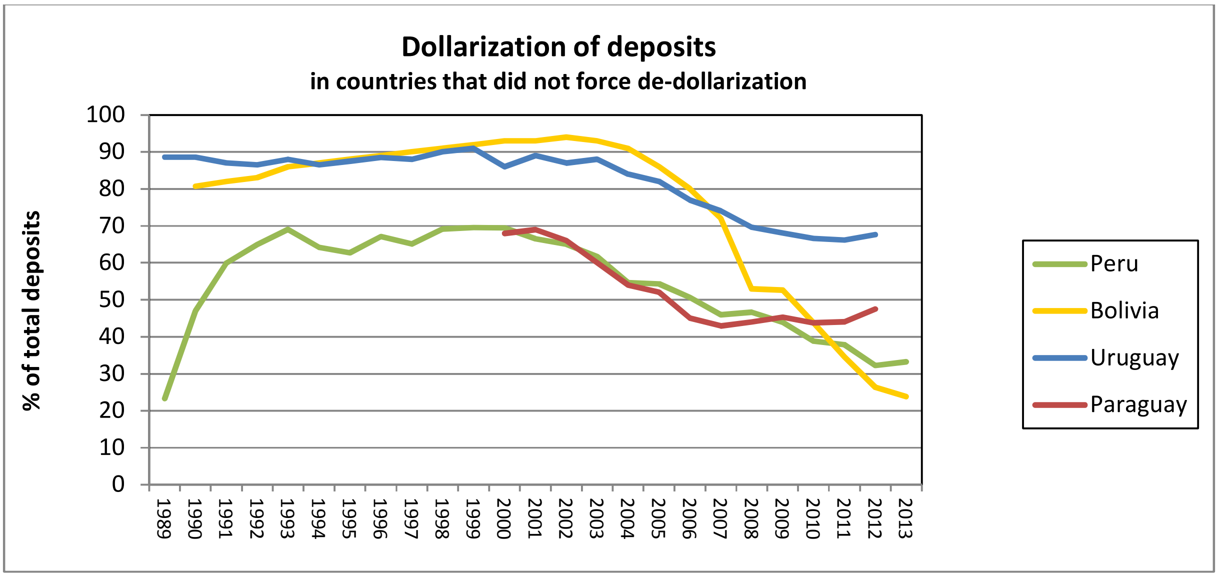


Growth performance was superior in highly dollarized economies. This may be related, among other things, to the fact that real interest rates can be kept lower in dollarized economies.



The experience of Bolivia, Ecuador, Paraguay and Uruguay corroborates the conclusion that financial dollarization helps to achieve and maintain low inflation. In the appendix we have added the respective graphs.

It is very interesting to note that the countries that started with very high degree of dollarization and were able to stabilize and keep inflation low (Bolivia, Paraguay, Peru and Uruguay) experienced a gradual process of de-dollarization, something very different from the forced de-dollarization imposed by the Argentinean government in 2002.



So far, the experience of Latin American countries 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 widespread 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.

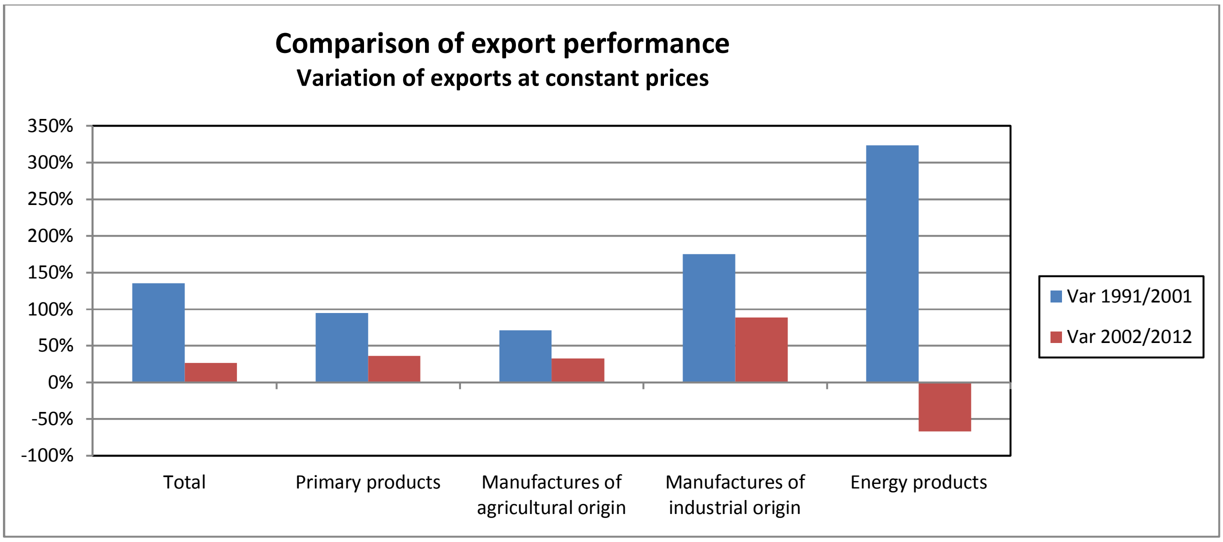
Unfortunately, instead of fixing the debt problem in an orderly way and changing the monetary rule to allow for a more flexible inflation targeting, the new authorities that emerged from the political crisis of December 2001 opted for a disorderly debt default and a change in the monetary regime. The 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.

Furthermore the "competitive exchange rate strategy" applied since 2003 in Argentina, did not encouraged investment in tradables, at least not in exportables. On the contrary, contradicting Dani

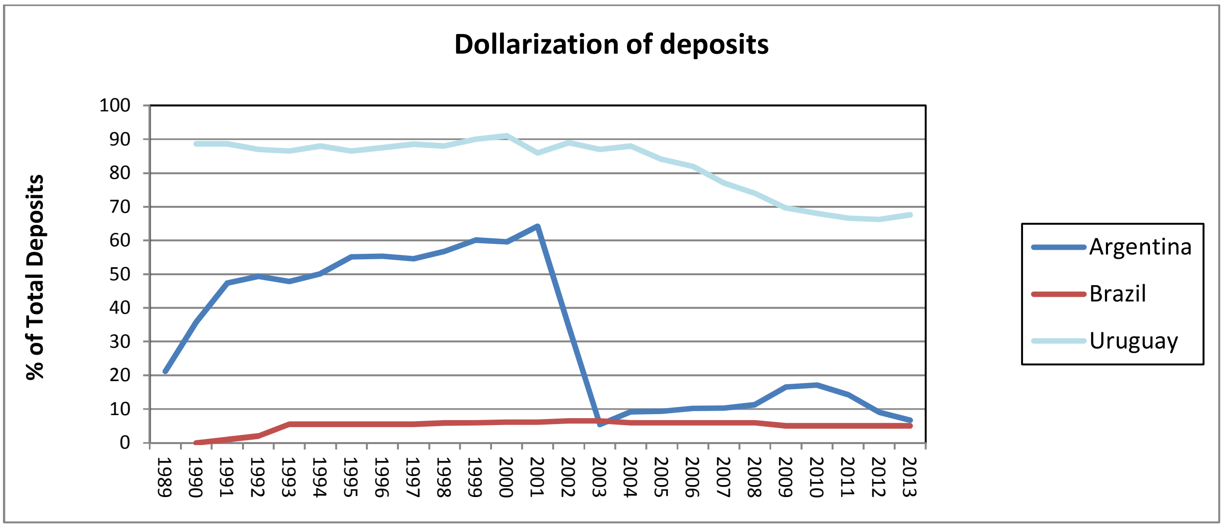
Rodrick's statement in his 2009 article[7], export performance (in constant value terms) was significantly inferior during the "competitive exchange rate experience" of the 2000's than during the "convertibility plan experience". Look at the comparison in export performance during the two periods.

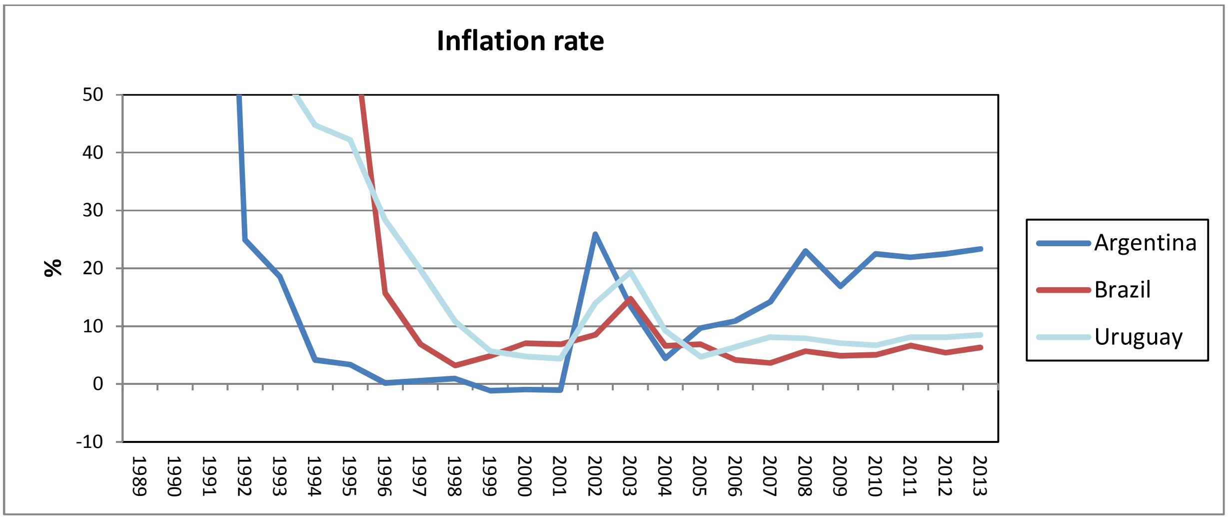


The experience of Uruguay

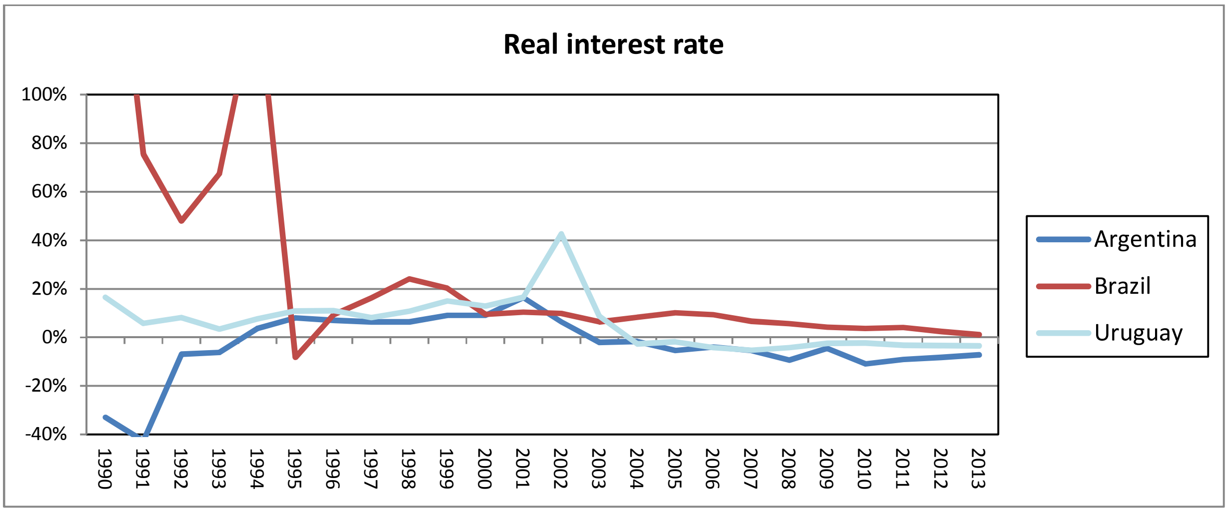
Uruguay shows that when a financial crisis arises, it can be solved without forced de-dollarization. It also shows that solving the financial crisis maintaining the dollar as an alternative currency in financial intermediations helps to keep inflation low without sacrificing growth. Look at the same plots which include Uruguay and exclude Peru. That is, a comparison between the performances of Brazil and two originally highly dollarized economies that suffered financial crises in 2001-2002: Argentina and Uruguay. Argentina defaulted on its public debt and implemented a forced de-dollarization; Uruguay conducted an orderly process of debt restructuring and kept its economy semi dollarized.

[7] Probably, Dani Rodrick was confused by looking at the variation in exports in nominal terms, but the higher variation during the 2002-2012 period came from much higher export prices, not an increase in exports in real terms.

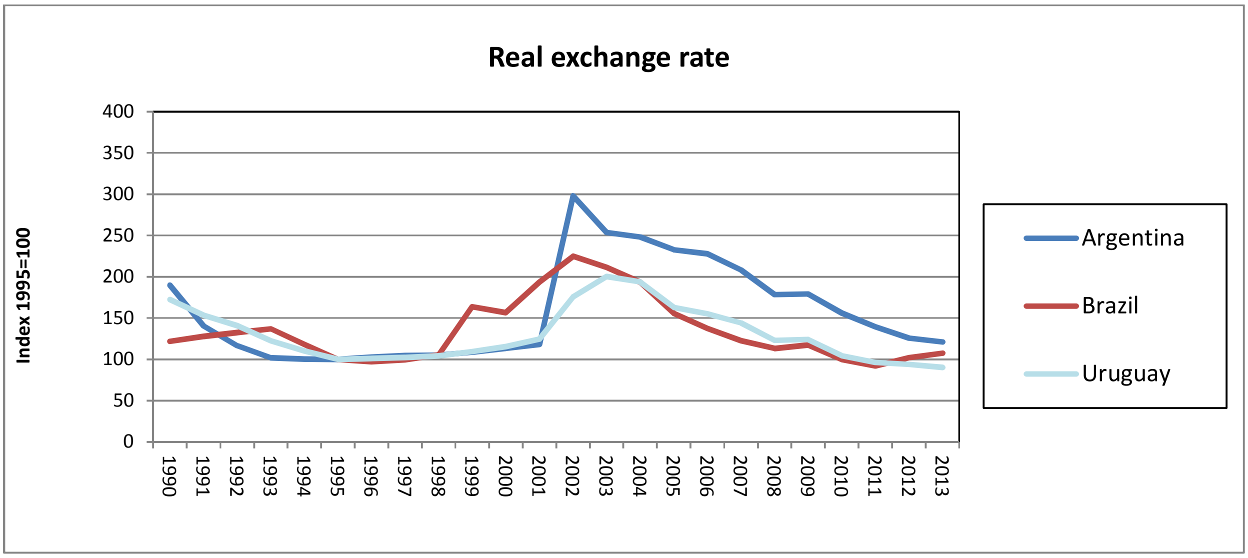




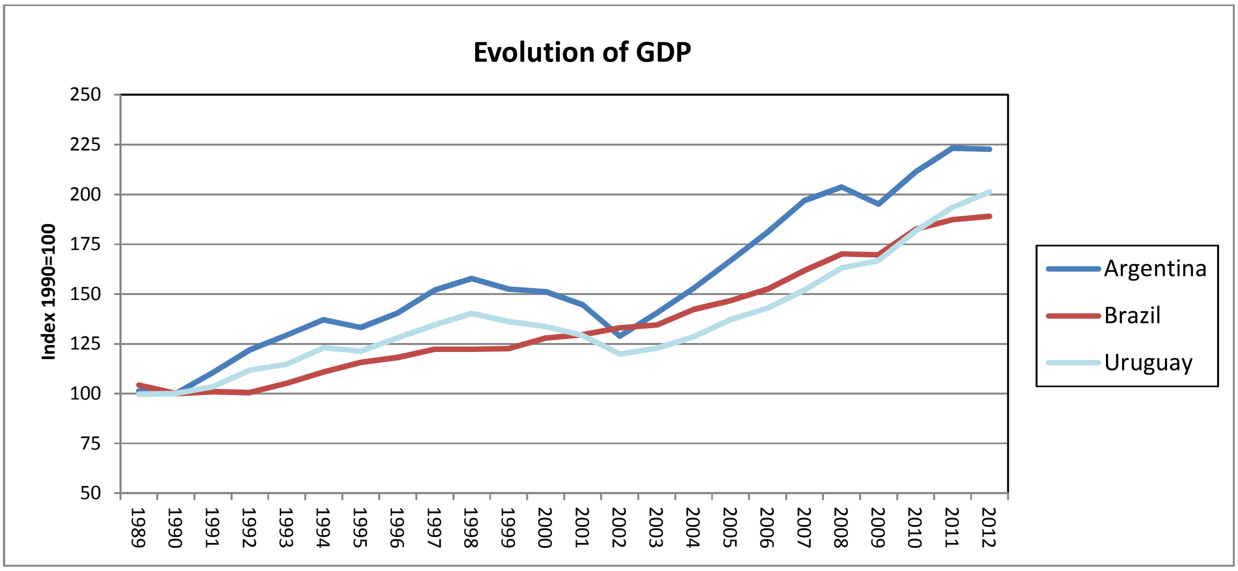
Even though the devaluation provoked a jump in the inflation rate in 2002 and 2003, since 2004 on the inflation rate was kept at one digit levels. That is, the fact that Uruguay conducted an orderly debt restructuring and maintained dollarization helped to avoid the acceleration of inflation observed in Argentina after 2004.



Real interest rate could be kept, most of the time, much lower than in Brazil. The higher real interest rate in 2002 and 2003 was the consequence of the financial crisis imported from Argentina and were required to avoid an extreme devaluation like the one that Argentina suffered in 2002. As a consequence, the real rate of exchange went up in 2002 and 2003, but less than in Argentina and Brazil.



GDP growth was slightly higher than in Brazil and lower than in Argentina. Much of the difference with Argentina happened during the 90's when Argentina implemented more growth enhancing reforms than Uruguay.



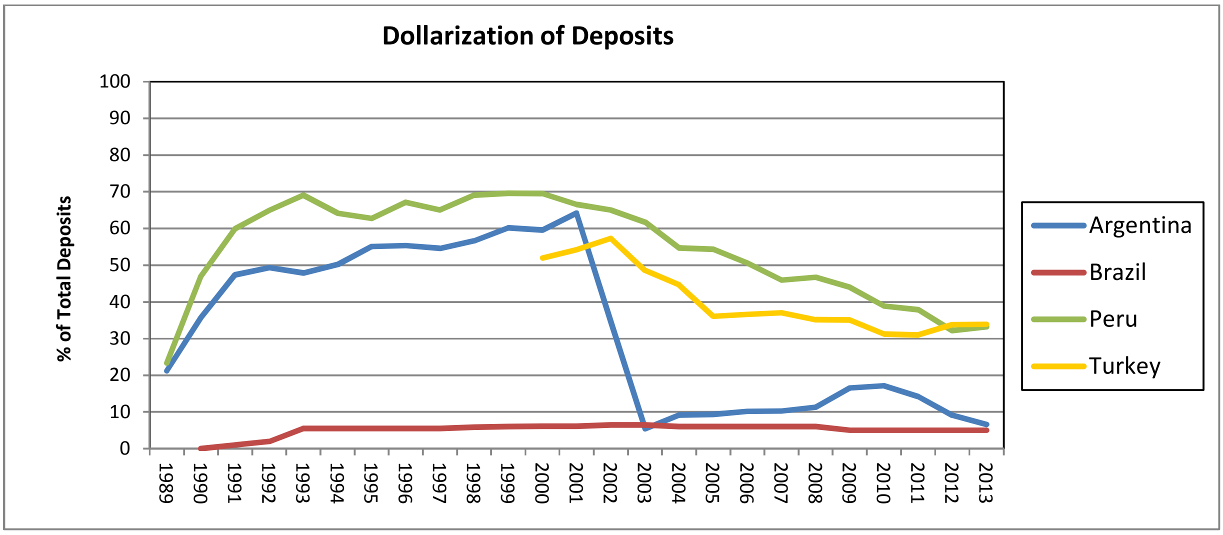
Latin American Lessons on Dollarization relevant for Turkey

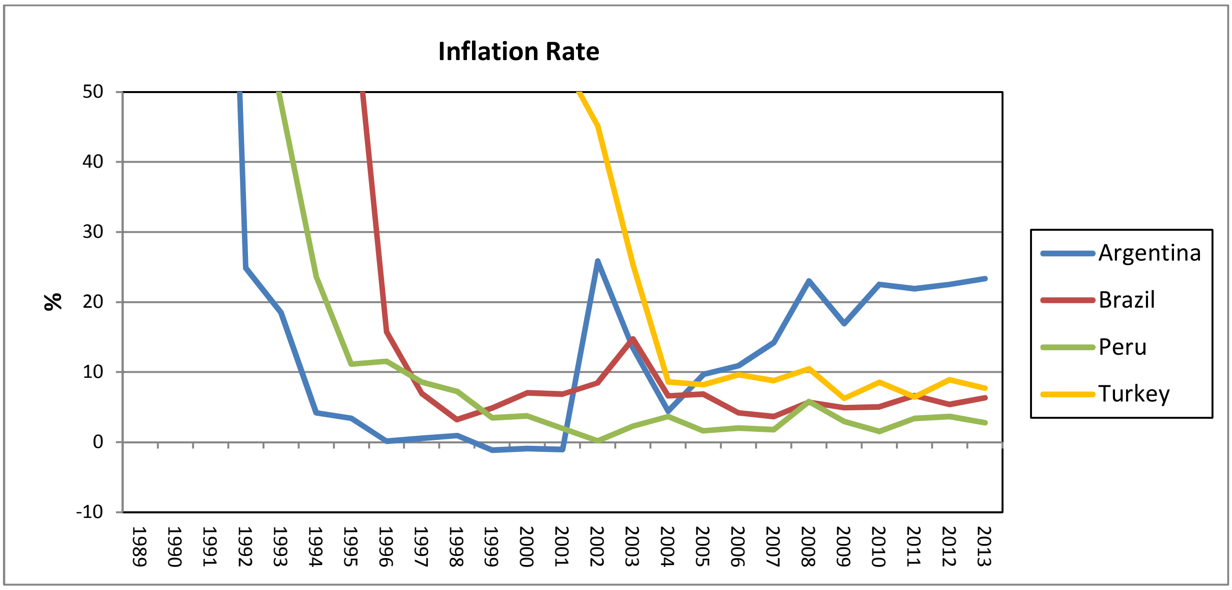
The experience of Latin America suggests that the best course of action for an economy that became highly dollarized at time of hyperinflation is to take advantage of large dollarization to stabilize the economy - as Bolivia did in the mid 80's, Argentina, Peru and Paraguay in the early 90's, Uruguay in the mid 90's and Ecuador in the early 2000'- and afterwards, to pursue prudent macro-economic and regulatory policies to prevent financial crises. And, if the financial crisis eventually comes, compulsory de-dollarization should be avoided.

The lesson learned from the experience of Latin American Countries in relation to financial dollarization and stabilization is very relevant for Turkey.

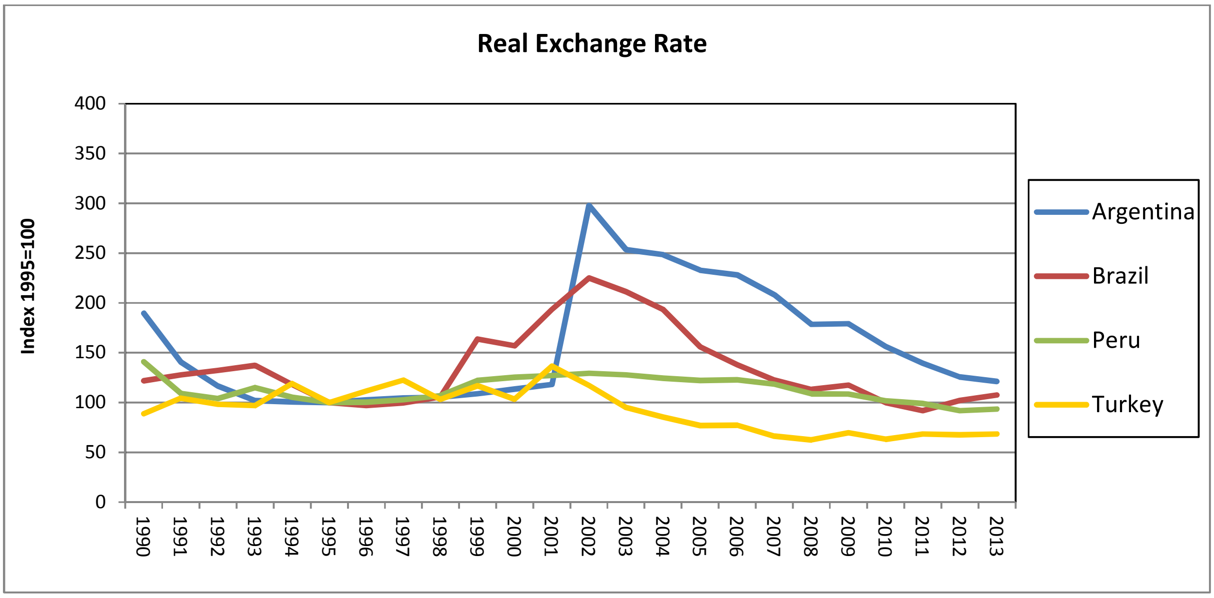
Fortunately, so far, Turkey resembles much more Bolivia, Ecuador, Paraguay, Peru and Uruguay than Argentina. As Bolivia, Ecuador, Paraguay, Peru and Uruguay, Turkey has taken advantage of dollarization to reduce the inflation rate after the crisis of 2001. As, in those countries, thanks to the progress in reducing the inflation rate there has been a natural process of de-dollarization that reflects increasing trust in the local currency rather than the effect of repressive restrictions on the use of the Dollar as a second currency.

Argentina, that had been very successful in using dollarization to stabilize the economy made the mistake of trying to solve the financial crisis of 2001 by compulsory de-dollarizing. As a consequence Argentina reintroduced inflation as a chronic problem into its economy.

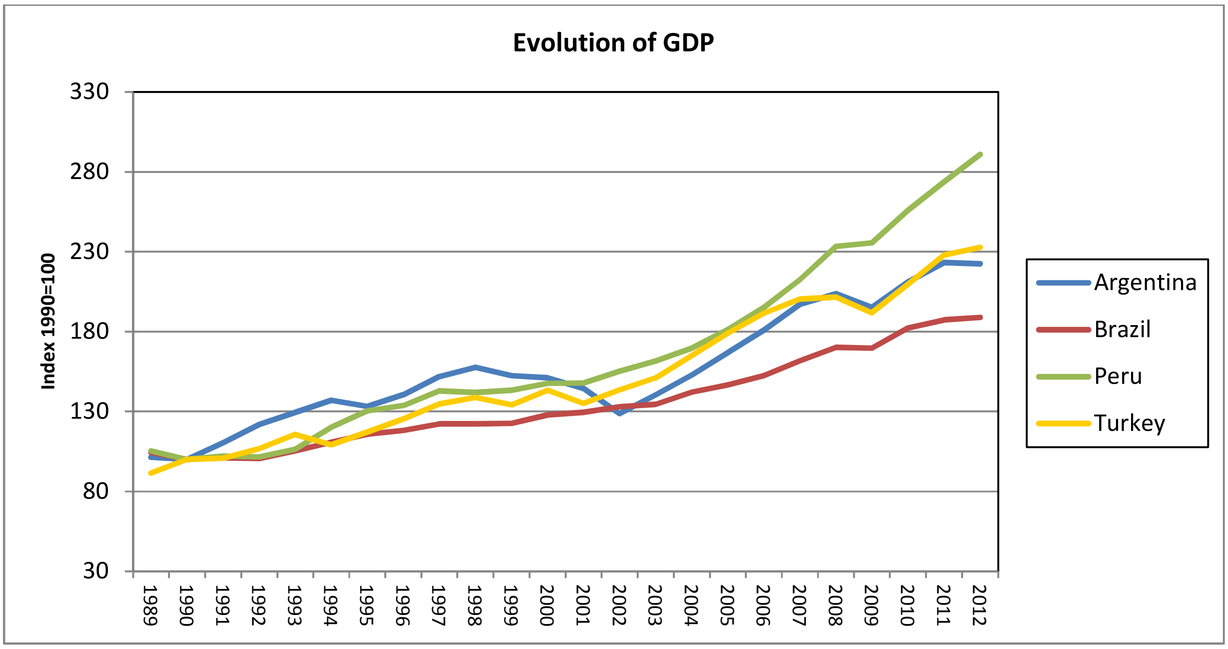




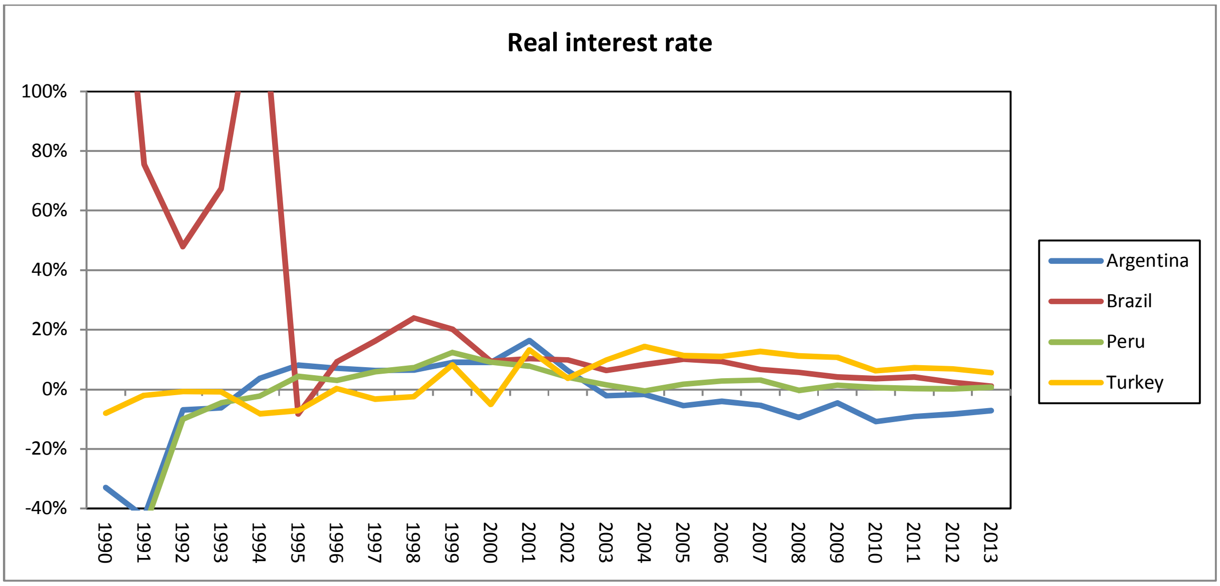
After the crisis of 2001, Argentina implemented a large real devaluation through monetary mechanisms and kept its currency undervalued for several years, while the Turkish Lira appreciated in real terms.



Contrary to what Dani Rodrick and others argue, Argentina did not get a significant advantage in terms of growth performance as compared to that of Turkey by trying to keep its currency undervalued after a large real devaluation implemented via monetary policy. On the contrary, while both countries had crisis in 2001, in the post crisis Turkey outperformed Argentina. On the contrary, Argentina outperformed Turkey during the 90's, when the Argentinean Peso was appreciating in real terms and that of Turkey remained fairly stable.



The only indicator of a weakness of the Turkish economy as compared to those of Argentina and Brazil is the larger negative effect of the global financial crisis on Turkish GDP. This may very well be related to the greater openness of the Turkish economy to both, trade and capital markets, but it may also be related to the fact that financial dollarization doesn't seem to have helped Turkey to manage inflation targeting avoiding high real interest rates. Actually, Turkey had to admit real interest rates higher not only than those of the highly dollarized economies of Latin America (like Peru, for example) but even higher than the real interest rates of Brazil.



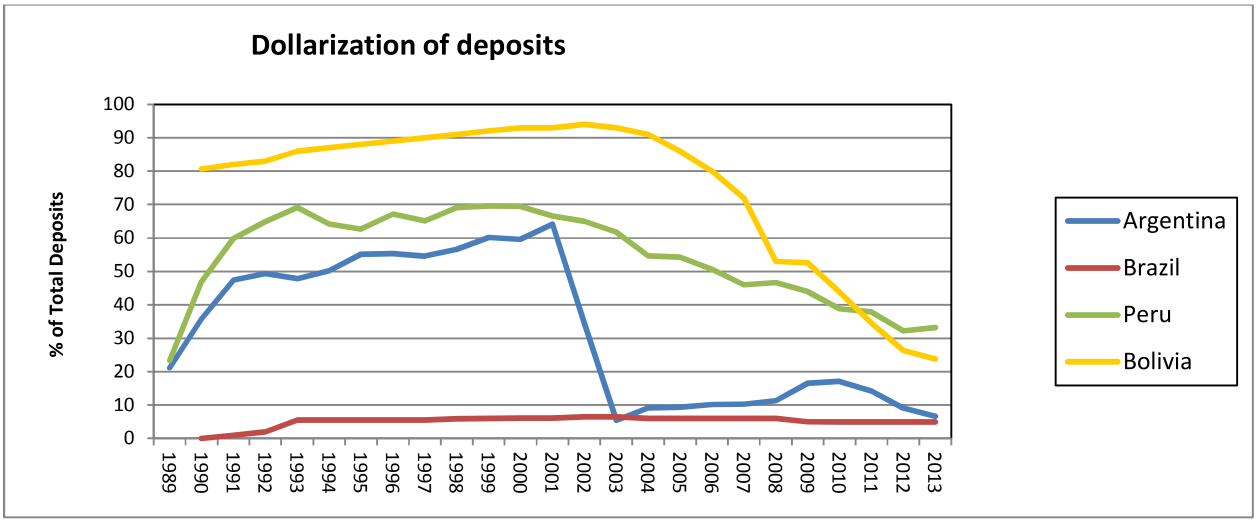
The two aspects on which Turkish economy behaves differently to that of Peru, the most successful of all the Latin American economies analyzed in this paper, are the real exchange rate and the real rate of interest. Turkey shows a stronger trend toward real appreciation inflation than Peru does. At the same time Turkey needs to keep higher real interest rates than Peru to target low inflation. This contrast is in line with the worries expressed by Dani Rodrick in his paper on post-crisis growth in Turkey. The way to cope with these two weaknesses of the Turkish economy is through fiscal policy. A smaller fiscal deficit that will generate higher public savings together with tax policies that encourage higher private savings will help to dampen the trend towards currency appreciation and, at the same time, help to reduce real interest rates.

This paper demonstrates that a forced de-dollarization of the Turkish economy 'a la Argentina 2002' is not the appropriate way to achieve those results. On the contrary, it would for sure reintroduce high inflation into the economy and generate the same king of problems that today are affecting the economy of Argentina.

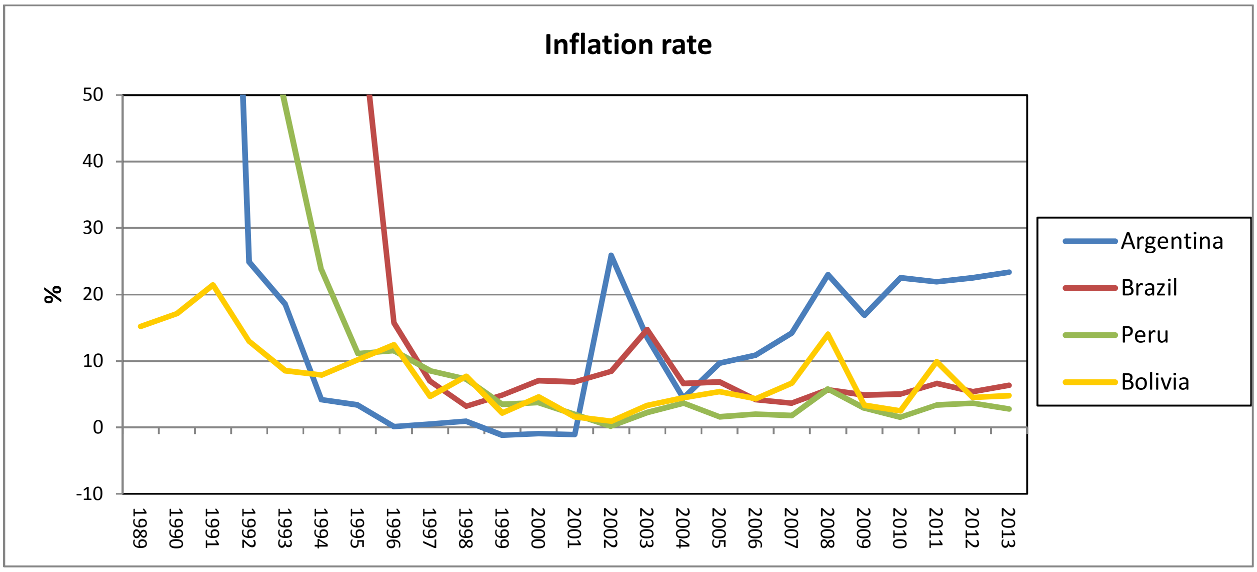
Appendix:

Dollarization, stabilization and growth in Bolivia

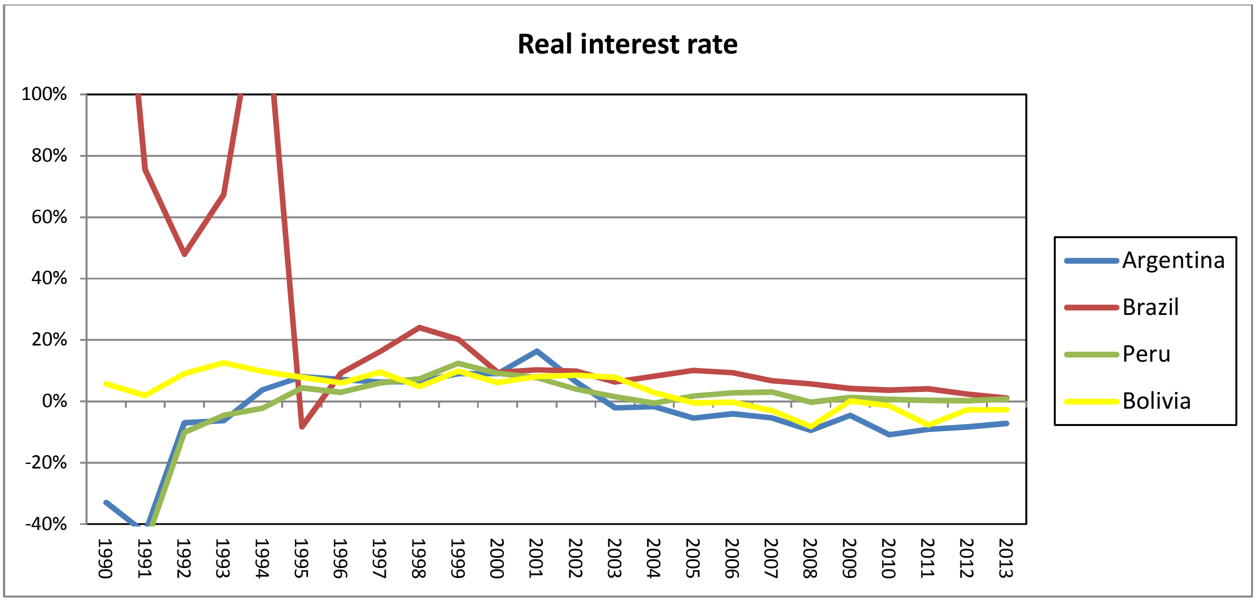
Bolivia, that stabilized its economy 5 years earlier than Peru and Argentina, kept a very high degree of dollarization until the 2000's and afterwards enjoyed a natural process of de-dollarization as its currency became increasingly trusted by its people. De –dollarization was never forced like Argentina did in 2002.



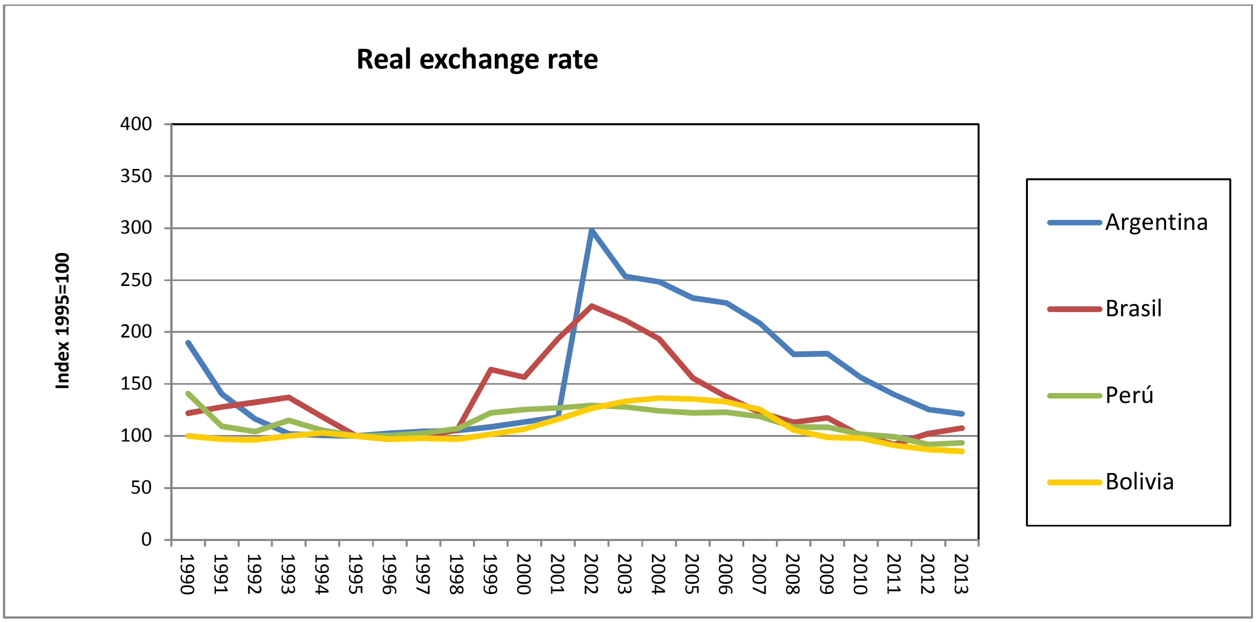
Bolivia was able to keep inflation low most of the years. The picks of 2008 and 2011 are related to increases in the prices of food. Bolivia imports a lot of foods and the domestic supply very often is affected by unfavorable weather conditions. But the general picture is one of inflation not higher than in Brazil and much lower than in Argentina during the last 12 years.



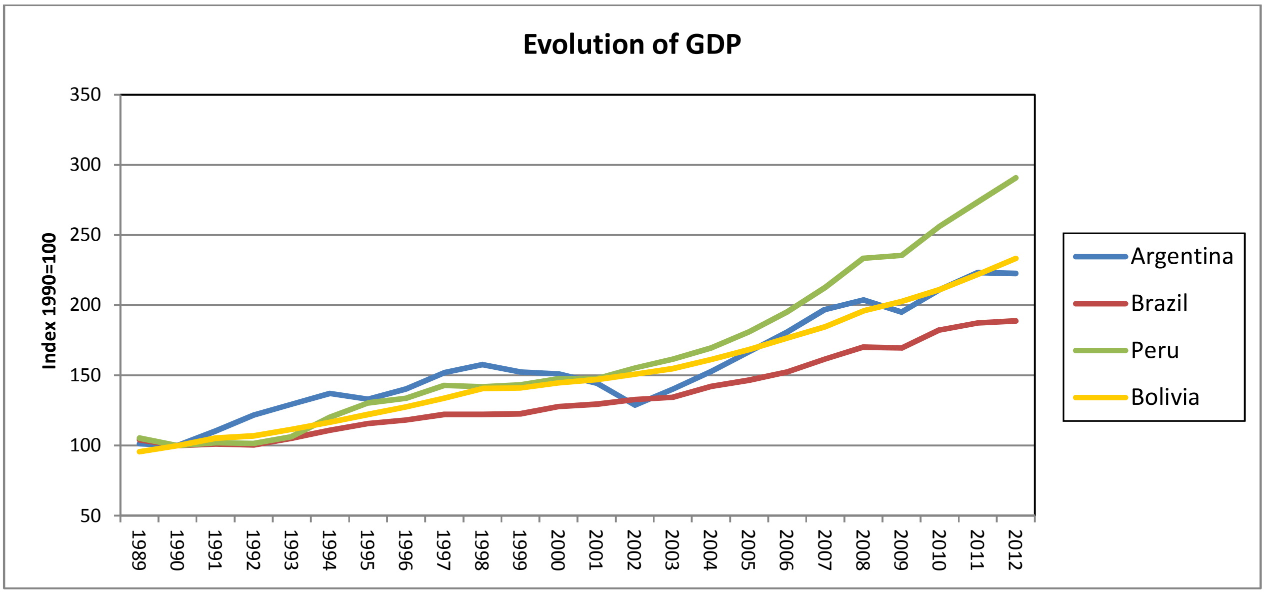
In real terms interest rates were kept much below the levels that Brazil needed to accept in order to keep inflation low.



The real rate of exchange was as stable as that of Peru; of course, much more stable than in Brazil and Argentina.

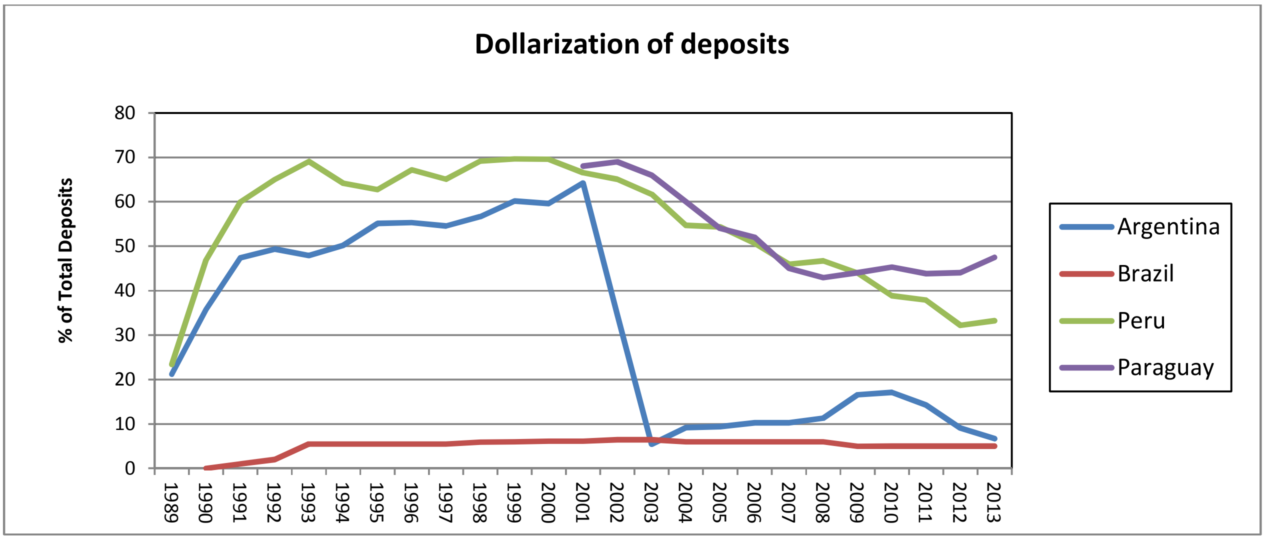


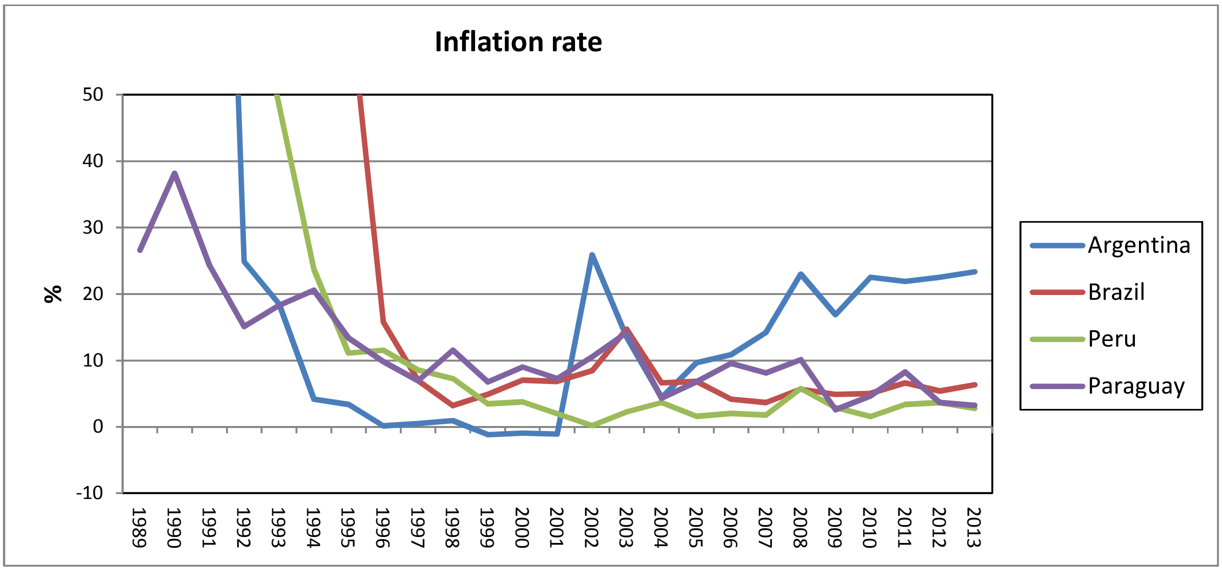
The growth performance of Bolivia during the period 1990-2013 was superior to that of Brazil and similar (o average) and more stable than that of Argentina.



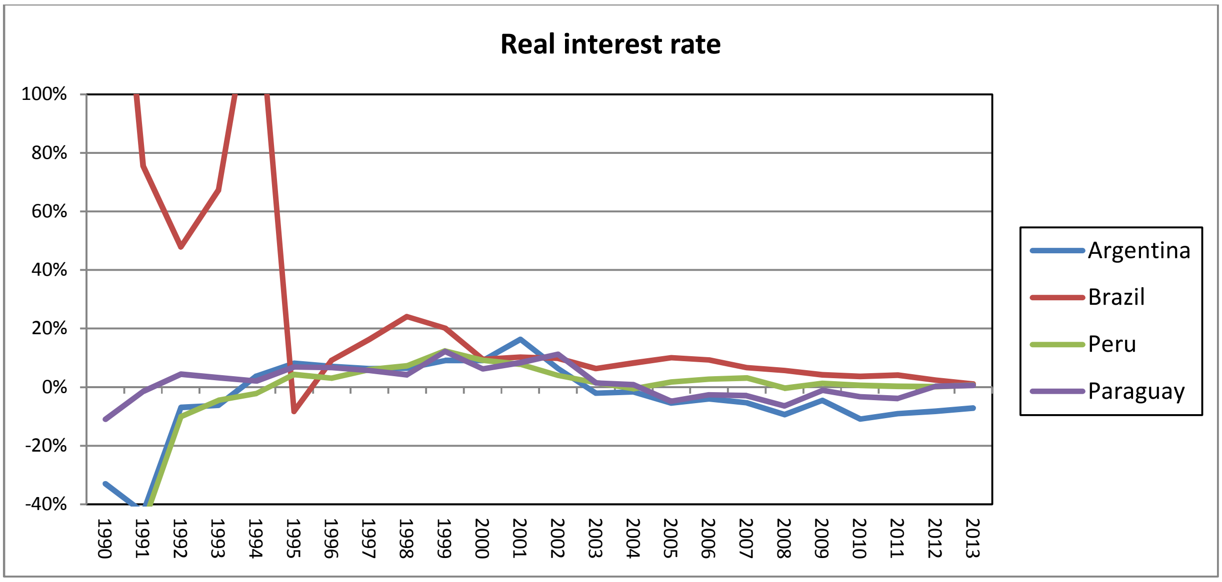
Dollarization, stabilization and growth in Paraguay

Monetary and real events in Paraguay, like in Uruguay, are significantly affected by what happens in neighboring Brazil and Argentina. So the performance of its economy cannot be very different than that of its two larger neighbors. But it is clear that dollarization helped Paraguay to avoid the higher inflation Argentina suffered after 2002.

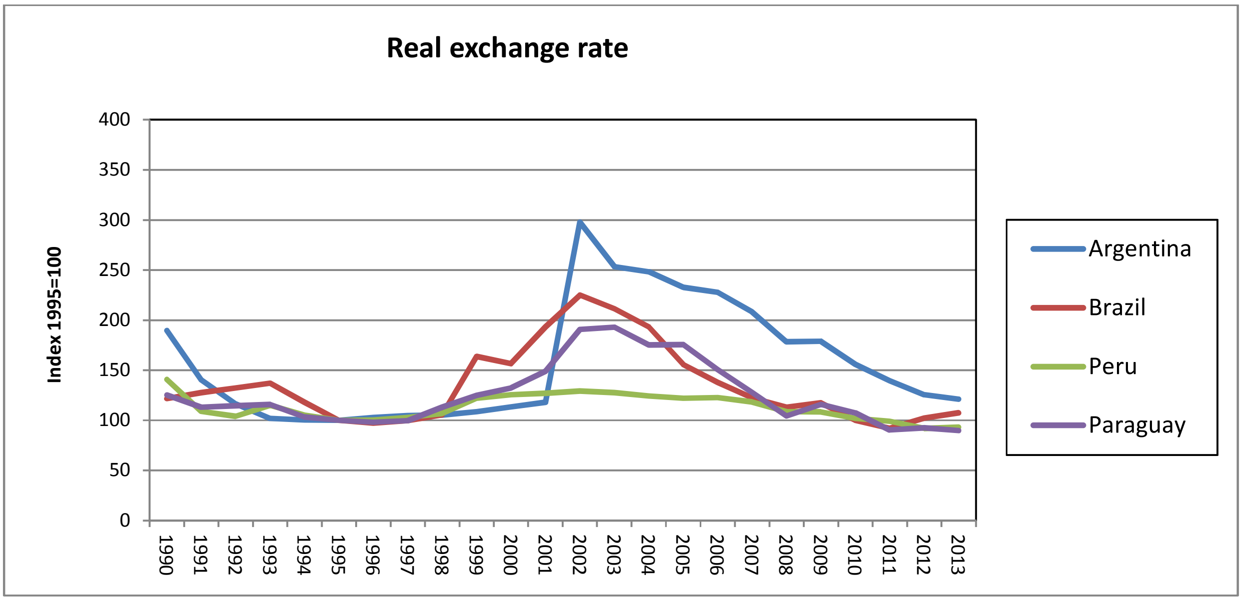




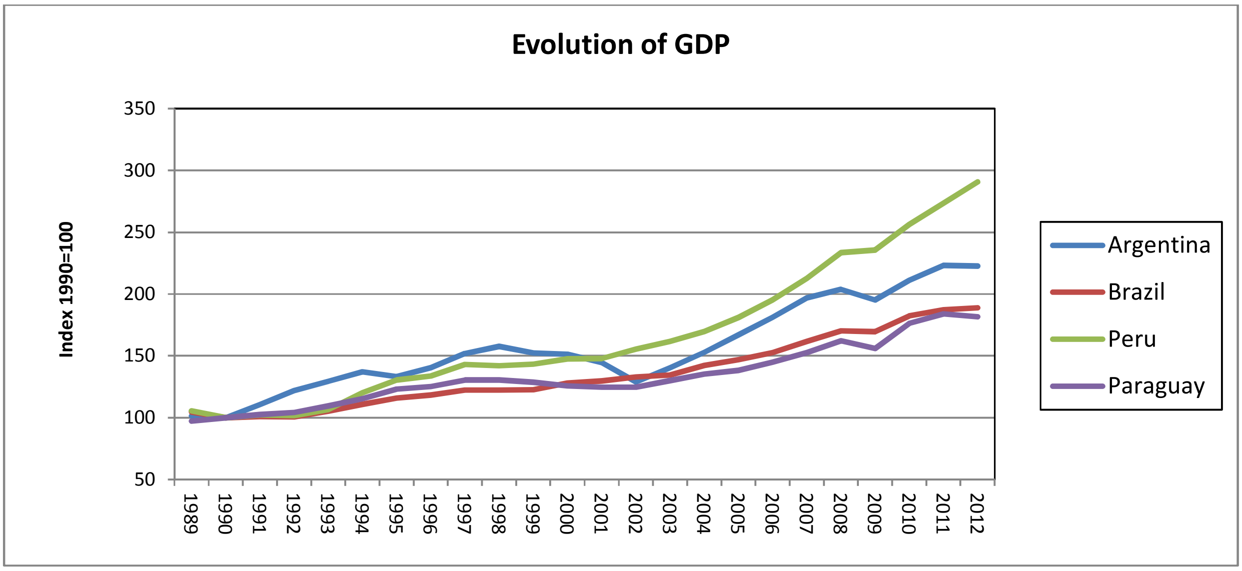
Paraguay could manage lower real interest rates than those required by the targeting of inflation in Brazil.



Even though it could not avoid the instability in the real exchange rate associated with the big devaluations of the Brazilian Real and the argentine Peso, overall the real rate of exchange was much more stable in Paraguay than in its two neighbors.

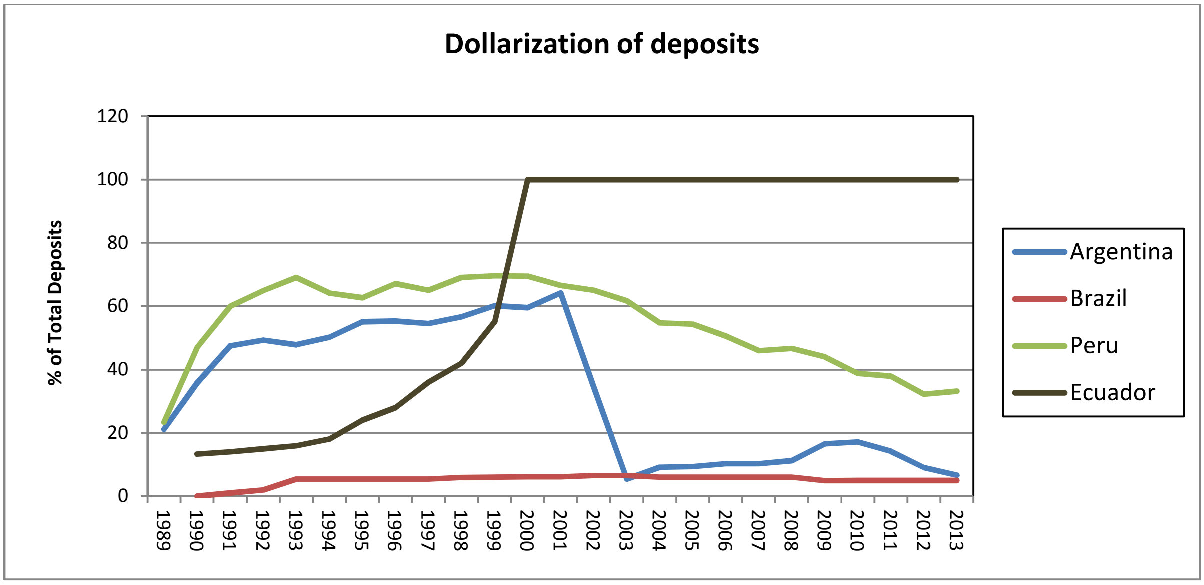


The growth performance was slightly inferior to that of Brazil and significantly inferior to that of Argentina and Peru. But this is not related to dollarization but to problems related to the low level of investment and of productivity growth. If to avoid dollarization hat to apply higher real interest rates like those of Brazil, the growth performance would have been even worse.

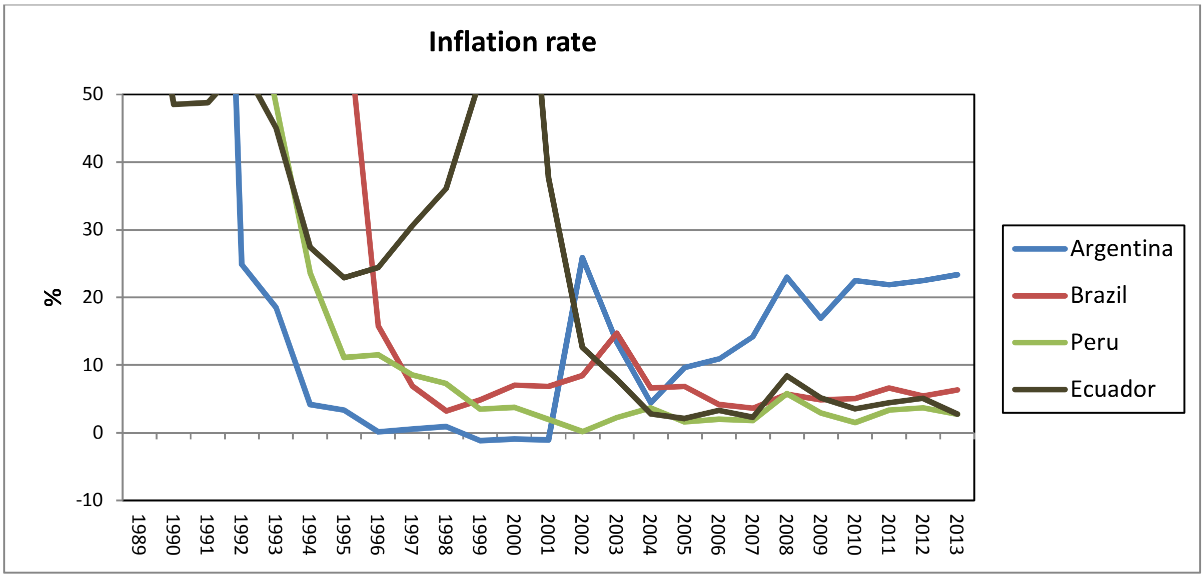


Dollarization, stabilization and growth in Ecuador

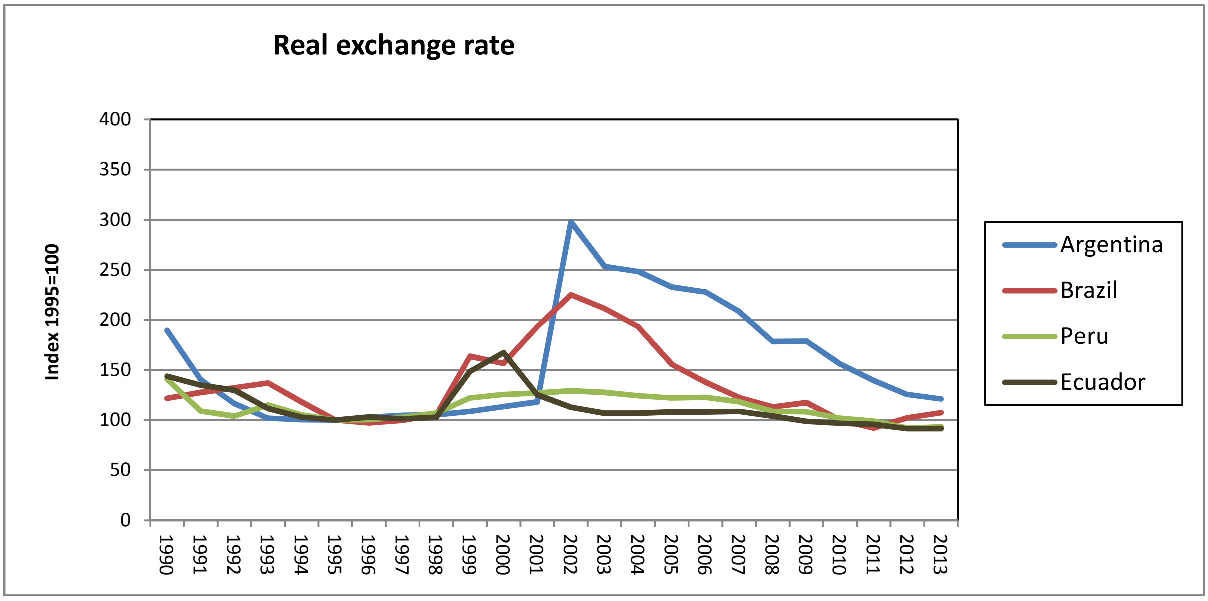
In Ecuador, the degree of dollarization increased during the 90's as the economy suffered a significant acceleration of inflation that, traditionally, had been not very different from that of its neighbor Colombia. It not only took advantage of the high degree of dollarization to implement its stabilization plan, but to defeat hyperinflation and create a climate of stability, it went all the way towards full dollarization.



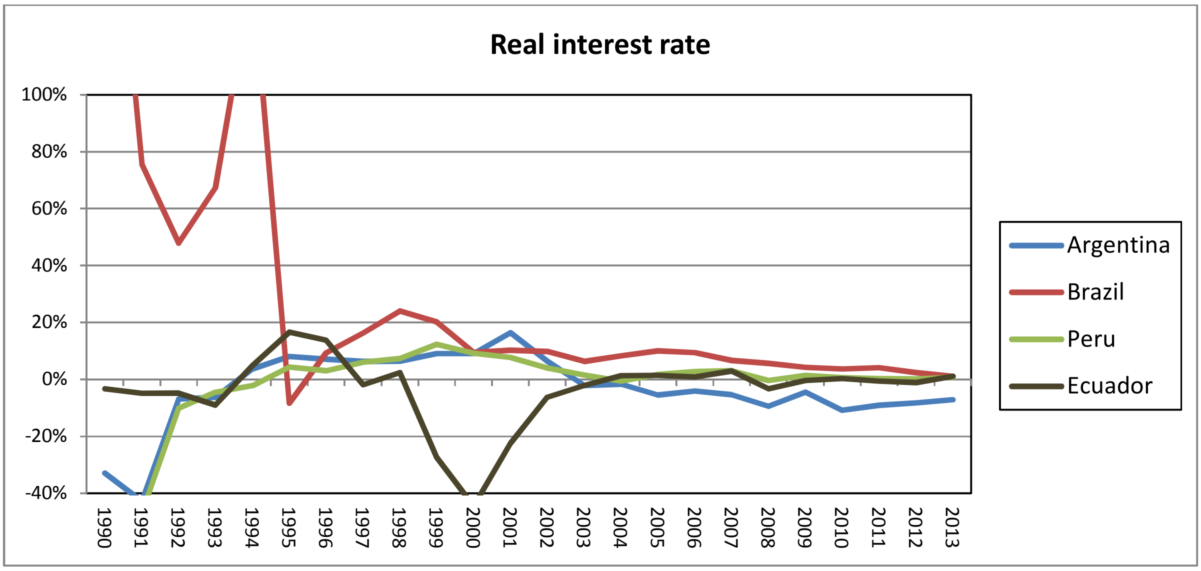
Inflation, that until the early 2000's had been much higher than that of the other Latin American countries, went down and remained below that of Brazil and, of course, much lower than in de-dollarized Argentina. Inflation in Ecuador was in line with inflation in Peru.



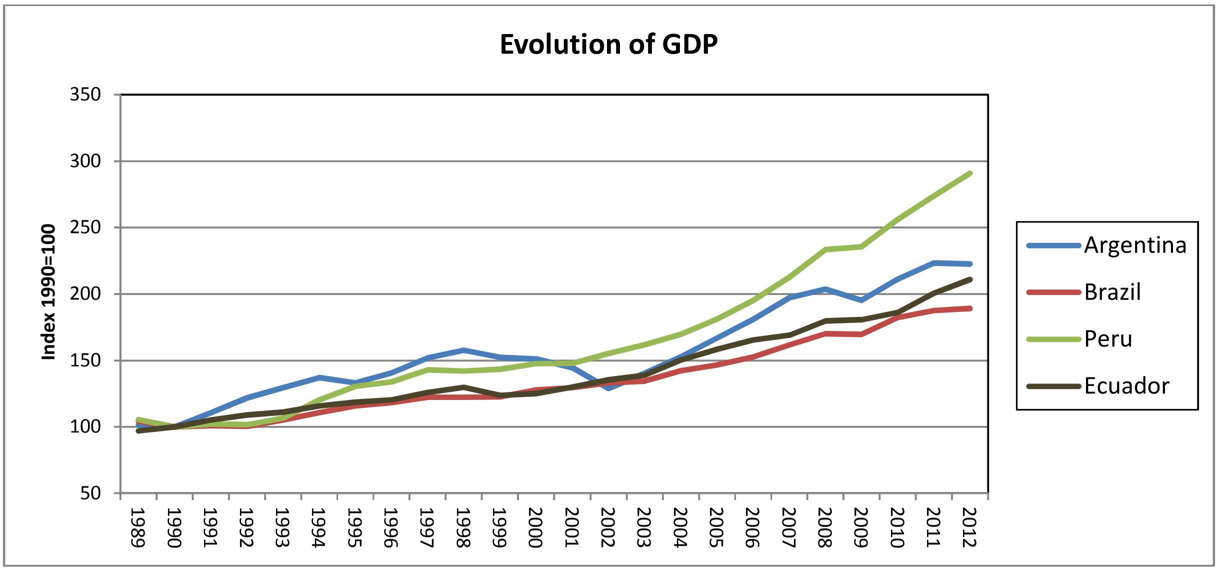
Except for the real devaluation around the crisis in 2000 prior to the decision to eliminate the Sucre, the real rate of exchange was very stable, almost like in Peru.



The real rate of interest was all the time below that of Brazil and extremely low only at the time of the inflationary explosion that preceded full dollarization.



Growth performance was superior to that of Brazil, but inferior to that of Argentina. The advantage of Argentina was mainly observed during the nineties when Ecuador was still suffering from extreme instability and Argentina was enjoying the good years of the convertibility plan.


Evolution of GDP
Index 1990=100
350
300
250
200
150
100
50
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
Argentina
Brazil
Peru
Ecuador