Crisis prevention and resolution in highly dollarized economies

By Domingo Cavallo with the collaboration of Mariano Giachetti[1]

People of many emerging economies that have a long history of high and unstable inflation use foreign currencies to protect their liquid savings from value erosion. Prices of goods and services are quoted in foreign currencies to avoid the instability associated with the permanent devaluation of the domestic currency. Also, most medium and long term contracts are written in foreign currencies to reduce the uncertainties on the future value of money.

When governments of this type of economies have to implement stabilization plans, very often they have legalized the use of foreign currencies in parallel with the local currency. It is at this stage that "financial dollarization"[2] becomes an important characteristic of these economies. Governments adopt this decision because "financial dollarization" has proven to facilitate the stabilization process[3].

There are even cases in which the local currency is eliminated and the economy becomes fully dollarized. Currency boards and monetary unions are the monetary arrangements that also share most of fully dollarized economies.

Unfortunately, the same way it helps to stabilize, when the economy suffers a "sudden stop" in the flow of foreign capital, financial dollarization increases the risk of financial crisis. This happens because financial dollarization normally facilitates the emergence of currency mismatches and balance sheet problems, particularly when income streams and debt services accrued in different currencies.

Additionally, as the local monetary authority has very little room for acting as lender of last resort, when the banks become illiquid as a consequence of a run on foreign currency deposits, liquidity problems may rapidly transform into insolvency problems, aggravating the crisis.

It has been argued that full dollarization, currency boards and monetary unions reduce the risks associated with currency instability in partially dollarized economies. But this is an illusion. The

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[2] Dollarization refers not only to the use of the Dollar, that is the most common foreign currency used, but to any other foreign currency widely used for the purposes described in the initial paragraphs. In some emerging economies it may be Euros, Pounds, Yens and other foreign currencies

[3] See my article entitled "Financial dollarization: help or hindrance in maintaining stability?: using the experience of Latin America to answer this question for Kazakhstan", written in collaboration with Mariano Giachetti for the International Conference "Marking 20 years of the national currency of the Republic of Kazakhstan", Almaty, November 16, 2013. It can be downloaded from http://www.cavallo.com.ar/wp-content/uploads/2013/11/Financial-dollarization1.pdf

same domestic and foreign shocks than in partially dollarized economies disclose currency mismatches and balance sheets problems via devaluation, in fully dollarized economies induce deflation as the mechanism for adjusting the relative price of tradable to non-tradable goods. Deflation creates exactly the same income-debt services imbalances as currency mismatches do in partially dollarized economies. Furthermore, in fully dollarized economies the local monetary authority has the same limitations to act as lender of last resort as in partially dollarized economies.

In this note I want to discuss three issues associated with the risk of financial crisis in dollarized economies (independently if they are partially or fully dollarized):

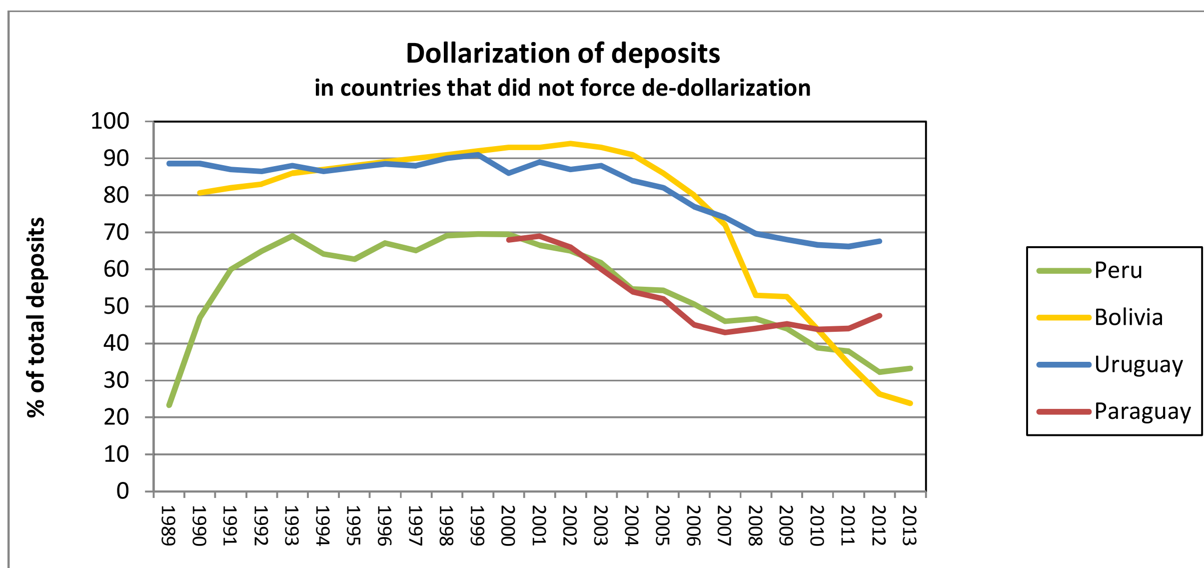
1. Crisis prevention
2. Crisis resolution
3. Implication for International Monetary Reform

Crisis prevention

Highly dollarized economies should try to minimize the domestic sources of instability in cross border financial flows. This means to avoid large fiscal deficits, to encourage private domestic savings and to keep the economy open to foreign trade and investment. The Central Bank should control credit creation by the banking system in both, domestic and foreign currencies by using reserve requirements and setting rules on the allocation of credit so as to be able to prevent currency mismatches between incomes and debt services. For example, loans in foreign currency should be banned or limited for families and firms whose incomes are not highly correlated with the value of the foreign currency.

The Central Bank should try to keep a high level of foreign reserves financed by fiscal surpluses and not by domestic currency creation. Interest rates and monetary creation controlled by the Central Bank should be targeted to low inflation but at the same time should try to smooth the fluctuations of the nominal exchange rate without preventing changes in the real rate of exchange that are needed when changes occur in the terms of trade and other exogenous real shocks Dampening the effects of foreign nominal shocks (like inflationary and deflationary pressures originated in monetary policies of the US or other advanced economies) should be used as a way of increasing people's trust on the domestic currency which should, eventually, be reflected in a gradually lower degree of financial dollarization.

Several Latin American economies, particularly Peru, but also Bolivia, Uruguay and Paraguay are good examples of highly dollarized economies that were able to prevent financial crisis by prudent domestic policies. The crisis in Uruguay during 2002 was caused by an external shock: the crisis in Argentina. It is interesting to see that these economies have gradually become less dollarized, but they did it without any compulsion.



Crisis management and resolution

When a crisis could not be prevented or avoided, either because domestic policies were not prudent enough or the external shocks were very large or, even more likely, because a combination of those two sources of instability, the crucial question becomes how to manage and resolve the crisis.

At time of crisis in dollarized economies, the government and, sometimes, foreign experts and advisors, come to the conclusion that the solution is to default on the public debt and simultaneously force a de-dollarization of the economy by making the conversion of foreign currency contracts to the local currency at a pre-devaluation exchange rate. This is known as 'a la Argentina 2002' solution to the crisis. Nouriel Roubini, and less explicitly, Paul Krugman, recommended this solution to Greece and the other Eurozone members that have suffered severe financial crisis since 2010. Fortunately they did not follow this advice.

I have used the experience of Argentina and Uruguay to argue that forced de-dollarization is not a good way to solve financial crises. At the time of the discussion of the crisis in Greece I explained my view, confronting that of Roubini.[4] More recently, I decided to bring the discussion here in Kazakhstan and in Turkey[5] because both countries have dollarized economies that may suffer financial crisis in the future (I hope not, but it is better to be prepared, just in case)

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

[4] See my paper "Greece should restructure its debt but stay in the Euro" in http://www.cavallo.com.ar/wp-content/uploads/2011/10/Greece-should-restructure.-revised.pdf

[5] See my paper "Forced de-dollarization is not a good option to speed up growth" written with the collaboration of Mariano Giachetti 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. It can be retrieved from http://www.cavallo.com.ar/wp-content/uploads/2014/05/Financial-Dollarization.-Version-for-Istambul-Forum-1-1.pdf

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.

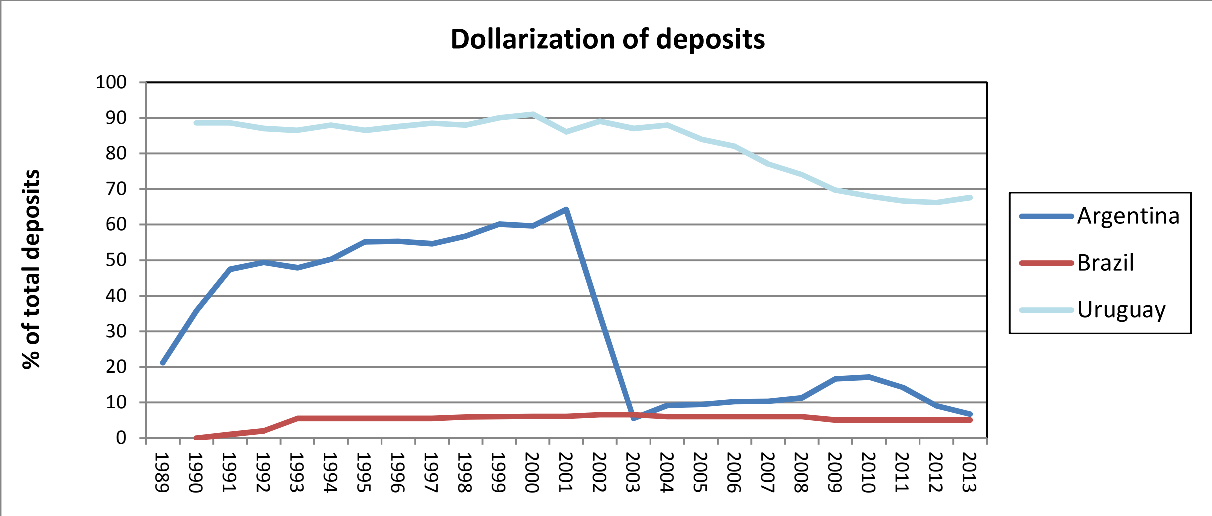
The default and forced conversion of contracts provoked an extreme devaluation of the Peso and opened the door for a very damaging freezing of public utility rates, price controls, distortionary taxes and all sort of administrative interventions thought as substitutes for an inflation targeting monetary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

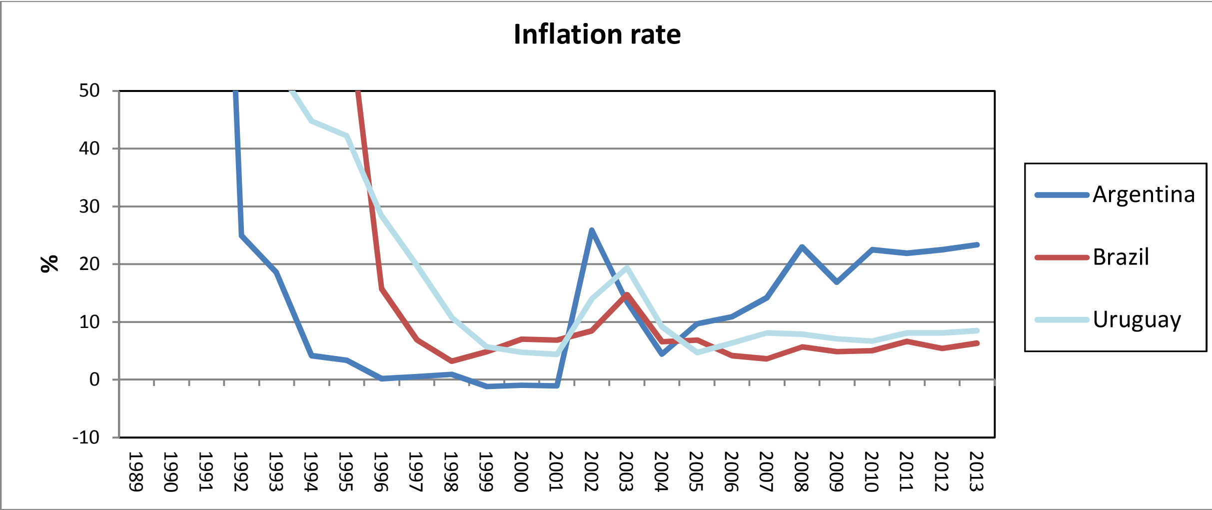
An expansionary fiscal policy was, at the beginning, very useful to reactivate the economy and resume growth, even without significant investment in key sectors of the economy that had been very well capitalized during the previous decade. But with the significant improvement in terms of trade since 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.

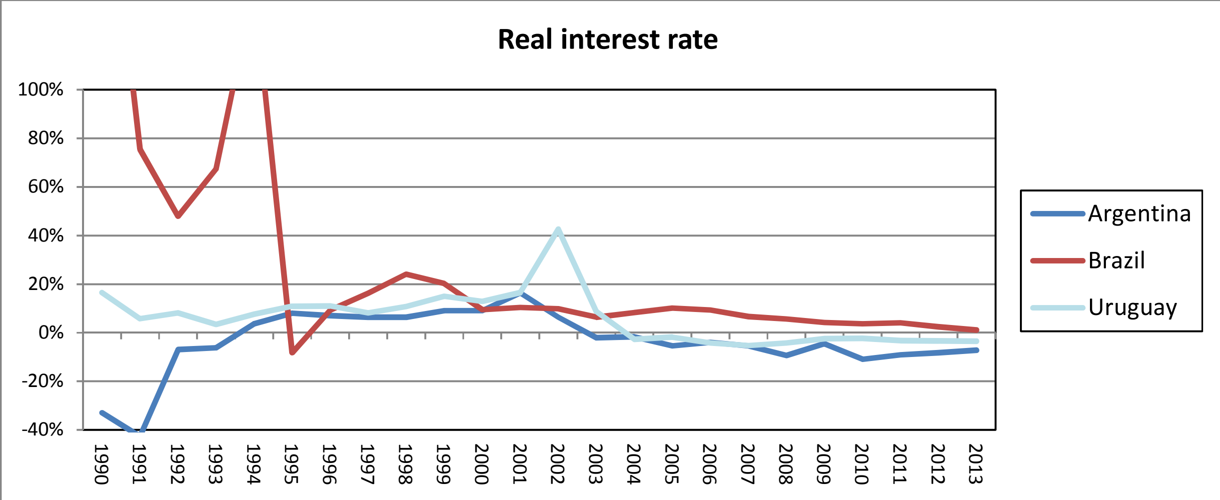
Uruguay shows that when a financial crisis arises, it can be solved without forced de-dollarization. It also shows that solving the financial crisis maintaining the dollar as an alternative currency in financial intermediations helps to keep inflation low without sacrificing growth.

Look at the comparison between the performances of Brazil, an economy that was not dollarized but suffered a crisis in 1999 and the 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.

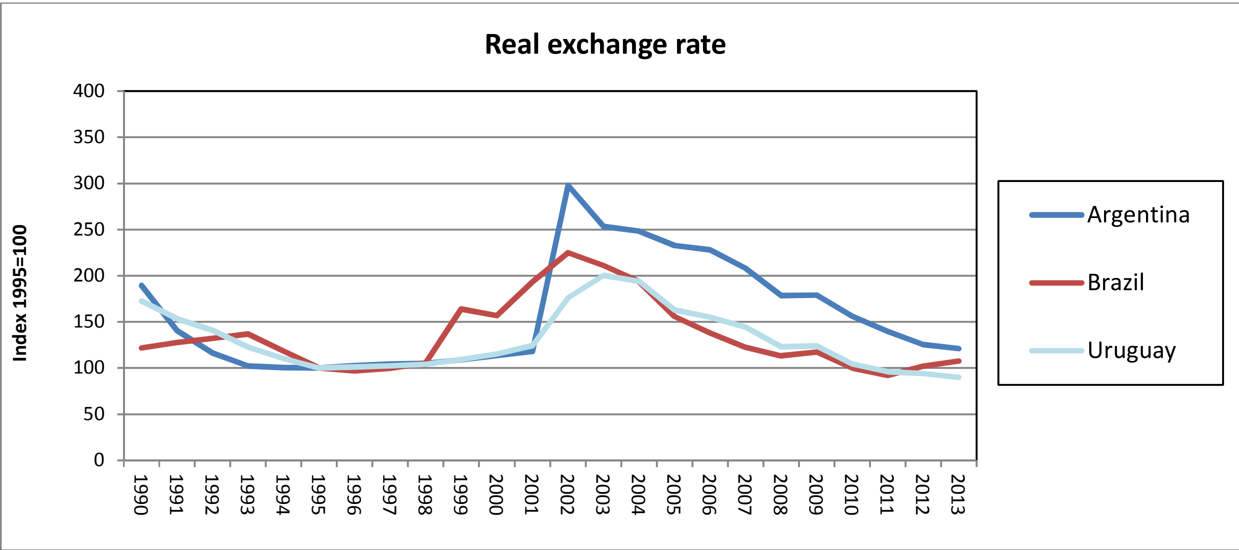




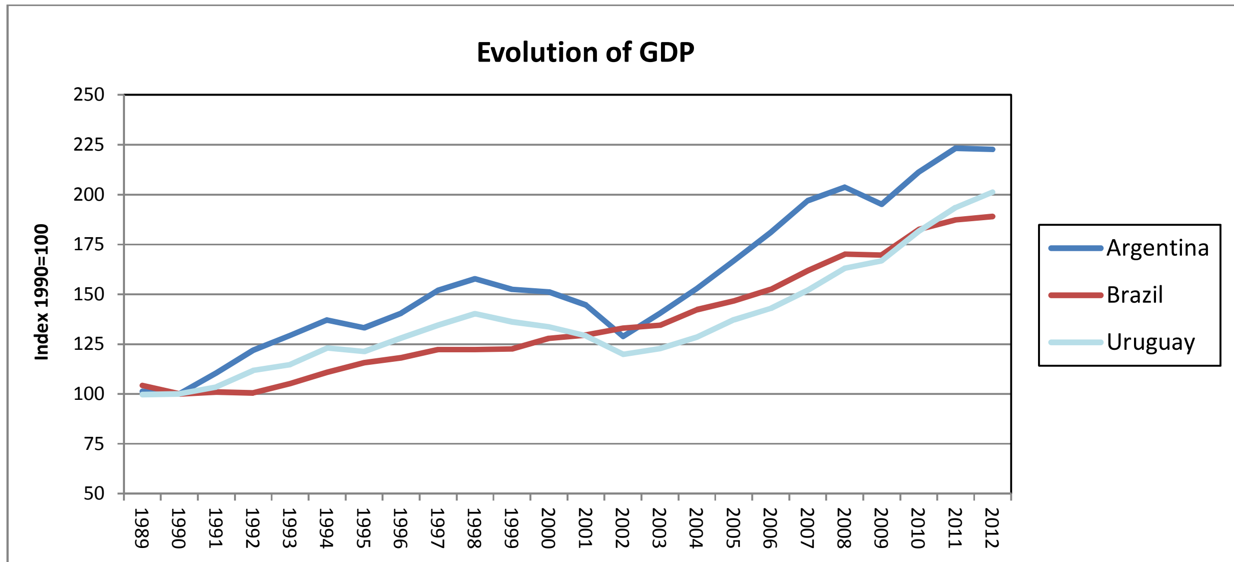
Even though the devaluation provoked a jump in the inflation rate in 2002 and 2003, since 2004 the inflation rate was kept at one digit levels. That is, the fact that Uruguay conducted an orderly debt restructuring and maintained dollarization helped to avoid the acceleration of inflation observed in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



Implication for International Monetary Reform

On one hand, wild fluctuations in the exchange rate of important currencies like the Dollar, the Euro, the Pound and the Yen, which are commonly associated with ups and downs on commodity and other important prices of tradable goods, have been very often one of the sources of the financial crises in financially dollarized economies.
On the other hand, orderly solutions to financial crises in the emerging economies that have best solved the financial crises they suffered, were only possible with external support and cooperation (Uruguay and the countries of the Eurozone are good examples of orderly solutions).

Future monetary and financial arrangements that make possible more coordination and cooperation of macroeconomic policies in advanced economies and provide advice and support for crisis prevention and crisis resolution in emerging economies, are crucial for a successful World Anti-Crisis Plan.

The purpose of this brief note has been to make some reflections which came to my mind as a consequence of my personal experience and that of the countries I know best.