How to reduce dollarization without risking stability.

Lessons from LA relevant for CIS countries

By Domingo Cavallo and Mariano Giachetti

All the CIS countries and several of the LA countries, particularly those that suffered hyperinflation, show a high degree of dollarization of their respective economies.[1]

CIS countries, including Russia, have become partially dollarized economies since the time of the dissolution of the Soviet Union and the introduction of national currencies. While in these countries the degree of dollarization has varied a lot since the mid 1990's, none of them has gone to the extreme of fully dollarize its economy nor to compulsorily de-dollarize it. By contrast, in LA the two extreme cases happened: Ecuador fully dollarized in 2000 and Argentina compulsorily de-dollarized in 2002. This can be seen in tables 1 and 2.

The experience of LA countries is relevant to discuss what would be the consequences for CIS countries to adopt the decision of moving in one of these two extreme alternatives. Over time there has been proposals on the two directions. Nowadays the worries with dollarization has surfaced strongly in CIS countries as a consequence of the overall trend towards appreciation of the Dollar and the deterioration of commodity prices. That is the reason why it is useful to asses again the LA experience, particularly that of Argentina with compulsory de-dollarization.

1 Brazil is the only country in LA 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 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 rest of the countries became largely dollarized. They are Argentina, Bolivia, Paraguay, Peru, Uruguay and Ecuador.

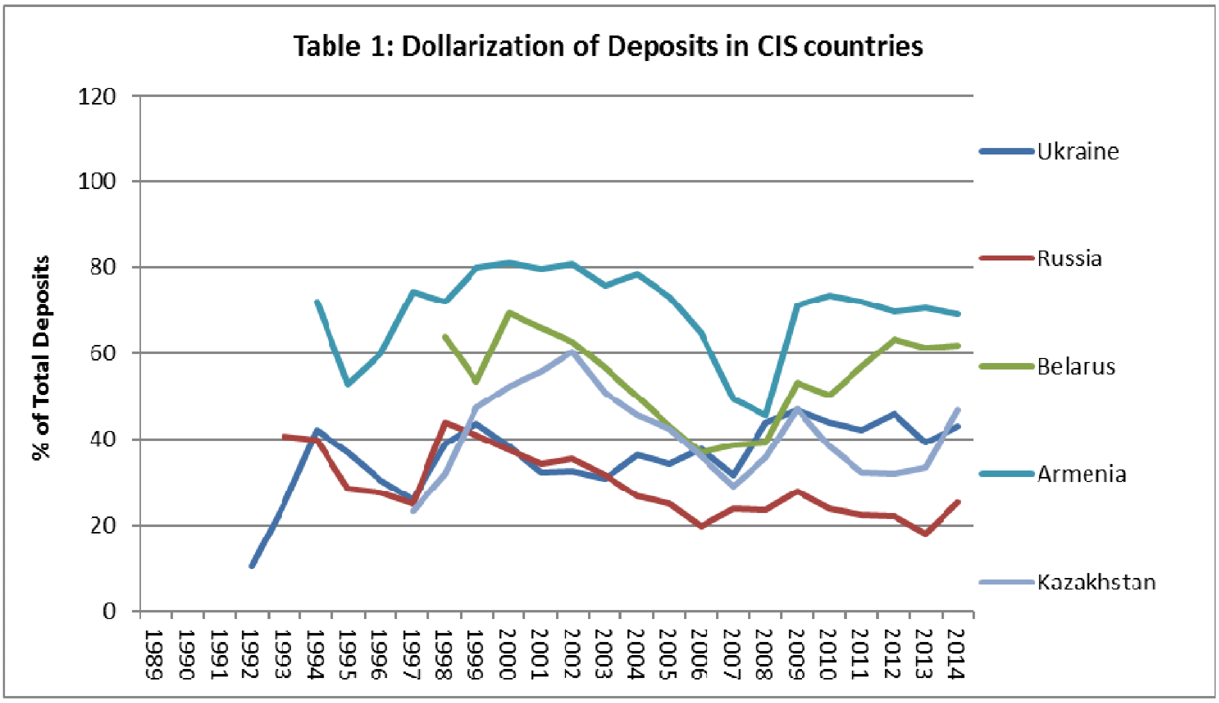
Table 1: Dollarization of Deposits in CIS countries
% of Total Deposits
120
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80
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1989
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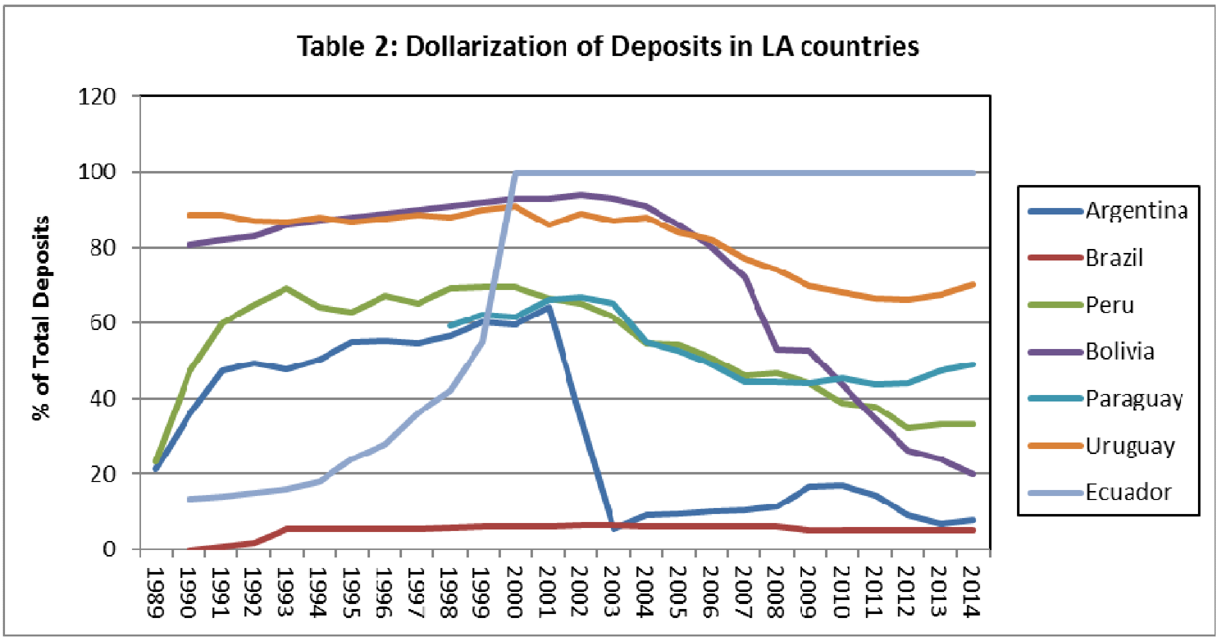
Table 2: Dollarization of Deposits in LA countries
% of Total Deposits
120
100
80
60
40
20
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1989
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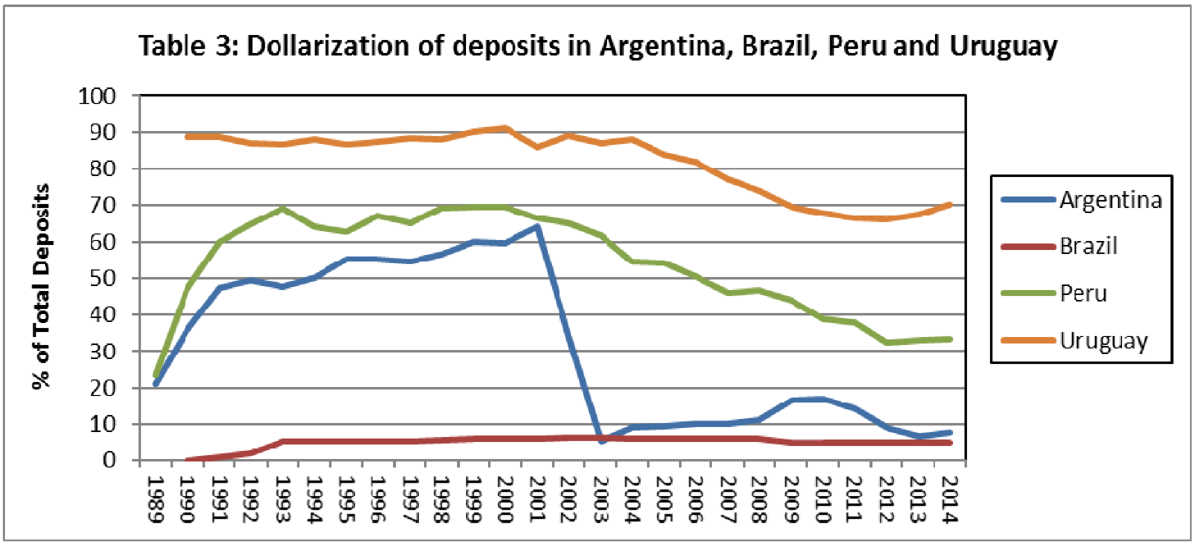
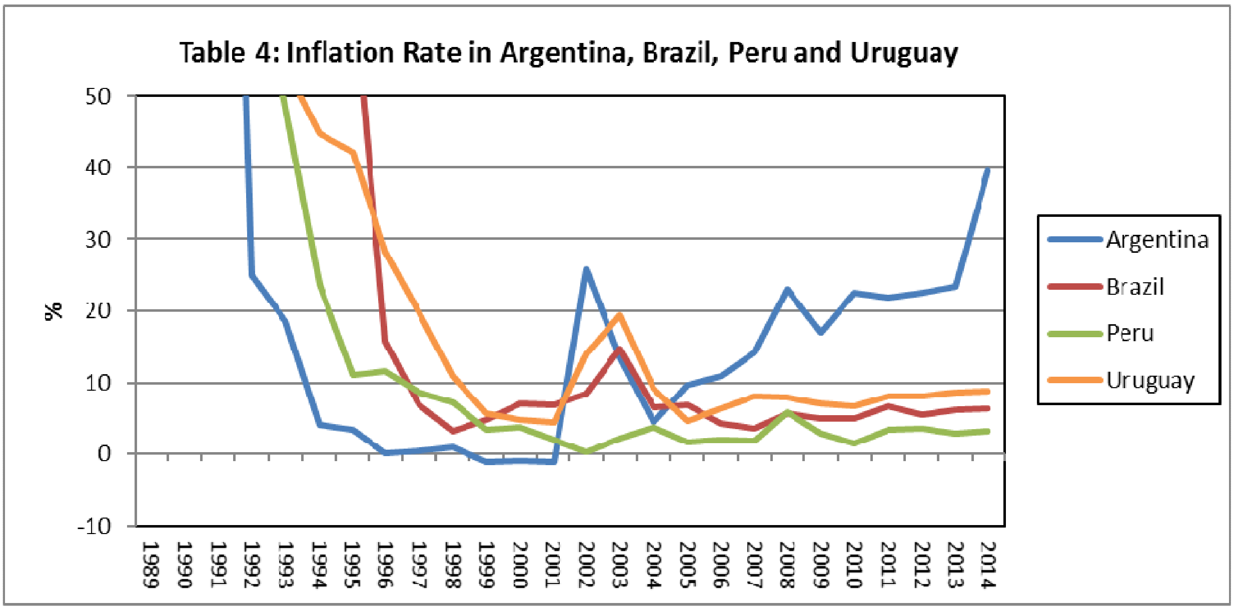
2011
2012
2013
2014
Argentina
Brazil
Peru
Bolivia
Paraguay
Uruguay
Ecuador

Dollarization helps to stabilize and to maintain low inflation

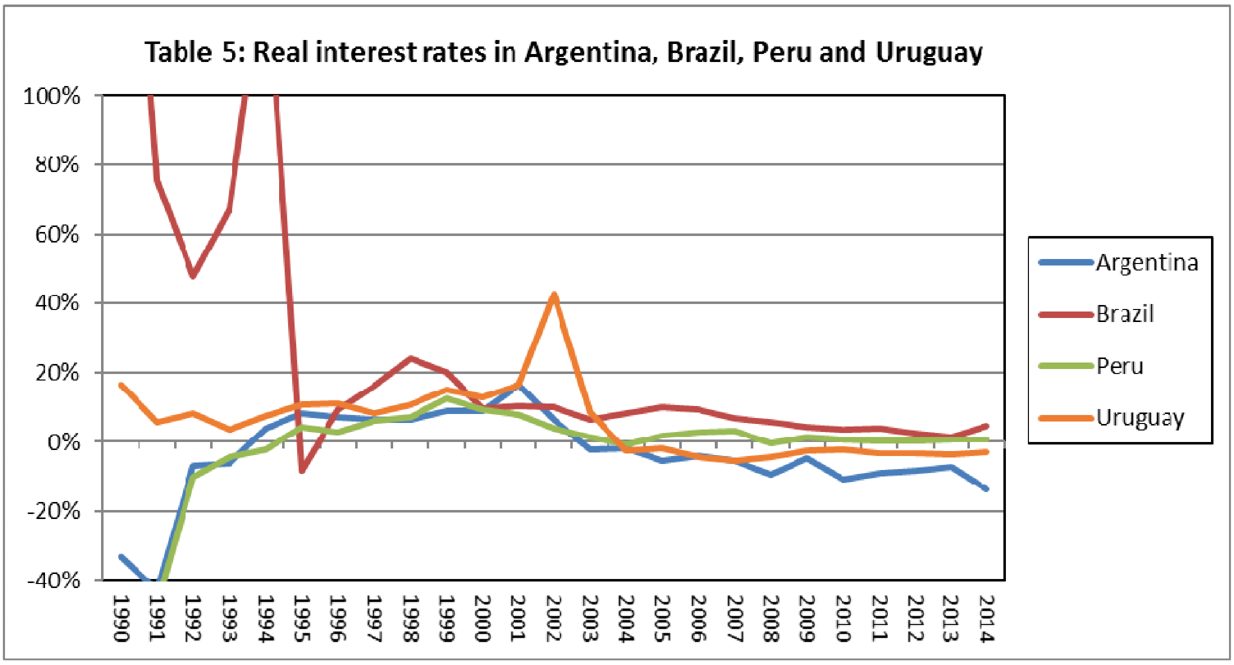
To demonstrate that dollarization helps to stabilize highly inflationary economies, we start analyzing the experience of Argentina, Brazil and Peru. Afterward, we will include references to the experience of Bolivia, Ecuador, Paraguay and Uruguay. In the plots, the figures for Uruguay are also included for the subsequent discussion on how to deal with financial crisis, but for the time being, they can be ignored.



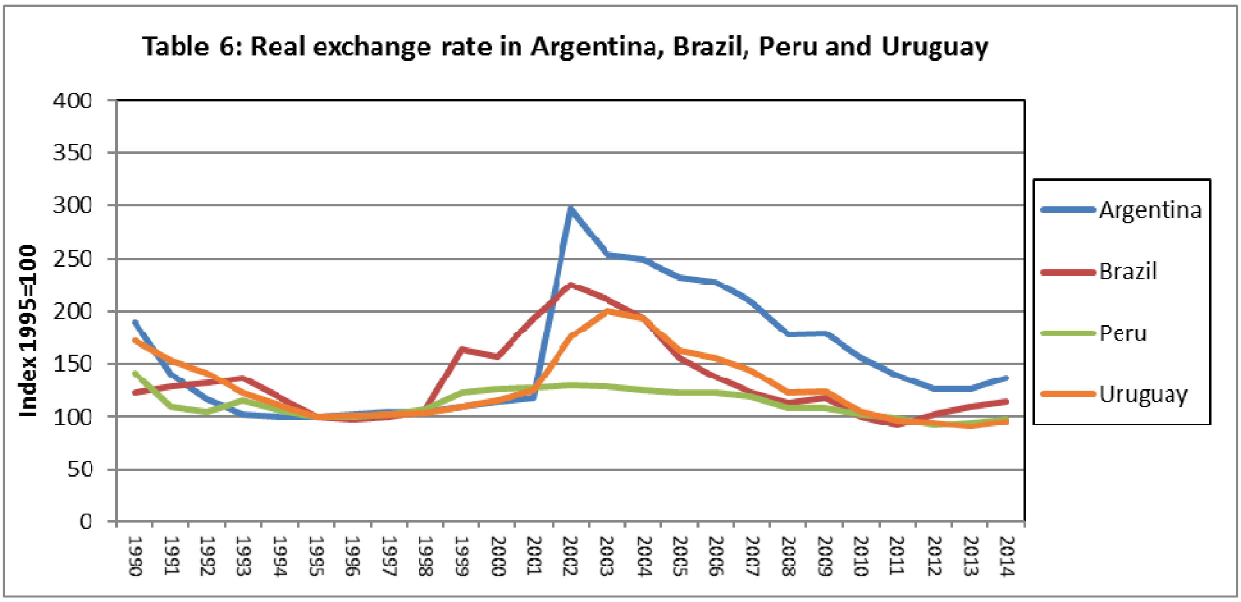
The experiences of Argentina, Brazil and Peru show that Dollarization can be very helpful to implement a stabilization program. In economies with very high inflation, the key to achieve price stabilization is finding effective ways to stabilize the exchange rate. Any commitment to a monetary policy that 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). This is done in Table 4. Higher inflation in Argentina after 2002 is related to the compulsory de-dollarization decided that year by the Government.



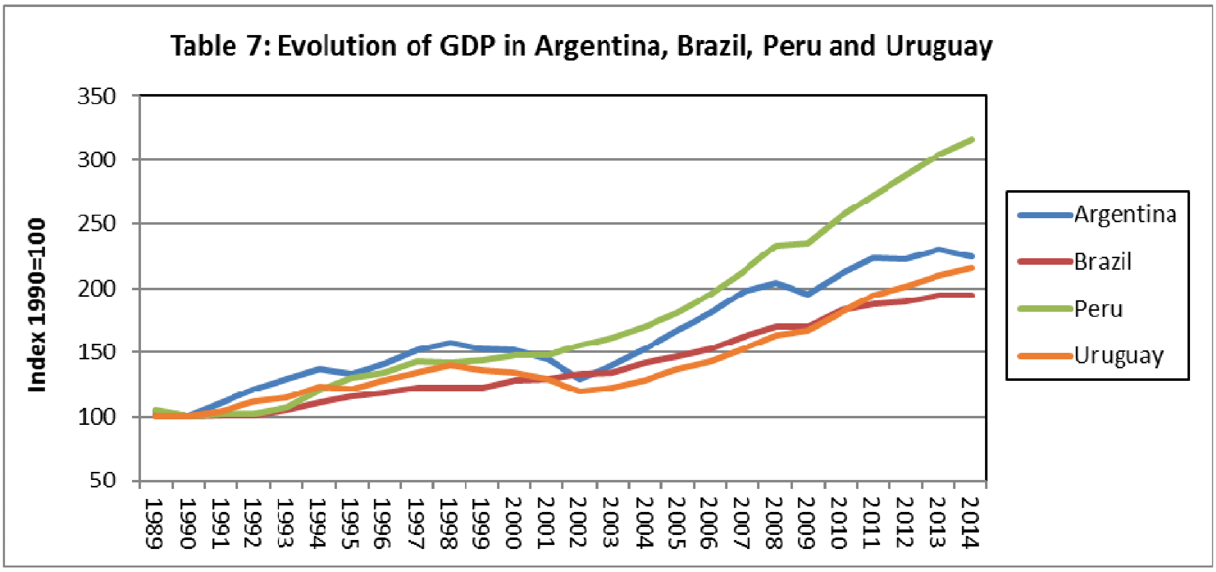
As shown in table 5, Brazil needed to maintain much higher real interest rates than Peru and Argentina to achieve stabilization and keep inflation low. Largely dollarized economies can stabilize their price levels and keep inflation low with lower real interest rates.



As can be seen in Table 6, 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)



As it is shown in Table 7, 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.



Although not shown in the tables, the experiences of Bolivia, Ecuador and Paraguay corroborate the conclusion that financial dollarization helps to achieve and maintain low inflation.

Dollarization increases the risk of financial crises

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. This became very clear at the time of the Argentine Crisis in 2001 and that of Uruguay in 2002.

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 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. This has been seen in several Eurozone countries, particularly in Greece, Portugal, Spain and Italy. In Ecuador, the problem did not arise because until the last year the Dollar was weakening, but worries have already started, like in CIS countries, now that the Dollar has started to appreciate and the price of Oil has collapsed. So, full dollarization does not seem to be the advisable course for CIS countries.

Crisis management and resolution in highly dollarized economies

At time of financial 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 crises since 2010.

I have used the experience of Argentina and Uruguay, which I describe in the next two sections, 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.[2] More recently, I decided to bring the discussion to Kazakhstan and in Turkey 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)[3]

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[2] 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

[3] See my following papers:

1)" Financial Dollarization: Help or Hindrance in Maintaining Stability?" in http://www.cavallo.com.ar/wp-content/uploads/2013/11/Financial-dollarization1.pdf

Compulsory de-dollarization is not a good solution

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.

Forced de-dollarization "*a la Argentina 2002"* should be discarded. The conclusion that compulsorily de-dollarization is a bad solution is reinforced by the negative experience of countries that have undertaken a forced conversion of dollar deposits into local currency, prior to the Argentina experience of 2002, including Mexico and Bolivia in 1982 and Peru in 1985. As documented in Savastano (1996) and Baliño et

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2) "Forced de-dollarization is not a good option to speed up growth" in http://www.cavallo.com.ar/wp-content/uploads/2014/05/Financial-Dollarization.-Version-for-Istambul-Forum-1-11.pdf

al. (1999), the highlight of these experiences was a brutal contraction of onshore domestic intermediation and acceleration of inflation without any gain in terms of economic growth.[4]

The solution is to conduct an orderly debt restructuring

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 again at Tables 3 to 7, but paying now attention to Uruguay in comparison with Brazil and Argentina.

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.

As can be observed in Table 4, 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.

As can be seen in Table 5, the 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. This can be observed in Table 6.

And finally, from Table 7, it can be concluded that 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.

The experience of CIS countries

The experience of CIS countries differs from that of the LA countries that remained partially dollarized: while Bolivia, Peru, Paraguay and Uruguay show a smooth and gradual reduction in the degree of dollarization, most CIS countries after a drop before the global crisis of 2008-2009, resumed an upward trend in the degree of dollarization that has accentuated during the course of 2014 and the initial months of 2015.This can be clearly seen by comparing tables 1 and 8.

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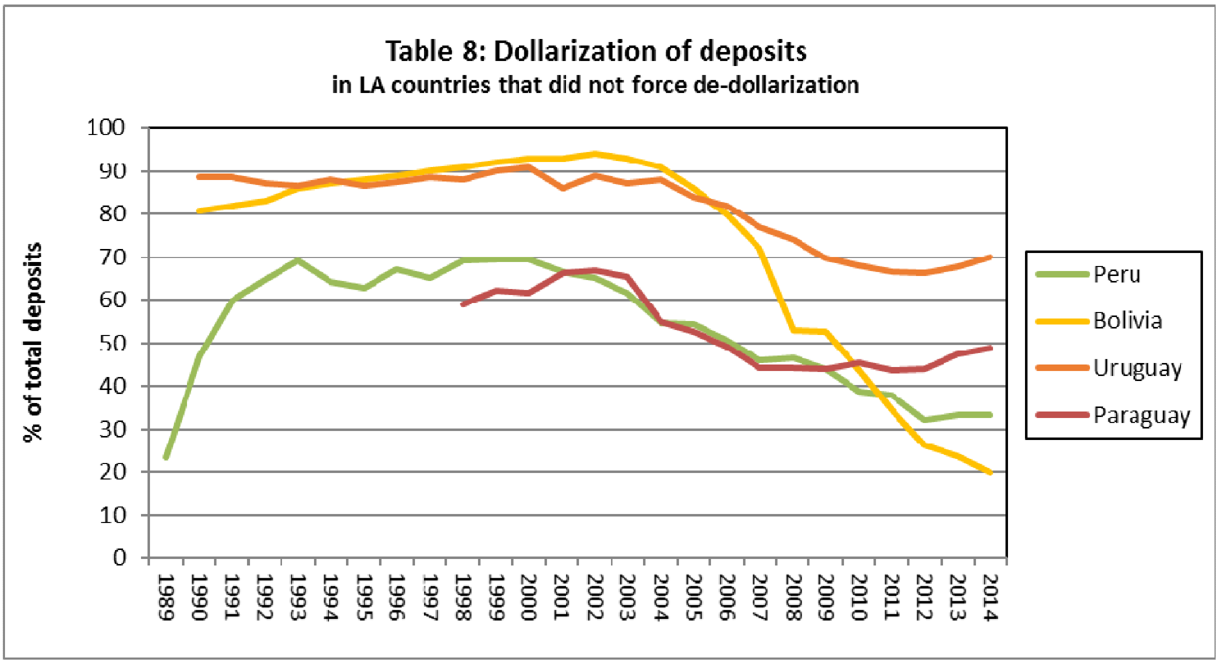
[4] Savastano, Miguel, 1996. "Dollarization in Latin America-Recent Evidence and Some Policy Issues," in P. Mizen and E. Pentecost (eds.), *The Macroeconomics of International Currencies*, Edward Elgar Publishing.
Baliño, Tomas, Adam Bennet, and Eduardo Borensztein, 1999. "Monetary Policy in Dollarized Economies," IMF Occasional Paper 171.



Most CIS countries suffered at least one financial crisis since the late 90's. Fortunately, none of them applied the solution "a la Argentina 2002". Instead tried to orderly restructure debts. That explains why there has been ups and downs in the degree of dollarization without a clear trend towards de-dollarization. It is the same reason why Uruguay maintains a higher degree of dollarization than Perú, Bolivia and Paraguay. The experience of these three LA countries, and particularly, that of Peru, the most successful one, offers relevant lessons and recommendations for CIS countries.

Crisis prevention in highly dollarized CIS economies

Highly dollarized CIS 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 target 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.

The management of reserve requirements and interest rates differentials between dollar and local currency deposits should be in such a way as to encourage the latter. Price indexation (not dollar indexation) for long terms deposits and loans in the local currency should be allowed and encouraged as an alternative to set too high nominal interest rates on domestic currency deposits and loans.

Encouragement of use of bank money (debit and credit cards, checks and electronic transfers) rather than cash in payments above a certain amount (e.g. $1,000) would help to maintain both, local currency and dollar deposits within the formal financial system and reduce the risk of runs against the banks. An instrument for encouragement of bank money that has proven effective in some countries was to limit the tax deductions both for the VAT and the corporate income tax to purchases and cost paid with bank money. Purchases and costs paid in cash would not be deductible, and, therefore would be discouraged.

Conclusion and recommendation for Kazakhstan

Dollarization should not be seen as a problem in Kazakhstan but a natural process of de-dollarization should be pursued. 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 was already evident in Kazakhstan until 2013 as it has been happening since the mid 90’s in Perú. Worries about increased dollarization have re-emerged during 2014 and in the initial months of 2015 because the depreciation of the ruble, the appreciation of the dollar and the fall of commodity export prices has induced an increased demand for dollar assets within Kazakhstan.

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.

To resume the natural course toward de-dollarization that prevail until 2013, Kazakhstan 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.

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