CHALLENGES OF DOLLARIZATION IN COMESA

PRESENTATION TO THE MER SUB-COMMITTEE

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Presentation Outline

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Introduction

• The 20th Meeting of the COMESA Committee of Governors of Central Banks which was held in Kinshasa, DR Congo in November 2014 noted that:

  o Measures to address dollarization in an economy tend to be country specific and could vary from one country to another.

  o Such measures include collecting all taxes in domestic currency only, extending short term credit in domestic currency only, all payments of goods and services to be made in domestic currencies etc.

  o There was need to shed light on the challenges of dollarization in selected COMESA countries.

• Governors therefore instructed CMI to undertake a study which addresses the challenges of dollarization in selected countries in the region.
Introduction

• In addition, exchange Rates in a number of COMESA member countries are going through a period of volatility.

• Most currencies in the region have drastically depreciated against major international currencies.

• Some of the causes of the depreciation of the currencies include:
  o Global strengthening of the U.S. dollar and recovery of the US economy
  o Uncertainty around the timing of the increase in U.S. interest rates increase
  o High import bill to fund huge infrastructure projects going on in most countries in the region
  o Removal of the Swiss Franc cap against the Euro
  o Debt crisis in Greece contributed to increased instability in the financial markets

• Excessive depreciation of currencies in the region is causing uncertainty and further worsening the problem of dollarization in these countries.
Introduction

- Dollarization occurs when a country adopts the currency of another as a legal tender (not necessarily the US Dollar). The domestic money is either replaced or used in parallel with foreign money.

- Dollarization is, in most cases, preceded by prolonged periods of hyperinflation and economic instability and the desire of residents to diversify and protect their assets from risk of further depreciation of their own currency.

- The high and unanticipated inflation rates decrease the demand for domestic money and raise the demand for alternative assets including foreign currency and assets denominated in foreign currency – there is "flight from domestic money".

- The flight from domestic money results in a rapid and sizeable process of dollarization, which usually starts in the banking sector (financial dollarization).

- The domestic currency tends to be gradually displaced by a stable currency such as the U.S. dollar.

- The domestic currency losses the store-of-value function, then the unit-of-account function (most prices are quoted in a foreign currency) and then the medium of exchange function to the foreign currency (most transactions are in foreign currency).

- In the end, authorities are forced to follow market preferences and pronounce official dollarization.
Introduction…

• There are various forms in which dollarization can assume, including asset, liability, partial and full dollarization.

• Official full dollarization occurs where a Government endorses, through political consensus, a foreign currency as having the exclusive status of legal tender in a country and abandons the use of its national currency.

• With full dollarization, a country completely gives up control of monetary and exchange rate policy.

• Semi-official dollarization refers to a situation where both the local and the foreign currencies are used as legal tender.

• Dollarization can also occur unofficially, without formal legal approval or treaty, where foreign currency is legal tender, but plays a secondary role to domestic currency officially, or where a country ceases to issue the domestic currency and uses only foreign currency (unofficial or unilateral full dollarization, as is the case with Zimbabwe).
Why Dollarization?

• Depends on the benefits v/v costs of dollarization

• Potential benefits include immediate cessation of inflation or hyperinflation, lower borrowing costs and deeper integration into the world market (Berg and Eduardo, 2000).

• Dollarization also help stabilizes the economy - credibility and predictability - which promotes foreign investment. Dollarization holds the promise of a steadier market sentiment as the elimination of exchange rate risk tend to limit the incidence and magnitude of crisis and contagion episodes.

• Eliminates the risk of devaluation, as well as other rent seeking behaviours and parallel market activities.
Benefits of dollarization

• Dollarization being an irreversible institutional change leads to lower inflation, fiscal responsibility and transparency

• Reduces country risk premium on foreign borrowing, obtaining lower interest rates and leads to higher investment

• Inability of the Central Bank to embark on expansionary monetary policies also bestows a measure of confidence in the economy, thereby helping to lock away damaging and often self-fulfilling inflation expectations

• The absence of currency risk helps to eliminate externally induced banking and financial crises

• The absence of seignorage induces more fiscal discipline, while the absence of a lender of last resort induces banks to seek for alternative contingent funds. This gives a competitive edge to international banks over domestic banks inducing a more stable international banking system;
Benefits of dollarization…

• Dollarization make economic integration easier, establishes a firm basis for a sound financial sector and thus promote strong and steady economic growth.

• Dollarization also bring about a closer integration in financial markets

• Dollarization avoids currency and balance of payments crises. Without a domestic currency there is no possibility of a sharp depreciation, or of sudden capital outflows motivated by fears of devaluation.

• By definitively rejecting the possibility of inflationary finance through dollarization, countries strengthen their financial institutions and create positive sentiment toward investment, both domestic and international.
Costs/risks

• Immediate loss of monetary policy autonomy and the benefits of seigniorage (the profits accruing to the monetary authority from its right to issue currency – buy back “stock” of domestic currency or giving up future seigniorage earnings gained by issuer country unless there is agreements to share the same)

• Country also lose the “exit option” to devalue in face of major exogenous shocks (Berg and Eduardo, 2000)

• Dollarization also increases the susceptibility of the host country’s economy to shocks in the anchor country

• The Central Bank loses the lender of last resort function – Central banks lacks instruments to influence monetary aggregates and anchor private sector expectations of inflation
Costs/risks …

• Dollarization may lead to loss of political sovereignty

• For a country with a small export base, dollarization also leads to liquidity problems and hence lowers economic growth (Nota and Sakupwanya, 2013).

• Liquidity risk - Sudden changes in investor and depositor perceptions about the health of the banking system may result in a deposit run and compromise international reserves holding

• Balance sheet risks - tend to arise in cases of partial dollarization. Banking sector vulnerabilities may be heightened because of direct exchange rate risks that result from currency mismatches in banks’ balance sheets.
Costs/risks of dollarization...

- The absence of monetary and exchange policy - may induce more volatility of GDP, and exposes the economy to shocks and other vulnerabilities that the Central Bank and Government are not able to offset.

- Dollarization may disenable the Central Bank and Government to issue domestic financial instruments, resulting in limited money market and inter-bank trading activities.

- Under dollarization, the flexibility to use exchange and monetary policy is limited, and with it also, the inability of authorities to implement counter-cyclical measures.
Causes of dollarization

- In most countries dollarization follows:
  - Large macroeconomic imbalances and hyperinflation
  - Financial repression and capital controls
  - Underdeveloped financial markets - domestic borrowers contract debt in foreign currencies in response to the lack of domestic currency alternatives in incomplete financial markets.
  - The appeal of a foreign currency as an anchor of macroeconomic stability
    - Driven by two main motives
      - The currency substitution motive - the use of foreign assets as means of payment and unit of account. Currency substitution tends to follow periods of hyperinflation, prompting the public to seek alternative currencies to use as money.
      - The asset substitution motive - results from risk and return considerations between domestic and foreign assets. Price instability and prolonged depressions have prompted the use of foreign-denominated assets as a store of value.
Country Experiences - Panama

- Panama is one of the first economies to dollarize (use USD while Balboa is symbolic).

- The country officially dollarized in 1904 while the Panama Canal was being constructed by the United States government (Goldfajn and Olivares, 2000).

- There is no central bank and the monetary authorities cannot issue Balboa-denominated notes.

- The Panama Canal strategic importance to the world trade has been the driving force in this economy. In addition, the domination of production by related services virtually insulates the economy from external shocks.
Country Experiences – Panama…

• Since dollarization, Panama has experienced low inflation, macroeconomic stability, and low interest rates, including the existence of long term credit.

• Since 1970 Panama has had no controls on capital mobility, and has been financially integrated to the rest of the world.

• Panama has been an important center for offshore banking, with a large number of international banks operating in the country (Moreno-Villalaz and Juan Luis, 1999).

• This promoted international lending through numerous international banks that regulate liquidity levels in the economy. Excess liquidity is invested abroad and shortages are bridged by injections from international bank’s parent companies.

• Panama’s experience confirms that an exchange rate peg, with full official dollarization, could generate low and stable inflation, as well as promote economic stability.
Country Experiences – Panama…

• This gain in inflation performance is sustained without compromising average GDP growth.

• However, Panama has a bit higher volatility in GDP growth, which could be attributed to its lack of flexibility in monetary and exchange policies.

• In addition, the country has also experienced large and persistent fiscal deficits, notwithstanding the absence of direct monetary financing (Goldfajn and Olivares, 2000) of the budgets.

• In the absence of the lender of last resort (LOLR), however, Panama instituted strict bank regulations, typified by bank auditing guidelines that assisted in the monitoring of bank practices, credit guidelines and overall bank administration.
Country Experiences – Ecuador

• Ecuador began the dollarization process in March 2000, amidst worsening macroeconomic conditions, heightened by banking sector problems.

• These problems culminated in a run on deposits and the subsequent freezing of demand and savings deposits for six months and time deposits for one year (Davidson, 2002; Quispe-Agnoli and Whisler, 2006).

• The banking crisis in Ecuador significantly undermined monetary policy, particularly with regards to ability to control inflation.

• Unofficial dollarization had increased - approximately 80% of financial assets were being held in US dollars

• This implied that the Sucre (domestic currency of Ecuador) had virtually ceased to function as a store of value (Davidson, 2002; Quispe-Agnoli and Whisler, 2006).
Country Experiences – Ecuador…

• The central bank floated the Sucre in February 1999 as exchange rate pressure mounted and international reserves dwindled.

• In the face of a full-blown crisis, on 9 January, 2000, the government announced official dollarization through enactment of the Economic Transformation Law (ETL)

• The ETL provided for the development of a liquidity fund, to supplement the Central Bank’s capacity to manage liquidity, and modernized and tightened banking supervision and regulations

• Banks were required to allocate one percent of their deposit base to the liquidity fund

• Ecuador dollarized after experiencing both domestic and international financial crises and a growing fiscal deficit
Country Experiences – Ecuador...

• Dollarization was meant to provide a “credible” financial system (Davidson, 2002).

• The Ecuadorian Sucre went out of circulation, and was replaced by the US dollar.

• Dollarization is estimated to have reduced Ecuador’s seigniorage revenue by as much as 0.2 percent of GDP (Davidson, 2002).

• The country also lost monetary policy autonomy, and its key policies on interest rates had to be in sync with Federal Reserve Bank’s Monetary Policy stance.

• Among the benefits of dollarization was that Ecuador’s inflation was reduced from 96% in 2000 to 19% in 2001, before declining further to 2.7% in 2004;

• There were no more currency crisis; interest rates fell; fiscal discipline was imposed; which created an environment conducive to long term planning and investment decisions, as well as positive economic growth rates.
Country Experiences – Montenegro

• The Montenegrin government dollarized in 1999, after realizing that almost all transactions and savings were being conducted in German Marks. The government was running fiscal deficits of around 20% of GDP.

• Montenegro introduced a parallel currency system, one in which the German Mark was made the legal tender and allowed to freely float alongside Montenegro’s domestic currency, the Dinar.

• The entire process was conducted swiftly and without the support of external parties or institutions.

• After January 2001, the German Mark (DEM) became the only legal tender, and this was changed to Euro in June 2002, following adoption of the Euro by eurozone countries.

• Montenegro had a fairly successful experience in the implementation of dollarization. It has remained a highly open economy with some measure of stability.
Country Experiences – El Salvador’s

• In 2001, the Salvadoran government implemented the Monetary Integration Law, which made the US dollar legal tender and the only unit of account in the financial system.

• Steps were also taken to aggressively integrate the Salvadoran economy into world markets. Local currency denominated bank reserves were converted into remunerated liquidity requirement reserves, which banks accessed to fund short-term liquidity shortfalls.

• Through dollarization, El Salvador managed to achieve lower interest rate spreads and obtained the benefits of closer integration with international financial markets (Quispe-Agnoli and Whisler, 2006).

• Adoption of the US dollar made sense for El Salvador, which relies substantially on remittances sent from Salvadorians living in the US (13% of El Salvador’s GDP - Swiston, 2011). The US is also El Salvador’s principal trading partner - 60% of total exports are sent to U.S. markets.

• Dollarization in El Salvador resulted in lower inflation rates, low interest rates, lower country risk premiums, gains in policy credibility and improvement in economic growth and stability.

• Although El Salvador still uses the US dollar as its sole legal tender, its proximity and strong economic ties with the US economy makes its case unique.
Country Experiences – Cambodia

• Cambodia has become Asia’s most dollarized economy.

• In contrast to most other cases where dollarization is associated with macroeconomic instability, growing dollarization in Cambodia has occurred against the backdrop of greater macroeconomic and political stability.

• The usual motive, currency substitution, does not appear to have been a factor. As the volume of dollars increased over the years, so has the volume of riel (domestic currency).

• A strong inward flow of dollars related to garments sector exports, tourism receipts, foreign direct investment, and aid, has benefitted the dollar based urban economy.

• Given international experience in de-dollarization, a carefully managed market based strategy, supported by a continued stable macroeconomic environment is essential for Cambodia’s de-dollarization.
Country Experiences – Israel

• Israel had high and rising inflation throughout the 1970s reaching 445% in 1984 in the context of a broad deterioration in macroeconomic conditions.

• The share of dollarized deposits peaked at 39 percent in 1984, as depositors attempted to protect the value of their assets.

• Israel adopted a comprehensive strategy based on macroeconomic stabilization and prudential measures.

• Fiscal consolidation cut the fiscal deficit from 19% of GDP in 1985 to about 10% in the late 1990s – consequently restored confidence in the local currency by reducing inflation, while gradually increasing exchange rate flexibility.

• On the prudential side, reserve requirements in domestic currency were remunerated at a higher rate than those in foreign currency. Regulations were issued to ensure risk based supervision.

• Concurrently, the securities market in domestic currency was deepened as the public sector began to finance its deficit with bonds in local currency - Successfully de-dollarized
Country Experiences – Poland

• Poland’s experienced severe macroeconomic imbalances in the late 1980s. Monthly inflation reaching 585 percent in 1990 and the fiscal deficit increasing to 7 percent of GDP.

• Lack of credibility of the government’s economic policies resulted in about 80 percent of bank deposits in US dollars.

• By 1993, however, the level of dollarization had declined to about 35 percent and reached 4.5% in 1999.

• This successful de-dollarization process was due to a significant strengthening of the macroeconomic environment.

• In 1990, Poland began to implementation of comprehensive reform program which initially led to a sharp recession (real GDP contracted by more than 11 percent in 1990), growth resumed in 1992 and rebounded to about 4 percent in 1993.

• Using the exchange rate as a nominal anchor helped reduce average inflation.

• Starting in May 1991, the issuance of local currency treasury bills, which were seen as a high yield and safe investment, also helped reduce the share of dollar deposits.
Country Experiences – Zimbabwe

• Dollarization in Zimbabwe followed nearly a decade of economic recession and hyperinflation (stagflation).

• Inflation had increased to over 500 billion percent by end 2008 (Kramarenko, et al, 2010)

• Zimbabwean dollar was effectively and officially abandoned on 12 April 2009. The country adopted a multiple currency system, under unofficial full dollarization

• Government approved the use of major foreign currencies such as the United States Dollar, South African Rand, British pound sterling, Japanese Yen, Botswana Pula, Chinese Yuan and the Indian Rupee among others, as legal tender.

• The US dollar is, however, the predominant currency, also used as the settlement account.
Country Experiences – Zimbabwe…

• Instant implication of dollarization then was that all national savings in local currency disappeared overnight and have not been de-monetized to date.

• The effect was loss of confidence in the economy, particularly in the banking system, and consequently destroyed the culture of saving in the population.

• Conservative estimates anything between US$1 billion and US$2 billion worth of hard currencies, circulating outside the banking system.

• In the case of Zimbabwe, the local currency was completely abandoned, while the country has no formal arrangements or agreements with the countries whose currencies Zimbabwe is using.

• Dollarization resulted in low inflation, restored financial stability, increased budgetary discipline, re-established monetary credibility and consequently some measure of economic stability (Noko, 2011).

• However, these nascent gains may not be sustained for long due to existence of underlying institutional rigidities and overarching infrastructural bottlenecks.
Country Experiences – SSA

- Depending on whether the deposits and loans dollarization trend is upward, downward, or relatively stable – the five SSA economies that are most dollarized economies are Angola, Democratic Republic of the Congo, Liberia, São Tomé and Príncipe, and Zambia (IMF, 2015)

- Angola recorded a downward trend in both deposits and loans, while Democratic Republic of the Congo, Liberia, and São Tomé and Príncipe recorded an upward trend during the decade.

- Contrasting with the previous cases, Zambia presents a peculiar characteristic: a downward trend in deposits dollarization but an upward trend in loans.

- However, the trends in the ratio of foreign exchange debt to total debt in SSA (from 78% in 2001 to around 60% in end 2012) show that countries have been able to tame, somewhat, the so-called “original sin problem.”

- This pattern confirms the increasing ability of governments to issue debt in domestic currency, which enhances the economy’s resilience to external shocks.

- In addition to this growing role of domestic debt markets, it is also noteworthy that, after a long absence from international capital markets, several SSA economies have recently been able to tap also into these markets (Ghana, Gabon, Nigeria, Kenya, Senegal etc.)
Other Countries Experiences with Dollarization

• In some of the countries, dollarization took place not only because of the loss of confidence in the local currency, but also because of corruption and bureaucracy in both the public and private sectors (Oomes and Ohnsorge, 2005; Quispe-Agnoli and Whisler, 2006).

• In the aftermath of the financial crisis in Brazil, Argentina and Mexico in the 1990s and the East Asian financial crises of 1997, a number of Latin American and some Asian countries informally adopted dollarization in an effort to address rampant inflation and avert economic instability.

• In Chile, Colombia, and Peru, dollarization followed periods of macroeconomic instability and high inflation.

• In Nigeria, Venezuela and many sub-saharan African countries, dollarization followed introduction of policies that repressed financial transactions and imposed capital controls.

• In Argentina and Ecuador, dollarization followed the appeal of the U.S. dollar as an anchor of macroeconomic stability.
Challenges / Lessons from Countries’ Experiences

• The balance of costs and benefits of full dollarization is still a complex issue which requires more research and empirical evidence (Berg and Eduardo (2000)).

• Dollarization results in potential benefits including lower inflation, lower interest rates, increased confidence and more stable economies;

• However, these benefits must be balance against the cost of forgone seigniorage revenues, loss of monetary policy, inability to cushion the economy against external shocks, and lack of a clear exit strategy from dollarization.

• Countries which are already highly integrated with the host country’s trade and financial relations are likely to benefit more from dollarization, compared to those that are distant and economically unrelated to the anchor countries.
Challenges / Lessons from Countries’ Experiences ….

- The choice of a specific currency to anchor the dollarization, and the subsequent inability of the government to enter into a formal dollarization agreement with the anchor country (Noko, 2011) e.g. Zimbabwe

- Dollarization tend to be permanent or nearly so, with no clear exit strategy. Reversing dollarization is much more difficult than modifying or abandoning a currency board arrangement.

- Under dollarization, there are no monetary policy instruments to effectively influence macroeconomic and financial conditions in the economy.
  - Due to inability to print local currency, there are no instruments like the Repo Rate, Bank Rate or such refinance facilities, which normally provide the Central Bank with a leverage over interest rates and other financial conditions in the market.
Challenges / Lessons from Countries’ Experiences ….

- Dollarization reduce the ability of the government to issue medium- and long-term debt in domestic currency - “the original sin”—further exacerbating vulnerabilities to shocks and thereby amplifying macroeconomic and output fluctuations.

- Giving up the Lender of Last Resort function imply that the central bank may not respond effectively to financial system emergencies with serious implication on the stability of the banking system.

- The money, capital and inter-bank markets tend to be inactive.
  - Treasury bills and Bonds issued by Government, may have no significant impact on secondary market trading, due to the non-competitive nature of their issuance and being short term.
  - Apart from Research and Policy Advice to Government, most central banks rely on Moral Suasion and other non-monetary policy interventions, such as Banking Supervision and Surveillance; administration of National Payment Systems; as well as enforcement of Exchange Controls and Anti-Money Laundering Regulations.
Conclusions/ Recommendations

• There is need for countries to avoid the policy pitfalls that may lead to stagflation and severe macroeconomic disruptions which precipitates the need for dollarization.

  o Loss of the use of own currency, for whatever reason, should be avoided at all costs, as the ability to issue own legal tender lies at the heart of effective monetary policy implementation and management, particularly in developing countries where monetary aggregates still play a central role in inflation control and prudent macroeconomic management policies.
Recommendations…

- Dollarization creates the prerequisites for accelerated economic growth, but in no way can it be treated as a substitute for economic reforms.

- There is need to introduce limitations on the availability of foreign currency deposits but also ensure this does not cause capital flight.

- There is need to build credibility of the Central Bank in order to make it easier to implement stabilizing monetary policies.

- When the costs outweigh benefits of dollarization, a country may consider an exit strategy.

- Gradual and market-driven policies have been more successful - supportive policies aimed at lowering inflation and deepening financial markets help reduce dollarization e.g. Israel.
Recommendations…

• Successful de-dollarization requires time, persistent, and coordinated efforts to implement an appropriate mix of sound macroeconomic policies, market-based incentives, and microprudential measures including:

• A combination of policies need to be implemented including:
  o Creating markets for local currency denominated bonds;
  o Active bank supervision to ensure that banks fully covered their foreign currency loans positions
  o Having a higher reserve requirement on foreign currency liabilities helps make such liabilities more costly. At the same time, this helps mitigate liquidity risk of dollarization (such as deposit runs) that is related to such deposits.
  o Maintaining a sufficient level of international reserves to mitigate against bank runs
  o Regulations to encourage use of local currency (e.g. prices to be denominated in local currency)
  o Policies that promote use of the local currency for payments through convenient and lower-cost services than for foreign currency
  o Moving toward risk-based supervision could help better monitor risks taken by banks in extending credit
Recommendations…

• Avoid forced de-dollarization since it tend to have high macroeconomic costs.
  o In 1982, Mexico forced de-dollarization led to substantial capital flight and private sector bank credit almost halved in two years. Growth suffered significantly and inflation shot up
  o In Bolivia and Peru, forced de-dollarization was subsequently followed by macroeconomic instability that resulted in hyperinflation and led these countries to later allow foreign currency deposits

• Reversing dollarization should be gradual
  o De-dollarization tends to be difficult, since it depends on institutional changes and occurs when significant benefits can be gained by switching currencies. De-dollarization requires persistence in reducing inflation and stabilizing macroeconomic policy.

• Mandatory measures and direct controls seem only to be effective when used as a complement to a market-based strategy.

• Establishing the credibility of macroeconomic policy is essential – establishing macroeconomic stability is critical.
Thank You