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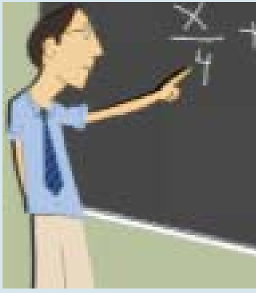

Dollarization:

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ECONOMICS may be a science, but it also seems to be subject to fashion. Dollarization—the use of a foreign currency, usually the U.S. dollar, for transactions in another country—was only a few years ago a hot theme at economic conferences and seminars. Now economists are putting more emphasis on caution as the costs and risks of dollarization have become more apparent. Nevertheless, dollarization remains widespread and has even intensified in some countries. More recently, other foreign currencies, such as the euro, are being used. While these countries have in effect *euroized,* the term dollarization is often used to refer to both cases: dollarization and euroization.

Increasing use of the dollar for real and financial transactions is often a response by a country's citizens or government to instability associated with the country's own currency. However, while the use of the dollar may lead to increased macroeconomic stability, it can also make financial systems more vulnerable to liquidity and solvency crises. Also, once it has taken place, dollarization can be very difficult to undo, even if the country has maintained its own currency in parallel and managed to stabilize its value. Accordingly, it is something that should be approached with great care.

What is it?

Dollarization can take multiple forms. Full or official dollarization occurs when a foreign currency—usually, the dollar—is adopted by a country as its main or exclusive legal tender. Partial or de facto dollarization occurs when a country keeps its own local currency in circulation, but also allows payments and transactions to be carried out freely in dollars. It is useful to distinguish between three different types of dollarization:

- payments dollarization—dollars are used mainly as a means of payment;
- financial dollarization—domestic residents hold financial assets in dollars; and
- real dollarization—local prices and/or wages are set in dollars.

There are only a handful of fully dollarized economies in the world, including Ecuador, El Salvador, and Panama. But de facto or partial dollarization is widespread. The ratio of foreign currency deposits to total deposits has increased in recent years in Latin America, Asia, Africa, and the European transition economies (see table).

Why countries dollarize

Dollarization often reflects a history of macroeconomic instability. People generally prefer their money holdings to have relatively stable purchasing power. That's why residents of countries with a history of high and volatile domestic inflation may favor a foreign currency whose value is more stable.

Institutional factors play an important role in determining why some countries with a history of macroeconomic instability are dollarized and others are not. Some countries may seek to contain the decline in savings that can result from inflation by authorizing the use of a foreign currency; others may try to resist dollarization by promoting financial indexation schemes or resorting to capital controls. That said, the lack of deep financial markets to support a liquid market for indexed instruments and the simplicity, transparency, and credibility of dollar instruments may tilt the balance in favor of partial dollarization in some countries.

Successful dedollarization occurred in Bosnia-Herzegovina, Israel, Mexico, Poland, and Slovenia after credible anti-inflation policies were implemented. In some of these countries, dedollarization was supported by controls and even forced conversion of dollar assets or liabilities into the domestic currency. However, for reasons not fully understood, dollarization has persisted or increased in many countries even after a successful stabilization of the domestic currency. For those tempted to pursue forced dedollarization, capital flight can be significant (in Mexico in 1982, capital flight was estimated at $6.5 billion) and it does not always achieve a sustained reduction in dollarization, as shown in the cases of Bolivia (1982) and Peru (1985).

No free lunch

While partial dollarization may contribute to increased financial intermediation in some countries, it also makes financial systems more vulnerable to liquidity and solvency risks. When these risks are not adequately assessed and controlled by financial institutions and other market participants, they can create—even exacerbate—turmoil by triggering bank runs and financial crises.

Liquidity risk in dollarized systems occurs when there is inadequate backing for the dollar liabilities of banks. A perceived increase in country or banking risk may lead depositors or other creditors to convert their deposits or lines of credit into dollar cash or transfer them abroad. Dollar liabilities need to be paid at par against foreign currency. Unless they are backed by sufficient liquid dollar assets abroad, banks may, therefore, run out of liquid dollar reserves and drain the central bank's international reserves in the process. Runs on dollar liabilities can be triggered by deteriorating

Controlling Risk Is Key

On the increase

Dollarization is spreading despite the risks.

(percent share of foreign currency deposits to total bank deposits)

Regions	Number of countries	1996	1997	1998	1999	2000	2001
South America	9	45.8	41.6	44.6	48.1	49.2	50.9
Transition economies	26	37.3	38.9	43.5	44.3	46.9	47.7
Middle East	7	36.5	37.2	37.7	37.5	38.2	41.9
Africa	14	27.9	27.3	27.8	28.9	32.7	33.2
Asia	13	24.9	28.0	26.8	28.8	28.7	28.2
Central America	6	23.2	23.4	24.7	24.8	25.2	27.3
Caribbean	10	6.3	7.6	6.8	6.7	6.1	6.2
Developed countries	14	7.4	7.5	7.5	6.7	7.0	6.6

Sources: *International Financial Statistics*, the IMF's Economic Data Sharing System, and statistical publications by various central banks.

macroeconomic conditions, as was the case in Mexico in 1982, Argentina and Uruguay in 2001, and Bolivia in 2003.

The main solvency risks in partially dollarized financial systems result from currency mismatches in balance sheets and the effects that large depreciations of the local currency can then have on net worth. A currency mismatch exists when foreign currency assets differ from foreign currency liabilities. When foreign currency liabilities of a bank are higher than its foreign currency assets, a depreciation of the local currency will reduce its net worth and may compromise its solvency. This happens, for instance, when a bank takes deposits in foreign currency and makes loans in domestic currency. This is known as foreign exchange risk. When a bank lends money to firms or households that have a currency mismatch, it may suffer losses as an indirect result of a depreciation of the domestic currency, even if the bank itself does not have a currency mismatch. The depreciation causes the unhedged borrower to suffer a loss that affects his or her capacity to service the loan to the bank, possibly leading to a default. When a large share of the banking system's loan portfolio is concentrated on this type of borrower, banks are exposed to currency-induced credit risk derived from their borrowers' foreign exchange risk. Such losses may threaten banks' solvency.

How to control the risks

Some policymakers in dollarized economies are pursuing complementary policies to reduce the vulnerability of their financial systems: prudential policies aimed at controlling the liquidity and solvency risks of dollarization are combined with measures to make the domestic currency more attractive and reduce dollarization.

Policies aimed at limiting liquidity risks are common in highly dollarized economies, but their extent and nature vary. High levels of foreign currency liquid assets in cash or in amounts deposited abroad often operate as a buffer. This serves to lower the probability of liquidity running out in the event of a bank run and also reduces the likelihood of a run itself. In some countries a large portion of these liquid assets correspond to the international reserves of the central bank. In other countries, financial institutions also maintain large liquid assets deposited abroad, either voluntarily or as a result of prudential requirements in the form of liquidity or reserve requirements imposed by regulation. The objective of such regulations is to ensure that banks share the cost of holding high liquidity, and thereby internalize the risks of operating in a dollarized environment. Other countries have explicit arrangements that allow the central bank to provide liquidity assistance in foreign currency. The credibility of these arrangements is enhanced if the central bank holds large international reserves.

Policies to control currency-induced credit risk, while still rare, are becoming more common. The main goal is to encourage creditors and debtors in the financial system to internalize the costs of operating in a dollarized environment. There is a wide range of possible measures. They vary from prohibitions or limits on lending foreign currency to unhedged borrowers (Argentina, Chile, Lebanon), to higher provisioning or capital requirements for unhedged loans (Georgia). Some countries have established credit risk management rules that explicitly require financial institutions to assess currency-induced credit risk of potential and actual borrowers (Peru).

Policies to enhance the attractiveness of the domestic currency generally aim to lower the risks and costs associated with its use. Such measures include keeping inflation low, removing administrative ceilings on interest rates, reducing high unremunerated reserve requirements for local currency deposits, moving toward inflation targeting and more flexible exchange rate regimes, developing markets for public securities denominated in local currency, and improving the efficiency of the local payment system. ■

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