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Financial sector development and dollarization in emerging economies

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ABSTRACT

This paper discusses important features of financial dollarization and its implications for the macro economy and financial sector deepening. Despite the need to slow down the rate of inflation and keep exchange rates under control, to achieve growth and economic development, monetary policies may permit increases in the base money to keep pace with real GDP growth. In heavily dollarized economies, during periods of sharp devaluations of the domestic currency, financial assets and liabilities shift toward foreign currency, exacerbating downward pressure on the exchange rate. When central banks face pressures to keep the exchange rate steady in nominal terms, interest rates in the domestic currency are set at levels substantially higher than those on dollar assets. In such states of the world, banks prefer to lend to the government sector at these higher rates than to the private sector. Although private firms may benefit from lower rates on dollar loans, they also face significant exchange rate or currency risk due to the currency mismatch emerging from their dollar debt while their receivables may tilt toward domestic currency denominated instruments. This weakens their balance sheet, which in turn increases the exposure of the banking sector to a variety of risks.

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1. Introduction

Financial dollarization, a phenomenon by which market participants use the dollar or the currency of a major trading partner as a store of value, is widespread in developing economies. Nonetheless, dual currency economies face some challenges in the areas of monetary policy, risk management, choice of exchange rate regimes, macroeconomic management, the deepening of the financial sector, and economic growth. Many of these features have received a great deal of attention in the incumbent policy literature. This paper surveys several trends in the extant literature to assess (1) the effects of financial dollarization on financial development in emerging markets; (2) the balance sheet effects of foreign currency lending; and (3) whether higher financial dollarization offsets monetary policies in emerging markets while hindering economic growth. In other words, it investigates whether financial dollarization leads to a misallocation of credit, the thinning of credit markets, and increased balance sheet effects in emerging markets.

The literature explains the conditions under which diversified portfolios of domestic and foreign money balances will be held and adapted in response to expected changes in relative risks and returns across the various currencies (see Ortiz, 1983). The idea that monetary policy will be ineffective in a country where foreign currencies are regarded as good substitutes for domestic currency is not novel.[1] Little attention has been accorded to the effects of financial dollarization on financial deepening. It is noteworthy highlighting that Schwartz (2004) posits that while accepting the need for today's issuers of fiat money to keep the credit system on an even keel, the belief in the powers of discretionary monetary policy to deliver growth and employment is, in the long run, an illusion.

Exposed to the risks associated with the local currency's loss of value, and in some instances, in conjunction with rising government borrowing, the corporate sector in emerging markets constantly needs external finance to purchase growth enhancing investments. Whereas the limited financial development of emerging markets is a significant factor behind the large share of dollar denominated external debt

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[1] See Miles (1978), Brillenbourg and Schadler (1980), Girton and Roper (1981), Ortiz (1983) for further discussions.

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present in these markets (Caballero & Krishnamurthy, 2003), large amounts of credits in these economies are in foreign currency or dollar denominated.[2] As monetary policies track exchange rate volatilities and the risk of inflation, they also seek to promote private credit through increased financial intermediation. To boost their local currency, emerging countries' central banks face the difficult choice of adopting a restrictive monetary stance, often, at expanse of growth in private credit in the local currency.

The mechanics of the relationships between financial dollarization, risks and financial deepening run through several channels. Financial disintermediation accelerates when financial institutions' incentive to innovate to provide new and structured financial products is impaired, due, in part, to distortions and arbitrage opportunities induced by interest rate differentials. Higher nominal interest rates on the local currency may lead to a stronger exchange rate while erecting steeper barriers to external finance and bringing weaker borrowers closer to bankruptcy.

The effect of exchange rate volatilities is a very complex issue, which depends on the treatment of revaluation gains (losses) on banks' fixed assets and trade investments as well as on changes in the business mix caused by the response of market participants. Economic agents may rush to convert their holdings into the foreign currency, thus accelerating the dollarization of the economy. This may hinder efforts by policymakers to allow the exchange rate to smooth out fluctuations and adjust to shocks or economic conditions. It may also undermine efforts to promote the provision of credit for investment purchases. De facto dollarization combined with lower levels of private credit is a reflection of financial disintermediation; which, when intersected with lack of effective monetary policy, may exacerbate mistrust in the local currency.

When monetary policy fails to counteract banks' lending cycles and their preference for dollar loans, highly dollarized emerging markets face the difficult decision to preserve incentives for increased intermediation. Monetary policy needs to take into account the extent to which the economy is dollarized; especially, in shallow credit markets where the elasticity of domestic investment and production is more sensitive to variations in nominal interest rates. Despite the need to keep inflation under control and smooth out exchange rate variations, to achieve growth and economic progress, monetary policies may permit increases in the base money to keep pace with real GDP growth.

In heavily dollarized economies, during periods of accelerated devaluations of the local currency, financial assets and liabilities shift toward foreign currency, thus exacerbating downward pressure on the exchange rate. When central banks face pressures to keep the exchange rate steady in nominal terms, interest rates in the domestic currency are set at levels substantially higher than those on dollar assets. In such states of the world, banks prefer to lend to the state sector at these steep rates than to the private sector since many poor countries cannot borrow internationally rather at home in their own currency. Although private firms may benefit from lower rates on dollar loans, they also face significant exchange rate or currency risk due to the currency mismatch emerging from their dollar debt while their receivables may be in domestic currency denominated instruments. This is clearly a double whammy for local firms. This results in weakened balance sheets for these firms while increasing the exposure of the banking sector to a variety of risks.

The remainder of the study is partitioned as follows. The next section discusses dollarization, its impacts on the development of the financial sector, and its measurements. The subsequent section looks the causes of dollarization while the fourth section looks much closely at its micro- and macroeconomic consequences. The fifth section discusses the challenges for policy reforms in the context of financial integration. The sixth section concludes with some policy recommendations.

2. Measures of dollarization and the depth of financial markets

The financial sector in emerging markets has witnessed some important developments in recent years. Dollarization has become an increasingly defining characteristic of many emerging market economies (Reinhart, Rogoff, & Savastano, 2014). With the persistent high levels of inflation of the seventies, together with underdeveloped capital markets and a repressed banking system that could not offer alternative assets, the US dollars became the alternative asset to hold on (Schwartz, 2004). Whereas the provision of credit in the local currency dwindles, the pools of foreign currency loans and deposits are expanding. As some countries witnessed impressive growths in credit, others have shown a thinning of their credit market. A priori, trends in financial dollarization can be explained by a lack of confidence in the domestic currency as a store of value. If the lack of credibility in the financial system, and by extension, prevailing monetary policies, causes agents to shift their savings toward major foreign currencies (usually the US dollar), financial disintermediation may ensue and cause the financial sector to lag behind in terms of innovation and the adoption of new financial products.

The breadth of the financial system, the shortage of financial instruments, and the persistence of traditional operations performed by financial institutions are important drivers leading agents to save in dollars as they seek to hedge their holdings against inflationary pressures along with the loss of value of the local currency. This economic behavior may be more prominent in countries with poor economic institutions devoid of a proven track record in risk management along with weak macroeconomic fundamentals. Banks in heavily dollarized emerging economies are highly responsive to fluctuations in exchange rates, which affect the value of financial holdings. The magnitude of the effect is determined by macroeconomic fundamentals and the perceived credibility or the efficacy of monetary policies. Asel (2010) argues that a lack of confidence in the quality of institutions of economic management can undermine confidence in the domestic currency and provide an incentive to hold assets in the foreign currency. In a modern open economy, for successful monetary policies to take place, the functions and capacities of the nation state are of great importance.

In a highly integrated world, first tier banks may find it more appealing to serve their economy's largest industrial and trade enterprises endowed with valuable collaterals but in need of foreign currency to carry out cross-border transactions and finance their investment requirements. Such intermediaries may be hesitant to supply foreign currency loans to households and to fledging small and medium businesses short of significant foreign currency stream of revenues, thus reducing their exposure to the twin currency and credit risk. As banks remain the most important players in the development of local financial markets in emerging economies, dollarization of their balance sheet, in the dual currency context, implies significant exposure to cross border risk. The consequence of this mechanism is an overly prudent banking sector, occupying financial markets with mostly traditional financial products.

Table 1 illustrates that dollarization of bank assets and liabilities is a widespread phenomenon in emerging economies. Several measures of financial dollarization have been proposed in the extent literature. From a cross country standpoint, most of the suggested indicators in the incumbent literature remain aggregated at the macro level due to lack of data at the firm level. More specifically, Quispe (2000) underscores that the dollarization ratio is the relation between the foreign currency deposits in the domestic financial system plus residents' deposits abroad with respect to the broad monetary aggregate. Calvo, Izquierdo, and Mejía, (2004) measure financial dollarization as the sum of dollar deposits and foreign liabilities in the domestic banking sector, computed as a share of GDP. The data in Table 1 is consistent

[2] We interpret this feature as reflecting the level of financial development.

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