Stategies for Dedollarization: Financial Sector Development and Inflation Targeting

Jorge Desormeaux

Central Bank of Chile

Prepared for the International Conference: "Dollarization: Consequences and Policy Options" organized by the Central Bank of the Republic of Turkey

December 14-15, 2006, Istanbul

Outline

I. Roots of Financial Dollarization (FD)
II. Empirical Evidence on Correlations between FD and Aggregate Variables
III. Dedollarization I: Strengthening the Financial Sector
IV. Dedollarization II: Adopting Full–fledged Inflation Targeting (IT)
V. Final Remarks

Roots of Financial Dollarization

Roots of Financial Dollarization

- There are two alternative explanations for financial dollarization (FD):
  1. FD is the result of a market equilibrium in which agents choose an optimal currency composition (Ize and Levy Yeyati 2006).
  2. FD may reflect policy or market failures (Levy Yeyati 2006)

Roots of Financial Dollarization

- FD is widespread in economies where:
  - Monetary policy is weak and lacks credibility
  - Monetary authority exhibits "fear of floating"
  - There is exchange-rate policy asymmetry and a tendency to currency overvaluation:
    - Local currency is not allowed to appreciate in good times but is expected to depreciate in bad times
  - An unhedged private sector expects a government bailout in case of large devaluations.

Empirical Evidence on FD

Empirical Evidence on FD

- There is empirical evidence on correlations between aggregate variables and FD – but note:
  - Most correlations do not imply causality
  - Many correlations are driven by third factors
  - Many correlations do not have immediate policy implications

Empirical Evidence on FD

- FD is positively correlated with:
  - The quality of institutions (Levy Yeyati 2006)
  - Exchange rate pass-through (Reinhart et al. 2003)
  - Fear of floating (Reinhart et al. 2003)
  - Output volatility (Levy Yeyati 2006)
  - Inflation (Levy Yeyati 2006)
  - Vulnerability to crises and capital flight (Levy Yeyati 2006)
  - Bias towards currency depreciation (Rennhack and Nozaki 2006)
- FD is not correlated with financial deepening (Rennhack and Nozaki 2006)

Dedollarization I: Strengthening the Financial Sector

Dedollarization I: Strengthening the Financial Sector

- Sound monetary policy and strong institutions are necessary conditions for a successful dedollarization.
- But the latter are not sufficient conditions if other binding market failures are present.
- To overcome market failures that lead to FD, financial sector development should be strengthened by adopting three sets of measures:

Dedollarization I: Strengthening the Financial Sector

1. Promoting the use of domestic currency or domestic currency-based substitutes and hedging markets (Levy Yeyati 2006).
   - Experiences of Chile and Israel are examples of successful adoption of inflation-indexed financial instruments to reduce (or elude) FD.

Dedollarization I: Strengthening the Financial Sector

- In Chile monetary, exchange rate and public debt policies supported indexation (and thus avoided dollarization) of financial markets.
  - Issuance of indexed public debt, indexation of the tax code and accounting rules, mandatory wage indexation
  - Indexation of the nominal exchange rate between 1984 and 1988
- But financial indexation generated costs: fragmented financial markets, low financial integration, high inflation persistence.

Dedollarization I: Strengthening the Financial Sector

2. Establishing financial regulation and safety nets that:
   - focus on currency exposure of local firms (dollar debtors with non-dollar revenues).
     - Chile's 2000 financial regulation of domestic banks, required them to provision against their clients' exposure to currency risk.
   - move away from currency-blind deposit insurance schemes.
     - lender of last resort role of central banks applies to domestic currency

Dedollarization I: Strengthening the Financial Sector

3. There is little agreement if measures geared at limiting dollarization directly can reduce FD
    - limits on dollar deposits, taxes on dollar intermediation, forced conversion from foreign to domestic-currency financial instruments (Argentina)
  - These policies can hurt more than benefit economies with high levels of FD since these economies are prone to capital flight (Cowan 2006)
  - Excessive domestic financial-sector regulation may lead to offshore dollarization, in which resident financial institutions and

Dedollarization II: Adopting Full-fledged Inflation Targeting (IT)

Dedollarization II: Adopting Full-fledged Inflation Targeting (IT)

- In addition to financial sector measures, successful dedollarization requires a suitable monetary and exchange-rate regime:
  1. IT contributes to monetary policy credibility and creates environment of low and stable inflation:
     - IT countries are successful in hitting inflation targets – one of the most successful has been Chile (Mishkin and Schmidt-Hebbel 2007)
     - IT strengthens central bank credibility and anchors inflation expectations (Gurkaynak et al. 2007)
     - Efficiency in coping with shocks increases with adoption of IT, particularly after a stationary inflation target has been achieved. Example, in Chile monetary policy efficiency has increased significantly after adoption of full-fledged IT

Dedollarization II: Adopting Full-fledged Inflation Targeting (IT)

2. A floating exchange rate regime overcomes fear of floating and mitigates dollarization bias (Schmidt-Hebbel 2006)

   - Countries are abandoning intermediate exchange rate regimes in favor of more flexible regimes or hard pegs as a superior response to the trade-off between independent monetary policy and exchange rate stability (Bubula and Ötker-Robe 2002)
   - Under IT, a free float reduces interest rate and reserve volatility, while exchange rate volatility rises, monetary policy becomes more independent of exchange rate shocks, and exchange rate pass-through declines, e.g. Chile (Schmidt-Hebbel 2006)
   - Inflation in IT countries responds less to oil price and exchange rate shocks (Mishkin and Schmidt-Hebbel 2007)

Dedollarization II: Adopting Full-fledged Inflation Targeting (IT)

- A uniquely successful case is Peru, a country with initially high dollarization that has adopted IT with a floating exchange rate, with success reflected by:
  - attaining low and stable inflation levels
  - lowering inflation volatility relative to exchange-rate volatility
  - reducing FD at a speed not observed in other countries with high levels of FD, like Bolivia or Uruguay.

Final Remarks

Final Remarks

- Adoption of a full-fledged IT regime with a floating exchange rate system helps countries to reduce the extent of FD.
- Dedollarization, however, also requires policies aimed at supporting financial sector development.
- Chile and Peru are good examples on how to avoid or reduce FD using the two latter complementary strategies.

Stategies for Dedollarization: Financial Sector Development and Inflation Targeting

Jorge Desormeaux

Central Bank of Chile

Prepared for the International Conference: “Dollarization: Consequences and Policy Options” organized by the Central Bank of the Republic of Turkey

December 14-15, 2006, Istanbul

Dollarization – and how to get out of it through IT and beyond

Jorge Desormeaux

Central Bank of Chile

Prepared for the International Conference: “Dollarization: Consequences and Policy Options” organized by the Central Bank of the Republic of Turkey

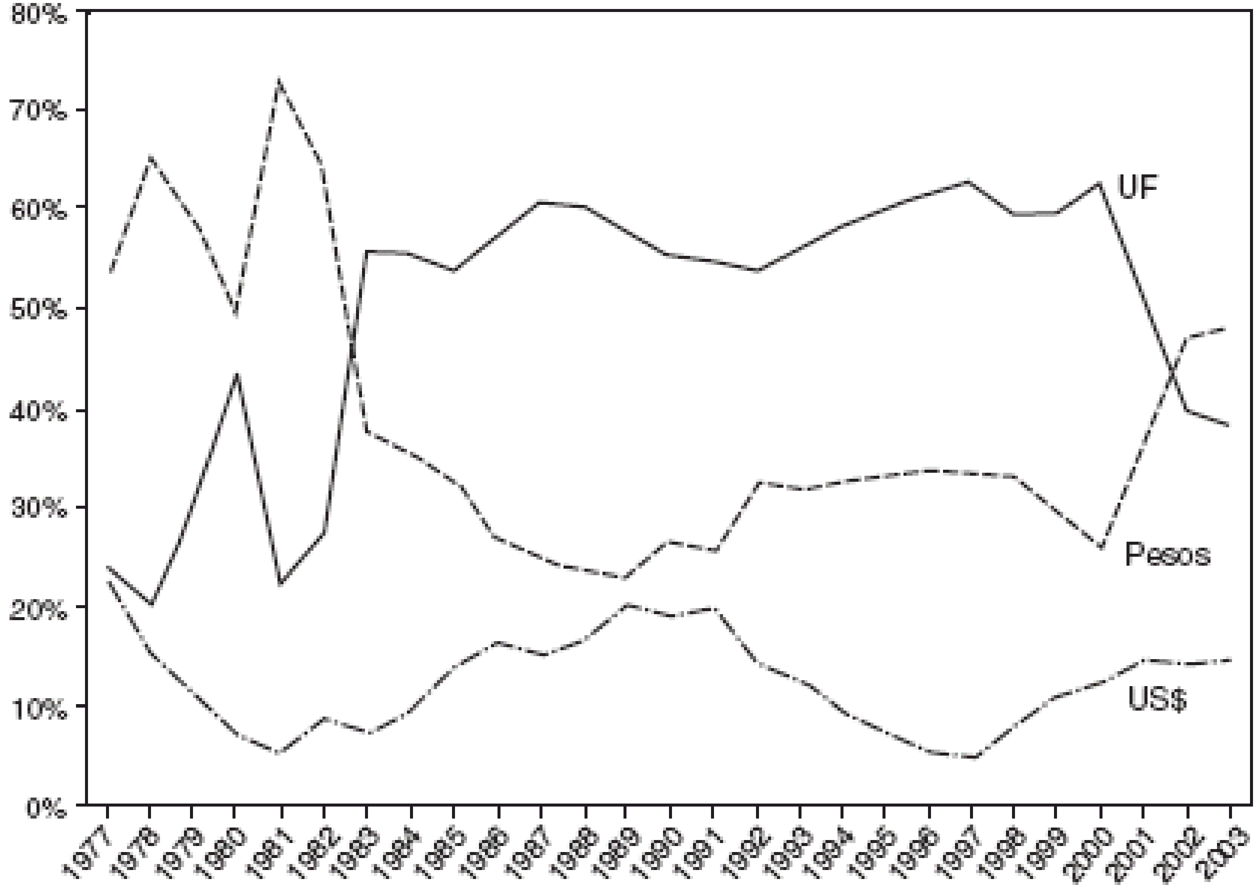
December 14-15, 2006, Istanbul

References

- Armas, A., A. Aize and E. Levy Yeyati (2006) *Financial Dollarization: The Policy Agenda*, Palgrave McMillan.
- Bubula, A. and Otker-Robe (2002) “Testing the Unstable Middle and Two Corners Hypothesis,” *IMF Working Paper* 02/155.
- Gurkaynak, R., A. Levin and E. Swanson (2007), “Inflation Targeting and the Anchoring of Inflation Expectations in the Western Hemisphere,” in F.S. Mishkin and K. Schmidt-Hebbel (ed.): *Monetary Policy under Inflation Targeting*. Santiago, Chile: Central Bank of Chile.
- Herrera, L.O. and R. Valdés (2004) "Dedollarization, Indexation and Nominalization: The Chilean Experience," *The Journal of Policy Reform*, vol. 8 pp. 281-312
- Mishkin, F. and K. Schmidt-Hebbel (2005), “Does Inflation Targeting Make a Difference?”, in F.S. Mishkin and K. Schmidt-Hebbel (ed.): *Monetary Policy under Inflation Targeting*. Santiago, Chile: Central Bank of Chile.
- Reinhart, C., K. Rogoff and M. Savastano (2003), “Addicted to dollars,” *NBER Working Paper* No. 10015.
- Rennhack, R. and M. Nozaki (2006), “Financial Dollarization in Latin America,” in A. Armas, A. Aize and E. Levy Yeyati (eds.) *Financial Dollarization: The Policy Agenda*, Palgrave McMillan.
- Schmidt-Hebbel, K. (2006), “Comments on Chapters 5 and 6,” in A. Armas, A. Aize and E. Levy Yeyati (eds.) *Financial Dollarization: The Policy Agenda*, Palgrave McMillan.
- Yeyati Levy, E. (2006) “Financial Dollarization,” *Economic Policy*, January pp. 61-118.

Dedollarization I: Strengthening the Financial Sector

Composition of Bank Deposits in Chile, 1977-2003

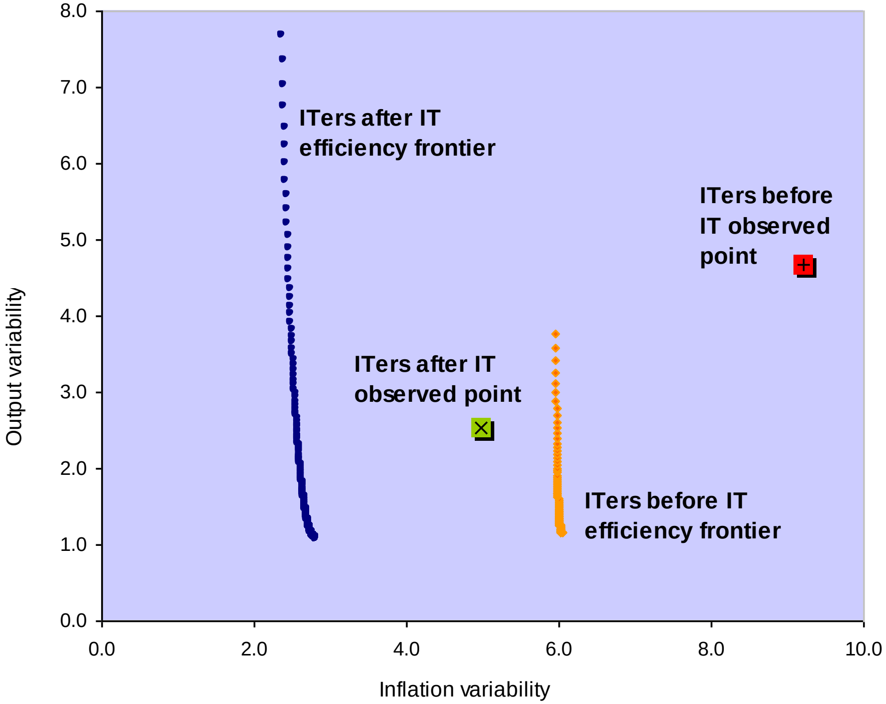


Source: Herrera and Valdés (2004)

Dedollarization II: Adopting Full-fledged Inflation Targeting (IT)

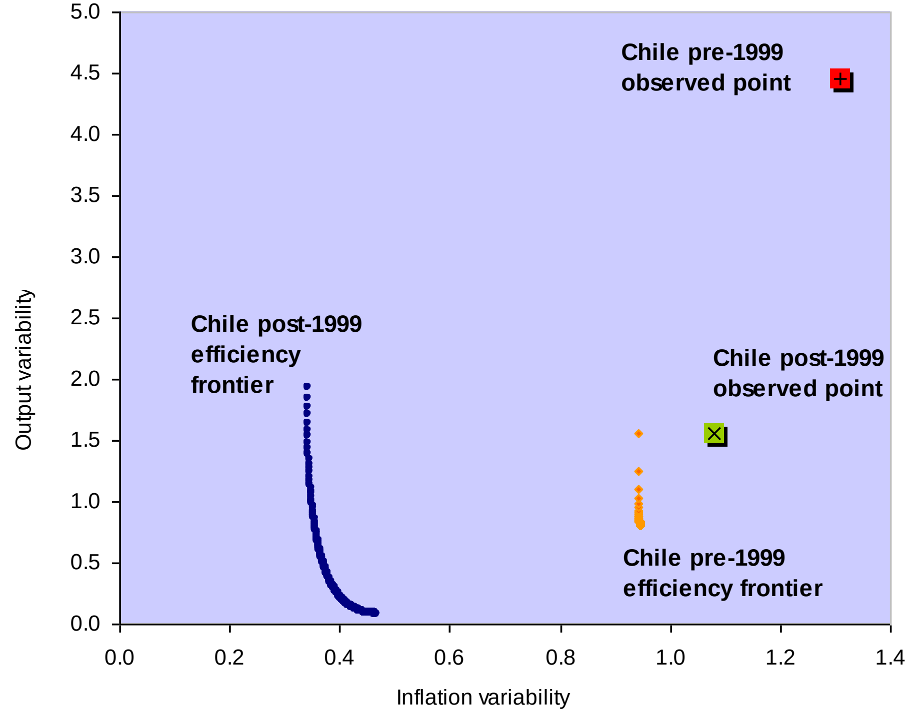
Changes in monetary policy efficiency in IT countries and in Chile

IT countries before and after de adoption of IT



Source: Mishkin and Schmidt-Hebbel (2007)

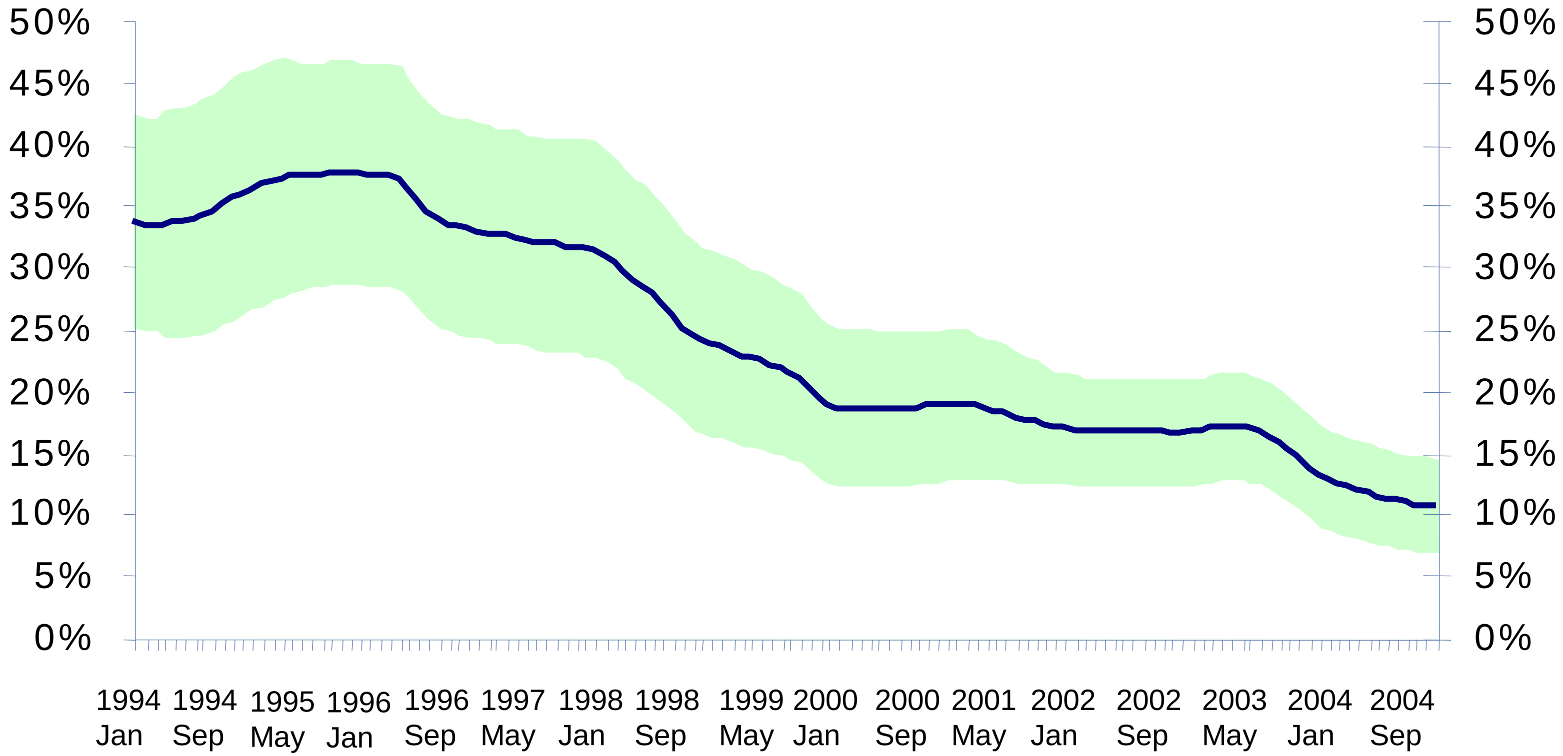
Chile before and after 1999



Dedollarization II: Adopting Full-fledged Inflation Targeting (IT)

Pass-through coefficient in Chile, 1994-2004

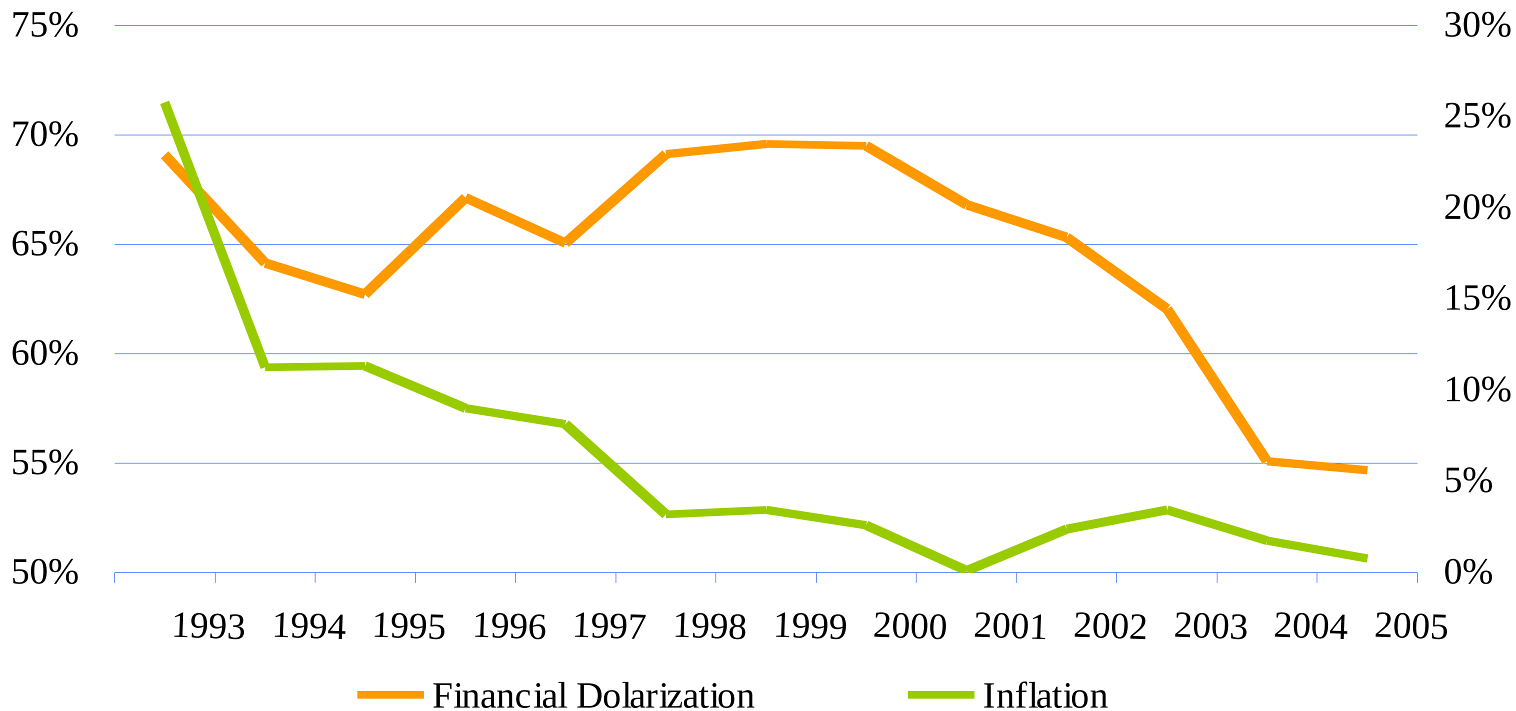
(Rolling coefficients, %)



Source: De Gregorio and Tokman (2005)

Dedollarization II: Adopting Full-fledged Inflation Targeting (IT)

Targeting Financial Dollarization and Inflation in Peru, 1993-2003



Source: BCRP.

Note: Financial dollarization is the share of banking system broad money in US$ dollars.