

Dollarization and Exchange Rate Fluctuations

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Outline

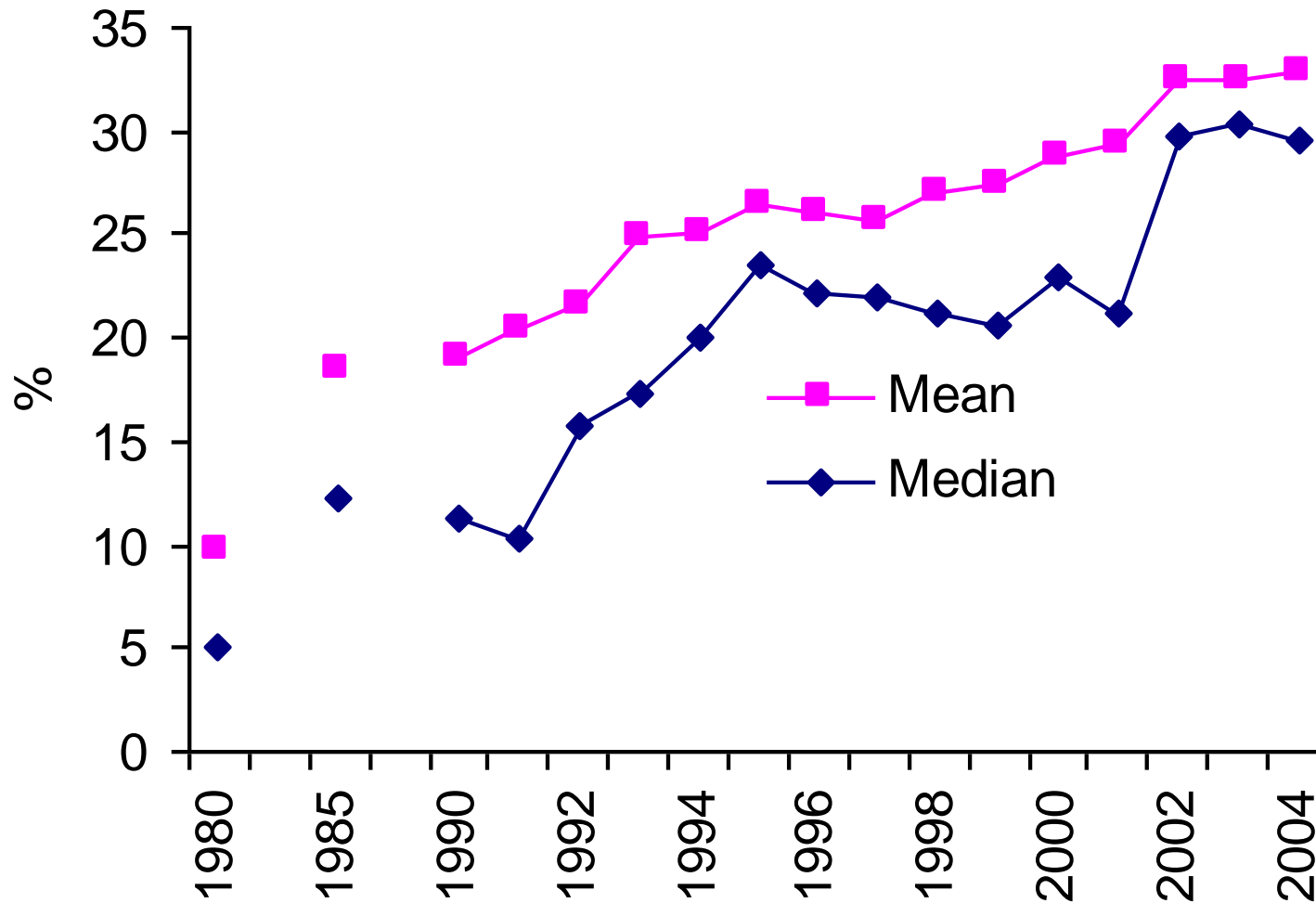
- Recent trends and causes
 - Upward trend not irreversible
 - A downturn in dollarization?
- Short-run currency fluctuations & dollarization
 - Fear of floating is exaggerated
- Impact on risks
 - Of depreciation and suspension
 - Measured by interest rates

Trends and causes

- The steady trend increase is an optical illusion
 - Balanced panel shows downturn after 2001
- High dollarization countries are of three types:
 - Inflation legacy; international financial centers, eurofringe
- Causes of country differences
 - Volatility of inflation and exchange rates
 - Credibility of macro/inflation/currency
 - Quality of institutions
 - Rules

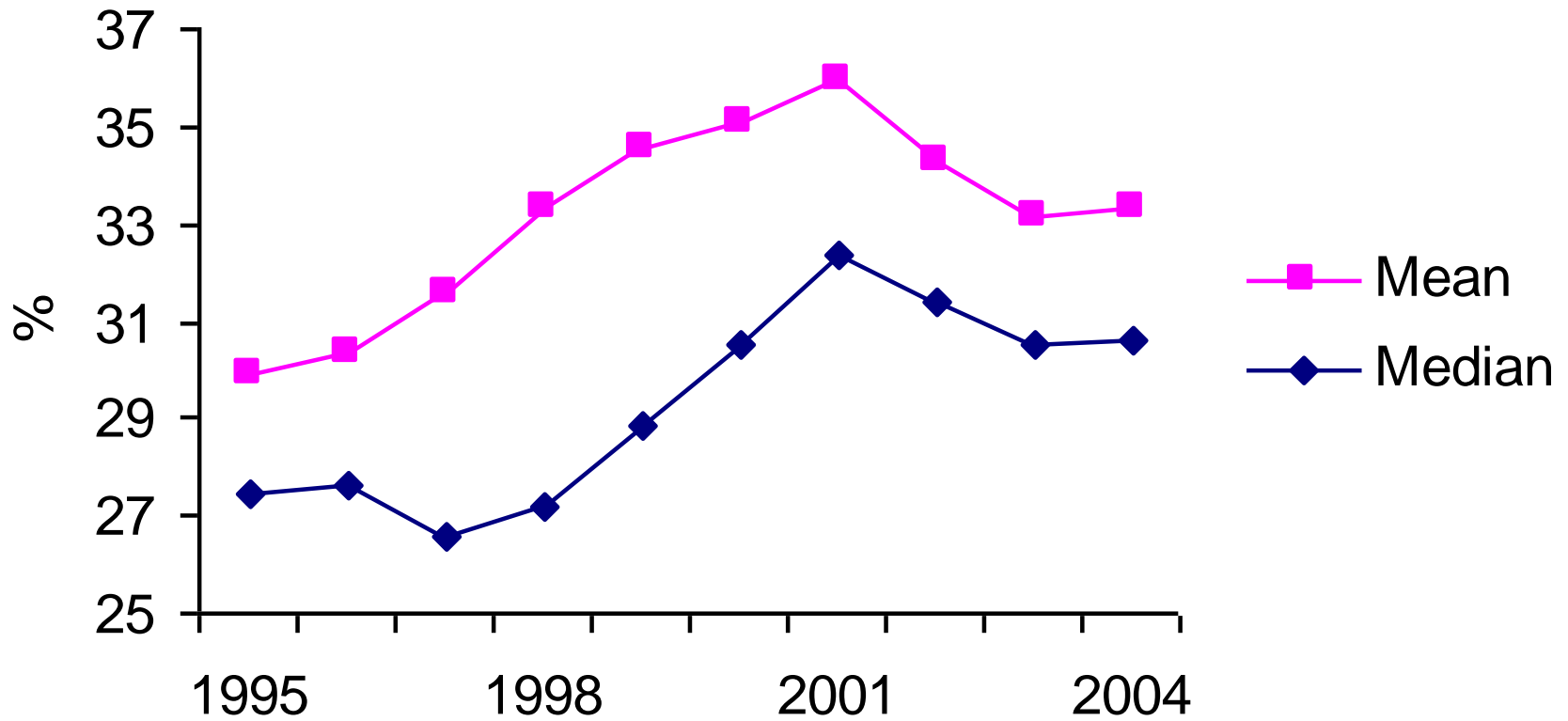
Deposit dollarization 1985-2004

Unbalanced panel (133 countries)



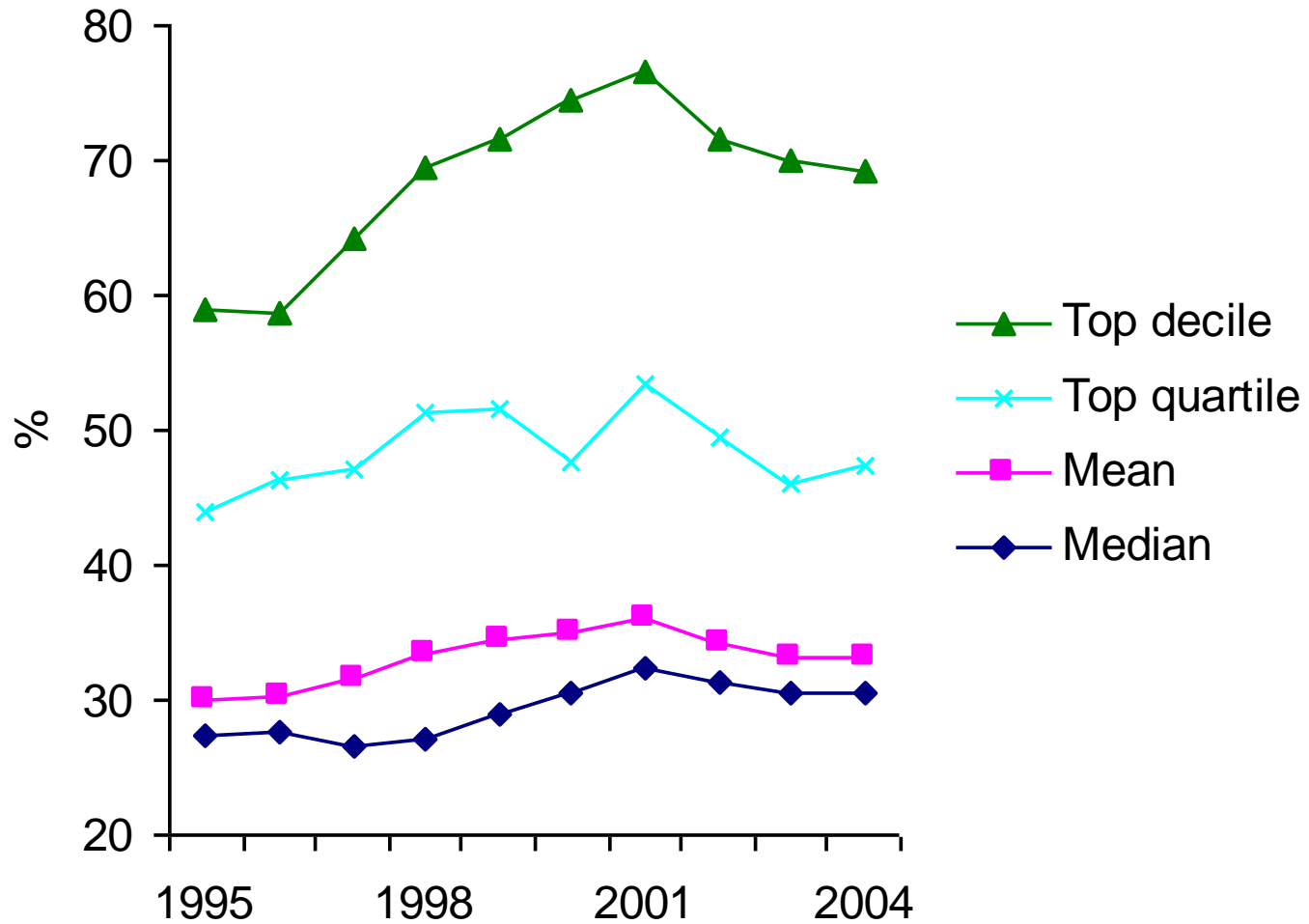
Deposit dollarization 1995-2004

Balanced panel 76 countries



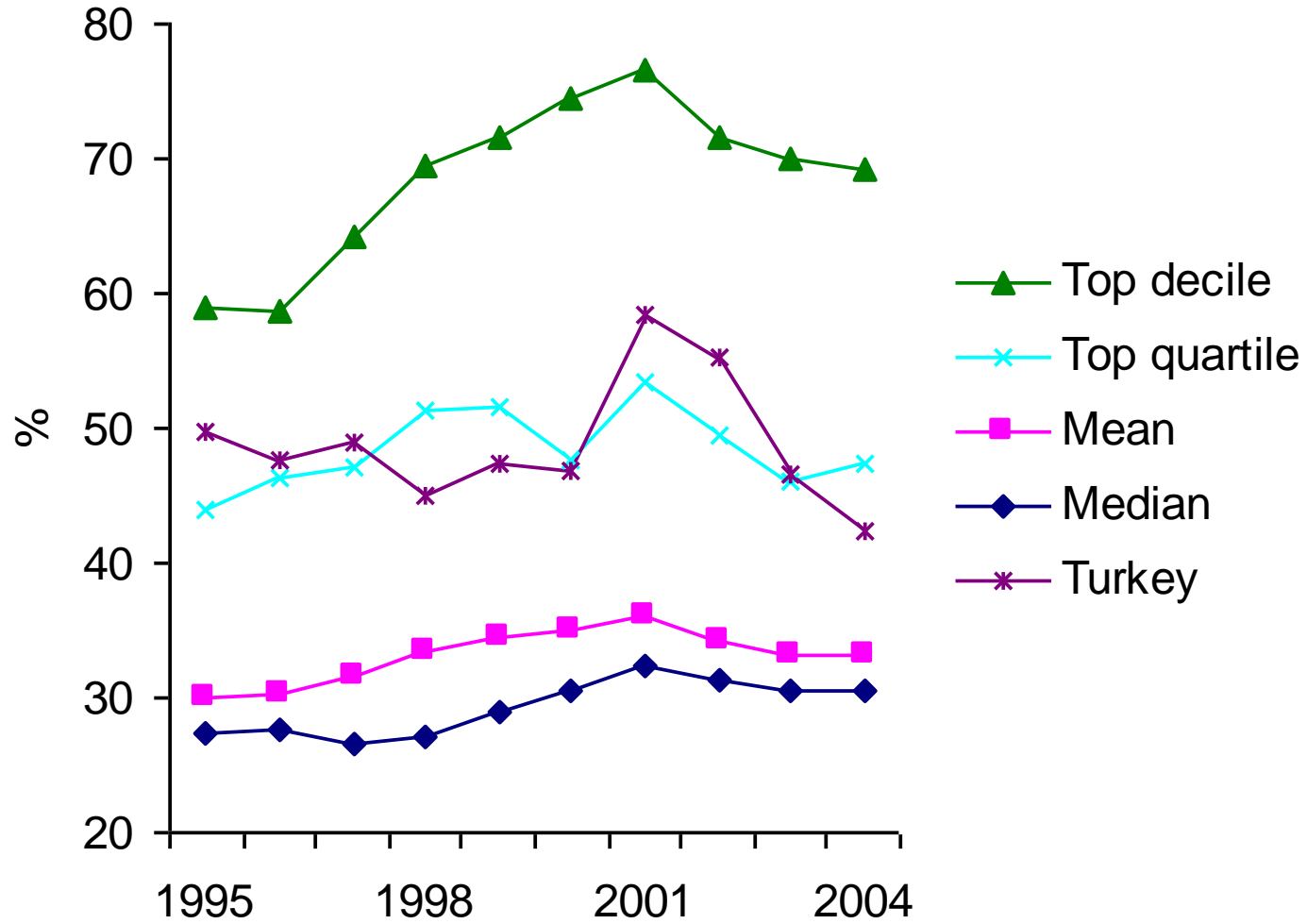
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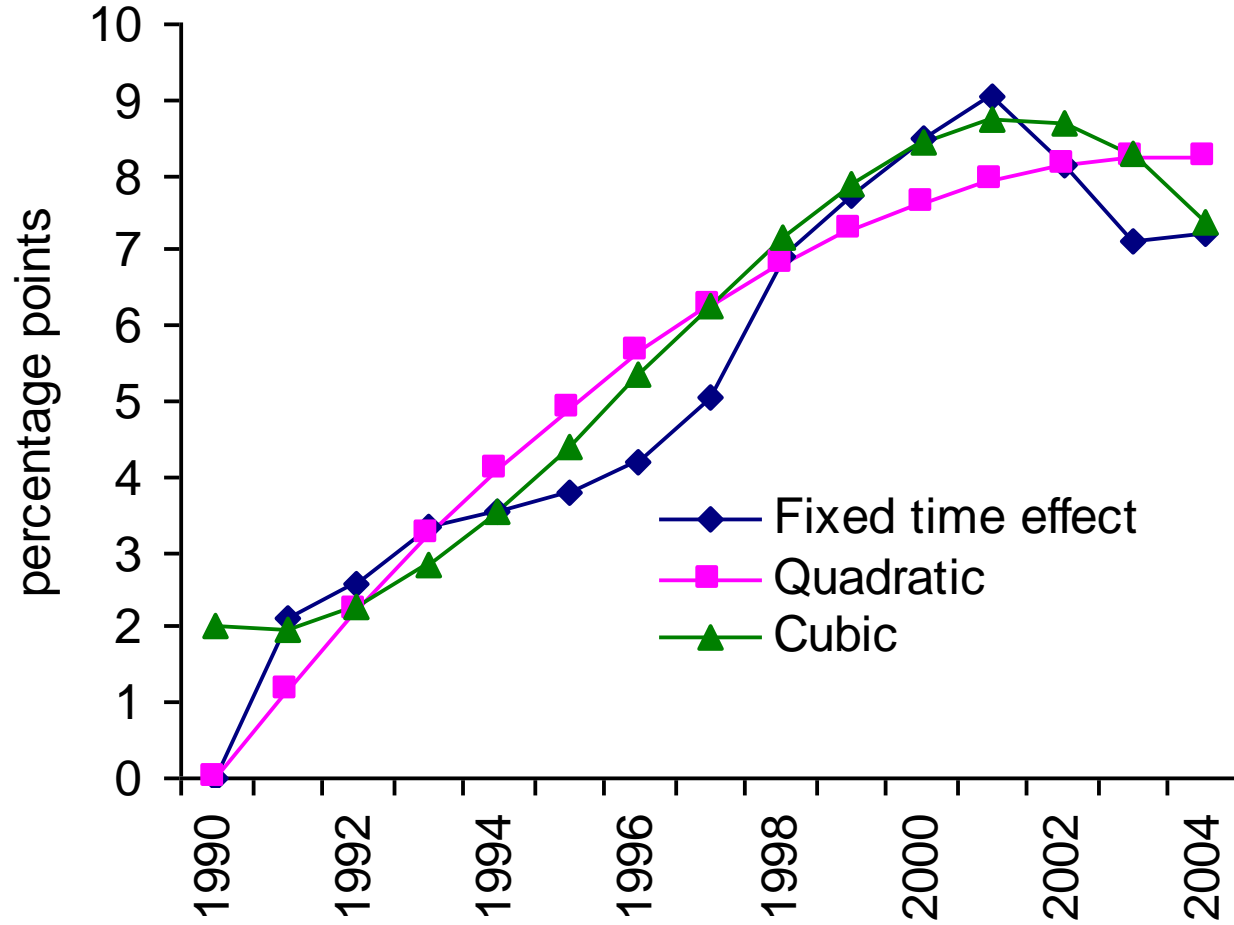


Deposit dollarization 1995-2004

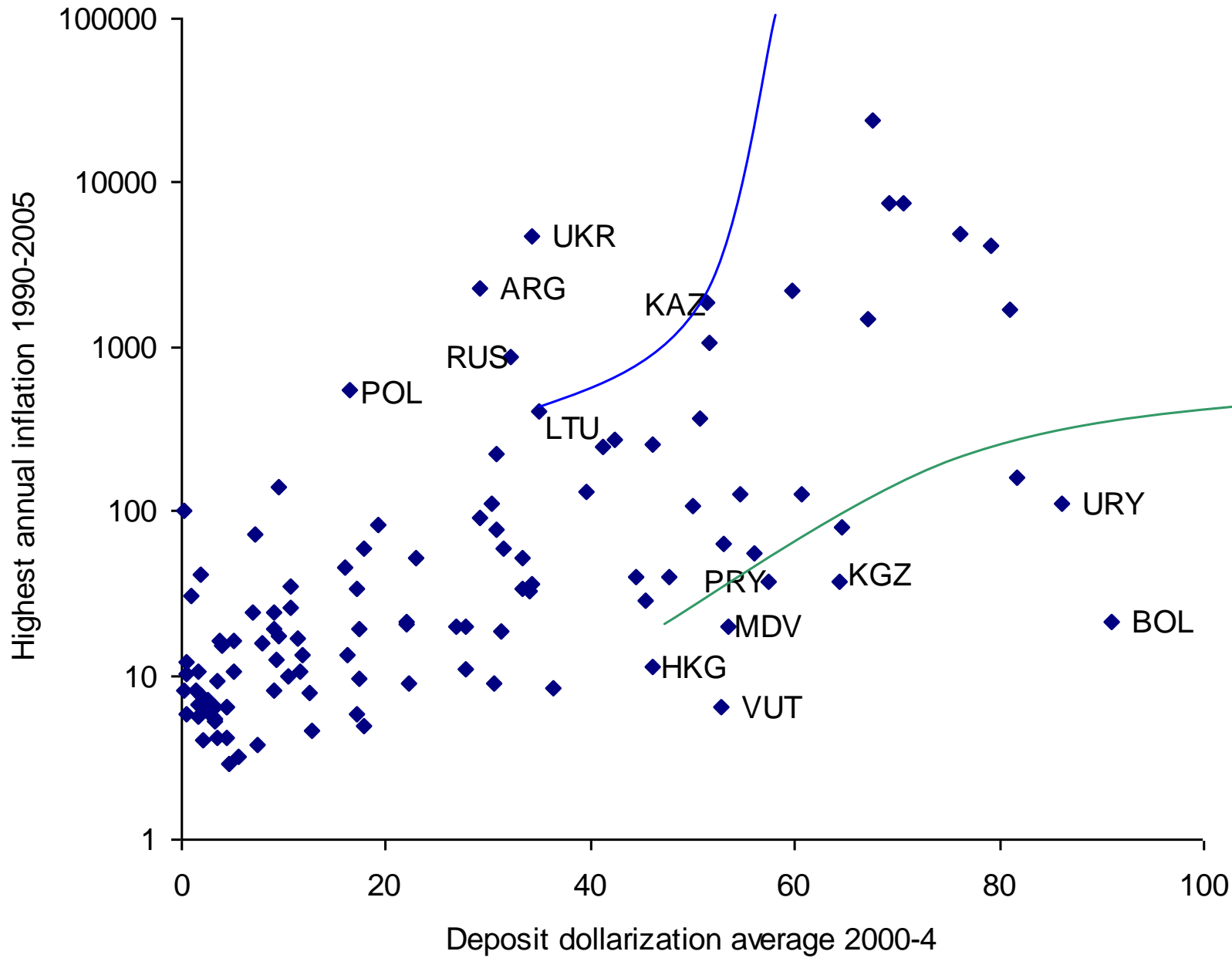
Balanced panel 76 countries



Estimated time effects



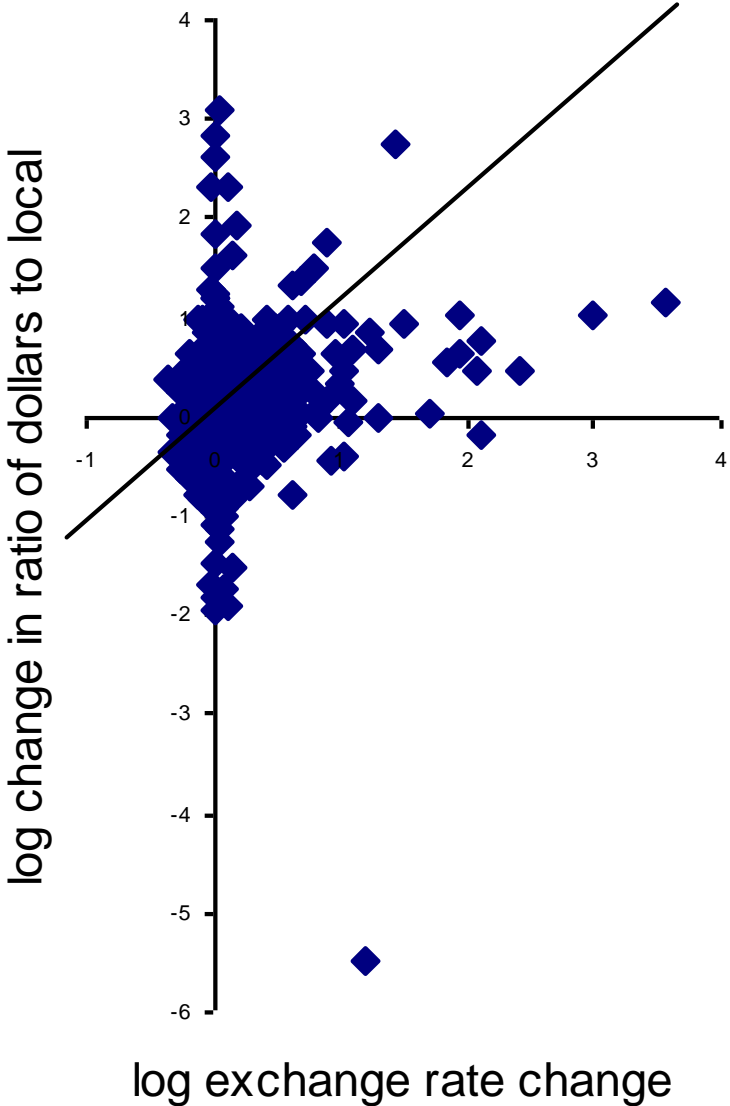
Peak inflation and dollarization



Currency fluctuations and dollarization

- There is a direct mechanical effect
 - But it can be rebalanced
 - Local money growth also important
- No evidence of destabilizing short-run response
 - (Econometric model)
 - Fear of floating a mistake
- Mechanical effect helps explain away 2002-3 downturn
 - but not change of trend

Exchange rate and dollarization ratios



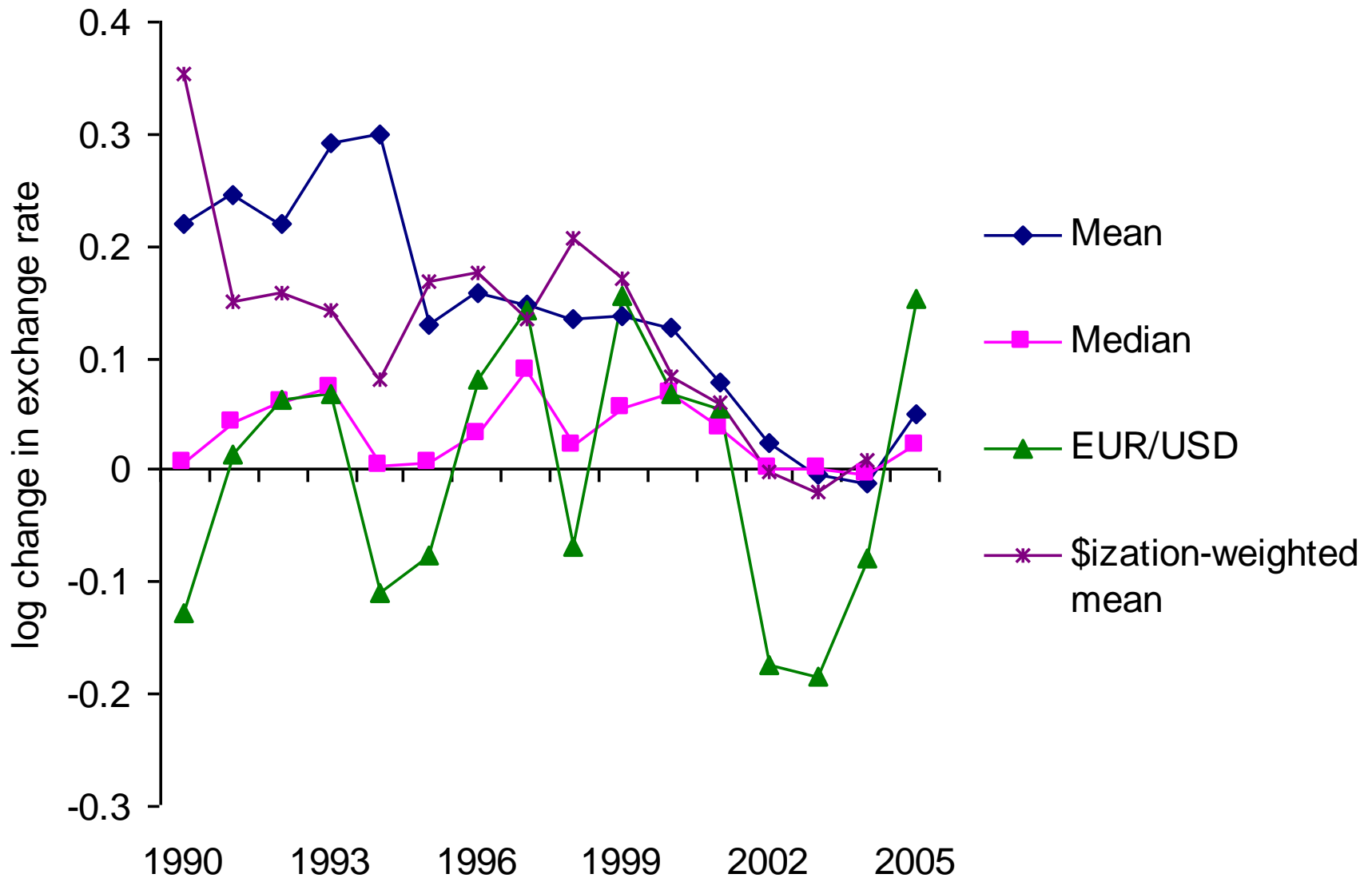
$$\Delta\delta_t = a_0 + a_1(1 - \delta_t)\delta_t \Delta \log e_t + a_2(1 - \delta_t)\delta_t \Delta \log m_t + a_3(\delta_t^* - \delta_{t-i}) + u_t$$

(Dependent Variable:
Change in Deposit Dollarization Percentage Share)

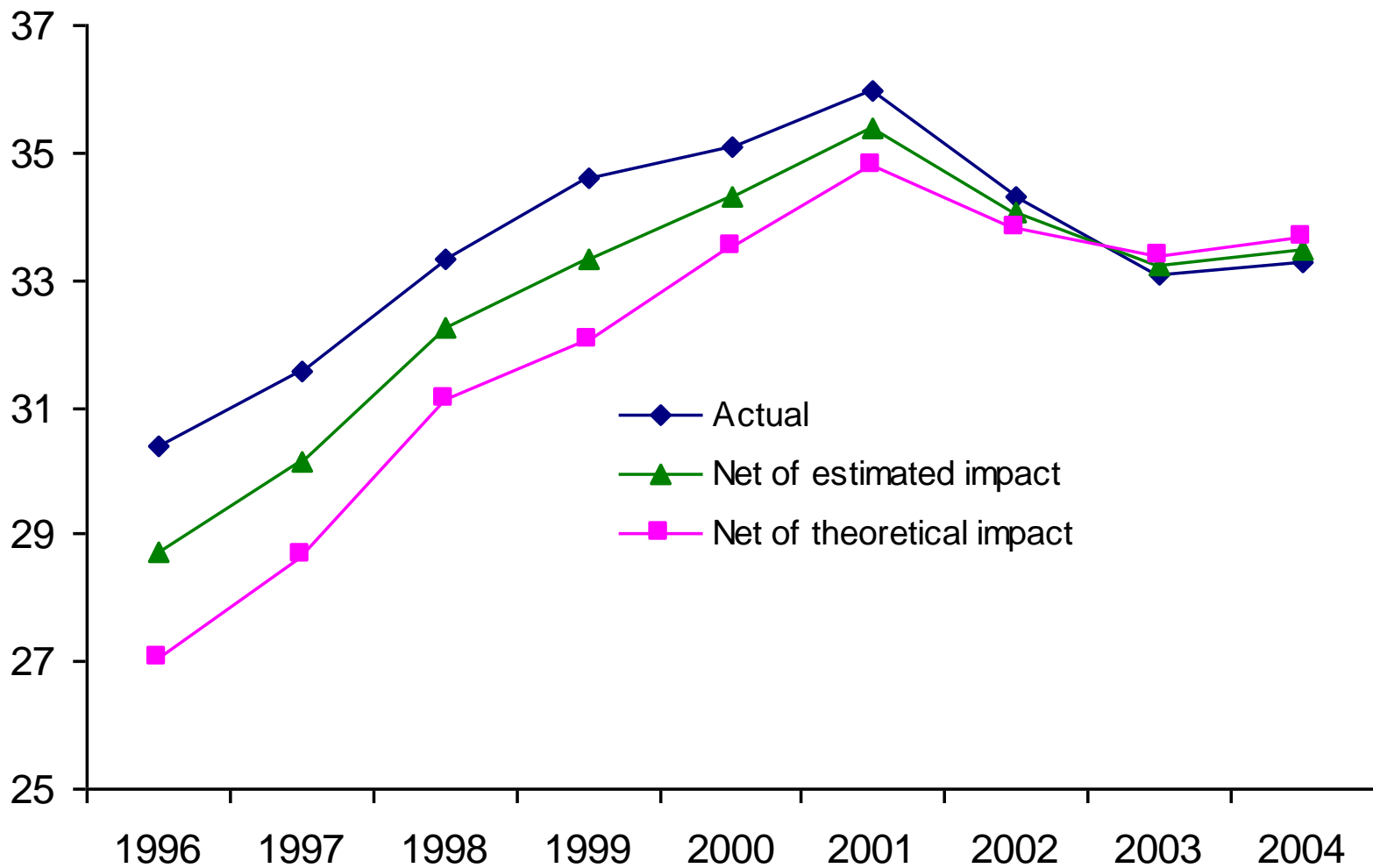
Equation: 1.3	
Variable	Coeff. t-Stat
Constant	country
Exchange rate factor	0.546 16.6**
Money base factor	-0.288 -8.7**
Lagged dollarization	-0.239 -16.3**
Time	0.123 4.6**
AR(1)	-0.417 -15.2**
No. of Countries	121
R-squared / NOBS	0.569 927
Adjusted R-sq / DW	0.501 2.17
SER/Method	2.90 LS

(wide outliers excluded)

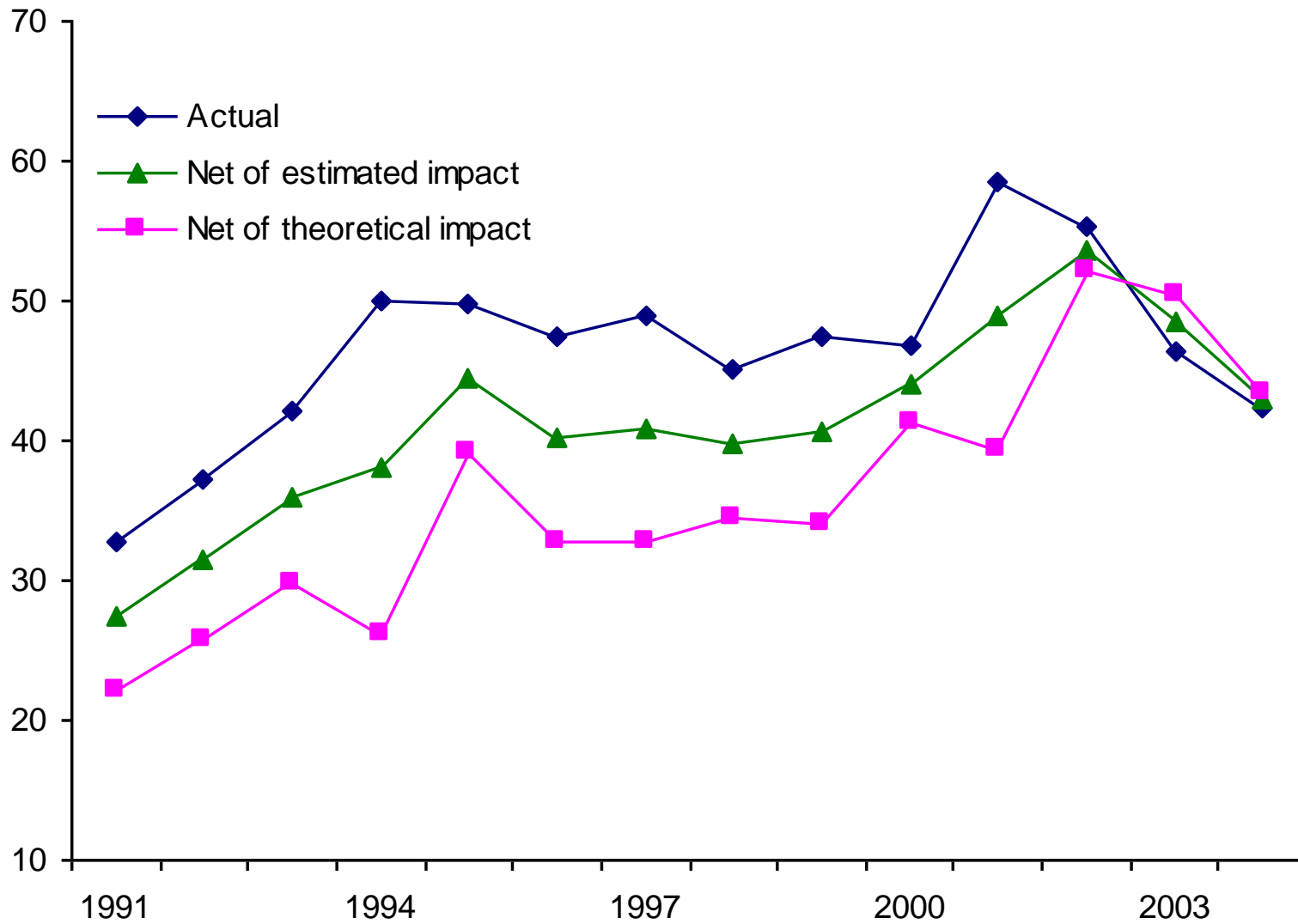
Exchange rate movements for sample countries



Dollarization net of depreciation impact
Mean of balanced sample (76 countries)



Dollarization net of depreciation impact Turkey



Dollarization and perceived risks

- Not just another portfolio asset
 - unhedged liabilities at systemic level
 - no LOLR
- Heightened risk of depreciation and suspension
 - Measured in interest spreads
 - Including for “hyphenated dollars”
- Dollarization shares are positively linked
 - With measures of future depreciation/suspension risk

Dollarization and USD deposit interest rate, 2004

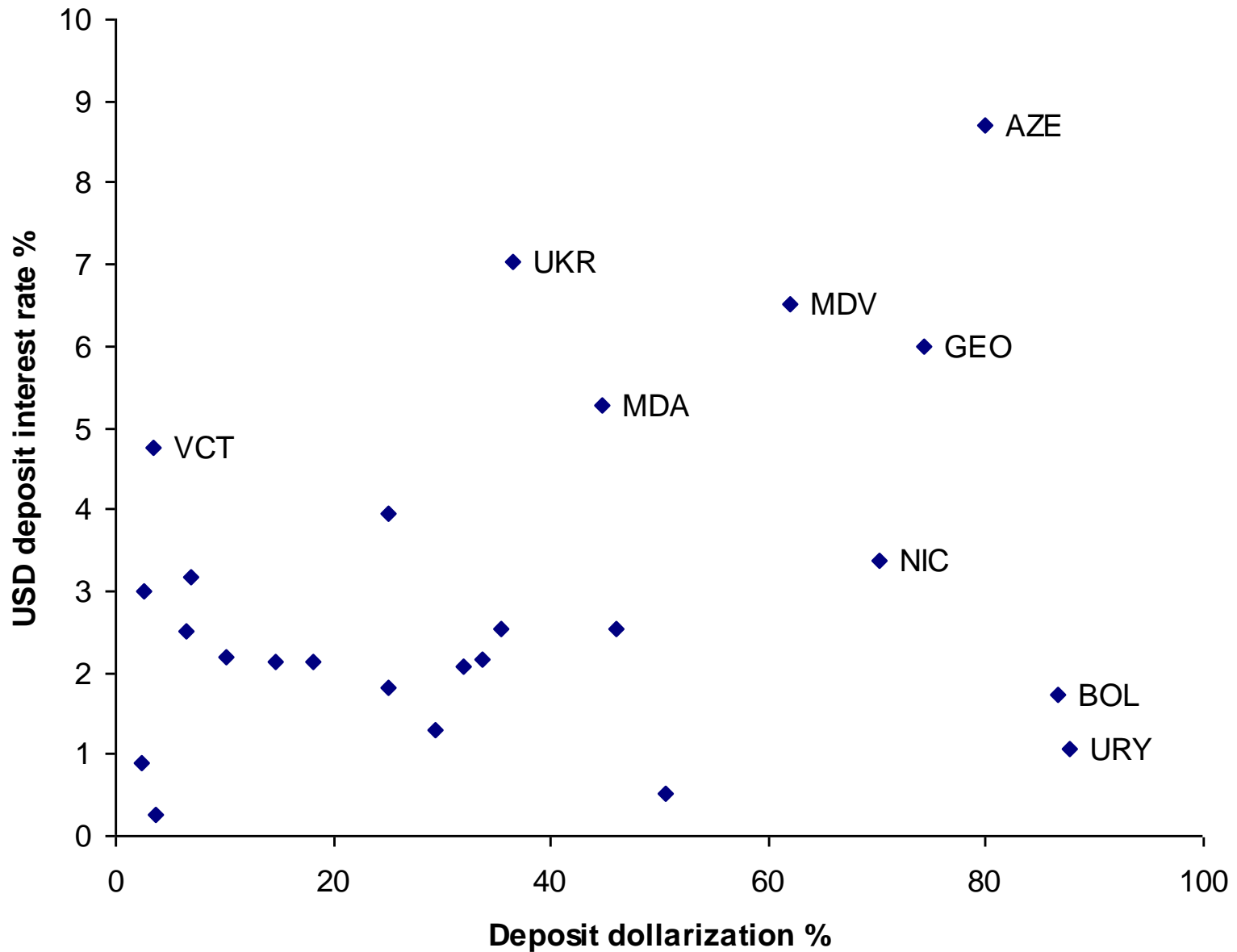


Table 2: *Summary of regressions linking interest rates to dollarization shares*

Explanatory variable:	Dollarization share (lagged once)			NObs (max)
		with AR(1)	with AR(2)	
Dependent variable				
Lending – Deposit (spread)	0.15**	0.11**	0.09**	1240
Lending	0.24**	0.13**	0.08*	1259
Deposit	0.09**	0.01	0.00	1307
Wholesale	0.15**	0.01	-0.04	988
Lending: Local – USD	0.12*	-0.07	-0.02	162
Deposit: Local – USD	0.07**	0.04	0.04	198
Lending – Deposit USD (spread)	0.08**	0.10**	0.08**	154
Deposit USD – Onshore US	0.03**	0.03**	0.02†	172

Conclusions

High share of FX deposits complicates practice and policy
... and increases systemic and bank risk

High dollarization is associated with high interest rates & spreads
...reflecting fears of depreciation & suspension.

Exchange rate movements confuse trend analysis.

...Although underlying dollarization has not declined,
there has been a break in trend.

...Dollarization is here to stay, but future growth will be slower.

Fear of floating is a mistake.

...Exchange rate movements do not destabilize.

Specific policy for consequences of dollarization itself is needed.

...But it is more important to address the underlying causes.