Financial Dollarization in Emerging Markets: Efficient Risk Sharing or Prescription for Disaster?

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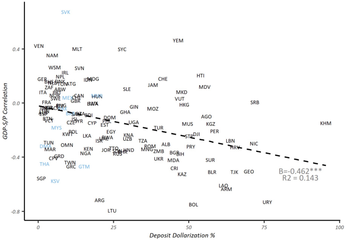
The Bigger Picture

- Two sides: Dollarization of loans and of deposits
- Deposit dollarization evidence for insurance
- no evidence of link to financial instability or crisis from deposit dollarization

The Empirical Results

Figure 2: Countries in which the Currency Depreciates More in a Recession Have Greater Deposit Dollarization



Notes: (i) statistic on vertical axis is correlation between real GDP and S/P where S denotes foreign currency per unit of domestic currency and P denotes domestic consumer price index; (ii) deposit dollarization is defined in equation 1; (iii) codes in the figure correspond to World Bank Country code; (iv) the sample over which each country's statistics are computed are the same across statistics, but differ across countries according to availability (see Figure 1).

Figure 3: Inflation vs Dollarization

Thoughts 1

- Show that there is an implicit tax that is increasing with the dollarization of deposits
- in the range of .5-1.5% for countries with 40-50% dollarization
- Main contribution is breaking link with crisis: challenging Levy-Yeyati (2006) by using currency crisis dummy of Laevan and Valencia (2018)

The last is an important result: Suggest that the paper be focused on this and the implications for policy.

Model

The key empirical findings:

- Countries in which the exchange rate depreciates a lot in a recession have a relatively high level of deposit dollarization.
- In countries where the level of deposit dollarization is relatively high, the premium on the domestic deposit rates is high.
- The level of deposit dollarization is not systematically related to the likelihood of financial crisis, nor to the intensity of a crisis if it occurs.

Households are hedging real wage risk and firms face exchange risk for inputs: both are on the same side of wanting to be long in foreign assets

Model: Thoughts

Key question to be answered:

- Is the ‘tax’ on foreign assets compensated by hedging motive in ex-post?
- Or is it mispriced: are households over-weighting the likelihood of a crisis?

This has real implications for:

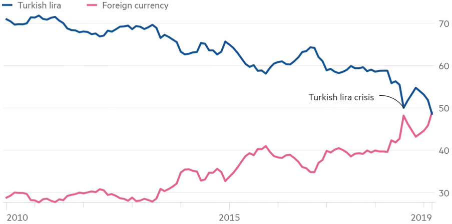
- Monetary Policy
- Domestic Yield curve and public debt sustainability

Cyclicality may be the anwer

Ex-ante or Ex-post

'Dollarisation' takes hold in Turkey

Proportion of total resident deposits (%)



*Figures do not equal 100 per cent due to precious metal deposits (not included in chart)

Source: Banking Regulation and Supervision Agency

Ex-ante or Ex-post

If dollarization is ex-post, based on incorrect expectations or mispriced, then inefficiency

- depreciates exchange rate, reduces imports
- raises domestic interest rates
- macroprudential policies may help to correct for this inefficiency:
  - capital weight for foreign currency deposits even if no currency mismatch
  - transaction costs for conversion
  - minimum maturity periods