



Why do people save in cash? Distrust, memories of banking crises, weak institutions and dollarization



Helmut Stix*

Oesterreichische Nationalbank, Economic Studies Division, P.O. Box 61, 1011 Vienna, Austria

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ABSTRACT

The paper analyzes why households hold sizeable shares of their assets in cash at home rather than at banks – a phenomenon that is widespread in many economies but for which information is scarce. Using survey data from ten Central, Eastern and Southeastern European countries, I document the relevance of this behavior and show that cash preferences cannot be fully explained by whether people are banked or unbanked. The analysis reveals that a lack of trust in banks, memories of past banking crises and weak tax enforcement are important factors. Moreover, cash preferences are stronger in dollarized economies where a “safe” foreign currency serves as a store of value.

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1. Introduction

Available evidence suggests that households in developing and transition economies tend to save in cash. The low reliance on financial intermediaries for saving decisions has the potential for adverse effects on economic development (Levine et al., 1998). Against this background, the objective of this paper is to find out whether and, if so, why households prefer to hold cash rather than income earning deposits at banks.

The question relating to the extent of cash preferences arises because the available evidence is only indicative and little information is available about the factual importance of cash. On an aggregate level, per capita figures of currency in circulation are uninformative as poorer economies are often dollarized (Feige, 2003). In turn, it is well known that sizeable shares of US dollar and euro in circulation are held abroad. Despite available evidence from a few countries showing that this money is used as a store of value (Dvorsky et al., 2009), the lack of evidence from a broader sample of countries prevents this information

from being used for detailed statistical analysis. More promising are data about the adoption of basic financial services, which is low in developing and transition economies (Claessens, 2006; Honohan, 2008). However, this source of information is also unsatisfactory for inferring the extent of cash savings – not least because cash savings could actually be more important than indicated by adoption rates, in particular if households prefer to save in cash despite their use of bank services. Also, the question about the driving factors behind the use of cash can only be partially answered by adoption rates, since these rates confound demand and supply effects – e.g., whether the main reason can be seen in the low density of the bank branch network or because people who have access to financial services decide not to use them (Beck et al., 2007). This suggests that a better understanding of the financial behavior of households in poorer countries requires data that reaches beyond households' adoption of financial products. For example, if the behavior were mainly demand driven, it would be of interest for policymakers to know whether people save in cash to avoid taxes or because they do not trust banks.

This paper contributes to overcoming the limited knowledge about the importance of cash by utilizing household survey data from ten Central, Eastern and Southeastern European countries.

* Tel.: +43 1 40420 7205; fax: +43 1 40420 7299.

E-mail address: helmut.stix@oenb.at

Importantly, the data provide several direct survey measures about the importance of cash. Moreover, they contain information on the availability of banking services and on a broad set of socio-economic characteristics of households to identify the main causes why people save in cash.

To exemplify the scope of cash savings, Fig. 1 depicts one measure of cash preferences derived from the survey data. In some countries more than a third of respondents report a strong preference towards cash over bank deposits. Cash preferences are, on average, lowest in EU member states and highest in Southeastern European countries—the latter group consists of countries with a considerable extent of dollarization. It is noteworthy that Fig. 1 only shows people who report to have savings, excluding the consideration that country differences are driven by differences in the share of the population with savings. Also, the overall picture does not change much if only respondents having a bank relationship are compared indicating that the decision to save in cash is not necessarily related to the availability of banks.

A different but equally remarkable feature of the data is that there is substantial heterogeneity—not only across but also within countries. For example, among a group of Croatian respondents aged 30–50 years living in a large city, with a high level of education, income in the top tercile and holding a savings account, 27% answer that they have a strong preference for cash relative to bank deposits, while 32% report to have no cash preference (the remaining 41% report a medium cash preference).

Against this background, I aim to answer two specific questions: first, which individual-specific factors determine whether households prefer holding cash in preference over interest bearing monetary assets? Second, why are liquidity preferences strong in some countries and weak in others?

To answer these questions, I present an empirical model which relates information on both self-stated cash preferences and actual portfolio choices of households to theoretically informed explanatory variables. In particular, the model accounts for (i) transaction and precautionary demand for money à la Baumol (1952), Tobin (1956), Tobin (1958) and Miller and Orr (1966), (ii) the role of trust, following the findings of Guiso et al. (2004) who show that demand for financial products is closely linked to trust and social capital in Italy, and (iii) results from the currency substitution literature—incorporating the idea that the relative return of currency is affected by the possibility of holding a “stable” foreign currency. Moreover, I analyze the role of memories of past banking problems

which could be important given the occurrence of episodes of financial distress in the banking system in all analyzed countries. The literature has shown that such crisis experiences have a long-lasting impact on financial decisions (Mudd and Valev, 2009; Osili and Paulson, 2009).

Foremost, I find that the observed importance of cash cannot be fully explained by a low density of the bank branch network or by consumers' unwillingness to adopt banking services, i.e., cash preferences are also high for persons who have adopted banking products. To identify which other individual specific factors are important I conduct estimations which control for a broad set of individual specific and institutional variables.

The estimation results show that a lack of trust in banks is a key factor driving cash preferences. This conclusion is based on several measures of trust in banks, including the perceived safety of deposits and a more general notion of trust in banks. The effect of trust in banks and the effect of doubts about the safety of deposits are economically important: distrust in banks is associated with (i) stronger liquidity preferences and (ii) a lower incidence of savings account ownership by about 8 percentage points (pp) or about one quarter to one third of the respective sample mean.

The strong impact of trust in banks is surprising given that banks are now predominantly owned by Western European banks.¹ This could imply that history is at work. The finding that memories of past banking problems contribute to explaining differences in cash preferences across individuals supports this conjecture. To ascertain that this effect is not driven by a misinterpretation concerning the direction of causality, I conduct instrumental variable estimations and use exogenous information about the timing of banking crises indicating that this finding is not driven by reverse causality.

Moreover, the results show that the extent of cash preference is closely linked to dollarization. This assessment is based on the findings that network effects of currency substitution and doubts about the stability of the local currency lead to higher cash preferences. I also find evidence for the importance of the gray economy: relatively higher cash balances are observed, on average, in environments with weak tax authorities.

Having established that trust is a key element in explaining *interpersonal* differences in cash preferences, I ask whether trust in banks can also contribute to explaining the observed regional variation in the importance of cash holdings. My results suggest that this is the case whereas social capital, as stipulated by Guiso et al. (2004), is not found to affect cash preferences. Although some caution is warranted regarding this finding, the results lend support to the view that institution-specific trust matters more than social capital.

The paper is related to the literature on bank access and outreach (e.g., Beck et al., 2007; Honohan, 2008). Examples for micro-data based studies are Djankov et al. (2008) for Mexico and Honohan and King (2009) for South African countries. Beck and Brown (2011) and Grosjean (2011) focus on the adoption of transaction accounts, bank cards and mortgages in transition economies. In contrast to these papers, I analyze cash preferences rather than whether households are banked or unbanked, which is important given that cash preferences are found to be high although access to financial intermediaries is available. Also, I focus on the demand side, while Beck and Brown (2011) mainly analyze supply effects, i.e., the impact of banking sector reforms.² Grosjean (2011) studies whether the legacy of the Ottoman empire exerts an impact on contemporaneous financial development.

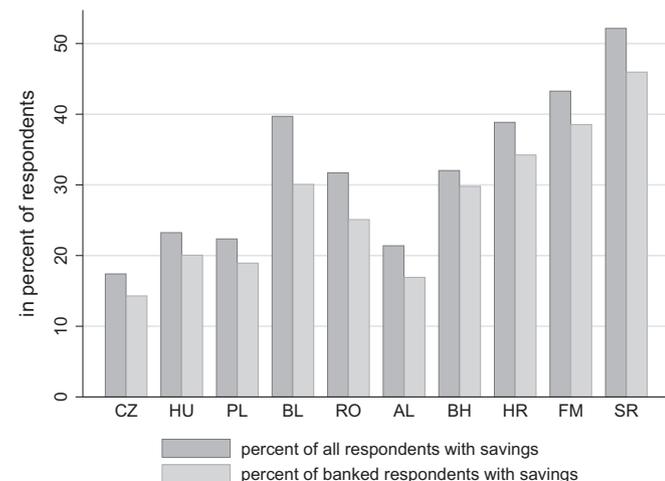


Fig. 1. Cash preferences by country. Percent of respondents who have a strong cash preference derived from the statement that “I prefer to hold cash rather than a savings account”. Values from 2010 to 2011. Source: OeNB Euro Survey.

¹ Western European banks own between about 70% (Poland) and 95% (Bosnia and Herzegovina) of banking assets in the analyzed countries.

² I have data on ten countries, while Beck and Brown (2011) analyze a sample of 27 countries which contains more heterogeneity in supply side characteristics.

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