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Dollarization, exchange rate regimes and government quality

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ABSTRACT

The dollarization of the domestic banking system represents a source of vulnerability for emerging market countries, and a debate has emerged over whether the exchange rate regime has an impact on dollarization. This paper argues that the regime is far less important than the literature has previously claimed. Unofficial dollarization results from a lack of faith in the domestic currency, which ultimately stems from the belief that the government will not follow policies that promote long-run currency stability. Empirical results indicate that improved government quality reduces unofficial dollarization, while the exchange rate regime plays no direct role in promoting dollarization.

"What I want is to figure out how we turn Argentina into Australia."

Paul Krugman[1]

1. Introduction

Given the susceptibility of emerging markets to financial crises and their devastating consequences, academics and policymakers have made it a priority to develop policies that can prevent such crises in the future. In particular, there is an ongoing debate about the choice of exchange rate regime. Goldstein

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[1] International Conference on Exchange Rate Regimes in Emerging Market Economies, 1999.

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(1999), for example, has blamed fixed exchange rates for recent financial meltdowns and recommends floating, while others have suggested pegging or even official dollarization as the best path towards stability (Calvo, 1999; Hausmann et al., 1999). For developed economies, the choice of exchange rate regime should still be analyzed in the context of the traditional optimum currency area literature (Mundell, 1961; McKinnon, 1963). Unfortunately, this decision is more complicated for emerging markets and developing nations, which face a host of additional concerns.

A serious concern that has received much recent attention, although little empirical treatment, is the liability dollarization of the domestic banking system.[2] Unhedged foreign-currency-denominated liabilities are a major source of vulnerability for both firms and banks because large depreciations can lead to significant reductions in net worth (De Nicoló et al., 2005; Mishkin, 1996). This process can lead to sharp contractions in output, producing a "fear of floating" among emerging markets (Calvo and Reinhart, 2002). It is, therefore, possible that a country that is unable to reduce this risk might choose to peg or officially dollarize even though it would otherwise prefer to float. Clearly, this is a suboptimal outcome. Not surprisingly, economists have begun to analyze the causes of unhedged dollar liabilities, and a debate has emerged over the role played by the exchange rate regime. The moral hazard view stresses that fixed exchange rates discourage hedging of dollar debt (Goldstein, 1999; Burnside et al., 2001; Mishkin, 1999) because banks and firms believe that the peg protects them from exchange rate risk. On the other hand, exchange rate volatility increases the cost of hedging and so floating regimes may increase the amount of unhedged dollar debt (Eichengreen and Hausmann, 1999).

Unfortunately, detailed data on forward contracts necessary to determine the extent to which dollar liabilities are hedged are unavailable. However, the total amount of dollar liabilities should at least be indicative of the total amount of *unhedged* dollar liabilities for two reasons. First, not all forward contracts eliminate foreign exchange risk. If a forward contract is made with other domestic banks or firms who earn revenue in pesos, the country's aggregate net foreign exposure remains unchanged. It is unclear whether domestic redistribution of this risk is stabilizing (Eichengreen and Hausmann, 1999). Second, as Eichengreen and Hausmann (1999) point out, foreigners are usually unwilling to sell dollars forward in exchange for domestic currency, thereby limiting hedging opportunities. Therefore, the debate over the effect of the exchange rate regime on unhedged dollar liabilities boils down to the effect of the regime on the total amount of dollar liabilities. This debate over the causes of liability dollarization requires empirical resolution and motivates the analysis of this paper.

This paper estimates the effect of the exchange rate regime on a country's exposure to foreign exchange risk by determining the effect of the regime on unofficial dollarization of the domestic banking system. Thus I focus on the domestic component of "Original Sin," that is, the inability to borrow locally in local currency, which has received less attention in the literature. The determinants of domestic dollarization are likely to be different than that of external liability dollarization. For example, a history of high inflation is likely to result in domestic dollarization, but would probably not predict a country's external debt (Reinhart et al., 2003). Finally, as this paper argues, domestic dollarization may be reversible, as opposed to external liability dollarization that exists irrespective of country heterogeneity because of the "Original Sin" of emerging markets (Eichengreen et al., 2002).

The empirical evidence indicates that the exchange rate regime does not significantly affect domestic dollarization. Instead, unofficial dollarization results from a lack of confidence in the currency, which ultimately stems from the belief that the government will not follow policies that promote long-run currency stability.[3] A fixed exchange rate does not ensure this stability, and the choice of exchange rate regime is not an easy fix. Using indicators of government quality, I demonstrate empirically that government quality is the key driver of domestic dollarization.[4] Therefore,

[2] Following the standard vocabulary, this paper employs the terms "dollar" when referring to any foreign currency and "peso" when referring to any domestic currency.

[3] This paper is part of the growing literature on the effect of institutions on macroeconomic outcomes (Acemoglu et al., 2003; Tommasi, forthcoming).

[4] Using a different empirical methodology, De Nicoló et al. (2005) come to similar conclusions.