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Dedollarization in Turkey after decades of dollarization: A myth or reality?

Kıvılcım Metin-Özcan[a,1], Vuslat Us[b,*]

[a]Department of Economics, Bilkent University, Bilkent, 06800 Ankara, Turkey
[b]Research and Monetary Policy Department, Central Bank of the Republic of Turkey, Istiklal Cad. No.10, Ulus, 06100 Ankara, Turkey

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Abstract

The paper analyzes dollarization in the Turkish economy given the evidence on dedollarization signals. On conducting a Vector Autoregression (VAR) model, the empirical evidence suggests that dollarization has mostly been shaped by macroeconomic imbalances as measured by exchange rate depreciation volatility, inflation volatility and expectations. Furthermore, the generalized impulse response function (IRF) analysis, in addition to the analysis of variance decomposition (VDC) gives support to the notion that dollarization seems to sustain its persistent nature, thus hysteresis still prevails. Hence, unfavorable macroeconomic conditions apparently contribute to dollarization while dollarization itself contains inertia. Furthermore, dedollarization that presumably started after 2001 has lost headway after May 2006. Thus, it seems too early to conclude that dollarization changed its route to dedollarization.

Keywords: Dollarization; VAR; Impulse response; Variance decomposition; Hysteresis; Dedollarization

1. Introduction

Dollarization, since the early 1970s, has been a topic of special interest in the context of developing countries, especially in emerging market economies (EMs). During periods of macroeconomic and political uncertainty, many developing countries experienced a partial replacement of their domestic currencies by a foreign currency either as a store of value, unit of account, or as a medium of exchange.

Dollarization has been analyzed extensively in the previous literature. The earlier works on dollarization demonstrate that dollarization occurs as a result of various factors depending on the structure of the economy. In developed economies, like USA and Canada, dollarization is seen as a counterpart to heavy cross-border trade whereas in Latin American countries, dollarization is usually perceived as a *hedging* strategy against high inflation.

*Corresponding author. Tel.: +90 312 310 9238; fax: +90 312 324 2303.
E-mail addresses: vuslat.alioglu@tcmb.gov.tr, kivilcim@bilkent.edu.tr (V. Us).
[1]Tel.: +90 312 290 2006; fax: +90 312 266 5140.

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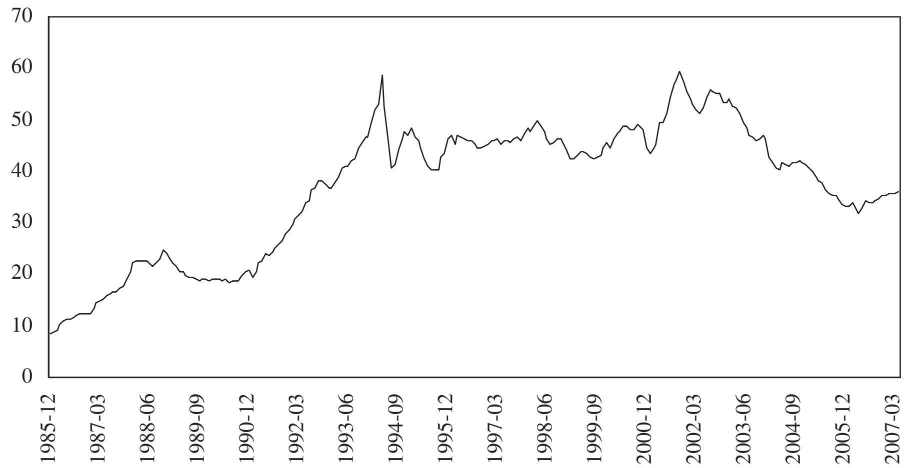

Fig. 1. Dollarization trend in the Turkish economy.

Turkish economy has been experiencing dollarization since the introduction of foreign currency deposits in December 1983. High and volatile rates of inflation, depreciating exchange rate in addition to unsuccessful stabilization efforts, financial crises, and underdeveloped capital markets played a key role in the rising dollarization ratios (Fig. 1).

There are now several studies on the issue of dollarization in the Turkish economy.[2] While some of these studies focus on analyzing the determinants of dollarization [1–5]; others inquire about the *hysteresis* nature of dollarization (ratchet effect), i.e. whether dollarization ratios have reached an *irreversible* stage or not [6,7]. In view of the ample evidence that infer the irreversibility of dollarization due to heavy switching costs, it is thus concluded that dollarization ratios might not decline even after local currency is successfully stabilized. Yet, these studies, which analyze the ratchet effect on dollarization in the Turkish case, confer that, despite high dollarization rate in the Turkish economy, there is still a room for the monetary policy to be effective.

Another line of research on dollarization issue in Turkey shows that dollarization reduces the *seigniorage* and results in higher and more volatile inflation than which is otherwise implied for a given level of budget deficit [8–10]. Consequently, the decline in seigniorage that occurs as the public switches from domestic to foreign money holdings is partially compensated through increases in administered prices, which are translated into higher inflation.

Inspired by the press releases[3] of the Central Bank of the Republic of Turkey (CBRT) declaring conditions of so-called *reverse currency substitution*[4] that justify the enormous reserve buildup despite conducting free float, the recent trend in studying dollarization issue in the Turkish economy has now shifted towards analyzing *dedollarization*—a reversal in the dollarization trend. Coincidentally, dedollarization is also in the agenda of other researchers around the globe. Apparently, dedollarization is perceived as an endogenous outcome of a persistent process of disinflation and stabilization [11]. Furthermore, seminal works such as Ize

[2]Ref. [43] provides an extensive survey on the previous studies on dollarization in the Turkish economy.

[3]Ref. [44] states that conditions of reverse currency substitution warranted foreign exchange intervention on May 11, 2004. Likewise, Ref. [45] also stated the same condition on account for foreign exchange intervention on December 2, 2002. Finally, Ref. [46], dated May 5, 2003 clearly explains the conditions of reverse currency substitution that mitigates buying auctions for foreign exchange.

[4]CBRT officials heavily used ‘‘reverse currency substitution’’ terminology in view of the decline in foreign currency denominated assets with respect to M2Y. However, the term is obviously a misnomer. Currency substitution is the situation where foreign currency replaces domestic currency at various extents. However, by naming currency substitution as ‘‘reverse’’ it then implies the replacement of foreign currency by domestic currency, which on the other hand does not call for a new terminology. Instead, a more appropriate term would have been ‘‘reversal in the currency substitution’’ or ‘‘reversed’’ currency substitution in order to describe the situation where people switch their money holding preferences towards domestic money from foreign money. As it happens, reverse currency substitution term was not used widely in the literature, but instead, ‘‘dedollarization’’ was prevalently preferred. Thanks to the prefix, the ambiguity was resolved.