# Monetary Policy In Dollarized Economies Occasional Paper International Monetary Fund

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***Monetary Policy In Dollarized Economies Occasional Paper International Monetary Fund*** ***2020-05-23***

## CERVANTES RANDOLPH

Monetary Transmission in Dollarized and Non-Dollarized Economies International Monetary Fund
The shift to inflation targeting has contributed to the relatively low inflation observed in some emerging market economies although, as noted by many economists, the preconditions required for a successful implementation were not in place. The existence of managed exchange rate regimes, a narrow base of domestic nominal financial assets, the lack of market instruments to hedge exchange rate risks, together with fear of floating and dollarization, have been stressed as factors that might weaken the efficacy of monetary policy. By examining various aspects of monetary transmission and policy formulation in two highly dollarized economies (Peru and Bolivia) vis-agrave;-vis two economies with low levels of dollarization (Chile and Colombia), we found that, while dollarization imposes differences in both the transmission capacity of monetary policy and its impact on real and financial sectors, it does not preclude the use of inflation targeting as a policy regime.
*The Case of Cambodia* International Monetary Fund
Exchange rate targeting is considered the best policy option in dollarized economies when wages and prices are

indexed to the exchange rate. Croatia is a highly dollarized economy, but empirical investigation conducted in this paper shows that exchange rate pass-through has been low after stabilization. This finding, which is robust to different methodologies (VAR, cointegration), would suggest that dollarization is mostly limited to financial assets and therefore that strict exchange rate targeting may not necessarily be the best option. However, policy implications are unclear due to the endogeneity of the pass-through to the policy regime.

**How to De-Dollarize Financial Systems in the Caucasus and Central Asia?** International Monetary Fund

This book by a leading authority on monetary policy offers a unique view of the subject from the perspectives of both scholar and practitioner. Frederic Mishkin is not only an academic expert in the field but also a high-level policymaker. He is especially well positioned to discuss the changes in the conduct of monetary policy in recent years, in particular the turn to inflation targeting. Monetary Policy Strategy describes his work over the last ten years, offering published papers, new introductory material, and a summing up, "Everything You Wanted to Know about Monetary Policy Strategy, But Were Afraid to Ask," which reflects on what we have learned about monetary policy over the last thirty years. Mishkin blends theory, econometric evidence, and extensive case studies of monetary policy in advanced and emerging market and transition economies. Throughout, his focus is on these key areas: the importance of price stability and a nominal anchor; fiscal and financial preconditions for achieving price stability; central bank independence as an additional precondition; central bank accountability; the rationale for inflation targeting; the optimal inflation target; central bank transparency and communication; and the role of asset prices in monetary policy.Frederic S. Mishkin is Alfred Lerner Professor of Banking and Financial Institutions at the Graduate School of Business, Columbia University, Research Associate at the National Bureau of Economic Research, a past Executive Vice President and Director of Research at the Federal Reserve Bank of New York and after finishing this book was appointed a member of the Board of Governors of the Federal Reserve System. He is the author of The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich and other books.

**Financial Dollarization** International Monetary Fund

This paper assesses the benefits and risks associated with dollarization of the banking system. We provide novel empirical evidence on the determinants of dollarization, its role in promoting financial development, and on whether dollarization is associated with financial instability. We find that: (a) the credibility of macroeconomic policy and the quality of institutions are both key determinants of cross-country variations in dollarization; (b) dollarization is likely to promote financial deepening only in a high inflation environment; and (c) financial instability is likely higher in dollarized economies. The implications of these findings for financial sector and monetary policies are discussed.

*Monetary Policy in Dollarized Economies* International Monetary Fund

The process of dollarization can take multiple forms, including when a country adopts the US dollar either as its predominant currency, or establishes a bicurrency system with the local currency. This publication examines how to establish an adequate supervisory and crisis management framework in dollarized economies, particularly when central banks and regulators may be constrained in the use of standard monetary and financial policy tools. It is based on a paper produced by the IMF Executive Board, as part of the policy development work conducted by the IMFs Monetary and Financial Systems Department.

*Dollarization and Financial Development* Springer

One distinguishable characteristic of emerging market economies is that they are not financially robust. These economies are incapable of smoothing out large external shocks, as sudden capital outflows imply large and abrupt swings in the real exchange rate. Using a small open-economy model, this paper examines alternative monetary policy rules for economies with different degrees of liability dollarization. The paper answers the question of how efficient it is to use inflation targeting under high liability dollarization. Our findings suggest that it might be optimal to follow a nonlinear policy rule that defends the real exchange rate in a financially vulnerable economy.

Financial Stability in Dollarized Economies Walter de Gruyter GmbH & Co KG

The paper conducts a comparative study of the monetary policy transmission in two economies that run a well-established IT regime, Chile and New Zealand, vis-à-vis two economies operating under relatively newer IT regimes, and which are exposed to a significant degree of dollarization, Peru and Uruguay. It is shown that the traditional interest rate channel is effective in Chile and New Zealand. For Peru and Uruguay, the exchange rate channel is instead more relevant in the transmission of monetary policy. This latter result follows from the limited impact of the policy rate in curbing inflationary pressures in these two countries, in combination with the fact that they have a relatively large and persistent exchange rate pass through. Finally, it is shown that the on-going de-dollarization process of Peru and Uruguay has somewhat strengthened their monetary transmission through the interest rate channel.

*Concepts and Implications for Monetary and Exchange Rate Policy in the Philippines* International Monetary Fund

Despite the general improvement in controlling price levels over the last two decades, substantial amount of the population in developing world still save and borrow in foreign denominated currencies. There are reasons to believe that high degree of financial dollarization might impose difficulties in both the transmission capacity of monetary policy and the overall functioning of the financial sector. Correspondingly, the case of a typical emerging market economy, where external debts are denominated in foreign currency, whereas domestic firms heavily rely on receipts in national currency, potentially causes a higher vulnerability in the domestic banking sector due to currency mismatch issues and large fluctuations in the exchange rates, which is also one of the features of Inflation Targeting monetary policy. The aim of this paper is to investigate various features of high level of financial dollarization, its challenges for conducting Inflation Targeting monetary policy, and formulate a number of relevant policy recommendations and implications.

**Financial De-Dollarization**

International Monetary Fund

The use of the US dollar for domestic monetary transactions outside the USA has gone on for many years now - Panama in 1904 being the earliest example. Since the advent of the Euro, the debate over the benefits of monetary integration has warmed up - particularly for NAFTA countries. This collection, with contributions from experts such as Philip Arestis, Malcolm Sawyer and Stephanie Bell, examines the various problems and benefits involved in monetary integration and covers the causes of Euro instability, monetary policy in non-optimal currency unions, financial openness and dollarization and the question of dollarization in Canada. This book addresses one of the burning policy issues in Europe and America: is monetary union worthwhile? The readable yet comprehensive style of this book will make it of interest not only to academics and students involved in European integration, financial liberalization and dollarization, but will also be an important book for policy-makers at intergovernmental level.

*A Global Perspective and the Peruvian Experience* Oxford University Press

This paper explores how real dollarization (dollar indexing of wages), financial dollarization (dollar denomination of financial contracts), and monetary policy interact in a general equilibrium, new open-economy macroeconomics model with real shocks. Real dollarization is avoided as long as the home monetary authorities conduct monetary policy optimally (maximize local welfare). Suboptimal monetary policies are more likely to induce real dollarization when the correlation between domestic and external shocks is high, since in this case the (presumably optimal) foreign monetary policy guarantees a better level of protection against macroeconomic uncertainty. While real dollarization contributes to financial dollarization, important asymmetries between the two were found.

<u>The Cases of Chile, New Zealand, Peru and Uruguay</u> International Monetary Fund

We explore monetary policy transmission by estimating VAR impulse response functions to illustrate the Belorussian economy's response to unexpected changes in policy and exogenous variables. We find a significant exchange rate pass-through to prices, and interest rate policy following, rather than leading, financial market developments. Our estimated monetary policy reaction function shows the central bank striking a balance between real exchange rate stability and containing inflation. We discuss dollarization, administrative interventions, and other features complicating monetary policy transmission, review specific constraints and vulnerabilities, and conclude with observations on possible measures that could raise the effectiveness of monetary policy in Belarus

**Dollarization in Transition Economies** International Monetary Fund

The paper looks at the challenges of conducting monetary policy in a context of high dollarization of the banking system and weak institutions in the Democratic Republic of the Congo. The empirical analysis confirms the limited effectiveness of the Central Bank of Congo in controlling inflation, despite a rapid policy response to inflation shocks. Options available to enhance the effectiveness of monetary policy are limited. After exploring the pros and cons of different exchange regimes we conclude that strengthening the current monetary policy framework remains the first-best option, given the country's exposure to frequent terms-of-trade shocks.

**Managing Economic Volatility in Latin America** MIT Press

The paper conducts a comparative study of the monetary policy transmission in two economies that run a well-established IT regime, Chile and New Zealand, vis-à-vis two economies operating under relatively newer IT regimes, and which are exposed to a significant degree of dollarization, Peru and Uruguay. It is shown that the traditional interest rate channel is effective in Chile and New Zealand. For Peru and Uruguay, the exchange rate channel is instead more relevant in the transmission of monetary policy. This latter result follows from the limited impact of the policy rate in curbing inflationary pressures in these two countries, in combination with the fact that they have a relatively large and persistent exchange rate pass through. Finally, it is shown that the on-going de-dollarization process of Peru and Uruguay has somewhat strengthened their monetary transmission through the interest rate channel.

*Monetary Transmission Mechanisms in Belarus* International Monetary Fund

Dollarization rates in the Caucasus and Central Asia (CCA) region are among the highest in the world, with adverse consequences for macroeconomic stability, monetary policy transmission, and financial sector development. Using dynamic panel data models, we find that foreign exchange deposits and loans in the CCA are mainly driven by volatile inflation and exchange rates, low financial depth, and asymmetric exchange rate policies biased toward depreciation. Although there is no unique formula for success, empirical studies and cross-country experiences suggest that credible monetary and exchange rate frameworks, low and stable inflation, and deep domestic financial markets are essential ingredients of any de-dollarization strategy. In implementation, policymakers need to consider proper sequencing of policies, effective communication as well as risks from potential financial disintermediation and instability, and/or capital flight.

*Inflation Targeting in Dollarized Economies* International Monetary Fund

A very commonly observed phenomenon in developing and emerging market economies is the use of another country's currency (whether the US dollar or another currency) in lieu or in addition to the local currency. The most common type of this financial phenomenon is partial (de facto) dollarization where foreign currencies are used side by side with local currency for saving and borrowing purposes in addition to serving as medium of exchange. Governments in these countries have been encouraging dollarization for years by allowing their citizens to save and borrow from local banks in foreign currency. Yet the existence of multiple currencies on banks' balance sheets on both the asset and liability side poses risks to the health and stability of the banking system. This book evaluates the practical aspects of partial dollarization in countries such as Turkey, South Korea, Peru, and Cambodia among others. Starting with the origins of the phenomenon, the impact on banking systems and financial depth of the credit markets are discussed along with risks to the banking systems. Challenges faced by Central Banks and banking regulators are evaluated using recent country studies.

Monetary Policy Rules for Financially Vulnerable Economies International Monetary Fund

This paper examines El Salvador's transition to official dollarization by comparing aspects of this regime to the fixed exchange rate regime prevailing in the 1990s. Commercial bank interest rates are analyzed under an uncovered interest parity framework, and it is found that dollarization lowered rates by 4 to 5 percent by reducing currency risk. This has generated net annual savings averaging 1⁄2 percent of GDP for the private sector and 1⁄4 percent of GDP for the public sector (net of the losses from foregone seigniorage). Estimated Taylor rules show a strong positive association between Salvadoran output and U.S. Federal Reserve policy since dollarization, implying that this policy has served to stabilize economic activity more than it did under the peg and more than policy rates in Central American countries with independent monetary policy have done. Dollarization does not appear to have affected the transmission mechanism, as pass-through of monetary policy to commercial interest rates has been similar to pass-through under the peg and in the rest of Central America.

**Monetary Policy Strategy**

International Monetary Fund

"Dollarization, in a broad sense, is increasingly a defining characteristic of many emerging market economies. How important is this trend quantitatively and how important is it for the conduct of monetary policy and the choice of exchange rate regimes? Though these questions have become a hot topic in both the theory and policy literature, most efforts are remarkably uninformed by evidence, in no small part because meaningful data has been lacking, except for a very narrow range of assets. This paper attempts to move the discussion forward and shed light on the critical questions by proposing a measure of dollarization that is broad both conceptually and in terms of country coverage. We use this measure to identify trends in the evolution of dollarization in the developing world in the last two decades, and to ascertain the consequences that dollarization has had on the effectiveness of monetary and exchange rate policy. We find that, contrary to the general presumption in the literature, a high degree of dollarization does not seem to be an obstacle to monetary control or to disinflation. A level of dollarization does, however, appear to increase exchange rate pass-through, reinforcing the claim that fear of floating' is a greater problem for highly dollarized economies. We also review the developing countries' record in combating their addiction to dollars. Concretely, we try to explain why some countries have been able to avoid certain forms of the addiction, and examine the evidence on successful de-dollarization"--NBER website

Dollarization of Financial Intermediation

International Monetary Fund

Dollarization - the holding by residents of a substantial portion of their assets in foreign-currency-denominated assets- is a common feature of developing and transition economies, and therefore typical of many countries with IMF -supported adjustment programs. This paper analyzes policy issues that arise- and various monetary strategies that

may be pursued- when the monetary sector is dollarized, and it considers the implications that dollarization has for the design of IMF programs.
Causes and Impact of Partial Dollarization on Developing and Emerging Markets World Bank Publications
Analyzes the costs and benefits of full dollarization, or the adoption by one country of another country's currency. Potential advantages include lower borrowing costs and deeper integration into world markets. But countries lose the ability to devalue, and become dependent on the U.S. Compares with currency board option.
*Understanding Dollarization* Springer
We re-appraise the cross-country evidence on the dollarization of financial systems in emerging market economies. Amidst striking heterogeneity of patterns across regions, we identify a broad global trend towards financial sector de-dollarization from the early 2000s to the eve of the global financial crisis of 2008–09. Since then, de-dollarization has broadly stalled or even reversed in many economies. Yet a few of them have continued to de-dollarize. This suggests that domestic factors are also important and interact with global factors. To gain insight into such an interaction, we examine the experience of Peru since the early 1990s and find that low global interest rates, low global risk-aversion, and high commodity prices have fostered de-dollarization. Domestic macro-prudential measures that raise the relative cost of domestic dollar loans and the introduction and adherence to inflation targeting have also been key.