PRESS RELEASE

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Dollarisation Does Not Go Hand In Hand With Heightened Financial Market Risks, Study Says

Financial Dollarisation in emerging market economies does not necessarily lead to more vulnerability in the respective financial system, according to a recently published study with the participation of the University of Mannheim. "The common view that financial dollarisation is a source of fragility is overstated," the authors said.

Dollarisation means the use of a foreign currency in parallel to or instead of the domestic currency and is widespread in a number of developing and emerging market economies. Deposit dollarisation can be seen as an insurance arrangement, mainly between different people inside individual countries rather than between agents across countries.

The median cross-country flows due to dollar debt are on average around half of the within-country flows, according to the authors, who used different datasets over the period 2000 to 2018 from up to 16 countries.

Insurance of dollar deposits comes from the fact that the US Dollar tends to gain in value when the local economy is in recession. "For many people - mostly the US audience - deposits sound like a trivial instrument but for most countries, specifically emerging market economies, deposits are the main saving device for residents," the authors explained.

Households who denominate their deposits in dollars are purchasing a business cycle insurance, according to the study.

The 'price' paid by the depositors for this insurance is the premium on the local interest rate. The payoff from the insurance is the spike in the dollar return that occurs when the local currency depreciates in a recession.

The results of the discussion paper "sketched a relatively benign picture of deposit dollarisation," Lawrence Christiano from the Northwestern University, Husnu Dalgic from the University of Mannheim and Armen Nurbekyan from the Central Bank of Armenia wrote. "However, there is a persistent view that deposit dollarisation is dangerous, by increasing the vulnerability of banks to a systemic crisis."

Still, the study's data suggest that dollarisation "does not raise the risk of financial crises because the currency mismatch it creates is in the hands of low-leveraged firms that can handle exchange rate fluctuations," the authors said. Currency mismatch describes a situation when a household's loan is denominated in a foreign currency, so that the cost of serving it varies with the exchange rate.

At the same time, the results show that the bulk of insurance supply to households is borne by nonfinancial firms, not by banks, not at least because of more prudential banking regulations, therefore limiting potential direct negative repercussions to the banking sector.

The view that dollarisation might lead to lower investment and employment due to a recession-caused depreciation of the currency was also not substantiated by the study's results. „Sales and GDP appear to be the main drivers of non-financial firm investment, not exchange rate fluctuations per se," Christiano, Dalgic and Nurbekyan stated.

Moreover, the researchers didn't find empirical evidence for the view that financial dollarisation creates significant over-reaction to exchange rate movements. Instead, data „suggest that the contribution of financial dollarisation to volatility is minimal," they wrote.

„Deposit dollarisation has no predictive power for financial crises or for the severity of a crisis when it happens, according to the authors. „While our results are consistent with existing findings that too much borrowing raises the risk of crisis, the currency denomination of debt does not, per se, increase that probability."

Husnu Dalgic, Ph.D. is member of the Collaborative Research Center Transregio 224 EPoS. The presented discussion paper is a publication without peer review of the Collaborative Research Center Transregio 224 EPoS. Click here for the full discussion paper. Or have a look at the list of all discussion papers of the research group.

Established in 2018, the Collaborative Research Center Transregio 224 EPoS, a cooperation of the universities Bonn and Mannheim, is a long-term research institution funded by the German Research Foundation (Deutsche Forschungsgemeinschaft, DFG). EPoS addresses three key societal challenges: how to promote equality of opportunity; how to regulate markets in light of the internationalization and digitalization of economic activity; and how to safeguard the stability of the financial system.

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