Research paper: The Central Reserve Bank of Peru on De-dollarization policies

Maria Fe Garcia Seminario

PSL UNIVERSITÉ PARIS

1 Introduction

1.1 Context of the episode of our study

The recent announcement of Brazil's president Lula to encourage Latin American countries to use a common currency to: "boost regional trade and reduce reliance on the US dollar" as well as the de dollarization of China and Russia have attracted my attention to this global movement towards de-dollarization and in some cases de-euroization. Since the end of the Second World War, the US dollar has dominated the world's economy. However, Russia and China have lately rebelled against this dominance by trading with their own currency. In fact, the Bretton Woods collapse of fixed exchange rates as well as the 2008 crisis have questioned the need for dollarization and the consequences. This wave of de-dollarization has started from 2010 until today and is taking place in mostly developing countries (EME).

1.2 What is dollarization?

The goal of the de-dollarization policy according to the article [8] dollarization can be defined as: the response of a country that is beginning to recognise a foreign currency as a medium of exchange or as a legal tender alongside or in place with its domestic currency. This is a response to economic uncertainty, which usually happens when local currency has become unstable and is beginning to lose its usefulness as a medium of exchange. There are different types of de-dollarization [7], the first one is financial, which is employed with the substitution of local currency assets or liabilities for foreign currency assets or liabilities. The second one is the real dollarization, which is employed through the indexation of domestic transactions to the exchange rate and currency. Finally we have the transaction or currency dollarization which describes the situation when dollars are used as a payment for domestic transactions. In this research paper, we will mainly focus on de facto dollarization which is defined as the holding by residents of assets and liabilities denominated in a foreign currency. The goal of the article is to restitute a durable de-dollarization based on the experiences of countries who made it successfully by using the IMF data. Moreover, in the economic literature, Peru's de-dollarization of 2015 and 2016 is one of the most successful cases of de-dollarization and one of the most commented ones [5][6][2]. Additionally, the IMF wrote a note on the Peruvian case of dedollarization as a "good study case" (Annex 1). Dollarization is very important for emerging economies that have stabilized their economies and want to regain the autonomy and effectiveness of their monetary policy. It allows countries their economic and monetary sovereignty.

1.3 History of the bank

From 1901 to 1914, the monetary base was the Golden standard system in Peru. However, when it first was implemented a great instability was observed since it was based on the variations in the stock of gold. After the financial crisis of the First World War, this system was put aside and that's when the creation of the Reserve Bank of Peru (BRP) was created in order to come up with a system that would avoid inflation or deflation. Nevertheless, the Spanish Flu, the reconstruction of Europe and the Great Depression of the 30s made the BRP take into consideration the return to this golden standard system. In 1929, the Central Bank of Reserve of Peru (BRCP) was created. The main goal was to respond to the demands for greater money and support the treasury. Plus, they had to evaluate the experience of the gold standard. In the context of the Organic Law, the BRCP had to cover the debt generated by the government. Nowadays, the goal of the central bank (BCRP) is to regulate the credits and monetary flows.

2 Literature review on the Peruvian role model case

In the article "Monetary Policy in a Highly Dollarized Economy: the case of Peru " by Richard Webb and Adrián Armas [11], the authors discuss how policy actions managed to be effective and achieve price stability, even in a high dollarized country as Peru. In fact, dollarization in Peru started in the 1970s. However the use of dollars peaked in the only period of hyperinflation of 1988 and 1990 of Peru's history. In 2002, Peru became one of the only highly dollarized countries to target inflation. Even though dollarization has many limits ,as we shall see, Peru managed to reach stabilization. Coming back to the article on "De Dollarization" by Kokenyne, Ley and Veyrune [8], the authors state that the de dollarization is protracted, meaning that once dollarization takes place agents do not really want to go back to using the local currency. Nevertheless, dollarization allows countries to integrate the world economy and to mitigate the exchange rate risk for foreign investment by boosting the investment and the diversification of the portfolio of the residents. Plus, lending in foreign currency can have a positive impact on domestic consumption and investment which can improve economic growth. It is important to point out that this will heavily depend on the economy's size, the openness and market development, and the degree of financial integration. On the other hand, multiple disadvantages arise. Dollarization limits the effectiveness of monetary policy and causes a loss of profit made by the government for issuing currency. It also increases the risk of the balance sheet and of a possible liquidity crisis.

The long lasting consequences of dollarization are not negligible. The article "Financial De-Dollarization: Is it for real?" by the IMF[5], states that countries with high dollarization eventually are led to inflation and have no progress in credibility of monetary policy. In fact, dollarization can sometimes be the source of the crisis. The authors state that dollarization is not an unavoidable and "largely inconsequential phenomenon". The article written by economists of the Peruvian central bank: “De-dollarization of credit in Peru: the role of unconventional monetary policy tools” [5] explains how financial dollarization was reduced from 80% to 30% through the use of unconventional tools. Their three goals were to help banks to internalize de-dollarization risks as well as preventing the impact of these shocks from spreading everywhere in the economy.

In order to achieve this, enhancing the financial system’s capacity to absorb shock was necessary. Three types of risk emerged: the risk of liquidity being higher than reserves, the excessive credit growth in foreign currency and finally the mismatches and default of agents. To mitigate these risks, first, the BCRP has increased the level of international liquidity in the financial system so this will reduce the bank’s incentives to lend in dollars. Second, they raised the cost of intermediation in dollars to stop the excessive credit growth. Third, they reduce the exchange rate volatility to prevent a negative balance sheet, therefore reducing the risk of mortgage default. They also implemented policies coordinated with the Insurance companies and Pension Funds (SBS) to guarantee individual solvency by raising high capital requirements for mortgage loans in foreign currency, making it more expensive to access loans in foreign currency. Previously, they had to control inflations by targeting and maintaining between 2% and 4%. According to their analysis, the demand for dollars was going to increase and banks were going to buy more dollars using the spot or forward rate, leading to the depreciation of soles. So, a policy generated by the BCRP was necessary to achieve a correct de-dollarization.

Another de-dollarization tool was the repos for credit substitution to convert the loans issued by the bank in dollars to soles. The public will hold loans in soles and the BCRP will hold assets in dollars (Annex 2). In the reports of the BCRP, we also see throughout this period a rise in the interest rate from 3,25% in 2015 to 4,5% in 2016, making the soles more attractive. On the other hand, we can see that even if the wave of dollarization took place in 2016, since 2010 the de-dollarization idea has been very present. For example another article from the BCRP written by Mercedes Garcia Escribano “Peru: Drivers of De-dollarization”[9], states how macroprudential measures, which aim to reinforce the system’s resilience to shock, are necessary to achieve depolarization.

A more recent article, written by Rivas and Quispe on ”Dollarization dynamics and de-dollarization policies in Peru” [2] states that the process is far from immediate, it requires both the construction of the autonomy of the central bank and of an anti-inflation reputation. According to the report, the inflation from 2015 to 2016 was held at 2,51 and 3%. Once these tools are installed, a vicious cycle will favor de-dollarization which establishes monetary effectiveness of policies and macroeconomic stability. However, Peru is not the only example of success, the article of Patricia Alvarez-Plata and Alicia Garcia Herrero on ”To Dollarize or De-dollarize: Consequences for Monetary Policy”, [1] presents the successful case of Israel in 2008. The country experienced both a high dollarization as well as a very transitory de-dollarization phenomenon. On the contrary, they also presented how Russia didn't manage to keep a sustainable de-dollarization rate. Israel used a tool called CPI-indexation, so while keeping a very target inflation they managed to appreciate their own currency. The authors argue that both macroeconomics solutions and government interventions are needed to complete the process of de-dollarization. As for the government intervention, they point out the importance of limiting the mismatches without forgetting about a possible disintermediation. This limit was not pointed out in any previous article.

3 Impact of de dollarization in the United States

From the American perspective, the increase in the demand of American dollars leads to an appreciation of their currency, which contributes to the economic growth of the country. However, we will see if the wave of de dollarization has impacted the economic activity of the United states. By reading the reports of the FED throughout 2015 and 2016. In their 2016 report on monetary policy the FED declared that they "are preparing for the eventual normalization of the stance and conduct of monetary policy". The normalization of the monetary policy is a measure used to tighten the financing conditions by raising the interest rates.

The article written by Berganza and Valles "The challenges for monetary policy normalization in the United States in the current economic situation" [3] explains that in December 2015, the FED officially raised the interest rate for the first time after holding them very close to 0% since 2008. In September 2016 the interest rates remained unchanged, however the FED declared that they will probably raise them in the future. The article also states that the global economy has developed a growing shortage of safe assets. In this case we define a "safe asset" as a highly liquid asset with a low probability of default and low currency risk. We also considered the bond of developed countries. Between 2000 and 2007, emerging countries' international reserves experienced a strong growth. Parellely, this period corresponds to a big period of dollarization, which explains this rise in international reserves. However, after 2008, the global financial crisis and the sovereign debt in the euro area transformed these assets into no longer safe assets. This phenomenon has shifted the demand for international currency. Emerging countries' international reserves began to shrink in 2014. This period corresponds to the wave of de-dollarization of many emerging economies previously discussed. Even if this produced a change in the demand curve of the dollar, this was compensated by the accumulation of safe assets developed by each country. Overall, the demand and supply of safe assets has shifted. Thus, this shift has depressed the yields of the treasury bonds.

Bussière and Grilliot state in "The dollar facing a financial crisis"[4] the excessive benefit the United States has because of the dominant power of the dollar in the world's economy. The United States goes into debt in their own currency. Therefore, they can manage to pay their external debt without fearing a depreciation. The United States is the country providing the safest assets and in times of crisis, they receive a massive affluence of international capitals. Therefore, this leads to an appreciation of the currency. Since we want to evaluate the impact of this wave of de-dollarization, we will focus mainly on the 2013 and 2016 period. In 2014, the dollar saw a strong appreciation in comparison to the yen and the euro. However, in 2015, the nominal effective exchange rate has significantly diverged. This could be explained by the cease of purchase of assets by the FED. We can also see that this decision can be explained by the decrease in safe assets mentioned before. In contrast, other banks like the Central Bank of Japan or the European Central Bank adopted more flexible measures.

Finally, another article written by McCauley, McGuire and Sushko in 2015 "Global dollar credit: links to US monetary policy and leverage"[10] aims to to study how the American monetary policy has influenced the dollar credit allocation to borrowers outside of the United States. Changes in monetary policy have a direct impact on the global financial system. For instance, when the FED changes their interest rates, there are around 5$ trillion US dollars in bank loans held by borrowers abroad. This stimulates and expands their economy. The expansion of dollar loans has accelerated the growth of the stock of dollar loans abroad because there is a reduced cost of borrowing dollars. Thus, we have an increase in the volume of dollar loans in the global market. On the other hand, we have a different behavior for bond investors. The FED reduced the returns on Treasury bonds, so investors tend to invest elsewhere. Therefore, they increase their extension of dollar credit to bond issuers outside the US. To me, this could explain why the overall volume of dollars in the global market remained pretty high even though emerging economies were achieving their de-dollarization. This would explain why the American economy was not very much affected and why the dollar is still a pretty dominant currency. Also, this explains how emerging countries that were going through the process of de-dollarization managed their dollar reserves. By allocating them in their bonds, maintaining the dollar currency so they do not lose their dollar reserves and preserving their monetary credibility. To conclude, changes in rates and unconventional measures have a significant impact on the global economy and the extension of dollar loans, the behavior of bond investors and the dynamic around the dollar.

4 Discussion

As we have seen in the literature review, de-dollarization is a topic of interest for many emerging economies that once had to rely on the dollar to ensure macroeconomic stabilization but want to get back their economic autonomy and sovereignty. In the case of Latin American countries, the vast majority has applied some kind of dollarization, mostly de facto, to finance an excessive government expenditure or to fight internal crises. When we look at Peru, we see that the dollarization gave some stability to the country at the beginning. However, this dependency is not holdable in the long run. Many articles previously mentioned disencourage the pursuit of dollarized economies and strongly recommend reinforcing the local currency. They even point out that eventually, dollarization will lead to big inflation and a loss in their monetary policy credibility. Some of them see dollarization as "unavoidable" and strongly encourage countries to do it, having also a plan for de-dollarization. The condition is that they see it as a short term policy . For others, it is "avoidable" because the risk and consequences are too severe. As we have seen, some countries have succeeded like Peru or Israel. However countries like Russia and China failed to maintain a persistent de dollarization ratio. For the case of Peru, even if dollarization was pretty strong and persistent, it was limited to the use of dollars as a store of value. Nevertheless, it helped reach stability even after the period of hyperinflation.

Many academics specify that the policies to ensure de-dollarization need a proper sequencing of policies and both macroeconomic and microeconomic measures. Plus, these policies can work well for some countries and not for others, the proper sequencing is very particular to the economic context and policy agenda. Some academics also argue that forcing de-dollarization, which is the mandatory conversion of foreign current deposit (FCD) into local currency, will only result from market based measures whereas some see it as a necessary measure. Therefore, many articles try to point out the policies that have worked which, overall, are less "invasive" than forced de-dollarization and mainly consists in the management of risk, capital flight, exchange rate, inflation, interest rate and mismatches, just to name a few. Every article contributed usually with a successful or failed case study of de-dollarization and much empirical evidence. We can conclude for the process of de-dollarization that most countries that have been through a dollarization must implement monetary policies to revert the effect and strengthen their local currency. It is crucial to increase the economic and monetary credibility of emerging countries in order to assure economic stability.

On the other hand, we have seen that even if there was a wave of de-dollarization in many emerging countries, the demand for dollars hasn't actually changed negatively. The process of dollarization is massively beneficial to the American economy because it allows them to ensure appreciation even in times of crisis. However, many academics put in question the "morality" behind having such a centered dollar economy. Since the American economy is the most powerful one, the only way to get the dollar out of the spotlight would be by expanding another currency strong enough to replace it. Nevertheless, we don't have another strong currency that could beat it. Plus, it wouldn't actually be beneficial for emerging countries to replace a dominant currency for another one. To some extent, dollarization was useful for countries to integrate the global economic market and can allow them to have international clients that will demand their exports without having to have a barrier for trade. In fact, nowadays in the context of globalization, countries that are left out of globalization and that do not participate will lack economic activity unless they already have a very stable and strong local economy and high standards of living. In addition, an isolated country will not suffer from a global crisis and the Covid 19 pandemic showed us how heavily we rely on international trade and how worldwide crises are so easily transmitted due to globalization. Therefore, an economy always needs a stable local economic system.

5 Conclusion

The last study I am going to use is a laboratory study to evaluate the impact of transactional de-dollarization policies written by economists of the BCRP. In the article "Policies for Transactional De-Dollarization: A Laboratory Study," we evaluate the impact and effectiveness of the following policies. First, we see taxes on transactions in foreign currency among domestic agents which was indicated previously as having the risk of mismatches. Second, we will study the impact of storage costs for foreign currency, which should be ensured by a low volatility of the exchange rate. Third, the effect of information on the foreign currency acceptance rate among domestic agents.

The evidence suggests that imposing taxes on domestic transactions in foreign currency as well as reducing the storage costs of local currency relative to foreign currency is an effective way to encourage the use of domestic currency in all types of encounters both international and domestic. This aligns with both the theories of the researchers but also with the empirical evidence that was used for the case of de-dollarization of the Peruvian case. We also find that taxes on domestic transactions with foreign currency diminish foreign currency acceptance in international meetings, but not necessarily local encounters. So without the reduction of the cost of storage of local currency instead of foreign currency, local agents do not entirely accept the use of local currency. As previously discussed, the theory aligns with the empirical evidence that we have found in the article and the theoretical sequencing policy measures suggested by many articles. The question of the "avoidability" of this measure is still put in question by many academics, however there is pretty much a consensus around the idea that, in the case of an applied dollarization, it has to be considered as a temporary measure and a plan of de-dollarization has to take place eventually.

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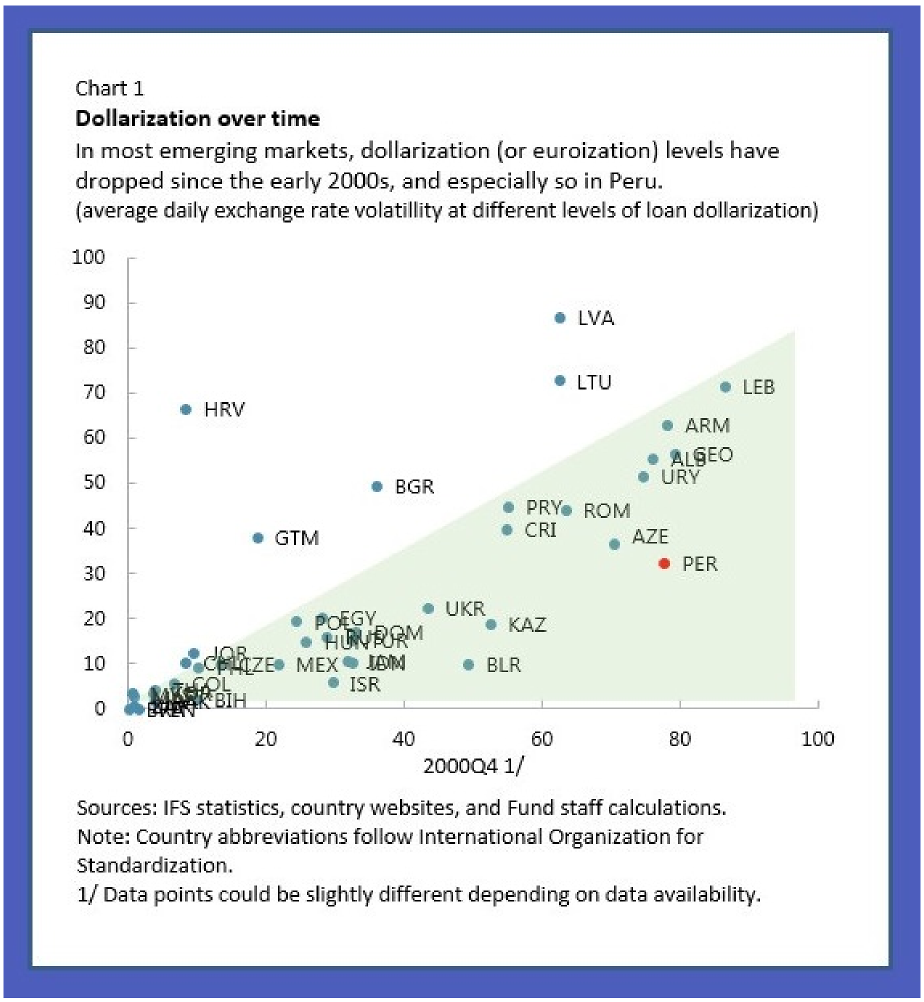

Figure 1: Annex 1

Figure 3: Evolution of credit dollarization in Peru

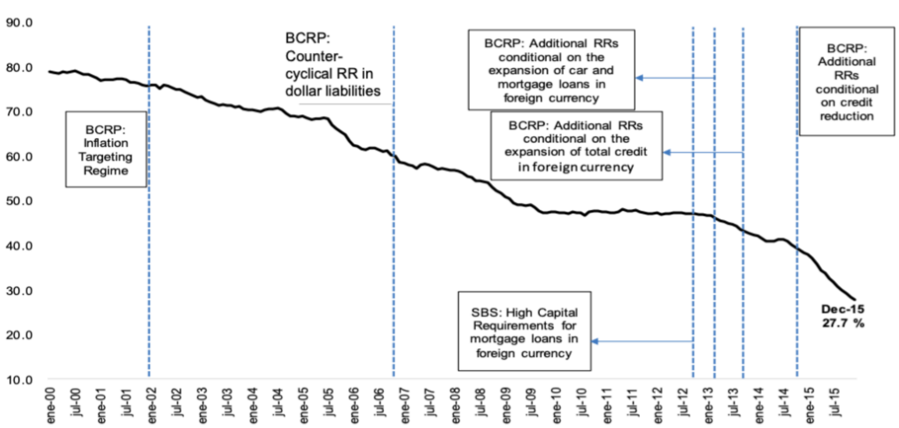

Figure 2: Annex 2