Dollarization of assets and liabilities: Problem or solution? The case of Bolivia

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ABSTRACT

Financial dollarization in Bolivia is near complete (over 90% of total deposits and loans). The paper gives an inventory of the problems caused by *de facto* dollarization to actual policy making. The phenomenon has deep roots and was engendered by high inflation that reached hyperinflationary proportions in the first half of the 1980s. Yet, controlling inflation has not been sufficient to reverse dollarization. Despite the declining trend of inflation since 1985, dollarization has increased. The policy of the Central Bank of Bolivia of increasing the rate of crawl of the exchange rate, in a crawling peg system, to deal with exogenous shocks, while inflation was relatively unstable even if low, may be an explanatory factor. However, the data seem to support the view that the lingering *peso problem* was more important. Indeed, the reduction in the pace of dollarization is still waiting for clearer signals that low inflation is to stay. Also, the liquidation policies of failing banks, policies that are currency-blind, and the lender-of-last-resort functions of the central bank, have further pushed dollarization. With dollarization, even partial, the nature of the central bank changes in fundamental ways and is reduced to a large extent to the role of liquidity insurer in dollars to the banking system, loosing more traditional functions. Also credit crunches and the implosion of the financial system are more likely in a (partially) dollarized economy. The gradual reduction of dollarization- through market-friendly mechanisms- would produce gains in total welfare by allowing a more independent monetary policy (and a more flexible exchange rate) to cope with exogenous shocks and to reduce the vulnerabilities of banks.

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