Dollarization hysteresis network externalities and the “Past legacy” effect: The case of Bolivia

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Abstract

Dollarization in Bolivia rose rapidly immediately after the hyperinflation and currency crisis episode that took place between 1984 and 1985, but failed to reduce and, in fact, continued increasing the following years. In order to explain this dollarization hysteresis, this document proposes and estimates a model, based in the work of Oomes (2003), where network externalities can generate multiple steady-states for dollarization while a so-called past legacy effect increases the likelihood of ending up in a high-dollarization steady-state. The empirical procedure utilizes a more adequate measure of dollarization than the deposit-based ratio, by taking into account a direct estimate of the USD currency holdings in Bolivia thanks to a new source of data. While the empirical results tend to confirm a strong significance of the past legacy effect in this country, the evidence in favor of network externalities seems to rely heavily in the incidence of the past legacy effect over the agents´ formation of exchange rate expectations. Given these results, the document discusses some exchange rate policy implications.

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