

Financial Dollarization and Dedollarization

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Abstract

Financial dollarization is a key factor behind systemic financial fragility in Latin America. The experience shows that dedollarization can be achieved but can just as easily be missed, and worse: blunt dedollarization measures that repress dollarization may easily fail to solve fragility and, instead, foster risky short-term debt or provoke massive financial disintermediation and crisis. This paper analyzes the sources of liability dollarization in a portfolio framework and identifies the failures leading to excessive dollarization that merit policy intervention as well as the reasons why dedollarization policy often goes awry. It then derives an analytically sound, multipronged domestic dedollarization program that takes into account the risks of misdiagnosis and the experiences, both successful and failed. This program centers around the development of good local currency substitutes for dollar debt, such as CPI-indexed debt, rather than the repression of dollar debt.

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