Dolarization in Georgia: Causes ad Problems

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ABSTRACT

Level of dolarization in Georgia:

High level of economy dolarization is one of the undesirable phenomena as it excludes implementation of the effective monetary policies by the central bank.

For the past period of current century, the highest level of deposits dolarization was recorded in November 2003 (86.87%). In December 2013, dolarization index was 55.67%, the lowest in the mentioned period (from 2000 up to present). Its value varied between 57.06% and 59.19% during year 2014. And from July 2015, the trend of deposits dolarization growth showed up and achieved 68.47% by January 2016 due to drastic fall of lari to dollar exchange rate. In the following months it varied within 63.2%-70.00% and was 69.83% by the end of year 2016 [1].

At the current stage, high level of dolarization of the economy is caused by low demand for lari. In the traditional sense, the function of demand for money is as followed:

$$\left(\frac{M}{P}\right)^d = L(r, y) \qquad (1)$$

Where M is nominal stock of money, p – level of prices, r – nominal interest rate, y - real gross domestic product and $\left(\frac{M}{P}\right)^d$ – demand for real stocks of money [2, p.: 63-84; 3, p.: 83-95; 4].

In the research performed by Drobishevski and Kozlovskaya the basic equation of the demand for money is written as:

$$\frac{M^d}{P} = f(y, \dot{e}) \qquad (2)$$

Where M^d is demand for nominal money balance, p – level of prices, y - real gross domestic product and $\dot{e}$- pace of change of the national currency nominal exchange rate.

In the opinion of the mentioned authors, in the dolarized economy, alternative value of money storage should be measured not by the rate of return of the financial assets, i.e. nominal interest rate but rather by national currency exchange rate pace [5, p.:647].

The Essence of the Problem:

In our opinion, 2nd equation requires correction. To assess the impact of changes at currency market on the demand for money more informative indices are required than pace of national currency nominal exchange rate change $\dot{e}$. We regard that such index is difference (e***) between future national currency nominal exchange rate change pace (e**) and current national currency nominal exchange rate change pace (e*) showing pace of change of the incomes saved from change of current and expected national currency exchange rates (in cash and at the deposits) (e.g. in case of its greater fall of the expected national currency exchange rate in comparison with the decrease of current national currency interest rate, it shows the rate of growth of the foreign currency income savings).

Based on the above consideration, expression (2) may be written as follows:

$$\left(\frac{M}{P}\right)^d = f(y, e^{***}) \qquad (3)$$

Where: e***= e** - e*.

In addition to high level of dolarization, Georgian economy is characterized with moderate inflation and presence of relatively well developed banking system. In such conditions, it would be unreasonable not to assess the role of nominal interest rate r as the alternative value of money stored in a form of assets, especially for the periods when lari to dollar exchange rate is distinguished with relative stability. for example, from early 2011 to November 2013, lari to dollar exchange rate varied within relatively narrow range – 1.63-1.68 lari / per dollar [1]. Consequently, with due regard to the characteristics of Georgian economy, function of the demand for money presented by equation (2) may be written as follows:

$$\left(\frac{M}{P}\right)^d = f(y, r, e^{***}) \qquad (4)$$

Based on the above analysis, we regard that in the dolarized economy, in addition to real gross domestic product and nominal interest rate, difference between the expected and current exchange rate paces as dependent variables should be included into the function of demand for money. In normal, non-dolarized economy there is no such necessity as interest rate, as one of the main variables determining demand for money, as such, is the most important determinant of the exchange rate.

In particular, growth of local interest rate causes growth of exchange rate, as can be seen from the following condition of interest parity:

$$E = \frac{1+i}{1+i^*} E^e \qquad (5)$$

Where i is local interest rate, i* - foreign interest rate, E – current exchange rate, E^e – expected future exchange rate [2, p.:430].

Regarding equation (3), the main thing is that even in such case, consolidated demand for money stays within the traditional frame and is formed of two components: demand for money for the transactions and demand for money in a form of assets.

Causes of Dolarization:

High level of economy dolarization in Georgia is caused by the problems in formation of demand for lari (both, for the transactions and in a form of assets.

Demand for money for the transactions depends on total transactions in lari in the accounting period. Measuring of total transactions is very hard. Therefore, based on the tradition accepted in the economic theory, it is expressed with the approximate value, in particular, as total nominal incomes formed in the economy. In Georgia such incomes are especially low.

Demand for lari in a form of assets depend on: total nominal income, nominal interest rate, as well as nature of preferences between lari and stable foreign currency (basically dollars).

Normally, demand for money in a form of assets depends on nominal interest rate level, in formation of which, in the normally functioning economy, together with the central bank, the stock exchange plays significant role. Due to underdevelopment of the mentioned segment of the finance market in Georgia, in making finance savings, Georgian population has to make choice between only two types of financial assets, in particular, M_1 money and term deposits and this limits choice of population in allocating of their savings and overall, contributes to formation of rigid interest rates incompatible with the economic development requirements that, as such, is the cause of inflexible demand for money.

Nominal interest rate determines demand for money not only directly, as the most important instrument of the money market but also indirectly as one of the determinants of expected profitability of the deposits in lari and dollar (together with the current and expected nominal exchange rates)/

In making choice between the national and foreign currencies, in the other equal conditions (on particular, in case of existing of optimistic attitude with respect of national currency stability and reliability), expectations of public with respect of expected incomes in moth, national and alternative foreign currencies, become decisive. In formation of the mentioned expectations, current, past and expected future inflation rates, as well as nominal interest rates on lari and dollar deposits, as well as nature of change of current and expected exchange rates etc. play substantial role. These determinants set the interrelations between M_1, M_2, and M_3 monetary aggregates to great extent.

In the post-soviet countries, demand for money (lari) in a form of assets is particularly sensitive to the pace of current and expected nominal exchange rates changes as mentioned above. Hence, in the instable, underdeveloped, income-oriented economy instable to external and internal shocks, like Georgia, in making choice between national and foreign currencies and determining demand for the national currency, the nature of changes of both, current and expected nominal exchange rates play more significant role than nominal interest rate.

Substantial fall of current lari to dollar exchange rate results in wide-scale loss of trust to lari among Georgian population. Reason for this is that permanent decrease of current exchange rate causes further,. And in case of greater fall of expected lari to dollar exchange rate the condition of percentage parity is violated in favor of dollar.

In case of breaking of the percentage parity condition in favor of dollar the economic subjects, in the other equal conditions (i.e. in case of constant nominal interest rates for the deposits denominated in both, lari and dollar), as a rule, preference is given to dollar as it ensures higher future incomes (for example, in case of dollar to lari exchange rate, dollar deposits will ensure higher expected incomes in lari compared with the deposits in lari). Hence, for the purpose of minimization of losses and maximization of profits from the exchange transactions, in case of such scenario, the savings (both, in hand and on deposits) are en masse converted into the strong currency, basically US dollars. And as a result, demand for lari falls drastically thus preventing stabilization of exchange rate.

This has occurred on years 2015-2016, where one of the main causes of large-scale fall of current lari to dollar exchange rate was even more dramatic expected fall of lari to dollar exchange rate. It is evident that such fall of lari to dollar exchange rate was not the primary cause of dramatic fall of lari to dollar exchange rate in 2015-2016, It was caused by the other main (primary) reasons. And expected fall of lari to dollar exchange rate has further aggravated the situation at money market.

Conclusion:

Instability of current and expected lari to dollar exchange rates, their dramatic fall, especially in 2015-2016, results in fall of larization of the economy and hence, adequate decrease of demand for lari, that, on its side, provides fertile soil for further devaluation of lari. Such scenario deprives the National Bank of the opportunity of implementation of the effective money and credit policies.

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