

THE IMPACT OF FINANCIAL DOLLARIZATION ON THE CREDIT POTENTIAL OF BANKING SYSTEM

Розглядається сутність фінансової доларизації та її вплив на кредитний потенціал банківської системи. Аналізується рівень доларизації економіки України, структура активів та участь банківської системи у процесах фінансової доларизації.

Ключові слова: доларизація, фінансова доларизація, кредитний потенціал банківської системи.

The paper presents the research of the essence of financial dollarization and its impact on the lending capacity of the banking system. We analyze the level of dollarization of the economy of Ukraine, the asset structure of the banking system and its participate in the processes of financial dollarization.

Key words: dollarization, financial dollarization, credit capacity of banking system.

Рассматривается сущность финансовой долларизации и ее влияние на кредитный потенциал банковской системы. Анализируется уровень долларизации экономики Украины, структура активов и участие банковской системы в процессах финансовой долларизации.

Ключевые слова: долларизация, финансовая долларизация, кредитный потенциал банковской системы

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Introduction. Banks in highly dollarized economies face risks that significantly affect their ability to perform their financial intermediation role. In these economies, dollarization plays a dual role: on one hand, it provides a hedging instrument protecting the value of savings and, on the other hand, it generates currency mismatch on banks' balance sheets and increases default risk. Through these effects deposit dollarization can impact credit extension.

The nature and condition of the banking system of each country are determined by law and are characterized by certain features, since their formation occurred in different historical circumstances. The specificity of the banking business to some extent influenced the formation of multiple views on the essence of the concepts of "credit potential of the banking system" in economic literature. Smoothing the differences in the organization and functioning of national banking systems as a result of globalization necessitates the universality of these concepts.

Literature review. The issue of the economy and its financial sector under dollarization is the subject of research of scholars such as O. Bereslavskaya, A. Halchynskiy, A. Gosh, V. Koziuk, Z. Lutsyshyn, A. Poyz, C. Reinhart, K. Rogoff, M. Savluk, M. Stelmach, J. Frenkel, S. Yaremenko and others.

Although the literature on dollarization is very vast, it leaves some important issues unaddressed. While there is a general presumption that dollarization restricts the scope for independent monetary and exchange rate policies, few attempts have been made to systematically estimate dollarization levels across countries based on macroeconomic conditions, or to explore the scope for altering dollarization through monetary and exchange rate policies [9, p.325].

Home researches on dollarization are mostly concentrated on the aspects of currency substitution. Further and more in-depth research needs to identify the impact of dollarization in the banking system, including the development and implementation of its lending capacity.

The aim of the article is the analysis of the impact of financial dollarization on the credit potential of banking system.

Main results. Financial strength of any bank in its essence is its resource base, and credit and investment potential are the basis of the final results obtained from conducting financial activities. All aspects of the economic potential of the bank are closely interrelated, resources and functional components can exist only together complementing each other.

The concept of "potential credit bank" in the context of the economic potential of the banking system as a whole is quite common in the literature, however, in our opinion, this concept reveals enough.

In our opinion, the credit capacity of the bank is a part of lending capacity of the banking system, qualitatively and quantitatively measured the ability of the bank to redistribution of existing and potential financial resources of the economic agents.

Based on this approach to the interpretation of bank lending capacity, we can define the essence of the lending capacity of the banking system as an integral value of redistributive capacity of all elements of the banking system in the effective use of credit instruments to finance current and investment needs of economic actors.

Dollarization is a common phenomenon among developing and transition countries. It normally occurs after a period of high inflation and / or devaluation. From this point of view dollarization can be interpreted as the consequence of a weak monetary policy in prior periods.

Financial dollarization is a home grown phenomenon resulting from a credit market equilibrium between creditors and borrowers who both optimize on the currency composition of loan contracts. The focus of analysis differs in this sense from that followed in the "original sin" and "liability dollarization" literature, which does not model currency choice as a market equilibrium or, when it does, stresses equilibria between domestic borrowers and foreign

lenders. Instead, this paper brings together the more limited (but growing) literature that looks at asset and liability dollarization as a simultaneous and interactive phenomenon [10, p.3].

Among the advantages of dollarization usually allocate its stabilizing effect on the credit system, because the maintenance of assets in foreign currency is viewed as economic agents in terms of the reliability of savings. In addition, the high level of dollarization can be considered as a motive for the central bank to abandon overly loose monetary policy, which may result in high inflation. In general, these effects will be beneficial to the long-run economic growth. On the other hand, dollarization itself automatically means lower demand for the national currency, as it involves the replacement of assets in domestic currency assets in foreign currency. The consequences of reduced demand for the national currency are partial loss of seigniorage and capabilities of autonomous monetary policy by the central bank. Therefore, the favorable effects of dollarization (euroization) can be applied to small countries, for which the role of an autonomous monetary policy substantially leveled. In extreme cases, countries may unilaterally accept foreign currencies as a legitimate means of circulation in the territory, by introducing the official dollarization. However, if the country wants to maintain an autonomous monetary policy as an instrument to influence the economy, the process of dollarization as a whole should be considered as a negative, which, however, may have a number of short-term positive effects.

In recent years, the majority of works devoted to dollarization, mainly focused on financial dollarization, that is, the dollarization of financial contracts (loans, deposits, etc.). However, this form of dollarization is not unique and can coexist with other forms of dollarization. One such initiative was the real dollarization, i.e. nomination in foreign currency prices and wages, as well as currency substitution.

In developing the measures to de-dollarization it seems necessary to clarify precisely which form of dollarization is an obstacle to achieve certain goals, and what is the negative effect of this form of dollarization.

For real dollarization of its attempts to quantify the level rarely effective, as there are no relevant statistics. Despite the difficulties with objective evaluation of real dollarization, on the basis of indirect assessments can only talk about a limited manifestation of real dollarization in developing countries [10], except in cases of official dollarization. Mostly a presence of the legal restrictions on the use of foreign currency as the currency of measurement of prices and wages is the simplest explanation for the limited real dollarization.

Another form of dollarization is shown in the case of replacement of the national currency of foreign currency as a medium of exchange. In practice, this translates to replace the cash foreign currency. If the extent of currency substitution is quite large, it is possible to say that the official rate of the demand for cash (M_0), which includes only the national currency, does not fully reflect the processes occurring in the cash turnover. In such a case, the more correct figure is the aggregate demand for cash, including, as demand for domestic and foreign currency. Ignoring the latter, at least, due to the lack of data may lead to erroneous estimates of the demand for money in the economy.

Currency substitution, as a rule, is the result of periods of high inflation and / or devaluation and the subsequent formation of expectations about inflation / devaluation. That is, economic agents are selected foreign currency as a medium of exchange, if, in their opinion, the national currency cannot fully ensure the implementation of this function. In addition, foreign currency cash can be maintained, and as a store of value, if the currency is associated with inflation / devaluation losses. In this case, despite the fact that the transactions are carried out directly in the national currency, the economic agents in the period between trades prefer to keep their wealth in foreign currency. Finally, the maintenance of foreign currency may be due to limitations in the area of financial dollarization. Typically, these two forms of dollarization coexist since

they cause very similar. But in the case of measures to limit the deposit dollarization, currency substitution can move relative to the dominant form of financial dollarization.

The most common modern form of dollarization is the financial dollarization, which reflects the nomination of financial contracts in foreign currency. Typically, it is measured by either the bank assets, that is, the share of loans denominated in foreign currency, or from the same liabilities, that is, the share of foreign currency deposits. By itself, the financial dollarization significantly limits the ability of monetary policy to narrow down the amount of money in national currency in relation to the broad money supply. In the worst case, the financial dollarization may make the complete dependence of monetary policy on the demand and supply of foreign currency, and the change in the money supply can only be done by changing the foreign assets.

Causes of financial dollarization are significantly different from the real causes of dollarization and currency substitution. High inflation / devaluation in prior periods are not fully explain the phenomenon of financial dollarization, especially the dollarization of deposits. High inflation may cause the formation of unfavorable expectations of economic agents, but if there are no preconditions rational reflation and / or continuing devaluation, then over a period of time it would be expected to reduce the dollarization of deposits. Moreover, in the case of financial dollarization inflationary losses seem less significant factor, as in the case of positive real interest rates, the interest on financial contracts already takes into account the corresponding expected rate of inflation. However, in practice financial dollarization may be sufficiently robust and occur over a long period of time, despite the decline in inflation and / or devaluation. Thus, financial dollarization is more complex phenomenon than a manifestation of adaptive expectations in response to the high inflation / devaluation.

Summarizing recent research on financial dollarization the last can be interpreted as a state of equilibrium, which is achieved due to the choice of

optimal currency composition of lenders' and borrowers' contracts. In this case modeling the behavior of bank depositors can be based on the premise that they estimate the real interest rate of the deposit portfolio, which consists of deposits in different currencies. Introducing the premise that holders of deposits are not prone to risk, we can determine the purpose of their activity in the deposit market to minimize fluctuations in the real interest rate of its portfolio. In other words, they choose a currency structure of the deposit portfolio, which will provide the minimum variance of the real interest rate. Under these hypotheses, a number of studies considered the "basic level" of dollarization [11], which corresponds to the share of dollar deposits in the portfolio with minimum variance of interest rates.

To consider the impact of dollarization on the formation of lending capacity of the banking system one should realize that the latter is based primarily on foreign currency resources: currency deposits of natural and legal persons of the country (international banks, institutions and organizations, private persons, exporters), self-financing in international financial markets. According to the NBU, the amount of foreign currency deposits increased in 2008-2012, and in the last two years of growth exceeding 19% annually, which increases the volume of external resources of the banking system and forming part of the financial lending capacity [2; 8].

In 2011-2012, an increase in the volume of loans, granted by banks, took place and in 2012 growth exceeded 10%, including through participation of foreign currency deposits in the formation of external resources. Fig. 5 shows that in 2008 the net foreign assets of banks in foreign currency form the majority of the bank's assets, namely amounted to 53.35%. So banks are largely affected by the consequences of the global financial and economic crisis.

With the increase in the dollarization of the economy there has been an increase in net foreign assets of banks in foreign currency (Fig. 5).

In 2011-2012 there was a decline of dollarization, while Fig. 5 shows the decline as the size of net foreign assets of banks in foreign currency, and their share in total assets of banks in this period.

Summary. Thus, the level of dollarization of the economy Ukraine remains high, which increases its dependence on the banking system and global trends. Increasing the level of dollarization leads to increase in external financial resources, which will increase the financial component of the lending capacity of the banking system, but credit conditions deteriorate, which makes possible the efficient use and the possibility of its realization. In addition, the dollarization of the financial resources of the banking system reduces the cost of credit and an increase in loan demand, diversification of banking risks, encourages savings and increase their involvement in the banking system, enhances the range of banking services through the use of deposits and loans in foreign currency.

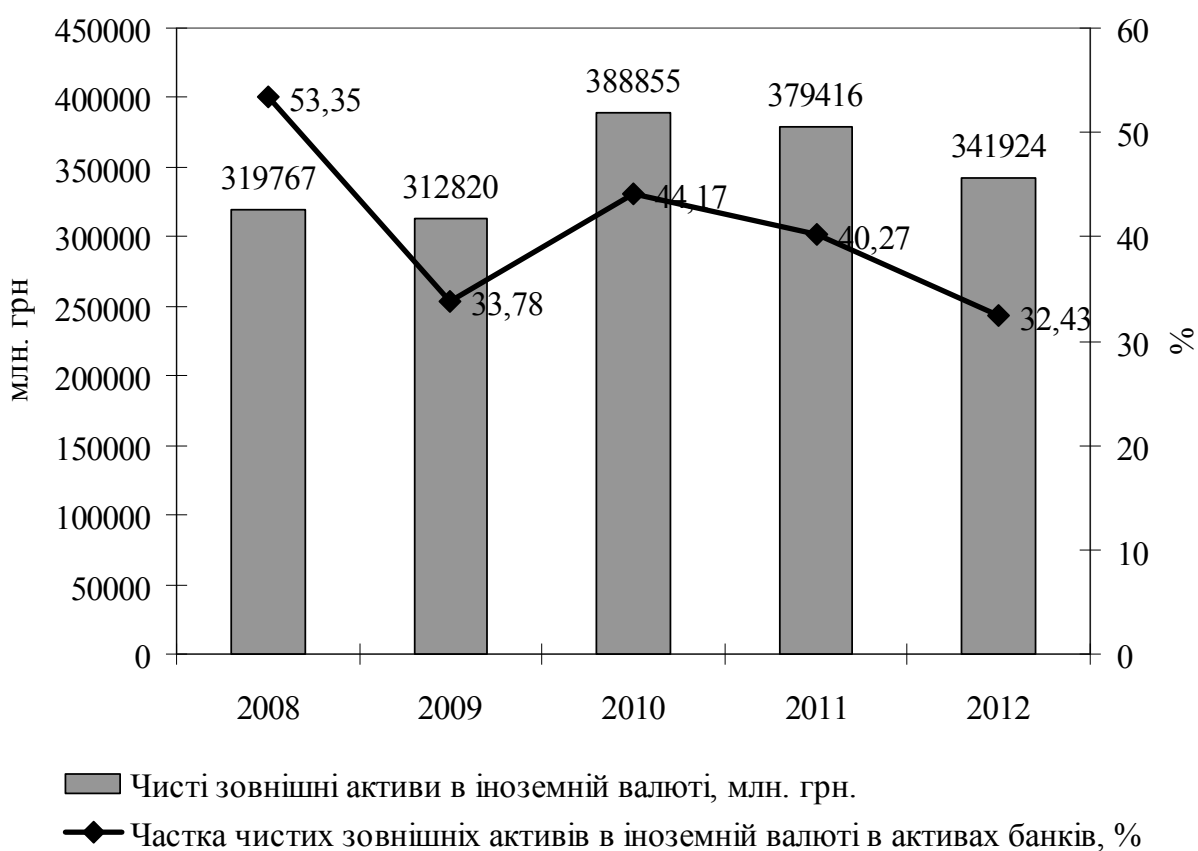


Figure 5. The dynamics of net foreign assets of banks in foreign currency
Resource: developed by the author based on NBU data [1;2;8;9]

The results also suggest that dollarization in some way affect the consolidation lending capacity of banks. The threat is not the dollarization itself, the level and rate of growth of dollarization are dangerous. Given the positive aspects of dollarization, it is essential for the development of economy of Ukraine during the transformation process and post-crisis recovery, because it promotes the formation and strengthening of lending capacity of the banking system. However, to mitigate its negative consequences requires deliberate government policy. As economic development rises dollarization may reduce, but it is necessary to provide a number of conditions:

- to maintain high rates of return on assets in local currency;
- to restore confidence in the national currency because of its stability, predictability, and predictability of the exchange rate;
- to provide financial market development as an alternative to deposits;
- to limit the level of lending in foreign currency to the introduction of a ban on this type of lending for individuals who are not engaged in entrepreneurial activities;
- to reduce the rate of inflation and macroeconomic stabilization in general.

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