Is banning dollarization in Ghana sound economic policy?

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There has been a huge outcry in recent weeks by the banking community in Ghana concerning the dollarization of the economy. In Ghana many transactions, such as the purchase of cars, houses, airline tickets, and payment of school fees etc., are made in dollars.

According to a report by the Ghana News Agency (GNA), the Ghana Association of Bankers (GAB) has "called on the Government to enforce the law that discouraged companies from invoicing and receiving payments in dollars, to halt the depreciation of the cedi.": http://www.ghanaweb.com/GhanaHomePage/NewsArchive/artikel.php?ID=247981

Another report by Daily Guide claims that "The Bank of Ghana (BoG) has decided to compel operators in the hospitality industry to transact business using the Ghana Cedi."

It is not clear whether the central bank's policy is in response to the depreciation of the cedi. However, the timing of this policy suggests that the depreciation of the cedi was the motivating factor.

Will banning dollarization halt the depreciation of the cedi? To answer this question, I shall consider a very simple model of buyers and sellers of goods and services in the economy of Ghana. Without any loss of generality, assume that in any given period, buyers only need money as a medium of exchange while sellers need it as a store of value (that is they expect to use it as a medium of exchange in future, for example, to finance imports); we may assume, for the sake of simplicity, that sellers and buyers are two distinct (non-overlapping) groups.

To make the analysis more interesting, assume that both buyers and sellers are all domestic residents. If all buyers were foreigners (e.g., Americans) with foreign currency (e.g., dollars), then demanding payment from them in a foreign currency (dollars) would not be a problem.

Consider a pre-dollarization period where all transactions were in cedis. Now suppose that the economy is dollarized. If sellers price in dollars but receive payments in cedis, then it is obvious that banning this practice will not change anything. They will simply quote prices in cedis using the dollar as their mental frame of reference.

The Bank of Ghana cannot convince a judge in a court of law that a seller used the dollar as his/her frame of reference. Besides, dollar-indexed prices are different from demanding payment in dollars. Accordingly, I shall use the less obvious and more challenging case where sellers do not only price in dollars but also demand payment in dollars. This also seems to be part of the concern of the Ghana Association of Bankers. Demanding payment in dollars increases the demand for dollars by buyers because they need dollars to transact business with sellers. The increase in the demand for dollars leads to a depreciation of the cedi.

Now suppose that there is a policy to ban dollarization. To stack the cards in favor of banning dollarization, assume that the government can fully enforce this policy. Then buyers no longer need dollars and therefore this will reduce the demand for dollars by buyers to pre-dollarization levels.

What will happen to the demand for dollars by sellers? To answer this question, we need to understand why sellers demanded payment in dollars before the practice was banned. It was because they had no confidence in the value of the cedi; they believed that inflation will be high in future because it was high today. Hence, the cedi was not reliable as a store of value.

Imagine that when dollarization was allowed, a seller sold a unit of her commodity or service for $100. If the exchange rate is say $1 = 1.5 cedis and dollarization is not allowed, then the same seller may price her commodity or service at 1.5 times $100 = 150 cedis and use it to demand $100. Banning dollarization does not change her lack of confidence in the cedi nor does it change her belief that the dollar is a superior store of value.

It follows that banning dollarization reduces the demand for dollars by buyers but increases the demand for dollars by sellers. It has no effect on the aggregate demand for the dollar and therefore will not affect the depreciation of the cedi. It will also not reduce inflation.

Banning dollarization only has a redistributive effect because transactions are now more convenient for buyers while sellers incur a higher transaction cost (e.g., they have to go searching for dollars). The intuition for this result is straightforward: if the sellers in an economy need dollars but cannot get it through those who buy their services because dollarization is illegal, then they will demand the dollar through different but legal means, given that the government can fully enforce the anti-dollarization policy. In particular, they will directly increase their demand for dollars in foreign exchange markets.

Dollarization is an effect not a cause. It is the effect of macroeconomic uncertainty, a high level of inflation, huge budget deficits, and a lack of confidence in the domestic currency. In a 1999 paper by J. Dirck Stryker titled "Dollarization and its implications in Ghana", he opined that:

"[I]t is important to realize that dollarization is more a symptom than a cause of instability. Above all, it indicates the reaction of the public in Ghana, as it has in many other countries of the world, to fiscal instability, and the desire of people to avoid its consequences in the form of an inflation tax, an erosion of their wealth, and a squeeze on their liquidity. [Michael] Melvin and [Bettina] Peiers …. even look on dollarization as a market-enforced monetary reform where the public, rather than the monetary authorities, introduces a new monetary unit, which forces a certain level of discipline on the government."

Stryker continues:

"Lack of fiscal discipline leads to inflation, which in turn results in dollarization, which helps to undermine the effectiveness of monetary policy in undoing the damage associated with fiscal deficits. The obvious solution is to avoid fiscal deficits in the first place. The government can of course intervene to prevent dollarization by making it illegal, but this just drives it underground and creates all of the rent-seeking opportunities … encouraging the keeping of foreign exchange overseas. Instead, dollarization should be monitored as an indicator of the soundness of the macroeconomic situation."

To conclude, I have presented a very stark and simple economic model to study the economics of banning dollarization. Complicated versions of the model and more sophisticated arguments will not change the point that banning dollarization is not a solution to a fundamental macroeconomic problem. When the fundamental problem is solved, economic agents will voluntarily abandon dollarization.