

Attributes of Unofficial Dollarization in an African Economy

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Abstracts

Dollarization turns out to be the most prominent economic phenomenon in the Somali economy although less is known about its attributes. Therefore, this study investigates impact of dollarization on Somali economy while paying special focus on the financial sector. Moreover, this study has adopted literature review analysis to uncover this alarming issue. The from this investigation indicates that dollarization plays a positive role in the Somali economy in terms of promoting financial deepening, expanding fluidity, reducing foreign exchange risk and facilitating exchange of goods and services. Despite of that this study finds that dollarization ruins the capacity country's monetary authority as monetary policy become idle due large amount of foreign currency circulating the economy. The outcome from this investigation led various policy implication. This study recommends the desire for the Somali government to undertake immediate measures to de-dollarize the economy, conduct transitioning measures to lower risks that are subjected to mobile network operators and banks as central bank is unable to provide short term liquidity to institutions that are subject to financial distress. Lastly, this finding suggest to mobile network operators and banks to upgrade their risk management approaches.

Keywords: dollarization, monetary authority, mobile network operators, money transfer operators and financial institutions

Introduction

The term dollarization is commonly described as the use of foreign currency alongside or instead of domestic currency. The term is not limited to the use of dollar but for all other foreign currencies that are used besides or as a substitute of domestic currency. Dollarization in any of the dollarized economies might be official, semi-official or unofficial dollarization. according to (Kurt Schuler, 2000) Unofficial dollarization takes place when citizens of a certain country keep much of their financial wealth in form of foreign currency even though it is not the legal tender. However, it doesn't matter whether holding financial assets in foreign currency is legal or not under this, as this currency serves the second role of the domestic currency in paying wages, taxes and daily expenses although it might dominate banking deposits. Lastly official or full dollarization as another type of dollarization occurs when a nation adopts foreign currency as its main legal tender.

Dollarization has gained in the recent decades the attention of many economists as a prominent feature of this modern globalized economy. As world trade and capital markets become more integrated difficulties associated with the type of exchange rate system a nation should adopt in order to achieve its development objectives have emerged. Some economists have the view that this challenge can be dealt with by adopting full dollarization which means countries to adopt stable foreign currency as legal tender by abandoning their local currencies.

Although most developing economies are experiencing dollarization by any of its kinds, there are both benefits and downsides associated to this economic phenomenon. As supported by (Cohen, 2000) dollarization introduces favourable and unfavourable economic conditions. Despite of the both aspects of dollarization there some literature indicating that dollarization brings economic turmoil to Somali economy according to (Nor, 2012).

As it is one of the biggest and most feasible economic phenomenonis experiencing by the Somali economy in last three decades, less is known and written about this alarming economic aspect. This article will shed some light on economic attributes associated with dollarization in Somalia by putting special attention on key areas such trade and financial institutions. Furthermore, this article will introduce possible measures needed to undertake by the stakeholder in order to deal with this matter.

Somalia's macroeconomic outlook

According to African development bank economic outlook the growth rate of Somali economy was 2.9% in the year 2019 which rised from 2.8% rate in 2018. This positive economic growth is derived by recovery in agriculture and strong consumer demand. Inflation reached at peak of 5.1% in 2018 which then declined to an estimated 4.4% in 2019 as food prices went down. Given the limitation on new public borrowing under staff monitored programs (SMPs) since 2016 and the need to keep inflation under control, government's budget remained in balance.

Revival of livestock export and decline of import growth led current account deficit to improve from 9% of GDP in 2019 to 8.3% in 2018. Somalia's current account deficit countered by aid and remittances while foreign aid remains subdued. Limited control of money supply due to forging and dollarization linked with low fiscal balances restricts the role of fiscal and monetary authorities to boost the economy in the short run as claimed by ADB.

Somalis remains to be among the poorest people in Africa as indicated by the Somali High Frequency Survey, wave 2, of 2017, with associated poverty incidence of 69.4% and per capita income of about \$400. Male-headed households poverty was about 72% compared to that of female-headed households which is about 66% as stated by ADB. Youth who constitutes 70% of the Somali population 67% of them are unemployed as reported by ADB.

Forces behind the dollarization in Somalia

Collapse of institutions and breakdown of almost all sectors came up as result of collapse of Somali republic in 1991. Significant devaluation of Somali shilling started which keep increasing time after time up to date due to private production of Somali shilling as competition for seigniorage began.

It is rare to see any other foreign currency in Somalia as U.S dollar become the most prominent and widely used currency in the country although Somali shilling is still used along dollar but is less used compared to volume of transaction involved in U.S dollar. Under the subsequent paragraphs we will look at the major forces that bring about dollarization in the case of Somalia.

The need for seigniorage as a major cause of dollarization led a large of amount of Somali shilling to be printed privately. This private production led significant devaluation of Somalia shilling and hyperinflation which as result of that deteriorated people's confidence for the use of the currency. Due to loss of confidence of Somali shilling people preferred to use dollar

for their daily transactions. However, competition for seigniorage is common cause of dollarization as it led dollarization in Zimbabwe (Nkomazana & Niyimbanira, 2014).

The collapse of industrial sector following the civil war outbreak fuelled the need for international trade. However, this contributed to the inflation in the country as import became more expensive as a result of decline in value of Somali shilling on the paper of (Cohen, 2000) transaction costs lessen as countries adopt dollarization.

The main attraction Somalia's unofficial dollarization was people's desire to hedge against exchange rate and inflation rate risks due to loss of confidence of Somali shilling borne by the deteriorating macroeconomic fundamentals consistent with the finding of (Isak, 2017).

Nevertheless, remittance from Somalia diaspora, income from exported goods and services and mobile money created by the local telecommunication companies serve as the main source of dollar in the country.

Somalia's financial sector

The collapse of Somali republic in 1991 led disappearance of almost all components of financial sector. However, right before the state breakdown nation's formal financial sector was composed of central bank of Somalia, commercial and savings bank, Somalia development bank and state insurance company.

Despite of countries underdeveloped financial sector, the recent financial sector is made up by central bank (although it remains inactive), banks, microfinance institutions, money transfer operators, money network operators supplying mobile money and insurance agencies.

There are concerns arising from the link between dollarization and financial sector as this economic phenomenon become very common in most of the developing economies. Financial dollarization in particular deposit dollarization has unfavourable impact on financial deepening although this negative influence become intensive in cases with past period of high inflation. Therefore dollarization limits financial efficiency and sector development as stated by (Bannister, Turunen, & Gardberg, 2018).

Besides the negative effects, there are significant role that dollarization plays in promoting financial deepening of countries that are experiencing hyperinflation as a curtained by (Nicolo, Honohan, & Ize, 2003).

Following these contrasting view, this article will put focus in the subsequent writing money network operators (as providers of mobile money) and banking sector as the major players of Somalia's financial sector.

Money network operators as suppliers of mobile money

Somalia has the most active mobile in world regardless of country's vulnerability and underdeveloped financial institutions as confirmed by the World Bank press release (2018). Per month transaction of Somalia's mobile money is approximately has worth of \$2.7 billion as over 70% of Somali adults use this service frequently. This huge amount of dollar is privately created and supplied the telecommunication companies are lacking the regulations needed in order to ensure healthy functioning of the economy.

Somalia's mobile money lacks robust consumer protection and know your customer requirements while there are alongside as it promotes financial broadening and widening which may result more competition and contestability in the financial service market as believed by the world bank.

Despite of the extent of transactions held in mobile money there significant risks associated with mobile money due to absence of regulation which make the system more fragile and fragmented as stated by (Victor O. Owuor, 2018). He stated that mobile money in somalia is vulnerable to money laundering as there is weak compliance in lined with global banking standards and lack of insurance is an another attribute of this system as no guaranteed parity between the mobile money balances held by mobile operators and those held in individual and business accounts. He further declared that issuing foreign currency by the domestic telecommunication agencies is unhealthy for the economy.

Nevertheless, (victor O.Owuor, 2018) considered the positive role played by mobile money. According to this article less percentage of the population have bank accounts. Mobile money has promoted financial inclusion. It is convenient and fast way to transfer money to the vulnerable groups as many aid agencies use it reach remote villages. Moreover, he argued that money mobile lower the risk of security incident as beneficiaries make payment without travelling with cash with the aim of making settlements.

Based on the report published by Altai consulting collaborating with word bank in the year 2017 confirmed that companies in Somali's ICT sector have been operating in an regulated environment. Even though some steps have been taken adequate regulatory and taxation policies do not exit except the communications act as further confirmed by this report.

As confirmed by Altai consulting report there are lack of customer protection, risk of fraud by money transfer operators, tax evasion, risk of further depreciation of local currencies, risk of inflation, risk that the international remittance market be eventually closed to Somali mobile money associated with the current system. Not merely the significant opportunities

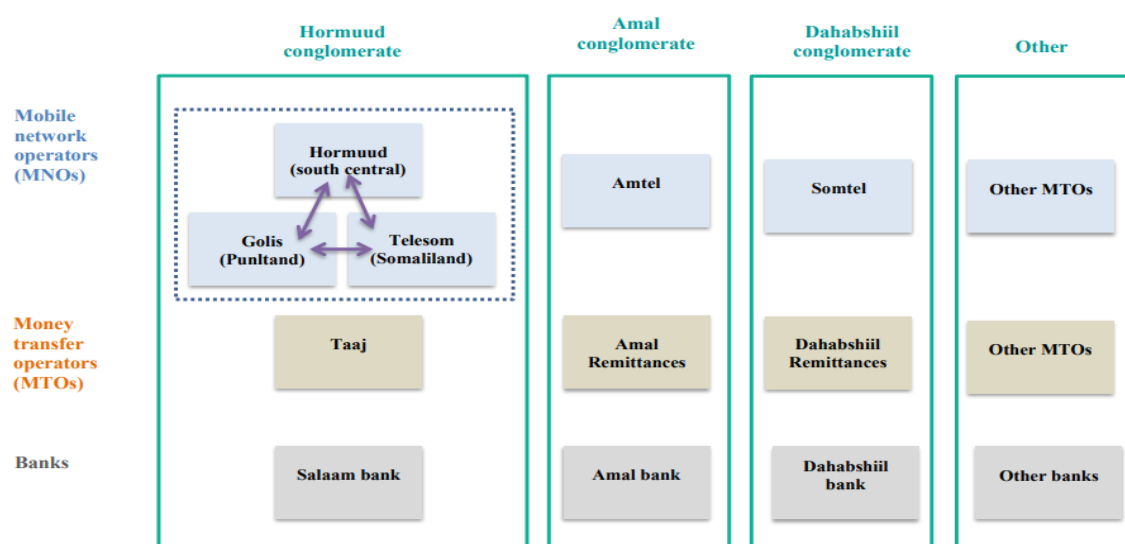
mobile money offer to the people as the system enables more fluidity among the society, compose lifeline for the poor and facilitate transfer of money from NGO’s and aid agencies to vulnerable groups.

Despite of Somalia’s complex political and security conditions, investment in the ICT sector is exclusively led by Somalis. There is no interlinking exist among the concurrent operators except for the agreement between Golis, Hormuud and Telesom.

The prevalence of mobile money throughout Somalia place smallest money transfer operators out of the market. However 17 MTOs based on the Hawala system operate across the country based on Altai’s report. Despite financial sector remains underdeveloped, there are seven sharia-compliant banks operating across the country while few of them offer ATM and credit card services.

Based on Altai consulting report market structure has evolved with consolidation around conglomerates arising from partnership between MNOs and MTOs and among MNOs and banks. This article will wind up this section by extracting figure from the study jointly conducted by Altai consulting and world bank in 2017. The aim is to clearly expose Somalia’s mobile money ecosystem from the supply side angle although this finding has updated following the same procedure as Amal money transfer has introduced Amtel as a money network operator.

Figure 1: Somalia’s mobile money ecosystem – supply side elements



Lastly, despite of the absence of inadequate regulation Somalia’s mobile plays significant role as it promotes financial inclusion, fluidity among the society and provide convenient way of making settlements.

*Altai consulting & world bank (2017), Mobile money ecosystem in Somalia.

Dollarization and Banking industry

At times of sharp devaluation of local currency in countries with heavy dollarization, financial assets and liabilities shift to foreign currency aggravating downward pressure on exchange rate. Under such instances monetary authority intervenes to keep exchange rate steady in nominal terms by setting interest rate of domestic currency at higher level compared to that of foreign assets. This lead banks to prefer lending to the government by this higher rate than private sector. In this scenario private sector face currency mismatch which comes up their dollar debt as their receivables may shift towards domestic currency denominated instruments. Banks will face a variety of risks due weakness of their financial statements borne by currency mismatch as confirmed by (Marcelin & Mathur, 2016).

Following the work of (Nicolo et al., 2003), dollarization influence negatively on banking industry as it creates financial instability. However, the widely notion that dollarization brings unappreciated impact on banking sector is under doubt as reported by (Honig, 2006).

Although Somalia's banking industry remains second largest agency in nation's financial sector after mobile network operators with users estimated to be 15% of the population as confirmed by the world bank. The impact of dollarization on banking industry is unknown as there is no single report clearly indicating about alarming economic aspect. Somalia's banking industry is expanding significantly as various remittance agencies have been transformed to commercial banks (Islamic/sharia compliant banks) as the case of Dahabshiil bank, Amal bank, Daryeel bank and Sombank.

Unlike Zimbabwe whose banking industry accepts multiple of currencies, Somalia's banking industry as fully dollarized system would freefrom currency mismatch complications as supported by (Ozsoz, 2009). Besides that, in agreement with (M. A. Berg, 2000) dollarization has played crucial role in Somalia economy as it lowered transaction costs and promoted easy integration of international financial markets due to reduced foreign exchange rate uncertainty.

Lender of last resort and Somalia's financial sector stability

Lender of last resort is a nation's monetary authority that conducts monetary policy and regulates banks. However, 'central bank is the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in that country' as stated by bank of international settlements. Monetary authority undertake these tasks with the intention to keep unemployment low, stabilize nation's currency and prevent inflation.

As stated by (A. Berg & Borensztein, 2001) nations that are highly dollarized (like Somalia) lender of last resort loses the ability to influence the economy. In this instance the central bank will neither be able to provide short term liquidity to the system or nor assistance to individual banks that are experiencing distress. This is an indication of serious consequence as absence of exchange rate, credit size and inflation control ruin financial stability and economic growth. Moreover, following the nation that dollarization does not only damage the economy but eliminates the role of monetary policy making the central bank idle as confirmed by the finding of (Ghalayini, 2011).

The bank of Somalia whose prime objective is to maintain price stability and keep exchange rate under control will not be able to realise such its target as monetary policy become ineffective due high dollarization of Somali economy. Therefore, any action aiming for currency regulation will not bring any result at all as confirmed by (Isak, 2017).

World Bank confirmed that more than 70% of Somali population use mobile money (US dollar denominated mobile money) making the nation highly dollarized. In this respect of having huge amount of foreign currency money supply in the economy complicates the role of monetary authority of Somalia. Therefore, dollarization left no option for the country's central bank as the supply of United States dollar is out of banks control.

Dollarization and trade

Trade as an act of exchanging goods and services it is not restricted to within a region but goes beyond as global value chain become relevant in boosting productivity and income in both developed and developing nations.

The role of dollarization in trade is beyond doubt as firm evidence is available from the literature. Dollarization promote trade by lowering transaction cost as there is no need to exchange the currency and assure stability of prices as stated by (A. Berg & Borensztein, 2001). This positive impact indicating that dollarization boosts trade in particular trade across borders is supported by the finding of (Gachet, 2018).

Somalia production sector disappeared following the collapse of Somali republic in 1991 which led country to depend heavily on imported goods. Therefore as the country has been importing and exporting goods and services in last twenty five years without any big complication it is clear that Somalia has already enjoyed benefit of dollarization in agreement with the above literature. Dollarization in particular mobile money has contributed positively to exchange of goods and services in Somalia by creating lifeline for the poor due to fluidity and enabling easy and fast transfer of money among the individuals.

Although Somali shilling is still in use in the country but for small transactions, there are some concerns indicating that dollarization harm trade activities that are involving Somalia shilling as confirmed by the work of (YUSUF & Abdurrahman).

Concluding remarks

Disappearance of crucial public institutions including the central of bank of Somalia following the collapse of Somali government in the year 1991 promoted huge dollarization of Somali economy due to fear of exchange rate and inflation risk as Somali shilling lost confidence.

The purpose of this finding is uncover role of dollarization in Somalia economy as it is the one of the prominent feature of present Somali economy and to achieve such aim this study deployed literature review analysis

This study find that dollarization in particular mobile money plays an important role in the economy as it promotes financial inclusion, provide fluidity to the economy and faster and reliable transfer of money among the people although it is lacking adequate regulation. Dollarization (particularly use of one foreign currency) banking sector influence positively on banking sector as it allows banks to be free from currency mismatch and easy integration of international financial markets. Nevertheless, this investigation find that dollarization significantly damages monetary policy by abolishing the role of central bank to regulate inflation, exchange rate and credit, this makes the whole financial sector fragile. Dollarization has contributed positively to trade with the country and across the bounder.

The outcome from this investigation led various policy implications. Despite of the positive impact of dollarization on financial sector, the absence of effective monetary policy will eliminate the whole advantage. Therefore we call Somali government immediate measure to de-dollarize the economy although dollarization remains good option during the transition.

There is need for the government particularly the central bank to undertake measure before de-dollarization to monitor and supervise mobile money and banks which if not monitored make the system riskier. Lastly we call mobile network operators and banks to further advance their risk management approaches.

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