

Financial Sector Development and Dollarization in the Economies of Central Asia

Isakova Asel

Non – technical summary

The present study focuses on financial dollarization in three transition countries of Central Asia – Kazakhstan, the Kyrgyz Republic and Tajikistan. The paper contributes to understanding of the factors that drive dollarization of the financial sector in transition economies using examples of the countries in the Central Asia. Financial dollarization comprises both sides of banks' balance sheet – deposits and loans denominated in a foreign currency.

Dollarization has developed in Central Asia following periods of macroeconomic instability, high inflation and depreciating national currencies. Financial dollarization has arisen as financial markets represented mainly by the banking institutions had started to develop. Important capital and foreign exchange inflows into these economies through financial systems have become important sources of banking system dollarization. High and persistent financial dollarization poses certain risks to the stability of the financial sectors in these economies.

The major factors that affect deposit dollarization are related to memory of economic instability and high inflation. Moreover, such factors as institutions, quality of governance and income appear to affect the decision of residents to hold deposits in foreign currencies. Thin and underdeveloped financial intermediation has a negative correlation to dollarization as well. Countries with large inflows of remittances are among those with the highest levels of deposit dollarization. Loan dollarization appears to be mainly driven by deposit dollarization which might be related to local regulations on the open position of the banks.

The past financial crises, in particular, in the countries of Latin America suggest a link between high levels of financial dollarization and financial stability. It is however not clear whether higher dollarization promotes financial development. Nevertheless, there is a clear correlation between dollarization of banks' assets and their exposition to

solvency and liquidity risks. The banks in Central Asia have large shares of their credit portfolio denominated in foreign currency. The simple correlation analysis shows that there is a positive relationship between the bad quality of the credit portfolio and a level of credit dollarization. Tackling risks that are faced by local banking institutions due to high levels of dollarization should become an agenda for monetary authorities in the region in order to deal with the vulnerabilities of the banks related to foreign currency and to further promote development of the financial sectors and the use of the local currencies.