THE EFFECT OF DOLLARIZATION ON DEVELOPING ECONOMIES: LESSONS FROM SOMALIA'S INFORMAL MARKET

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ABSTRACT

Arguments on dollarization and its effect on the economy have been published mainly on economics and financial journals, yet, little is known about Somalia's unofficial dollarization. To contribute in that matter, this paper presents the effect of dollarization on Somali economy. The study is carried out using literature analysis. The study found out that dollarizing Somali economy brings severe economic turmoil including an absolute failure to achieve price stability in the local market. In addition, adopting this policy impedes achieving strong financial management system in the country. The study recommends that policymakers and business community should try to lessen the reliance on US dollar and encourage the use of a basket of currencies (in the short-run) while strengthening the use of local currency (in the long-run). Adopting such strategy will facilitate to avoid recurrent financial crisis which might happen if the use of US dollar as an internal currency is collapsed.

Keywords: dollarization, economy, Somalia

INTRODUCTION

Scholars have been trying to find out the effect of dollarization on the monetary system in particular and the economic systems in general. Rose and his co-authors have been arguing that currency union promotes trade. Monetary stability and trade integration are the two driving forces appealing to dollarize economies (Klein, 2005). A country is called dollarized when its inhabitants use a foreign currency in parallel to or instead of domestic currency. This paper investigates the extent to which dollarization policy is favorable for a poor nation like Somalia. The paper focuses on the financial management implications of using US dollar as a medium of exchange in a state where it is estimated that 45% of its population live on less than $1 a day. This study is carried out reviewing and analyzing the available literature. In Section 2, the historical formation of Somali monetary system is discussed. Section 3 is a discussion on currency union, dollarization and pegging policy. Section 4 is on the differences between official dollarization and unofficial dollarization. Section 5 discusses reasons encouraging dollarization of the economy. The effect of dollarization on Somali Economy is discussed in section 6 and the final section concludes the paper.

OVERVIEW OF SOMALI MONETARY SYSTEM

A monetary system is established to secure the appropriate running of money in the country by setting-up policies and procedures that monitor the supply of and demand for money. Traditionally, monetary system is formed by individual governments and controlled as a domestic economic issue; however, the current tendency is to employ international trade and investment to adjust the policy and legislation of individual governments. As contemporary currencies are not linked to silver and/or gold, the value of a currency goes up (appreciation) and down (depreciation) based on the politics, perceptions and emotions of the financial markets and institutions.

Somalis used to rely on a nomadic life-style for centuries; they relied on their livestock for subsistence and luxuries. The camel (a large animal that lives in the desert and has one or two humps) was playing a central role in the life of Somalis in early days. Camel was recognized as a symbol of wealth, therefore it was a reliable source of wealth. In addition, it was used as a medium of exchange in the important issues of the social transactions; it was used as compensation and dowry in marriage (Robert et al, 1982).

Early in the fifteenth century, business routines were active in the coastal cities. In the Northeast of the country, the ports of Sylac and Berbera had strong international business relations with Arab economy. In the South, the coasts of Banadir, Marka and Barawa had direct international business relations with China, India and Arabia (Robert et al, 1982).

There were no coins issued in Somalia until fourteenth century, which imitated the coins of Mamluk Egypt. Prior to the arrival of European traders, most of the business activities were done by barter or the use of Maria Theresa Thalers. On the other hand, baisa bronze coins of Muscat, Mombasa and Zanzibar also circulated. These coins were needed for the high value of the Rupee and the necessity for coins of smaller value to complement the Rupee (Symes). As Somalis started dealing with various business communities from different economies, the use of Indian Rupee, Maria Theresa Thalers and Eritrean Talleros has become common in Italian Somalia before it became an Italian protectorate. In the North-Eastern of the country, studies indicate that Egyptians introduced the Egyptian Piastre (EGQ) when they occupied Somaliland (Robert et al, 1982).

On July 1, 1925 the Italian Lira (ITL) replaced the Somaliland Rupee. When Italian Somalia incorporated with Italian East-Africa, Italian East-Africa Lira (AOIL) was used alongside with Italian Lira. The East-African Shilling (XEAS) replaced the Italian East-Africa Lira at the rate of one Shilling equal to 24 Lira, yet the Lira was not totally abandoned, it was customary for small payments which valued less than two pounds. The East-African Shilling remained the medium of exchange till the independence of the country in July 1960 (Robert et al, 1982).

In the North-Eastern of the country, the British colonial had never had their own currency. Indian Rupees (INR) was introduced into Somaliland as a medium of exchange in the 1800s. The Rupee was the medium of exchange, allowing government of India banknotes to circulate in Somaliland along with Maria Theresa Thalers (Robert et al, 1982).

In 1960, Somalia achieved to have its own civil government and the economy was at a subsistence level. The “Cassa per la Circolazione Monetariadella Somalia” opened on 18th April 1950 and issued Somali banknotes at par with the Italian Lira. The Somali Shilling, divisible into 100 Cents was introduced on 1st July 1960 at par with the East African Shilling (Global Financial Data).

Somali National Bank was the first financial institution in the country, which was established on July 1, 1960 following the unification of Italian Somaliland and British Somaliland (Symes). The plan was that the bank replaces two foreign banks (Somalcassa and the Bank d’Italia) operating in the country at that time (Little, 2003). The National Bank at first had one office in Mogadishu, employed fourteen people, but by 1965, the Bank had succeeded to initiate nine branches (Little, 2003).

Somali shilling was recognized as the currency for the unified nation after the Presidential Decree No. 93 of 10th April 1961, which authorized the exchange of East African shillings with Somali shilling. On 31 July 1961, The East African shilling lost its legal tender status in Somalia (Symes). Consequently, the Somali shilling became the only legal tender circulation in the country.

On May 1970, the Somali National Bank has gained the opportunity to efficiently control exchange rates of the Somali shilling after the economy is nationalized (Barrow, 2006). In 1971, the banking system of the country was restructured creating two commercial banks namely Somali commercial bank and Somali saving and credit bank. Four years later, the system was reorganized again and the Somali national bank became Somali central bank, while the two banks had merged becoming the Somali commercial and savings bank (Little, 2003).

The failure of the Somali commercial and savings bank in providing adequate financial service to business community stimulated the establishment of Informal financial system pushing the creation of private money brokers. The Somali central bank collapsed in 1991 wherein the complete formal financial system stopped. Somali shilling started depreciating in a very short period of time to an extent where it was reduced to a near worthless state (Symes). Foreign currencies have found a place in Somali economy. US dollars, Dirhams of the United Arab Emirates, Saudi Riyals and Ethiopian Birr all started circulating in the country. Yet, the Somali shilling remained to be used for small changes and as a significant medium of exchange for marginal transactions and this kind of transaction is important for smaller businesses and the poorer sections of the community (Symes).

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CURRENCY UNION, PEGGING AND DOLLARIZATION

In the continuing arguments over the proper exchange rate regime, events of the 1990s have led to the view that economies should either let their currencies float or choose for a hard peg, such as a currency union or dollarization (Klein, 2005). Fisher (2001) argues that it is worth nothing that there will be a conceptual distinction between a currency union and a dollarization. A currency union takes place when a group of countries agree on to establish a new central bank that may be administered by representatives from member countries using the new currency. Dollarization, on the other hand, is the use of the currency of another country (usually the US dollar) (Fischer, 2001).

Michael W. Klein did a study on dollarization and trade. He found that there is no strong evidence that indicates that Western hemisphere nations which have already dollarized have experienced an increase in their trade with US as a result of dollarizing the economy. His study has also shown that there is no evidence that the US trade with dollarized non-industrialized economies fares more than other non-industrialized economies not using this policy (Klein, 2005). This contrasts the argument of Rose and his co-authors that dollarization of a certain economy promotes trade with US.

UNOFFICIAL DOLLARIZATION VS OFFICIAL DOLLARIZATION

The degree to which a country pegs its currency to another currency differs from nation to nation. There are some countries wherein the US dollar is the legal tender and this is known as an official dollarization of an economy. In 2000, the government of Ecuador has officially dollarized followed by the official dollarization of El Salvador in 2001 (Klein, 2005).

Some countries may have not officially dollarized but allow the use a foreign currency at an individual level and this is referred as an unofficial dollarization of an economy. Kelly Philip's study on dollarization shows that many individuals in developing economies have been removing their nation's monetary sovereignty by dollarizing unofficially at an individual level (Wurtz, 2006). The findings of the Kelly Philip agree with the results of U.S. Federal Reserve Researchers. In 1996, they estimated that between 30 to 70 percent of the total supply of United States currency (dollars) circulated outside of the country (Porter, 1996).

Since the abandonment of the gold standard after the Bretton Woods Conference, some economies have been looking for methods to encourage global economic stability. Pegging the domestic currency to a major convertible currency has been the optimal way to gain currency stability for the majority of the countries. The exclusive use of the US dollar, on the other hand, is another option (Heakal), nevertheless, weighting between the advantages and disadvantages are of a great requirement because adopting a foreign currency as a legal tender domestically may to economic and financial panic due to the monetary implications it holds.

REASONS BEHIND DOLLARIZATION OF AN ECONOMY

There are two potential benefits to opt for hard peg option: to provide a nominal anchor for macroeconomic stability, and to foster trade integration between countries that have dollarized its economy and the country to which it links its currency (Klein, 2005). So the main motivation to dollarize an economy is to achieve economic stability. Many developing countries believe that pegging the domestic currency to the US dollar or using the US dollar as a medium of exchange is better than floating exchange rate regime that might put a country into a severe economic situation. A believe which might not be there in the following years.

Malaysia removed its peg to the US dollar after several years of pegging and the rate of inflation has been running at its highest level in those years (Netto, 2005). Malaysian currency (Ringgit) is now in a managed float that guides the currency against a basket of currencies of its main trading partners and as soon as this policy put in place, the Malaysian currency has experienced an appreciation against US dollar (Netto, 2005). China lifted a similar peg. The current debate in oil-rich Gulf countries remains one of the hottest monetary policy implications in the world and the centre of the debate is to de-peg their currencies from the US dollar. Qatar and the UAE are believed to be the most likely Gulf countries to quit US peg (Drummond, 2008). Before quitting this policy, Gulf countries have to identify a suitable alternative monetary policy that can replace the current policy.

There is disagreement on the effect of dollarization on actual economic variables of growth, employment and volatility (Edwards, 2006). Supporters of dollarization argue that it really affects growth through two ways: firstly, it tends to produce higher investment, lower interest rates, and faster growth (Edwards, 2006). Secondly, dollarization will encourage international trade particularly between the two countries; the country that adopted dollarization policy and the senior country to which it links its monetary policy (Rose et al., 2001).

A view which goes back to Meade (1951) indicates that economies with a hard peg will have troubles accommodating external shocks, which may be translated into greater volatility and might sometimes lead to lower economic growth (Magendzo, 2006). Another substantial drawback to adopting a foreign currency is that a dollarized nation cannot influence its economy directly. The right to administer monetary policy and any forms of exchange rate regime will be sacrificed for the benefits of using the US dollar (Heakal).

THE EFFECT OF DOLLARIZATION ON SOMALI ECONOMY

After having read the arguments on dollarization and how this policy influences the economy, the next question is “what are the effects of dollarization on Somali economy”? After the collapse of the central bank of Somalia, the monetary system of the country is unofficially dollarized, meaning that US dollar has gradually become the medium of exchange in the market and Somali Shilling has been used for small payments. When the shilling lacked a central bank that regulated the supply of and demand for the currency, the idea of adopting US dollar as a medium of exchange came out because of several reasons.

Firstly, the confidence of the people on local currency was destroyed because of the vulnerability of the shilling to be forged easily due to lack of regulatory body to administer the operations (supply of money and demand for money) of the shilling. Secondly, the shilling experienced excessive devaluation since the civil war started; as a result, it became unavoidable for the people to carry their money (Somali Shilling) in large fragile bundles which was difficult for security purposes. Thirdly, the degree to which the local currency retains its value in the long run is an important characteristic for the stability of that currency. This is significant, particularly, for those who involve in business as their trade transactions need to be involved in foreign exchange markets. After years of confusion, the business community preferred to use US dollar as a business currency due to the apprehension that the local currency may not retain its value and the fear that Somali Shilling may lose its legitimacy in the long run as there is no Regulatory Body that regulates, supervises and protects it. The US dollar has been, in Somalia, the medium of exchange and value for storage in more than a decade.

The above mentioned factors coupling with the lack of capabilities of the central bank remain the driving forces of unofficial dollarization of Somali economy. Let us now turn to the reality in the ground. It is estimated that the amount of foreign currency, mainly US dollar, in circulation ($150-$200 million) is more than the amount of Somali Shilling that was estimated around $60 million when the exchange rate was about 20000 shilling to a dollar (World Bank, 2006). More than 75% of the money in circulation is a foreign currency which is not controlled absolutely by a local body. The local currency is estimated to be less than 25% of the money in circulation. This implies that the local authorities have no any influence on the monetary system in the country and they cannot have any influence in the long future as the use of foreign currencies as a medium of exchange continues. Having capability to influence the monetary system of a country is the lifeblood for economic development in a fragile situation such as Somalia. Similarly, having a power to control the monetary system leads to a better strategic financial management system and this in-turn facilitates to balance the supply of and demand for money circulating into the economy.

In a country where 45% of the residents live on less than $1 a day (UNDP, 2003), it is necessary to have a strong monetary system that can meet the increased demand for money which leads to an increase in economic activity and to achieve the objective of rational price stability in the price index for nationally produced goods and services. In addition, inflation is now a common issue in almost every country, however its effect on low income and war-torn countries such as Somalia is in an alarming situation. In Somalia, inflation reached in its highest rate in the year 2008 because of couple of reasons including the military intervention of Ethiopian troops, which has been strongly opposed and the global financial crisis. Though there is no empirical evidence that 2008 global financial crisis has affected the economy of Somalia, it is assumed that the price increase of imported goods such food stuff and oil, that has been observed by the local markets, has been affected to some extent by the global financial crisis that has started from the housing market but spread to good markets (Real Economy). In 2008, the prices of the necessities increased more than three-times and the agribusiness industry market is also skyrocketing increasing its prices in more than six-times. The Somali shilling lost its value against US dollar in a new record. After relative price stability, the prices of consumer item have increased again in 2011. The following tables indicate the prices of the basic goods and exchange rate in 2008 and 2011 respectively. The data used in the table is received from Somali Business Review (SBR), a business oriented magazine published by SIMAD UNIVERSITY quarterly.

Table 1.Five Year Analysis of Basic Food Prices

NO	*Item*	*2006 (So.Sh./1kg)*	*2011 (So.Sh./1kg)*	*Variance (%)*
1	Sugar	10,000.00	55,000.00	450%
2	Flour	6,000.00	31,000.00	417%
3	Rice	8,000.00	42,000.00	425%
4	Pasta	9,000.00	34,000.00	278%
5	Cooking Oil	2,800.00	47,000.00	1579%
6	Maize	5,000.00	11,000.00	120%
7	Sorghum	4,000.00	9,000.00	125%
8	Semsem Oil	35,000.00	64,000.00	83%

As shown in table 1, there is a great price shift for the last five years. The prices of the basic commodities have been significantly increasing steadily. For example, a kilo of sugar was So.Sh.10,000 in 2006 but after five years it is priced at So.Sh.55,000 which is about 450% of price increase. As most of these commodities are imported from Asia and Latin America in most cases, its prices have been directly affected by exchange rate market specially the US Dollar. In Somalia, consumers claim that fluctuations in the basic good markets are not in line with that of exchange rate market. There are some reports that indicate owners of goods increase prices when ever exchange rate increases; however, they do not decrease the prices when the exchange rate goes down. As a result of this, business people try to keep the prices of basic goods up even if the exchange rate volatility is against that because of nothing but to increase their profits. To make the situation worse, there is not effective regulatory body that supervises the efficiency of the market to balance between the demand and supply of goods as well as the number of money circulating into economy. There is no empirical research that carried out to test the relationship between basic good market and exchange market, thus, future studies should give attention to this phenomenon.

Table 2.Ten (10) Year Analysis of Exchange Rates (So.Sh./$1)

Year	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
Exchange Rate(So.Sh./$1)	19000	18500	15400	15200	13000	22000	33800	32700	31000	24800
Appreciation(-) or Depreciation (+)	N/A	-3%	-17%	-1%	-14%	69%	54%	-3%	-5%	-20%

Table2 indicates that the volatility of Somali exchange rate is very high showing no trend or pattern to follow. For example, in December 2006 the rate of $1 was So.Sh.13,000 but the Shilling depreciated the following year shifting from So.Sh.13000 to So.Sh.22000 which is around 69%. And again from So.Sh.22000, the rate reached to So.Sh.33800 in 2008. This depicts that Somali Shilling is not relative stable currency and this fact encouraged Somalia's Informal Market to use US dollar as a medium of exchange. To encourage the use of the national currency, the regulatory authority should effectively regulate, properly supervise and protect the Somali Shilling.

The reason for this crisis in Somalia or elsewhere in the Muslim world is that the monetary system which is based on the US dollar remains the root cause for these and other upcoming economic turmoil. There are plenty of proposals recommending adopting Gold System as the basis of the world financial system (Kameel, 2002). The evidences that US dollar is the root cause for this economic crisis can be understood from the excessive depreciation that the dollar faces against other independent currencies. Besides the economic crisis, some of the world leaders believe that using dollar as medium of exchange or in other words having a monetary system based on US dollar is also the root cause for political imbalance in this century enriching US administration to wisely manage their economic crisis (Mahathir, 2008).

If this is the reality, what is the solution? It is obvious that changing financial system is not something that can happen overnight. It takes time to reach that goal; however, there is no much hurdle to start the process now. Many Eastern economists proposed to shift the focus from the Western hemisphere to Eastern civilization because, for them, the Western civilization has already been shattered (Zaman, 2008). There are a number of countries that implemented this theory and it had an observable influence on their economic development. Malaysia is a good example whereby the country is achieving steady economic growth. In the context of Somalia, it is recommended that the policy makers and business community take a step forward to, at least, lessen the reliance on US dollar which is disappearing. They have to encourage the use of a basket of currencies of the main trading partners in order to avoid total failure in case of dollar collapse. In addition to that, all efforts must be put in place to develop ideas of achieving a strong and stable monetary system.

CONCLUDING REMARKS

Foreign currencies have found a place in Somalia followed by the collapse of Somali central bank. US dollar remained the reliable currency as a medium of exchange in the market either in physical or in value for more than a decade. The root cause for the current price scramble, relentless devaluation of Somali shilling and the general economic turmoil is believed to be the use of US dollar in Somali market while the dollar is depreciating universally. An option to avoid further loses in business might be the exercise of a basket of a foreign currencies whilst developing ideas to attain strong domestic monetary system.

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