

Political Institutions, Policy Instability, and Financial Dollarization

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Abstract

The most recent generation of currency and financial crisis literature blames the borrowing decisions of real and financial sector actors; in particular, it argues that the de facto dollarization of liabilities is inherently risky and can trigger a host of economic ills that impede economic development. This paper presents and tests an institutional theory of de facto financial dollarization. It argues that dollarization represents the rational response of domestic investors to policy instability—individuals will store value in alternative currencies when they fear the expropriation of wealth through future volatility. The empirical evidence supports the hypothesis that dollarization provides a hedge against policy instability in the absence of checks on executive authority. The finding, which is robust to an instrumental variables approach that exploits historical institutional variation, suggests that democratic institutions influence financial development through previously unidentified channels.

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1 Introduction

Only a handful of countries throughout the world use dollars as their official currency. However, *de facto* (unofficial) dollarization is on the rise. The phenomenon has attracted the attention of researchers because of the risk that dollarization poses in the event of domestic currency depreciation. In fact, several of the most recent models of financial crises consider balance sheet currency mismatches—in which liabilities are dollarized but income streams are denominated in domestic currency—as salient contributing factors (Aghion, Bacchetta, and Banerjee, 2001; Krugman, 1999). Deposit dollarization (DD), one type of *de facto* dollarization, has received significant notice, in large part because financial sector vulnerabilities have been tied to currency crises (Kaminsky and Reinhart, 1999). The scale of DD is striking: in 25 countries, greater than 50% of bank deposits are denominated in foreign currency; the recent trend is also striking: since 1995, 64 countries have exhibited an increase in deposit dollarization (World Bank, 2004).

The upward trend in DD is particularly puzzling given that inflation, which has long represented one of the standard explanations for the phenomenon, has declined at nearly a concomitant rate throughout the 1990's (see Figure 1). The divergent trends have challenged researchers to search for alternative explanations for DD, with much of the work adopting political economy approaches that mirror the recent advances in the economic growth and development literature (Acemoglu, Johnson, and Robinson, 2002; Acemoglu et al., 2003; Acemoglu and Johnson, 2005; Engerman and Sokoloff, 1997), which highlights the institutional determinants of macroeconomic outcomes. In particular, recent studies have presented evidence that political institutions may also matter for the lending decisions of domestic depositors; countries with “good institutions” are shown to be less financially dollarized (Levy-Yeyati, 2006; de Nicolo, Honohan, and Ize, 2005; Rajan and Tokatlidis, 2005; Honig, 2006). But the following

question remains: what types political arrangements constitute “good institutions” in the context of financial intermediation?

[Figure 1 about here]

This paper represents a preliminary effort at addressing this question. First, building on a theoretical framework presented by de la Torre and Schmukler (2004), the present study develops a political economy theory of financial dollarization in which DD represents the rational response among private sectors actors to future policy uncertainty and volatility. For example, in an institutional environment in which politicians cannot make a credible commitment not to expropriate the value of domestic currency for electoral or other goals, economic actors may turn to dollarized deposits as a low-cost insurance mechanism. By contrast, in institutional environments in which politically-motivated expropriation is more difficult (i.e., where political checks and balances are more firmly entrenched), DD will be lower. This is because the perception of future policy stability—and therefore more firmly protected property rights (i.e. less expropriation risk)—is enhanced under political institutions exhibiting multiple veto gates.

Cross national evidence is strongly supportive of this proposition. Using a data set of over 100 countries, this study finds a robust negative relationship between DD and political checks and balances. We show that two distinct indices of veto players have a significant negative effect on DD to the inclusion of various economic and regulatory controls. Furthermore, concerns about endogeneity and reverse causality are diminished through the implementation of a two-stage least squares model that controls for selection bias and endogeneity in the institutional variables through the use of historical measures as instruments. The theoretical propositions and strongly suggestive empirical support contribute to the existing literature by specifying the institutional mechanisms that deter financial dollarization, and thereby contribute to financial development.

2 The Dependent Variable

De facto dollarization is distinct from de jure (official) dollarization, which refers to the case in which a government adopts the dollar—or some other foreign tender—as the official currency. While very few countries have officially dollarized, the vast majority of emerging market and transition countries exhibit a preference for foreign currency in some sectors of the economy. This paper focuses on bank deposits, which represent the revealed currency preference of economic agents with respect to a primary function of money, which is the store of value.

The database upon which we draw was created by Levy-Yeyati (2006) from several sources, including central bank bulletins, IMF staff reports, and previous studies by de Nicolo, Honohan, and Ize (2005), Arteta (2002), and Baliño, Bennett, and Borensztein (1999). The variable of interest is a measure of the ratio of foreign currency deposits to total deposits in domestic deposit money banks. The unbalanced panel covers 122 countries from 1990-2004.

3 Current Approaches

The literature on financial dollarization is related to a body of work which analyzes the causes and consequences of financial development. DD is often viewed as both a symptom and a source of shallow financial markets in developing countries. This section surveys the recent literature explaining de facto dollarization.

3.1 Consequences of Financial Dollarization

The motivation to study the political economy of de facto dollarization derives from a host of studies which tie the phenomenon to several economic ills, including currency crises (Krugman, 1999; Aghion, Bacchetta, and Banerjee, 2001), banking sector

vulnerabilities (Levy-Yeyati, 2006; de Nicolo, Honohan, and Ize, 2005; Goldstein and Turner, 2004), and slower and more volatile growth (Levy-Yeyati, 2006).

Much of the recent research on DD is motivated by the so-called “third generation” of currency crisis literature. The analytical models of Krugman (1999) and Aghion, Bacchetta, and Banerjee (2001) developed in response to the wave of crises that hit emerging markets in Asia and Latin America in the late 1990’s. The underlying mechanisms driving the Asian Crisis in particular deviated from standard explanations. Specifically, it did not appear that either governments’ macroeconomic mismanagement (“first generation”) or international investors (“second generation”) were to blame. Rather, microeconomic misalignments in the form of balance sheet currency and maturity mismatches were cited as fundamental determinants of the Asian Crisis, shifting the focus of the literature to the borrowing decisions of domestic private sector actors.¹

The risks from currency misalignments are not confined to the real sector, however. For banks, minimizing currency mismatch risk implies an asset composition denominated in foreign currency to a degree that matches liability (deposit) dollarization. However, bank assets are also subject to depreciation risk to the extent that borrowers suffer from currency mismatches themselves (Mishkin, 1996). Thus, dollar lending to minimize currency mismatch may merely trade balance sheet exposure for default risk. In this way, negative economic shocks, including a rapid depreciation of the local currency, may affect the banking sector through two main channels. If deposits are dollarized and loans are made in local currency, then currency depreciation has obvious deleterious effects on bank solvency. Namely, the value of bank liabilities

¹In the models of Krugman (1999) and Aghion, Bacchetta, and Banerjee (2001), depreciation of the local currency (and the expectation of future depreciation) initiates a decline in economic activity due to the harmful effects of currency mismatch in the real sector. The logic of currency mismatch is simple: if liabilities are dollarized, and assets and income streams are denominated in local currency, a depreciation of the exchange rate will decrease the net worth of the dollar borrower. Thus, the balance sheet effects of financial dollarization channel through to a decrease in investment, stifling growth.

decline relative to bank assets. On the asset side, banks may also be vulnerable if a depreciation of the local currency causes borrowers to default on their loans. This twofold risk provides a strong motivation to understand the determinants of de facto dollarization.

3.2 Causes of Financial Dollarization

If financial dollarization is indeed so fundamentally hazardous, then why is it so prevalent? This section reviews the current explanations for DD, which focus largely on economic variables that are likely endogenous to domestic institutional development.

Ize and Levy-Yeyati (2003) highlight the optimization decision of domestic investors, for whom dollar deposits represent one component of their portfolio. Asset returns are subject to a host of factors, including changes in the domestic price level and fluctuations in the real exchange rate. In their model, the domestic investor chooses an asset currency composition (including domestic deposits) that minimizes the variance of portfolio returns. The authors show that the degree of dollarization that depositors chose is directly proportional to the coefficient of exchange rate pass-through. Empirical tests show that this measure, the minimum variance portfolio (MVP), predicts the degree of deposit dollarization quite successfully—countries with higher passthrough exhibit greater degrees of deposit dollarization. However, the analysis assumes that inflation and exchange rate fluctuations are exogenously determined, a premise that may not hold for two reasons. First, there is reason to doubt that the direction of the causal arrow unambiguously leads from price volatility to DD. And even if this causal claim is valid, it is likely that other, systemic institutional factors related to the credibility of government commitments are simultaneously affecting both DD and MVP.

Recent empirical studies suggest that the institutions play a role in shaping depositor incentives. However, little explanation has been offered as to which institutions

are most likely to matter and why. Instead, the discussion in the literature centers around a correlation between dollarization and aggregate measures of broad institutional quality,² with researchers arriving at varying conclusions as to why institutional development may matter for dollarization.³ For de Nicolo, Honohan, and Ize (2005, p. 1703), the correlation between dollarization and low quality institutions is suggestive of a moral hazard interpretation of dollarization, as “countries with weaker institutions are more likely to engage in government bailouts,” which increases the incentive to dollarize.⁴ Honig (2006, p. 4) interprets the correlation as evidence that “government quality is the key driver of domestic dollarization,” since residents of countries with low quality governance will lack confidence that future policy will promote currency stability. While both stories have intuitive appeal, what is lacking is a clear theory about the specific institutional arrangements that enable governments to make a credible commitment to domestic depositors that the value of domestic currency will be maintained. The following section contributes to that end.

²The most commonly used institutional controls are “indices of indices” in the sense that they aggregate institutional measures of governance from a variety of ratings agencies and risk services. The most commonly used index is Kaufmann, Kraay, and Zoido (2003), which synthesizes several hundred indicators from international sources to provide measures of governance along six dimensions: government effectiveness, political stability, rule of law, corruption, quality of economic regulation, and voice and accountability. In Levy-Yeyati (2006) and de Nicolo, Honohan, and Ize (2005), these six dimensions are then averaged to create a single variable. Honig (2006) generates a similar measure from the International Country Risk Guide, which also aggregates indices along multiple governance dimensions.

³It is well known that GDP per capita correlates highly with the governance quality indices, making it all the more difficult to discern for which theoretical construct the governance indicators actually proxy. Indeed, it is rare to find an empirical presentation in which an aggregated index of governance quality enters significantly in specifications that include GDP per capita.

⁴For instance, if bank managers and depositors expect to be bailed out in the event of financial distress, they will not fully internalize foreign currency risk. Rather, they will take advantage of the stability that foreign currency provides, assuming that the government will come to their rescue if problems arise. The focus on moral hazard created by the expectation of government bailout follows the analytical models of Mishkin (1996), McKinnon and Pill (1999) and Burnside, Eichenbaum, and Rebelo (2001).

4 The Argument

The main problem with existing studies that consider political determinants of deposit dollarization is that they lack a clear institutional theory. There is a general consensus that countries with “low quality” institutions will exhibit less deposit dollarization, but little explanation exists as to why this may be true. In this section, we outline an institutional mechanism that could affect the degree of deposit dollarization at the country level.

Previous studies pitch financial dollarization as an aggregate outcome that is subject to the degree to which microeconomic actors have an incentive to store value in foreign currency. Specifically, if private agents fear declines in the future value of their assets due to unfavorable economic circumstances (such as inflation or domestic currency depreciation/devaluation), they will tend to store value in foreign currency. This portfolio view of deposit dollarization has that resident investors choose the currency composition of savings that minimizes the variance of portfolio returns. The problem with such an approach is that empirical verification is subject to endogeneity bias. In particular, it is very difficult to test the causal effect of economic variables on dollarization, when it is highly likely that the economic determinants are themselves influenced by the degree of dollarization of the financial system. Furthermore, contemporaneous economic outcomes such as inflation are unlikely to represent the sole determinant of future expectations. It is probable that political institutional arrangements will hold greater weight in determining the prospects of future volatility.

We argue here for the salience of domestic political institutions, which are less likely than inflation and other economic outcomes to be endogenously determined, while similarly being more likely to influence perceptions of future economic instability. As is commonly the case, we model the decision to dollarize deposits from the perspective of the domestic investors. We begin by positing that depositors will consider the sovereign risk environment in which they operate when deciding upon

the optimal allocation of foreign currency in their asset portfolio. In this context, one type of risk is particularly salient. Namely, depositors will seek insurance against the effects of future policy instability that threatens to undermine the net present value of their assets. De la Torre and Schmukler (2004) call this “dilution risk,” or “the threat that the sovereign...might face incentives to liquefy peso liabilities through surprise inflation.”⁵ The incentives to which they refer most often derive from electoral goals, where the dilution of peso contracts between private agents may favor a valued interest group, thereby increasing the probability of the incumbent’s electoral success. Contracting may not provide protection against such risk, since as de la Torre and Schmukler note, dilution “can obliterate contract value without breaching any contractual clause” (2004, p. 357). While the domain of their study is emerging markets, it is clear that the dilution threat is present in any political economy.

Dilution risk can be thought of as a breach of property rights, since the value of the contractual claim is expropriated by the government without the consent of the governed. Thus, our approach argues that property rights institutions (Acemoglu and Johnson, 2005) will affect the incentives of those who are subject to dilution risk. A rich theory has built around the seminal work of North and Weingast (1989), who demonstrate that constraints on the executive (veto players) increase the credibility of government commitments. According to their story, a newly powerful parliament improved the credibility of promises by the English Crown to repay loans to foreign lenders following the Glorious Revolution. The work was further developed by Tsebelis (2002), who formally demonstrates that veto players increase policy stability. The reason is that veto players constrain the executive from pursuing policies that are in her narrow interests. A related literature finds empirical correlation between veto players and favorable outcomes such as economic growth (Henisz, 2000), lower infla-

⁵As is common in this literature, domestic currency is referred to as the “peso” whereas the foreign currency is the “dollar.”

tion (Keefer and Stasavage, 2002, 2003; Fatas and Mihov, 2006) and improvements in the overall quality of governance (Panizza, 2001).

There are, to date, few studies testing whether veto players affect *perceptions* of future policy stability, however. Do veto players represent a mechanism by which governments can credibly commit to future policy stability? One obstacle to answering this question is that perceptions are notoriously difficult to measure. Improvements in cross national surveys provide one avenue for assessing the link between various institutional arrangements and perceptions of credibility (see, for example, Weymouth and Broz, 2006). But perceptions are also reflected in behavior, which means that assessments of policy instability may be inferred by the extent to which economic actors seek insurance against the effects of dilution and other risks through hedging instruments such as the dollarization of bank deposits.

Two main assumptions are needed for our purposes. The first is that private actors' perceptions of stability are inversely related to the extent to which they hedge against future economic downturn; economic actors will seek less insurance when they perceive less risk of future expropriation. The second assumption is that the dollarization of bank deposits represents one mechanism by which agents may hedge against risk.⁶ Neither assumption appears particularly problematic; indeed, both represent standard assertions in the literature. For instance, de la Torre and Schmukler (2004, p. 350-351) explain that "contracts denominated in foreign currency...represent optimal responses to cope with the systemic risks prevalent in emerging economies." This statement is accompanied by the claim that dollarization represents a "hedge against price (interest rate and exchange rate) risk at the expense of exposure to price-induced default risk" (2004, p. 353).

⁶Other such mechanisms include spot and futures contracts. While the markets for these alternative instruments would provide another interesting venue in which this theory could be tested, lack of available data prevent such a cross-national study at present.

These two assumptions allow us to test the extent to which political institutions affect perceptions of policy stability. The purpose of the following empirical section is to examine whether institutions provide a credible commitment to policy stability. If veto players represent a credible commitment, then not only should economic stability be improved as others have shown, but the behavior of economic actors should reflect the *perception* of future policy stability. If this is indeed the case, then countries with greater numbers of veto players should exhibit, *ceteris paribus*, less overall financial dollarization.

5 Empirical Results

The relationship we wish to identify can be specified by the following equation:

$$Y_i = \gamma + \alpha * I_i + \epsilon_i$$

where Y_i is a measure of deposit dollarization in country i , the portion of total bank deposits that are denominated in foreign currency (i.e., dollarized). The dependent variable is averaged over the period 1990-2004 for 134 countries. The variable I_i is the average measure of checks and balances institutions over the same time period. The coefficient of interest is α , which is an estimate of the linear causal effect of political checks on deposit dollarization. Table 1 reports the summary statistics for the variables used in this study.

The most common technique is to use OLS to estimate α , but there are problems with this approach. The first concern is that institutions are endogenous; it may be that constraints on the executive have an impact on deposit dollarization, but it is also possible that financial dollarization impacts the number of veto players. A second and more likely pitfall is that an omitted variable is affecting both the institutions

and the degree of deposit dollarization. Both of these problems would imply that $Cov(I_i, \epsilon_i) \neq 0$, a violation of the OLS assumption of strict exogeneity.

The approach employed here attempts to correct for the endogeneity problem in two ways. The first method consists of adding to the equation variables that are correlated with deposit dollarization as well as the institutional arrangement. Such an approach estimates the following:

$$Y_i = \gamma + \alpha * I_i + \beta * \mathbf{E}_i + \epsilon_i$$

where \mathbf{E}_i is a vector of economic variables. Included in \mathbf{E}_i is a measure of initial development, which is proxied for using logged GDP/capita in 1990. The log of average inflation (1990-2004) captures the response of economic actors to the detrimental effects of contemporaneous asset value deterioration that are likely to affect political outcomes as well as the degree of hedging through deposit dollarization. The openness of the economy to international trade is captured with a measure of total trade as a proportion of the economy, (Imports + Exports)/GDP. Finally, regulatory restrictions on deposit dollarization are included.

This study employs two distinct indicators of political checks and balance. The first, referred to as Checks on the Executive (Keefer and Stasavage, 2003), is a discrete count of the number of veto players in government and ranges from 1-7. The second is Political Constraints (Henisz, 2000), an index derived from a spatial model that measures the extent to which different branches of government can affect changes in the status quo policy. It is calculated as one minus the calculated degree of political discretion, so the range of this continuous variable is from 0-1. Higher values of both Checks and Political Constraints correspond to more checks and balances in government.

Columns 1, 3 and 5 of Table 2 report the OLS estimates of the association between Checks on the Executive and deposit dollarization. The estimated coefficients, significant at higher than 95% levels of confidence, suggest a negative relationship between veto players and financial dollarization. The results in Columns 2, 4, and 6 substitute Checks on the Executive with the Political Constraints indicator. Though the negative relationship holds (more constraints on executive power leads to lower levels of deposit dollarization), the higher standard errors weaken the statistical significance as compared with the results when using the Checks measure. Overall, these results suggest that political institutions thought to increase policy stability are recognized by depositors. In particular, economic actors hedge against the effects of policy volatility less often in countries with greater checks on executive policy discretion.

The second tactic is to measure the equation using instrumental variables (IV) regressions, in which institutions are instrumented using variables that intend to capture exogenous sources of institutional variation. Let Z_i denote the instruments. Valid instruments must meet two criteria. One, instrument relevance means that the instruments employed explain cross-national variation in current institutions; that is, $Cov(Z_i, I_i) \neq 0$. Two, instrument validity requires that the instruments not explain dollarization other than through the channel of political institutions; namely, $Cov(Z_i, \epsilon_i) = 0$.

As both the Checks on the Executive and the Political Constraints indices have extensive historical coverage, we first employ the 1980 values of the political indices as instrumental variables. The first stage F-test that the instruments do not explain current institutions is rejected at the 1% level, providing confidence that the instruments are relevant. Columns 1 and 2 of Table 3 report the results of the IV regressions in which our institutional variables are instrumented using their respective lagged values. The validity of the instruments could be questioned, however, since the errors of the first and second stage regressions may be serially correlated.

A second set of IV regressions employs an historic indicator of democracy as an instrument for current checks and balances institutions. Countries with longer history as democracies are more likely to have established institutions of checks and balances. And as Przeworski and Limongi (1993) have shown, the economic effects of democracies are ambiguous and subject to debate. Thus, we are more confident in the relevance of the democracy score than in the lagged institutional variables. The democracy indicator employed as an instrument for checks and balances institutions is the lagged (1960) value from the Polity IV database. Columns 3 and 4 of Table 3 report the results of these estimates. The first stage regressions indicate that more democratic countries are more likely to have set up institutions of checks and balances. The second stage coefficients remain negative and are significant at the 5% level. The results of the IV analysis provides further statistical evidence of the negative effect of veto players on deposit dollarization.

The preliminary results reported here suggest a highly significant negative relationship between stability-enhancing institutions and financial dollarization in which concerns about endogeneity of political institutions have been assuaged through (1) the inclusion of a vector of control variables, and (2) an IV strategy that extracts the component of current institutions that is exogenously determined. The proposition that institutions that promote policy stability affect the perceptions of private economic actors finds strong preliminary empirical support.

6 Conclusion

That political institutions influence economic outcomes is no longer a major point of contention. The debate now concerns the how and the why. How do political arrangements affect the incentives and behavior of political actors? Why might these arrangements in turn influence the perceptions of private sector actors in measurable

ways? This paper moves beyond a “good institutions matter” paradigm to examine how a specific mechanism—democratic constraints—can influence outcomes that affect financial development.

De facto dollarization has in the past been studied largely as an economic phenomenon: economic actors who attempt to minimize the variance of their asset portfolios will dollarize in countries with high pass-through from exchange rate volatility to inflation. This paper borrows the assumption that depositors seek to minimize the effects of volatility and highlights how political institutions that signal stability will deter dollarization. Specifically, political checks and balances (veto players) enhance policy stability because large policy swings are more difficult in the presence of constraints on executive authority. This paper has argued that the effects of political checks are recognized by economic agents: we have shown that de facto financial dollarization is smaller in countries with multiple veto players. In so doing, we have highlighted the previously unidentified “good institution” that deters de facto dollarization.

The empirical analysis of this paper is motivated by the endogeneity concerns that have plagued previous research on this topic. Specifically, the instrumental variables technique utilized here has allowed us to extract the exogenous political determinant of dollarization to better identify its causal impact. The empirical section provides strong evidence that political checks and balances institutions have a measurable impact on perceptions of future policy stability. This result is important to the extent that the dollarization of liabilities has been blamed for previous currency and financial crises in developing countries. As a matter of sound policy, political leaders would be wise to build the types of institutions that make expropriation of asset value more difficult; broadly, they should focus on the institutions that enhance the protection of private property. Property rights institutions have been shown to promote eco-

conomic growth. This paper provides evidence that—through their effect on de facto dollarization—they may also help deter crises and promote financial development.

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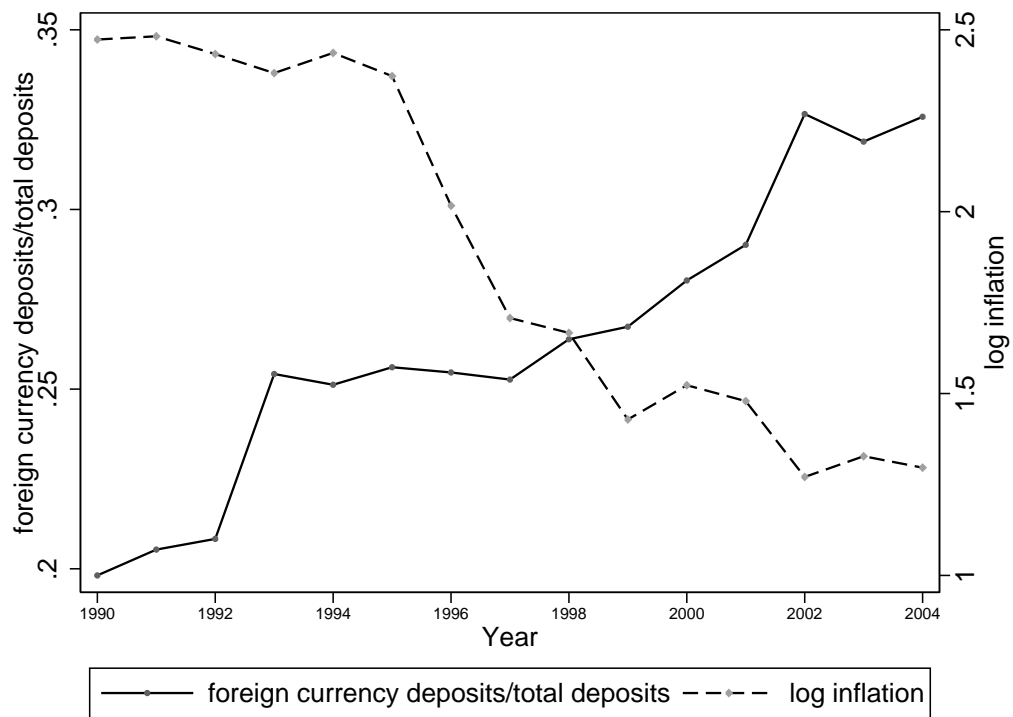


Figure 1: Financial Dollarization and Inflation. Full sample, 1990-2004.

Table 1: Summary Statistics

Variable	Mean	Std. Dev.	Min.	Max.	N
Dollar Deposits/Total Deposits	0.253	0.226	0.002	0.924	134
Checks on Executive	2.827	1.364	1	7.4	125
Political Constraints	0.289	0.188	0	0.626	117
Checks on Executive (1980)	2.042	1.399	1	7	96
Political Constraints (1980)	0.177	0.215	0	0.631	92
Log GDP (1990)	7.483	1.448	4.55	10.412	125
Log Average Inflation (Imports + Exports)/GDP	2.489	1.587	-0.99	7.019	121
Dollar Restrictions	81.094	37.32	3.589	275.779	130
Dollar Restrictions	0.648	1.24	0	5	125
Polity (1960)	9.217	7.631	0	20	106

Note: All values are country averages (1990-2004) unless otherwise noted. Deposit dollarization and dollar restrictions data from Levy-Yeyati (2005). The political institutional variables Checks on Executive (Database of Political Indicators, Beck, et al. 2004) and Political Constraints (Henisz, 2005) measure the number of veto players in the government in a particular year. The economic variables are from the World Bank Development Indicators.

Table 2: OLS Regressions

Variable	(1)	(2)	(3)	(4)	(5)	(6)
Checks on Executive	-0.047*** (0.014)		-0.033** (0.016)		-0.038*** (0.013)	
Political Constraints		-0.240** (0.108)		-0.139 (0.121)		-0.155* (0.085)
Log GDP/Capita (1990)			0.012 (0.013)	0.009 (0.013)		
(Imports + Exports)/GDP			0.001 (0.001)	0.001** (0.000)	0.001** (0.000)	0.001*** (0.000)
Log Inflation			0.085*** (0.010)	0.085*** (0.011)	0.067*** (0.009)	0.068*** (0.009)
Dollar Restrictions					-0.056*** (0.010)	-0.057*** (0.009)
Constant	0.387*** (0.048)	0.334*** (0.036)	-0.018 (0.098)	-0.072 (0.100)	0.148*** (0.055)	0.082 (0.050)
R^2	0.078	0.040	0.444	0.433	0.467	0.440
rmse	0.220	0.223	0.162	0.163	0.167	0.170
N	125	117	109	102	106	99

Note: The dependent variable is dollar deposits/total deposits. Checks on Executive and Political Constraints measure the number of veto players in the government. Dollar Restrictions is a discrete variable (1-5), measuring the degree of restrictions on dollar deposits in the banking system; 1=no restrictions to 5=dollar deposits prohibited. Heteroskedasticity-robust standard errors in parentheses. ***, **, * indicate significance at the 1, 5, and 10 percent level, respectively.

Table 3: IV Regressions

Second Stage				
Variable	(1)	(2)	(3)	(4)
Checks on Executive	-0.108*** (0.026)		-0.118** (0.053)	
Political Constraints		-0.842*** (0.196)		-0.747** (0.349)
Constant	0.512*** (0.089)	0.462*** (0.074)	0.582*** (0.171)	0.473*** (0.126)
rmse	0.222	0.233	0.262	0.259
N	96	92	66	66
F	16.79	18.44	4.98	4.59
First Stage				
Checks on Executive (1980)	0.520*** (0.083)			
Political Constraints (1980)		0.491*** (0.077)		
Polity (1960)			0.069*** (0.020)	0.011*** (0.002)
Constant	1.754*** (0.206)	0.202*** (0.021)	2.360*** (0.246)	0.225*** (0.029)
R^2	0.292	0.314	0.158	0.248
rmse	1.138	0.157	1.249	0.149
F	38.81	41.15	12.01	21.06

Note: The dependent variable is dollar deposits/total deposits. Checks on Executive and Political Constraints measure the number of veto players in the government. These variables are instrumented for using their lagged values (columns 1 and 2) and a lagged democracy score (columns 3 and 4). Heteroskedasticity-robust standard errors in parentheses. ***, **, * indicate significance at the 1, 5, and 10 percent level, respectively.