

## The Effects of Dollarization on Local Currency in Somalia

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### ABSTRACT

*This study focused on the effects of dollarization on local currency (Somali Shilling) in Somalia. The study employed quantitative research method. The study adopted descriptive research design to assess the effects of dollarization on local currency in Somalia. The researcher collected the data through documentary review of several articles, books and journals in relation to the effects of dollarization on local currency in Somalia. The key findings the effects of dollarization on local currency in Somalia encompass: dollarization leads to local currency depreciation and shortages in Somalia, dollarization increases the rate of foreign exchange on local currency and inflation rate and dollarization weakens the local financial institutions, which creates lack of financial control in the economy by the government authority leading to financial instability. The study recommended that, the Central Bank of Somalia, and Parliament of the Federal Republic of Somalia should introduce new regulation to regulate finance in the economy, new policy on financial control, introduce financial reform and review business models in the sphere of finance in Somalia to curb the increasing devastating effects of dollarization on local currency in Somalia.*

**Keywords:** Dollarization, local currency, effects.

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## **1. INTRODUCTION**

Dollarization which means a situation where a country uses all or part of a foreign currency such as United States dollars instead of the domestic currency (Klein 2005) is highly common in many developing countries in the world. Dollarization also means the situation where there is use of other people's currency in another people's economy whether officially or unofficially. Dollarization of the economy of a given country entails dollarizing loans, deposits of the banks in the country and charging prices of goods and services in dollars and carry out exchange in dollar. Dollarization common among the developing countries in Asia and Africa where they face difficulty in promoting effective macroeconomic system. According to Musoke (2017: 2), "dollarization undermines the monetary sovereignty and results loss of autonomous monetary policy".

Historically, Somalia was a pastoral economy with trade and businesses on barter trade between small agriculturalists and nomadic herdsman (Chossudovsky, 2011). Due to the absence of central authority due to prolonged civil war, the main contributors to Somalia's Gross Domestic Product (GDP) were "livestock, agriculture, finance and then telecommunications services" (African Development Bank, 2019: 175). After the collapsed of the Central Government of Somalia in the year 1991 in which most government institutions such as finance institutions were destroyed and they ceased to function, dollarization was adopted in Somalia. Due to the prolonged civil war and political unrest for over a period of three decades, the circulation of the banknotes and other currency in Somalia were self-regulated. That is why the last printed banknote currency that was issued by the Central Government of Somalia was in the year 1991. The collapsed of the Central Bank of Somalia in 1991 left the country with no immediate remedy to overcome the challenges of cash in the economy and to replaced the mutilated, old and damaged banknotes that were in circulation. Hence, the United States dollars has been used physically and electronically for over three decades in Somalia as the only reliable currency in Somalia (Nor, 2012: 596).

The dollarization of the economy was authorized and implemented as the most reliable and

secured currency due to the fact that the printing of local currency in Somalia was done by the private owners of business, not the Central Government of Somalia. This currency printed were used domestically by the private business owners and some sometimes the local currency were imported from abroad without the authorization of the central authority of Somalia (Ahmed Nuh YUSUF et al, 2019). Furthermore, the major causes of dollarization in Somalia entail: the collapsed and absence of the central bank to print local currency an supervise the financial institutions and the use of currency in the economy; the implementation of money transfer called Hawallah; the increasing rate of imports and exports in Somalia; the lost of trust and confidence in Somali shillings due to its rapid depreciation in value and lastly the easy access and printing if Somali Shillings by the few selected market players in the economy (Osman Sayid Hassan Musse and Abdelghani Echchabi, 2017).

The dollarization of the economy of Somalia is leading to currency depreciation and shortages in Somalia as most of the people especially in urban areas in Somalia use dollar to carry various transaction to the disadvantage of local currency. For instance, the current Somali Shilling which suffers from being only one denominator-thousand shilling due to severe devaluation is heavy to carry in the pockets, old and damaged to be in circulation, susceptible to be faked. (Ahmed Nuh YUSUF et al, 2019). Furthermore, Sidra Institute 2021, observed that dollarization of the markets in Somalia poses an existential threat to the Somali shilling leading to its depreciation and shortages in Somalia owing to the fact that the Somali shilling is prone to sudden exchange rate increases and shocks. It has lost more than 30 percent of its value in a matter of three weeks between August and September 2020. The exchange rate of Somali shilling to US dollar has reached an all-time high of 46,000 SoSh per US dollar. Hence, this study will investigate the effects on dollarization on currency depreciation and shortages in Somalia and come up with clear strategies to reduce the effects of dollarization on currency depreciation and shortages in Somalia.

## **2. LITERATURE REVIEW**

### **2.1. Clarification of the concepts of dollarization and local currency**

Dollarization has many definitions. According to (Duffy, Nikitin & Smith, 2006: 1), dollarization refers to “the use of foreign currency in any of its three functions: unit of account, means of exchange and in particular, store of value”. Whereas, local currency refers to the currency that can be spent in particular geographical locality. A local currency can also refer to the currency that acts as a complementary currency to a national currency without replacing it Naqvi and Mona (2013).

Dollarization also means the holding by residents of a significant share of their assets, in the form of foreign currency-denominated assets (Alvarez-plata & García-herrero, 2007). Dollarization does not refer just to the United States dollar. It is a generic term used to characterize the use of any foreign currency that effectively serves as a replacement for national currency. The substitute currency is typically the currency of a major trading partner or an important industrial power with a reputation of a sound monetary policy (Panteleo Kessy, 2011). Meyer (2000) distinguishes three types of dollarization. First is official dollarization which means a complete replacement of the domestic currency by a foreign currency. In this case the chosen foreign currency becomes a legal tender, and plays the three fundamental roles of domestic currency namely, store of value, means of payment and unit of account. Examples of countries which have abandoned their local currency and adopt another currency include Panama and Ecuador. Second is official semidollarization which refers to a situation where both domestic and foreign currencies are freely used in the domestic economy-the foreign currency becomes a legal tender but the country also issues its own currency.

## **2.2. The effects of dollarization on local currency**

According to the study conducted by Towers & Borzutzky (2004) on the demerits associated with dollarization in the economy that outweigh its benefits. The study revealed that dollarization in the economy causes serious economic crises such as depreciation of currency, high inflation and currency shortages that require economic measures such as financial control and control of inflation to overcome those economic crises (Towers & Borzutzky, 2004). Similarly, based on both the Bayesian model and Ordinary Least Square (OLS) models estimation, it clearly

indicates that dollarization has got positive relation with currency depreciation and shortages in the economy and it has significant effects on currency depreciation and shortages (Chițu, 2012: 5). Dollarization weakens local currency leading to currency depreciation and shortages in a given economy (Duffy, Nikitin & Smith, 2006: 1). The same way Somali Shilling is defeated by the U.S dollar.

Based on the empirical study conducted in Montenegro on the benefits and costs of dollarization in the economy, the findings of the study clearly indicates that dollarization in a given economy does not guarantee effective promotion and implementation of economic policy that can protect the economy against economic costs such local currency depreciation and currency shortages (Lakić et al, 2016: 52).

According to the study conducted in Montenegro, the study found that costs of dollarization exceed its benefits since its effects deteriorate economy growth in the country. Dollarization system in Montenegro made it impossible for the government authority to intervene with appropriate measures to control its cash flow and external imbalances to overcome the its costs such as local currency depreciation and shortages. Additionally, Montenegro is part of the countries that use European currency, but they are not a member of European union even though a candidate to join European Union. And due to dollarization, Montenegro is unable to intervene with effective monetary policy that can stabilize the economy and implement fiscal policy to reduce currency depreciation and local currency shortages. Dollarization also hinders a country from reducing the risks of foreign exchange risks and to develop effective financial and banking system that can help overcome the economic costs such as high inflation, currency depreciation and shortages (Lakić et al, 2016: 61). One of the disadvantages of dollarization is financial instability in dollarized economies (Nicolo et al., 2005). Generally speaking, dollarization is often due to high or hyperinflation; however, the findings indicated that a temporary increase in inflation rate leads a permanent use of foreign currency in a domestic market (Freitas, 2004).

Furthermore, dollarization also leads to great loss of effective monetary, fiscal, foreign trade policies as well as macroeconomic instability respectively (Kang, 2005; Bolbol, 1999).

Similarly, the dollarization, countries are likely to lose an ability to devalue their currency and control their monetary policies. Hence, they become totally dependent on United States monetary policies (Berg & Borensztein, 2000). Moreover, dollarization caused a large seigniorage loss; which is estimated up to US\$682 million from 1992 to 2004 and with an additional loss of US\$61 million annually for every following year in Cambodia (Kang, 2005). In addition, the high share of foreign currency in the domestic market reduces government's ability to gain seigniorage revenue concluding that Cambodian government has little opportunity to gain from seigniorage revenue (Samreth, 2010). This is due to that the majority of the local transactions are taken place in US Dollar. In line with the above finding, currency replacement (dollarization) was found to be one of the main factors that causes currency depreciation and shortages in Eastern Europe Countries (Aarle & Budina, 1996).

However, according to Bogetic (2000) according to study conducted in Panama on the benefits of dollarization they reached the conclusion that adaptation of dollarization in a given economy has got a lot of benefits to the economy of the host country. Panama survived from banking crises that overwhelmed other Latin American nations. The advantages of dollarization substantially outweigh the costs, due to technological innovations that have undermined the demand of money therefore, reduced the losses from seigniorage. Dollarization also produces a lot positive economic benefits if the country adopting the system of dollarization if the country adopting it understand the conditions of adopting it and using it (Calvo, 2002). In addition, dollarization may contribute in the creation of a more competitive domestic economy through reducing the risks of devaluation (Calvo, 2002).

### **3. MATERIAL AND METHODS**

The study employed quantitative research method. The study used descriptive research design to describe asses the effects of dollarization on local currency in Somalia. The study used documentary review to collect data on the effects of dollarization on local currency in Somalia. The study reviewed several articles, books and journals in relation to the effects of dollarization on local currency in Somalia.

#### **4. RESULTS AND DISCUSSION**

The results of the study and discussion on the finding of the study encompass the following:

##### **4.1. Depreciation and shortages of local currency**

Dollarization in Somalia causes depreciation and shortages of local currency (Somali Shillings) due to the massive uncontrolled inflow of dollars in the economy. In Somalia, due to the absence of effective monetary control by the central bank of Somalia that should monitor and supervise institution, the increase in exports and imports, the lack of trust and confidence in Somali currency and the simplicity of orienting of Somali currency by private business owners and so forth; there exists massive increase of United dollars currency inflow in Somalia is being triggered by increased rate of money transfer from Somali diaspora called “Hawalla” or “worker’s remittance”, and due lead to currency depreciation and shortages in Somalia (Musse & Echchabi, 2017: 19). According to Nor (2012: 596) dollarization causes price fluctuation in Somalia and continuous devaluation of Somali shilling and creates currency shortages in Somali markets in contrast to other countries in the world that use United States dollars. According to Somalia Ministry of Finance 2018 report, the worker’s remittance informed of dollars has increased to the foreign grants amounting to the total of 363.1 million dollars in the period of 2014-2018 in the economy. This massive inflow of foreign dollars in the country creates local depreciation and replaces local currency leading to its shortages in the country

##### **4.2. Creates lack of financial control in the economy by the government authority**

The dollarization in the economy of Somalia creates lack of control financial institutions and financial activities by the central bank of Somalia leading to local currency depreciation and shortages. In Somalia, most of the inflow and outflow of dollars in the economy is being controlled by private businessmen who increase or decrease the rate of dollar exchange with local currency at their own will and it leads to local currency depreciation and shortages in Somalia. The inflow and outflow of dollars in Somalia is controlled by private businessmen on daily basis, the rate is determined most of the time by the supply of the dollars in the market and

the rate of the dollar usually goes up at the end of every month or the start of a new month, indicating the flow of hard currency from abroad. The country depends heavily on importation of most products from other countries using foreign currency (dollars). For instance, Somalia imports products such as food and khat (a legal drug chewed by many Somalis extensively on daily basis) from the neighboring countries such as Ethiopia and Kenya at expensive prices and send them in the economy expensively in dollars and contribute to the vulnerability of Somali shilling since the Central Bank does not implement the monetary policy and supervise the financial activities of the financial institutions and business owners in the country.

According to Central Bank of Somalia 2021, they stated that Central Bank is facing challenges of having enough resources and financial material to control the increasing rate of local currency depreciation and shortages due to dollarization of the economy. Furthermore, United States dollars is widely being accepted in Somalia to carry transaction and it is replacing the local currency due to low trust and confidence the local population have on local currency which is manipulated by counterfeits without any control and supervision by the Central Bank. Hence, increase in the use of United States dollars is causing currency depreciation and shortages in Somalia since majority of the local population use United States dollars for transactions, money transfer, foreign exchange and other financial activities. Hence, dollarization of the economy where the government cannot control the inflow and outflow of foreign currencies, makes it impossible for the Central Bank of Somalia to implement its domestic monetary policy and control the financial activities in the economy and it drives the country into financial crises such as local currency depreciation and shortages in the country.

#### 4.3. Increases exchange rate and inflation due to local currency vulnerability

The use of dollar currency in the economy of Somalia weakens and replaces local currency leading to increase exchange rate on the local currency in Somalia that tantamount into currency depreciation and shortages in the economy. One of the main disadvantages of dollarization in the economy is that it does not control inflation, it makes the local currency to lose credibility and it limits the power and opportunity of the Central Bank to manage and control inflation and



exchange rate which directly leads to currency depreciation and shortages in the economy. In Somalia dollarization, or in other word, adopting dollar instead of Somalia Shilling is caused by the extreme devaluation and instability of the currency which is characterized macroeconomic and financial vulnerability the country leading to increase exchange rate on local currency (Najibullah Nor Isak, 2017).

According to Sidra Institute (2020), dollarization has weakened the local currency leading to currency depreciation and shortages; for instance, the Somali shilling is now valueless and so prone to exchange rate increases and shocks. The Somali shillings lost over 30 percent of its value within the period of only three weeks between August and September 2020. In the same year, the exchange rate of Somali shillings to United States dollars reached the high level ever of 46,000 SoSh per US dollar. Furthermore, Sidra Institute, 2021, they estimated that due to the increasing dollarization of all the markets in Somalia, the increasing exchange rate against the local currency (Somali Shillings) seal the fate of Somali shillings and would completely be replaced by United States dollars. For instances, Somali shilling becomes undesirable and unacceptable in Puntland, Somalia, it could lead to rapid depreciation and shortages of local currency as well inflation in Puntland state and in all major states in Somalia.

## **5. CONCLUSION**

From the findings of the study derived from the various documents reviewed, the various effects of dollarization on Somali currency encompass: causing depreciation and shortages of local currency in Somalia and creates lack of control of financial control in the economy by the government authority and increase exchange rate and Inflation due to local currency vulnerability. Hence the Federal Government of Somalia should implement new policy and regulations to reduce the devastating effects of dollarization on local currency in Somalia.

## **6. RECOMMENDATIONS**

The various recommended derived from the findings of the study encompass the following:

### 1. Regulation

The Federal Government of Somalia through the Central Bank of Somalia should introduce new and strict regulations such as effective supervision on financial institutions operating in Somalia to help curb the increasing financial crimes leading to local currency depreciation and shortages.

### 2. Implementation of effective macro prudential measures

The Federal government of Somalia should introduce macro prudential measures to enable de-dollarization process of the financial system in Somalia. This will help the local currency to attain its value and increase its circulation in the local market.

### 3. Implementation of new policy

The Federal Government of Somalia should implement new policy that allow the private commercial banks and mobile money providers should be required to accept exchange of Somali shilling to US dollar in order to improve the acceptability and the use of Somali shilling. Similarly, the big telecommunication and utility companies must accept payments in Somali shilling.

### 4. Introducing financial reform

the Somali authorities are recommended to rationally assess the current monetary status of the country and establish an adjusted monetary framework favoring more financial stability and economic growth, away from the US Dollar hegemony

### 5. Review of business models in Somalia

In addition, the Somali market players and foreign participants are required to review their business models and trade terms to avoid the eventual shocks to the value of the US Dollar, which if persists can have a major contagion effect on the whole Somali economy.

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