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Currency Reform and Real Estate: Lessons from El Salvador
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A growing number of emerging economies have been dollarizing, replacing their own currencies with the U.S. dollar, in order to promote price stability and stimulate economic growth while avoiding local currency crises. Dollarization eliminates local political influence on monetary policy, providing a means for governments to credibly commit to policies consistent with low inflation and economic growth. It also reduces the risk of credit crises arising from currency devaluation or balance of payments problems. Eliminating devaluation risk, in turn, dampens interest rates and interest rate volatility. Hence, the economy benefits from lower and more stable inflation coupled with less interest rate risk. The policy experience, however, is not so clear cut. Inflation declines in most cases, as expected, but overall growth sometimes slows as well. It is not clear why the second effect arises, but it could be due, at least in part, to dollarization limiting the ability to adjust to external shocks.

Clearly, the effects on inflation, economic growth and employment are important, but the effect of dollarization on housing markets is also important. Home ownership in these economies, as in the U.S., represents the primary means for middle and lower income households to build family wealth. New research focusing on how currency reform affects housing markets begins by recognizing that dollarization can have offsetting effects on housing values. First, dollarization influences macroeconomic factors that increase housing prices.[1] If lower inflation risk translates into lower interest rates then the lower user cost of housing increases value. And if, as dollarization proponents argue, dollarization promotes a higher economic growth rate, then this leads to two reinforcing effects on housing prices. Higher incomes increase housing demand hence prices. At the same time, greater expected income growth means greater expected real price appreciation over time, which lowers user cost and increases current house value. If dollarization successfully stimulates economic growth, then it also stimulates greater housing prices through these two channels.

1. Mauricio Rodriguez and Jonathan Dombrow, “Dollarization and Real Estate Market Performance: Evidence from Housing in El Salvador,” *Journal of Housing Research*, 2013, forthcoming.

Further, if dollarization improves real estate price discovery and market liquidity, then the more efficient market process will be reflected in higher asset values. In terms of expected asset valuation, greater market efficiency reduces the illiquidity premium in the user cost of housing capital, supporting higher housing prices.

But if dollarization results in a lower rate of economic growth—the experience of several countries—then lower aggregate income and growth put downward pressure on house values through the separate housing demand and user cost channels described above.

For small economies, like El Salvador, that rely heavily on remittances from workers in the U.S. there is an additional channel through which dollarization can affect the housing sector. Prior to dollarization, housing mortgages in El Salvador were denominated in the local currency. Therefore, El Salvador's pervasive local currency depreciation relative to the U.S. dollar reduced the net interest cost facing families receiving at least part of their incomes in the form of dollar remittances from family and friends in the U.S. This exchange rate driven advantage for mortgage borrowers disappeared when all contracts and prices became denominated in dollars under currency reform, thereby increasing the net interest cost and user cost of housing to affected households. This, in turn, put downward pressure on house prices.

Beginning January 1, 2001, El Salvador adopted the U.S. dollar as its legal tender. Consistent with the experience of other economies, El Salvador experienced relatively low inflation and slower growth after dollarization. As expected, interest rates fell. Nonetheless, dollarization depressed housing prices. Interestingly, even after statistically removing the effects of slower housing demand growth from slower economic growth and value enhancing effects of lower interest rates, dollarization still had a significant negative effect on the housing market. Dollarization also reduced the ancillary benefit of housing as a local currency hedge in El Salvador for many households drawing dollar remittances from friends and relatives working in the U.S. to pay off their mortgages in the local currency. The study is the first to focus on how currency reform affects the real estate sector; nonetheless, the strength of the currency hedge effect on housing values is surprising. The feedback effect of the resultant decline in household wealth on aggregate consumer spending provides an additional rationale for why dollarization can reduce, rather than enhance, economic growth for some countries.

Economic growth suffers when important sectors like real estate struggle. Depressed home values translate into adverse effects on household wealth, particularly for middle and lower income families. El Salvador's dollarization experience draws out the importance of real estate as a currency hedge in small emerging economies with significant remittances from abroad. Currency reform in such situations can have deleterious effects on housing markets and as a consequence, the broader economy, complications not present in larger industrialized countries. While unstable countries suffering from high inflation can benefit from development policies like dollarization, policy makers also need to pay attention to the different roles housing and real estate markets play in emerging economies in order to avoid overlooking unintended effects on those markets and, as a consequence, on economic growth.

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