

The dollarization of world trade and its impact on cambodian economy



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Introduction

IRP is an essential part of IS 305 Global Governance course. With its aim to address each student's understanding a particular issue of global governance in relevant to Cambodian current affair and its important place in the course's assessment, I have paid tremendous amount of time working on each MC as well as the final MC.

Among all the topics suggested, I have chosen the 6th topic: "The Dollarization of World Trade and Its Impact on Cambodian Economy" This particular topic is related to economic as a course theme of global governance. Apparently, economic is an interesting and vital theme which is getting more and more recognition in global governance. Global governance is a complex interplay among many themes whose one of which is economic.

On top of this, I have chosen the above topic as my IRP topic for two main reasons. First of all, this topic is personally appealing to me. I have seen other neighboring country with stronger economy using their national currency so widely. In contrast, in Cambodia US currency is more preferably accepted throughout the whole country. This is actually only a short part of the story since dollarization started to spread worldwide after WWII ended. I want to find out more about the causes and effects of this phenomenon on the small economy of Cambodia. I am also keen to find out about the struggle of local government and other IGOs to govern the very impact of dollarization. Last but not least, this topic allows me to demonstrate the intersection of global governance with the US as one of the most powerful players in international arena as well as the role of IGOs, pattern of trade

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globalization and global governance, and indeed the response of Cambodian government on regulating the impact of dollarization on Cambodian economy.

I have divided my IRP into five main parts in which each aims to address different aspect of “ dollarization phenomenon”.

Part I: Causes and Growth of Dollarization of World Trade

International recognition of a foreign currency in world trade is not a brand new phenomenon. During the eighteenth and nineteenth centuries, the pound of Great Britain reigned as the first reserve currency in the world, but in the twentieth century, the U. S. dollar laid claim to this title. It has since been the dominant reserve currency since the end of World War II.

Definition of Dollarization

To fully understand the impact of dollarization on Cambodian economy, the initial step is to define what dollarization is. Most simply put, Dollarization means adopting the US dollar as the currency of choice in a foreign country[1]. However, dollarization’s definition does not end here.

Dollarization is a generic term that can fall into three categories:

Official Dollarization: The dollar is the only legal tender. In other words, there is no other local currency. Examples are that in Panama, El Salvador and Ecuador. For example, since independence in 1903, Panama has only used the U. S. dollar.

Semi-Dollarization: A country will use both its own currency and the U. S. dollar interchangeably as legal tender. Lebanon and Cambodia are good examples of this.

Unofficial Dollarization: For many countries in the developing world, the dollar will be widely used and accepted in private transactions, but it is not classified as legal tender by the country's government.[2]

Official dollarization occurs mostly in small or developing countries. Countries that normally adopt such a radical change in monetary policy are often encountering instable economies, high levels of inflation and a very low competitive currency. Under official dollarization the local currency is completely replaced by the dollar, with the possible exception of coinage. That means domestic banks only accept dollar checking accounts and issue dollar loans. Federal Reserve notes are legal tender and the only form of paper money recognized by the government.

In the case of Semi-dollarization, as in Latin America and in the former Soviet Union, where the purchasing power of the local currency has been volatile and people put more confidence on foreign currency, people often hold dollars as a store of value. In those cases the domestic currency is commonly used in small transactions, but the dollar is preferred in large transactions and in savings.

It should be noticed that although many people associate dollarization with the U. S. dollar, the association is not exclusive. Dollarization may increasingly refer to conversion to other currencies such as the Euro.

Besides, South African rand, Russian rouble, New Zealand dollar and <https://assignbuster.com/the-dollarization-of-world-trade-and-its-impact-on-cambodian-economy/>

Australian dollar are also accepted outside their countries, although in a localized nature. For example, the Russian ruble is accepted in a number of the countries from the old Soviet Union. Thus dollarization may not solely refer to US Dollar. Despite this, in this MC as well as IRP, I will exclusively talk about US Dollar to link it with the reality of

dollarization in Cambodia. Dollarization, in this sense, is different from monetary union because the US continues to set monetary policy in its own interest alone, whereas the European Central Bank is required to take all Eurozone countries' interests into account.

Origin of Dollarization in World Trade

The origin of dollarization rooted back to the Bretton Woods Agreement. In the aftermath of World War II, US dollar was the only major currency in which international exchange could freely take place thanks to its relatively stable value while all other European's big economies were shattered due to the war. The dollar's role was formalized under the 1944 Bretton Woods monetary agreement, an international agreement to govern monetary policy among nations. Other nations set official exchange rates against the dollar, while the US agreed to exchange dollars for gold at a fixed price on demand by central banks. It was a chance to create a stabilizing international currency and ensure monetary stability once and for all. The Bretton Woods Agreement also had the purpose of rebuilding after World War II through a series of currency stabilization programs and infrastructure loans to war-ravaged nations. By 1946, the system was in full operation through the newly established International Bank for Reconstruction and Development (IBRD, the World Bank) and the International Monetary Fund (IMF).

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It is also important to note that the United States owned 80 percent of the world's gold reserves at the time. So the United States had every motive to agree to the use of the gold standard to organize world currencies and to create and encourage free trade.

This system functioned well for a brief period. However by about 1958 the initial worldwide dollar shortage had turned into an overabundance. As only gold and the U. S. asset were considered seriously as reserves, when gold production was lagging, dollar reserves had to expand to make up the difference in lagging gold availability, causing a growing U. S. current account deficit. The Bretton Woods agreement collapsed in 1973.

As it is seen, the actual outcome of the Bretton Woods Agreement was to replace the gold standard with the dollar standard, and this is the origin of dollarization in the world.

Growth of Dollarization

Following the origin of dollarization, it is important to take a closer look at how dollar grew and the reasons behind it.

After World War II ended, the US ran large current account surpluses as the war did not fight on its land. As the biggest economies in the world, the US also aimed to have the strongest ideological power, democracy. During Cold War period, in order to deter communism in Western Europe, the US initiated the plan famously known as the Marshall Plan. Through this, American financial aid is offered for a program of European economic recovery. During its three years of existence, 1947-1951, the US spent almost \$12, 500, 000,

000. The result of this was a buildup of dollar assets by foreign firms and central banks.

Another reason behind the growth of dollarization is that the rapid growth of the industrialized economies after World War II created a growing demand for dollar balances around the world. The more of its own currency a central bank issued, the more dollars it wanted as underpinning for its currency.[3]

Besides these former reasons, US dollar possesses some outstanding characteristics that made it the currency of choice. Stability is one of the major factors that explains why a number of countries have adopted the U. S. dollar as official currency. With American both economic and military might, the U. S. dollar has never been devalued nor invalidated. This characteristic of dollar makes countries with uncertain financial circumstance all familiar with bank failures, devaluation and inflation, has a peace in mind by adopting and enjoying the benefits of the stability of the U. S. dollar.

As it is noted, similar to official dollarization, unofficial dollarization is also very hard to reverse once it is in place. As unofficial dollarization also takes root in countries with unstable and weak economy, only certain policies and remarkable national economic growth will reverse the trend, and this does not happen very often.

Dollarization Today

As of nowadays, dollarization is clearly seen. As of the start of 2000, 28 countries and territories have officially dollarized, and countries with unofficial dollarization are numerous. Over half of all dollar notes in

circulation are held outside the borders of the US. About half of US Treasury
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securities are owned by foreigners, mainly held as reserves by foreign central banks. The dollar is the main currency in international capital flows, as well as the currency of invoice for commodities and for many manufactured goods and services. All countries that trade directly with the US invoice both imports and exports in US dollars.

Part II: History of Dollarization in Cambodia

This part is going to discuss the main reasons why Cambodian economy is dollarized by providing evidences as well as my own analysis. It will also about the present situation of semi-dollarization in Cambodia. This part crucially contributes to the Individual Reflection Paper since an understanding of the causes as well as the situation of Cambodian dollarized economy is essential to analyzing the responses to this phenomenon.

How Dollarization Took Root in Cambodia

Dollarization in Cambodia occurs primarily to several main reasons. I arrange each cause according to their formality.

Firstly, Cambodian people have lost a big trust on local currency, Riel, after it was completely abolished during the Pol Pot regime. Cambodian people have bitterly seen all the savings they had in Riel become just scraps of paper in one day. Virtually, Cambodia is the only country in the world ever to have abolished money. This radical experiment, which left Cambodia being without a currency from 1975 to 1980, has left its mark on Cambodian people perception today. In March 1980 Riel was once again introduced as the national currency in Cambodia. However, massive central bank financing of recurrent budget deficits during 1988-1991 led to high inflation in the

range of 90%-177% a year.[4] This further eroded public confidence in the national currency. As a result, although the reissued Cambodian riel has been in circulation for three decades, Cambodians remain distrustful of it and regularly convert their riel into gold, jewelry, or U. S. dollars instead.

The second reason links to the peacekeeping operation performed by the United Nations from 1991-1993. During this period, millions of Dollars were poured into Cambodia each year. With tremendous amount of Dollars in circulation and a big number of Cambodians started using Dollars, Cambodia's economy became effectively dollarized. Simultaneously, since most public still tried to protect their own assets, they sold their riel-denominated assets in exchange for gold in the first phase and for the dollar in the second phase. They got stuck with dollars afterward.[5]

Thirdly, the reason may lie on the nature of Riel itself. Riel, compared to dollar, is less convenient to use for large transactions. Ten US dollar bill already equal in at least four ten-thousand Riel bills. The government gradually has introduced larger denominations, but these bills have not come into common usage. On top of that, since the introduction of Riel in 1980, Riel has seen continuous depreciation which subsides Cambodian citizens' willingness to store it as an asset. From the first time Riel was reintroduced in 1980 until now, value of Riel has gone down for 1000%.[6]

Last but not least, dollarization in Cambodia may link to Cambodian people perception. Majority of Cambodian views Dollars as the demonstration of wealth and sophistication which leads to certainly high Dollar usage in urban area. A simple example can be seen. High class restaurants and boutiques in

Phnom Penh all have their price labeled in dollar whereas smaller shops still have some tendency to use Riel. As much, in sophisticated workplace, Dollar is used instead of Riel, and as people becomes richer, they will automatically convert the use of Riel to that of Dollar, thus continuing the Dollarization trend.

Current Situation of Dollarization in Cambodian Economy

Although Cambodia is still a country with semi-Dollarization, Dollar is widely used throughout whole Cambodia, and the percentage of Dollar usage is incredibly high in urban area.

In 1998, the National Bank of Cambodia, or Central Bank, conceded that it was unable to account for the volume of foreign currency in circulation. Bank officials believed that it exceeded their official figures, and they estimated that the U. S. dollar was probably three to four times more liquid than the riel.[7]8

The subsequent years have seen the growth in banking sector in Cambodia, and the habit banking deposit and lending has substantially increased. In 2005, bank deposits grew by about 16% with the upward trend continuing into 2006, reflecting improved confidence in the banking system. Despite this positive sign, the share of the riel in these areas has been as low as 4% and 6% respectively[9], indicating the highly dollarized nature of Cambodia's economy. In other words, the percentage of Riel deposits has grown by merely 2% from 1990 until 2004.[10]

Although Cambodian authorities want to encourage greater use of the

national currency, they have emphasized that they have no intention of
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imposing restrictions on the use of foreign currency. They on the other hand believe the use of the riel will develop as an outcome of economic development. Nowadays, the exchange rate system consisted of two rates: the official rate and the parallel market rate.

Part 3: Costs and Benefits of Dollarization in Cambodia

The high degree of dollarization in Cambodia has played a major role in shaping Cambodian's economy. It brings about many advantages to the small Cambodian economy which just started from the zero-point thirty years ago and whose aim is to be integrated in to regional or even global economy. However, along with benefits, high dollarization also poses a challenge to Cambodian economy. This paper will briefly present these whole issues.

Costs of Dollarization to Cambodian Economy

There are certain costs caused by high dollarization in Cambodia. First and most apparently, high dollarization makes it hard for government to conduct fully effective monetary policies. With any policies government makes, high degree of dollar holding in Cambodia will hinder the policies to be fully implemented and thus undermine its effectiveness. These policies include the management of money supply, interest rates, and to some extent the exchange rates. Due to high dollar deposit in banks, the role of National Bank of Cambodia (NBC) as lender of last resort for banks facing liquidity problems is also greatly constrained. The high degree of dollarization limits the flexibility of exchange rate policy to deal with external shocks. For instance, the increase in world oil prices in 2005 was followed by inflation in Cambodia. The inflation rate rose between 9% and 10% in just a few months.

Secondly, government's income from seigniorage is reduced. Seigniorage, simply put, is the difference between the value of money and the cost to produce it – in other words, the economic cost of producing a currency within a given economy or country.[11]The amount of loss is quite significant as the net annual income forgone is estimated to be in the range of \$20 million to \$90 million.[12]

Another cost is that dollarization may lead to currency mismatches. This happens to firms or business whose income is in Riel. As a high amount of deposit in Cambodia is in dollar, these firms and businesses may have to take on dollar-denominated debt because that is the only way to receive longer-term loan. In this sense, in the event of a large devaluation of Riel, such firms and businesses may find themselves at great loss and are unable to service their debt. Although this problem occurs only to small number of firms, this is also a challenge of dollarization.

The last disadvantage of high dollarization deals with the real role of Riel. Under such circumstance, Riel may only stand as a symbol of sovereignty and national identity and does not play a full role in the economy. This is not a good idea since the symbol of national identity is not sufficient for a national currency.

Benefits of Dollarization to Cambodian Economy

Despite above costs, dollarization also brings about remarkable advantages to Cambodian economy. First of all, the introduction of dollar during UNTAC operation in 1990s has helped Cambodian people to convert their assets from gold to dollar and consequently made money deposit in banks easier

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and as incentive to place savings abroad was eliminated, this encouraged domestic financial intermediation to flourish which resulted in the growth of the financial system.

Secondly, dollarization lowers the risk of Riel devaluation. Because of high degree of dollar circulated in Cambodian economy, the demand for Riel remained low. With this low demand, the NBC will not unnecessarily print more amount of Riel. Very high dollarization in Cambodia is therefore resulted in low inflation and economic stability.

Thirdly, dollarization makes Cambodian economy more stabilized. The diminished risk encourages both local and foreign investors to invest money into Cambodia. Currency stability promotes macroeconomic stability and a predictable business environment. Evidently, high degree of dollarization protected Cambodia against contagion in the face of the Asian financial crisis of 1997-1998.

Last but not least, the use of the dollar facilitated the integration process of Cambodia's trade in the international economy. It reduced the transaction costs by omitting currency conversions cost. Besides, it also enabled the boom in the garment industry in Cambodia.[13]

Part 4: Role of Cambodian Government and International Actors on Reducing the Impact of Dollarization

Having been exposed to the costs and benefits of high dollarization, it is essential to take a further step to find out what the stance of Cambodian government is and what it has done so far to make the best out of this

situation. Accompanied this, the role of other international actors regarding dollarization's impact issue will also be discussed and presented.

Cambodian Government's Policies

To begin, it is important to understand that in Cambodia, the decision maker regarding monetary policy is the National Bank of Cambodia (NBC). NBC is autonomous from the government and government cannot interfere with NBC's monetary policy decision. However, to make it simplified, I will merely use the word "Cambodian government" along with "NBC" in terms of monetary policy's decision maker.

So far, NBC has taken advantage of dollarization in Cambodian economy to stabilize inflation rate and obtain a favorable exchange rate. As government-backed securities such as treasury bills and government bonds do not exist in Cambodia, dollar serves as an alternative for the Open-Money Operation (OMO), one of the conducts of monetary policy to control money supply and thus inflation rate. To illustrate, OMOs are defined by National Bank of Cambodia (NBC) as operations to purchase or sell dollars against the riel with the objective to stabilize the fluctuation of the exchange rate between the two currencies.[14]With dollar, NBC can manipulate the inflation rate to a desirable level and thus achieve price stability. History has shown that dollar auction has been an effective tool to adjust the exchange rate.[15]

Although dollar plays an important role in OMO in Cambodia, the ultimate goal of Cambodian government is still to increase the role of riel in economy and make it more than a mere sign of sovereignty. Various steps have been taken by the NBC regarding de-dollarization measure.[16]Most importantly,

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for macroeconomic policies, NBC aims on maintaining the stability of exchange rate and low inflation rate, while concerning legal reforms, NBC has set a fixed amount of riel as reserve requirement ratio for banks.

However, these steps have been insignificant and so have been the result.

This is probably because of

the current situation of Cambodian economy, whereas we will discuss this issue more deeply in the next part.

Role of Other International Actors

In currency affairs, the need for more cooperation is urgently pronounced since apparently harsh decision of one state's monetary policy can draw varieties of external effects that go beyond the host state's territory, and for which a unilateral response is not desirable. Contrastingly, even with call on more cooperation in international monetary policy among great powers, monetary policy still rests primarily on individual state to decide.

On the national level, regarding dollarization issue, it is apparent the US Federal Reserve has not taken into account those countries that are officially dollarized, not to mention unofficially dollarized countries like Cambodia. The Fed has stated that it would never act as a lender of last resort to foreign banks, nor would its monetary policy be contrary to the best interests of the US. Thus, dollarized countries have to bear their own cost and find appropriate policies to deal with it. So far, US Fed has taken a neutral position, neither encouraging nor discouraging dollarization.

On the international level, there has been more sign of interest for

cooperation. However, even with more cooperation, it still stresses only on <https://assignbuster.com/the-dollarization-of-world-trade-and-its-impact-on-cambodian-economy/>

major currency such as dollar, euro and yuen, whereas economy for small states like Cambodia is ignored. Thus, main decision still rest with Cambodian government on how to steer for a blessing environment for its currency. Despite this fact, we should all be aware that, desirable or not, any decision made by the US Fed to appreciate or depreciate its currency will make the effect be felt in Cambodia who is highly dollarized.

Part 5: Future Response of Cambodian Government: Dollarize or De-Dollarize

High dollarization in Cambodia has blessed the economy with stability and growth. However, even with increased economic and political stability, dollarization has been persistent which is not a good sign for a healthy economy with its national currency. The National Bank of Cambodia has taken measures to eventually de-dollarize and improve its power over monetary policy, but the realization of this goal is still a long way to go.

Why Cambodia Should Remain Dollarized and Why Cambodia Should De-Dollarize

As expressed in the previous part, high dollarization has brought about significant advantages to Cambodian economy. Dollarization, for instance, helps maintain low inflation rate, and as a result also stable exchange rate. The Open-Money Operation (OMO), one of the conducts of monetary policy, strictly speaking, do not exist in Cambodia due to a lack of government-backed securities such as treasury bills and government bonds. However, OMOs are defined by National Bank of Cambodia (NBC) as operations to purchase or sell dollars against the riel with the objective to stabilize the fluctuation of the exchange rate between the two currencies.[17]With dollar,

NBC can adjust the inflation rate to a desirable level and thus achieve price stability. Since 2005, only NBC has the legal rights to conduct the dollar auctions, and history has shown that dollar auction is really an effective tool to adjust the exchange rate. Besides, dollarization also assists the integration of small Cambodian economy with the rest of the world by reducing transaction costs for purchasing international currency.

Despite the above factors, it is still convincing for Cambodia to de-dollarize because of some reasons. Most apparently is that NBC cannot manipulate the flexibility of its monetary policy due to high level of dollar circulation in the economy. As illustrated in 2005, inflation rose between 9% to 10% in just a few months due to the rapid increase in the world oil price. Also, any slight change with US monetary policy can have effect on Cambodian economy as well. Besides, high dollarization also limits Cambodia's effort to maintain a currency value favorable for export since dollarization hinders price-wage flexibility. Last and most importantly, de-dollarization is a sign of growing and healthy economy. For Cambodia to keep depending on foreign currency is not a favorable choice to make. Mainly, de-dollarization will bring about a meaningful national currency as well as a powerful and effective monetary policy tool to influence the national economy.

Possible Solutions

Besides what Cambodian government has done so far, there are some recommended policies that could be done to strengthen the de-dollarization process. Firstly, the NBC will start refinancing banks with Riel only for operations conducted in Riel. This is a dramatic move. Secondly, NBC will have to make operations in Riel more attracting compared to dollar in the <https://assignbuster.com/the-dollarization-of-world-trade-and-its-impact-on-cambodian-economy/>

banking system. This include, for example, making the interest rate of Riel-denominated deposits much higher than that of the dollar. Another way is to develop a new financial instruments denominated in Riel such as treasury bills, and these bills have to offer higher yields for the compensation for exchange rate risks. Last but not least, there has also been encouragement for Cambodia to adopt a Currency Board Arrangement (CBA). Creating CBA means to peg the national currency to another currency. If so, NBC can only issue a certain amount of Riel that is fully backed by foreign assets at fixed exchange rate, which in the case of Cambodia would be naturally dollar. By adopting a fixed exchange rate, a successful CBA would allow Cambodia to de-dollarize as well as to maintain continued economic stability for economic growth. However, Cambodia would need substantial foreign reserves in order to sustain the amount of money in circulation.

Remaining Challenges

Among all the envisaged solutions, there is still left with one remarkable challenge Cambodia must overcome to make the above policies effective. This challenge is that the NBC has to ensure exchange rate stability and macroeconomic stability so that private sectors will gain confidence that it will not be penalized for holding riel-denominated assets. Ensuring exchange rate stability and macroeconomic stability requires time, effective effort as well as continuing healthy economy, thus the success of de-dollarization is still in the far future to come for Cambodia. As shown nowadays, interest rate for Riel-denominated deposits is already higher than that of the Dollar, but public opinion still place their confidence in Dollar and the ratio of Dollar-denominated deposits is still higher than that of Riel.[18]

In conclusion, Cambodia should de-dollarize its economy, just like what a country with a healthy economy would do. However, given the unresolved challenges, the de-dollarization of Cambodian economy is still a long-term goal. These challenges may increase as Cambodia gets exposed to more capital flows from FDI in dollar which makes it even more difficult for the NBC to achieve its ultimate goal. On top of renewed investment, more tourism receipts, the launching of financial market and increased lending in dollar can all contribute to more dollar circulation.