

# What is dollarization and its effects in cambodia



There is overwhelming definition of the dollarization given by well-known financial institution-IMF, economists, and scholars and other famous professors of universities and institutions. In Mario de Zamaroczy and Sapanha Sa's working paper, funded by IMF, defined that "dollarization is a situation where a foreign currency is used for the same purposes as national currency, i. e., as a medium of exchange, a unit of account, and a store of value" (Macro Adjustment in Highly Dollarized Economy, 2002). Andrew Berg and Eduardo Borensztein, Writers for IMF of Economic issues No 24 with topic of full Dollarization: The Pros and Cons, claimed that the term dollarization is shorthand for the use of any foreign currency by another country. Another definition of dollarization from Joint Economic Committee Staff Report is that "Dollarization occurs when residents of a country extensively use the U. S. dollar or another foreign currency alongside or instead of the domestic currency" (Connie Mack, 2000). In the other term is that "Dollarization occurs when the inhabitants of a country use foreign currency in parallel to or instead of the domestic currency. The term is not only applied to usage of the United States dollar, but generally to the use of any foreign currency as the national currency" (Wikipedia, 2010). However; within the Cambodia context, dollarization can be defined as the use of the US dollar in any of the three functions of money in an economy other than US. The term dollarization is used to specifically to describe the currency regime in Cambodia where the US dollar is dominant currency in circulation notwithstanding the availability of the local currency, the riel (Hang Chuon Naron, 2008).

Cambodia is considered and characterized as a multiple currency zone where co-exists Vietnamese Dong that can be found of using it in border provinces like Prey Veng

and Svay Rieng. Thai-Baht currency is also being circulated in business transactions in many Cambodian border provinces such as in Battambang and Koh Kong. More significantly, US dollar circulates in almost every part of Cambodia in the means of daily life exchange, expense, or any kinds of transfers or deposits etc. In 2008 in the third quarter, about 97% of banking deposits are in US (Jayant Menon, 2008). Dollarization appears in several forms: official dollarization, semiofficial dollarization, and unofficial dollarization. In some countries, US dollar circulates legally but some countries are not. It can be mostly seen in small and developing countries. In condition or situation which the local currency is completely replaced by US dollar or foreign currency, this phenomenon can be called Official dollarization or full dollarization (Hang Chuon Naron, 2008). Panama and Ecuador are two countries best examples for full dollarization (Wikipedia, 2010). According to Connie Mack, Chairman of Joint Joint Economic Committee Staff Report in 2000 stated that under semiofficial dollarization or bi-monetary system, “ foreign currency is legal tender and may even dominate bank deposits, but plays a secondary role to domestic currency in paying wages, taxes, and everyday expenses such as grocery and electric bills”. Semiofficial dollarized economy such as Cambodia maintains a central bank or other monetary authority and has some flexibility to conduct monetary policy (Hang Chuon Naron, 2008). Regarding to unofficial dollarization or partial dollarization, Hang stated that it occurs when people

hold a portion of their financial wealth in foreign assets such as people hold foreign bonds and deposits abroad as stores of value. This is equivalent to “Asset substitution” which is also considered as first stage. Connie Mack added that people do so because they want to protect against losing wealth through inflation in the domestic currency or through the outright confiscations that some countries have made. Connie Mack emphasized more seriously that in the second stage of unofficial dollarization, which economists sometimes call “currency substitution,” people hold large amounts of foreign-currency deposits in the domestic banking system (if permitted), and later foreign notes, both as a means of payment and as stores of value. People within the country pay wages, taxes, and everyday expenses such as food and bills by domestic currency, however, in big business transaction such as buying bond or stocks, mortgages everything is paid in foreign currency. In the final stage of unofficial dollarization, people think in terms of foreign currency, and prices in domestic currency become indexed to the exchange rate. Examples are French franc, German mark-Balkans and others developed countries’ currency etc.

In the time that there is high dollarization, Cambodia will confront many several obstacles and losses which are inevitably avoided such as loss of seigniorage, loss of an effective monetary policy, etc.

The loss of seigniorage is the main cost of dollarization for the government. Seigniorage is kind of revenue that government earns from issuing currency. The seigniorage arises from the difference between the cost of producing and distributing paper money and coins and their purchasing power.

According to Hang Chuon Naron, “ seigniorage losses can be significant for <https://assignbuster.com/what-is-dollarization-and-its-effects-in-cambodia/>

Cambodia as it is estimated that National Bank of Cambodia (NBC) foregone income (Loss of seigniorage) ranges from US\$20 to US\$90 million”.

Another major cost of high dollarized economy is loss of an effective monetary policy. From the research has shown that highly dollarization may hinder the effectiveness of monetary policy as in case of Uruguay. Similarly, the Central Bank of Cambodia, the NBC, cannot directly implement monetary policy because there is no or slight influence over foreign currency component of broad money. Therefore, money supply is not determined by the NBC, but it depends on the behavior of agents holding both dollar and riel-denominated assets. For fully dollarized economy countries, “ they have no choice but adopt the issuing money policy country, US” (Mario de Zamaroczy, 2002).

Another potential drawback with high dollarization in Cambodia can be the loss of the central bank as lender of last resort. In the banking system in the period of crisis happening, the central bank should function as a lender of last resort to the commercial banks by providing advance or credit lines to solvent but not liquid commercial banks. However, in high dollarized economy, it prevents the monetary authorities from giving short-term liquidity to the banking system to handle with liquidity crunch. The central bank cannot inject the riel into market in which dominated by dollars. Thus “ the NBC cannot develop strong instruments of monetary policy and its role of lender of last resort for banks” (Hang Chuon Naron, 2008). So what are commercial banks going to do in case they are facing liquidity problems or crisis? Who and where are they going to ask for if the central bank used to be the last resort to address with problems but could not?

<https://assignbuster.com/what-is-dollarization-and-its-effects-in-cambodia/>

High dollarization provides some protection against exchange rate risks. As we know large scale of financial and trade-related transactions are settled in dollars; whereas, only small scale of bulk of national currency is being used in non-trade and trade transactions. “ The demand for riel is low and riel therefore remained very stable with average annual depreciation against the dollar of approximately one percent for the three year period ended 2005” (Hang Chuon Naron, 2008). As the result the effect of higher import prices on inflation has been limited. The impact of ASEAN economic crisis in 1997 is the best example to convince that “ Cambodia with high dollarization is favorer than Thailand. From 1997 to 1998 Thai Baht depreciated by 71 percent against dollar; whereas at the same time, Cambodia Riel depreciated by 21 percent” (Mario de Zamaroczy, 2002).

Another benefit of dollarization is facilitating international trade and economic integration. Dollarization lowers transaction costs, which stem partly from difference between the buying and selling rates for converting domestic currency to foreign currency. By reducing trade transaction costs through avoiding conversions it has contributed to the rapid growth of the booming garment industry.

One another benefit of dollarization is “ promoting price stability and financial fundamental strengths in dollar terms. By definitively rejecting the possibility of inflationary finance through dollarization, countries might also strengthen their financial institutions and create positive sentiment toward investment, both domestic and international” (Andrew Berg and Eduardo Borensztein, 2000).

Financial institutions after the 1970s, economic mismanagement in the 1980s, and the large inflows of US dollars that occurred during the UNTAC period in the early 1990s are three main factors contributing to dollarization in Cambodia. At that time, Cambodia, unlike other countries, was in macroeconomic instability and hyperinflation that induced dollarization. “ During UNTAC peace building activities, there was estimation that a massive \$1.7 billion was transferred into Cambodia which was considered a high level of dollarization. More specifically, large flow of foreign assistance and privates were also in dollars that made high degree of dollarization” (Jayant Menon, 2008). Political and economic uncertainty in 1990s also contributed to keep high level of dollarization in Asia as well as the world. Cambodia is considered as one of the highest dollarization in the world.

Despite of a decade of government efforts to de-dollarize its economy, Cambodia remains one of the most heavily dollarized economies in the world. According to VOA Khmer NEWS published online July 07, 2010 stated it is believed that Cambodia is still unable to de-dollarize. As mentioned earlier, every year Cambodia government loses between \$20 million and \$90 million from being unable to implement monetary policies, earn revenue from printing and issuing new currency so on. Therefore, to overcome this problem, there is only way which is to de-dollarize. But the question is how to handle with this? The answer comes out and the most feasible solution to this problem is to have a discrete economic policy to encourage more use of riel and promote economic growth, low inflation and high riel value. The way of promoting de-dollarization through banking system is an effective and basic method. As part of process, government should enforce all private and

public sectors start to be paid their employees and staffs' salaries in riel as well as encourage all major banks setup policies which are given depositors with higher rates when depositing in riels. It is said that if the government could accelerate these reforms, Cambodian people will naturally prefer to use riels.

However, if the enforcement is not the answer and the costs outweigh benefits. What then should be done? Currency Board Arrangements (CBAs) can be an answer to this question. For Cambodia, it seems that she is on right track entering a successful CBA. Cambodia is well integrated to world trade, WTO and a member of ASEAN. However, moving from high dollarization requires many challenges; an effective independence of the NBC (removing the government representatives from the NBC's board); the ability to resist pressure for budget financing in times of uncertainties; and the ability to decide freely on the exchange rate policy (Mario de Zamaroczy, 2002).

According to Jayne, Mennon, he states that a CBA is close to official dollarization, but there are important differences. First, it is less rigid in that devaluation is possible. Second, it would reinstate seigniorage when official dollarization would remove it completely. Although Hong Kong, China is perhaps the most well-known economy employing a currency board, a number of less well-known, newly-independent transitional economies such as Lithuania, Estonia, and Bosnia have implemented currency board-like systems with success, having their local currencies anchored to the Euro (Jayne, Menon, 2008).



To recap, as Cambodia is also one of the high dollarized economy countries, she also acquires either drawback or benefits of being a high dollarized macro economy in the region. If government as well as National Central Bank of Cambodia is reluctant ignores this concern. In the future, the value of local currency will lose trust and government can't do anything to restore the situation. The only way to deal with the problem is de-dollarization process. However, without direct involvement from the government to promote local currency, dollarization is sticky to Cambodia economy and as we have mentioned that being high dollarized country the disadvantages simply outweigh the advantages. Therefore, Royal Government of Cambodia should enforce de-dollarization no matters how long it will take.