Dollarization and Dedollarization: The typical dilemma of economic in Cambodia

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ABSTRACT

In order to integration in ASEAN region , Cambodia should be ready for all sectors and must be solving some critical issues currently encountering well and on time for forwarding to develop sustainability and inclusive development. All dilemmas such as dollarization, illegal immigration and stability of political system. In addition, I would only mention the dollarization market in Cambodia. Somewhat paradoxically, growing dollarization in Cambodia has occurred against the backdrop of greater macroeconomic and political stability. The usual motive, currency substitution, does not appear to have been a factor. As the volume of dollars increased over the years of UNTAC for first Cambodia's election, so has the volume of riel. A strong inward flow of dollars related to garments sector exports, tourism receipts, foreign direct investment, and aid, has benefitted the dollar based urban economy. The riel based rural economy has, however, lagged behind. Given international experience in de-dollarization, a carefully managed market based strategy, supported by a continued stable macroeconomic environment is essential for Cambodia's de-dollarization (Masato 2011).

Cambodia has been losing around $20 million to $ 100 million annually in using this international currency. Cambodia's loss of seigniorage ,the value a country gains in producing its own currency equates to about 2 percent of total GDP. In this term paper will assert that ,with ample deficit current account of our country in mechanism of using domestic currency in market, and allocate the resource by transparency and accountability in order to promote the financial inclusive devolvement in Cambodia.

Keywords: Dollarization, De-dollarization, Seigniorage , Dilemma, Cambodia

1. INTRODUCTION

After some dilemmas occurred to Cambodia for long time from that horrible and sorrows events that eroded experiences and the confidents of people in domestic currency and national authorities in order to maintain the value of national currency, Riel. However ,By 19970-1979 in Khmer Republic system which was already circulated the some amount of dollars in market But domestic currency was still used as major one in daily transactions. Gradually events were pushed Cambodia to new dilemma in 1995-1979 ,it was called " Khmer rouge regime" . There were bad melancholy for Cambodia societies and economy too. Everything was tremendously smashed as well as financial and physical infrastructures too. Banking system was automatically destroyed while some financial institutions closed and crushed down. Later on, after conquered and alliance the nation, The biggest financial authority has been re-established as a Central Bank of the Country by sub-decree No 1211 dated October 10, 1979 of the Council of the Revolutionary People of Cambodia and titled as "Bank of Cambodia" which was existing the head office in our capital city. The commercial transactions were made up by barters or rice and gold or even other currency. In 1980 the Central Bank was transformed under the name of the People's Bank of Kampuchea and the Riel was again the country's legal currency. During the 1980s, the People's Bank of Kampuchea provided a multitude of services, including acting as the monetary authority, the cashier of the Government, and the only institution providing banking services, such as deposits, loans, and payment instruments. The use of US dollar (USD) and Thai baht (THB) was restricted by the centrally planned economy. However, confidence in the Riel remained low, given the political structure and the security situation, with the consequence that dollar and baht and above all gold were largely considered as a refuge by Cambodians. In January 30, 1992, in the 22nd ordinary session, the 1st legislature, the National Assembly of the State of Cambodia adopted the Law on the Change of Organization's name and duty of the Bank of Cambodia from the People's Bank of Kampuchea to the National Bank of Cambodia, which was promulgated by the council of state in February 8, 1992.

2. Cause of dollarization and Capital flow into Cambodia

By understanding well of some disvantages and Advantages of the centrally planned economy which was an economic system in which the government controls and regulates production, distribution , prices. Cambodia had changed from centrally planned economy to market economy in late 1980s. It mean that trade border is free and opened globalization in diplomatic with all nations around the worlds. In early 1992, Cambodia's GDP grew by at least 8 percent making it one of the fastest growing economies of the region according to a United Nations (UN) report released at the end of February. But despite this dramatic figure, all the more impressive for being recorded during times of continued political uncertainty, such growth had largely been stimulated by the U.S.$2-3 billion United Nations Cambodia operation, which had placed more than 20,000 personnel in country as part of the United Nations Transitional Authority in Cambodia (UNTAC).The US flooded flow into country which was creating the risks or new socks facing with national currency without sense from central bank in advance to deal with .

Cambodia has become Asia's most dollarized economy. In contrast, dollarization in neighboring Lao P.D.R., Mongolia, and Vietnam has been either declining or broadly stable. Somewhat paradoxically, growing dollarization in Cambodia has occurred against the backdrop of greater macroeconomic and political stability. The usual motive, currency substitution, does not appear to have been a factor. As the volume of dollars increased over the years, so has the volume of riel. A strong inward flow of dollars related to garments sector exports, tourism receipts, foreign direct investment, and aid, has benefitted the dollar based urban economy. The riel based rural economy has, however, lagged behind.

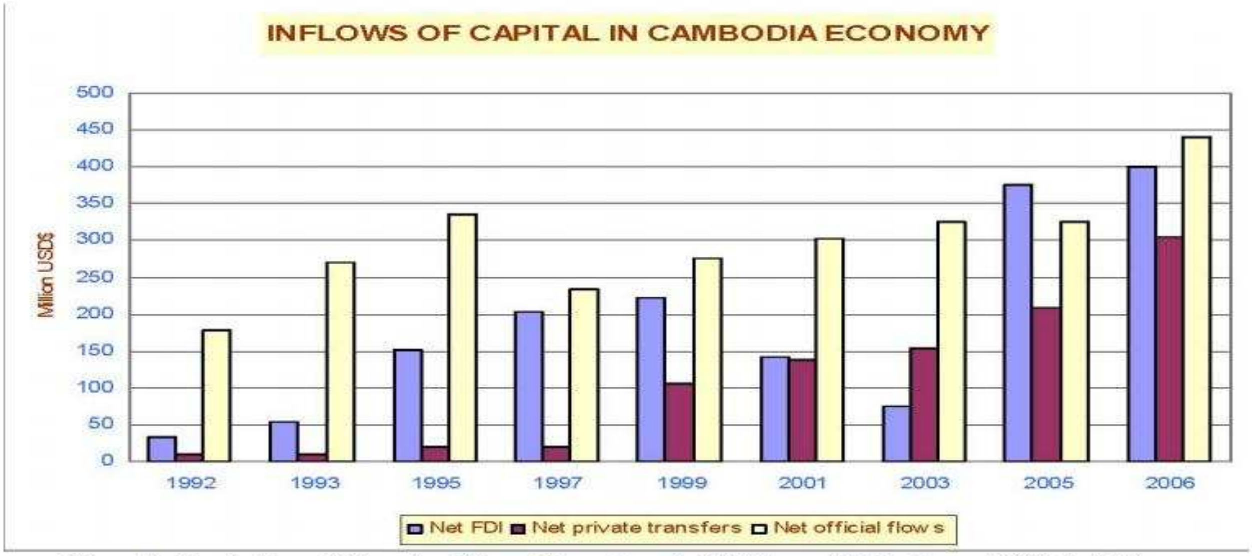


Chart 1-Evolution of Foreign Direct Investment (FDI), and Private and Official Flows

3. Expenditures and Perils of Dollarization

The financial authority has lost the lender of last resort and lacks instruments to influence monetary aggregates and anchor private sector expectations of inflation. Movements in private sector credit tend to be outside the control of the NBC. The extent of dollarization forces the NBC to delegate its monetary policy to the United States. Figure 1 illustrates that macroeconomic variables in Cambodia respond significantly to changes in U.S. monetary policy. While the NBC uses from time to time the dollar reserve requirement ratio (RRR) as a monetary policy tool to control liquidity, its effectiveness has proven limited. When the RRR was reduced in early 2009 to provide liquidity to banks and help boost economic activity in the wake of the global crisis, banks instead accumulated more reserves at the NBC. Excess reserves rose to their highest levels in history and credit to the private sector contracted.

3.1. The loss of seigniorage

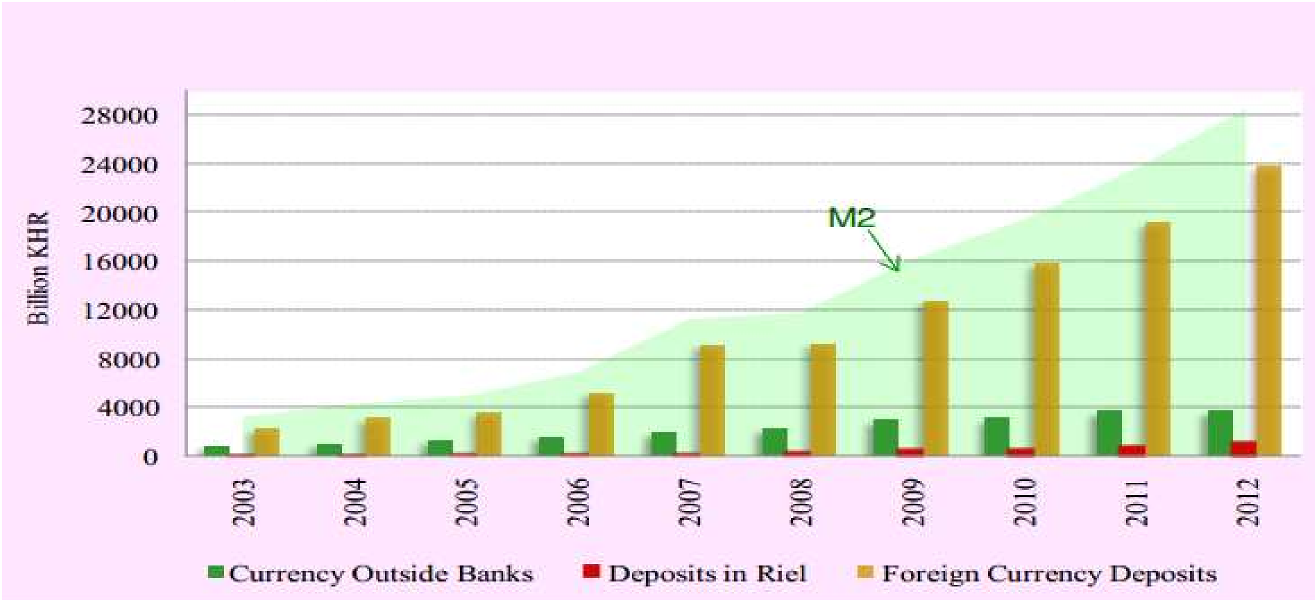
Dollarization has resulted in loss of seigniorage revenue.Seigniorage revenue is the difference between the value of money and the cost to produce it. When the cost of producing money exceeds (is below) its value, seigniorage is negative (positive). The cost of seigniorage can be estimated as a one-time stock cost from the amount of new foreign currency that is being acquired, or as a continuing flow cost in terms of seigniorage revenue foregone (Bogetić, 2000). Given the nature of dollarization in Cambodia and the way it was acquired—that it was not a conscious choice to adopt the dollar calculation of seigniorage loss using the continuing flow method is more appropriate. Through the creation of base money, the NBC buys real resources for nothing in return considering the cost of printing money and any remuneration of bank reserves by the monetary authorities. The high level of dollarization diverts this flow of revenue from the NBC to the United States. Estimates of seigniorage loss for Cambodia are broadly comparable with those of other countries. Bogetić(2000) estimated seigniorage loss for Latin American countries to range from ½ percent of GDP for Argentina to about 7½ percent of GDP in Equador for the period 1991–97. Similarly, Humpage (2002) estimated seigniorage loss for Latin American countries to range from 0.1 percent of GDP in Ecuador to about5½ percent of GDP in Chile for the period 1990–2000.

As much as $320 million is being lost annually as a result of Cambodia's reliance on the US dollar, while a longstanding mistrust in the riel means there is less of the local currency in circulation, restricting the national bank's ability to respond in times of economic crisis. Cambodia's loss of seigniorage, the value of a country gains in producing its own currency equates to about 2 per cent of total GDP (Jayant Menon, ADB economist, 2014). Cambodia is currently the most dollarized economy in all of Asia, with an estimated 85 percent of all currency in circulation being US dollars. In 2010, however, when the US dollar circulation was at 80 per cent, the International Monetary Fund estimated Cambodia's seigniorage losses to be as high as 19 percent of GDP. Dollarization did not result from a policy decision. It emerged because confidence of the public in the national currency and in the government policy was eroded. Chang (2002) argues that in cases where policy credibility has been a problem, interpreting seigniorage loss becomes delicate. In countries where dollarization has increased, credibility of policies had been an issue. In these cases, the increase in dollarization could in fact have been associated with an increase in social welfare provided, which would otherwise not have been realized if dollarization had not taken place. Chang (2002)further argues that purely considering computed seigniorage loss can only be unambiguously interpreted as "real losses" to the economy if policy credibility problems are assumed away.

3.2. The Monetary Policy and dollarization in Cambodia

In case of dollarization of Cambodia, Cambodia might have suffered with some issues as well as increasing the balance sheet risks too. The direct exchange rate risks that results from currency mismatches in banks' balance sheets. Also, indirect credit risk might increase in case of devaluations in the presence of substantial dollar lending to non hedged borrowers (Kokenyne, Ley, and Veyrune, 2010). To the extent that currency mismatches exist in banks' balance sheet such as where, balance sheet risk remains. High dollarization requires that the NBC maintains an adequate level of dollar liquidity both at the macro level and at the individual financial institution level. In the early 1990s, while tax revenues were very limited due to inactive economy, low profile of the fiscal policy and lack of international support, the budget was mainly financing by central bank, which caused banks' net claims on government be multiplied by four between 1990 and 1993. The money supply (M2) swelled by 241% in 1990, 29% in 1991, and above 200% in 1992.And furthermore, Broad money (M2) increased to KHR 28,592 billion (47% of GDP), an increase of 20.9%. Residents‟ foreign currency deposits increased KHR 4,625 billion (24.2%), and domestic currency deposits increased KHR 328 billion (44.3%), while currency outside banks declined by KHR 16 billion (0.4%). This resulted in a sharp devaluation of the riel and in a three-digit hyperinflation which created additional shocks for potential users of the riel.

Chart 2- Money supply structure



	2007	2008	2009	2010	2011	2012
Net claim on Government	-90.5	-64.5	24.6	5.6	0.2	-17.1
Credit of private sector	76.0	55.0	6.5	26.6	31.7	34.1
Liquidity (M2)	62.9	4.8	36.8	20.0	21.5	20.9
Currency outside banks	24.4	15.3	30.8	3.2	21.7	-0.4
Inflation rate	14.0	12.3	5.3	3.1	4.9	2.4

Chart 3- Liquidity Components & Inflation (Year-on-Year Percentage Change)
Source: National Bank of Cambodia (NBC),2013.

In 2012, net domestic assets of the National Bank of Cambodia (NBC) declined by KHR 477 billion (9.6%) to KHR -5,453 billion. This drop reflected reductions in net claims on banks of KHR 70 billion (12.1%) and net claims on the government of KHR 345 billion (19.4%), while other items increased by KHR 59 billion (10.2%). The decrease in net claims on government resulted entirely from an increase in government deposits. Net foreign assets of the NBC rose to KHR 18,543 billion (31% of GDP), an increase of KHR 2,573 billion (16.1%) compared to 2011. This growth was due to an increase in foreign assets (NBC,2013).

Furthermore, Cambodia's economy has been strongly connecting with US economy and it is very vulnerable while the US might change its monetary policy. This poses constraints on the tools available domestically with which to respond to external shocks. Monetary expansion in the United States tends to result in economic booms in other countries (Kim, 2001), including in dollarized economies (Goux and Cordahi, 2007).During late 2007 and early 2008, Cambodia experienced an increase in inflation pressures as commodity prices and foreign inflows rose. Coincidentally, U.S. monetary policy had become loose following the Federal Reserve's attempt to increase liquidity as the subprime crises hit. The federal funds rate had declined from about 5.26 percent in July 2007 to1.98 percent by May 2008.This means that Cambodia is importing seriously the US monetary policy while its country is still poor. About 60% of Cambodia's garments exports go to the United States indicates strong real linkages between the Cambodian economy and the U.S. economy in addition to the financial linkages caused by dollarization.

3.3. The advantage of Dollarization

The dollarization demolishes strongly the public confidents with domestic currency and dollarization in Cambodia has been helping Cambodia's payment capacity . Cambodia has extremely high levels of dollarization-our estimates are something in reality close to 90 to 95 percent(Jeremy Carter, IMF,2007).The large quantities of banknotes in dollars, at the beginning of the 1990s, allowed the public to switch from using gold to banknotes for transactions and to store wealth. Until then, using unproductive physical assets such as gold was common practice in Cambodia. Subsequently, the progress of monetization has encouraged savings within the middle class. Dollarization prevented capital flight and promoted financial deepening. The elimination of incentives to place savings abroad encouraged domestic financial intermediation, which resulted in the growth of the financial system. Only over the past three years, the volume of bank activity has roughly doubled, and the loan to deposit ratio has grown regularly. And Cambodia has given that the Cambodia loan-to-deposit ratio was already about 100 per cent at the end of 2013, then the fact that commercial bank loans are growing at twice the rate of deposits is actually quite concerning,(Grant Knuckey ,2014).

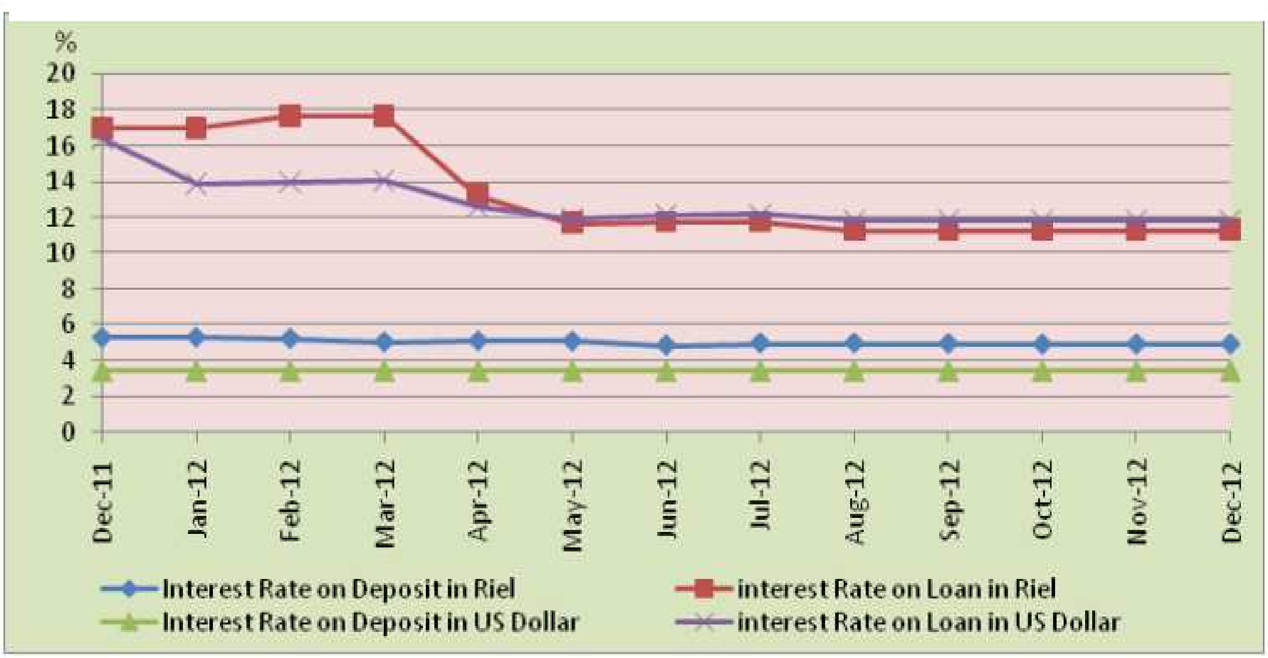


Chart 4- Interest on loan and Deposit (6months weighted average),Source:NBC,2012.

3.3.1 To Bargain the financial stability

Actuality that a dollarizing country gives up the ability to conduct its own monetary policy controlling means that monetary policy in the adopting country will mimic the policy of the issuing country. From the optimal currency area perspective, this is presented as a potential cost to dollarization. But in many (maybe most) cases, countries that dollarize are also countries that have high inflation rates, and in these cases the benefits of dollarization are assumed to arise precisely because domestic monetary policy is jettisoned. Evidence suggests countries that experience medium to high inflation rates have low growth rates.(Boyd, Levine, and Smith (1996) argue that this correlation may in large in part operate through the deleterious effects of inflation on financial markets. Dollarization thus enables a country to "import" a credible monetary policy of low and stable inflation rates, contributing to the strength and stability of the economy's financial markets and institutions and enhancing the growth prospects for the adopting country. Here again, we argue that, to the extent that dollarization works to promote growth and trade, financial market integration and stability, and so on, these affects would inevitably work to the benefit of the issuing country as well as the adopting country. Some might argue to the contrary that closer integration, particularly in financial markets, represents a significant potential cost to the issuing country, because with integration comes greater responsibility for, and exposure to, risk in the rest of the world. In this view, one cost to the issuing country is the possibility that domestic policy decisions of the central bank or federal government will at times be dominated by shocks in other economies. I argue that this does not represent a "new" cost. It is a cost that large countries such as the U.S. have been bearing for some time, and it is quite independent of dollarization. For example, U.S. domestic policy was directly influenced by collapse of the Thai baht and the problems that followed in South East Asia in 1997, by the collapses of the Russian ruble and Long-Term Capital Management in 1998, and the Brazilian real in early 1999. We have for some time lived in a world where foreign and domestic markets have been tightly integrated and where U.S. domestic policy has been impacted by events outside of the U.S. Hence, it is our belief that the marginal cost of dollarization-driven integration of domestic and foreign markets is easy to overstate because these markets are already highly integrated (IMF, 2002).

3.4. The disadvantage of Dollarization

Dollarization in economy will be having the good and bad points for Cambodia. By this experience, it undermines the effective conduct of monetary policy. The NBC cannot develop instruments of monetary policy and its role of lender of last resort for banks facing liquidity problems is greatly constrained. Furthermore the national currency may appear as a symbol of sovereignty and nationhood. The income from seignorage is strongly minimized. The government of the United States gains seignorage benefits from Cambodia, since the dollar denominated money stock held by Cambodian people does not earn interest. The net annual income foregone is assessed in the range of USD 50 to 100 million per year.

4. Strategies and de-dollarization policies

In Asian, only a few countries were able to contain dollarization, since they did not experience high inflation or severe macroeconomic instability (for example India, Sri Lanka, Bangladesh, and advanced economies such as Singapore, Malaysia, Taiwan).While some empirical trends did raise up in order to curb or reduce the dollarization in market as well as. In this strategies we should focus on some empirical and prudential policy measures which are helping to the reduction of foreign currencies in economic.Moreover,Cambodia should strongly concentrate on the financial literature to people and promote the people to know how the advantage and disadvantage of using dollars .And more major three strategies as well as :

1-To arrest inflation expectations, macroeconomic policies were aimed at maintaining exchange rate and price stability. Inflation targeting is one of these policies.

2- Regulatory and legal reforms have intended to create incentives to use the national currency, through regulatory differential reserve requirements or remuneration rates, provisioning standards, liquidity requirements, etc. For example, a premium was paid on dollar-indexed local currency deposits over dollar deposits (Nicaragua); a tax was introduced on checks paid in dollars (2% in Peru); domestic transactions were required to be paid in local currency (Lao); several countries also implement higher reserve requirements for foreign currency deposits(Bolivia, Honduras, Nicaragua, and Peru). Some countries barely escaped dollarization by introducing financial indexation that helped contain the erosion of financial savings in domestic currency (Chile, Colombia).

3-Administrative enforcements were implemented in some countries, such as a ban on direct transfers of foreign currency deposits among residents (Israel), limitations of foreign currency lending (Lebanon, Vietnam, Malaysia, Philippines), forced conversion of dollar deposits to local currency (Peru, Bolivia, Mexico in the 1980s) and prohibition or limitation of foreign currency deposits (several African countries). Several countries relied on financial repression and capital controls (Venezuela, Nigeria, sub Saharan Africa); these measures led to capital flight, financial disintermediation, and high levels of dollarization.

If we have a look with some nice experiences, only 4 out of a sample of 85 countries succeeded in de-dollarization. Only 2 had lasting reversals with minimal side effects (Israel, Poland); for the other 2, it is too early to tell if de-dollarization will be sustained (Mexico, Pakistan). Both Poland and Israel implemented successful disinflation programs, built on a strong exchange rate anchor. Israel also used indexed assets, which proved to be an effective substitute for dollar deposits. High interest rates were applied to local currency deposits in Poland. It is unclear that these conditions can be replicated, especially since the initial level of dollarization was not too high in these two countries.

Foreign currency deposits to broad money	1980	1985	1990	1995	2000
Argentina			34%	44%	55%
Azerbaidjan				50%	40%
Bhutan					25%
Bolivia			71%	79%	85%
Bosnia					60%
Cambodia				56%	68%
Croatia				57%	70%
Haiti					30%
Israel	29%	48%	27%	20%	18%
Lao				43%	75%
Mexico	17%	3%	15%	10%	6%
Mongolia				20%	26%
Nicaragua			29%	55%	70%
Pakistan			3%	15%	8%
Peru	38%	67%	80%	63%	69%
Philippines				22%	29%
Poland		25%	80%	29%	15%
Romania			4%	23%	41%
Russia				20%	27%
Turkey			23%	47%	44%
Uruguay			80%	65%	72%
Vietnam		2%	33%	21%	32%
Yemen				23%	31%

Source: Wafa Abdelati.

4. Conclusion

Dollarization is deeply rooting to Cambodia's societies although the volume of riel being used has risen significantly over time. But the belief of people still strongly stable and not changing with using the dollars in market. Cambodia has spent several costs associated with dollarization, including loss of monetary policy and loss of seigniorage. So Cambodia should deduct gradually the levels of dollarization in market. Forwarding to ASEAN,Cambodia should be thought roughly with using the administrative regulation in order to curb using the dollars so much.Otherwise I think that it is not that it is irreversible but it lasts longer time. In these reasons ,The counter cyclical fiscal policy in public investments should be major tools beside from the monetary policy .

Financial literature and promotion of disadvantage in using the dollars to people are very useful. In addition I strongly reckon that these policies and dedollarization would take place in order to innovate the country but I would more longer act in order to get the long term utilities. . Based on international evidence and an understanding of the Cambodian context, one thing is clear: trying to enforce de-dollarisation will mean that it will take even time.

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