



**POLICY OPTIONS AND CHALLENGES
FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA**

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**DE FACTO DOLLARIZATION AND
ITS EFFECTS ON FINANCIAL DEVELOPMENT
AND ECONOMIC GROWTH
IN CAMBODIA, LAO AND VIETNAM**

**WATANABE SHINICHI
INTERNATIONAL UNIVERSITY OF JAPAN**

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De facto dollarization and its
effects on financial development
and economic growth
in Cambodia, Lao and Vietnam

Watanabe Shinichi

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1. Introduction

- In Cambodia, Lao PDR and Vietnam (hereafter, CLV) foreign currencies perform important functions of money in parallel with domestic currency, although the use of foreign currency is not legally permitted as a means of payment in Lao PDR and Vietnam.

Dollarization

Definition 1 Monetary dollarization (cash dollarization plus deposit dollarization) is the use of foreign currency and deposits as money in parallel with national currency.

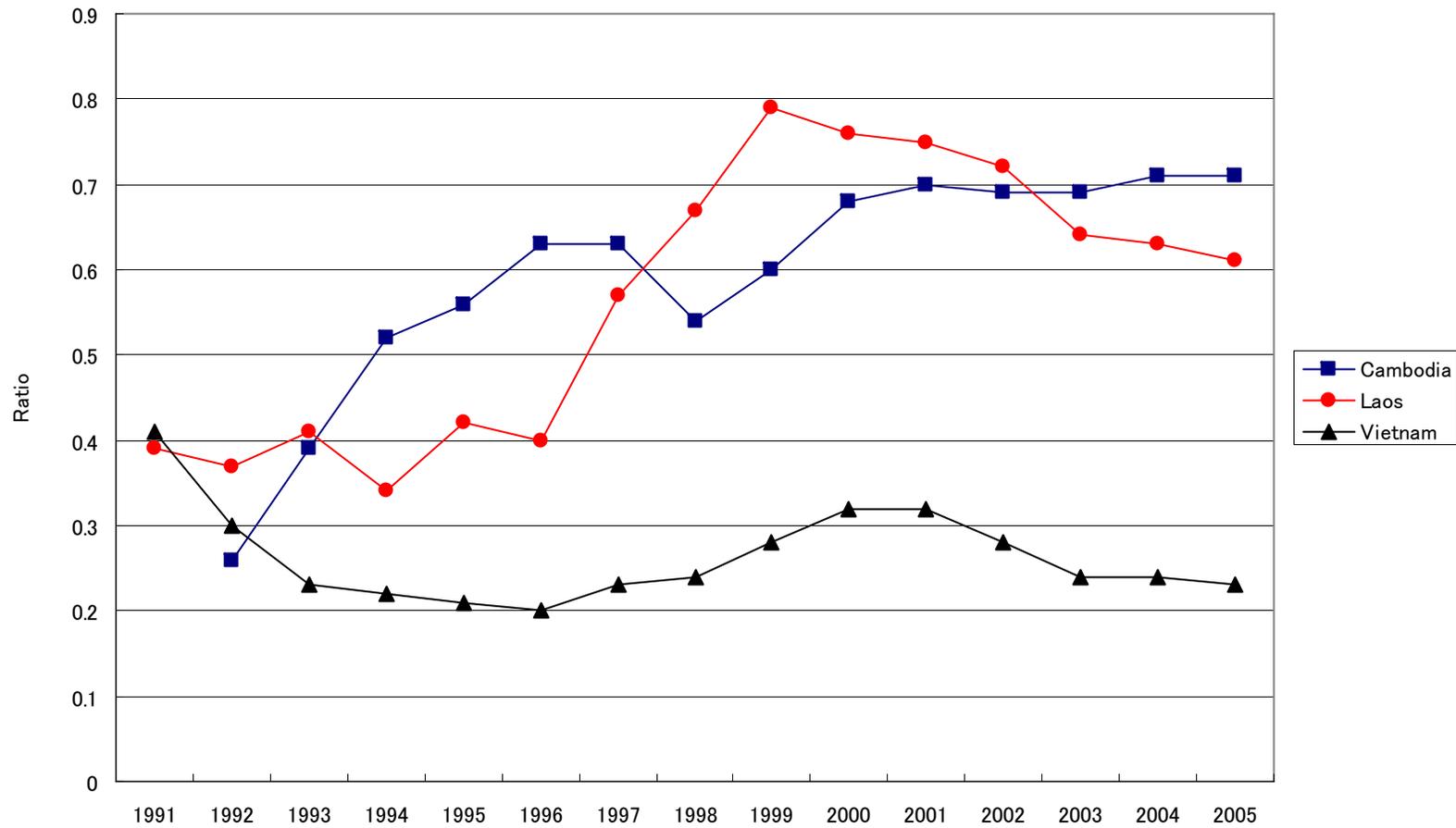
examples: the U.S. dollar, the euro

Definition 2 Financial dollarization is the use of foreign currency for financial transactions.

Definition 3 Real dollarization is the use of foreign currency for pricing wages, goods and services.

Figure1 Deposit dollarization

Figure 1 Foreign Currency Deposits (FCD) /Broad Money (BM)



Cash dollarization

- Typically currency circulates within the national boundary of its issuing country. The major exceptions are the U.S. dollar and euro. They are widely used as money outside their national or regional boundaries, although the depth and range of their use vary across countries.

Cash Dollarization in Cambodia

De Zamaroczy and Sa (2003, p. 13) estimate that 96% of total money supply of Cambodia was U.S. dollar cash and deposits during the period 1995-2000, the remaining 4% being riel cash and deposits. Furthermore they find that the amount of cash dollar was from 10 to 16 times higher than dollar deposits over the same period.

Cash Dollarization in Lao PDR

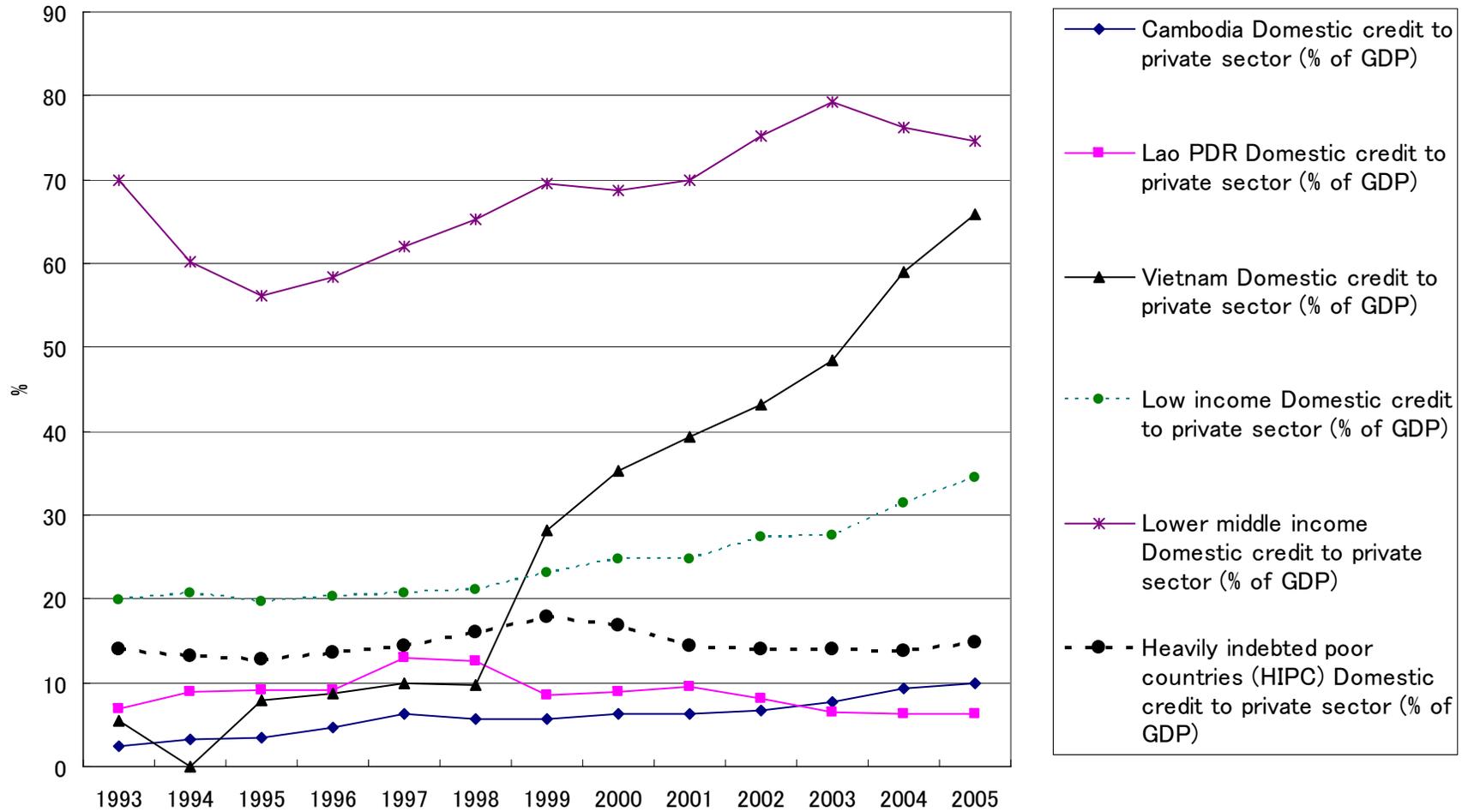
- The survey implemented by NERI in 2001 shows that the currencies used for daily transactions (including cross border trades) consisted of Thai baht (26%), U.S. dollar (26%), Lao kip (21%), Vietnamese dong (16%) and Chinese yuan (5%).

Cash dollarization In Vietnam

- The survey implemented by SBV/JICA finds that unofficial foreign exchange markets in Vietnam are quite liquid and can handle a large amount of purchases and sales of cash U.S. dollar by using the network of traders.

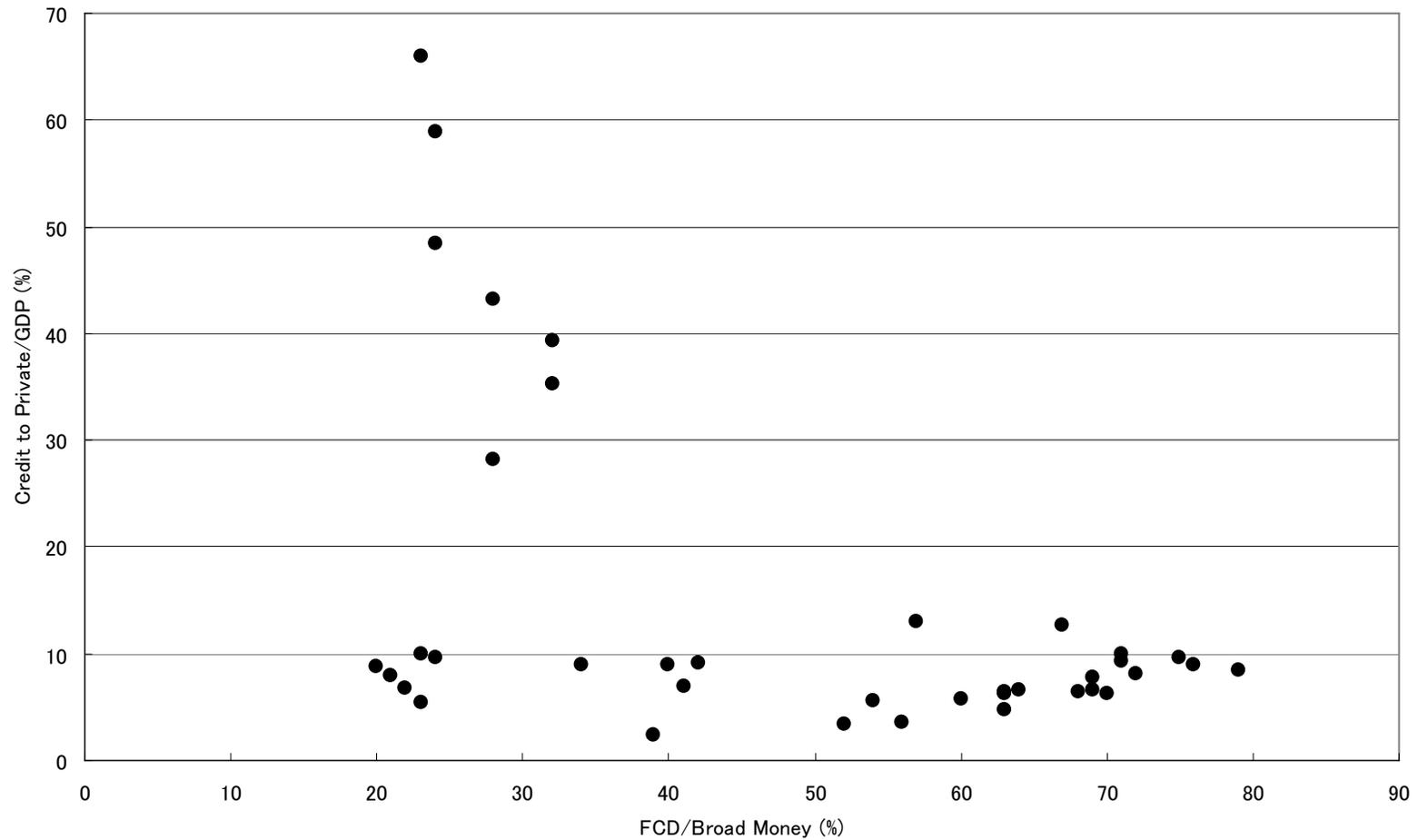
Financial Development

Figure 2 Credit to Private Sector/GDP (%)



Dollarization and Financial Development

Figure 3 Deposit Dollarization and Financial development



Question

- Do Figures 1, 2 and 3 indicate that there is no systematic relationship between dollarization and financial development? But is it true?

Positive view on monetary dollarization for financial development

- Balino, Bennett & Borensztein (1999) argue that foreign currency deposits promote financial deepening and financial intermediation in the countries where the confidence in domestic currency is lost due to high inflation and macroeconomic instability.
- De Nicolo, Honohan and Ize (2003) present the evidence that supports the argument of Balino, Bennet and Borensztein.

- This paper will argue that at least two important channels are in operation that link dollarization and financial development, and will present the evidence that supports the argument.
- Contrary to Balino, Bennet and Borensztein, we will show that higher dollarization will deter financial development.

2. A conceptual framework

- How does dollarization affect the development of the functions of the financial system?

Financial development

- Financial intermediaries perform these functions by
- (1) offering deposit facilities to individuals who desire to fill the gap between their income and consumption patterns over time under uncertainty,
- (2) finding borrowers who have promising investment projects and will be able to repay the loans with high probability, and
- (3) monitoring business activities of borrowers and exercising control over their decisions if necessary in order to secure the safety of their credits.

2.1 Self-insurance channel

- Self-insurance channel is well developed in the mainstream dollarization literature that focuses on currency risk or currency-induced credit risk of banks and economic organizations associated with dollarization of liabilities.

- An increase in dollarization discourages banks to find good domestic borrowers in order to avoid the currency-induced credit risk, and induces them to invest in liquid, risk free foreign currency assets abroad or at the central bank.
- In the long run such self-insurance behaviour of banks deters the development of their organizational capability to strengthen their screening and monitoring functions, and has negative effect on financial development and economic growth.

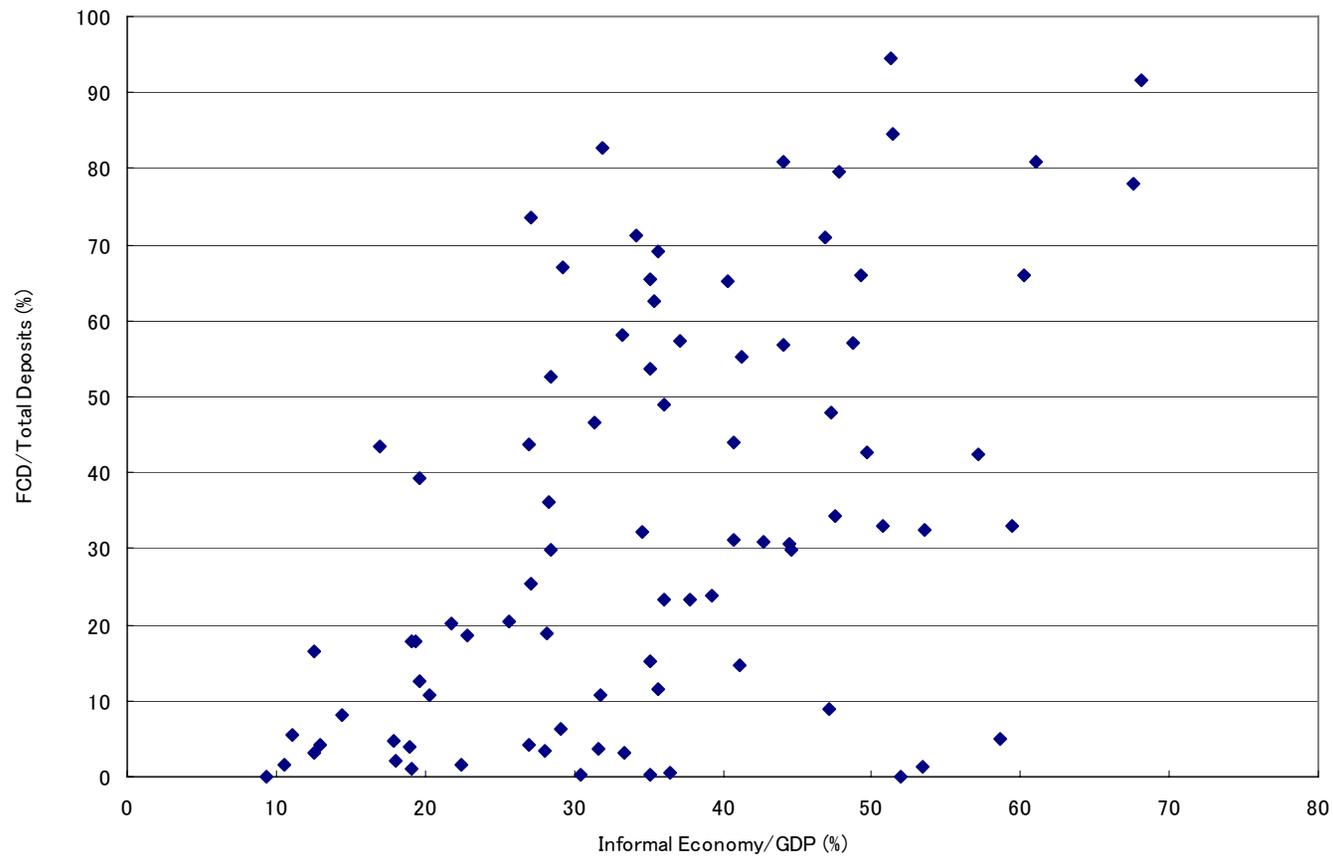
2.2 An informal remittance channel

- This section integrates the insights obtained in the previous studies on remittances that are implemented largely independently but share the view that remittances play an important role as a private supply channel of foreign currencies, some of which is informal and associated with the existence of informal economies.

- (1) Ratha (2003, 2005) show that remittances are now the most important source of finance for many developing countries, in particular for low income countries. Furthermore unrecorded remittances sent through informal channels are at least 50% higher than the recorded ones.
- (2) Papers collected in the conference volume of State Bank of Vietnam and JICA (2002) on dollarization in CLV. They demonstrate that remittances play an importance role as the money supply channel of foreign currencies.

- (3) Mourmouras and Russel (2000) examine how dollarization emerges with the smuggling of foreign currency cash.
- (4) Schneider (2004) provides the estimate of the size of the informal economies for 145 countries. All the highly dollarized economies listed in Balino, Bennet and Borensztein (1999) have large informal economies except Argentina and Costa Rica. The size of the informal economy in CLV is 52.4% of GDP in Cambodia, 33.4% in Lao PDR and 17.9% in Vietnam respectively in 2002/2003.

Figure 5 Informal economy and Dollarization



(5) Literature on the roles of laws and institutions for financial development.

- An agreement is emerging that institutional capacity, the capability of the government to enforce the law in particular, is crucial for financial development. Levine (2004) and MacFarlan, Edison, Spatafora (2003) summarize the current state of the literature.

- The observations from (1) to (5) indicate that the limited organizational capability of government to enforce the law underlies both high dollarization and the failure of financial development in the long run.

Hypothesis 1

- High dollarization discourages banks to find good domestic borrowers in order to avoid the currency-induced credit risk and induces them to invest in liquid, risk-free foreign currency assets abroad or at the central bank.

Hypothesis 2

- When the organizational capability of the government to enforce the laws (financial contracts in particular) is limited, an economy is more likely to suffer from both high (cash) dollarization and the low level of financial development.

3. Empirical evidence

Testing Hypothesis 1

Figure 6.1 Cambodia

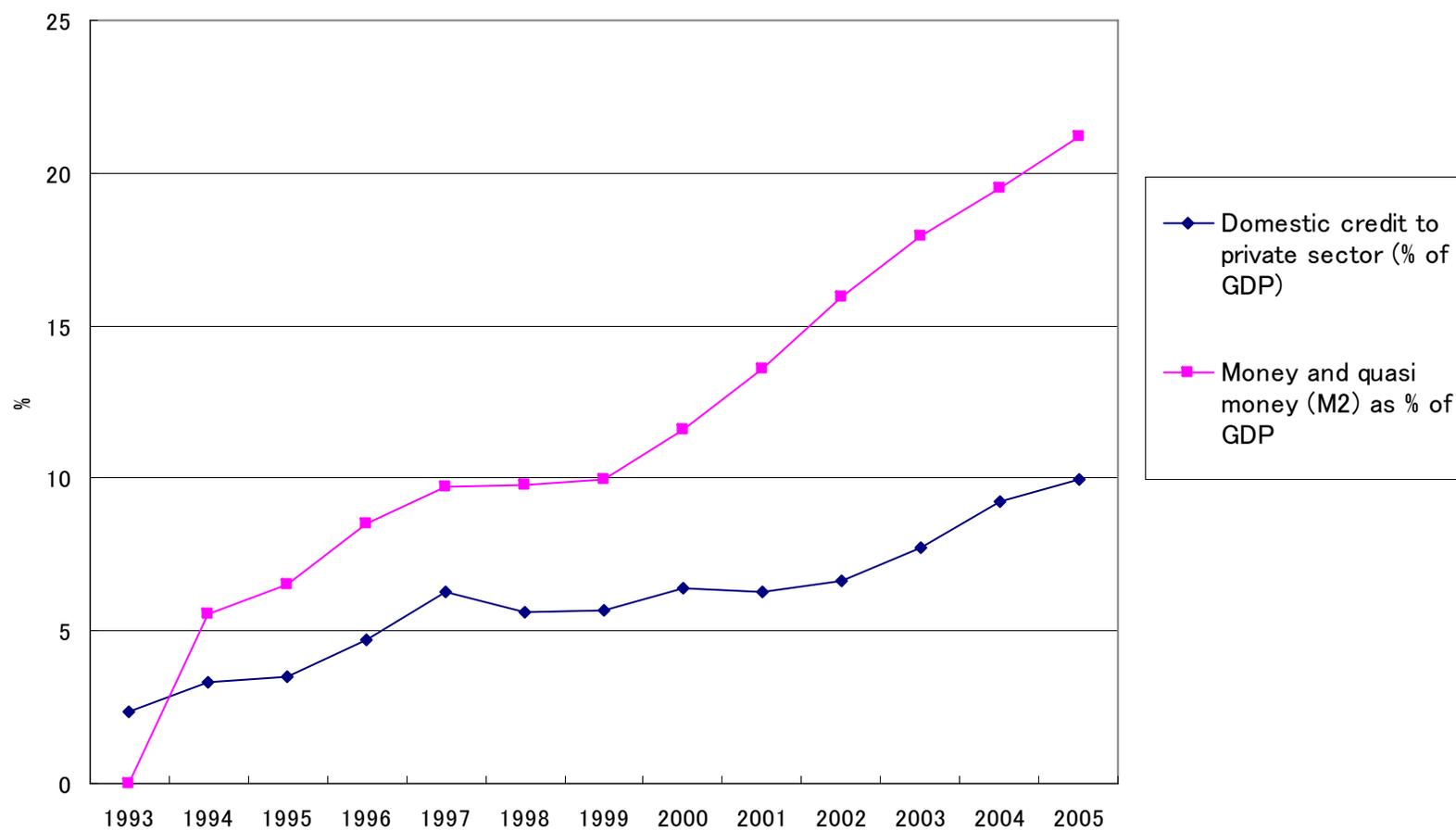


Figure 6.2 Lao PDR

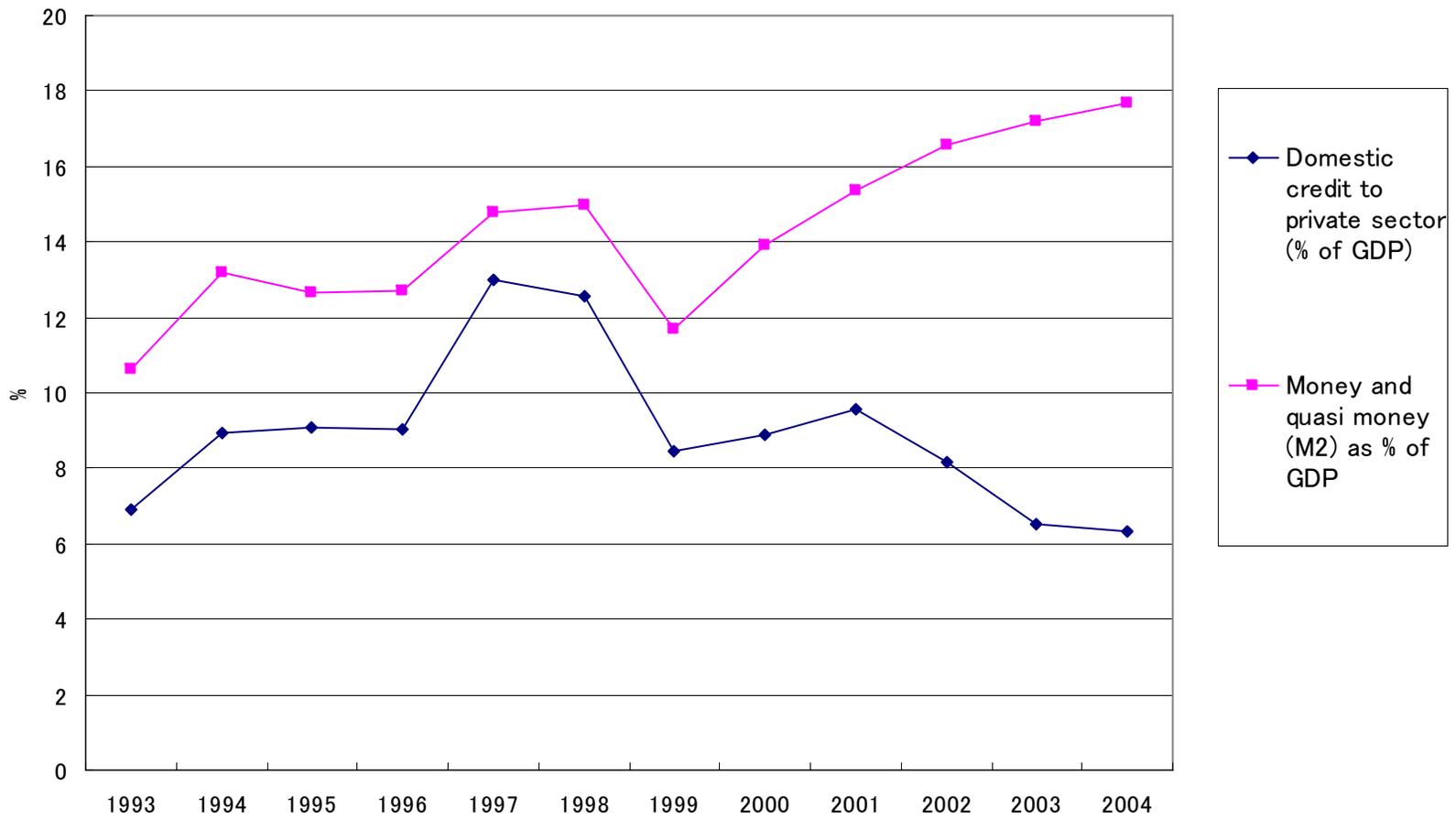


Figure 6.3 Vietnam

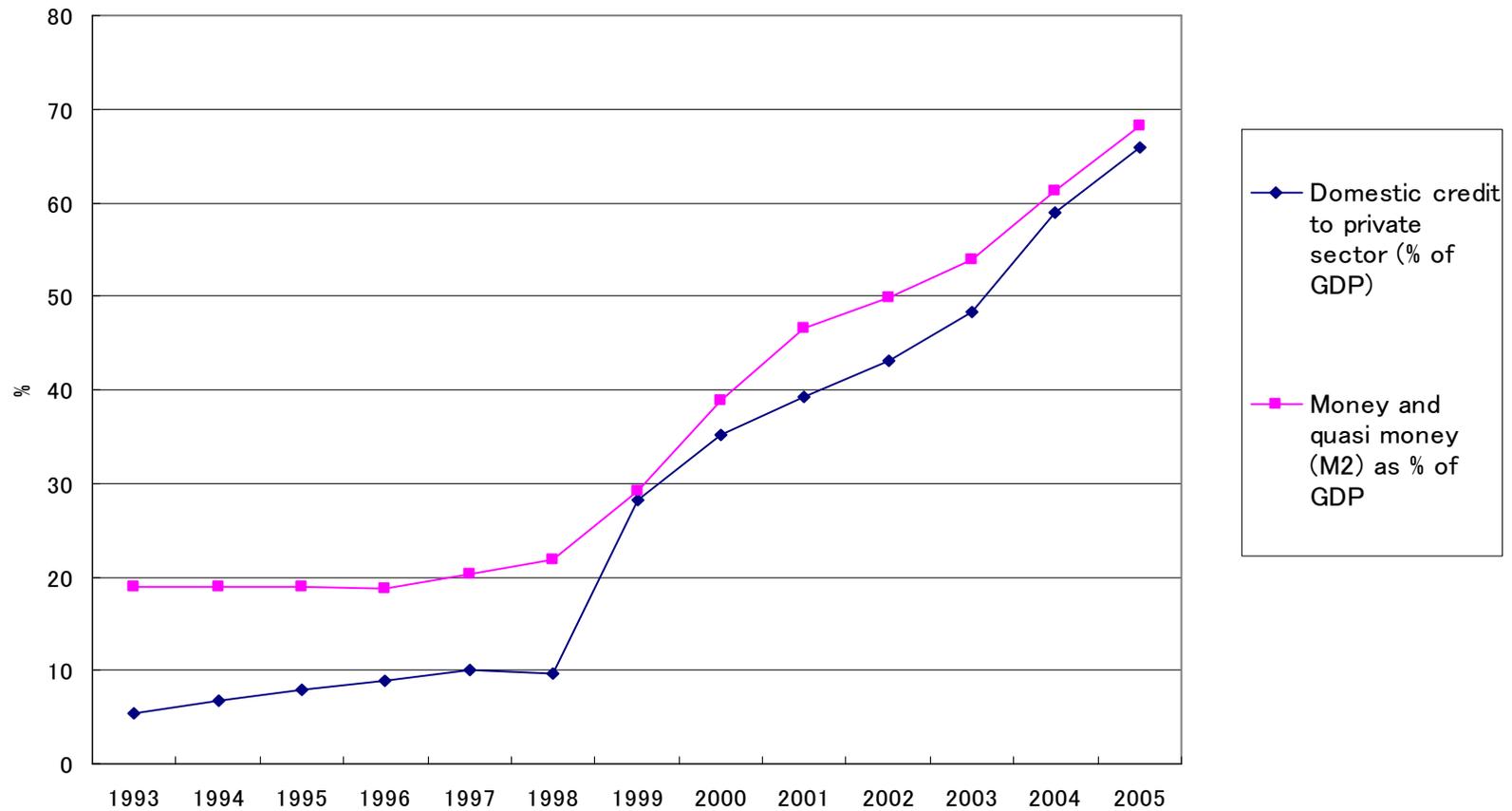
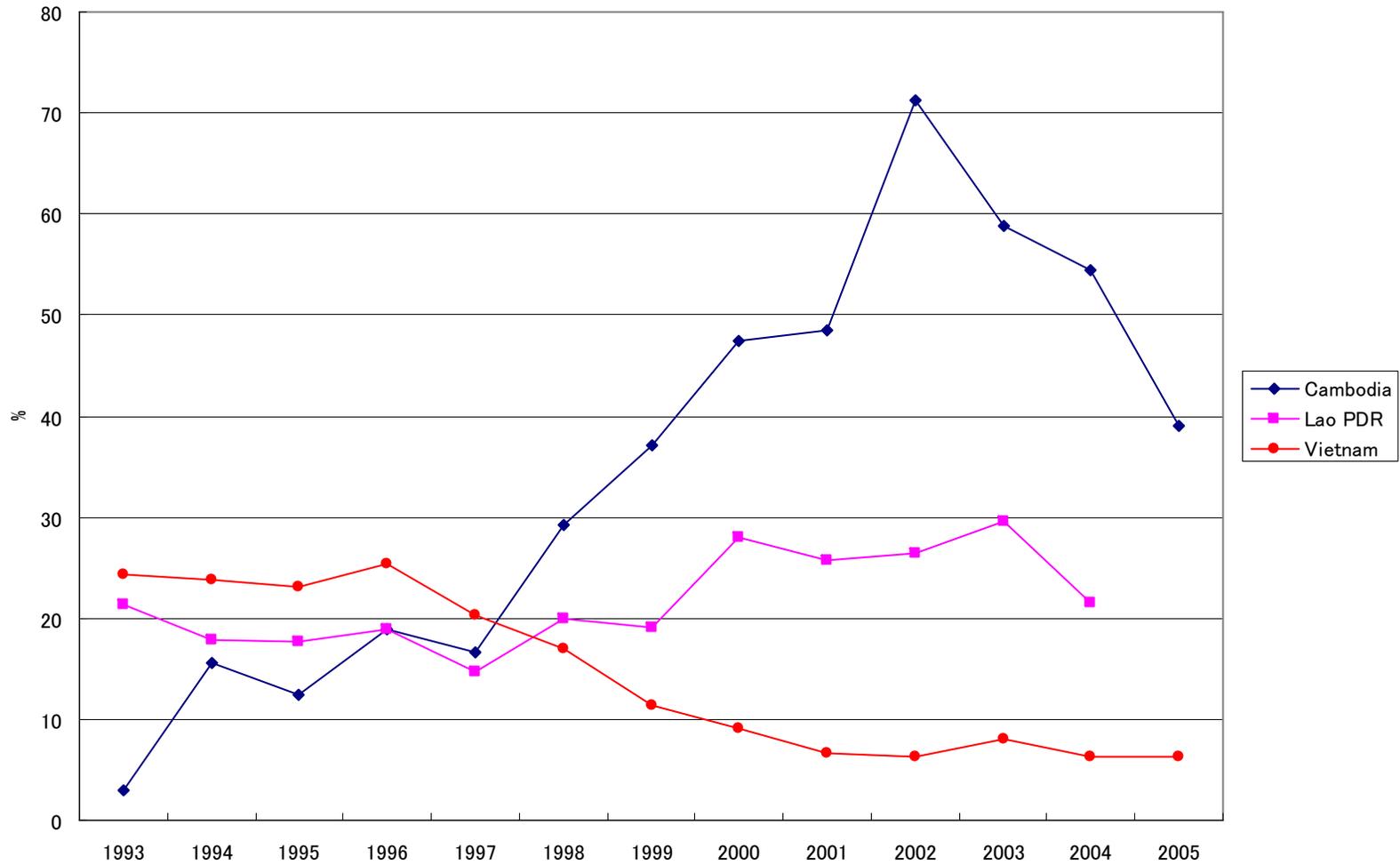


Figure 7 Reserve assets



Testing hypothesis 2

- As a measure of the organizational capability of government to enforce the laws we use the Rule of Law Index of Kaufmann, Kraay and Mastruzzi (2006).

Figure 8 Rule of law

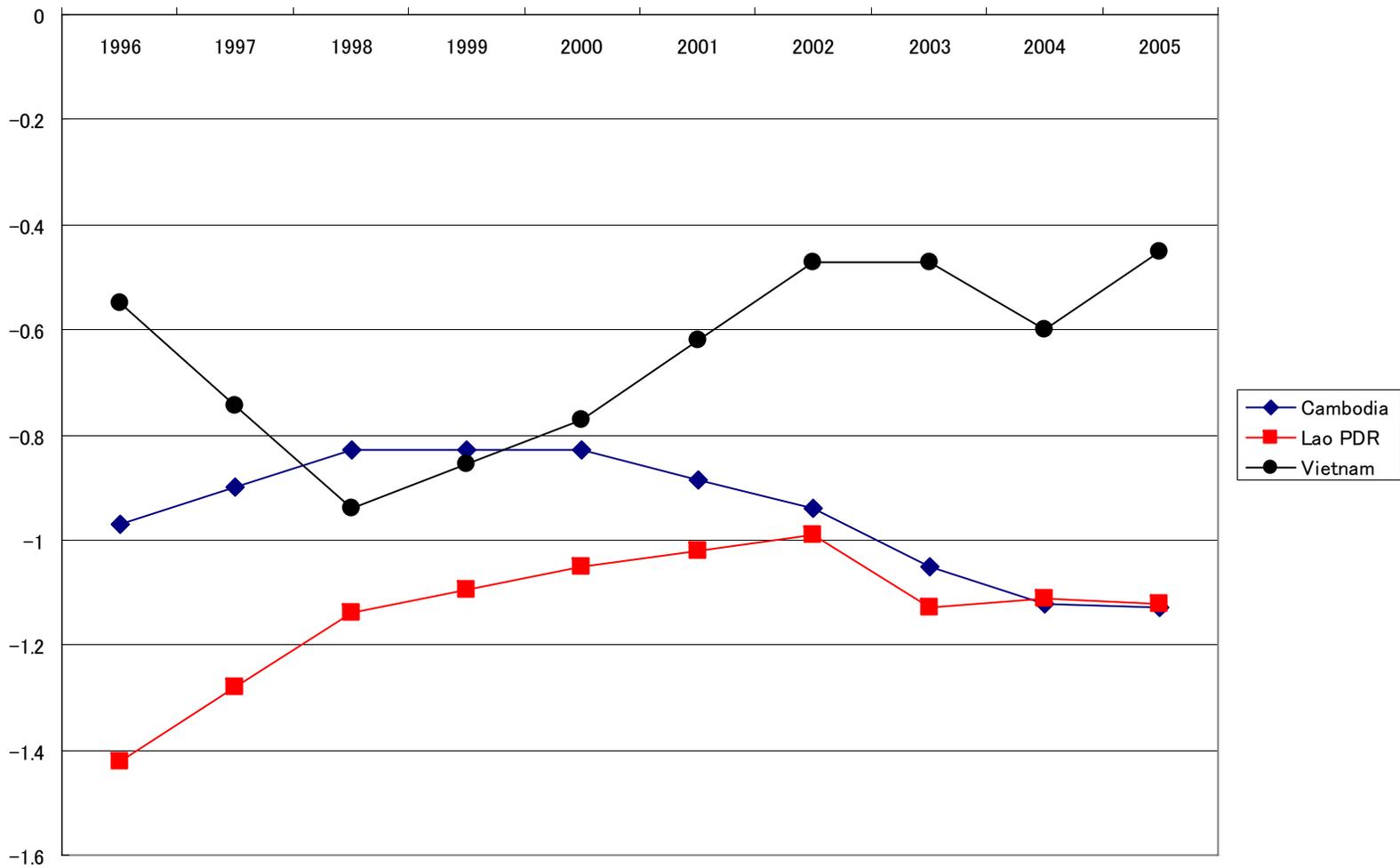


Figure 9 Rule of law and Private credits/GDP

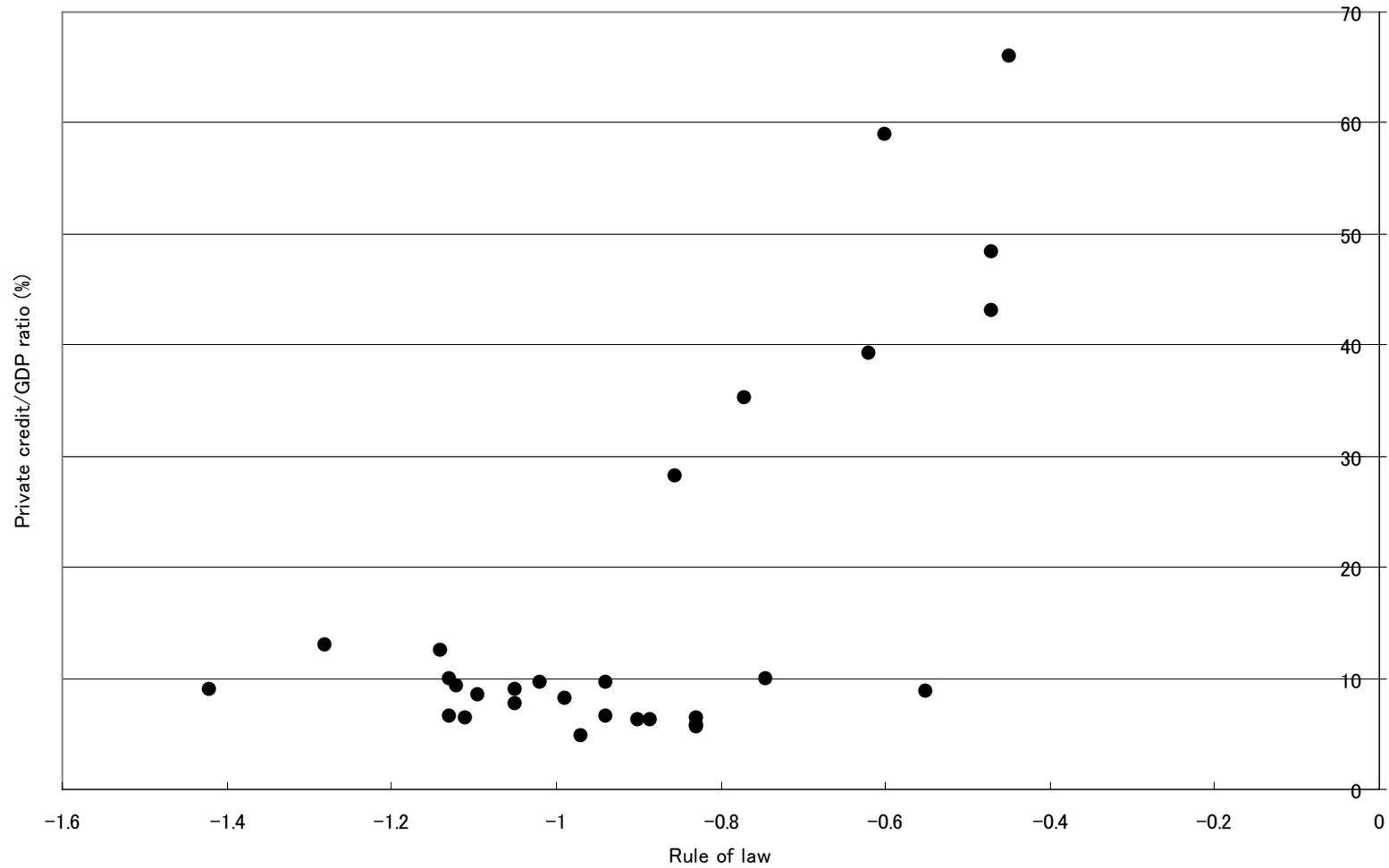


Figure 10 Rule of law and Dollarization

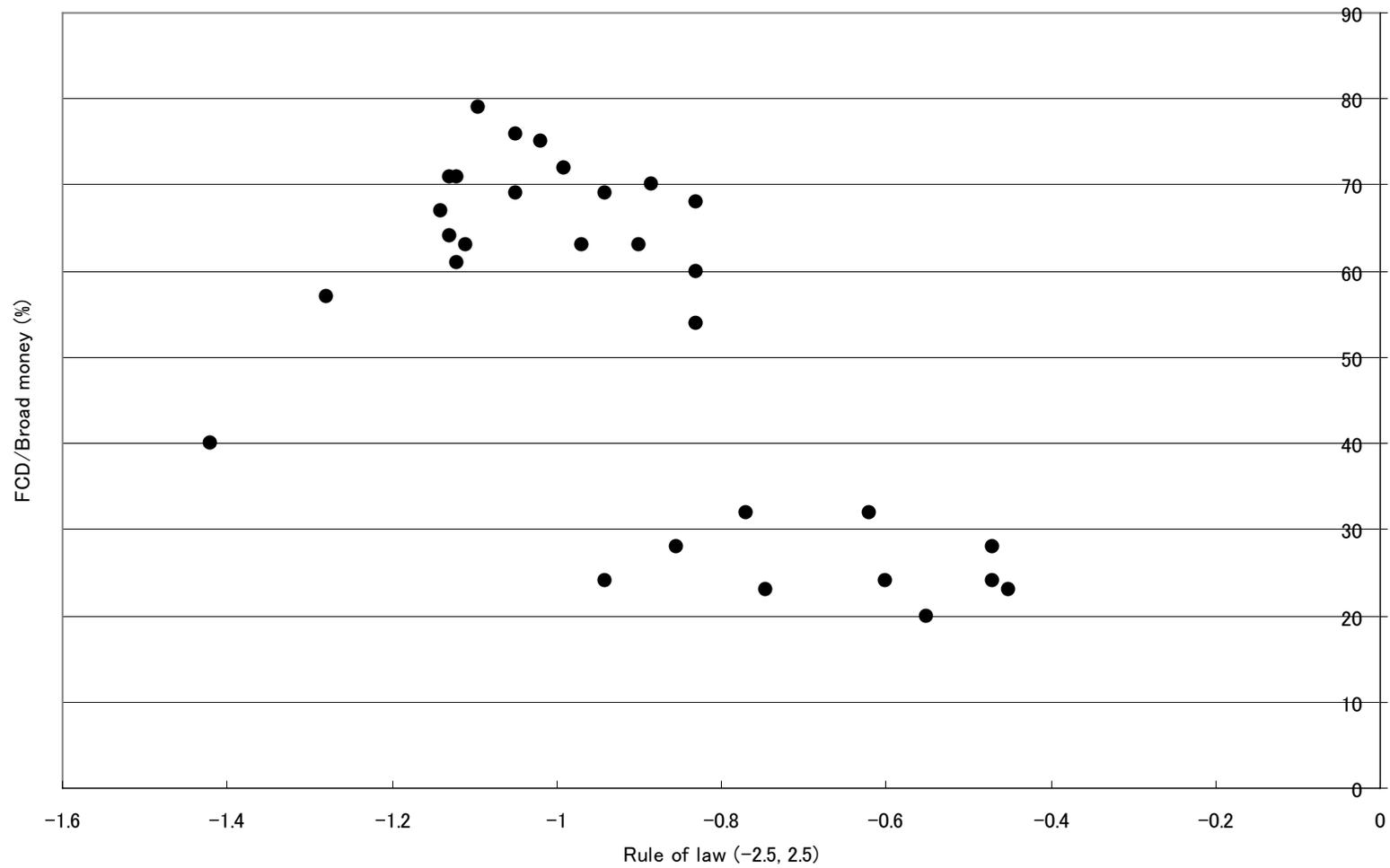
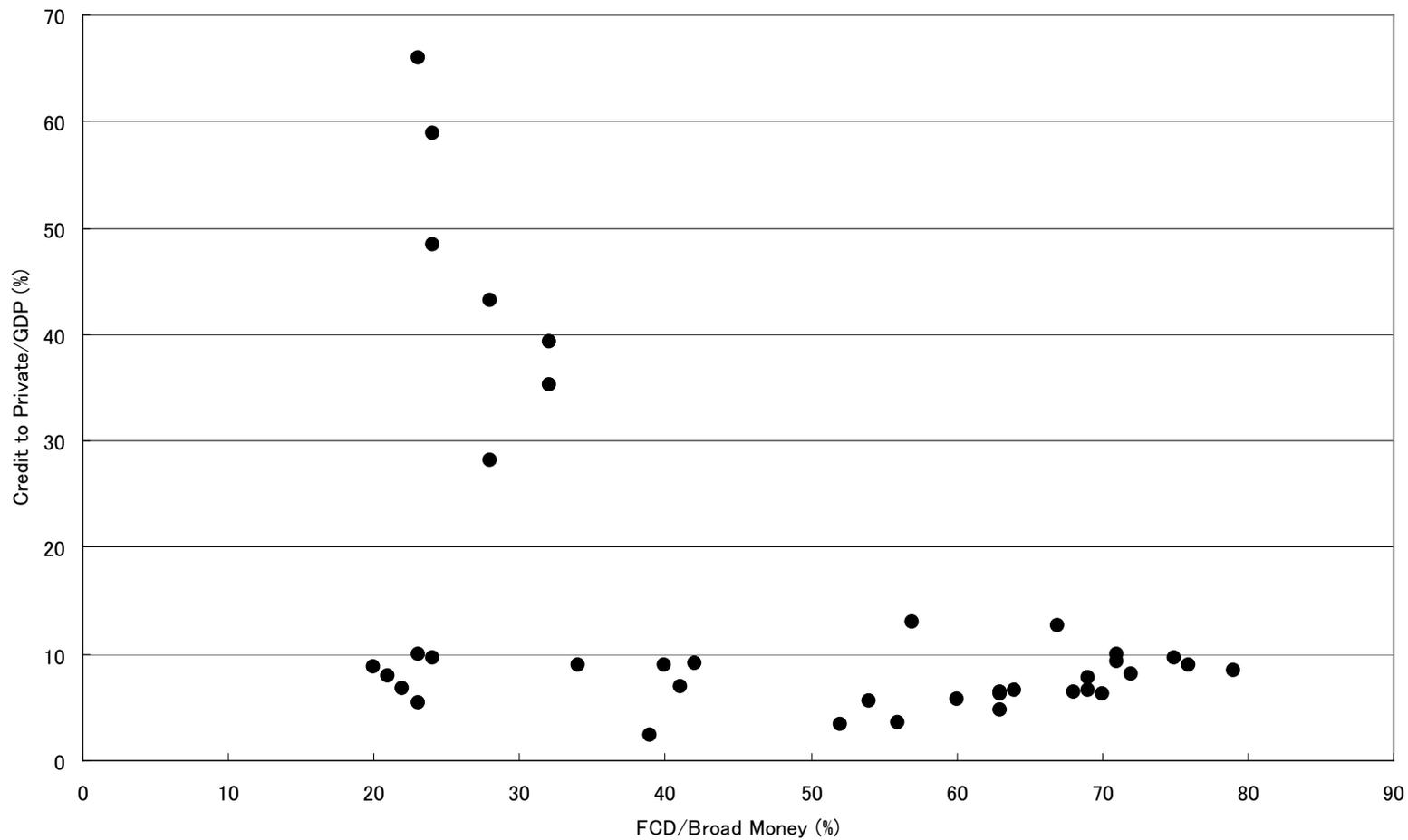


Figure 3 Dollarization and Financial development



4. Concluding remarks

- We have found a very interesting possibility in Vietnam. Important changes may be taking place which are strengthening the organizational capabilities of the government and banks, that is, the law enforcement capabilities of the government and the intermediation capabilities of banks to find borrowers with good investment projects. Dedollarization in Vietnam may reflect such progress.

- In spite of the high economic growth in recent years, the financial systems of Cambodia and Lao PDR have not yet found a way toward dedollarization. If the interpretation of the findings of this paper is correct, dedollarization will take place in the long run as the organizational capabilities of governments, banks and other financial intermediaries are strengthened.

- One important issue that is not addressed in this paper is the implications of global increase in dollarization and remittances for the architecture of international monetary system.
- An important source of the increase of dollarization in low or lower middle income countries is the increase of remittances associated with an increasing number of temporal labor migration. International community has started to establish a globally coherent policy framework that benefits all the parties concerned, that is, migrants themselves, sending countries and receiving countries.

- It is desirable to find a comparable arrangement in the area of international monetary system. The increase of people flows and remittances will continue the increasing trend of dollarization, which will increase the vulnerability of the financial system to the currency shocks or currency-induced credit risk. Given the prospect of an increasing importance of remittances as a source of development finance for low or lower middle income countries, an international monetary arrangement that helps reduce the currency risk for developing countries will become more important.