



**POLICY OPTIONS AND CHALLENGES
FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA
APRIL 19-20, 2007
TOKYO**



**COMMENTS
FROM THE NATIONAL BANK OF CAMBODIA**

**NEAV CHANTHANA
THE NATIONAL BANK OF CAMBODIA**

*Paper presented at the Conference: POLICY OPTIONS AND CHALLENGES FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA*

*Organized by the International Monetary Fund (IMF) and
Japan Bank for International Cooperation (JBIC)*

April 19-20, 2007

Tokyo, Japan

The views expressed in this paper are those of the author(s) only, and the presence of them, or of links to them, on the IMF website does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the paper.

**Dollarization and Its Effect on Growth and Financial Development
in Cambodia, Lao PDR and Viet Nam**

Professor Watanabe Shinichi
International University of Japan

Comments from the National Bank of Cambodia
Neav Chanthana, Deputy Governor

1. This paper on **De facto dollarization and its effect on financial development and economic growth of Cambodia, Lao PDR and Viet Nam** by Prof. Watanabe Shinichi gives an overview of the existing macroeconomic framework of the CLV countries, that is determined by dollarization at a varied degree in each individual economy, assess the relationship between dollarization and the present conduct of banking and financial sector of these three countries, and last but not least it attempts also to provide fruit for thoughts with respect to the implications of dollarization for the future policy courses for the economic and financial development.
2. Many economies have a certain degree of dollarization because in many countries people hold dollars as a store of value. As correctly observed in this paper and various literature, the reason for a dollarized economy is multifaceted. As a result of currency crisis dissatisfaction with existing central banking and foreign exchange system has increased, and the search for new solutions is leading some countries to look seriously at “dollarization”. I would like to call such move as “desired dollarization”. Nonetheless, I also supports the view that dollarization is driven my informal mechanism, and enhanced by a presence of large informal sector within the economy.
3. For Cambodia, I personally think that the reason is somewhere in between. First, the emergence of dollarization in Cambodia is based on a historical ground, which has been maintained due to a subsequent weak macroeconomic management and sustained due to the so called “hysteresis” phenomenon as mentioned by Giovannini

& Turtelboom (1992). Dollars started to flow into Cambodia in the mid 1980s as the United Nations began humanitarian, emergency aid, international governments organizations were allowed to return and remittances from abroad resumed. The signing of the Paris Peace Agreements, allowed UNTAC to take over the country's administration for the next two years, during this two-year period around US \$2 billion was poured into Cambodia. As a result, foreign currency deposits in the banking system started to rise notably. During the early 90s dollarization was largely a response to economic instability, high inflation, lack of confidence in the local currency and the desire of domestic residents to diversify their asset portfolios.

4. The USD is now widely used in Cambodia without being declared as a legal tender and all the transactions denominated in foreign currency are carried out in a formal way, which means that they are not considered as transactions in the informal sector to the extent that they are subject to tax and other regulations of the authorities as domestic currency transactions would do.

5. Cambodia has faced in attempting to rebuild a war torn economy, a macro-framework which has been inundated with US dollars. It is all in one: asset and liability dollarization (as 90% of banks operations are in foreign currency, mainly USD), medium of exchange dollarization and unit of account dollarization. The NBC tried to measure the degree of dollarisation using the same conceptual framework as does Prof. Watanabe Shinichi. We come to a ratio of FCD plus FCC over total money supply of about 91% and 92% respectively in 2005 and 2006 (compared with a ratio of FCD to officially measure M2 of 71% and 75% for the same reviewed years).

6. Such high degree of dollarization embodies benefits as well as drawbacks as identified in many literature and we also can find them in today paper (Watanabe's). Proponents of dollarization stress the protection gained against exchange rate risks

and limited pressure on inflation. The impact of the Asian Crisis in 1997-98 on Cambodia illustrated dramatically the isolation effect of high dollarization.

7. The paper has illustrated the short run effect of the change of foreign money supply. In this respect I fully agree that other things being equal net inflow of foreign money, as long as it is not used as stored value in the form of sleeping money, would have expansionary effect on the economy. And although the dollar in circulation does not contribute to a multiple money creation it has definitely contribute to expand economy's liquidity, which is very much desirable in case GDP is at below potential and the supply of goods and services is able to response to increased demand.

8. With respect to the downside risks, though I prefer to support the view that the larger the countries using the dollar, the greater will be the gains from reducing exchange risks, but such risk still remain as banks cannot fully hedge their credit exposure, as Prof. Watanabe clearly pointed out in his presentation. Such situation can be particularly observed in the micro-finance sector in Cambodia, where MFI's loans to rural household are predominantly in domestic currency. Currency risk is also one of the reasons why commercial banks tend to decline from operating in small retail rural credit operations.

9. Nonetheless, I could not see that dollarization would have negative effect on financial development and economic growth in the long run. In general, when selecting borrowers banks are less concerned with currency risk. With local currency notes representing about 27% and 9% of officially measured M2 and estimated total money supply, respectively, there is little room for large business being conducted in local currency. Therefore, banks' primary concerns associated with lending are placed on other things such as legal enforcement of the business contract, lack of borrowers' information such as financial statement or cash flow etc. This is further intensified by

banks own specific weakness such as lack of credit culture and insufficient knowledge and capacity of banks' personals for credit appraisal. Saying this, it is positive correlation between the rule of law and financial development, whereby it would be more interesting to include deposits as well in the indicator for financial development.

10. Before concluding, I would like to make some remark on the use of variables for the measurement of specific conditions. There is no doubt about the important place of the monetary and financial data in the statistics of an economy. However, the interpretation of those statistics becomes complicated when taking into account all the technical aspects involving the structures, definitions and other issues associated with each individual variable that might also have influence on the real situation of the economy. The gap or negative relationship between Cambodia's money and credit or FCD and credit are in fact less an issue of dollarization, but a reflection of lack of investment opportunity. In a matured economy, it is more likely that a given increase in banks deposits would bring about a fair increase in investment. However, while FCD with domestic banks can adjust quickly as a result of push and pull factor existed in the local economy and external market, domestic investment opportunity cannot be created overnight, given a less developed state or poor starting conditions of the economy. It is therefore the task of the authorities to create conducive environment for investment to take place, including the legal framework, and other necessary infrastructure.

11. To conclude I would like to highlight that dollarization has so far contributed favorably to the stability of the monetary system and growth performance in Cambodia. In the face of very high dollarization, the NBC's monetary and exchange policies and the Ministry of Economy and Finance's (MEF) budget policy have

served Cambodia well since 1999. By refraining from bank's budget financing on the one hand, and by introducing a managed floating exchange rate regime, on the other hand, both institutions have been conducting a mutually reinforcing macroeconomic policy mix. Very high dollarization, coupled with prudent macroeconomic policies, has thus largely sheltered the Cambodian economy from the international economic turmoil, while providing a propitious environment for growth and poverty reduction, and giving therefore some breathing space for the authorities to create an environment to promote the use of local currency in the future.

