Promote Riel and De-dollarization through Exchange Rate Policy: Fix or Float or Anything Else?

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Abstract

Exchange rate policy has an important role in promoting local currency and de-dollarization because it is one of the policy instruments that monetary authorities could use in order to boost confidence local currency. In setting exchange rate policy, there have been a lot of debates on whether to fix it or allowing it to float or combination of these two. There have been also a lot of debates on what are additional measures that country could adopt to accompany with the exchange rate policy in order to promote local currency and to de-dollarize successfully.

This paper reviews existing studies and reports on the exchange rate policy and the complementary measures and we conclude that for a small, open economy and under highly dollarized economy like Cambodia, the floating exchange rate regime—the Cambodian government adopted—is appropriate. But, adoption of the exchange rate regime alone is not sufficient to promote Riel and de-dollarization. There are two priorities Cambodia needs to do in next 5-10 years. The first priority is developing a comprehensive plan to promote Riel and de-dollarization. Such plan would need to be developed by relevant authorities, who would be responsible for the implementation. The second priority is the establishment of a task force that has sufficient capacity to response to market's reactions when the de-dollarization plan is enforced. From the experience of countries that have attempted to de-dollarize their economies, the success or failure depends very much on whether the market looks at the plan and the authority who implements the plan that is credible or not. Therefore, stronger efforts need to be made to build capacities of relevant institutions what would be responsible for the formulation and implementation of the de-dollarization plan.

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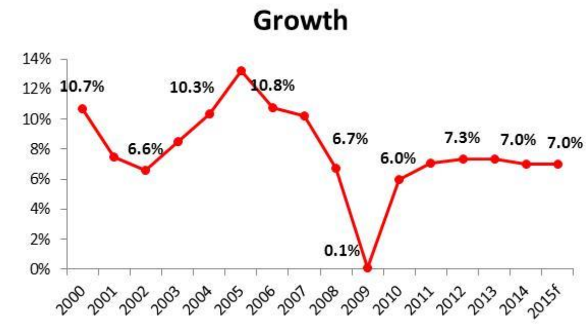
[1] The paper is written by Neak Samsen, Head of Economic Research Unit at Nuppun Institute for Economic Research. The purpose of the paper is to contribute to policy debates at 2nd Macroeconomic Conference under the theme of "Leveraging Financial Markets to Promote Use of Riel", organized by National Bank of Cambodia in September 2015.

A. Introduction and Rationale

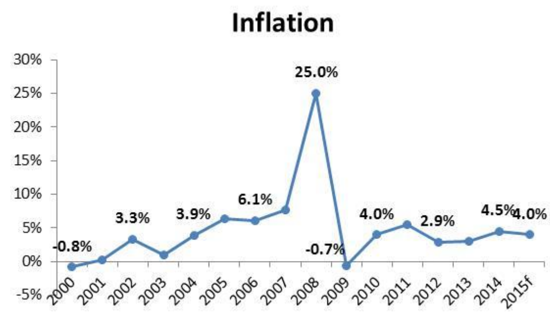
Cambodia has had greater political, economic and financial stability over the past 15 years. Cambodia is considered as one of the countries that has relatively political stability. The internal armed conflicts were completely ended in 1997 and political parties challenged each other to take power through ballots. From 2000 to 2014, the economy grew at 7% on average and the growth outlooks for 2015 and in next few years is expected remain strong at 7%, based on latest assessments by multilateral development financial institutions ADB, IMF and WB[2]. Government expenditure and public debts management has been sound despite slight downsize risks of contingency liability. Banking sector was not affected strongly by the 2008 global financial crisis. Inflation rate has been at the official target of below 5%, except in 2008 when the country's was impacted by the global fuel and food crisis.

Figure 1: Economic growth rate, 2004-1015



Source: National Institute of Statistics

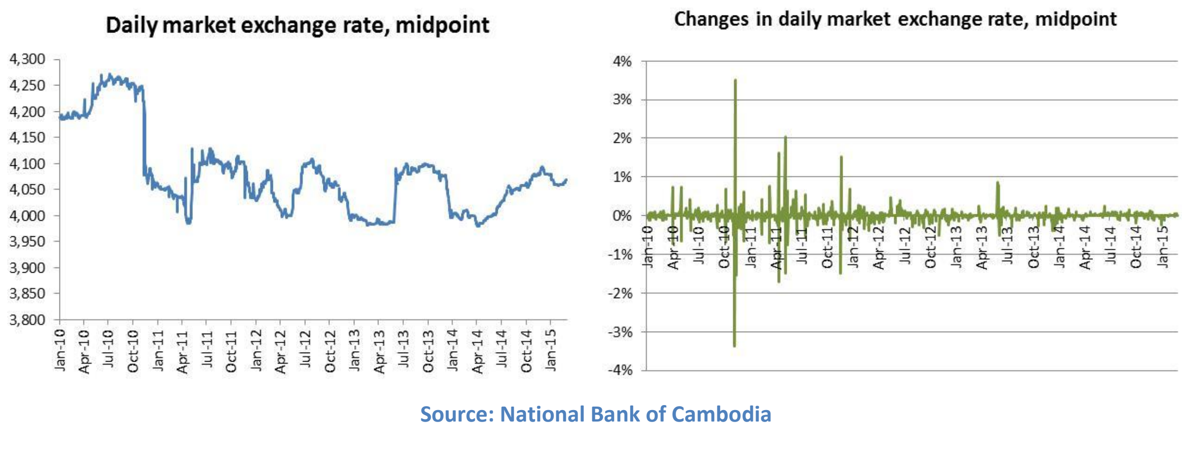
Figure 2: Inflation rate, 2004-2015



Source: National Institute of Statistics

Exchange rate between Riel and US dollar has been stable. Fluctuations of daily exchange rate between Riel and dollar were low, which are mostly at +/- 1% or +/- 2% or at most +/- 3%. This suggested that Cambodia is one of the countries that have stable exchange rates. Many countries including developed economies target their exchange rate to move+/-1 or 2%; some developing countries even allow their exchange rate to fluctuate up to +/- 4 or 5% and at these levels of movement, they were considered it as stable.

Figure 3: Daily exchange rates and its movement



Source: National Bank of Cambodia

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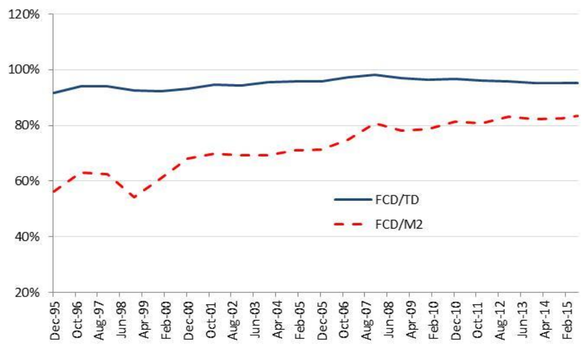
[2] Asian Development Bank projected Cambodian economy to grow at 7% in 2015 and 7.2% for 2016; The World Bank projected Cambodian economy will grow at 6.9% in both 2015 and 2016. IMF forecasted the economy would grow at 7% in 2015.

The government has implemented a number of measures to encourage the use of Riel. The measures include higher reserve requirement (12%) for US dollar deposits compare with (8%) for the Riel deposits; all government transactions, taxes and utilities are in Riel; and encourage business entities to quote their prices of goods and services in Riel.

Despite there have been political, economic and financial stability as well as the government's efforts to promote Riel, the degree of dollarization in Cambodian economy has not decreased. In contrast, it has increased. This was observed by the large amount of foreign currency deposits in banking systems. The ratio of foreign currency deposit to total deposits has been well over 90% since 1995[3]. The ratio was at 92% in 1995; 93% in 2000; 97% in 2010; and remained high at 95% in 2015. Another common measure of the degree of dollarization is to look at the ratio of foreign currency deposit to total money in circulations (broad money). Data suggested that the ratio of foreign currency deposit to broad money had actually been risen. In 1995, the ratio was at 56%; it increased to 68% in 2000; to 81% in 2010; and to 83% in 2015.

Figure 4: Deposits of foreign currencies



Source: National Bank of Cambodia

B. Key findings from Literature

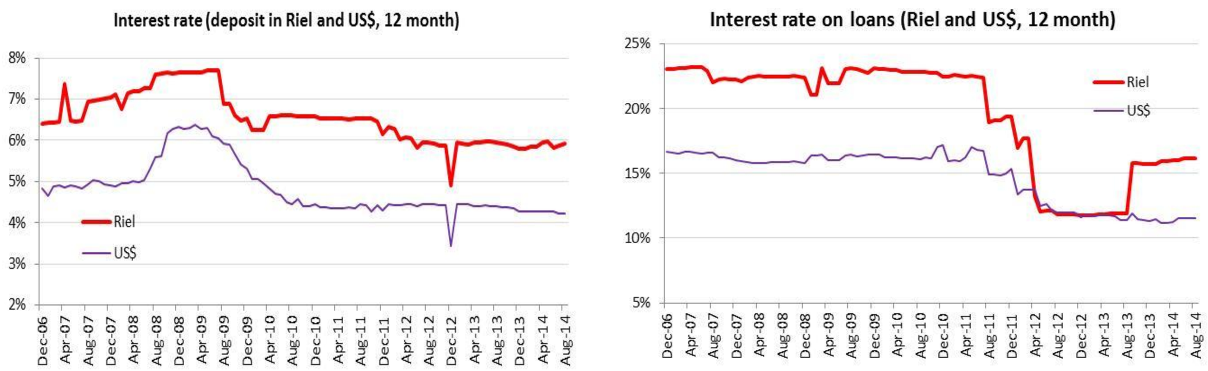
It is still unclear why dollarization in Cambodia has not been reduced even the country has had the greater stabilities for 15 years. There could be many reasons and those reasons re-enforced each other, but perhaps the persistence of dollarization in Cambodia is due to losses of confidence in Riel resulted from abolishment of Riel during the Khmer Rouge from 1975-1979 and poor macroeconomic management and economic stability in late 1980s and early 1990s.

Another possible reason that contributed to the dollarization is due to interest rate policies. Interest rate policies in Cambodia encourage Riel for making deposits, but discourage it when making lending. So, the policy has encouraged people to keep foreign currency. Banks favor of Riel in getting deposits as they had given interest rate 2% higher than those of deposit in US dollar. In 2014, deposits in Riel for 12 month, on average, could get interest rate at 6% while deposits in dollar for the same duration could get interest rate at 4% only. But when making loans, banks encourage

[3] The best way to measure level of dollarization in an economy is to know the volume of dollar in circulation, then compare it with the volume of local currency. But, this is very difficult do given that in cash-based economy, a large proportion of dollars are circulated outside the financial systems.

dollar. Bank charged interest rates for loans in dollar about 6-7% lower than those loans in Riel. This was observed from 2006 to August 20111, before there is a flip of charging interest rates in Riel loans closer to those in dollar. But this was not durable, starting in 2014; the gap between loans in Riel was high again at around 4-5 % difference. A loan in dollar was charged at 11-12% in 2014 compared with loans in Riel at 15-16%. The higher for loans in Riel has discouraged need of Riel in the economy.

Figure 5: Interest rate on 12 month deposit and loan in Riel vs. Dollar



Source: National Bank of Cambodia

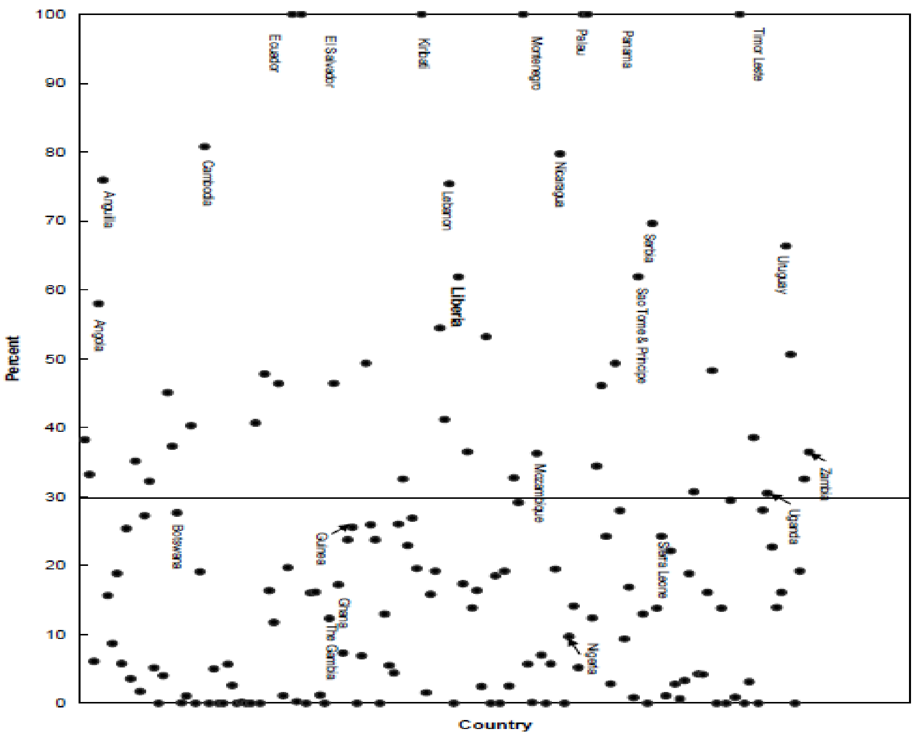
And, does it have anything to do with the exchange rate policies the government has implemented? The government implemented "managed float" that has made the exchange rate between Riel and US dollar very stable.

Cambodia is one of the highest dollarized economies in the world. The ratio of foreign currency deposit to broad money in Cambodia is about 80%, making Cambodia one of the highest dollarized economies in the world (Figure 5). Economies that have higher levels of dollarization than that of Cambodia are Timor Leste, Palau, Montenegro, Kiribati, El Salvador, Ecuador and Panama, but these countries have adopted full dollarization. For other developing countries, all of them have lower degree of dollarization. For example, ratio of foreign currency deposit to broad money in Angola is 58%; Lebanon (78%), Liberia (64%), Vietnam (20%); Laos (50%), Mongolia (30%).

Yet, dollarization is not necessarily all bad things. It also provides benefit to the country. One main benefit of using dollar provides incentives to foreign firms to come to Cambodia. Foreign firms who want to do business in Cambodia do not have to worry about foreign exchange rate risks for their operations; so does it provide easiness to repatriate their profits back home. Another benefit of using dollar is the attraction of tourism sector in Cambodia. Foreign tourists do not need to feel hurdle about changing the money at airports and hotels and to spend time to covert to US dollar in order to know the value of a particular good or service.

Although dollarization provides benefit to the economy, the Cambodian government has made it clear that the high level of dollarization is not the desire of their economic policies. This is because dollarization has made government lost control over its key monetary policies and would limit National Bank of Cambodia's abilities to have meaningful interventions. Dollarization also made financial sectors of the country more vulnerable to shocks. Apart from currency substitution and the loss of seigniorage, the government and central bank needs to have autonomy of monetary policies and full options to implement monetary policy instruments to facilitate economic growth and particularly to prevent economic and financial crisis or to stabilize macro and financial stability including as a lender of last resort when the economy facing economic or financial crisis or to minimize adverse impacts of the crisis.

Figure 6: Comparison of dollarization across countries measuring by foreign currency deposits to broad money



Source: Lodewyk Erasmus et all "Dedollarization in Liberia—Lessons from Cross-country Experience", IMF Working Paper WP/09/37

The government also has a policy intention to de-dollarize at a level that National Bank of Cambodia regains central bank's independence over its monetary policies. One major reason for the persistency of high dollarization is perhaps due to the high depth of dollarization, the prevalence of cash in the economy and under-development of financial systems, which caused the central bank's reluctant to enforce forced measures. However, the government also has made it clear that while the long term goal is to de-dollarize, in the short to medium term, people could use dollar officially and unofficially. And at the same timer, the government would take measures to increase the use of Riel gradually.

There are countries that have successfully de-dollarize. The country that has successfully de-dollarize does not mean they could completely de-dollarize. If a country could reduce the ratio of foreign deposit to broad money to below 20% for a long period of time, it would be considered as a successful country. Countries that have been considered as successful in de-dollarize include Indonesia, Israel, Poland, Mexico, Egypt, Turkey, Vietnam, and Pakistan[4]. There are also countries who attempted to de-dollarize, but not successful. Those countries include Laos, Cuba, Liberia, or Russia.

[4] Countries that have successfully de-dollarized are defined loosely as countries that could reduce the share of dollar in broad money. Israel, Poland, Mexico, and Pakistan could reduce the share of foreign currency deposits in broad money by at least 20 percent and settled at a level below 20 percent. Nombulelo Duma (2011)

There are measures that Cambodia could promote Riels in the short to medium term and ways to de-dollarize in the longer term. These measures, regardless of market-based measures or forced measures, includes policies and measures related to three areas (a) macroeconomic policies and public debt management (exchange rate policy, monetary policy, fiscal policy/taxation, and debt management), (b) financial policies; and (c) prudential regulations on financial sector[5], and (d) a number of administrative measures that facilitate enforcements of macroeconomic and financial policies. Implementation of those measures need to have careful, sequence, and comprehensive plan and ability of the National Bank of Cambodia and other relevant authority to implement it so as to make the plan look credible and de-dollarization is durable. If not managed well, such measures could be counterproductive; making people even lost more trust in local currency and increase use and keep of dollar.

The have been some studies and papers on dollarization in Cambodia. One set of papers focused on empirical analysis of the relationship between dollarization and exchange rate. For example, Sovannaroeun Samreth (2011) conducted an empirical study on the hysteresis of currency substitution in Cambodia using data from June 1993 to June 1999. The paper concluded that the persistence of dollarization in Cambodia is partly due to long tradition in using dollar in the country, but partly also because of stable exchange rates. In other words, the paper found that stable exchange rates for a long period of time in Cambodia are one of major causes that make dollarization persistence.

Kem Reat Viseth (1999) conducted an empirical analysis using monthly data from July 1993 to April 2001 and concluded that dollarization in Cambodia was to substitute local currency Riel and the reasons that people had used US dollar is because of depreciation of Riel.

Sok Heng Lay, Makoto Kakinaka and Koji Kotani (2010) conducted empirically analysis of the relationship between dollarization and exchange rate movements in Cambodia using data from. They found that dollarization is one of the main reasons that had caused Riel depreciated as well as intensified exchange rate variability in Cambodia.

Another set of papers focused on policy suggestions to address persistent dollarization. For example, Jayant Menon (2008) suggested that to de-dollarization, Cambodia should not use forced de-dollarization. Instead, Cambodia should accelerate policy reforms in financial sector and legal and institutional framework in order to prepare ground works for a natural process of de-dollarization.

Nombulelo Duma (2011) suggested that de-dollarization had to be gradual. In order to de-dollarize, Cambodia should focus on efforts to have continued macroeconomic stability and supportive policies to promote Riel and Cambodia needs comprehensive market-based strategies that may include (i) exchange rate policy and other measures, (ii) further development of financial market including interbank market, (iii) financial policy and prudential regulation (higher reserve requirement on dollar and lower reserve requirement on Riel, deposit insurance system and having higher rate for Riel, and maintaining a sufficient level of international reserves, encourage use Riel as unit of account, and encourage use of Riel through lower tax rates). Nombulelo Duma (2011) also suggested that exchange rate policy is endogenous; so exchange policy alone to stabilize exchange rate and inflation are not sufficient. It needs to do with other measures.

[5] These policies and measures are explained clearly in IMF Working Paper written by Annamaria Kokenyne, Jeremy Ley, and Romain Veyrune

Phurichai Rungcharoenkitkul (2014) stressed that measures to achieve the policy objective of financial sector development and de-dollarization has to be hands in hands and cannot be prioritized one over the other. While it is important to deepening the financial sector development further, initiatives and measures for the deepening will have to be undertaken. However, such initiatives and measures when implemented have to also avoid the encouragements of asset and financial dollarization.

In this paper, we focus on the choices of exchange rate to promote Riel and de-dollarize— that is in order to promote Riel and de-dollarize, which exchange rate regime would be suitable for Cambodia under different circumstance? In other words, the focus of this paper is to assess which exchange regime (fix or float or blend) would be suitable for Cambodia in order to reduce dollar in the economy in the future and what complementary measures that has to bring in with the exchange rate policy; so that it is more effective. Fixed exchange rate means making the rate at a certain level and doesn't allow it move. Floating exchange rate means allowing the rate to move. Blended exchange rate means combination of the fixed and the floating.

Fix or float or blend has both pros and cons. There is no perfect choice of one exchange rate to another. On the one hand, fixing the exchange rate would make the business agent free of risks from rate fluctuation, and therefore reduce certainties for international trade and investment. Fixing the rate would help the government to refrain domestic inflation pressures and disinflation after price instabilities. Yet, fixing the rate is very costly for the government and the economy when the country faced speculative attacks on its local currency. On the other hand, floating the exchange rate would not cost the government and central bank resources in order to stabilize value of local currency and reign over inflation. However, allowing the rate to float would limit policy options of the central bank to do adjustments in controlling domestic inflation and make business operations having additional risks that could stemmed from currency fluctuations.

In the literature, there seems to be more arguments in favor of the floating exchange rate regime over the fixed regime. The suggestions of using the floating exchange rate are strongly recommended for both developed and developing economies and there are three reasons for that. The first reason is that it is very costly for the government and central bank to try to maintain a fixed exchange rate. The good example is the experience from United Kingdom in 1992 and Mexico in 1995. The Bank of England lost 5$ billion in few hours in September 1992 and Mexico spent $25 billion from reserves and borrowed $25 billion and suffered a huge loss, according to Maurice Obstfeld and Kenneth Rogoff (1995). Secondly, even if some government who could fix the exchange rate, they couldn't do it for long. Most of the countries who tried to fix exchange rates to stabilize their macroeconomy during financial crisis couldn't do it for years. At some point, they allowed it to float because the government and its central back were running out of resources to keep the rate fixed. Thirdly, the volume of world exchange rate market trading is too big for any countries to defense any speculative attacks. The world exchange rate was traded at 3 trillion per day, which is higher than the total economic size of UK (US$2.9 trillions); France (US$2.5 trillions); India (US$2.3 trillions); Brazil (US$2.9 trillions), Italy (US$1.8 trillions), Canada (US$1.6 trillions). The volume of the world exchange rate trading is only lower than three top biggest economies in the world: US (US$18.1 trillion), China (US$11.2 trillion), and Japan (US$4.2 trillions).

Main papers that have argued for the floating exchange are the following. Maurice Obstfeld and Kenneth Rogoff (1995), in their paper entitled “The Mirage of Fixed Exchange Rates”, explained difficulties and high costs of any economies who tried to fixed an exchange rate and they referred to the 1992 Swedish and British crises and the 1994-1995 Mexican collapse as examples of great losses to the government and the broader economy for trying to control movements of the exchange rate when there are speculative attacks. They advocated countries adopted floating regimes.

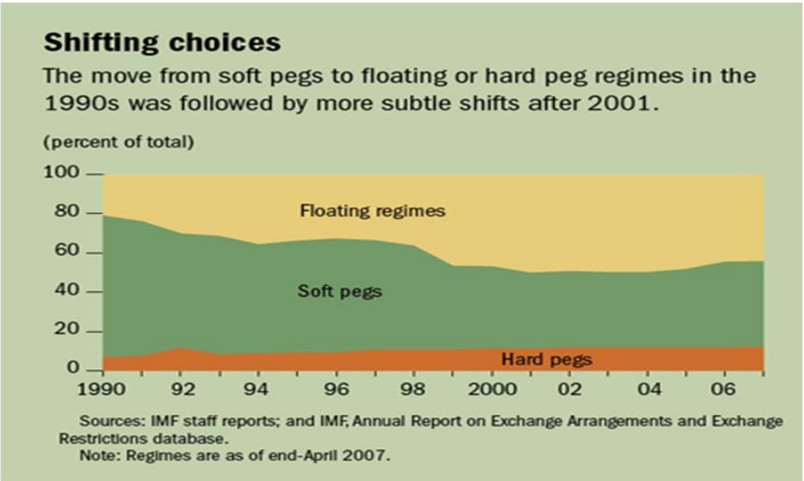
Liliana Rojas-Suarez (2013), in a paper “Monetary Policy and the Exchange Rate: Guiding Principles for a Sustainable Regime”, reviewed experience of exchange rate policies in Latin America and the paper concluded that inflation targeting combines with managed floating regime is more suitable for many countries in Latin America because it would allow central banks to send message to markets that they have commitment to keep inflation low while they could also avoid speculative attacks on the exchange rate. But, the paper also suggested the government in Latin America to accumulate foreign liquidity in the banking sector and the government managed fund to complement the exchange regime.

Mark Stone, Harald Anderson, and Romain Veyrune (2008), “Back to Basics” stressed that in the future there are two schools of thoughts on the exchange regime choices. The first school of through it moving towards currency bloc, who mean a group of countries will use the same currency US dollar, Japanese Yen or Euro. And, the second school of thought is moving floating regime.

Floating exchange rates are particularly suitable for small open economy and highly dollarized economy. Luis Palacios-Salguero (2008) conducted an empirical analysis to test the superior of floating exchange rate over the fixed exchange rate and found that floating exchange rate is the best policy in providing a greater level of benefits to domestic economy than that of fixed exchange rate.

By 2008, 48 countries have declared full dollarization 60 countries fixed rates, and 79 countries floating rates. This was a marked shift of exchange rates from fixed to full dollarization and float since early 1990s. The countries that have claimed to adopt fixed exchanges rate sometime allowed the rates to fluctuate more than 2%, implying that in theory their practice are not fixed exchange rate regime, but floating exchange rate. This would mean the number of countries that have fixed exchange rate might be less than 60 countries.

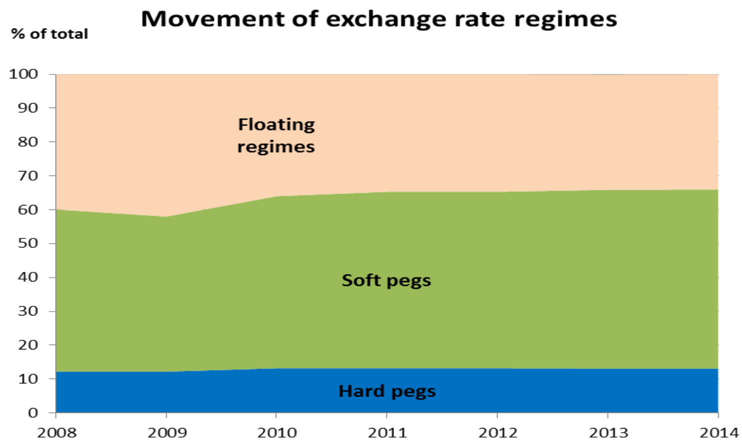
Figure 7: Shift of exchange rate regimes in 2008



Source: Mark Stone, Harald Anderson, and Romain Veyrune (2008)

However, in practice the number of countries applied floating exchange rate is clearly less than the number they declared. Many countries, in practice, did intervene in the market in order to stabilize their exchange rate movements. According to assessment by IMF in the Annual Report on Exchange Rate Arrangements 2015, it showed that 13% of the economies practiced full dollarization; 53% fixed exchange rate and 34% floating. This would translate to 25 countries that practiced full dollarization; 99 countries fixed regime, and 64 countries floating regime. In ASEAN, countries that practiced fixed exchange rate are Cambodia, Myanmar, Malaysia, Vietnam and Laos while countries that practiced floating regime are Thailand, Indonesia, Singapore, and Philippines. Countries that was regarded as successfully in reducing dollarization Israel and Peru also use floating regime. Therefore, the number of countries that tried to fix their exchange rate is more than those who allow it to float freely.

Figure 8: Exchange rate regimes in practice by economies



Source: IMF Annual Report on Exchange Rate Arrangements 2015

Carmen Reinhart and Guillermo Calvod looked at the behavior of exchange rates, reserves, and interest rates in 39 countries using monthly data from January 1970 to November 1999 to assess whether there is evidence that country practice is moving toward the fixed exchange rate or implemented the floating exchange rate as they officially announced. They found that almost of all countries were practicing fixed exchange rates although they claimed that they had allowed their exchange rate to float.

Despite existing literature tends to favor the floating regime, we argue that the adoption and practice of exchange rate regime depends on circumstances. There are instances where fixed exchange rate is more suitable and there are other instances where floating regimes are more suitable.

The choices and practice of exchange rate regime alone is not sufficient to promote Riel and de-dollarize. In countries where they successfully de-dollarized, we observed that there are three main things that are fundamental and instrumental. The first thing is that those countries have records of strong macroeconomic, financial and political stabilities for long time. The second thing is that the country had developed a comprehensive plan for de-dollarization, which seen as credible by the market. And, the third thing is that institutions that involved in the implementation of the plan were capable in response to market reactions effectively.

The de-dollarization plan typically focused on four fronts. First front: effective macroeconomic policies and public debt management (exchange rate policy, monetary policy, fiscal policy/taxation, and debt management). Second front: sound financial policies. Third front: prudential regulations on financial sector. Forth front: introductions of administrative measures that facilitate the enforcements of macroeconomic and financial policies. Promoting local currency and de-dollarization requires policies that are comprehensive, sequenced and complement to each other and to get higher chances for success of the plan implementation, it is required that plan is seen credible by business and ordinary people.

The plan has to adopt marked-based approach. Forced depolarization has been proven ineffective from experience of other countries. Lodewyk Erasmus, Jules Leichter and Jeta Menkulasi (2009) "De-dollarization in Liberia—Lessons from Cross-country Experience" suggested a market-based de-dollarization strategies. They explained that experience from many countries suggested that forced de-dollarization has been proven unsuccessful and these countries have experienced adverse macroeconomic effects and some countries has to reversed their policies several years later after there was no sustained reduction in dollarization. They argued for two (1) establish track record in stable macroecnomic management; then withdraw legal tender of US$ and encourage the use of local currency for transaction and a store of value.

In addition, in the context of Cambodia that has persistence dollarization due to its history of currency demolishment in 1975-1979 and poor macroeconomic management in late 1980s and early 1990s as well as legacy of weak institutions—the urgent priority now is to build capacities of institutions that involved in de-dollarization. Implementation and enforcement of the future dollarization plan needs coordination from a number of government institutions. The task is certainly would be led by National Bank of Cambodia, but would also need active participation from key departments of Ministry of Economy and Finance and Ministry of Interior and cooperation from other line ministries. Establishment a task force on de-dollarization under the Economic and Financial Committee is recommended; so that there is team with clear mandate to start preparing the ground works.

From the literature, there are papers that have argued the need for strategies and measures to improve institutions before the government intended to implement de-dollarization plan. In a paper entitled "The Mirage of Exchange Rate Regime for Emerging Market Countries", Guillermo A. Calvo and Frederic S. Mishkin advocated that the choice of exchange rates are not the most important priority compare with developments of good fiscal, financial, and monetary institutions in producing macroeconomic success in emerging market countries. They suggested that, in developing countries, efforts should be made toward developing institutions that are tasked with macro and financial policies so as to manage the economy in a more efficient way. The decision on the choices of exchange rate regimes and how this could be implemented would come after institutions were better built and responsive to the changes.

Jayant Menon (2008) who studied specifically for Cambodia suggested that the priority for Cambodia to promote riel and eventually de-dollarize is to accelerate accommodative reforms, especially in the financial sector and on legal and institutional reforms so as to prepare ground works for the country to formulate and implement comprehensive de-dollarization plan in the future.

C. Conclusions and Ways Forward

The "managed float" exchange rate regime National Bank of Cambodia adopted is appropriate. However, given that Cambodia's financial market is deepening and more integrated to international financial market systems, it is suggested that National Bank of Cambodia allow the exchange rate to move more freely. The appreciation of Riel for the next 5-10 years would make confidence in Riel stronger, which, in turn, would increase the use of Riel for transactions and stores of value to replacing US dollar.

Greater macroeconomic, financial and political stabilities are necessary conditions to achieving the long term policy objective of de-dollarization. While Cambodia has enjoyed greater macroeconomic, financial and political stabilities over the past 15 years, it is important that the country maintaining those stabilities. Stricter fiscal disciplines (increasing revenues, effective spending and limited borrowing), prudential banking sector and predicable inflation would be keys to have a sound macroeconomic management. On political front, repeated pre and post-elections political standoffs are not helpful in boosting confidence in Riel and therefore should be avoided.

Cambodia has a record of 15 years of stability in economic and political fronts, so perhaps it is a right time to start developing a comprehensive de-dollarization plan. Any dollarization plans in the future should base on market based approach instead of forceful approach because the forceful approach has been proven unsuccessful in most of the countries. A taskforce on de-dollarization could be established; so that they could start prepare ground works for the plan.

Building institutional capacities is very critical at this stage. Although the task force is the leading agency for implementing the de-dollarization, enforcement of plan would require measures and actions from various parts of the government. At this stage, it is important for Cambodia to put efforts in building capacities of relevant agencies on de-dollarization. Success or failures on de-dollarization will rely on not only a good plan, but also effective implementation of the plan. So, capacities of institutions have to be ready in order to response promptly and effectively to market reactions during the course of the plan implementation.

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