

Policy Implications

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According to our survey results, the degree of dollarization is not homogeneous across the regions in the Kingdom. Dollarization is concentrated mainly in urban areas, where economic activities are more dynamic and exposed to foreign currency flows, especially in Phnom Penh, the capital city. In the rural and central areas, the KHR dominates in payments, price quotations and even as a store of value. Within these patterns, the US dollar is generally used for large transactions and imported goods, or in modern markets, while the KHR is essentially used in small payment transactions such as those for foodstuffs, or in traditional markets, and in some large transactions in the agricultural sector. In the border areas, neighboring currencies are also used along with the KHR and USD. The Thai Baht is frequently used in the areas close to the Cambodia-Thailand border in the exchange of goods and services, but also in financial transactions such as the deposits and credits provided by formal financial institutions. At the Vietnam-Cambodian border the Vietnamese Dong is also used for the exchange of goods, but to a very limited extent, and not in financial transactions.

The degree of dollarization in the activities of an enterprise is not necessarily dependent on its size; other factors such as geographic spread and sources of incomes and borrowings are also important. In other words, there is no clear trend in the use of foreign currency in regard to enterprise size. Most enterprises, and in particular the foreign ones, declare that they use USD as an essential part of their activities; they receive revenues in USD and pay in USD, except for tax payments, and they also largely borrow in USD. There are a few enterprises using THB in their activities and also borrowing in THB in

the Cambodia-Thailand border areas. Naturally, it is quite convenient for these firms to use foreign currency, depending on their income and borrowing needs, as they can avoid exchange rate losses and transaction costs when using different currencies in their activities. For some enterprises, mostly in the retail trade sector, KHR is the main currency used in their financial operations. We also observed that some large enterprises in the Agro-industrial and utilities sectors, for example, are operating using multiple currencies. Here, large rice millers pay farmers or even middle men in KHR, or to a lesser extent THB in the border areas, but pay workers in KHR. If these were to export or sell to retailers, they would receive incomes in foreign currency or KHR. The state-owned enterprises that provide utilities, such as water and electricity, receive their income totally in KHR, but they have to convert the KHR to USD to pay their suppliers. These currency mismatches potentially expose them to exchange rate losses and risks.

Because of this use of multiple currencies, the currencies used in income and expenditure could be different, not only for households but also for enterprises. This situation is favorable to the development of currency exchange activities. As a result, there are many money changers, especially those of micro and small sizes, operating the currency exchange business in Cambodia, and they render this market as perfect competition. The money changers facilitate the use of foreign currency by minimizing the costs of holding it. We frequently observed that both foreign and local currency is often exchanged at non-currency exchange shops; the shop agrees to exchange because they need it for their operation; for example, to pay their wholesalers (normally in USD). Currency exchange helps these sellers reduce costs of exchange at the money changers or banks, and also to get some profits in addition to their main business activities.

The financial sector is more dollarized compared to the real estate sector, as around 90% of financial transactions in this area operate in USD. This pattern results from the way that currency mismatch risk is managed by the financial

institutions whose source of funds is foreign currency. However, MFIs use more KHR in their operations than commercial banks, especially in providing credits to the poor and SMEs. Nevertheless, the recent trend of KHR operations in the microfinance sector during the survey period (2009-2013) has been decreasing. One pertinent explanation is that the MFIs are trying to reduce their currency mismatch risks by providing credits in the same currency as their source of funds (deposits and borrowing). This behavior of MFI means that they are transferring risk of currency mismatch on the shoulder of borrowers. In this context, it is also justified the promotion of usage of KHR for loans.

So far the good economic performance of Cambodia has demonstrated that dollarization is not an obstacle to growth and financial sector development. In contrast, it has facilitated and promoted economic activities and integration into global markets. Nevertheless, dollarization could expose the country to risks, and thus make the economy vulnerable to external and internal shocks alike. Dollarization imposes constraints on monetary policy implementation and effectiveness, and potentially limits central bank actions as a lender of last resort. In addition, further financial development may result in reduction of cash based transaction while increasing the level of credit expansion in the economy. This means that the risk associated with lack of function of the lender of last resort will be increased. The level of damage with financial turmoil may be more serious than before the financial development.

Dollarization in Cambodia has persisted for a long time though, and does not seem to decrease if there is no concerted effort to promote the local currency. One recent World Bank report also mentioned that dollarization is likely to stay unless addressed (World Bank 2015). It is noted that macroeconomic stability is a prerequisite for the promotion of riel, but the stability itself may not result in expansion of usage of KHR. In the context where Cambodia's economy has grown robustly, with both macroeconomic and financial stability being well-preserved, but in a situation where the global and regional economy is facing grow-

ing uncertainty, it is in fact indispensable. However, it is time for Cambodia to impose effective monetary policies to protect the country from shocks so as to support the economy that it may grow sustainably. This may be best achieved by considering our survey results, which indicate that the following policies or measures to promote the use of KHR would contribute significantly to government policy formulation during this time of uncertainty.

Enhance confidence in the Riel

To further enhance confidence in riel is indispensable to sustain the momentum of increasing trend of KHR use. To meet this end, the purchasing power of the Riel should be preserved. To do this, inflation should be maintained at a manageable level, and the KHR should not be largely depreciated. So far, the stability of the exchange rate between KHR and USD has been serving as an anchor of price stability, and has promoted public confidence in the Riel. However, in the medium-to-long term, a more flexible exchange rate in accordance with economic fundamentals, and in particular a bias towards KHR appreciation, seems appropriate.

In this context, inflation targeting could a good option in relation to the development of a future monetary regime that can maintain price stability and at the same time leave the exchange rate more flexible after attaining significant level of usage of KHR. The flexibility of the exchange rate could for example signal the market about the risks of holding USD when the latter fluctuates. Notwithstanding the need for flexibility, the stability of the exchange rate should be maintained until confidence in the Riel is strong enough. Then, the exchange rate could be allowed to float in a gradual and careful manner. Furthermore, any suggestion that argues for the adoption of inflation targeting should be studied rigorously before it is implemented.

Promote price quotations and payments of goods and services in Riels

Salary and wages are the most dollarized type of income compared to other sources of dollarization, followed by that from business activities. The latter may be a result of payments to employees in foreign currency by firms/companies whose revenues are in foreign currency, such as garment factories, foreign companies, supermarkets, and so on. Households then use this foreign currency to buy goods and services from enterprises and sellers. However, it is worth highlighting that, in the garment sector, even though employees receive their salaries in USD, only a small proportion of their expenditures are in USD (in particular on telephone services and rental housing). Apart from this, their spending is in KHR. According to our survey, nearly half of worker's salaries were transferred in USD to their parents/relatives in their home town through a money transfer service. In the majority of cases, their parents/relatives withdrew the transferred money in KHR, or exchanged it to KHR quite quickly. Our survey also reaffirmed that households exchange USD to KHR quite frequently, because they need KHR for their spending.

Therefore, if salaries and wages were increasingly (gradually) paid in KHR, households would not suffer losses in exchange operations, especially as the prices of goods and services would be quoted in KHR. Business firms and other companies could also use one single currency in their operations when KHR is used for payments of salaries, as currently they have at least spent KHR on taxes and utilities. In this regard, the government should gradually encourage firms and sellers to quote the price and payments of goods and services in KHR, and promote the payments of salaries and wages in KHR. These measures should gradually begin in both the public and private sectors.

Promote the opening of bank accounts in Riels

Though financial inclusion has increased during the past two decades, the majority of the Cambodian adult population has not had a bank account yet,

and even fewer have had a bank account in KHR. Few banks have yet provided financial services (deposits/credits) in KHR, and most firms/companies have not opened bank accounts for their employees. Increasing the number of bank accounts opening in KHR would encourage the payment of salaries in KHR, and the overall usage of KHR. It would reduce cash holdings and its associated risks, as well as facilitate the use of KHR through different types of payment instruments. It could also address the complaints about the inconvenience of holding too much KHR in order to make large payments, or the ones about too many zeroes on the KHR notes. To achieve this end, the government, financial institutions, and companies should encourage the use of bank accounts denominated in Riels.

Improve the payment system and financial instruments in Riels

The payments system is a crucial part of the infrastructure of the financial system that could reduce cash based transactions. In addition, it promotes the greater use of KHR if the system is designed in favor of KHR. Recently, an electronic retail payment system in local currency has been introduced. This should further promote KHR transactions. In addition, a greater variety of KHR notes should be made available in ATM machines as well as increasing the numbers of the ATM machines available in major cities. This will offer the possibility of using KHR more widely, as currently only few banks put Riel notes in their ATM machines, and there are as yet very limited KHR denominations that are suitable for this. Most ATMs contain only one denomination of KHR notes (10,000 Riels), with very few making two denominations (the 10,000 Riel and 20,000 Riel notes) available.

According to our survey, only a small percentage of the population uses the two largest KHR denomination notes. Therefore, it is important to promote the use of the largest note (100,000 Riels, equivalent to around 25\$). In addition, the NBC should also consider issuing larger denominations (for example 500,000

Riels - equivalent to around 125\$) to raise the value of the KHR notes in circulation. The issuing of larger denomination banknotes would correspond to the demand for higher value of notes as the value of economic and financial transactions becomes greater. Alternatively, it is worth considering the reissue of current riel notes by removing two zeroes from each of them.

Finally, money transfer or remittances should also be carried out within formal financial institutions or through the use of agents to reduce the direct use of foreign currencies. Informal transfers have favored the use of foreign currency as the beneficiary who received it could then use it outside the formal banking system. By forcing this change, formal financial institutions could keep track of the flow of foreign exchange, and control its value relationship with the KHR, so that the foreign currency is well captured by the banking system. Further study may be needed to promote formalization of transfer through banking system.

Promote financial intermediation in Riels on a gradual basis

According to our survey, banks continue to operate almost entirely in USD, but MFIs operate in KHR as they provide more financial services to the poor than the formal banking system. During the survey period (2009-2013), the trend of KHR credits provided by MFIs decreased from 40% to 20% of total credits. This is a worrying trend, as MFIs are forced into trying to manage their currency mismatch risks when their sources of funds are in a foreign currency. Therefore, measures should be taken to encourage banks, and in particular MFIs, to expand their financial intermediation in KHR. The possible measures are as follows:

- In some dollarized countries, financial institutions are required to increase the proportion of their operations in local currency on a gradual basis. Thus, the central bank should consider encouraging and requiring

banks and financial institutions to operate in KHR at a certain level. It would be ideal if this could begin on gradual basis;

- Develop hedging instruments for financial institutions that allow banks and financial institutions to obtain KHR liquidity when their sources of funds are in foreign currency;
- Gradually widen the reserve requirement rate on KHR deposits and USD deposits, so that KHR is more available to financial institutions for the provision of credits;
- Promote deposit savings in KHR, giving priority to the poor and those living in rural areas. In general, households save money in terms of cash holding in their residences rather than keeping their cash in bank deposit accounts. This cash is effectively outside the financial system of the country. Though the amount of saving in foreign currencies is higher than that of KHR, in rural areas households save more KHR compared to those in urban areas. Also, the poor hold more KHR cash for their savings compared to the rich. Targeting that segment of households, the authorities should introduce deposit schemes favorable to the promotion of deposits in KHR. This type of scheme may have better preferential interest rates than the market rate, and could, in turn, be structured so that those who save using such a scheme over a longer period may enjoy preferential borrowing in KHR

Improve foreign exchange markets

An effective and formal wholesale foreign exchange market is essential to absorb foreign currency inflows, and also to provide foreign currency when the market needs it, such as in responding to the demands of importers, or for other transfers abroad. As the foreign exchange market in Cambodia is rather more a retail market, and not basically formal, the inflow of foreign currency can be used outside the banking system. Thus, their transactions are mainly

in cash. This favors the persistence of dollarization. Therefore, the foreign exchange market should be further developed toward a wholesale and formal market in which banks play a central role in responding to the demand for Riels, and to efficiently absorb foreign currency inflows to the economy.

Further developing interbank and money markets

The existence of an Interbank and a more formal money market would allow banks and financial institutions to better manage KHR liquidity, and encourage them to use KHR in their operations. Currently, the formal interbank market is underdeveloped. Among certain major banks, there are established relationships through credits and deposits, but these are very limited and at the same time, the market is lacking in several important instruments. Up to now, the National Bank of Cambodia has paid great attention to the development of the market through the introduction of a new tradable debt instrument, the Negotiable Certificate of Deposit (NCD). Despite its gradual promotion, the NCD has yet to be used in the interbank operation; in other words, there is no secondary market for NCD at this time. Recently, the launch of liquidity-providing collateralized operations (LPCO) aims at providing KHR liquidity to financial institutions using NCD as collateral. These operations may contribute to the development of the interbank and money market in Cambodia. Furthermore, there is a need to continuously develop an active interbank and money market in favor of the KHR instruments, which will depend on the availability of instruments. In this context, short-term debt instruments, specifically Treasury Bills in KHR, should be created to support the demand for KHR.

Further develop securities markets

A Securities market was launched at the end of 2012, and there are now four listed companies. Quotations in this market are solely in KHR. Though trade volume is still limited, the establishment of a securities market demonstrates

to the public the government's strong commitment to the support of KHR, and will mobilize funds in KHR that will further create supply and demand for the domestic currency. In the future, when the government requires sustainable financing, it should not see these funds as necessarily coming from concessional loans from abroad; instead, it should seek options for long-term debt financing from domestic sources, such as issuing government bonds in KHR to finance its long-term investment plans. This domestic debt financing will contribute to reducing dependence on foreign debt and currencies, and will reduce risks associated with exchange rate fluctuations such as those the government is currently facing.

Fiscal support for the Riel

The fiscal system is one of the key arenas for encouraging the use of local currency, because willingness and positive attitudes from the government are prerequisites for public recognition and understanding of commitment to change. Through its roles, the government earns revenues both from tax and non-tax sources and also spends on consumption, wages and investment. In this regard, the government could play a major role to create demand and supply in local currency through fiscal measures.

So far, public sector revenues from taxes and non-taxes are mostly in Riels. However, there are still some revenues collected in foreign currency, such as entrance fees to tourism sites, airport taxes, visa fees, rents, and so on. On the expenditure front, though all public wages are in Riels, some public consumption and most public investments are paid in foreign currencies. Therefore, if all revenue collection and all payments for consumption and investment are in Riels, the government would increase the demand for, and raise the supply of Riels in the economy. It may also consider expenditure associated with donor assisted projects or NGO projects should be made in Riels. In addition to this, if the possibility is allowed, the government should consider imposing taxes on

revenues, profit, and any other form of tax on operations in Riels at a lower rate than the operations carried out in foreign currencies to provide incentives for economic agents to conduct their operations in the domestic currency.

Promote public awareness and participation

Using USD has become deep rooted in the mindset of the people, such that it has become a Cambodian habit to think and pay in USD. Thus, the policy on promoting the use of national currency cannot be realized in a subjective manner without changing the public mindset. In this connection, the public has to be aware of the roles and usefulness of the national currency and the policies of the government, and take part in the process of promoting the preferential use of the national currency. Mainstreaming and encouraging participation can be done through various actions, including broadcasting, training, and/or at discussion forums between the authorities and the public or through the education system, and so on.

Enhance cooperation for implementation of effective measures

Finally, promoting the use of the Riel is a macroeconomic issue that requires collaborative efforts in the preparation and implementation of consistent policy, as well as actual measures. Meanwhile, the framework of cooperation must cover inputs from all of the key relevant parties in both the public and private sectors. Thus, a National Policies to promote the use of riel is needed to promote the participation of all stakeholders.