CDR, VOLUME 20, ISSUE 1, March 2016

The Obstacles to Promoting Local Currency: A Cross-Country Study of Bolivia, Ecuador and Peru

Introduction

Cambodia became dollarised in the early 1990s and is now regarded as the most highly dollarised economy in Asia (Duma 2011). Despite certain advantages such as financial deepening, trade facilitation, signalling effects for macroeconomic management and monetary stability rendering incentives less necessary, dollarisation has caused some problems that need policy attention. Dollarisation makes monetary policy less effective. It limits the role of the National Bank of Cambodia (NBC) as lender of last resort, undermining its control of domestic monetary conditions. In addition, currency is a symbol of sovereignty. Dependence on the dollar means that Cambodia loses out on seignorage revenue; instead, the benefits accrue to the US government (Tal and Dabadie 2007). Dollarisation has both advantages and disadvantages, but comparative cost-benefit analyses show that costs outweigh benefits (Kang 2005; Tal and Dabadie 2007).

Successive Cambodian administrations have proved capable of maintaining exchange rates, price stability and economic growth (Menon 2008). Yet, although the NBC reissued the riel three decades ago, public confidence in local currency has not yet been restored, and Cambodia is still struggling to promote the riel against foreign currencies. This situation reveals a gap in existing research. Previous studies have largely overlooked the question of why Cambodia has failed fully to promote the riel. This article aims to contribute to the discussion by drawing lessons from the Latin American experience, specifically from Bolivia, Ecuador and Peru. It starts with a historical overview of the riel, followed by the current state of affairs and efforts to de-dollarise. It then discusses the experience of Bolivia, Ecuador and Peru and lessons for Cambodia.

Shocks hitting the riel

National currency abolished (1975-79)

On coming to power in 1975, the Khmer Rouge regime demolished the National Bank and abolished money (Prasso 2001). Riel banknotes were reduced to worthless pieces of paper blowing along the streets. Because there were no banknotes, there were no financial transactions. The banking system was completely destroyed.

Distrust of central planning (1979-89)

With the economy in very poor condition and the experience of the civil war still fresh in people's minds, confidence in the riel hit rock bottom. Rather than money, rice was commonly used to buy other goods, but rice itself was bought with gold (Prasso 2001). It was essentially a barter system. Although centrally planned economies commonly restrict the use of foreign currencies, the US dollar and Thai baht were widely accepted and used in Cambodia because citizens regarded them as a safe means of storing value (Tal and Dabadie 2007).

Economic and political instability—deficit, dollar influx and hyperinflation (late 1980s-early 1990s)

Limited government revenues during the 1990s led to budget deficits, which were financed to a large extent by the NBC. Indeed, NBC monetary emissions accounted for 20 percent of public expenditure in 1989 and increased to 40 percent in 1990 (Irvin 1993). Then inflation started, culminating in three-digit hyperinflation in 1992; the riel's value against the dollar depreciated sharply from 800 in 1990 to 2600 in March 1992 (Irvin 1993). The consequent loss of purchasing power shattered public confidence in the riel.

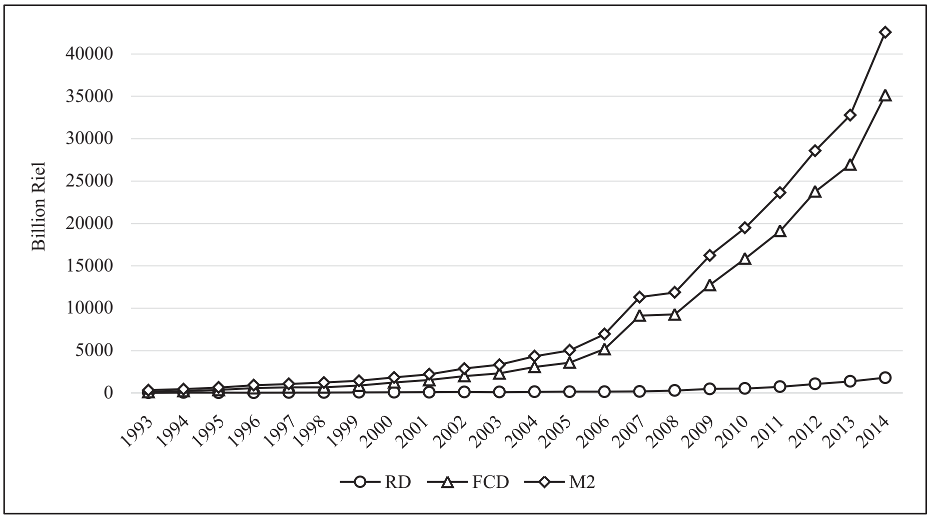
Nonetheless, the domestic political situation was improving, marked by the signing in 1991 of the

---

This paper was prepared by Khorn Dalin, intern, Economics Unit, CDRI. It draws on Khorn (2015). Full citation: Khorn Dalin. 2016. "The Obstacles to Promoting Local Currency: A Cross-Country Study of Bolivia, Ecuador and Peru." *Cambodia Development Review* 20(1): 14-18.

1 "Seignorage is the difference between the cost of producing and distributing money, and the eventual income withdrawn from lending this money" (Tal and Dabadie 2007,12).

Figure 1: Riel and foreign currency deposits and money supply



Sources: Beresford et al. 2004; NBC 2005, 2010, 2013, 2014

Paris Peace Agreement, which paved the way for political liberalisation. The arrival in 1992 of the United Nations Transitional Authority in Cambodia (UNTAC), set up to oversee the first national election after the civil war, was critical since it marked the first massive inflows of foreign capital, largely in the form of US dollars. It was also one of the most costly UN peace operations, amounting to some USD1.7 billion (Tal and Dabadie 2007).

Current state of affairs and efforts to de-dollarise

Composition of Cambodia's reserves

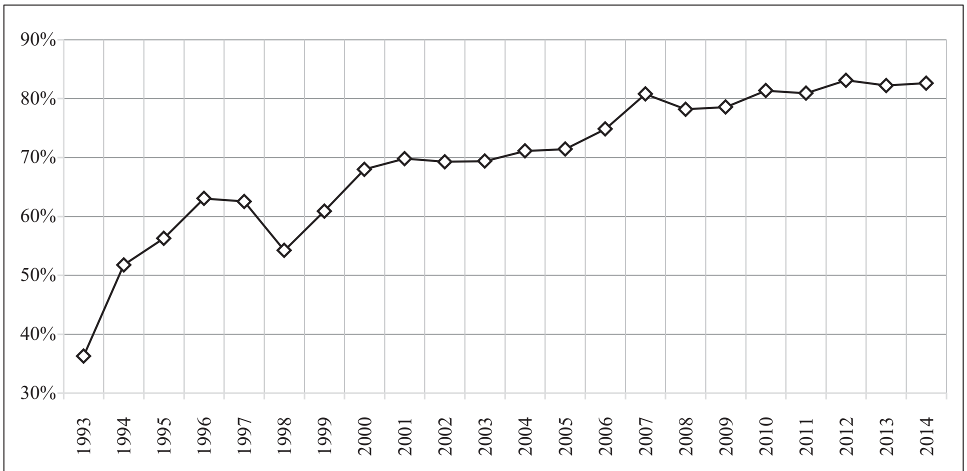
This section describes NBC data on money supply (M2) for the period 1993 to 2014. Foreign currency deposits (FCD) have dominated, increasing from 84 percent of total deposits in 1993 to 95 percent in 2014, while riel deposits (RD) decreased from 16 percent to 5 percent. As the economy has grown, both FCD and RD values have increased. Between 1993 and 2014, FCD rose from KHR121 billion to KHR35,161 billion, and RD increased from KHR23 billion to KHR1805 billion (Figure 1). FCD have increased at a greater rate than RD because the demand for the riel is lower than for foreign currencies (Beresford et al. 2004). At the same time, the dollarisation index expanded from 36 percent to 83 percent (Figure 2); this calculation does not include foreign currency circulation, which is unknown.

Reasons for persistent dollarisation

More and more people hold US dollar deposits, and 90 percent of bank transactions are done in dollars (Beresford et al. 2004). There are two main reasons for this persistence—the US dollar is a convenient currency for transactions, and the demand and supply of dollars. The perception that the dollar is already widely used in the economy makes it the preferred choice for transactions. Prices are mostly quoted in dollars, and goods and services paid for in dollars, private sector wages are mostly paid in dollars, and the minimum wage is denominated in dollars. Further, there are no restrictions on the use of the dollar.

Cambodia's GDP (current USD prices) almost tripled between 2003 and 2013, with annual GDP growth of around 7 percent from 2011 to 2014 (World Bank 2016, 2015). Five main economic indicators give evidence for increases in US dollar inflows. International tourism receipts, which in 2014 contributed 29.9 percent of GDP (WTTC 2015), increased 5.56 times between 2003 and 2013. In the same period, net foreign direct investment grew 16.02 times, net official development assistance rose 1.55 times,

Figure 2: Share of foreign currency deposits in money supply



Sources: NBC 2005, 2010, 2013, 2014

and net current transfers were 1.77 times greater. Furthermore, as the net trade deficit widened due to rising imports, the demand for US dollars increased. These five indicators are usually calculated in US dollars rather than riels. In addition, between 2011 and 2014, deposits increased 7.88 times and loans increased 3.17 times (NBC 2014), indicating financial deepening and heightened economic activity.

Overall, the US dollar offers better economic prospects and is therefore in greater demand than the riel. This severely limits monetary policy options. Because only a small proportion of the money in circulation is riels, the NBC cannot intervene in the market by using M2 to soften the impact of financial problems. Thus, to achieve sustainable economic development, particularly to gain monetary power, promoting local currency is a must.

Analysis of policy implementation

There have been no forceful policies to promote the riel, nor have related efforts by the NBC been done within a targeted timeframe (McGrath 2015). On the demand side, it is compulsory to pay utility bills, tax and public sector salaries in riels (Tal and Dabadie 2007). A recent survey reveals that salary payments constitute the biggest source of foreign currency in Cambodia (Khou and Odajima 2015).

On the supply side, the NBC has maintained economic stability, particularly price and exchange rate stability. Inflation has been kept in check, standing at 4 percent in 2013 (NBC 2013). Furthermore, the NBC has been injecting new notes into the economy to replace old, worn-out ones. This may restore people's pride in the riel. The Securities and Exchange Commission of Cambodia was established under the Law on the Issuance and Trading of Non-Government Securities in 2007. This is yet another way of increasing riel usage, as prices in both primary and secondary markets are quoted in riels. However, the Cambodia Securities Exchange is not yet mature, nor has the government issued any bonds. Another achievement is that the NBC has developed a fully functioning interbank market to help manage liquidity risk. Also, the government will soon come out with new policies to promote the riel and de-dollarisation, for instance through leveraging financial markets.

Dollarisation in Bolivia, Ecuador and Peru

Why were these three countries selected for study?

Like Cambodia, Bolivia, Ecuador and Peru have experienced high levels of dollarisation. Average FCD to total deposits for the period 1995-2004 range from 94 percent in Cambodia and 90 percent in Bolivia to 76 percent in Ecuador and 68 percent in Peru (Alvarez-Plata and García-Herrero 2007). Bolivia, Ecuador and Peru have followed different strategies in response to dollarisation. Ecuador remains an officially dollarised economy, whereas Bolivia and Peru opted for de-dollarisation. First, Bolivia and Peru implemented a compulsory policy, but that only made the situation worse and caused more dollarisation. Their second tactic—market development—has been more successful.

Experiences of dollarisation—before and after

Ecuador, as part of structural reform to manage serious political and economic instability, adopted the US dollar as its legal tender in 2000. After it became an officially dollarised economy, the inflation rate fell dramatically, from a peak of 96.09 percent in 2000 to 37.68 percent in 2001 and 3.57 percent in 2014 (World Bank 2016). In the late 1990s the country experienced declining growth rates, dipping to -4.74 percent in 1999. This trend gradually reversed from 2000 onwards, with GDP growth standing at 3.80 percent in 2014. In addition, trade, which had remained fairly stagnant before official dollarisation, increased its share in GDP.

Similarly to Ecuador's experience, dollarisation in Bolivia came about in response to the hyperinflation and economic instability of the 1970s. However, a balance of payments crisis and inflation rate of 32.13 percent in 1981 led in 1982 to a compulsory de-dollarisation policy. Five consecutive years of negative GDP growth and hyperinflation followed. Average annual inflation rates shot up to 123.54 percent in 1982, a staggering 11,749.64 percent in 1985 and then 273.35 percent in 1986, before falling to more manageable levels of 14 to 21percent in 1987-92 (World Bank 2016). Since then, a market development policy introduced in 2006 has had positive results. Bolivian boliviano deposits to total deposits rose to 78 percent in 2014 from 23 percent in 2006, while local credit to total credit grew to 92 percent from 15 percent (Catacora 2014).

Pursuit of three criteria—macroeconomic stabilisation, prudential policy and debt sustainability—appeared to be successful in stabilising Bolivia's economy after de-dollarisation (Staines 2014). An outward-looking policy during the 1990s brought lower inflation, steady GDP growth and increased trade. Incentive policies had an important role in promoting the boliviano, mainly through discriminatory legal reserve ratios, credit risk provisioning, foreign exchange net exposure limits and foreign financial transaction tax (Staines 2014). For instance, the Bolivian Central Bank increased its reserve requirement rate from 7.5 percent to 30 percent, and set higher exchange rates (minimum and maximum buy and sell prices) for foreign currency than for the boliviano. Foreign currency transactions exceeding USD2000 were taxed (MEPF 2013). In addition, unlike in Cambodia, the minimum wage is denominated in the local currency. Government debt as a proportion of GDP decreased from 80.4 percent in 2005 to 32.4 percent in 2014, ranking Bolivia fifth (out of 10) in Trading Economics[2] (2016) country list. These market conditions favoured government bond issues, particularly in the boliviano, which in turn helped reduce credit dollarisation (García-Escribano and Sosa 2011).

Peru also experienced hyperinflation and consequent growing dollarisation in the mid-1970s, culminating in the government forcing people to convert their foreign currency holdings to the local currency. Contrary to what was intended, dollarisation continued to increase, with dollar deposits rising to about 80 percent of total deposits in 1990 from just above 60 percent in the 1980s (Staines 2014). A market development policy has played a critical role in facilitating Peru's de-dollarisation. Initially it helped curb the rise in inflation, which more than halved from 163.40 percent in 1985 to 77.92 percent in 1986, although in subsequent years it shot up, reaching a peak of 7481.66 percent in 1990 (World Bank 2016). Further policy implemented in the early 2000s reduced dollar deposits to 52 percent and credit dollarisation to 55 percent in 2009 from almost 80 percent for each in 2001.

Peru's macroeconomic outlook during the 2000s was good due to lower inflation and positive GDP growth. Government debt as a share of GDP was reduced, ranking Peru fourth in Trading Economies (2016) country list, and local currency bonds were issued. Regarding prudential policy, discriminatory legal reserve ratios, credit risk provisioning requirements and foreign exchange net exposure limits were adopted. There is a big gap between the reserve requirement ratios for the Peruvian sol (less than 5 percent) and foreign currency (more than 30 percent) (García-Escribano 2010), and credit provision for foreign currency (20 percent) is set higher than for the sol (8 percent). The Peruvian Central Bank maintains exchange rate stability by accumulating international reserves (Rossini, Quispe and Serrano 2013). As in Bolivia, the minimum wage is denominated in the local currency.

Similarities, differences and policies

In Bolivia, Cambodia, Ecuador and Peru, dollarisation was a response to political and economic instability, particularly hyperinflation. Cambodia's case is unique in that its domestic currency had been practically abolished relatively shortly before its economy was swamped with a colossal and sudden influx of US dollars, equivalent to two-thirds of GDP in 1993 (Khou and Ken 2015).

Lessons from Ecuador imply that it is not desirable for Cambodia to continue under official dollarisation given that the country's macroeconomic outlook is stable with positive trends. However, drawing on what Bolivia and Peru have gone through, Cambodia is strongly recommended to avoid compulsory de-dollarisation because it might only entrench official dollarisation. Instead, market development could be the optimal policy to promote the riel (Tal and Dabadie 2007; Duma 2011). Cross-country comparison of the preconditions for de-dollarisation reveals significant inconsistencies between Cambodia's policies to promote the riel and attract capital inflows in that the bid to attract tourists and foreign investors is a powerful incentive to use US dollars.

2 Based on the debt credit ratings reported by five major credit rating services, namely Moody's, Standard & Poor's, Fitch, Economic Indicators, and Financial Markets, Trading Economics (2016) 10-tier ranking is as follows: 1st rank is prime; 2nd: high grade; 3rd: upper medium grade; 4th: lower medium grade; 5th: non-investment grade speculative; 6th: highly speculative; 7th: substantial risks; 8th: extremely speculative; 9th: in default with little prospect for recovery; and 10th rank is in default.

Ecuador's macroeconomic conditions are not very different from those of Peru and Bolivia, yet it is ranked sixth (Trading Economies 2016) because it cannot issue its local currency. One of the factors that has contributed to decreasing the dollarisation of Bolivia's and Peru's economies is the issuance of local currency bonds. Therefore, being in sixth rank, Cambodia is well placed to issue government bonds in riels. Doing so would promote riel usage and increase domestic debt rather than foreign debt.

Among the various prudential policies adopted by the comparator countries, three stand out as being particularly fruitful approaches to rein in dollarisation: reserve requirement ratios, provision, and foreign exchange intervention. Bolivia and Peru both set large local-foreign currency deposit rate gaps, but Cambodia's is very small—8 percent for the riel and 12.5 percent for foreign currency (NBC2016). The comparator countries have adopted discriminatory currency practices to treat local currency more beneficially than foreign currency. Cambodia, however, treats the riel and the dollar more or less equally. On the one hand, riel usage is promoted and riel deposits attract higher interest rates; on the other, slightly higher interest rates are charged for riel loans (NBC 2013). Bolivia levies a tax on foreign currency transactions and limits the size of its local currency loan portfolio. Cambodia has not yet followed suit.

Conclusion

High and persistent dollarisation in Cambodia is largely the result of inconsistencies in polices designed to promote the riel and attract capital inflows. It would be difficult for Cambodia to replicate lessons learned from Bolivian and Peruvian experiences because the NBC has limited policy tools at its disposal, and existing policy does not provide adequate incentives to stimulate greater riel usage. In addition, Cambodia's domestic capital market is relatively immature. If Cambodia is to maintain a positive political and macroeconomic outlook, it will have to improve its capital market. This can be achieved through the issuance of sovereign bonds. Importantly, to create incentives that make it desirable to use riels, macroprudential policies should be cumulative and marketable and policy inconsistencies should be minimised.

References

Alvarez-Plata, P. and A. García-Herrero. 2007. "To Dollarize or De-dollarize: Consequences for Monetary Policy." Manila: Asian Development Bank.

Beresford, Melanie, Nguon Sokha, Rathin Roy, Sau Sisovanna and Ceema Namazie**.** 2004. *The Macroeconomics of Poverty Reduction in Cambodia.* Phnom Penh: United Nations Development Program.

Catacora, Luis Alberto Arce. 2014. "The Model that Changed Bolivia's Economy." PowerPoint presentation at Harvard University, 5 September.

Duma, Nombulelo. 2011. *Dollarization in Cambodia: Causes and Policy Implications*. Working Paper 11/49. Washington, DC: International Monetary Fund.

García-Escribano, Mercedes. 2010. *Peru: Drivers of De-dollarization*. Working Paper 10/169. Washington, DC: International Monetary Fund.

García-Escribano, Mercedes and Sebastian Sosa. 2011. *What is Driving Financial De-dollarization in Latin America?* Working Paper 11/10. Washington, DC: International Monetary Fund.

Irvin, George. 1993. *Rebuilding Cambodia's Economy: UNTAC and Beyond.* Working Paper No. 149. The Hague: Institute of Social Studies.

Kang, K. 2005. " Is Dollarization Good for Cambodia?" *Global Economic Review* 34(2): 201-211.

Khorn Dalin. 2015. "The Obstacles to Promoting Local Currency: A Cross-Country Study of Bolivia, Ecuador and Peru." Master's thesis, Korea Development Institute School of Public Policy and Management.

Khou Vouthy and Ken Odajima. 2015. *Dollarization or Dedollarization? Dollarization in Cambodia Policy to Promote the Usage of Riel*. Phnom Penh: National Bank of Cambodia and JICA Research Institute.

McGrath, Cam 2015. "Central Bank Seeks To Promote Riel Use." *Khmer Times*, 1 July.

Menon, Jayant. 2008. "Cambodia's Persistent Dollarization: Causes and Policy Options."*ASEAN Economic Bulletin* 25(2): 228-237.

MEPF. 2013. *Memoria De La Economía Boliviana 2013.* Sucre: Ministry of Economy and Public Finance.

Continued on page 27