



## De-Dollarising Cambodia: 10 Years On

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“For a long time it seemed that the extent of... dollarization was impervious to improved economic performance. Now however we have several examples of countries that have dedollarized successfully... including Israel, Poland, Mexico, Egypt, and Turkey. And some signs of declining dollarization are evident in Latin American countries where it seemed that dollarization was impossible to reverse.”

Stanley Fischer (2006)  
Governor, Bank of Israel

### 1. Introduction

Ten years ago I wrote an article for the Cambodia Development Review (Menon 1998) on the pros and cons of dollarisation in Cambodia, and policy options on the way forward. A lot has happened since then. GDP growth has averaged close to 10 percent over the past decade, resulting in an almost doubling of income per capita (Table). Poverty incidence is estimated to have fallen by about 1 percent per annum (from 47 to 35 percent, for the decade up to 2004), even though inequality has worsened (World Bank 2007). Consumer price inflation has fallen sharply, from an average of 56 percent over 1990–98 to an average 3.5 percent over 1998–2007. Inflation has started rising again recently, with the spike in food and energy prices, but this is happening almost everywhere.<sup>1</sup> Government revenue collections have recently consistently exceeded expectations, and the budget deficit has

<sup>1</sup> There are also concerns relating to excess liquidity fuelling inflation, and the inability of the National Bank of Cambodia to mop this up, because of the lack of monetary instruments as a result of dollarisation (see Section 2).

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fallen to manageable levels. The recent discovery of oil and gas could be a significant boon for the country, and should provide the resources necessary to address a range of socio-economic issues, provided of course that the resources are not mismanaged. In short, the economic and social achievements over the past decade have been the most spectacular in Cambodia's history.

It is against this backdrop that we find that Cambodia today is as dollarised, if not more so, as it was 10 years ago. The dollar still serves all the three functions of money: it is widely used as a medium of exchange, store of wealth and unit of account. The IMF estimates the share of dollars in currency in circulation to be about 90 percent, little changed from what it was a decade ago. The National Bank of Cambodia estimates the share of foreign currency deposits in broad money (M2) to have risen to its highest level ever, 75 percent, in 2006, and significantly higher than the 54 percent recorded in 1998 (Table). Currently, about 97 percent of bank deposits are in US dollars.

The apparent lack of progress with de-dollarisation has led to frustration among a number of commentators, some of whom are pressing the government to play a more direct, interventionist role. There is growing concern that the process may be irreversible unless forced. At the launching of the Cambodia Economic Forum on 17 January 2006, Finance Minister Keat Chhon concluded his opening remarks by stating, “The combination of economic and political instability, which is disturbing the world now, requires Cambodia to be more proactive in enforcing de-dollarisation policy ...”. An article in the June 2007 Phnom Penh Post (15–28 June 2007) titled “Moves to Ban US Dollar” summarises prevailing sentiments: “Renewed calls to remove the US dollar from widespread circulation in Cambodia are drawing bipartisan support, and some high-ranking government officials are calling the ban a pressing matter of national sovereignty and pride. The move to finally ‘de-dollarize’ the Cambodian economy has been sidelined for years ...”. The same article quotes Tioulong Saumura, a Sam Rainsy Party lawmaker: “To de-dollarize is even more important now ... Decree it. Ban it! This is unthinkable in other places”.<sup>2</sup> This frustration is indeed understandable. But is enforced de-dollarisation the right policy choice?

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Menon (1998) argued: “... dollarisation is not the problem, but is merely a symptom. The problem (or the cause) is a lack of confidence in the riel, whilst the symptom (or the effect) is the use of another currency such as the US dollar. The causes of the problem emanate from an underdeveloped monetary system, political and economic uncertainty, and weak legal and institutional structures. These are the problems that need to be addressed directly.

<sup>2</sup> Given the title of this paper, it is also somewhat ironic that Cheam Yeap, chair of the Finance and Banking Commission of the National Assembly, claims he has been pushing for enforced de-dollarisation for exactly a decade now: “I have raised the idea of banning (the) dollar since nine years ago (quoted in 2007). I have talked about this issue many times with the minister of finance and economy Keat Chhon and National Bank governor Chea Chanto—how to de-dollarize” (Phnom Penh Post, 15–28 June 2007).

When these problems are addressed, then the symptom, which is dollarisation, will also cease to be a constraint”.

Political and economic uncertainty has since been significantly reduced; legal and institutional structures have improved; and even the monetary system has matured and deepened, to some extent. So, why is Cambodia still highly dollarised?

Here we revisit this issue and try to explain why the favourable economic, political and other developments have thus far failed to start de-dollarisation. We argue that the apparent paradox between a decade of economic and political improvements and continued dollarisation can indeed be explained, and that the policy prescriptions advocated a decade ago remain just as valid today, with only minor modifications.

The paper is in five parts. Section 2 examines the reasons for the recent increase in dollarisation by drawing a distinction between “good news” and “bad news” dollarisation. We argue that this is part of a transition, and therefore temporary. But what needs to be explained is the longer term factors underlying

the persistence of dollarisation in Cambodia. In Section 3, this persistence is attributed to an unfinished reform agenda, as well as inertia and stickiness in the system. The unique circumstances surrounding the introduction of dollars into the Cambodian economy, combined with a very high level of dollarisation, suggest that the process of de-dollarisation is likely to be more protracted than it would otherwise be. Based on these explanations, policy choices are then considered in Section 4. We consider the full spectrum of options, ranging from attempts to enforce de-dollarisation at one end, to official dollarisation at the other. In between, we have a currency board, monetary union and a “muddling through with accelerated reforms” approach. A fifth section concludes.

## 2. Explaining the Recent Increase in Dollarisation: ‘Good News’ versus ‘Bad News’ Dollarisation

Increases in dollarisation are usually attributed to episodes of macroeconomic or political instability. So, why has dollarisation in Cambodia increased recently, despite the spectacular economic achievements of the recent past? Rather than reversing the process, the current level of dollarisation may partly be a reflection of the exceptional economic performance itself. Increased confidence in the economic and political situation may be partly responsible for the increasing share of foreign currency deposits in M2. Large amounts of foreign currency, from both domestic and foreign investors, have been flowing in. It is an open secret that large amounts of foreign currency held by resident and non-resident Cambodians in offshore banks (in Singapore, Hong Kong etc.) have found their way back recently. Some of these flows have gone into real investment, but apparently the bulk has been speculative, in response to, as well as further fuelling, land price inflation. The latest World Investment Report from UNCTAD estimates that the stock of FDI increased from \$38 million in 1990 to \$1.6 billion in 2000, to about \$3.5 billion in 2007. The annual inflow of \$820 million in 2007 is more than five times the average annual inflow for 1990–2000 (Table). Increasing dollarisation in this respect reflects increasing, rather than decreasing, confidence in the economy.<sup>3</sup>

There are other so-called good news factors driving increasing dollarisation. Cambodia became a member of the WTO in 2004, and today it is much more open and outward-oriented than it was 10 years ago. Trade has flourished, with the export share of GDP rising from around 30 percent in 1998 to about 70 percent today. Its trade openness index is currently around 120 percent. In transitional economies especially, almost all trade and capital movements involve the use of foreign currency—usually dollars. Even on the financial side, there has been rapid growth in

<sup>3</sup> .....  
*An aspect of this that relates to dollarisation is the inability of the National Bank to mop up excess liquidity, due to a lack of monetary instruments. It is increasingly being acknowledged that this excess liquidity, in addition to food and energy prices, is pushing inflation up at the moment. Changes to reserve requirements can help, but are a blunt instrument in this context because dollarisation allows capital inflows to become part of the money stock without passing through the financial system.*

monetisation (albeit from a low base) and increased financial intermediation (also from a low base), but both have contributed to the increase in dollarisation. There is little doubt, however, that dollarisation itself has facilitated this financial deepening.

The increase in the share of dollars as a result of these factors should not be a cause for concern. They are essentially quantum or volume effects, not substitution effects. That is, with the volume of riels remaining relatively unchanged, large inflows of dollars are increasing its share in the aggregate. It is not that people are substituting dollars for riels, but that these types of transactions are naturally dollar based. The fact that dollars continue to be regarded as the de facto currency of the country reinforces this.

But these “good news” factors causing an increase in dollarisation are part of a transitory phase. De-dollarisation would need to involve a substitution of riels for dollars, and this has not yet started. We turn next to examining the longer-term factors that underlie the persistence of dollarisation.

## 3. Explaining the Persistence of Dollarisation: Degree of Required Reforms and ‘Hysteresis’

There are two related factors that explain the persistence of dollarisation in Cambodia. The first is the degree or magnitude of the reforms themselves, and the second is hysteresis, or the fact that history matters.

Starting with the reforms, the critical point is not how far Cambodia has progressed in the past decade, but rather how much more needs to be achieved. While it is clear that Cambodia has come a long way, and perhaps achieved more than most expected, there is still a lot to be done before underlying uncertainties are substantially removed. While growth has been spectacular, and political uncertainty greatly reduced, Cambodia remains a low income country with significant inequality and poverty, and some degree of political uncertainty remains.

The greater constraint, however, relates to the level of development of financial, banking and monetary systems, as well as the continued absence of riel-denominated interest-bearing assets. Cambodia continues to wrestle with the challenge of developing

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**Table: Selected Macroeconomic and Monetary indicators, 1998–2007**

	98-07 Ave	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP growth, %	9.3	5.0	12.6	8.4	7.7	6.9	8.5	10.0	13.5	10.8	9.6 a/
Per capita income growth, %	5.5	-2.4	4.2	5.0	3.3	3.6	6.7	8.2	11.2	8.2	7.2
Inflation, % per year	3.8	12.6	0.0	0.5	0.3	3.3	1.2	3.8	5.9	4.7	5.9
Budget deficit, % of GDP	4.9	5.5	3.9	5.3	6.6	6.4	6.7	4.6	3.4	3.0	3.2
FDI, USD m	252	121	144	112	142	139	74	121	375	475	820
Foreign currency deposits/M2, %	67.5	54.0	60.0	68.0	70.0	69.0	69.0	71.1	71.4	75 b/	NA

### Notes:

a/ ADB estimate from *Asian Development Outlook* 2008.

b/ data from National Bank of Cambodia

### Sources:

*Asian Development Outlook*, various issues.

IMF Country Reports, various issues.

National Bank of Cambodia

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a viable banking system with emphasis on a solid legal and supervisory framework. Unlike many other transitional economies, Cambodia faces a situation of rebuilding rather than transforming a banking system. While banking restructuring has made considerable progress, the state-owned Foreign Trade Bank retains its role as a key player. Furthermore, lax licensing requirements have led to a proliferation of weak joint-venture banks, putting a strain on Cambodia's supervisory and regulatory capacity, and whose problems have hampered the building of confidence in the banking system (Unteroberdoerster 2004). As a result, even though monetisation has been increasing, Cambodia remains largely unbanked.

Many institutions and laws have appeared in the last decade, but many more need to emerge. There are also important issues relating to the enforcement of these laws that need to be addressed.

In sum, although Cambodia's economic, social and political achievements over the past decade have been nothing short of spectacular, they have been insufficient to start de-dollarisation. Furthermore, monetary and financial reforms have lagged behind, and these are arguably more relevant in reversing dollarisation.

These issues lead naturally to the second factor—hysteresis. The concept of hysteresis extends all the way from simple inertia to path-dependence to rigid irreversibilities. Basically, it suggests that history matters, and that there can be non-linearities, or “stickiness”, in the system, which should be taken into account in order to understand the process, or its unravelling. The circumstances under which Cambodia came to be dollarised are somewhat different from other dollarised economies, and this is important in understanding the persistence of dollarisation.

Dollarisation in Cambodia is the direct legacy of the destruction of economic and financial institutions after the 1970s, economic mismanagement in the 1980s and the large inflows of US dollars that occurred during the UNTAC period in the early 1990s. Thus, unlike other countries where bouts of macroeconomic instability and hyperinflation induced or increased dollarisation, the final and determining source of

dollarisation in Cambodia was an administrative and political event.

With the cost of the UNTAC intervention estimated at a massive \$1.7 billion, the subsequent level of dollarisation was very high. Large inflows of foreign assistance and private transfers, all of them also in dollars, and political and economic uncertainties in the 1990s, have kept dollarisation high. Cambodia is easily the most highly dollarised country in Asia, and one of the highest in the world. The magnitude and duration of dollarisation have combined to create significant inertia and path-dependence in the system. It will take just as much and just as long, if not more of both, before any reversal is likely. The stronger hysteresis effect in Cambodia, compared to either Vietnam or the Lao PDR, suggests that de-dollarisation will be more protracted.

As Fischer (2006) puts it, “Dollarization typically has a long life, generally surviving long after the period

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of instability that gave rise to the phenomenon”. The special circumstances surrounding the introduction of dollars into Cambodia, combined with the high initial level of dollarisation, imply an even greater level of persistence. In addition, and as noted earlier, recent

economic and financial good news has contributed to increasing dollarisation, suggesting that the reversal is likely to take even longer. If all of this is true, then what is required is patience, since high and prolonged dollarisation may have induced significant hysteresis. Reacting, through frustration, by trying to enforce de-dollarisation is then not only unlikely to work, but may be counter-productive, resulting in an even longer wait for the reversal to begin.

There is substantial international evidence to support this call for patience, as evinced in the quotation from Fischer that we presented at the start. Cambodia too may appear as one of those countries where dollarisation seems impossible to reverse, at present. But there are many examples of successful de-dollarisation if patience is combined with a commitment to pursue credible economic and financial reforms, and almost as many examples where attempts to enforce de-dollarisation have failed, miserably.

salaries should be paid in riels, even if indexed to a US dollar amount to ensure their purchasing power.

In essence, institutional constraints preventing greater use of riels, when there is demand for them, should be removed. Another example relates to microfinance agencies, which often complain of a lack of riels to supply their lending requirements for small borrowers. It is estimated that the microfinance industry alone will require 120 billion riels in 2008, and that amount is more than is available in the market.<sup>7</sup> Apparently the restricted supply of riels is intended to avoid any further depreciation against the dollar. If

<sup>7</sup> Quoted in "Microfinance needs more Riel to lend: Phnom Penh Post, 17 December 2007.

there is a demand for more riels for lending purposes, then this concern would appear to be misplaced.

In sum, rules and regulations, whether implicit or explicit, that favour the use of dollars are just as detrimental as those that impose the use of riels in terms of the long-run objective of de-dollarising. These can and should be removed immediately. Sustaining and building upon the macroeconomic and political achievements of the past decade, combined with renewed urgency in completing the financial, legal and institutional reform agendas, will eventually bring about a natural process of de-dollarisation in Cambodia, as it has done elsewhere.

## 5. Concluding Remarks

Cambodia has come a long way in the past 10 years. The economic achievements in particular, but also political, legal and institutional reforms, have surpassed the expectations of most commentators. With these achievements, many expected that a process of de-dollarisation would have been in train by now. Instead, what we see is an increase in dollarisation over this period. This has understandably led to frustration and increasing calls for more interventionist action. In particular, there have been calls for government to try to enforce de-dollarisation.

In this paper, we have tried to explain the recent increase in dollarisation, as well as the apparent delay in de-dollarisation in Cambodia. We argued that the recent increase is part of a transition process, being driven by "good news" rather than "bad news". This is likely to be temporary and no cause for alarm. What is more worrying to some is the persistence of dollarisation, or its apparent irreversibility. We attribute this persistence to an unfinished reform agenda, as well as inertia and "stickiness" in the system. The unique circumstances surrounding the introduction of dollars into the Cambodian economy, combined with a very high level of dollarisation, suggest that de-dollarisation is likely to be more protracted than it would otherwise be. It is not that it is irreversible without direct intervention; it will just take more time.

For these reasons, any drastic policy action, such as attempts to enforce de-dollarisation, is not only likely to fail, but could prove counter-productive. Since the costs of dollarisation appear to exceed the benefits, some action is warranted. One option is formal dollarisation, but this is politically unpalatable and economically questionable. Another is the adoption of a currency board, but this too appears premature, if not financially infeasible, at present.

We therefore advocate a policy that does not directly interfere with monetary arrangements, but focusses instead on accelerating accommodative reforms, especially in the financial sector, and on legal and institutional reforms. We also identify institutional barriers that need to be overcome to prepare the groundwork for a natural process of de-dollarisation.

It would be foolish to predict that this policy prescription would lead to de-dollarisation within the next decade. It is unclear how long it will take, and it may well take longer. But it will happen, naturally, as it has in Indonesia, Israel, Poland, Mexico, Egypt and Turkey (to name just a few) and as it is happening next door in Vietnam. Based on international evidence and an understanding of the Cambodian context, one thing is clear: trying to enforce de-dollarisation will mean that it will take even longer!

## 4. What To Do?

As noted in the introduction, there are growing calls in Cambodia for enforcing de-dollarisation. The views on enforcing de-dollarisation are probably driven by a belief that: (i) the time is ripe for de-dollarisation; and (ii) dollarisation has more costs than benefits.

The second point may well be right. Kang (2005) estimates the loss in seigniorage to be \$682 million to the end of 2004, with an additional \$61 million lost annually. Although this estimate is broadly consistent with the international evidence, which points to an annual loss amounting to about 2 percent of GDP, it is likely to be an underestimate in Cambodia because a significant, but undetermined, amount of foreign currency flows are unrecorded. Furthermore, there is the almost complete loss of autonomy with regard to monetary policy. This constraint is evident at present, with the US Federal Reserve running an expansionary monetary policy at a time when Cambodia needs tightening, to curtail growing inflationary pressures.

Even if we ignore the policy constraint and unrecorded flows, the estimated seigniorage loss alone may well outweigh the benefits flowing from greater price stability, reduced exchange rate volatility and other forms of macro policy credibility. These benefits, however, are even more difficult to quantify than the costs. Nevertheless, even if the costs do indeed outweigh the benefits, does this then mean that the time is ripe? In essence, this is akin to asking if enforced de-dollarisation will be an improvement on the current situation. The international evidence would suggest otherwise (see Menon 2008).

Indeed, there is no need to look to Cuba, Liberia or Russia to demonstrate the difficulties associated with attempting to enforce de-dollarisation; a glance across the border to the Lao PDR is sufficient. When the Bank of the Lao PDR moved to enforce Decree No. 53 in June 2007, stipulating that only the kip can be used as a medium of exchange in all domestic transactions, the result was counter-productive. The depreciation of the kip that followed actually reduced its value share in the money stock (see Menon 2007). It is not sufficient

to demonstrate that the costs of dollarisation outweigh the benefits; proponents of enforced de-dollarisation have to also show that their “solution” will be an improvement on the status quo. All of the international evidence suggests that this is highly unlikely.

If enforcement is not the answer, and the costs outweigh the benefits, what then should be done? A spectrum of policy options is available, bounded by enforcement at one end and official dollarisation on the other, and in between lie currency board arrangements (CBAs) and the muddling through approach.<sup>4</sup>

Let's start with official dollarisation. A number of Latin American countries, such as Ecuador, El Salvador and Panama, have chosen to adopt the US dollar officially as their currency. Most of these countries have had quite stable inflation rates subsequently, and Panama in particular is often hailed as a success story of formal dollarisation. Given the high level of dollarisation in Cambodia, could this be a feasible option? It is unlikely for a number of reasons. Unlike the Latin

American countries that have chosen official dollarisation, Cambodia is not that closely integrated with the US economy. The US has also been unwilling to return seigniorage revenues to countries that formally dollarise. Thus, whatever seigniorage revenues are currently being earned would be

lost under official dollarisation. The main obstacle standing in the way of official dollarisation is political, however. The government is unlikely to consider this option seriously because it is politically committed to reversing dollarisation.

Moving along the spectrum, a CBA is close to official dollarisation, but there are important differences. First, it is less rigid in that devaluation is possible. Second, it would reinstate seigniorage, while official dollarisation would remove it completely. Although Hong Kong is perhaps the most well-known country whose economy employs a currency board, a number

<sup>4</sup> Another option involves a single currency or monetary union. This option is considered in detail in Menon (2008). Based on that analysis, it would appear that this is not a feasible option for Cambodia or its neighbours at present, since any feasible configuration fails to meet the criteria of an optimal currency area.

of newly independent transitional economies, such as Lithuania, Estonia and Bosnia, have implemented currency board-like systems with success, having their local currencies anchored to the euro.<sup>5</sup>

How feasible is a CBA for Cambodia? At the moment, official reserves cover about three times the amount of riels in circulation at present exchange rates. Although this may sound impressive, the fact remains that most estimates place the share of foreign currency in circulation at between 85 and 95 percent (de Zamarocky and Sa 2002). Taking the mid-point of these estimates, this implies that riels constitute only about 10 percent of currency in circulation. To recoup the foreign currencies in circulation at present would thus require a tripling in the amount of official reserves. Without substantially increasing government borrowings, most of which would have to come from abroad, this appears to be a binding constraint.<sup>6</sup>

Thus, although CBAs may provide an attractive alternative, either interim or permanent, to the current situation, implementing one appears to be beyond the financial capacity of Cambodia at present.

This brings us finally to “muddling through but accelerating reforms”. This option involves the minimum amount of direct intervention, but the maximum amount of indirect changes in policy and reform measures. With this approach, the current monetary arrangements are left as they are, but the focus shifts to accommodative policy reform. The macroeconomic situation must continue to improve as it has over the past decade, and stability has to be a permanent feature of the political

landscape. These are minimum requirements for the long-term reversing of dollarisation.

But more will be needed. For instance, it is critical that the key medium-term challenges identified in the Financial Sector Development Strategy 2006–15, such as increasing intermediation, strengthening the links between banking and microfinance and improving overall financial institution operations, are addressed. Macroeconomic stability will also be crucial in restoring confidence in the riel. The role that macroeconomic reform can play in reversing dollarisation is easily illustrated by tax reform. A significant portion of the demand for riels is related to tax payments, since they need to be made in riels. The revenue base from tax collections is likely to increase, particularly in the context of sustained economic growth, as a result of: (i) fiscal reforms,

including broadening of the tax base; (ii) improvements to tax collection mechanisms; and (iii) policies designed to curb tax avoidance. This will directly increase the demand for riels, as well as fiscal sustainability and macroeconomic stability. All of these will contribute to de-dollarisation.

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*These are “big ticket” macroeconomic, political and financial issues that need to be addressed. A host of other institutional barriers need to be dismantled, which currently add to the differences, both perceived and real, between dollars and riels. These stand in the way of a gradual process of de-dollarising, and some have been in place for decades.*

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These are “big ticket” macroeconomic, political and financial issues that need to be addressed. A host of other institutional barriers need to be dismantled, which currently add to the differences, both perceived and real, between dollars and riels. These stand in the way of a gradual process of de-dollarising, and some have been in place for decades. These include the preference given to US dollars in the payment of wages to private sector workers. The fact that the Labour Law defines the minimum wage in US dollars exemplifies this preference. Another example is the fact that international aid organisations and NGOs tend to pay their staff solely in US dollars, when in other countries organisations such as the UN tend to pay a minimum of 30 percent of salaries in the currency of the home country. A useful step in setting up the preconditions for de-dollarising would be to remove this favoured status of dollars in the payment of wages. It goes without saying that government

<sup>5</sup> Argentina had a currency board system anchored to the US dollar up until 2002, and many Caribbean states continue to employ a dollar-anchored CBA.

<sup>6</sup> This assumes that the foreign currencies in circulation are held for transaction purposes, or to serve as medium of exchange. Some share of foreign currencies in circulation may be held to serve the store of value function, given low confidence in the domestic banking system. This share would not have to be recouped in implementing the CBA. Although the precise amount that this share constitutes is unknown, it is unlikely to be substantial enough to alter the conclusion that implementing a CBA will be financially demanding on government.