The Dollarisation Paradox in Cambodia: Network Externalities Matter

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Abstract

The increase in dollarisation in Cambodia has been contrary to the general belief that macroeconomic and political stability help reduce dollarisation. We provide so far the first explanation for this counterfactual phenomenon. In doing so, this paper develops a theoretical model based on the framework of Uribe (1997) by including a dollar pricing index to amplify the network effects of using a foreign currency (denoted dollar). The dollar pricing index, a proportion of an economy denominated by the dollar, reduces the dollar's transaction cost, thus increasing its usage in the economy. This increased use of the dollar further improves the experience of using it, hence results in higher usage of dollar in the price quotation. The positive interaction of using the dollar as a unit of account and a means of payment causes dollarisation continues to rise, even though the economy has achieved low inflation and political stability.

Keywords: Dollarisation; Dollar pricing index; Network externalities

JEL Classification: E41; F41

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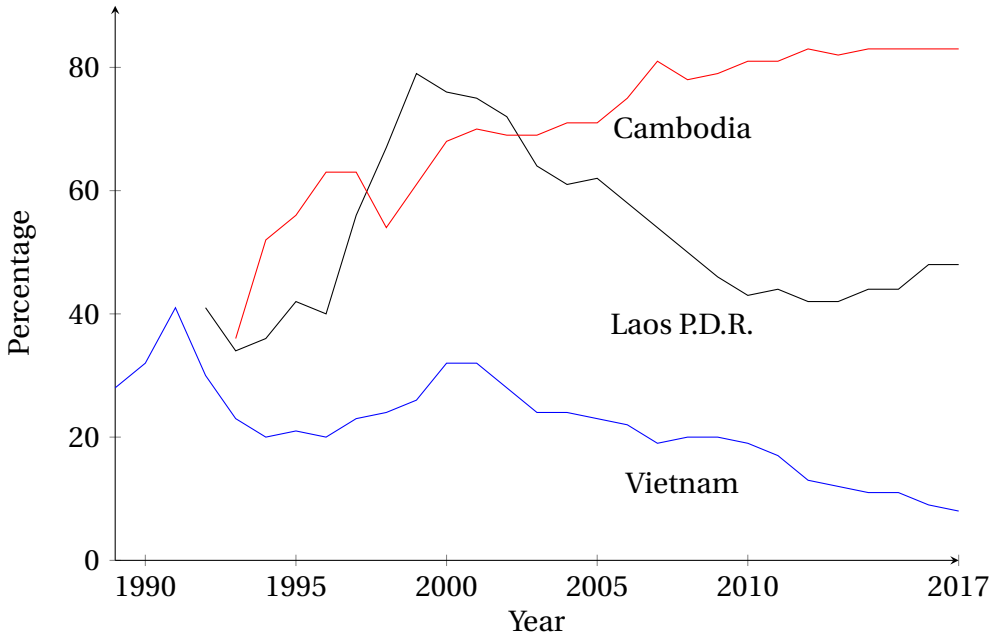
"*In Cambodia, the Ghosts Prefer Dollars.*"

— *The New York Times (2016)*

1 Introduction

The US dollar is a dominant currency in Cambodia instead of its currency, Riel. When economies such as Cambodia use a foreign currency in parallel to or instead of their own currencies (as a result of high inflation), this financial adaptation is known as *dollarisation*. The general belief about the evolution of dollarisation is that with dollarised economies experience macroeconomic and political stability for extended periods of time, their level of dollarisation gradually declines (Menon, 2008). For instance, as Laos P.D.R. and Vietnam have achieved an average annual economic growth of about 7% and inflation of about 6% along with political stability over the last two decades, their degrees of dollarisation have respectively reduced from 32% and 75% in 2001 to 8% and 48% in 2017. Somewhat paradoxically, although Cambodia has had similar experience during the same period, its dollarisation trend has continued to rise from 35% in 1993 to 84% in 2017 (Figure 1).

Figure 1: Trends of dollarisation in Cambodia, Laos P.D.R. and Vietnam



Note: Degree of dollarisation is a ratio of dollar-denominated deposits to broad money (M2). Data were sourced from the International Monetary Fund Country Reports (Appendix A).

To help explain this upward trend of dollarisation in Cambodia, Menon (2008) offers three possible factors: exports, inflows of foreign direct investments (FDI), and aid. Yet, the data (Figure A1) do not actually support this conjecture. In Vietnam, the total averages of these three factors from 2000 to 2017 accounted for about 83% of the country's gross domestic product (GDP), which was higher than in Cambodia. However, whereas Vietnam's dollarisation has expectantly shown a downward trend, Cambodia's dollarisation has increased.

For the sake of understanding the causes behind this phenomenon, this paper extends Uribe (1997) cash-in-advance model by including a *dollar pricing index*, defined as a proportion of an economy that quotes the dollar as a unit of account. The inclusion of this variable amplifies the network effects of using the dollar in an economy.

The network effects are the central feature in Uribe (1997) model to explain dollarisation dynamics in developing countries.[1] In his model, Uribe (1997) assumes that an economy's accumulated experience in using the dollar as a medium of exchange acts an externality that lowers the transaction cost of buying goods with dollars. However, the network effects would be far more significant if dollar quotations were included[2] because dollar-denominated goods promote and ease dollar usage. Therefore, the inclusion of the dollar pricing index further reduces the transaction cost of buying goods with the dollar, increasing its usage in an economy. The higher usage of dollar then improves the knowledge of using it, encouraging the economy to quote the prices in dollars. The interaction between the use of the dollar in the price quotation and the accumulated experience of using it increases the degree of dollarisation, even though the economy has achieved social, political, and economic stability.

Two waves of survey data[3] in Cambodia along with qualitative data from Laos P.D.R., Vietnam, and Peru, support this augmented model's prediction. With the increasing use of foreign currencies as an unit of account in Cambodia, the use of foreign currencies as a medium

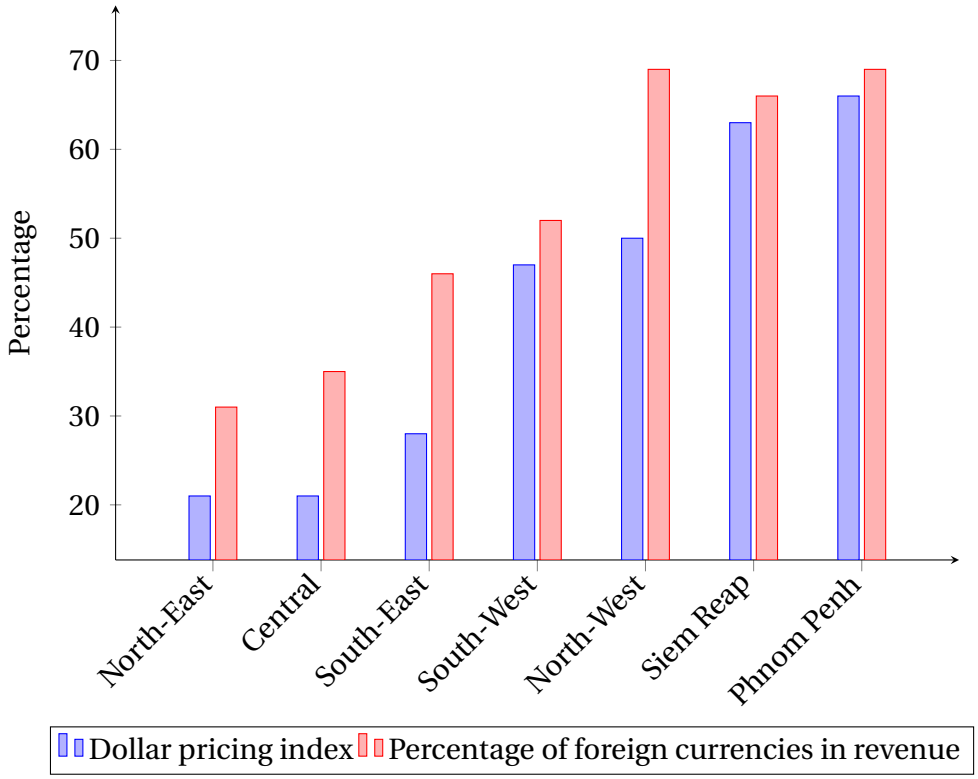
[1] Uribe (1997) model shows that a temporary high inflation triggers an economy to adopt the dollar. Because of the network effects, the degree of dollarisation declines gradually when the inflation stabilises in the economy. This model explains well the dynamics of dollarisation in most developing countries; however, it can not explain the evolution of dollarisation in Cambodia - Dollarisation trend continues to rise, even though Cambodia's inflation has stabilised.

[2] Some dollarised economies, such as Laos P.D.R. Vietnam, and Peru, officially ban a foreign currency from being used as a unit of account, while another like Cambodia does not forbid such a role of foreign currency in its economy.

[3] The first survey was conducted by Khou (2012) in 2010 with a sample of 1106 local merchants, and the second one was conducted by the National Bank of Cambodia (NBC) and JICA research institute in 2014-2015 with a sample of 856 enterprises.

of exchange also grows. Over the period 2010-2014, the dollar pricing index and the degree of dollarisation have increased from 28% to 43% and 81% to 83%, respectively. This positive relationship was also observed in Cambodia's cross-regional areas. Figure 2 shows that the higher the dollar pricing index a region has, the larger proportion of revenue in foreign currencies the region receives.

Figure 2: Dollar pricing index and percentage of foreign currencies in revenue in Cambodia's cross-regional areas



Note: The dollar pricing index is measured by a proportion of products that merchants quote their prices in foreign currencies. The data were retrieved from National Bank of Cambodia (2016, p.53-58).

While Cambodia has no restrictions on which currency is used to quote prices, Laos P.D.R., Vietnam, and Peru have banned foreign currencies from being used as a unit of account. The ban has decreased the dollar pricing index, thus raising the cost of using the dollar in transactions, which further reduced the use of dollars in transaction. As a consequence, the degree of dollarisation in these countries has gradually declined, as predicted by Uribe (1997) model.

The rest of the paper proceeds as follows. Section 2 reviews the relevant literature con-

cerning with currency risk and network externalities as the roots of dollarisation. Section 3 briefly discusses the dollarisation in Cambodia. Section 4 develops a model of currency substitution. Section 5 discusses the effects of government policies including how changes in depreciation rate (or inflation), dollar pricing index, or both affect the equilibrium. Section 6 provides some qualitative evidence to support the model's predictions, and Section 7 concludes the paper with policy implications and model limitation.

2 Currency Risk and Network Externalities

The present study is related to two main strands of literature. One is concerned with how currency risk triggers the use of a foreign currency. The other focuses on the network externalities of using a foreign currency to help explain the evolution of dollarisation in developing countries.

Craig and Waller (2004) and Camera et al. (2004) develop a model in which households use both domestic and foreign currencies in their transactions. Because the domestic currency is perceived to have a relatively high probability of losing its value before its use in a transaction, households tend to use and accept the foreign one instead. However, because using the foreign currency incurs a transaction cost, the domestic one still remains a medium of exchange. The inclusion of the transaction cost in the model is motivated by the fact that in developing countries, households might need to verify the authenticity of an unfamiliar currency (Engineer, 2000; Tandon and Wang, 2003), and spend time switching between currencies (Guidotti and Rodriguez, 1992).

These two factors – currency risk and transaction cost – lead to the coexistence of both currencies in the economy, which neither supports nor contradicts Gresham's Law that risky money drives safe money out of the economy (Rolnick and Weber, 1986). Although they are offsetting factors in explaining the extent of currency substitution, yet the studies by Melvin and Fenske (1992) and Clements and Schwartz (1993) show that the effects of a decrease in currency risk are weaker in an economy that has already experienced a history of exchange rate instability, implying that de-dollarisation might not occur or may be slow in such economies.

Based on the idea that using a foreign currency incurs a transaction cost, Uribe (1997) develops a simple cash-in-advance model, to which this paper is the closest. In his model, the network externalities play a central role in explaining the continued existence of the foreign currency in an economy once it has already been widely used as a medium of exchange. In other words, the more experience an economy has with using the foreign currency as a medium of exchange, the lower its transaction cost becomes. These network effects are also present in the search theoretical models of money (see e.g. Matsuyama et al., 1993; Trejos and Wright, 1995). Kiyotaki and Wright (1989) show that even an item without any intrinsic value can become a means of payment if widely accepted as such. Then, the use of such a thing fundamentally becomes the norm. This indicates that if a foreign currency is broadly used during a period of high inflation, its use will continue after inflation returns to a lower level.

Empirically, the network effects on hysteresis have been supported in several studies. For instance, Valev (2010) uses survey data to examine the impacts of currency risk and network externalities as causes of hysteresis of currency substitution in Bulgaria. He finds the network externalities to be a major factor of hysteresis (see also Duffy and Ochs, 2002; Samreth, 2011).

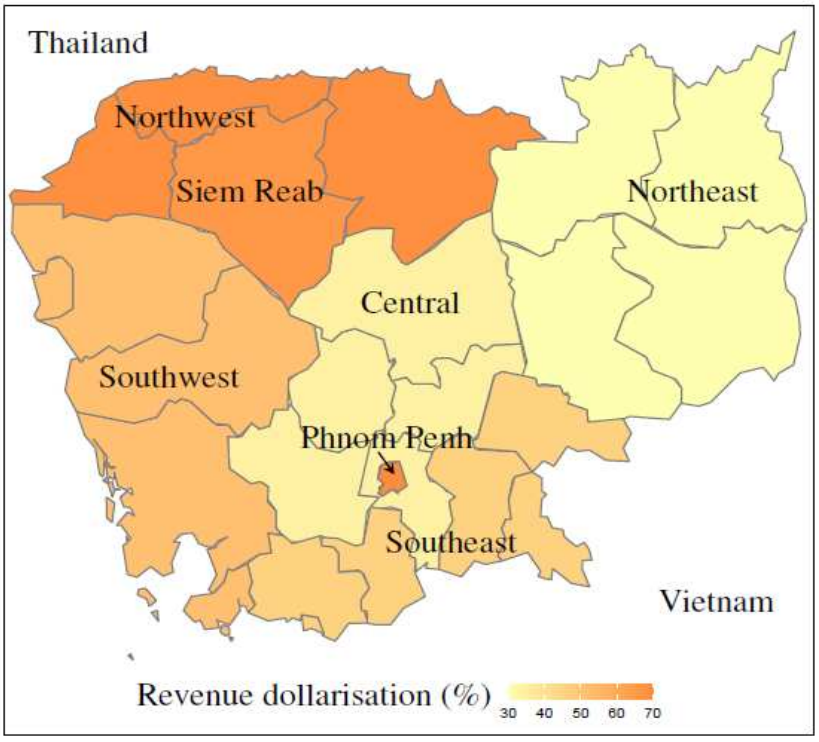
3 The Dollarisation in Cambodia

The currency risk and network externalities are the roots of rising dollarisation in Cambodia. Cambodians had already lost trust in the domestic currency (riel) when the riel and economic institutions (e.g. banks) among others were abolished during the Khmer Rouge regime, known as the Cambodia Genocide, from 1975 to 1979. In March 1980, the riel was introduced back into the economy. Yet, people preferred barter and gold for most domestic transactions (De Zamaroczy and Sa, 2002). This loss of confidence in the riel was further eroded by the fact that the riel became highly depreciated against the dollar during the period 1988-1991.

In the early 1990s, the usage of US dollar grew rapidly as Cambodia was open to foreign investments and aid. The United Nations Transitional Authority spent around USD 1.7 billion

– around 75% of Cambodia's GDP at that time – on rents and local services for its peacekeeping operations including assisting Cambodia with its first national election in 1993 (National Bank of Cambodia, 2016, p.8).

Figure 3: The use of foreign currencies across regions in Cambodia



Note: Revenue dollarisation is a fraction of foreign currencies in revenues. The US dollar is used predominantly in two cities – Phnom Penh and Siem Reap. The US dollar and Thai currency (baht) are widely used along the northeast and southwest border with Thailand. The US dollar and the Vietnamese dong are frequently seen along the southeast border with Vietnam. In other regions, which are mainly rural, the domestic currency (riel) is predominant. Source: National Bank of Cambodia (2016, p.53–58).

For the sake of price stability and economic growth, Cambodia has placed no restrictions on the use of foreign currencies, thus leading multiple currencies to be in use. The type of currency used as a means of payment is positively associated with the type of currency used as a unit of account. For instance, as merchants in Phnom Penh City use the US dollar to display prices for approx 65% of their total products, they also receive around 69% of their revenues in the US dollars (Figure 2). Moreover, the type of currency used in price quotation depends mainly on types of goods and services[4], and whom Cambodians do business with. As a result, the degree of dollarisation differs across regions, and concentrates in urbane

[4] e.g. The US dollar is predominantly used to quote salaries and pay employees in the private sector as well as international organisations, and for big-ticket items, such as houses and vehicles.

areas, tourism sites and near trade borders (Figure 3).

Since Cambodia was increasingly integrated into the world in the early 1990s, it has performed spectacularly (e.g. its average annual GDP growth is around 7%), but it has made it easy for foreign currencies to be used because products have been quoted in a foreign currency. Hence, the degree of dollarisation has increased from 35% in 1993 to 84% in 2017. This upward trend of dollarisation in Cambodia appears to be the odd one out among other dollarised economies. To the best of our knowledge, the theoretical model we develop in the next section is a first effort towards a formal way to explain this counterfactual phenomenon.

4 Model

The theoretical framework is a cash-in-advance model, as presented in Uribe (1997). Differing from Uribe (1997), we introduce the role of a foreign currency as a unit of account to amplify the network effects of using the foreign currency. In addition, we incorporate a government's degree of regulations on the use of the foreign currency in price quotation. These inclusions are motivated by observations in dollarised economies: Some dollarised economies, such as Laos P.D.R., Vietnam, and Peru, officially ban a foreign currency from being used as a unit of account, while Cambodia allows such a role of foreign currency in its economy.[5]

The economy is a small open dual-currency system, in which a foreign currency, denoted dollar, is used along with a domestic currency, riel. This economy is endowed and populated by a large number of infinitely lived, identical households whose preferences are defined over paths of consumption, $\{C_t\}_{t=0}^{\infty}$, and represented by the following lifetime utility function:

$$\int_0^{\infty} e^{-\rho t} U(C_t) dt, \tag{1}$$

[5]We have data of only these four countries about using a foreign currency as a unit of account. For other dollarised economies, we could not find any document that shows whether they have allowed a foreign currency to be used in the price quotation.

where ρ is a discount rate and $U(\cdot)$ is an instantaneous utility function which is assumed to be continuously differentiable, strictly increasing, and strictly concave. Consumption is a composite of a continuum of goods, $c_t(\theta)$, indexed by $\theta \in [0,1]$,

$$C_t = \int_0^1 u(c_t(\theta))d\theta,$$

where $u(\cdot)$ is assumed to be continuously differentiable, strictly increasing, and strictly concave, and to satisfy $\lim_{c\to 0} u_c(0) = \infty$. The condition $u_c(0) = \infty$ implies that a consumption of every type of good θ is always positive: $c(\theta) > 0$.

Households can use either riels or dollars to pay for goods. However, using dollars incurs a transaction cost that differs across goods θ. That is, the unit transaction cost of buying good θ with dollars is $\phi(\theta, k_t, q_t)$. The variable k_t represents the economy's accumulated experience at time t with using dollars as a medium of exchange, and it is referred to as *dollarisation capital*. The variable $q_t \in [0,1]$ – referred to as *dollar pricing index* – is a proportion of products that merchants quote their prices in dollars:[6] $q = 0$ means that all products' prices are displayed in the local currency, riel; $q = 1$ indicates all prices are quoted in the foreign currency, dollar. This dollar pricing index indicates the economy's accumulated experience at time t with using dollars as a unit of account (The variable q is the main feature that this paper contributes relative to Uribe (1997)'s work.[7]). While the paths of k_t and q_t are taken as given, both variables are endogenously determined and positively reinforcing each other at the aggregate level. The function $\phi(\theta, k_t, q_t)$ satisfies the following assumption:

Assumption 1. $\phi : [0,1] \times \Re^+ \times [0,1] \to \Re^+$ *is non-negative, twice continuously differentiable, and strictly convex in three arguments and satisfies* $\phi_\theta > 0$, $\phi_k < 0$, $\phi_q < 0$, $\lim_{k\to\infty} \phi_k = 0$, $\lim_{q\to 1} \phi_q = 0$, *and* $\lim_{\theta\to 1} \phi(\theta, k, q) = \infty$.

Assumption 1 states that the transaction cost is strictly increasing in θ, and becomes infinitely large as θ approaches 1. This prohibitive cost ensures that there always exists a positive demand for the domestic currency. But the transaction cost is strictly decreasing

[6] Cambodia's survey data show that q was 28% in 2010 and 43% in 2014 for the economy as a whole.

[7] If we relabel q and k as one variable to capture an economy's accumulated experience in using a foreign currency, the model is unable to explain the dollarisation phenomenon in Cambodia because there is no reinforcing mechanism to amplify the network effects of using a foreign currency.

in both k_t and q_t. This decreased cost is used to capture the network externalities resulting from adopting the dollar as an alternative legal tender. In addition, the condition $\lim_{k\to\infty} \phi_k = 0$ and $\lim_{q\to 1} \phi_q = 0$ is for technical convenience when characterising a steady state.

There exist only two types of markets in this endowed economy: financial market and goods market. As in Lucas (1982), the financial market opens first, and the goods market opens only after the former closes. At time t, households hold a stock of riel-denominated wealth W_t. With this amount of money, they go to the financial market to obtain their desired balance of dollars (d_t) and riels (M_t) with a nominal exchange rate (E_t). This exchange rate – expressed as units of riels per unit of dollars – is set by the government. In addition, they can buy or sell an internationally traded, dollars-denominated bond, b_t, at the price of one dollar per unit. This bond bears the constant real interest rate $r > 0$ in dollars at time t. We assume strict purchasing power parity and perfect capital mobility to ensure that this is the real interest rate in both the domestic economy and the world. Denoting $w_t \equiv W_t/E_t$ and $m_t \equiv M_t/E_t$, the household's budget constraint in dollars is given by:

$$w_t = b_t + m_t + d_t. \tag{2}$$

As the goods market opens, one member of the household goes to purchase the desired amount of each good θ, while another member receives an endowment of y_t units of each good θ. All goods θ are traded internationally at the common price of one dollar or E per unit. When selling their goods, producers can accept either riels or dollars. If they take riels, they have to wait until the financial market opens to convert riels into dollars. Denote Θ_t^d and Θ_t^m as the set of goods the household purchases with dollars and riels at time t, respectively, the household faces the cash-in-advance constraints to purchase goods with riels and dollars as follows:

$$\frac{m_t}{1+\pi_t} \geq \int_{\Theta_t^m} c_t(\theta)\, d\theta, \tag{3}$$

$$d_t \geq \int_{\Theta_t^d} \left[1 + \phi(\theta, k_t, q_t)\right] c_t(\theta)\, d\theta, \tag{4}$$

where $\pi_t \equiv \dot{E}_t/E_t$ is the depreciation rate (or inflation rate) at time t that needs to satisfy $(1+r)(1+\pi_t) > 1$ so that there is always a cost of liquidity of services provided by currency holdings (a nominal interest rate $i > 0$). Moreover, household does not have any debt after exiting the economy: $\lim_{t\to\infty} e^{-tr} w_t \geq 0$. Denoting $\tau_t \equiv T_t/E_t$ to be the government's transfers to households in terms of dollars, the household's evolution of real wealth is given by:

$$\dot{w}_t = r b_t + \frac{m_t}{1+\pi_t} - m_t - \int_{\Theta_t^d} \left[1+\phi(\theta, k_t, q_t)\right] c_t(\theta) d\theta - \int_{\Theta_t^m} c_t(\theta) d\theta + y_t + \tau_t. \tag{5}$$

The representative household chooses paths $\left[c_t(\theta)_{\theta\in(0,1)}, \Theta_t^m, \Theta_t^d, m_t, d_t\right]_{t=0}^{\infty}$ to maximise its lifetime utility Equation (1) subject to the constraints Equations (2)-(5) by taking as given the initial wealth (w_o) and paths $\left[\pi_t, q_t, k_t, y_t\right]_{t=0}^{\infty}$ and satisfying the No-Ponzi condition. The first-order conditions associated with the household's optimisation problem are Equations (3)-(5) binding and (hereafter, we drop time subscripts when no risk of confusion arises)

$$\Theta^d = [0, \bar{\theta}(k,q,\pi)), \tag{6}$$

$$\Theta^m = [\bar{\theta}(k,q,\pi), 1], \tag{7}$$

$$\bar{\theta}(k,q,\pi) = \begin{cases} 0 & \text{if } \phi(0,k,q) \geq \pi \\ \theta \text{ such that } \phi(\theta,k,q) = \pi & \text{otherwise} \end{cases} \tag{8}$$

$$c(\theta) = c(\bar{\theta}(k,q,\pi)) \quad \text{for } \theta \in \Theta^m, \tag{9}$$

$$\frac{u_c(c(\theta(k,q,\pi)))}{1+\phi(\theta,k,q)} = \frac{u_c(c(\bar{\theta}(k,q,\pi)))}{1+\pi} \quad \text{for } \theta \in \Theta^d, \tag{10}$$

$$\dot{\lambda} = \lambda[\rho - r], \tag{11}$$

$$U_C(C)\, u_c(c(\theta(k,q,\pi))) = \lambda[1+\phi(\theta,k,q)][1+r] \quad \text{for } \theta \in \Theta^d. \tag{12}$$

Equations (6) and (7) show that there exists a cut-off good $\bar{\theta}(k,q,\pi) \in [0,1]$ at time t, such that goods with index $\theta \geq \bar{\theta}(k,q,\pi)$ are bought with riels and the rest with dollars (Figure 4). This cut-off good is referred to as the degree of dollarisation at time t. Equation (8) shows that when the degree of dollarisation is positive, it is given by the good whose cost

is the same whether it is purchased with dollars or with riels. Assumption 1 implies that $\bar{\theta}(k,q,\pi)$ is continuous and any triple (k,q,π) such that $\bar{\theta}(k,q,\pi) > 0$, $\bar{\theta}(k,q,\pi)$ is strictly increasing in all three arguments, continuously differentiable, and strictly concave in k and q (Figure 5). Equations (9) and (10) state that $c(\theta)$ is continuous and strictly decreasing in θ for $\theta \in \Theta^d$, and constant for $\theta \in \Theta^m$. Equation (11) implies that λ – the shadow price of wealth related to flow constraint Equation (5) – is constant over time because the interest rate equals the discount rate at the steady state. Equation (12) shows that the marginal utility of consumption of the goods bought with dollars is equal to the product of the shadow price of wealth and the effective price of the goods. This effective price equals to its direct cost $(1+\phi)$ plus the opportunity cost of holding $(1+\phi)$ units of dollars required by the dollar cash-in-advance constraint to buy one unit of goods.

Figure 4: Degree of dollarisation

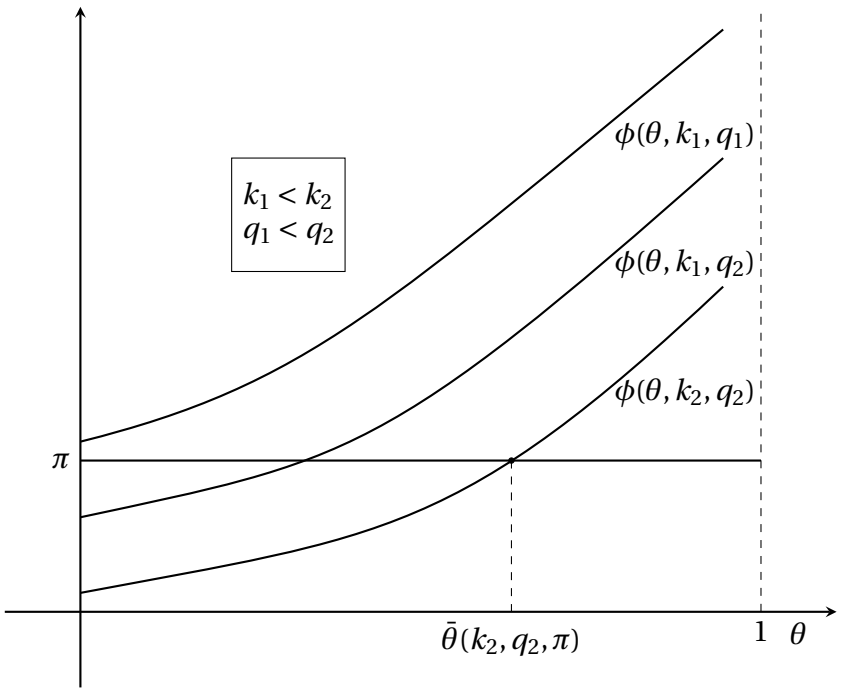
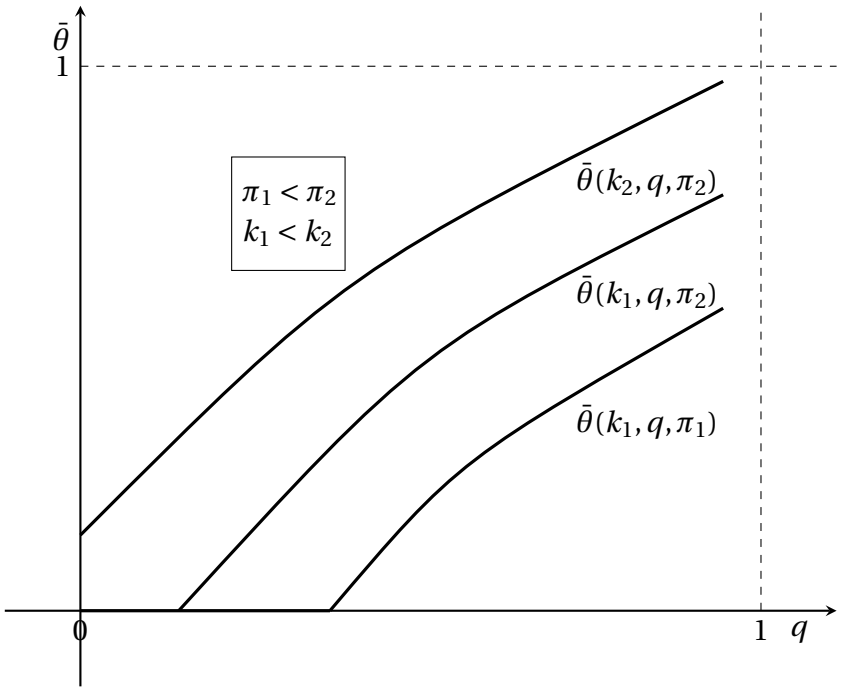


Figure 5: The function of $\bar{\theta}(k,q,\pi)$



Following Uribe (1997), we postulate the dollarisation capital k and the dollar pricing index q to evolve respectively as follows:

$$\dot{k} = f(\bar{\theta}(k,q,\pi)) - \delta_k k, \tag{13}$$

$$\dot{q} = h(\bar{\theta}(k,q,\pi)) - (\delta_q + \eta)q, \tag{14}$$

where $\dot{x}$ is the time derivative of x, δ_x refers the depreciation rate of x; η refers to the degree of government regulations on using the dollar as a unit of account, and $f(\cdot)$ and $h(\cdot)$ satisfy the following assumption.

Assumption 2. *f and h : $[0,1] \to \Re^+$ are continuously differentiable, strictly increasing, and strictly concave, with $f(0) = 0$ and $h(0) = 0$.*

Assumption 2 states that as more people use dollars for purchasing goods, the amount of dollars circulating the economy and the proportion of the economy that quotes prices in

dollars increases. That is, there is social learning by doing in the process of adopting dollars as a legal tender. The depreciation rates $\delta_k \in (0,1]$ and $\delta_q \in (0,1]$ together with $f(0) = 0$ and $h(0)$ mean that the stock of dollarisation and that of the dollar pricing index gradually decrease as the dollar is no longer used in the economy – the economy as a whole forgets how to use the dollar. The degree of regulations η captures the effects of government intervention in the use of the dollar in price quotation. The more stringent the regulations, the faster the fall of the dollar pricing index. For analytical convenience, η is assumed to be between 0 and 1 and satisfy $\eta + \delta_q \in (0,1]$.

The Steady-State Equilibrium

To simplify and characterise the steady state, Equations (13) and (14) can be rewritten as

$$\dot{k} = F(k,q,\pi) - \delta_k k, \tag{15}$$

$$\dot{q} = H(k,q,\pi) - (\delta_q + \eta) q, \tag{16}$$

where F and H are the composites of functions f and θ, and h and θ, respectively. Assumption 2 together with the fact that θ is strictly increasing and concave in k and q implies that F and H are also strictly increasing and concave in k and q.

A steady-state equilibrium is defined by the stock of dollarisation and that of the dollar pricing index (k^*, q^*), which satisfy the following two equations:

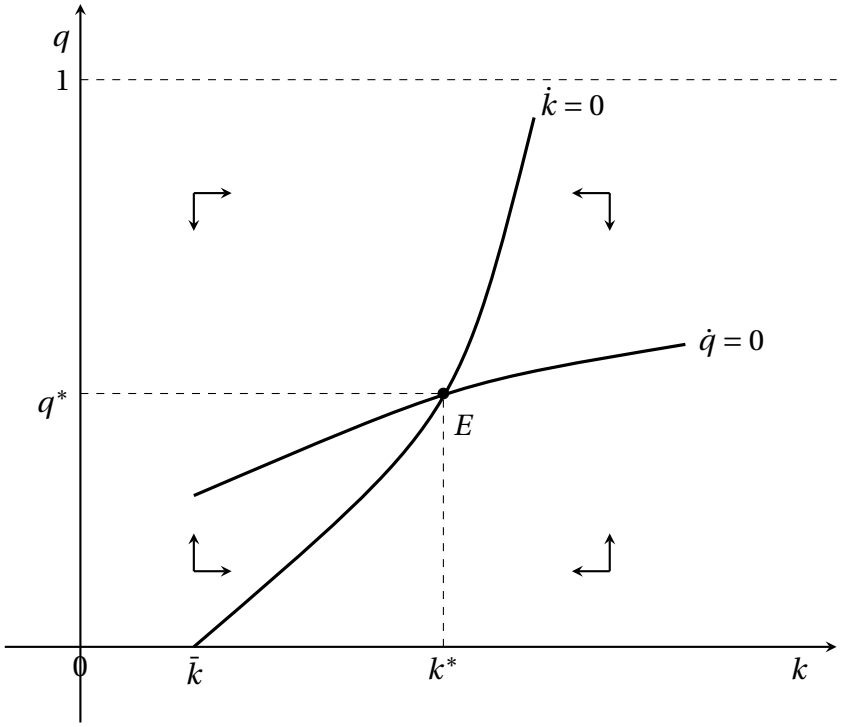
$$F(k^*, q^*, \pi) - \delta_k k^* = 0, \tag{17}$$

$$H(k^*, q^*, \pi) - (\delta_q + p) q^* = 0. \tag{18}$$

This steady-state equilibrium (k^*, q^*) is globally and uniquely stable. To see this heuristically, consider Figure 6, drawn in the (k,q) space. The curves $\dot{k} = 0$ and $\dot{q} = 0$, corresponding respectively to Equations (17) and (18), have a positive slope so that a higher dollar price

index is associated with a higher dollarisation capital in equilibrium. Moreover, the slope of $\dot{k} = 0$ curve is steeper than that of $\dot{q} = 0$ curve at the equilibrium.

Figure 6: The dynamics of q and k



To show that these statements are true, first consider the slope of $\dot{k} = 0$ curve in the (k, q) space. Based on the implicit function theorem, this slope is given by:

$$\frac{dq}{dk}\Big|_{\dot{k}=0} = \frac{\delta_k - F_k(k,q,\pi)}{F_q(k,q,\pi)}, \tag{19}$$

where $F_k \equiv \partial F/\partial k$ and $F_q \equiv \partial F/\partial q$. Equation (15) implies that $\delta_k = F(q,k,\pi)/k$ as $\dot{k} = 0$. The fact that F is strictly concave in k and $F(0,q,\pi) \geq 0$ yields the following inequality:

$$\begin{aligned} F(k,q,\pi) &> F_k(k,q,\pi)k + F(0,q,\pi) \\ &> F_k(k,q,\pi)k. \end{aligned}$$

This inequality leads to $\delta_k - F_k(k,q,\pi) > 0$, thus proving that Equation (19) is strictly positive.

Similarly, when the same method and argument are applied to Equation (16), the slope of $\dot{q} = 0$ curve, given below, is also strictly positive:

$$\frac{dq}{dk}\Big|_{\dot{q}=0} = \frac{H_k(k,q,\pi)}{\delta_q + \eta - H_k(k,q,\pi)}. \tag{20}$$

Second, to show that the slope of $\dot{k} = 0$ curve is steeper than that of $\dot{q} = 0$ curve at the equilibrium, we need to prove that the following inequality is true:

$$\begin{aligned}
\frac{dq}{dk}\Big|_{\dot{k}=0} &> \frac{dq}{dk}\Big|_{\dot{q}=0} \\
&\Updownarrow \\
\frac{F/k - F_k}{F_q} &> \frac{H_k}{H/q - H_q} \\
&\Updownarrow \\
(F - kF_k)(H - qH_q) &- qkF_qH_k > 0 \\
&\Updownarrow \\
kH_k(F - kF_k - qF_q) + qF_q(H - kH_k - qH_q) &+ (F - kF_k - qF_q)(H - kH_k - qH_q) > 0.
\end{aligned}$$

The second line is a result of substituting $F(k^*, q^*, \pi)/k^*$ for δ_k in Equation (19) and $H(k^*, q^*, \pi)/q^*$ for $\delta_q + \eta$ in Equation (20). The third and last lines result from simplifying and rearranging the terms in the second line (note that all functions are evaluated at the equilibrium point). Assumptions 1 and 2 together with Equation (8) show that this inequality is satisfied (see proof in Appendix B).

Third, the dynamic movements of k and q are dictated by the signs of the time derivatives of k and q, respectively. Since $\partial\dot{k}/\partial q = F_q > 0$, all the points below the $\dot{k} = 0$ curve are characterised by $\dot{k} < 0$ and all the points above the curve by $\dot{k} > 0$. Similarly, because $\partial\dot{q}/\partial k = H_k > 0$, all the points to the left of the $\dot{q} = 0$ curve are characterised by $\dot{q} < 0$ and all the points to the right of the curve by $\dot{q} > 0$. Therefore, the $\dot{k} = 0$ curve and $\dot{q} = 0$ curve divide the phase space into four regions, each with its own distinct pairing of signs of $\dot{k}$ and $\dot{q}$, as indicated by the right-angled directional arrows in Figure 6.

Finally, since this paper focuses on developing economies that have already experienced high inflation, the steady-state stock of dollarisation as shown by Uribe (1997) is positive while the dollar pricing index is 0 ($q = 0$). This steady-state stock is denoted by $\bar{k}$ in Figure 6. At the point $(\bar{k}, 0, \pi)$, the $\dot{q} = 0$ curve lies above the $\dot{k} = 0$ curve because $\dot{q} = F(\bar{k}, 0, \pi)$ is greater than 0 ($\theta(k_0, 0, \pi) > 0$). Assumption 1 implies that as q approaches to 1, the slope of the $\dot{k} = 0$ curve approaches to infinity. Likewise, k approaches to infinity, the slope of $\dot{q} = 0$ approaches to 0.

Therefore, the two demarcation curves ($\dot{k} = 0$ and $\dot{q} = 0$) intersect only once at point $E(k^*, q^*)$. This point is the globally stable equilibrium because regardless of where a point (k, q) starts, it tends to move toward point E as indicated by the directional arrows.

5 The Effects of Government Policies

In this section, we illustrate how changes in government policies affect the steady-state equilibrium and present three relevant cases to explain the rise and fall of the degree of dollarisation in developing countries.

5.1 The Effects of Changes in Inflation

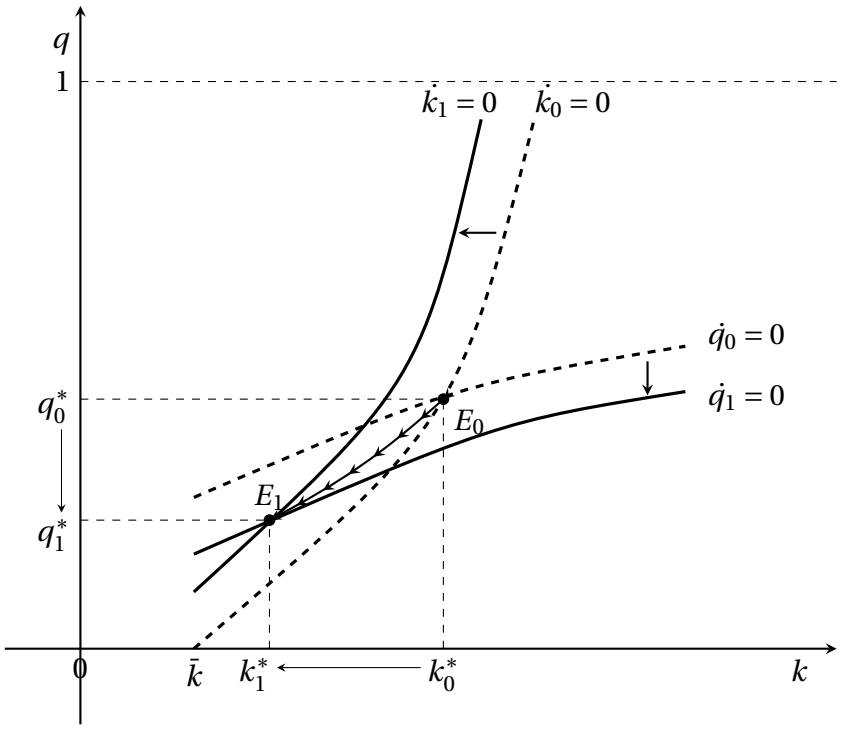
First, consider what happens to the equilibrium when a government reduces inflation. Empirically, when high-inflation countries decreased the inflation rate to a low level for a certain period of time, their dollarisation has gradually declined (see e.g. Figure 10 and Figure A.2). Figure 7 explains how this mechanism works.

A decrease in inflation causes the $\dot{k} = 0$ curve to shift to the left, from the $\dot{k_0} = 0$ curve to the $\dot{k_1} = 0$ curve; but the $\dot{q} = 0$ curve moves downward, from the $\dot{q_0} = 0$ curve to the $\dot{q_1} = 0$ curve. These directional movements are derived from the fact that

$$\left.\frac{dq}{d\pi}\right|_{\dot{k}=0} = -\frac{F_\pi(k,q,\pi)}{F_q(k,q,\pi)} < 0, \text{ and } \left.\frac{dq}{d\pi}\right|_{\dot{q}=0} = \frac{H_\pi(k,q,\pi)}{\delta_q + \eta - H_q(k,q,\pi)} > 0.$$

Now the economy is governed by the new curves $\dot{k}_1 = 0$ and $\dot{q}_1 = 0$. At the point E_0, both q_0^* and k_0^* are at such a high level that they cannot generate enough social learning by adopting the foreign currency to compensate for their depreciation. Hence, both stocks gradually decline through a stable saddle path E_0E_1 until they reach a new steady state at point E_1, where the new level of both stocks are lower than before.

Figure 7: The effects of falling inflation



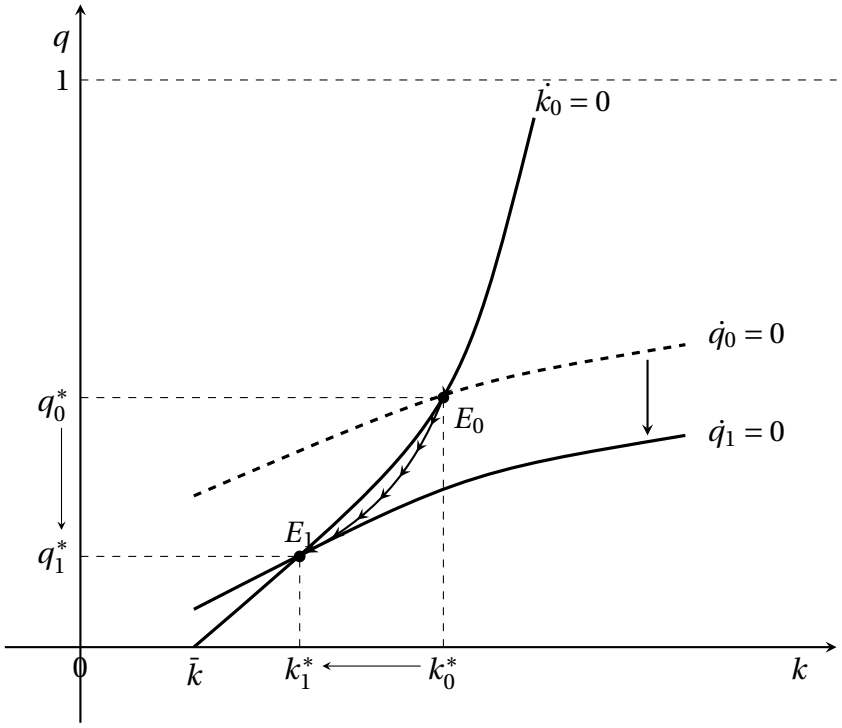
5.2 The Effects of Changes in Dollar Quotation

Next, consider how the equilibrium changes when a government imposes restrictions on dollar quotation. Restricting the use of the dollar as a unit of account affects only the $\dot{q} = 0$ curve, making the stock of the dollar pricing index depreciate more quickly. In other words, if the other variables remain the same, an increase in η – the degree of regulations on the use of the foreign currency as price quotation – leads to a decrease in q. That is,

$$\frac{dq}{d\eta}\Big|_{\dot{q}=0} = -\frac{q}{\delta_q + \eta - H_q(k,q,\pi)} < 0.$$

As the curve $\dot{q} = 0$ shifts downward, from the $\dot{q}_0 = 0$ curve to the $\dot{q}_1 = 0$ curve (Figure 8), the equilibrium moves along a stable saddle path E_0E_1 from the point E_0 to the point E_1, where the stock of dollarisation and dollar pricing index capitals are lower than before.

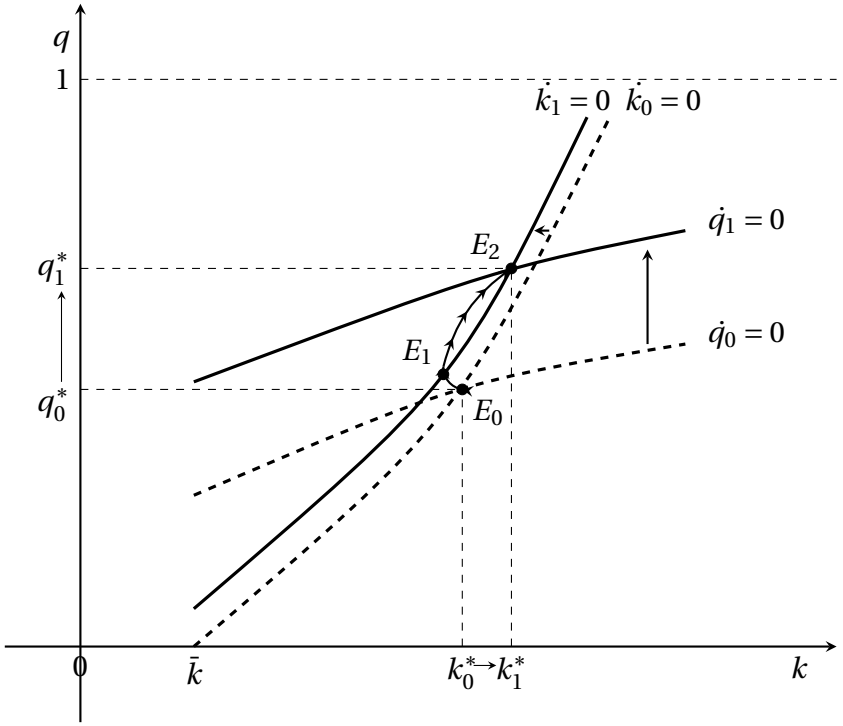
Figure 8: The effects of increasing regulation on dollar quotation



5.3 The Effects of Changes in Inflation and Dollar Quotation

Finally, consider a case in which a government has lowered inflation but has relaxed restrictions on using the dollar as a unit of account. Melvin and Fenske (1992), Clements and Schwartz (1993), and Valev (2010) provide evidence that the effects of network externalities are stronger than those of currency risk. This evidence implies that the shift of the $\dot{q} = 0$ curve (from the $\dot{q}_0 = 0$ to the $\dot{q}_1 = 0$), as shown in Figure 9, is larger than that of the $\dot{k} = 0$ curve (from the $\dot{k}_0 = 0$ to $\dot{k}_1 = 0$). Since the point E_0 is below both new curves, the stock of dollarisation initially declines, but that of dollar pricing index increases along the stable saddle path $E_0E_1E_2$ from E_0 to E_1. From E_1 onward, both stocks gradually rise to reach the new equilibrium at the point E_2, where the level of both stocks are higher than before.

Figure 9: The effects of a decrease in inflation and an increase in dollar quotation



6 The Model Predictions and Evidence

The illustrations Figure 7 to 9 suggest the explanations behind the upward trend of dollarisation in Cambodia and the downward trends in Laos, Vietnam, and Peru. Since its first national election in 1993, Cambodia has maintained an average depreciation rate of the riel around 2%. However, the Cambodian government has acquiesced to the use of dollar, and has had no restrictions on how foreign currencies are used. In particular, the government has not imposed any regulation on which currency is used to quote products' prices (Kubo, 2017). This implies that η – the degree of regulations on using the dollar for price quotation – approaches to 0. Because the network externalities of using the dollar are proved stronger than the currency risk, the dollarisation degree has increased (Table 1 and Figure 10).

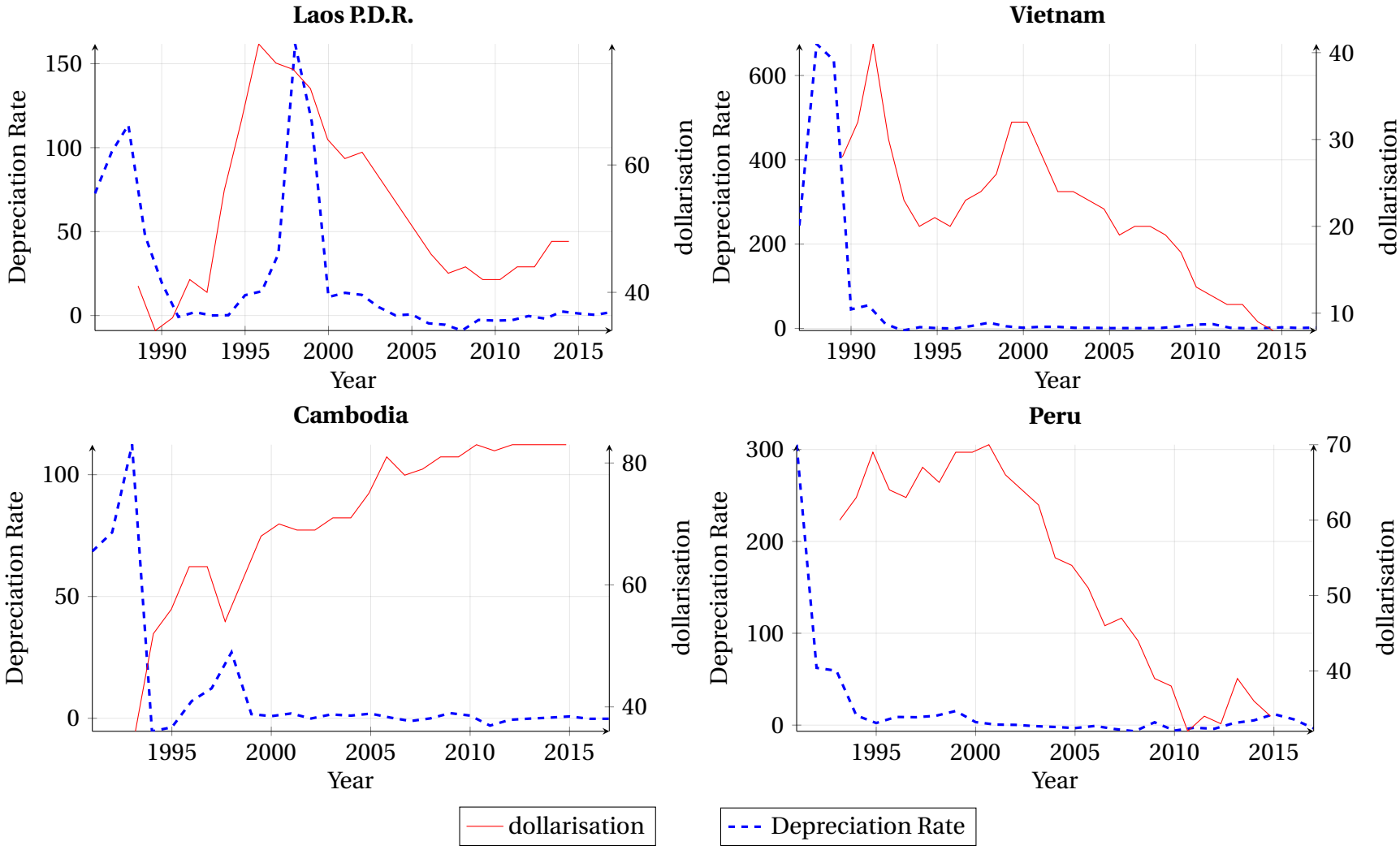
Table 1: Regulations on dollarisation in four selected countries

	Quotation of Prices in Foreign Currency
Cambodia	No control
Laos P.D.R.	In 1990, Laos issued Decree No53/CM to prohibit the use of foreign currency for domestic transactions, but it was not strictly enforced. In March 2008, the decree was upgraded for stringent enforcement with penalties.
Vietnam	Vietnam banned (but did not strictly enforce) foreign currency for quoting prices in the 1990s. In 2011, the restriction was upgraded to raise the penalties to a maximum of VND 500 million.
Peru	In 2004, Peru enacted a law stipulating that all prices be denominated in soles, the local currency.

Note: Data for Cambodia, Vietnam, and Laos P.D.R. are sourced from Kubo (2017), and data for Peru are obtained from Castellares et al. (2019).

In contrast, Laos P.D.R., Vietnam, and Peru have repeatedly restricted their economies by forbidding price quotations in foreign currency. For instance, as in Cambodia, it has been a common practice in Laos P.D.R. for firms and households to use foreign currencies as a means of exchange and unit of account instead of its local currency, the kip. The use of the Thai baht and the U.S. dollar is common throughout the country, particularly in urban areas, tourism sites, and Thailand's border. However, in the 2000s, the Laotian government imposed regulations on dollar-denominated bank lending and prohibited pricing in dollars. To enforce the regulations, the Bank of the Laos P.D.R. even establish a committee to conduct regular inspections to monitor the price quotation of products in markets, shops, companies, and trade fairs or exhibitions (Kubo, 2017). This regulation has increased the cost of using the foreign currency. The increased cost and low depreciation rates in Laos P.D.R., Vietnam, and Peru, have reduced the degree of dollarisation in these economies (Table 1 and Figure 10).

Figure 10: Depreciation rate and dollarisation in four selected countries



Note: The degree of dollarisation is a ratio of foreign currency deposits to broad money (M2). The data to construct dollarisation are sourced from various IMF Country Reports (Appendix A) and the exchange rate is obtained from International Financial Statistics (2019).

7 Concluding Remarks

In this paper, we provide so far the first explanation for the puzzle of dollarisation in Cambodia. To do so, we develop a theoretical model based on the framework of Uribe (1997) by introducing a new stock variable, *dollar pricing index*, and a degree of government regulations on the stock variable. This index, defined as a proportion of an economy that uses a foreign currency (denoted dollar) as a unit of account, amplifies the network effects of the dollar usage. Because the impacts of the network externalities have proven to be more substantial than those of currency risk, the positive interaction between the use of the dollar as a unit of account and a medium of exchange raises dollar usage, even though Cambodia has achieved economic and political stability.

Our model has important implications for dollarised economies. To reduce the widespread use of a foreign currency, dollarised economies need to stabilise not only their macroeconomic conditions (e.g. reduce inflation) but also increase the transaction cost of the use of the foreign currency (significantly restricting the foreign currency from being used as a unit of account because foreign currency-denominated goods explicitly promote the use of the foreign currency).

Our model has one limitation, though: it produces only one stable steady state; hence, it cannot capture the hysteresis of dollarisation as Uribe (1997) model which provides two stable, steady states and one unstable steady state. However, since our work focuses on the developing countries that had already experienced high inflation and thus a certain degree of dollarization, our model suffices to deal with the present objective: Explain whether this particular degree of dollarisation continues to rise or fall as a result of government's regulations on the use of a foreign currency as a unit of account.

Declaration of conflict of interest: The authors declare no conflict of interest.

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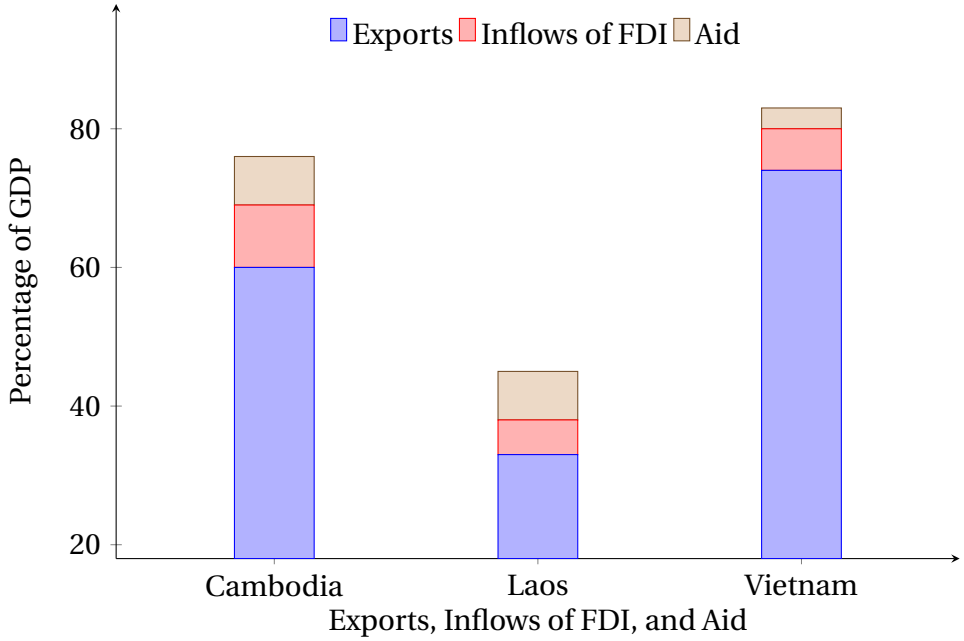
Appendix A

Table A1: Data sources used to construct dollarisation in eight selected countries

	Sources
Cambodia	IMF Staff Country Reports: No. 95/108, No. 99/33, No. 00/134, No. 06/265, No. 09/325, No. 11/45, No. 14/33, and No. 18/369.
Laos	IMF Staff Country Reports: No. 96/54, No. 98/77, No. 3, No. 02/62, No. 04/394, No. 06/398, No. 08/340, No. 11/44, No. 13/369, No. 15/45, and No. 17/53.
Vietnam	IMF Staff Country Reports: No. 95/93, No. 99/56, No. 03/382, No. 07/386, No. 12/165, No. 16/240, and No. 18/215.
Peru	IMF Staff Country Reports: No. 95/108 , No. 99/33 , No. 00/160, No. 06/265 , No. 09/325 , No. 11/45 , No. 14/33 , and No. 18/369.
Argentina	IMF Staff Country Reports: No. 95/110, No. 98/38, No. 00/134 , No. 03/226, No. 05/236, No. 17/409.
Bolivia	IMF Staff Country Reports: No. 95/24, No. 97/99, No. 00/38, No. 03/258, No. 05/393, No. 07/248, No. 10/27, No. 12/149, No. 15/334, and No. 18/379.
Turkey	IMF Staff Country Reports: No. 96/112, No. 00/14, No. 02/138, No. 05/163, No. 07/362, No. 10/278, No. 13/363, No. 16/104, and No. 18/110.
Uruguay	IMF Staff Country Reports: No. 95/75, No. 99/102, No. 01/183, No. 04/327, No. 06/425, No. 08/45 , No. 10/43, No. 14/6, 15/81, and No. 18/23.

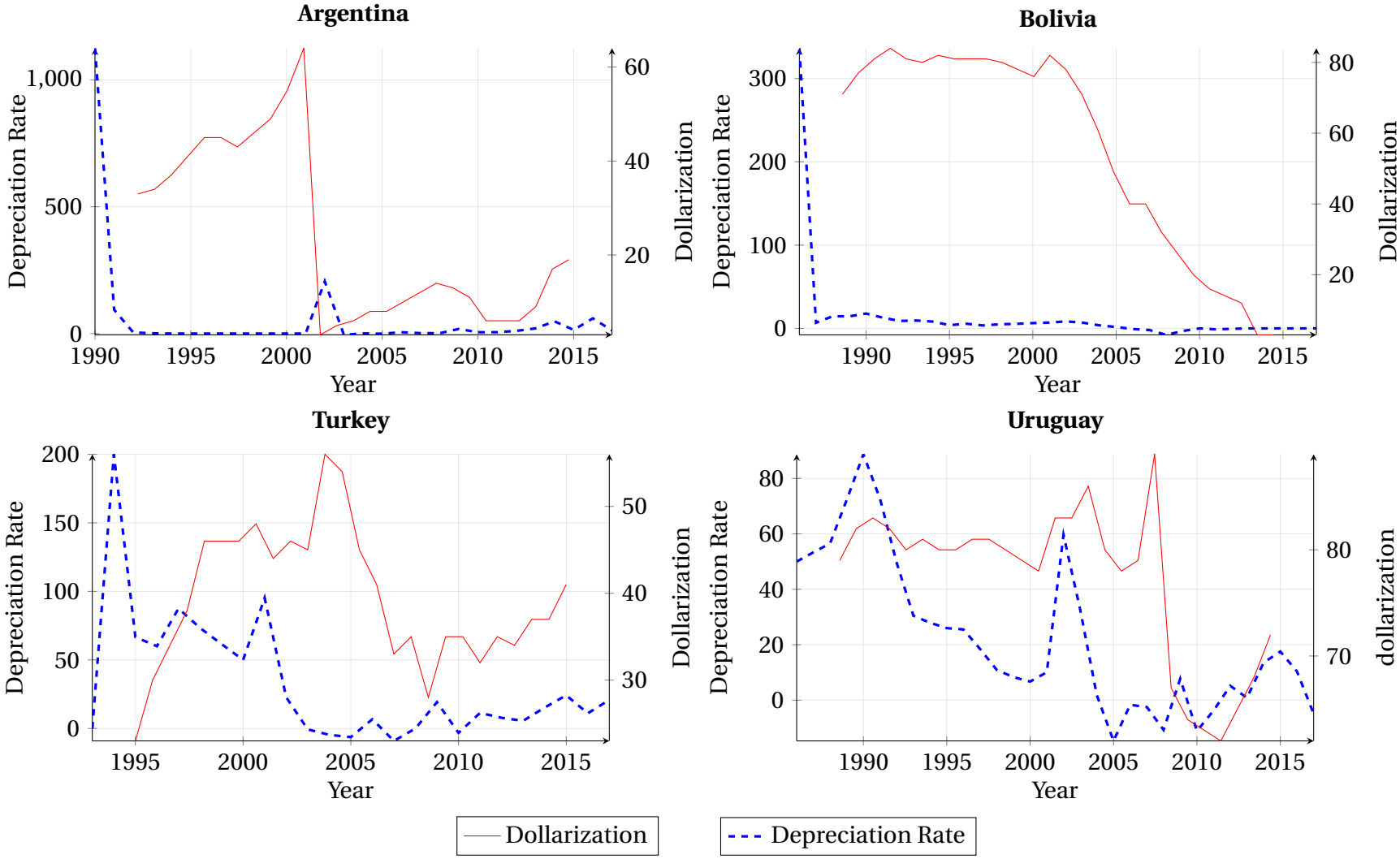
Note: Dollarisation is a ratio of foreign currency deposits to broad money (M2). Data for Cambodia are supplemented by the data from the Ministry of Economy and Finance, Cambodia, where the author Veasna Kheng worked as an economist in 2015.

Figure A1: An average of exports, net inflows of FDI, and aid as percentage of GDP from 2000 to 2017



Note: The selection of sample period is based on data availability. Aid is "Net official development assistance and official aid received". The data are retrieved from the World Development Indicators (2019).

Figure A2: Depreciation rate and dollarization in Argentina, Bolivia, Turkey and Uruguay



Note: The degree of dollarization is a ratio of foreign currency deposits to broad money (M2). The data to construct dollarization are sourced from various IMF Country Reports and the exchange rate is obtained from International Financial Statistics (2019).

Appendix B

The following proof responds to inequality (21). First, rewrite the expression $(F - F_k k)(H - H_q q) - F_q H_k q k$ as:

$$(F - F_k k - F_q q)(H - H_k k - H_q q) + H_k k(F - F_k k - F_q q) + F_q q(H - H_k k - H_q q)$$

Next, show that the terms in parentheses are positive. The assumption 1 implies that

$$\phi_\theta[\theta_2 - \theta_1] + \phi_k[k_2 - k_1] + \phi_q[q_2 - q_1] > \phi(\theta_2, k_2, q_2) - \phi(\theta_1, k_1, q_1);\ \forall \pi, \tag{B.1}$$

where $k_2 > k_1$ and $q_2 > q_1$ and thus $\theta_2 > \theta_1$ (θ strictly increases in k and q). Adding and subtracting π from the right hand side of inequality (B.1) and applying Equation (8), we obtain:

$$\big[\phi(\theta_2, k_2, q_2) - \pi\big] - \big[\phi(\theta_1, k_1, q_1) - \pi\big] = 0.$$

Thus, the inequality (B.1) becomes

$$\theta_2 - \theta_1 > -\frac{\phi_k}{\phi_\theta}[k_2 - k_1] - \frac{\phi_q}{\phi_\theta}[q_2 - q_1] = \theta_k[k_2 - k_1] + \theta_q[q_2 - q_1], \tag{B.2}$$

where $\theta_k = -\phi_k/\phi_\theta$ and $\theta_q = -\phi_q/\phi_\theta$ by applying the implicit theorem on Equation (8). The assumption 2 together with (B.2) yields

$$\begin{aligned} f(\theta(k_2, q_2, \pi)) - f(\theta(k_1, q_1, \pi)) &> f_\theta[\theta_2 - \theta_1] \\ &> f_\theta\theta_k[k_2 - k_1] + f_\theta\theta_q[q_2 - q_1]. \end{aligned} \tag{B.3}$$

By setting $k_1 = 0$ and $q_1 = 0$, the inequality (B.3) becomes

$$F(k_2, q_2, \pi) > F_k k_2 + F_q q_2 + F(0,0,\pi)$$
$$> F_k k_2 + F_q q_2.$$

Thus, $F - F_k k^* - F_q q^* > 0$. Analogously, $H - H_k k^* - H_q q^*$. ■