

Chapter 3

Prices and Monetary Developments

3.1. Inflation

Price stability is crucial for macroeconomic stability and the livelihoods for the poor because inflation is reflected in the increased cost of living. A sudden increase in prices may benefit some producers and traders. But given limited domestic production and dependence on intermediate imports, inflation would not benefit much the economy as a whole. Moreover, since quite a large proportion of the population has very low income, the higher prices of basic consumer goods simply make the lives of the poor harder.

Inflation has implications for different groups of people and for different parts of the country. For example, while total food consumption accounts for about 65 percent of the total expenditure of the poor, they share less than 40 percent of total expenditure of the rich. Food-inflation raises costs of living and worsens the livelihoods of the poor and those with low income. In many countries, inflation is closely monitored and is used as an indicator for adjustments of cost-of-living allowances to make sure that lives of those who live with meager income will not be affected. The government should take inflation seriously in its salary raise policy and poverty reduction strategy.

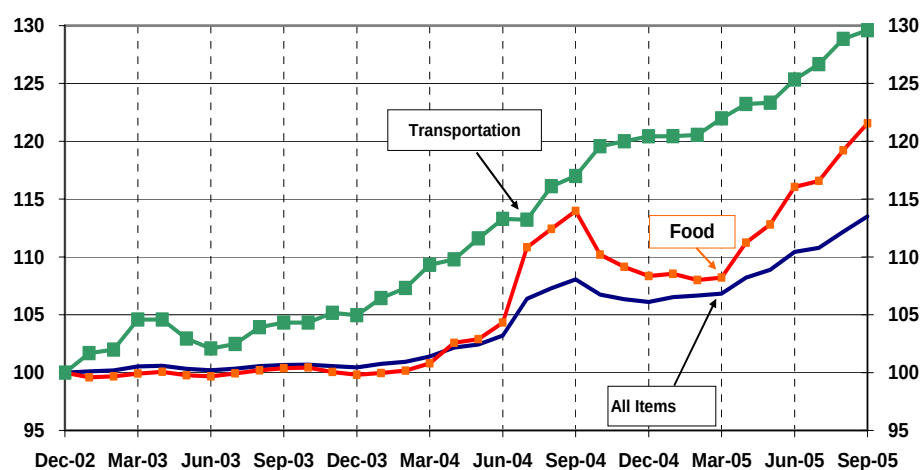
For Phnom Penh, inflation has been on upward trend since the beginning of 2004. The annual average increase of overall prices in Phnom Penh in 2004 was 5 percent higher than that of 2003 which was just at ½ percent. The prices were driven mainly by higher prices of foods, transportation and communications. Food prices are weighted at 39 percent of the overall price index and increased by 9 percent due to jumps in the price of rice, meat, fish, and eggs which rose in the range from 12 percent for rice to 68 percent for cheese fish or “prahok” compared with prices in 2003. Costs of transportation and communications also rose by more than 15 percent caused by a 27 percent rise in the price of gasoline and 38 percent for diesel.

According to NIS figures, inflation remains in the first nine months of 2005. The overall price increased 5 percent in September 2005 compared with that of September 2004. This high inflation was fuelled by an upward trend of food prices and transportation costs. On average, prices of rice rose by 18 percent, where those of meat, eggs and fish increased around 20

percent. The price of gasoline increased 25 percent and that of diesel was 29 percent higher than in September 2004. Average inflation for 2005 is expected to be at 5 to 6 percent and both food prices and transportation will increase by 9 and 10 percent respectively.

The main causes of inflation, especially in foodstuffs, are the reduction in fish stock, drought, and sudden shift of demands for quality meats as a result of the eruption of bird flu in the region. Seasonality is also a factor of price shocks i.e. a ban on large-scale fishing during the reproduction period June – September for upstream Mekong and July – October for the downstream Mekong. In addition, an increase in the prices of petroleum products coupled with a depreciation in the Riel are the cause of higher prices of consumer imports and retail prices of traded commodities as costs to transport them are higher.

Figure 3.1: Cambodia's Consumer Price Index (December 2002=100)



Source: NIS.

EIC studies on the production structure of the economy suggest that petroleum is one of the most important intermediate inputs of production across sectors of the Cambodian economy. Petroleum is 1 percent to 63 percent of the total cost of production among the 22 sectors of the EIC macro-model. According to calculations, by offsetting the increase in sale prices with higher costs of production caused by price increases of petroleum, any 10 percent increase in the price of oil within a year would cause at least a 1 percent net reduction in GDP growth.

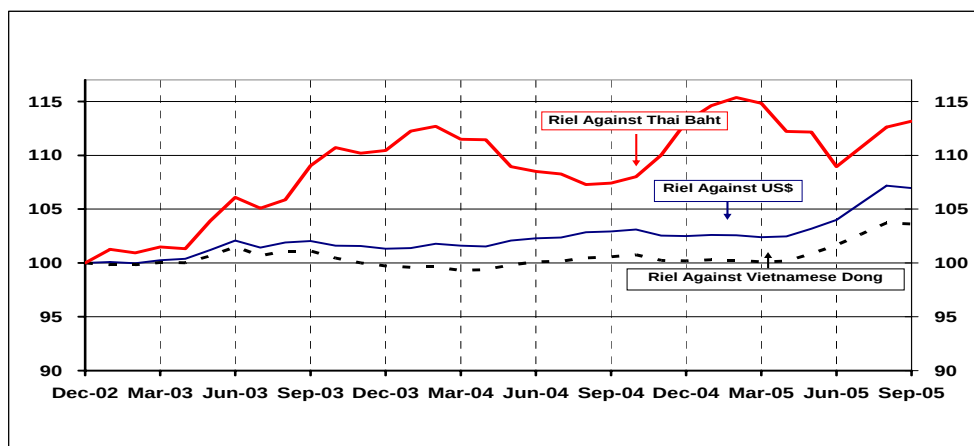
The impacts of the price of oil on consumers' welfare and cost competitiveness of exporting sectors should be taken into consideration. Given its total dependence on oil imports, Cambodia should establish a national reserve of oil in order to cope with oil shocks. The government

should also rethink its higher taxes on petroleum which are the main cause of increasing oil prices, which are higher than that of its neighboring countries.

3.2. Exchange Rate

Normally, exchange rate manipulation is one of the tools to manage the international trade of a country. Depreciation of domestic currency makes prices of exports cheaper and imports more expensive should domestic currency assume its role as a medium of exchange in the country. However, with the prevalence of dollarization, the exchange rate is prone to speculation. Therefore, a fixed or stronger Khmer Riel may be good for the whole economy especially consumers of imports, and there will not be any negative impact on the export performance of the country. However, depreciation of the Riel simply adds higher costs and makes life harder for those who hold it.

Figure 3.2: Cambodian Riel against US\$, Thai Baht and Vietnamese Dong (December 2002=100)



Source: EIC, Compiled from IMF-IFS.

According to the International Monetary Fund (IMF) and National Bank of Cambodia (NBC), US\$1 was purchased officially at 4,025 Riel by the end of 2004 compared with 3,976 Riel per US\$ that of 2003. The market rate ranged between 5 Riel to 10 Riel higher than the official rates. The Riel continued to weaken for the first half of 2005, depreciated about 2 percent compared with the end of 2004. The exchange rate of the Riel against the Thai Bath was 103 Riel per Bath by the end of 2004 compared with 100 Riel per Bath at the end of the year before. The rate was down to 101 Riel per Bath by the end of September 2005. The value of the Riel against the Vietnamese Dong was less volatile during the same period.

The weakening of the Riel against US\$ was caused mainly by a sharp economic slowdown in rural areas, where the national currency is mostly used. It is also caused by the widening of trade deficits in 2004 compared with 2003. Surges in imports especially for construction materials and vehicles and higher prices of imported petroleum were factors causing stronger demand for foreign exchange, especially the US\$. Moreover, repatriation of US\$ abroad and speculations are also behind the fluctuations of the Riel against the US\$. The current expansion of imports will put further pressure on the depreciation of the Riel in 2005. The average exchange rate of the Riel against US\$ in 2005 will stay around 4,200 Riel per US\$ compared with 4,025 Riel in 2004 or 4 percent depreciation

The central bank should take effective measures to either stabilize or strengthen the exchange rate to protect those who hold Riel from loss. Only with the stability of the Riel combined with regulatory measures, then will Riel-denominated transactions be feasible. The confidence in Riel as a medium of exchange in the economy will enable the central bank to retain its monetary policy. However, independence and effective implementation of monetary policy are separate issues. Capacity and institutional arrangements in terms of physical, human and legal infrastructures should be first in place before the central bank can take command of its own policy tools.

3.3. Money Supply

In well-established financial markets, demand and supply for money are closely linked with interest rates, one of the fundamental transmission mechanisms of monetary policy. But money supply and demand in Cambodia are largely dependent on seasonal executions of the government budgets, political situations, speculations, and partially on interest rates. Since the US\$ is predominant on the market, fluctuations in exchange rate signal actual demand and supply for dollars and Riel.

In 2004, total money supply continued to expand by 30 percent compared with 2003 and to reach more than 22 percent of GDP. The increase in foreign currency deposits was attributed to the hike, while the use of local currency was still limited. In fact, foreign currency deposit surged by 33 percent and Riel in circulation also increased by 23 percent in 2004 compared with that of 2003. The trend is expected to continue for 2005 and 2006, but at a lower pace.

Table 3.1: Cambodia's Monetary Survey (End of Period, Billion Riel)

	2002	2003	2004	2005e	2006p
Total Money Supply	2,888	3,329	4,329	5,010	5,728
Local Currency in Circulation	766	908	1,115	1,205	1,349
Foreign Currency Deposits	2,001	2,310	3,079	3,643	4,188
Other Money Supply	122	111	135	162	192
Total Money Demand	2,888	3,329	4,329	5,010	5,728
Credit to Private Sector	1,059	1,337	1,817	1,970	2,141
Credit to Public Sector	(117)	(128)	(209)	(192)	(176)
Others (*)	1,947	2,120	2,722	3,232	3,763

Source: National Bank of Cambodia for 2002-2004, EIC model projection for 2005-2006.

(*) This item represents mostly the money sent abroad.

The total amount of money, especially foreign currency deposits which were available were either lent to domestic borrowers or sent abroad. The latter accounted for a larger proportion of total money demanded. Credits to public sectors continue to decline due to an increase in government deposits. In 2004, total credit to the private sector increased by 36 percent, 10 percent higher than the growth rate of 2003. This credit expansion was the result of lower interest rates in 2004 compared with 2003, and the growths in manufacturing and service sectors. The trend is expected to carry over into 2005 and 2006, but at a slightly lower pace.

However, higher risks and interest rates on loans make it difficult for domestic borrowers to access credits. Therefore, large amounts of foreign currency deposits have to flow overseas. Lack of credit access for domestic enterprises and small businesses is one of the main constraints for private sector development in Cambodia. According to EIC surveys, high interest rates on lending coupled with high transaction costs discourage small and medium enterprises (SMEs) from expanding their operations. For financial institutions, informality of the businesses, lack of legal infrastructure, and poor law enforcement are factors behind higher risks of lending and uncertainty that force banks to charge higher rates.

3.4. Interest Rates

The interest rate is the most important and effective transmission mechanism of monetary policy in developed financial markets. The interest

rate reflects costs of utilization of funds through which it affects demand and supply for money. An underdeveloped financial system and lack of confidence in the banks have narrowed sources of funding in Cambodia. Higher rates of interests are the only option for banks to mobilize resources and funds in addition to their initial capital requirements.

Table 3.2: Cambodia's Interest Rate (% per annum, end of period)

	2002	2003	2004	June 2005
Riel 12-months Deposits Rate	7.2	7.0	6.6	6.6
US\$ 12-months Deposits Rate	4.2	4.0	3.7	3.7
Riel 12-months Lending Rate	21.0	21.1	18.7	18.6
US\$ 12-months Lending Rate	18.2	17.3	16.7	16.7
Inflation rate (year on year, in riel)	3.0	0.5	5.6	7.0
Inflation rate (year on year, in US\$)	3.1	-1.0	4.7	4.5

Source: *National Bank of Cambodia and NIS.*

According to data from the National Bank of Cambodia (NBC), annual interest rates on deposits in Riel and US\$ were quite high, while the rates on lending were more than 10 percent over the deposit rates. Interest rates in Riel were higher than that of US\$ due to mainly risks from its depreciation. However, with a gradual confidence in the financial system and economic expansion for the last decade, banks have pulled down both deposit and lending rates.

Evidently, the lower rates have encouraged private sectors to seek alternative funds from borrowing to enlarge their business operations in recent years. But most large loans are given to formal sectors especially in industry, construction, and services, which are still concentrated in urban areas. The remaining financial operations are covered by growing microfinance institutions led by ACLEDA bank. EIC's consultations with local and smaller businesses suggest that lower rates of lending, around 2 percent per month, will encourage more small domestic businesses to expand their operations.