

The Economic Situation of Cambodia in 2005 and Critical Challenges for the Future

Cambodia enjoys relative strong economic growth. But its effect on poverty reduction seems very minimal. Complementary reform measures must be in place to redistribute gains from growth.

The question of linkage between economic growth and poverty reduction has become a focal point of policy debates in Cambodia. Whether the country could reap the benefits from regional integration and membership in World Trade Organization (WTO) is still a great challenge. Some observers and analysts have started questioning the country's readiness to compete in a global arena after "the graced periods" expire. These graced periods resulting from the integrations have given Cambodia a formidable opportunity to prepare itself before fully opening up to the world.

Others have warned against slow progress in critical reforms that could jeopardize both the national and socioeconomic security of the country. Nonetheless, the hallmark of policy debates is on what course Cambodia should take in realizing the significant linkage between growth and poverty alleviation.

Economic Growth

According to the Economic Institute of Cambodia (EIC) estimates based on available data for the first 6 months of 2005 and prospects for each sector, evaluation of reform progress and global economic environments, annual growth rate for 2005 is expected to be around 5.0 percent down from 7.7 percent of 2004 and lower than the government's forecast.

The growth rate continues to be boosted by high tourist arrivals, and expansion in residential constructions and real estates. Performance of the garment industry remained relatively good, due to temporary measures taken by the US and EU to restrict their garment imports from China. But the current drought and continuous hike of the international price of oil are factors causing a lower growth

rate. EIC estimates that a 10 percent increase in retail prices of petroleum will reduce GDP growth between 0.5 to 1 percent.

The speed of reforms in critical areas also indirectly affects the economy's growth prospect in the following year. Growth in the industrial and service sector is dependent on multi-faced reforms in trade and investment, in public finance, and in the legal and judicial systems. Some of these reforms are unlikely to be achieved in the short term, but are feasible should political will exist.

External factors such as continuous increases in prices of petroleum, the security situation, and changes in international trade regimes, especially the implications of the Vietnamese membership in the WTO are important. These external factors continue to affect inflows of foreign direct investment (FDI), growth in competing export industries and service sectors of the country in the short run.

Sectoral Performance

Agricultural production in 2005 will be either flat or slightly increased due to another year of a severe drought in many paddy produc-

ing areas. Therefore, growth in agriculture is expected to be at roughly 1.3 percent compared with 2.4 percent forecasted by the government. The growth is due to an expansion in livestock, more arable (cleared) lands for other crops and paddy, given their favorable increase in prices and the government's commitment to rehabilitate countryside irrigation systems in the following years.

The growth rate of the industry and construction sectors for 2005 is down to about 7 percent due to a lower increase in garment and textile exports to the US and a decrease in exports to EU markets.

The construction industry is expected to slow down to 6 percent growth in 2005 down from 13 percent in 2004. The lower rate of growth is the result of a slow down in public constructions since many big roads have almost been completed. Lower disbursement of capital expenditure of the government in the first half and the year 2005 and fewer hotel constructions are also the reason, despite continuous strong growths in garment factories and private constructions especially flats and apartments.

In 2005, projected growth rate of the services is 6 percent, about 3

Table 1: Cambodia's Economic Growth (% , 2000 prices)

	2002	2003	2004	2005e
Agriculture	-2.8%	12.0%	-2.1%	1.3%
Paddy	-7.8%	22.3%	-12.3%	-0.4%
Industry & Construction	17.7%	12.3%	16.5%	6.8%
Garments	21.2%	16.9%	24.9%	8.5%
Services	4.4%	0.1%	9.2%	6.5%
Tourism	18.8%	-10.3%	23.6%	18.0%
Total GDP	5.2%	7.0%	7.7%	5.0%

Sources: NIS for 2002-2004, and EIC Model projection for 2005

percent lower than the growth in 2004. Based on trends and seasonality, EIC estimates that the number of international tourist arrivals will increase by 28 percent in 2005.

International Trade

Exports are still dominated by garments and textile but with lower growth rates. Projected total exports of goods and services for 2005 is US\$2.5 billion, 7 percent higher than 2004, and the imports are expected to be 14 percent higher, reaching US\$3.6 billion in 2005. Total exports of garments in the first half of 2005 increased by only 9 percent compared with a 23 percent growth of the first half of 2004 compared with that of 2003.

The higher value of imports is due to higher prices, especially of petroleum, that will cause a wider trade deficit gap to 20.5 percent of GDP in 2005. Moderate surpluses from other accounts, especially from the services, FDI, and foreign assistance, will not be sufficient to cover trade deficits so the overall balance of payment will deteriorate. Large deficits in trade will worsen the foreign reserve due mainly to an increasing demand for higher amount of foreign currencies to finance the deficits. As inflows of FDI and foreign aid may not be strong enough, the deficits would threaten foreign reserve and put pressures on the depreciation of the riel.

Investment

According to data from the Council for the Development of Cambodia, registered investment projects and fixed assets in the first 6 months of 2005 soared and exceeded the total figure of the whole of 2004. The figure excluded three mega projects whose registered fixed assets are over US\$3.5 billion. EIC estimated that actual private investment for 2005 will continue to be strong even though construction of new hotels will decline. The garment factories to be built in 2005 are expected to double the num-

ber established in 2004 as safeguard measures taken by the US and EU who continue to curb Chinese garment exports from flooding their markets.

The increase figure on investment may come after the elimination of the 2 percent of registered-fixed-asset as investment guarantee deposit from early 2005. This would open opportunities for speculative investors easily not to commit to the approved investment projects. A real concern, however, is that Cambodia will face stiffer competition from Vietnam in both attracting FDI and promoting exports of garment and textile should it become a full member of WTO.

Moreover, the slow progress of legal, judicial and public administration reforms are still the main obstacles to doing business in Cambodia, according to EIC's study on the country's competitiveness. These areas have fostered "corruption as a way of life" and must be dealt with to improve the country's investment climate.

Inflation and Exchange Rate

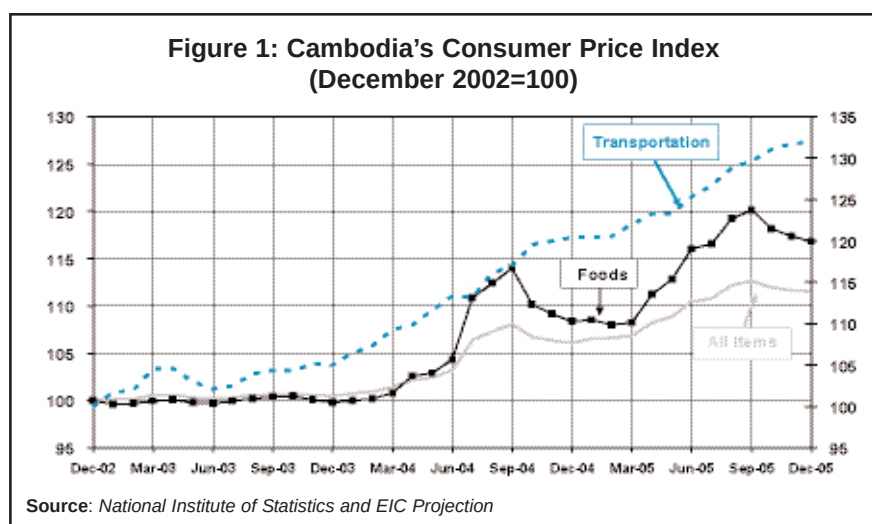
Inflation has implications for different groups of people and for different parts of the country. For example, while total food consumption accounts for about 65 percent of the total expenditure of the poor, they share less than 40 percent of total expenditure of the rich. Food-inflation raises costs of living and worsens the likelihoods 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 the 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.

Inflation continues to accelerate in the first half of 2005. The overall price increased 7 percent in June 2005 compared with that of June 2004.

This high inflation was fuelled by an upward trend of food prices and transportation costs in which each increased by more than 11 percent. On average, prices of rice rose by 15 percent, where those of meat, eggs and fish increased more than 20 percent. The price of gasoline increased 19 percent and that of diesel was 27 percent higher than in June 2004. Average inflation for 2005 is expected to be at 5 percent and both food prices and transportation will increase by 7 and 11 percent respectively.

The exchange rate of the riel against the US\$ will be weakened by a widening of trade deficits in 2005 with 4,200 riel per US\$ compared with 4,025 in 2004, or 4 percent depreciation. 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 weakening of the riel was caused mainly by the decline of production in rural areas.

The Central Bank should take effective measures to either stabilize or strengthen the exchange rate to protect those who hold riel (mostly rural poor) 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 infrastructure should be first in place before the Central Bank can take command of its own policy tools.

Monetary Development

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 2005, total money supply is expected to expand about 16 percent compared with 30 percent growth in 2004 compared with 2003. The increase in foreign currency deposits was attributed to the hike, while the use of local currency was still limited. In fact, while foreign currency deposit surged by 33 percent and riel in circulation also increased by 23 percent in 2004, the growth in 2005 will be down to about a half of the growth rate in 2004.

The total amount of money, especially foreign currency deposits which are available was 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 the government deposits. In 2004, total credit to the private sector increased by 36 percent, 10 percent higher than the growth rate of 2003 due to a lower interest rates in 2004 compared with 2003, and growths in the manufacturing and service sectors. The trend is expected to carry over into 2005, but at a lower pace.

However, higher risks and interest rates on loans make it difficult for domestic borrowers to access credits. Therefore, a large amount 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.

Fiscal Development

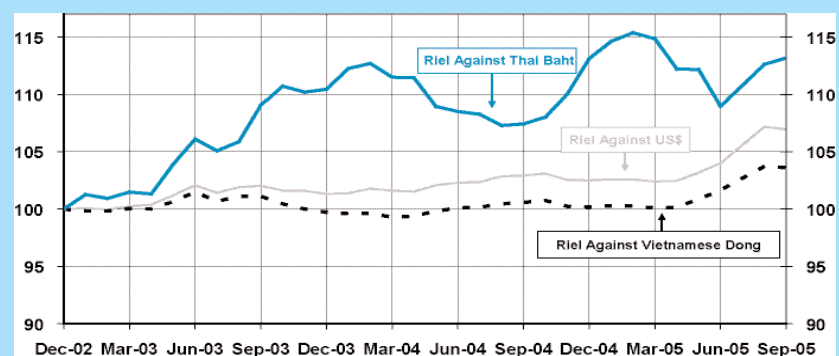
Budget revenue continues to increase and is likely to meet its target

of 2005, which is based on a low economic growth forecast of 2 - 3 percent. Tax revenue increased by 22 percent in the first 6 months of 2005 compared with the same period in 2004 and reached 53 percent of the annual budget target. Surprisingly, all taxes (VAT and Import Duties) on petroleum were 49 percent lower than for the first 6 months of 2004, while petroleum imports (except diesel) increased significantly compared with that of 2004. Non-tax revenue was also close to a half of the annual target.

For the first 6 months of 2005, expenditure reached only 38 percent of the budget level. Most ministries' spending was below 50 percent of their allocated budget. Salary payments were about 40 percent of the budget and non-wage disbursement was just 28 percent of the annual earmark. A slow reporting process from line ministries may be a reason for the low figures. However, overall expenditure in 2005 is expected to reach the target given better revenue performance. Budget disbursement as a share of GDP for priority sectors may reach 3 percent and for wages will slightly increase but will still be below the target.

Even though, the government has recently declared a salary raise for its bureaucrats, only its already "relatively-well-off" public servants will benefit from the raise while most still live far below a "decent wage". For that reason, morale of public servants

Figure 2: Cambodian Riel Against US\$, Thai Baht and Vietnamese Dong (December 2002=100)



Source: EIC, IMF-IFS and EIC Market Survey

continues to be low and they keep "moonlighting" just to survive. Unless salaries can be raised for all public servants to a decent level, public service deliveries will not improve much. The raise can only be done through reduction of large revenue leakages and wastage in unnecessary expenditures.

However, revenue from trade taxes and non-tax sources, even though improved, are still a big concern. While most collections from import duties and excises increased, the revenue from petroleum decreased by about 49 percent in the first half of 2005 compared with the same period in 2004. Smuggling of petroleum is still at large as its consumption is unlikely to decrease. Imports of petroleum-dependent goods such as vehicles continue to increase significantly. For the first 6 months of 2005, import of cars increased by 158 percent, buses 99, trucks 31 and tractors 43 percent compared with the same period in 2004.

Non-tax revenue is still small and revenue collection from unused lands and other state properties is very low. Moreover, most concessions on fee collection activities (such as fees to enter Angkor Wat complex) are awarded to private companies without the appropriate bidding. Likewise, most exchanges of state fixed assets and concessions are done without the knowledge of the Ministry of Economy and Finance (MEF). The exchanges (swaps) are mostly approved by the Council of Ministry, and MEF is just playing an accommodating role rather than a leading role in the management of state fixed assets. There is no concrete report on gains to national revenues from these exchanges.

As Cambodia continues to borrow abroad to meet cash limitations, proper debt management is necessary to ensure the financial viability of the country. According to the IMF, total public external debt was estimated to be US\$3 billion (including debt owed to US and Russia before 1993) by 2003 and debt service was US\$71 million. Cambodia is negotiating with

the US and Russia for debt forgiveness and rescheduling. But as Cambodia is starting to pay interest on loans borrowed after 1993, more funds are needed for debt services. This will exacerbate the current scarcity of funds for development unless domestic revenue is strengthened to reach around 15 percent of GDP or more annually.

Concluding Remarks

Available estimates by the World Bank and other institutions suggest that poverty may be reduced indirectly by good performances in the garment and tourism sectors. However, if the US\$1 poverty line were applied, then the Cambodian poverty headcount would be 42 percent in 2004, the highest compared with her neighboring countries.

Concentration of growth and marginal trickle down effects of economic growth on income distribution and poverty reduction in the past decade requires an acceleration of reforms across sectors. Development will not change the distribution of innate ability, and therefore will not change the distribution of income. Higher public investments in physical and social infrastructure are highly critical to mitigate and alter the current pattern that requires an effective and efficient mobilization and utilization of both national revenues and foreign assistance.

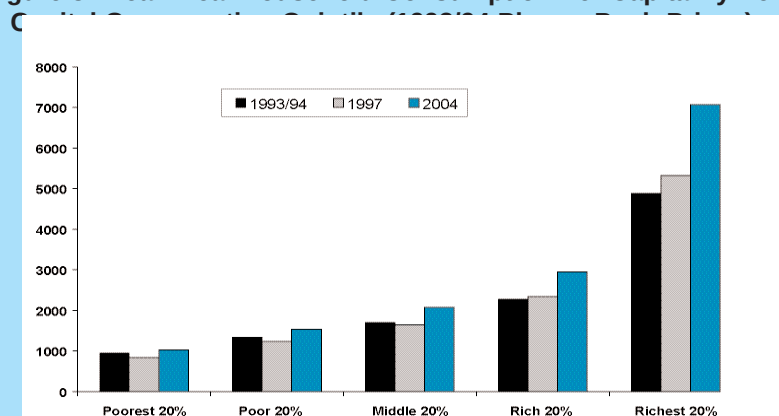
There are no other suggestions except furnishing the measures that have been already prescribed by the government itself in poverty reduction and the rectangular strategy.

However, several reforms, if achieved, would help redistribute gains from economic growths. While the reforms in the areas of land and natural resource management, with particular emphasis on the landless and land poor, will directly benefit the poor. Those in legal and judicial systems, public administration, and fiscal will provide more room for the private sector to lead the growth, job creations, and better public service deliveries.

From evidence from the latest reports of the World Bank on "Doing Business 2006" and EIC on "Cambodia's Competitive Report 2005 -2006", Cambodia is ranked very low in the world and not an ideal destination for investment and business. The most cited obstacle is rampant corruption, which is a result of slow progress of reforms in legal and judicial systems and public sector. The unreliable public sectors and justice systems mean poor law enforcement which provides an unpredictable and a costly environment for a secure living space, let alone for business transactions. If these reforms fail to materialize, the prospect for future growth and poverty reduction is simply far too remote.

Oum Sothea

Figure 3: Mean Real Household Consumption Per Capita By Per



Source: Chan Sopha, Poverty Specialist, The World Bank, Presented at EIC Project Launch Meeting on "Trade, Development and Poverty Reduction", Aug 23, 2005