

Cambodia's Economy During the Political Deadlock and Aftermath

The political impasse of almost a year does not seem to produce significant impacts on the economy, even though some basic reform remains necessary for a better economic outlook.

A recent World Bank publication shows that annual growth of the Cambodian economy in recent years has been relatively strong, but not strong enough to curve down its rising poverty. It has been a great challenge for the government to achieve its economic growth and poverty reduction goals as ambitiously prescribed in the National Poverty Reduction Strategy 2003-2005. Despite a sharp increase in agriculture production, an estimate of real growth of GDP in 2003 falls short of the 6-7 percent targeted growth. Numerous internal and external factors had affected the economy, including the SARS outbreak, anti-Thai riots, chronic weak governance, and political uncertainties after the general election in July 2003.

In 2003, Avian Influenza A (bird flu), a late rainy season, and the worldwide rise in oil prices may have some repercussion on the economy, especially the agricultural sector. Furthermore, the export quota phase-out by the end of this year poses serious concerns for the textile and garment industry, which has been the biggest export earner for Cambodia. How significantly were these factors affecting the general performance of the Cambodian economy in 2003, and its outlook in 2004 and beyond?

Production

EIC estimates that real growth of GDP in 2003 was 5.5 percent, the same rate as in 2002. This non-progressive growth can be attributed to domestic political uncertainties, including anti-Thai riots, and the ongoing political crisis after the election, plus exogenous factors such as the Iraq War and SARS outbreak that adversely affected constructions, consumption, tourism, and delayed official fund transfers pledged by donors. The principal contribution to growth in 2003 was a recovery in agriculture following a decline due to drought in 2002, and a continuous growth of the garment sector. However, activities in services industry were subdued by declines in hotel and restaurant business as a result of lower tourist arrivals.

Agriculture

Agriculture is one of the most poverty-stricken sectors, which thus deserves a special attention. It is one of the main sources of income for rural households that comprise about 85 percent of the population; it employs more than 70 percent of the population, and accounts for about 28 percent of the economy.

The sector recovered from its previous year sag to reach an estimated 10 percent growth in 2003 - the highest rate in the past seven years. Paddy and other crops production increased by 27 and 7.4 percent, respectively, thanks to favorable weather conditions. Livestock was slightly increased. However, fishery, rubber, and forestry turnovers posted negative rates due to poor management and the degradation of the resources. The significant growth in the agricultural sector is crucial in improving the livelihoods of the rural poor.

Unfortunately, in 2004, the performance of the sector may not be as good as in 2003. Overall productivity is still low due to insufficient investments in irrigation systems, limited technology, and concomitant high vulnerability to weather changes. The outbreak of the bird flu, from early this year until April, severely damaged livestock production. The most recent data on rainfall shows that the average precipitation level in the first five and a half months of 2004 was 20 percent

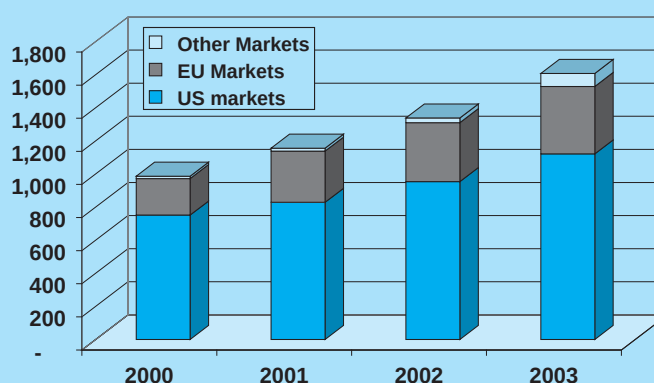
below the mean and the level of 2003 (rainfall patterns of 2003 were at about the mean level). These factors make it unlikely that agricultural production will surpass or even be on par with the 2003 level.

Industry & Construction

As a main "engine of growth", the industrial sector achieved a growth rate of 8.4 percent in 2003. This is down from 11 percent in 2002, even though the garment, electricity and water sectors remained strong. The garment industry, a dominant factor in Cambodia, achieved 13.4 percent growth in 2003, slightly lower than its 2002 growth rate of 14.3 percent. Garment exports to the US and EU markets increased by 16 and 15 percent in 2003, a similar level compared with 2002. The electricity and water sectors increased their growth by 13.2 percent. Construction, wood, paper, and publishing, however, shrank slightly compared to 2002.

The construction sector, the second biggest of the industry, experienced a low growth of only 2 percent in 2003, compared to 12 percent in previous year. Non-residential private construction declined as a result of the postponement of construction of tourism-related facilities, owing to the SARS outbreak. Lower capital expenditures by the government also hindered development of new public infrastructure. However, it is possible

Figure 1: Cambodia's Garment Exports (Million US\$)



Source: Ministry of Commerce

that the residential construction growth figures may be underestimated as many new construction projects went unregistered, due to loose management during the period of political stagnation.

The industrial sector may remain strong in 2004, underpinned by the impressive performance of the garment industry and the possibility of construction growth. The growth in exports of garment and footwear in the first four months of 2004 exceeded the annual rate of 2003. Garment and footwear exports, in fact, grew by 26 percent. Exports of rubber rose by 32 percent compared with the same period in 2003. Garment exports to EU markets soared by 66 percent, whereas to the US they increased by 18 percent compared with the first four months of 2003.

Construction also seems to have recovered and accelerated. Provisional data released by the Municipality of Phnom Penh show that total construction permitted in Phnom Penh increased by 34 percent in the first five months in 2004 compared with the same period in 2003. Construction of new hotels in Siem Reap is booming, in response to a prospect of significant increases in the number of foreign tourists. The overall growth prospect of the sector may, however, be dampened if the political stalemate leads to a slowdown in public constructions financed by external assistance.

Expectations of continued growth in the garment industry will need to be tempered in the face of the quota phase-out by the end of this year that could pose a threat to the industry in the areas of competitiveness and prevailing high transaction costs. According to an EIC simulation that assumes Cambodia does not address good governance issues and somehow manages to increase its access to the EU market in line with an expected world trend, the garment industry's exports would shrink by at least 7 percent by the end of 2007. Not less than 10,000 jobs would be lost in such scenario. The impact will be more dramatic if the assumed access to the EU market fails to materialize.

Services

The services industry, which is the biggest share of the economy, grew by 3.1 percent in 2003, down from 7.4 percent in 2002. That slower

growth can be in part attributed to a slowdown in the tourism industry, which experienced a decline in arrivals of international visitors due to the various factors mentioned earlier. According to the Ministry of Tourism, the number of international tourist arrivals was 701,014 in 2003, a decrease of 10.9 percent from 2002. Tourists from the U.S.A., Italy, Germany, France, Canada, Japan, and Australia declined very significantly in 2003 compared with the previous year's. The overall hotel occupancy rate dropped to 45 percent, 5 percent lower than that of 2002, and the average length of stay declined to 5.5 days from 5.8 days.

In the first four months of 2004, though, the tourism sector paints a promising picture. The total number of foreign visitors increased by 27 percent compared with the same period of 2003. The number of visitors from South Korea rose exponentially, by 177 percent, compared with the first four months of 2003, to be followed by a 19 and 26 percent rebound of tourists from Japan and the U.S.A., respectively. If the current trend continues through 2004, it will have a positive impact on the overall growth of the economy. However, a concrete strategy is still needed to further develop tourism infrastructure and supporting services in more attractive destinations so that tourists will be enticed to stay longer, and therefore spend more in the country.

Trade and Investment

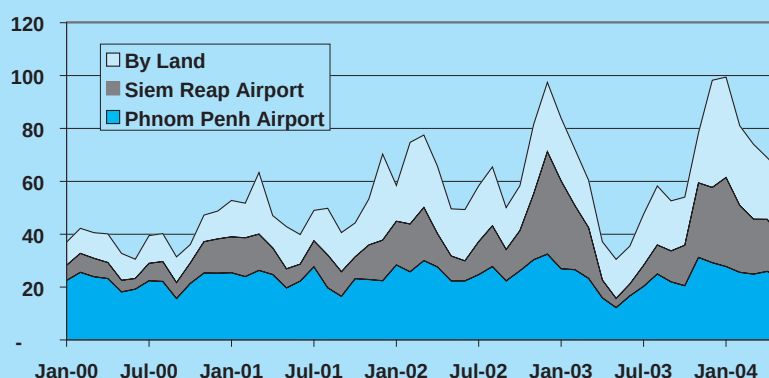
EIC estimates that in 2003, total exports increased by 22 percent, to more than US\$ 2 billion. This fig-

ure reflects the strong growth in the exports of paddy and garments. The export of garments has continued to expand since the grant of special access and quota protection to the US and EU markets in the late 1990s. Total garment and footwear exports grew by 20 percent, and accounted for over 80 percent of total exports. Paddy exports were estimated to increase about sixfold compared to 2002, reaching about US\$ 109 million. Meanwhile, imports also increased by 11 percent to about US\$ 2.4 billion with rises in investment-related merchandises and fuel imports, respectively up by 19 and 17 percent. Thanks to better performance of exports, the trade deficit was narrowed to US\$ 420 million in 2003, from US\$ 512 million in 2002.

The current account deficit was also reduced to 7.6 percent of GDP in 2003, from 9.3 percent in 2002. The deficit was financed through official transfers and capital inflows, including about US\$ 104 million of actual estimated foreign direct investment (FDI).

In the first four months of 2004, total merchandise exports have increased by 24 percent, fueled by exports of garments and footwear. Total imports also expanded dramatically, 19 percent higher than the first four months of 2003. Imports of fuels and automobiles went up by 6 and 64 percent, respectively. The surge in automobile imports was due to lower tariffs recently imposed by the government. The trade deficit was almost the same compared with the same period of 2003. The most recent data on investment shows a sharp decline in FDI in the first quarter of 2004 com-

Figure 2: Number of Foreign Tourists Visiting Cambodia (000's)



Source: Ministry of Tourism

pared with the same period in the previous year. Foreign investors are perhaps reluctant to come in during the post-election political uncertainties, even though the reduction trend has already been in effect for some years.

According to an EIC estimate, recognized external debts, excluding large amounts owed to the former Eastern Europe and the US, were about 21.3 percent of GDP. Debt service was less than a percentage point of GDP at the end of 2003. But the 2004 UNDP report suggests the country debt service ratio has reached its acceptable ceiling.

Monetary Development

As in many other developing countries, the rudimentary financial system and high degree of dollarization have handicapped effective implementation of monetary policy in Cambodia. The country's degree of monetization or financial deepening measured as the shares of aggregate narrow money, and total liquidity in GDP were low, about 5.8 and 21.1 percent in 2003, respectively. Cambodia is also very highly dollarized; the foreign currency deposit has expanded very rapidly and accounts for 70 percent of the total liquidity.

Both narrow money and total liquidity grew at 15 percent in 2003, a slower pace compared to the previous year's 33 and 31 percent, respectively. The increases were induced by 15.4 and 18.6 percent surges in foreign currency deposits and liquidity in riel in circulation, as the result of gradual confidence in the country's financial system. Domestic credits rose by 28 percent of which credits to private sector increased by 26 percent, but net claims on the government decreased by 7 percent due to a faster increase in government deposits.

For the first quarter of 2004, total liquidity increased by 10 percent, a faster pace compared to 4 percent of last year. Narrow money went up by 7.5 percent of which currency outside banks rose at about the same rate. Foreign currency deposits increased by 10.4 percent, compared to 5 percent in the first quarter of 2003. Domestic credits have increased by only 4 percent compared with 12 percent of last year. Net claims on the government did not vary much. Overall, the current political situation does not seem to

have a negative impact on the financial development of the country. But the shrinkage in domestic credits, especially to private sectors, shows a sign of slowdown in business activities.

According to the National Bank of Cambodia figures, net foreign reserves increased to US\$ 633 million at the end of 2003, from US\$ 567 million at the end of 2002. The reserves have continued to increase, up to US\$ 643 million at the end of April 2004. Despite this good performance, monetary policy in Cambodia still needs to work. The country's financial markets and monetary instruments must become more sophisticated. The central bank can then conduct its policy through open market operations to influence short-term interest rates, and let the market determine the quantities of monetary aggregates as in developed countries.

Inflation and Exchange Rate

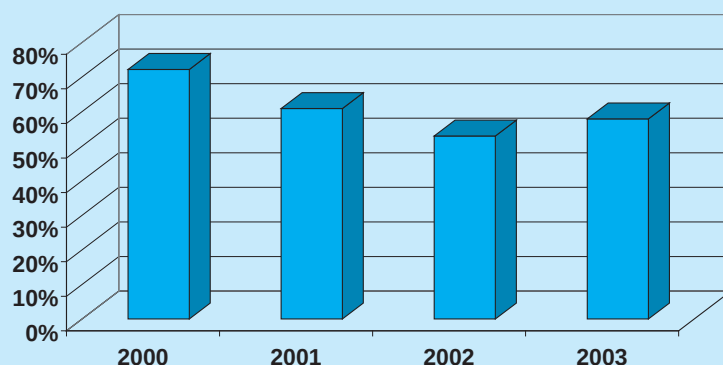
According to the National Institute of Statistics, the inflation rate in 2003 was 1.2 percent compared to 3.3 percent in 2002. Average price of transportation and communication was up by 4.8 percent, mainly due to 9 and 16 percent increase in price of gasoline and diesel respectively. The price of food rose by 1.5 percent. The prices of other commodities were slightly down compared to 2002. Even though overall price levels are relatively low, the higher prices of gasoline and diesel have had a far-reaching impact on poverty and overall economic activities of the country, as explored in the previous EIC economic reviews.

This price stability was an apparent result of a prudent fiscal and monetary policy, where the lower budget deficit and growth of total liquidity put less pressure on price. Moreover, relative exchange rate stability attenuated the price of imported commodities. Contrary to a marginal appreciation in 2002, the riel depreciated by 1.6 percent against the US dollar in 2003. The central bank has been actively taking measures to keep the spread between the official and market exchange rates at 1 percent.

The most recent data for the first quarter of 2004 shows no sign of large fluctuations in exchange rate. The average exchange rate of the riel against the US dollar in March depreciated slightly at 0.3 percent compared with the average rate in 2003. It further depreciated in May. For the reluctance of donors to commit more assistance in the present circumstances and the possible worsening of the balance of payment, it is very likely that the exchange rate will come under more pressures, and be volatile. The depreciation of the exchange rate will qualitatively put burden on small consumers especially the poor, since cheaper riel means a higher price of basic imported goods.

Inflation in Phnom Penh in the first quarter of 2004 was on an upward trend with month-to-month rate increase of a half percentage point. Of particular notice was the cost of transportation and communication that surged by 2.7 percent overall; the price of gasoline was up by 10 percent in that period. Inflation kept rising in April and May, 0.7 and 0.3 percent, respectively. In April, food prices

Figure 3: Share of Credit to Private Sector on Bank Deposits



Source: National Bank of Cambodia

increased by 1.8 percent, and transport price crept up by 0.4 percent. The price of transports went up a further 1.6 percent in May, followed by 0.3 percent increase in the price of food.

The price of gasoline has continued to rise, up by 5.7 percent in May compared to its level in March. This higher price has reportedly forced many motorbikes and car taxis to suspend or stop their operation altogether. Likewise, the business environment becomes more difficult as transportation fees and other gasoline dependent activities in general are becoming more expensive.

Fiscal Development

According to data from the Ministry of Economy and Finance, the fiscal performance in 2003 was moderate. Government revenue decreased by 1.7 percent compared to that of 2002. Tax revenue fell 15 percent short of its budget target, and was 3.7 percent lower than that of previous year. Non-tax revenue was 12 percent below the target forecast for forestry and civil aviation. However, it was only less than a percentage point lower than that of 2002.

On the expenditure side, total government spending reached 91 percent of the budget level. But it was 13.5 percent below the level of 2002, because of the reduction in non-wage and capital expenditures, respectively 7 and 24 percent lower than the amount in 2002.

The fiscal deficit was narrowed to 5.5 percent of GDP in 2003, from 6.0 percent in 2002. This was mainly financed by foreign assistance. Budget support and project aid covered more than 90 percent of the deficit, and the rest made up by domestic financing, including bank borrowings.

Before both the National Assembly and the government for the third term are up and running, the caretaker government was entitled to execute its expenditures each month by one twelfth of annual allocated budget. By the end of April 2004, domestic revenue recorded at a 19 percent increase compared with the same period in 2003. Tax collections reached 36 percent, or 4 percent higher than the budget level.

Although the government revenue achieved a good performance, the line ministries seemed to continue

to suffer from a shortage of cash. During the first four months of 2004, total government current expenditure declined by about 27 percent, compared with the same period in 2003. Spending on wages and non-wages declined, by 9 and 44 percent respectively compared with the same period in 2003. Subsequently, this would affect the processing of salary payments to civil servants and other public service deliveries. Overall budget implementation in the first four months in 2004 posed a temporary surplus.

Concluding Remarks

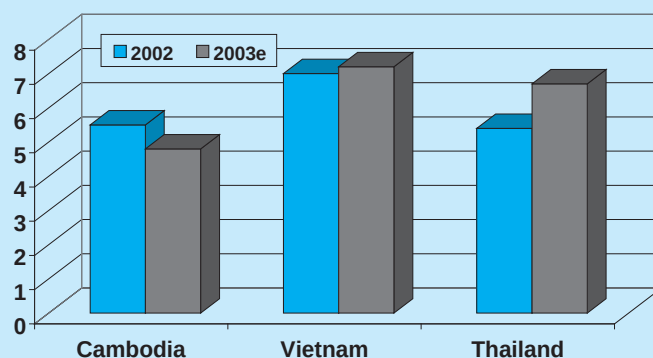
While the economic growth in Cambodia is perceived as relatively low and insignificant to reduce poverty, Thailand and Vietnam have achieved a superb record growth, respectively, at 6.7 and 7.2 percent in 2003, according to a recent World Bank East Asia Update. Out of the remarkable performance of their private sectors, the government of Thailand and Vietnam are very rightly active in structural reforms, not to intrude on the private sector integrity, but to aim for harmonized fiscal policy, effective public administrative reforms, and strengthening financial sector. Due to the viable business environment spearheaded by the government actions, these countries have witnessed large annual private investments, both domestically and externally, and the expansion role of private sector in their economic prosperity. The economic outlooks of the two for 2004 are much brighter than that of Cambodia.

Nevertheless the impressive performance in Cambodia's garment exports and the pickup in the services industry in 2004 could drive the overall growth of the Cambodia's economy. The growth, however, may be jeopardized by the lower prospects in the agricultural production and a persistent increase in prices of fuels for local consumption. Moreover, the structure of the economy is very fragile, as it is heavily dependent on a few factors, namely garment and textiles, tourism, and foreign assistance. More diversified and balanced growth is vital for sustainable development.

Natural resources must be well preserved and managed to avoid drastic changes in the ecosystem of the country. National revenues should be consolidated, and the expenditures must be on time and on budget to help improve the efficiency of public service deliveries such as basic education, health cares, research and development, and technology transfer to the potential productive segment of the population, especially the rural farmers. The use of foreign aid should be more economically viable and socially tangible. Political stability and good governance are still the mainstays for attracting new investment into the country. To overcome the worst scenario, concrete measures must be taken to support long-term prospects of the garment and textile industry and other potential engines of growth. No more lip service; the investment climate must be improved if the government genuinely prefers private sector-led development.

Oum Sothea

**Figure 4: Real GDP Growth (%)
in Cambodia, Vietnam and Thailand**



Source: The World Bank East Asia Update, April 2004