

The Cambodian Economy in 2004 and Prospects for 2005-2007

Implementation of reform is imperative if the country is to sustain economic growth, enhance competitiveness and alleviate poverty.

Despite relatively strong economic expansion during the past decade, Cambodia faces a number of looming challenges in the coming years, including a significant economic slowdown, higher inflation and a dramatic increase of unemployment among young people unless the government's "war against corruption" becomes effective now.

Critical reforms, such as civil service and judicial system reforms, are imperative to sustainable development in Cambodia. Such reforms will be possible only if current political tensions are mitigated and the electoral agenda does not alter the actual enforcement of such reforms, which currently remain tentative.

Economic Growth

According to the National Institute of Cambodia, the country's economy rebounded to 7.7 percent in 2004, reaching 7 percent in 2003, compared to 5.2 percent growth in 2002. Growth is expected, however, to slowdown to about 5 percent in 2005 and to stabilize at 4 percent per annum in coming years.

The agricultural sector currently experiencing a sharp decline of natural resources, including forestry and fish stocks; and low and erratic growth in paddy production. An efficient irrigation system, as well as regulation enforcement, will help in anchoring the sector. Yet larger challenges remain. More than 70 percent are employed in agriculture and 80 percent of the poor derive their main source of income from this sector. Hence, improving agricultural productivity is key to alleviating poverty.

Thanks to an impressive increase in garment exports (+31 percent), the industrial sector achieved a remarkable 16.5 percent growth in

2004. However, expectations of continued growth in the garment industry need to be tempered given the quota phase-out at the end of 2004 that will continue to pose challenges to the industry due to current inadequacies in competitiveness and the prevalence of high transaction costs.

Results of a recent study on labor competitiveness in the Cambodian garment industry show that, out of 80 factories surveyed, about half are optimistic about future production growth with expectations of increased capacity in coming years. Only about 20 percent expected a reduction in their respective production output, while the remaining 30 percent have taken the position of "wait and see".

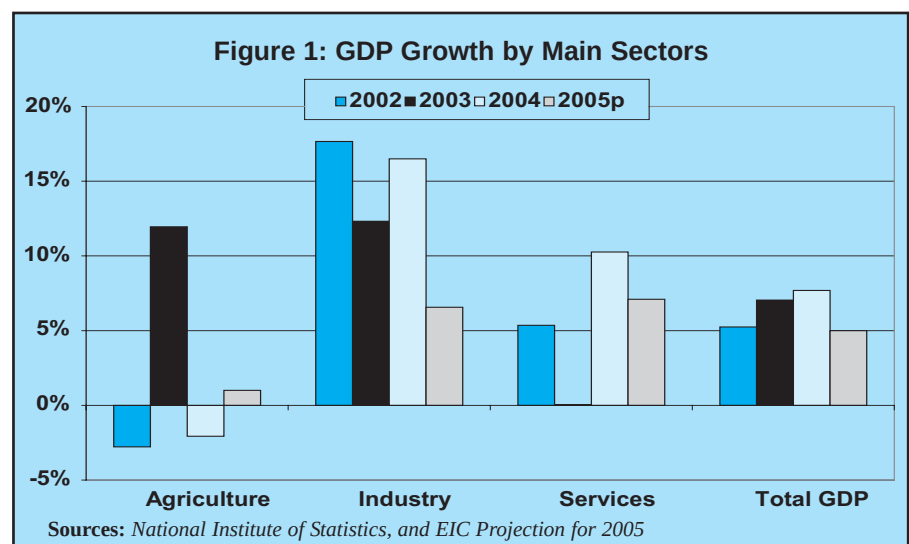
Another EIC survey of the top 100 CEOs in Cambodia, including those from approximately 34 garment factories, conducted during the same period, indicates that a majority of garment factory managers had concerns over the elimination of the quota system; many expressing that 2005 would likely be more difficult than previous years. However, the industry has held steady and under control. For example, many factories that initially faced order problems are now again producing garments originally protected by

the quota system.

Recent statistics released by the customs department show that Cambodian garment exports continued to increase steadily in non-EU markets during the first five months of 2005 with a 15 percent increase to the US market and a surprising 16 percent drop to the EU market compared to the same period in 2004. In other markets, Cambodian garment exports doubled. On the price side, Cambodian garment exporters have kept their prices basically flat.

In June 2005, the EU and US moreover imposed a quota on Chinese garment imports until the end of 2007. This new development allows Cambodian garment exports to keep, to some extent, its market share in the world's largest economies. Accordingly, EIC expects that Cambodian garment exports will continue to increase, at a moderate rate of 5 to 7 percent per annum in the coming years. On the price side, it is expected that Cambodian exporters will be forced reduce prices, or, at best, keep prices flat.

Nevertheless, Cambodia faces impending challenges with Vietnam's likely accession to the WTO in 2006. In that case, Vietnam will have no quota constraints to export its gar-



ment products to the US and EU. Vietnam is known to be one of Cambodia's greatest competitor countries. In 2000, approximately 15 percent of Cambodia's garment factories moved to Vietnam after the signing of US-Vietnam economic agreements and signaling the threat of such an outward migration of production in the future.

An economic slowdown may be avoided altogether, however, with the elimination of unnecessary transaction costs and through increased competitiveness, now indispensable in the open global market. According to a recent study funded by USAID, labor productivity in the garment industry can increase of upwards to 15 to 20 percent by promoting training among factory-level middle management.

The service sector increased by 9.2 percent from last year mainly due to an impressive rebound in the tourist industry in 2004. Almost 1 million tourists visited Cambodia in 2004 representing a 41 percent growth from 2003; increasing proportion arriving through Siem Reap. During the first five months of 2005, this high growth has remained unchanged, compared to the same period last year.

To sustain this growth while protecting Angkor sites from deterioration, Cambodia will need to diversify its tourism offerings. Domestic trade, transportation, and financial services are also potential contributors to growth. Sustainability will be possible only if infrastructure and regulation are effectively implemented.

Trade and Investment

External trade and FDI are still important to Cambodia's economy and have recently been primary sources of job creation, thanks to the garment and tourist industries. Yet the garment sector continues to face challenges in global competitiveness while the number of hotels in Siem Reap has already reached the point of saturation. As a result, FDI will likely drop by about half between 2005 to 2008. Worker productivity increased by

about 4 percent per annum during the last five years due in large part to the industrial and private services sectors.

Yet, as recently noted by the World Bank, Cambodia's comparative advantages will have an effective impact on competitiveness only if the risks and costs of doing business in Cambodia sharply decrease. Cambodia can capture real benefits from the open market only if the economy is enabled to produce competitive goods for export. This is predicated on the ability of the government to institute other reforms, such as trade facilitation, and the elimination of burdensome informal transaction costs.

Price and Money

Cambodia has experienced very low inflation and a stable exchange rate since 1999. However, according to the National Institute of Statistics, Cambodia may face considerable inflation. In June 2005, the inflation rate on year over year was 7 percent compared to 3 percent in June 2004. The 20 percent increase in fuel prices has impacted all sectors of the economy. Food prices also endured high inflation, with a 11 percent increase, due to last year's drought and the alarming decline in fish stock. Proper irrigation systems and the responsible enforcement of fishing regulations are the only means to lessen these fluctuations of supply.

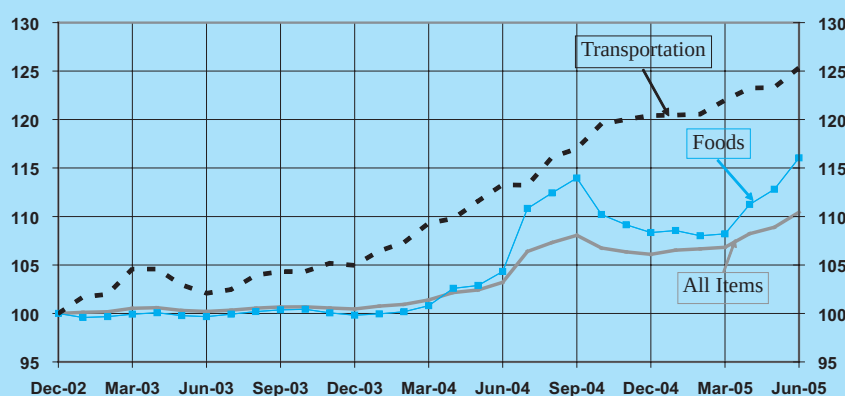
Prudent fiscal and monetary

policies in recent years, as well as measures to control the spread between the official and market exchange rates, have led to price stability. However, recent signs of a weakening riel against the US dollar must not be neglected. It is now imperative to reduce the amount of riel in circulation. The riel exchange rate will likely decline if there is no tightening of monetary policy. Such devaluation would indeed decrease consumer buying power, especially for the rural poor since a devalued riel means higher costs for basic imported goods.

Scarcity of credit and banking system weaknesses seem to be the main factors behind the current high interest rates in Cambodia, though rates have been on a downward trend since 2002. Unfortunately official interest rates, as reported by the National Bank of Cambodia, seem to have had very little effect on the living conditions of the typical Cambodian. Credit from official institutions is nearly nonexistent, and especially for the rural poor, though to the benefit of the informal sector where interest rates are very high.

Institutional reforms need to be accelerated to make financial reform more effective. In fact, financial sector reforms started in 1989 and the adoption of the "Financial Sector Blueprint for 2001-2010" twelve years later; 2004 marking the end of the first phase. Since then, much effort has gone towards developing regulations.

Figure 2: Cambodia's Consumer Price Index (December 2002=100)



Source: National Institute of Statistics

Yet real actions remain to materialize such as the creation of a basic framework for monetary policy; capacity building for industry; increased and extended access to financial intermediation, especially in rural areas. According to the UNDP, access to credit is available to only 15 percent of Cambodian households.

Fiscal Developments

Budgets and enforced fiscal structures are key tools to implement Cambodia's reform strategy and to improve the overall social conditions of the Cambodian people. Domestic revenues increased by an estimated 22 percent in 2004, thanks to real improvements in tax collection, which satisfied the planned budget target. Non-tax-based revenues remained, however, flat. Civil aviation and tourism outcomes remained very low reaching only 54 percent of the planned budget, despite the over 40 percent increase of foreign tourists coming to Cambodia. Provisional figures released by the Ministry of Finance for the budget implementation during the first five months of 2005 showed that government revenue collections reached the planned budget, while expenditures remained below targets.

Indeed, while budgetary incomes saw substantial increases, government spending increased moderately, at 12 percent in 2004, thus reaching only 92 percent of the budgeted level. According to the Ministry of Economy and Finance, budget expenditures for the "priority sectors", such as Rural Development, Health, Agriculture and Education, reached only 88 percent of the allocated budget. For 2005 and beyond, government expenditures are expected to increase more slowly than the nominal GDP because of projected moderate growth in government domestic revenues and in foreign aid.

In 2004, the budget deficit dropped by 1.5 percentage points of GDP and was mainly financed by for-

eign assistance. Loans represented about 21 percent of total foreign aid disbursed during the last twelve years with a steadily growing share over that period. Cambodia's outstanding foreign debts were estimated at US\$ 1.2 billion at the end of 2004. Should growth of loan disbursements remain strong over the next ten years, and if no critical reforms are made to improve tax collections, Cambodia will inevitably face a debt crisis.

Efficient use of the budget as a tool of economic management will be possible once public financial management reforms become effectively implemented. Over the past few years, the government has made great efforts to design revenue and expenditure benchmarks and to implement some fiscal regulations. Non-tax-based revenues, such as the sale of state assets, have not always been through transparent public auctions however. This has led to revenue leakage and corrupt practices, and has hindered the government from meeting its financial targets. Proper revenue mobilization will provide for public expenditures, especially in priority sectors, and thus improve general public services.

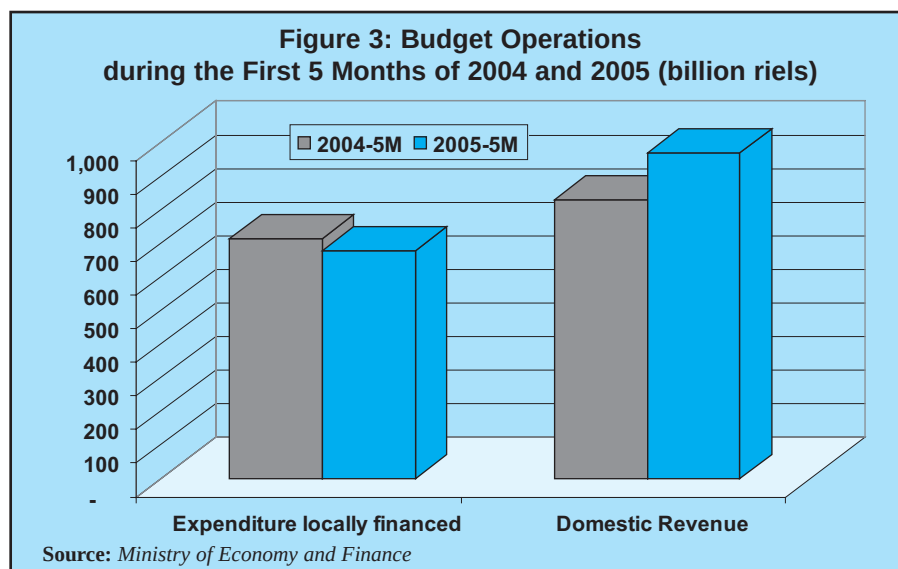
Income and Poverty

Aside from the low level of government spending, the excessive inequalities in income distribution has impeded poverty reduction. Since

1997, the garment industry has provided 300,000 jobs formally, and at least twice this number in informal employment. The expected decline of garment exports coupled with the approximately 230,000 additional young people seeking jobs every year, raises concerns. In addition, EIC estimates that more than half a million young people will migrate from the provinces to urban areas during the next four years. One must question the ability of Cambodia's economy to absorb a surge of new entrants into the labor market.

The socio-economic gap between urban and rural areas is also indeed very wide. While monthly income averages US\$ 500 per household in Phnom Penh, it only reaches to about US\$ 100 in rural areas. Moreover, rural incomes remain tenuous and are seasonal. Enabling multiple production cycles of agriculture will result in continuous increases in productivity, income and capital formulation, and eventually reduce the risk of farmers falling into poverty. Maintaining and expanding growth in non-agricultural sectors will provide momentum for poverty reduction as well.

According to the UNDP, economic growth in recent years may have, ironically, only a minimal impact on poverty reduction. The World Bank estimates that the poverty rate has actually increased from 41.5 percent in 1999 to 45.5 percent in 2003. As a result, Cambodia remains



at the bottom quartile of the UNDP human development index ranking 130th out of 177 countries in 2004. The UNDP education index for Cambodia was 0.66; the second lowest after Lao, among ASEAN countries. According to the World Health Organization, Cambodian public health indicators are among the worst in the world. Life expectancy is estimated at only 57 years; 13 years below the regional average.

Key Institutional Reforms

It follows that implementation of serious reforms is crucial and urgent for Cambodia. At the "cross-roads" of development, Cambodia needs to change now. As opposed to its regulatory role of ensuring market fair-play, the government has been distorting markets through onerous transaction costs. This has been hindering competitiveness and deterring new entrants from business. The necessity of fighting corruption and strengthening institutions has been vocally proclaimed by the government. It is now time for the actual implementation and enforcement of these reforms.

Improvements in administrative accountability and transparency have long been promised by the government. This will only be possible through deep structural public administrative reforms. If some progress has been made these last years, civil servants' pay still remain far below a living wage, which merely fuels corrupt practices. Public administrative reform also includes military demobilization, decentralization of power, and diffusion of administrative tasks. To speed up the reform, clear, harmonized, and strongly enforced guidelines need to be drawn up immediately. Indeed, any progress in this process depends heavily on the willingness of line ministries still reluctant to delegate responsibilities to provincial and district administrations.

Effective and reliable legal and judicial reforms are keystones to ensure the proper implementation of

any such reforms noted above. Some progress has already been made, such as the establishment of a council on legal and judicial reform.

Yet long awaited milestones such as the anti-corruption law and fundamental codes still await draft review or ratification. Restructuring the council of magistrates and the creation of a credible court of law will also enhance crucial judiciary integrity. Most importantly, judicial reform means partly to get rid of the current patronage system in which Cambodia is mired. Without equal compliance to the law by all agents of society, the rule of law is unforeseeable.

Last but not least, responsible management of Cambodia's land and natural resources must be promptly implemented as they are pre-requisites to all agricultural activity. Only then can land management reforms "transform the land into an engine of economic growth and poverty reduction", as pledged by the Prime Minister. Serious concerns are, however, being raised, considering the recent reservations of the Prime Minister and the opaque process resulting in concentrated land ownership in the hands of private companies.

Forestry management reform raises questions as well. The impacts of forest destruction on the country's socio-economic development have been minimal according to some studies. Yet, present and continuous illegal logging necessitates an examination of

the effectiveness of reforms. Fish resource management has manifested similar problems of over-exploitation and destructive practices by a limited number of powerful fishermen.

Concluding Remarks

If Cambodia benefited from relatively strong economic growth during the last ten years, 2005-2007 will be a period of reflection on the country's socio-economic development. Income stagnation and poverty for many in the rural population have led some to think of the past ten years as a "lost decade". Real political will and full commitment to bring all efforts to fruition, in addition to sufficient time and allocation of resources are the key factors in the success of reform.

Considering the current political standoff that has led to the strip-off of three parliamentarians' immunities and to the National Assembly and Senate sessions' boycott, one might be doubtful of any significant reform in the near future. As long as this political conflict remains unresolved, ratification of many laws required by the WTO and other crucial draft-laws, such as the anti-corruption law, will tragically remain pending. Cambodia may therefore slip again into another lost decade.

Sok Hach

