

Chapter 3

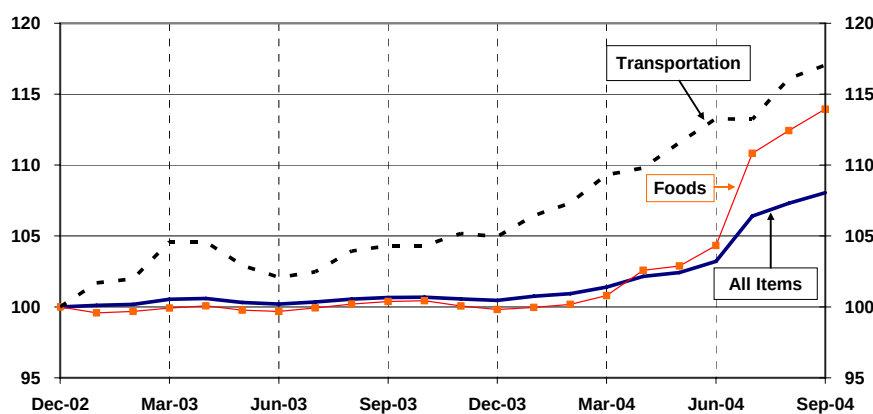
Prices and Monetary Developments

Cambodia has experienced very low inflation since 1999. However, recent figures compiled by the National Institute of Cambodia show that the country may, beginning in July 2004, be facing huge inflation. The sudden surge in inflation is mainly due to high prices for food and gas. The riel has also showed signs of weakness against the US dollar during 2004. Inflation and exchange rate fluctuations have ineluctable effects on income distribution and on purchasing power, especially rank-and-file civil servants and rural poor who overwhelmingly hold the local currency. Moreover, as in many other developing countries, the rudimentary financial system and high degree of dollarization have handicapped effective implementation of an independent monetary policy in Cambodia.

3.1. Inflation

According to the National Institute of Statistics, the inflation rate from January to December 2003 was 0.5 percent compared to 3.7 percent in 2002. The average price index in transportation and communication was up by 5 percent, mainly due to 9 and 16 percent increases in the prices of gasoline and diesel, respectively. The price of food rose by 1.5 percent, while 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 levels and overall economic activities, as explored in previous EIC economic reviews.

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



Source: National Institute of Statistics

Inflation in Phnom Penh in the first nine months of 2004 has risen significantly. The consumer price index compiled by the National Institute of Statistics rose by 7.4 percent from September 2003 to September 2004. Of particular note was the cost of transportation, which surged by 12.8 percent overall, and the price of food, which rose by 14.8 percent in the same period. The price of food rose by 6.2 percent from June to July 2004 alone. The food price increases are mainly attributable to the current scarcity of some kinds of meat such as fish, beef and chicken. For instance, the price of fresh fish rose by 69 percent this September over last September, followed by beef (45 percent), and chicken (30 percent). In some provinces, such as Kampong Cham, the price of fish is three times higher than last year, based on local media reports.²⁰

The dramatic increase in the price of fish is mainly due to the rapid decline in the stock of fish in Cambodia, according to fishery officials and specialists, who now warn about a “fish crisis.” These same officials now predict that Cambodia will no longer be an exporter of fish.²¹ The Fisheries Action Coalition Team, a group of eight NGOs working with fishery communities, blames this decline on illegal fishing and poor management of fishing lot concessions granted by the government. Furthermore, a prolonged drought in some parts of the country this year will continue to push meat prices upward.

Due to the continuous increase in crude oil prices on the international market, the price of gasoline in Cambodia rose by about 30 percent in August 2004 compared to the year before. This higher price has reportedly forced many motorbike and car taxis to suspend or stop operation altogether. Likewise, the overall business environment has become more challenging as transportation fees and other gasoline-dependent activities have become suddenly and unexpectedly more expensive.

The implications of the increase in oil prices for Cambodia’s economy are thus enormous. Various surveys by the National Institute of Statistics (NIS) reveal that fuel costs comprise 13 percent of the total cost in agricultural production, 5 percent in manufacturing, 38 percent in electricity and water, 65 percent in transportation, and 8 percent in trade. According to tourism professionals in Siem Reap interviewed by EIC in July 2004, fuel costs represent about 30 percent of total costs in hotel and restaurant activity there.²²

²⁰ The Cambodia Daily, vol.29, issue 80, Thursday, 18th of August, 2004.

²¹ Idem

²² National Institute of Statistics (2000), *Survey of Industrial Establishment 2000*, and *Cambodian Agriculture Finance Survey 2002 Statistics Report*

**Table 3.1: Estimation of Costs of Utilization of Fuels
for Cambodian Producers and Final Consumers in 2003 (million US\$)**

	Total Production Costs	Share of Fuels in Production Costs	Total Fuel Costs
Agriculture	195	13%	25
Manufacturing	1,360	5%	68
Electricity & Water	264	38%	100
Construction	225	4%	9
Hotels & Restaurants	203	30%	61
Transportation	377	65%	245
Trade	450	8%	36
Other Sectors	650	7%	45
Total Producers			590
Total Households(*)			85
Total Economy			675

Source: NIS and EIC Estimates (*) The fuel costs of households represent 2.5% of total household consumption that amounted US\$ 3,4 billion in 2003

Based on a calculation using official survey results and EIC figures of the production costs by sector shown in the table 3.1, the estimated fuel costs for producers totaled US\$590 million, representing 15 percent of the country's GDP in 2003. For end consumers, the direct consumption on fuels represented 2.5 percent of total private consumption, according to official statistics. With total private consumption estimated at US\$3,400 million, the costs of fuel paid by end consumers (households) was US\$85 million, bringing the total estimated costs of fuel paid by both end consumers and producers to US\$675 million, or 17 percent of GDP in 2003.²³

The retail price of gas in Phnom Penh is about 67 percent higher than in Vietnam and 43 percent more than in Thailand and Laos. To illustrate further the impact of fuel prices on the Cambodian economy, it is interesting to simulate the alignment of the price of gas in Cambodia with prices in neighboring countries. To simplify the simulation, if the price of fuel was reduced by 40 percent to bring Cambodian fuel prices in line with its neighbors, with all other input costs remaining the same, there would be a decrease in the total costs of production and consumption of about US\$270 million in 2003 (or 7 percent of GDP), of

²³ This amount is more than 4 times higher than that officially released by the Ministry of Economy and Finance, but very close to the figure estimated by EIC that includes smuggling in the total imports of gas.

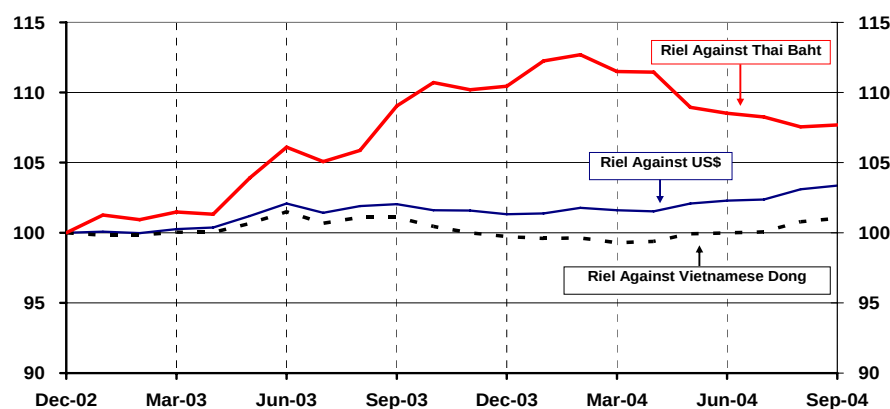
which US\$236 million would accrue to producers and US\$34 million to households. The theoretical impact of fuel price alignment on other areas such as investment, competitiveness, and the overall basket of prices in Cambodia strongly implies that there are many other reasons arguing for such an alignment.

3.2. Exchange Rate

Price stability in recent years was an apparent result of prudent fiscal and monetary policy, under which a lower budget deficit and the growth of total liquidity put less pressure on prices. Moreover, relative exchange rate stability attenuated the price of imported commodities. As was the case in 2002, the Cambodian riel depreciated only slightly (1.3 percent) against the US dollar during 2003. Moreover, the central bank has been actively taking measures to keep the spread between the official and market exchange rates at less than 1 percent.

The most recent data for the first nine months of 2004 shows, however, some sign of weakness of the riel against the US dollar. The official rate depreciated at 1.9 percent in September 2004, compared with earlier in the year. This depreciation was more significant for the market rate, reaching 2.8 percent during the same period. According to figures released by the National Bank, the value of the riel at the market rate in Phnom Penh crossed the level of 4,100 per US dollar in September, as compared to only 3,980 as of early January.

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



Source: EIC, Compiled from the International Financial Statistics of the IMF

Over roughly the same period, the riel was quite stable against the Vietnamese dong, but strongly fluctuated versus the Thai baht. The riel continuously depreciated against the Thai currency during 2003, but has

significantly recovered since March 2004. It should be noted that Cambodians living in the western part of the country primarily use Thai baht, rather than riel or US dollars.

As a dollarized economy, it is crucial that the riel be kept stable against the US dollar. In order to maintain the stability of the national currency at around 4,000 riels per US dollar, it is important that the government reduces the growth in the amount of riel in circulation. From January to December 2003, the amount of riel rose by 18.5 percent, and this growth remained very strong during the first nine months of 2004 (see table 3.3). However, real GDP growth is estimated at only 5 or 6 percent. For 2005, it is very likely that the exchange rate will come under more pressure, and become volatile, if there is no tightening of monetary policy. The depreciation of the exchange rate will put an additional burden on small consumers, especially the rural poor, since a devaluing riel means higher costs for basic imported goods.

For that reason, it is strongly recommended that the National Bank buy back an amount of riels in circulation from the market with its reserves in US dollars. According to the National Bank of Cambodia, net bank foreign reserves increased to US\$633 million at the end of 2003, from US\$567 million at the end of 2002. These reserves have continued to increase, up to US\$ 660 million at the end of August 2004.

3.3. Money Supply

Based on official statistics released by the National Bank of Cambodia, the country's degree of monetization is still very low, relative to neighboring countries. Total liquidity, grouping local currency in circulation with foreign currency deposits at commercial banks, represented only 22 percent of GDP at the end of August 2004, of which more than 70 percent was US dollar dominated. However, its growth during the last five years seems very strong, averaging 24 percent annually.

Relative to nominal GDP, the amount of local currency in circulation in the market (or liquidity in riel) was relatively stable until the end of 2002, fluctuating at around 5 percent of GDP. In 2003, this amount significantly grew, reaching 5.4 percent of GDP at the end of 2003, and 5.6 percent eight months later. The riel is generally used by the rural poor, and to some extent, by the government to pay the meager salaries of civil servants, representing about 50 billion riels per month (or 5 percent of total liquidity in riel). This significant increase of liquidity in riel has put some pressure on the exchange rate during recent months.

Cambodia is known as a highly dollarized economy, and recent data shows that its reliance on the dollar is increasing. After experiencing some uncertainty during the election period in 2003, foreign currency deposits continue to expand very rapidly in 2004, increasing by 27 percent during the first eight months of the year. This high growth also reflects strong activity in sectors such as tourism and garments.

Nevertheless, this high performance may not be repeated in 2005, because of the phasing out of the quota system for garment exports. It is thus strongly recommended that the government start to de-dollarize the economy gradually by, for example, requiring all government transactions be conducted in riel.

Table 3.2: Cambodia's Monetary Survey

	Billion Riels			Percentage of GDP		
	December 2002	December 2003	August 2004	December 2002	December 2003	August 2004
Total Money Supply	2,888	3,329	4,106	18.4%	19.8%	22.0%
Local Currency in Circulation	766	908	1,038	4.9%	5.4%	5.6%
Foreign Currency Deposits	2,001	2,310	2,929	12.8%	13.8%	15.7%
Other Money Supply	121	111	139	0.8%	0.7%	0.7%
Total Money Demand	2,888	3,329	4,106	18.4%	19.8%	22.0%
Credit to Private Sector	1,059	1,337	1,604	6.8%	8.0%	8.6%
Credit to Public Sector	(117)	(128)	(92)	-0.7%	-0.8%	-0.5%
Others (*)	1,946	2,120	2,594	12.4%	12.6%	13.9%

Source: National Bank of Cambodia

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

On the demand side, credit to the private sector significantly increased in 2003 compared with 2002. Domestic credits rose by 28 percent of which credits to the private sector increased by 26 percent. Money sent abroad seems to have slowed down, compared with previous years, although it continued to expand at 9 percent in 2003. For 2004, the growth of credit to the private sector has remained robust, reaching 20 percent for the first eight months of the year, while money sent abroad expanded by 22 percent during the same period.

3.4. Interest rates

The scarcity of credit and weakness in the country's banking system seem the main factors behind high bank loan interest rates in

Cambodia, though rates have been on a declining trend since 2002. The 12-month dollar loan interest rate decreased to 16.7 percent in June 2004, from 17.3 percent in December 2003, and 18.2 percent in December 2002, according to National Bank figures.²⁴ On the deposit side, the same source also showed that the dollar-denominated fixed deposit 3 months rate slightly declined during the same period.

The riel-dominated interest rates followed the same trend as that of US dollar-dominated rates, and the gap between the interest rates of these two currencies has been falling progressively over the years, reaching only a 2 percentage point gap in June 2004 for a 12-month loan. This decline can be explained by the low inflation rate and the stability of the riel against the US dollar during the past several years. However, the prospects for 2005 are unclear, as the inflation rate is increasing and the riel is currently depreciating against the US dollar.

Table 3.3: Cambodia's Interest Rate
(%, per annum)

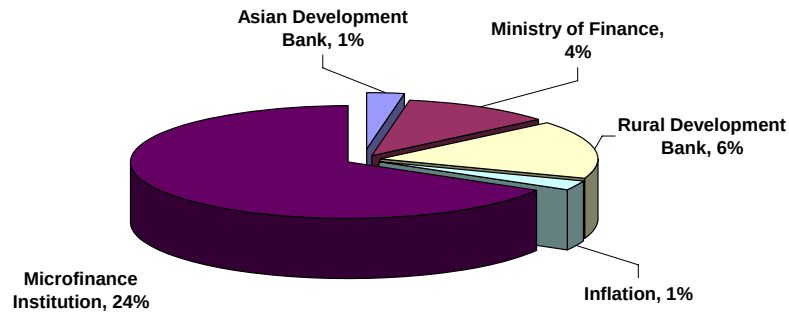
	December 2002	December 2003	September 2004
Riel 3-months Deposits Rate	5.0	4.8	4.8
US\$ 3-months Deposits Rate	3.1	2.7	2.5
Riel 12-months Lending Rate	21.0	21.1	18.7
US\$ 12-months Lending Rate	18.2	17.3	16.7
Inflation rate (year on year, in riel)	3.7	0.5	7.4
Inflation rate (year on year, in US\$)	3.1	-0.8	6.1

Source: National Bank of Cambodia and National Institute of Statistics

The evolution of the official interest rates, as reported by the NBC, unfortunately seems to have very little effect on the living conditions of Cambodians. Credit from official institutions to citizens, especially to the rural poor, is nearly nonexistent. The informal sector is where the majority of rural people go for loans to boost their economic activities and standard of living. But interest rates in the informal sector are extremely high; in general, interest rates contracted by individuals in the rural areas reach between 5 and 10 percent a month. For that reason, some microfinance institutions, such as ACLEDA and PRASSAC, have succeeded in attracting more clients due to a more tolerable level of interest rates.

²⁴ National Bank of Cambodia, "Economic and Monetary Statistics", June 2004

**Interest Rate Breakdown in the Microfinance Sector
(An example of ADB microcredit loans in 2003)**



Source: EIC interviews with microfinance professionals

For instance, most microfinance institutions lend at about 3 percent a month (or 36 annually), but this rate depends on the amount of loan and type of client. For example, PRASSAC, an NGO specializing in microfinance, charges its individual debtors about 3 percent a month, and its group debtors about 3.5 percent a month. ACLEDA, a commercial bank that began life as a microfinance institution, has an array of interest rates from 2 to 5 percent monthly, depending on the amounts and duration of loans. According to the microfinance professionals interviewed by EIC, the higher interest rates in Cambodia are due to the high cost of funds (about 12 percent a year), operational costs (at least 10 percent) and relatively high intrinsic risk of lending to anyone in Cambodia.