



Cambodia

Cambodia's economy has exhibited a general slowdown in growth. Areas that require attention include tax reform, budgetary discipline, administration of the Foreign Investment Law, and poverty alleviation. In addition, to promote capital formation the authorities need to de-dollarize the economy and reform the financial sector.

RECENT TRENDS AND PROSPECTS

The economy's performance in 1997 was far from promising. GDP growth was 2 percent, the inflation rate was 9.1 percent, and budget revenues were 9.3 percent of GDP. These numbers fell considerably short of the government's targets of 7 percent real GDP growth, an inflation rate of less than 5 percent, and budget revenues of 10 percent of GDP. Agriculture, which is the largest sector in the economy, did show a respectable growth rate of 4.9 percent in 1997, after growing at only 1.8 percent in 1996. However, both the industry and service sectors experienced drastic slowdowns, reporting 0.6 percent and -0.4 percent growth, respectively, for 1997. The labor force grew by 3 percent in 1997, which translated into a need for around 135,000 new jobs, 100,000 of them in rural areas. The agriculture sector absorbed some 75 percent of the workforce.

Trade reform and exchange rate liberalization have had positive effects on trade volumes since 1992. Both export and import volumes reported respectable increases from 1992 to 1995, but experienced negative growth rates from 1995 to 1997. The trade deficit was around \$388 million in 1997. Foreign direct investment amounted to about \$240 million in 1996, but substantially fell in 1997. The main areas of investment include the textile and

garment industries, construction, and tourism. The recent declines in trade volume and investment reflect the general slowdown in economic activity. The 1997 national budget targeted a shift from defense and security expenditures to social expenditures, while the expenditure to GDP ratio declined to 13.9 percent. Operational outlays by the civil administration, which include the bulk of social spending, were targeted to increase by 0.5 percent of GDP; however, actual social expenditures decreased by 0.18 percent of GDP compared with 1996. Overall expenditures still reflect strong demand from the defense and security sectors. In 1998 Cambodia will need \$21 million to fund elections, of which more than 60 percent will have to be financed by foreign assistance.

Increasing political instability in the coalition government culminated in the violent political events of early July 1997, when Prime Minister Hun Sen toppled his co-prime minister, Prince Norodom Ranariddh. The July event severely disrupted economic performance and slowed the economy's regional integration. Not only did tourism slump, but more important, trade and customs duty receipts fell sharply (customs duty receipts provide, on average, about 70 percent of annual government tax revenues). To make things worse, some bilateral donors suspended their programs and Cambodia's planned membership in the Association of Southeast Asian

Nations was put on hold. In addition, the International Monetary Fund suspended budgetary support because of the government's failure to meet formally agreed performance conditionalities, particularly as concerned the management of nontax proceeds from logging and other forestry practices.

If confidence in the Cambodian economy by the international community and domestically is restored fairly rapidly following new elections, GDP growth may reach as much as 3.5 percent in 1998 and 7 percent in 1999. Inflation is projected to rise to 9.6 percent in 1998, but to drop to 6 percent in 1999.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

The major critical issue in short-term economic management is the need for tax reform and budgetary discipline. Fiscal policy has to aim at managing the government's budget more efficiently through restructured revenue and expenditure measures, so that the authorities can meet budget targets without increasing the money supply. From the revenue side, the main thrust of fiscal policy has been tax policy. By adopting the Law on Taxation in February 1997, the government intended to expand its revenue base by further improving tax administration and by introducing a value-added tax. In this context, the main priority at this point is to speed up the implementation of this new law. Another priority relates to discipline with respect to the approved budget: the implementation of the 1997 budget did not achieve its main targets. In addition, the weak budget position will undermine efforts to contain inflation.

POLICY AND DEVELOPMENT ISSUES

Financing its development will inarguably be Cambodia's most important objective in years to come. About 40 percent of government expenditure is financed by foreign aid, which amounts to \$200 million to \$300 million a year. In September, the International Monetary Fund decided to freeze a \$120 million, three-year Enhanced Structural Adjustment Facility program to the country. Hun Sen's takeover also led the United States to suspend all but humanitarian aid and Germany to cut all assistance, both of which reduced total foreign aid

by 10 percent. Thus restoring international confidence in the country is the key to Cambodia's recovery. Nevertheless, political commitments, economic development, and domestic policies to implement programs that ensure more effective management of natural resources, especially forestry, would immediately lead to marked improvements in national income.

Financial Sector Reform and Foreign Investment Policy

Further reform of the financial sector is essential to promote capital formation by increasing domestic savings and investment. It will also raise the potential for more effective monetary policy as increased formal transactions through banks enhance the economy's responsiveness to monetary instruments. At the same time, the government must accelerate de-dollarization of the economy by continuing to denominate all its transactions in riels and restoring confidence in the currency through a commitment to both macroeconomic and political stability.

The authorities also need to address the lack of banks in rural areas. While existing rural credit programs by nongovernment organizations have proved useful, they are limited in both geographical coverage and the scope of local participation. In addition, interest rates in some nongovernment organization programs are based more on an estimation of clients' ability to pay than on market determined rates of interest. The development of a sustainable rural credit system will require liberalization of interest rates. Furthermore, the government needs to strengthen Central Bank supervision of commercial bank lending practices, particularly in the areas of credit risk analysis and debt recovery. In general, increased coverage of rural credit must be based on sustainable financial service provision to the poor and must be consistent with national financial stability. However, if the Central Bank is to take on the necessary supervisory tasks, it must first completely end its direct involvement in the commercial banking sector, and then introduce appropriate market-oriented monetary instruments, such as Treasury bills.

Given Cambodia's current stage of economic development, external financing will have to play a much more active role than at present. While po-

litical stability; social security; sound institutional, financial, and legal frameworks; macroeconomic stability; and appropriate physical and social infrastructures will gradually have to be instilled in the economy, a more direct way to improve the domestic investment environment is major improvement in the administration of the Foreign Investment Law. The latter incorporates liberal provisions for profit remittances, exemptions from duties, limited tax holidays, and a ceiling of 9 percent corporate tax on foreign investors. However, to be effective it requires strengthening through further simplification of approval procedures and elimination of inconsistencies pertaining to royalties. In addition, the authorities should develop a monitoring system to track everything from the number of queries by foreign investors, to the number of formal applications and the number of approved investments that are actually implemented. The monitoring system would involve regular reporting on the operation of foreign investment policy so that any necessary changes could be implemented efficiently.

Poverty Alleviation

Cambodia must focus on alleviating poverty: 30 percent of the population fall below the poverty line. In developing Asia, Cambodia has one of the lowest

life expectancies at birth, one of the highest infant mortality rates, and lowest calorie intake per person, facts which all indicate the existence of widespread poverty. Implementation of the reforms already mentioned will certainly promote economic growth, and thereby contribute to alleviating poverty, but policies that directly address poverty are also needed. These efforts would include providing basic social support services, improving access to basic education and training, and creating job opportunities.

To facilitate the targeting of poverty reduction initiatives the government must rely on external assistance. Given its current fiscal constraints, without any external assistance the government has little capacity to identify and design effective delivery mechanisms to protect vulnerable groups. The facts are daunting: even with an annual growth rate of 7 percent, the target growth rate for GDP set by the government, the economy may not be able to absorb more than 250,000 low-skilled, unemployed workers and simultaneously create jobs for 135,000 new entrants into the labor force each year. Neither could it absorb the 30,000 workers likely to be displaced as a result of initial public sector restructuring. The task of poverty alleviation is going to be long and arduous, but it is certainly one that the government cannot afford to postpone.