

# INTRODUCTION

After longstanding domestic turmoil and subsequent international isolation in the 1980s, Cambodia began to return to a period of peace in 1993. Since then, the country has made steady efforts to recover in all aspects of socioeconomic development and to maintain social, political, and macroeconomic stability; and international aid operations have resumed.

The Socioeconomic Development Plan for 1996-2000 (SEDP I) marked the Government's first systematic efforts toward economic development to achieve economic growth, poverty reduction, and broad participation in the development process. Since the successful implementation of SEDP I, the Government has been engaged in finalizing the Socioeconomic Development Plan for 2001-2005 (SEDP II), which identifies poverty reduction as the primary development goal. SEDP II targets reducing the poverty rate from 36 percent<sup>1</sup> in 1999 to about 31 percent in 2005, as well as lessening the degree of deprivation. These rates will be achieved by (i) promoting broad-based, sustainable economic growth at a rate of 6-7 percent with equitable income distribution, (ii) facilitating social and cultural development, and (iii) ensuring the sustainable management and use of natural resources and the environment.

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<sup>1</sup> The poor are those with a per capita income level below the poverty line, which was KR54,050 per head per month, equivalent to about \$14 (less than \$0.50 per day).

The Government's strategy to accomplish the poverty reduction target is to promote growth in all sectors but especially in the agriculture sector, because about 90 percent of the poor live in the rural areas. Moreover, mobilization and efficient allocation of resources are at the core of the economic development strategy. Specifically, the Government has targeted the following areas:

- (i) implementing fiscal reforms and maintaining a stable macroeconomic environment;
- (ii) improving the efficiency and effectiveness of the public sector through reforms in civil service, judiciary, and public enterprises;
- (iii) enhancing private sector development while protecting public interests by (a) improving physical infrastructure, (b) developing the legal and regulatory frameworks within which business enterprises operate, (c) liberalizing trade and investment policies, and (d) supporting banking system reform and financial sector development;
- (iv) promoting agricultural development and off-farm employment creation in both rural and urban areas; and

- (v) empowering the poor to participate in, and thus benefit from, the growth process by improving their access to natural assets, health and education services, appropriate technology and credit, and by removing any antipoor distortions in product and factor markets.

A sound and efficient financial system is essential for achieving broad-based economic growth and socioeconomic objectives, including poverty reduction. A well-functioning financial system is the key to ensuring macroeconomic stability, mobilizing savings, allocating resources for productive purposes, promoting private sector development, and in turn generating employment opportunities and reducing poverty. In a developing country like Cambodia, financial sector development will also contribute to promoting foreign direct investment (FDI) and safeguarding the economy from external shocks.

**Sustainable Economic Growth and Poverty Reduction.** The Royal Government of Cambodia (the Government) has identified poverty reduction as its priority. In its Interim Poverty Reduction Strategy paper, the Government outlined a broader approach based on a multidimensional assessment of poverty. Furthermore, it emphasized macroeconomic stability to foster sustainable growth that will create employment and have a long-term impact on reducing poverty.

Deficiencies in Cambodia's financial system undermine macroeconomic prospects and economic growth. The development of a sound, efficient, and well-regulated market-based financial system is crucial to achieving higher and sustainable economic growth and achieving the country's social and economic development objectives - poverty reduction, in particular.

**Enabling Macroeconomic Policy.** An important component for achieving and sustaining macroeconomic stability is a sound monetary policy to support growth, control inflation, and promote the strengthening and deepening of the financial sector to increase the mobilization of savings that supports private sector growth. With the development of a sound financial system, the Government can be better equipped with monetary policy tools.

**Safeguarding the Economy from External Shocks.** Developing a robust financial sector will protect the economy from or minimize the impact of external shocks, which are becoming more common with globalized financial markets. As the recent financial crisis attested, those Asian countries with the stronger legal and banking supervisory frameworks were more capable of minimizing the negative effects of the massive disruption in the regional market than the countries with weaker frameworks.

**Promoting Foreign Direct Investment.** A transparent financial system is also essential for attracting FDI, which have been the driving forces for economic growth in Cambodia. Because the availability of reliable means for conducting financial transactions is essential for the viability of the investments, a sound and efficient financial system is the fundamental condition to attract FDI. Foreign investors tend to invest in countries with sound governance that fosters transparency, accountability, and predictability, and promotes wide participation of the private sector by establishing the rule of law and a sound and efficient financial sector.

In recognition of the strategic value of financial sector development, the Government requested the Asian Development Bank (ADB) for assistance in formulating a long-term vision and a financial sector development plan for the 10-year period, 2001-2010. In response to the Government's request, ADB conducted a

comprehensive diagnostic review of the financial system from 2000 and formulated a financial sector development plan, or the Financial Sector Blueprint (the Blueprint) for 2001-2010.

The Blueprint outlines a long-term vision and strategy for sequencing policy reforms to develop the financial system over three phases during 10 years. The Blueprint addresses key policy issues in the banking and nonbanking sectors, contractual savings, and interbank/money and capital markets, as well as the basic infrastructure to underpin the development of the financial sector. It proposes reform agenda and illustrative policy actions over the three-phase, 10-year period.

The Blueprint is a multi-purpose plan for developing the financial sector and intends to serve as:

- (i) the Government's planning tool for financial sector development,
- (ii) the basis for formulating ADB's Financial Sector Program Loan, and

- (iii) the coordination panel for external assistance to the financial sector.

Aid coordination is a key component underpinning the Blueprint strategy. Given the extent of issues that need to be addressed in financial sector development, such coordination will be critical to the effective allocation of resources. Funding agencies will be able to use the Blueprint to plan and coordinate technical assistance (TA) to the financial sector. In addition, duplication will be minimized through better planning and communication, which will be facilitated by the Blueprint.

The remainder of this document is organized as follows. Chapter II reviews the background of and analyzes the key issues in Cambodia's financial sector. Chapter III presents a long-term vision for financial sector development, and Chapter IV provides the long-term strategy and sector development plan to achieve the vision. A summary table of the Blueprint is in the Appendix.