Cambodia

Headwinds buffeted the economy in 2008, contributing to double-digit inflation and then cutting into economic growth. Continuing weakness in garment exports, tourism, and construction is forecast to reduce GDP growth this year. This deceleration, combined with rising prices, threatens to undermine steady gains made to reduce poverty. Thus the major challenge is to diversify growth and make it more resilient, inclusive, and beneficial to the poor.

Economic performance

The momentum of high growth in 2007 carried over into the first half of 2008 and slightly beyond, as garment exports and tourism stayed robust, agricultural output relatively strong, and construction activity buoyant. Late in 2008, however, the economy felt the combined effects of political instability in neighboring Thailand and the closure of Bangkok's airports; and of the start of the global economic downturn in terms of an associated deceleration in demand from traditional export markets and weakening investor sentiment. Imports by the principal market, the United States (US), of Cambodian garments declined by 2% in value terms in 2008, according to US data. Tourist arrivals slowed and construction activity fell sharply following a drop in land and property prices after several years of rapid growth.

Largely on the basis of these factors, GDP growth in 2008 slowed to an estimated 6.5% (Figure 3.23.1). Agricultural expansion was relatively buoyant at 4.5%, spurred by good weather and higher farmgate prices, but overall growth in total manufacturing production (5.0%) and services (8.5%) was lower than in 2007.

On the expenditure side, rising domestic demand, fueled by an increase in commercial bank lending and wealth effects from previously fast-rising property prices, stimulated increasing amounts of consumption-related imports and contributed to inflation pressures. Net exports continued to subtract from GDP growth.

Inflation accelerated from 6.4% in September 2007 to a peak of 25.7% in May 2008, driven largely by the global surge in oil and food prices (Figure 3.23.2). In addition, because the economy is heavily dollarized (over 90% of total bank deposits are held in US dollars), a depreciation of the riel and the US dollar against trading partner currencies contributed to imported inflation, while rising domestic demand contributed to domestically generated pressures. The domestic price of rice doubled between mid-2007 and mid-2008, a result of domestic supply shortages, in turn partly created by increased exports from provinces bordering Thailand and Viet Nam in response to higher prices in those countries. Prices of pork, chicken, and fish also rose steeply. Later in the year, food and fuel prices declined and, combined with an appreciating riel and

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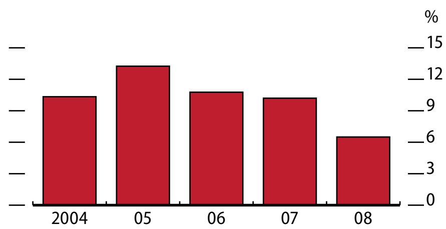
3.23.1 GDP growth



Sources: Asian Development Outlook database; staff estimates.

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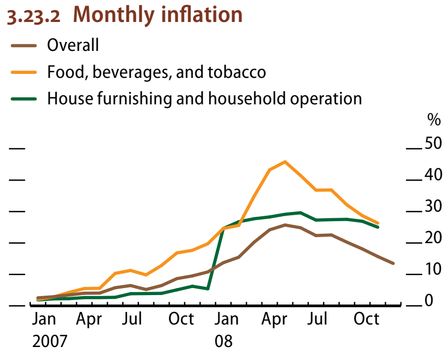
3.23.2 Monthly inflation



Note: Data refer to Phnom Penh only.

Sources: Economist Intelligence Unit, *Country Report*, February 2009; CEIC Data Company, Ltd.; National Bank of Cambodia, available: www.nbc.org.kh, all downloaded 3 March 2009; staff estimates.

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US dollar plus monetary policy measures taken at midyear, helped bring down inflation to 13.5% by December. The year-average figure of 19.7% was three times 2007's rate. The riel's real effective exchange rate appreciated by about 10%, reflecting higher inflation in Cambodia.

In response to the higher oil and food prices, the Government took a series of fiscal-related steps to help offset the negative social effects, including raising wages and allowances of civil servants and teachers, and improving the supply of rice in the hardest-hit rural areas. Despite these moves, higher than projected government revenue and containment of current expenditure to its budgeted level permitted an increase in the current budget surplus to 3.7% of GDP.

The overall budget deficit (including capital spending) narrowed to 2.1% of GDP in 2008 from 2.9% the year before. Total domestic revenue rose by just under a half percentage point of GDP, to 12.5%, with tax receipts edging up to 10.4% of GDP (from 10.2% the year before), mainly on continued improvements in administration and collections. Total budget expenditure declined marginally, to 14.6% of GDP, reflecting lower externally financed investment. Concessional loans and grants continued to finance the overall fiscal deficit.

Fueled by rising foreign capital inflows and bank deposits in the first half of the year, broad money growth accelerated sharply, peaking at 63% in April 2008 (year on year) (Figure 3.23.3). This contributed to an unsustainable rate of growth in bank credit, which exceeded 100% (year on year), and stoked inflation. The monetary authorities responded by imposing a 15% limit on bank credit to the real estate sector at end-June, by doubling the minimum reserve requirement on foreign currency bank deposits to 16% a month later, and by easing restrictions on capital outflows.

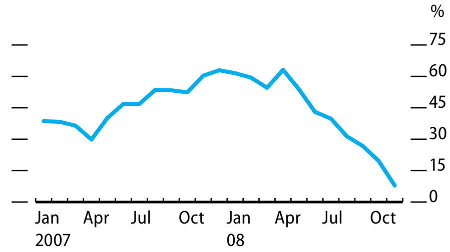
These moves helped ease credit growth and inflation in the second half. After clear signs that inflation pressures were dissipating, on 1 February this year the authorities reduced the minimum-reserve requirement to 12% and removed the cap on lending for real estate.

Export performance is heavily dependent on garment shipments to the US and Europe, but these markets weakened in the second half of 2008. Garment exports were also hurt by higher domestic inflation, which led to a 20% rise in garment workers' minimum wage. In 2008, such exports to the US fell by 2% (Figure 3.23.4), as lower prices more than offset small volume gains.

Rising domestic demand and higher international oil prices lifted imports, and the trade deficit widened to an estimated 18% of GDP in 2008. Growth in tourist arrivals eased to 5.5%, the slowest gain since 2003. Arrivals were up by 10% through midyear, but declined to around 3% following the political turmoil in Thailand and the onset of the global financial crisis. The current account deficit therefore widened to an estimated 14.0% of GDP. International reserves increased to just over $2 billion by December 2008 (equivalent to 3.5 months of import cover), reflecting buoyant inflows of aid and, until the latter part of the year, foreign direct investment (FDI).

Total public debt remains sustainable, but there are risks. At end-September 2008, total nominal external public debt was $2.8 billion, equivalent to 27.0% of GDP (down from 29.7% at end-2007) (Figure 3.23.5),

3.23.3 M2 growth



Sources: CEIC Data Company, Ltd.; National Bank of Cambodia, available: www.nbc.org.kh, both downloaded 3 March 2009.

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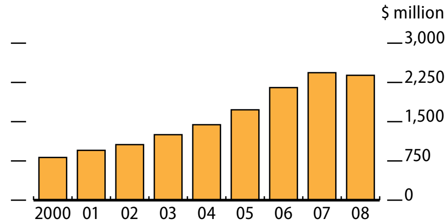
3.23.4 US imports of textiles and clothing from Cambodia



Source: Office of Textiles and Apparel, available: http://otexa.ita.doc.gov, downloaded 3 March 2009.

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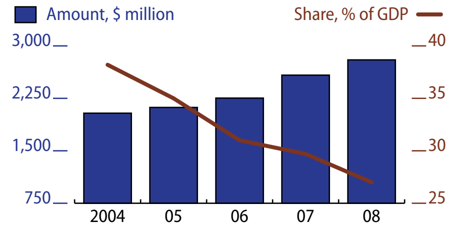
3.23.5 Public external debt



Sources: International Monetary Fund, *Country Report* No. 09/48; staff estimates.

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while domestic public debt stood at about $100 million, equivalent to 0.75% of GDP, one third in foreign currency. Over half the external public debt stock is owed to multilateral institutions, and includes the negotiated debt stock for the Russian Federation ($457 million) and the agreed amount of total principal owed to the US ($162 million). Most of the external public debt is highly concessional.

The ratio of external public debt service to domestic exports of goods and services is low, at around 0.8%. Cambodia is not servicing its debts with either the Russian Federation or the US and it remains in arrears to both creditors, although negotiations on outstanding debt obligations are continuing. According to an analysis conducted in late 2008, external public debt is sustainable and the risk of debt distress is moderate. However, the country remains vulnerable to external shocks, and a protracted economic downturn could result in debt burden indicators breaching their indicative thresholds for extended periods.

In terms of structural reform, progress was made in implementing a public financial management reform program. Advances were also achieved in preparing for the devolution of functions, human resources, and financial resources from the central to local levels. The aim is to promote transparent and accountable local development and delivery of public services, and to contribute to more effective poverty reduction.

On the logistics front, an automated system for customs clearance and risk management was test-piloted in the port of Sihanoukville (through which 30–40% of total trade is routed), from May 2008. This has reduced processing times and costs for clearing customs, according to private sector users.

As for fostering private sector development, Cambodia moved up a little in the World Bank's *Doing Business 2009* rankings, to 135 in a list of 181 countries, but it fell in Transparency International's *Corruption Perceptions Index 2008*, to 166 out of 180.

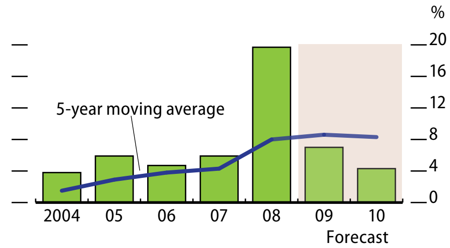
Economic prospects

Inflation, which affects the poor and those on low fixed wages the most, is forecast to decelerate to single-digit levels, but economic growth is set to decline sharply. The following forecasts are predicated on the Government's ability to regain overall macroeconomic stability in the form of a return of inflation to sustained low single-digits (Figure 3.23.6); increased and more efficient infrastructure spending; and a continued safeguarding of the health of the financial system (through sustained improvements in regulation and supervision).

Against this background, growth is forecast to slow to 2.5% in 2009, for three main reasons. First, garment exports are expected to contract because of lower demand in the US and Europe, higher wage costs, cessation of safeguards on the People's Republic of China at end-2008, and increasing competition from Viet Nam. Orders for delivery in the first half of 2009 are sharply lower than at the same time last year, and the outlook is poor for overall retail sales in the US.

Second, the growth in tourist arrivals has already slowed significantly (Figure 3.23.7), reflecting the combination of recession in Europe and a continued decline in the number of tourists from the Republic of Korea

3.23.6 Inflation



Note: Data refer to Phnom Penh only.

Sources: Asian Development Outloook database; staff estimates.

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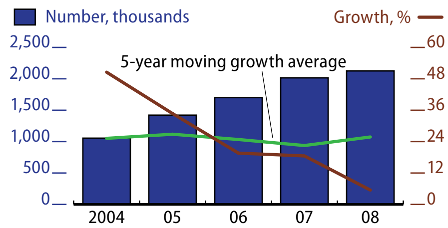
3.23.7 Tourist arrivals



Source: Ministry of Tourism, available: http://www.mot.gov.kh, downloaded 3 March 2009.

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3.23.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.5	4.0
Inflation	7.0	4.3
Current account balance (share of GDP)	-16.0	-10.0

Source: Staff estimates.

(the most important source country), partly owing to a much weaker won against the US dollar.

Third, the recent slowdown in construction growth from rapid rates is expected to continue and to turn negative for the year as a whole, reflecting reduced FDI from Korea, which is heavily invested in the sector, and the decline in property prices. Non-tourism services are also projected to grow much more slowly than in recent years, reflecting the overall downturn in economic activity and sentiment.

On a more positive note, agricultural production is expected to be marginally higher this year than last year's estimated growth of 4.5%, reflecting improvements in irrigation, a drop in fertilizer prices from last year's high, and a continuation of policies to increase production. These policies include improving the availability of high-yield seeds, strengthening disease and pest control, providing more irrigation facilities for dry paddy lands, and increasing the popularity of the system of rice intensification to increase the productivity of irrigated rice cultivation, which has contributed to raising overall land productivity.

Offshore oil and gas deposits have been found, but the amounts that are economically recoverable are uncertain, and any revenues that might be generated from exploiting the deposits would not flow within the forecast period.

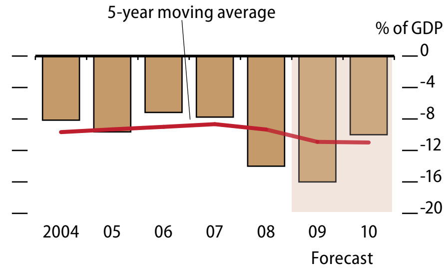
Domestic credit is expected to be somewhat tighter this year, as capital inflows and growth in bank deposits slow. Inflation is forecast to continue moderating, to average 7.0%, reflecting lower domestic demand and global oil prices. The current account deficit is set to widen further, to 16.0% of GDP (Figure 3.23.8), as easing domestic demand fails to compensate for declining export-related receipts from garments and tourism. International reserves are expected to decline, taking import cover to below 3 months.

The Government has requested development partners to accelerate their disbursements on existing projects and their approvals of projects planned for 2009, in order to help offset the likely reduction in private domestic demand and exports. In addition, the prime minister has stated that public spending in 2009 will be redirected toward growth enhancement and social safety nets, although he has not given details. The 2009 budget, which was prepared while the global financial crisis was beginning to unfold, did not contain any specific measures to offset the possible adverse effects of the crisis, but by early March 2009, the authorities had announced their intention to double development spending in 2009 on transport, public infrastructure, and irrigation. They were also considering accommodating a somewhat larger overall budget deficit in 2009 than originally envisaged.

In terms of structural measures, the Government has indicated that it is looking at how to relieve constraints to growth and faster poverty reduction, by, for example, providing some tax relief to the garment and tourism industries, and accelerating trade facilitation reforms.

In 2010, GDP growth is expected to pick up to 4.0%, in line with the anticipated rebound in industrial-country growth in the second half of next year. Inflation is projected to return to its recent historical average of just under 5%, while the current account deficit will narrow slightly to around 10.0% of GDP, as exports recover faster than imports.

3.23.8 Current account



Sources: Asian Development Outloook database; staff estimates.

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3.23.1 Development challenges

Cambodia recorded strong economic growth averaging over 11% in 2004–2007, which was a key factor in reducing poverty to around 30%. However, this achievement is at risk of being undermined by the sharp run-up in food and fuel prices in 2008, and by the subsequent global financial crisis and economic downturn.

The immediate needs are for the Government to continue bringing down inflation to low single digits, and to help mitigate the adverse effects on the most vulnerable of the decline in growth.

Medium to long term, the Government will need to promote policies and reforms to sustain rapid growth. This requires not only strengthening existing sources of growth, but exploiting new avenues, in particular those that benefit the poor, including—since over 80% of the population lives in rural areas—a renewed emphasis on agricultural and rural development.

Faster rural development could be achieved if the coordination and implementation of various government plans were improved, notably five programs under the Strategy on Agriculture and Water 2006–2010, whose objective is to help diversify economic growth and reduce poverty.

It will also be necessary to integrate these initiatives with related reforms, including the extension of social and physical infrastructure, and the creation of more nonfarm jobs.

Finally, raising the priority for current spending on well-targeted social safety nets for the most vulnerable would also help maintain the gains in poverty reduction.