Cambodia

Declines in clothing exports, tourism receipts, and construction caused by the global recession brought about a contraction in GDP last year. Inflation faded, then turned up by year-end. Despite the adoption of an expansionary fiscal policy to cushion the impact of the slump, poverty incidence likely increased. This demonstrates a need to diversify sources of growth and to better target fiscal policy. The improved global outlook this year paves the way for moderate rates of economic growth during the next 2 years.

Economic performance

After growth that averaged 9.1% from 1998 to 2008, the economy contracted by an estimated 2.0% in 2009 (Figure 3.23.1). The shrinkage reflected output declines in three of the four drivers of growth: garment exports, tourism receipts, and construction, which together account for over one-third of GDP.

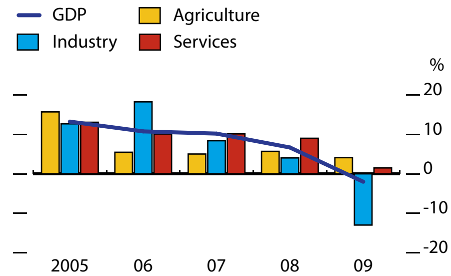
In contrast, the primary sector, the economy's fourth driver producing about 30% of GDP, maintained trend growth and served as a social safety net for many laid-off workers. Agricultural output expanded by an estimated 4%, mainly a result of favorable rains. Fisheries production received a boost from aquaculture and marine fishing expanded by about 9%, while growth in livestock and forestry-related production is estimated to have remained at around trend rates.

Growth in services slowed to 1.5%, principally a reflection of a decline in tourism receipts as global travel waned, and of border tensions with Thailand, a country through which many tourists transit. Total tourist arrivals rose by 1.7% in 2009 (to 2.2 million), pushed up by increases of about half from neighbors the Lao People's Democratic Republic and Viet Nam. However, the number of higher-spending tourists from the Republic of Korea (hereafter Korea) and Japan fell by 26% and 11%, respectively.

Industrial output last year fell by an estimated 13.0%. Data from the United States (US) Department of Commerce showed that US garment imports from Cambodia plummeted by 20.9% in dollar terms in 2009 (Figure 3.23.2) because of lower overall US demand and a loss of market share to competitors such as Bangladesh. (The US accounts for 70% of Cambodia's garment exports.) Construction is estimated to have contracted by 10%, reflecting a sharp decline in inflows of construction-related foreign direct investment (especially for large projects, including those funded from Korea), and a slowdown in residential construction.

Heading into 2009, inflation decelerated from very high levels, such as 35.6% in May 2008 (Figure 3.23.3), as world oil and food prices fell and domestic monetary policy was tightened in mid-2008. Weakening domestic demand in 2009 further subdued price pressures, so that the consumer

3.23.1 GDP growth



Source: Asian Development Outlook database.
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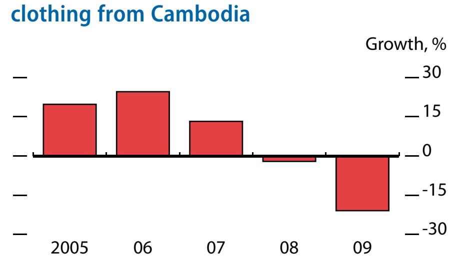
3.23.2 United States imports of textiles and clothing from Cambodia



Source: Office of Textiles and Apparel. http://otexa.ita.doc.gov (accessed 1 March 2010).
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This chapter was written by Eric Sidgwick and Poullang Doung of the Cambodia Resident Mission, ADB, Phnom Penh.

price index on average in 2009 was 0.7% below prior-year levels. By December, though, year-on-year inflation had returned at a rate of 5.3%. The real effective exchange rate of the riel appreciated by about 2% during 2009.

After clear signs that inflation was dissipating, and in response to the economic slump and very low growth in broad money (3.7% at end-March), the National Bank of Cambodia, the central bank, in early 2009 lowered the minimum reserve requirement on banks' foreign currency deposits and introduced a new method of calculating minimum reserves that, in effect, increased banks' liquidity. As a result, broad money growth accelerated to 36.8% by end-December 2009 (Figure 3.23.4), driven by a buildup in foreign currency deposits (the economy is heavily dollarized).

Private sector credit growth, however, decelerated from 55% at end-2008 to 6.5% at end-2009 (Figure 3.23.5), attributable to subdued economic activity and increasingly risk-averse behavior of banks. The banks grew more cautious as property values declined (most loans are collateralized on property) and their nonperforming loans rose to 4.8% of total loans at end-2009 from 3.7% a year earlier.

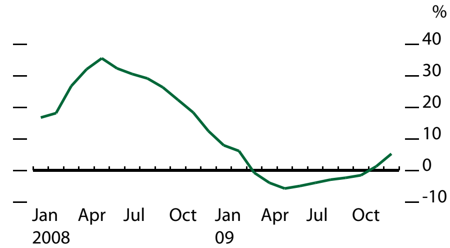
The government took a more expansionary fiscal stance to stimulate the slowing economy. It raised total expenditure to an estimated 17.6% of GDP, above the budgeted allocation of 16.1%. Measures included temporary tax relief for the tourism and garment industries; increases in locally financed spending on rural infrastructure; elimination of tariffs on fertilizers and imports of agricultural machinery; and $10 million for retraining laid-off garment workers. The government also awarded large increases in wages and allowances to civil servants and military personnel, so that its wage bill jumped from 3.4% of GDP in 2008 to 4.7% in 2009.

Increased public outlays, at a time that revenue was eroded by the economic slump, pushed out the overall budget deficit to an estimated 5.9% of GDP in 2009, double the 2008 gap (Figure 3.23.6). An expansionary fiscal stance was appropriate given the weakness in aggregate demand, though the policy's impact on the economy generally and on poverty reduction specifically was likely hindered by inadequate targeting. Furthermore, in a reversal from recent years, the government drew down its deposits in the banking system to help fund the budget deficit. This large injection of riel liquidity (equivalent to 1.4% of GDP) risked undermining macroeconomic stability.

In the external accounts, preliminary data show a 17.0% fall in merchandise exports in 2009, mostly stemming from the drop in garment exports to the US. Imports contracted by 16.3%, on lower oil prices and cooling consumption. Tourism receipts likely declined. The current account deficit (excluding official transfers) narrowed to an estimated 10.7% of GDP (or 5% including official transfers). Foreign direct investment inflows fell by an estimated 27% to $593 million, reflecting the financial crisis and global recession, but donor inflows remained buoyant, and international reserves increased to around $2.4 billion, equivalent to more than 4 months of projected imports.

An analysis conducted by multilateral organizations in late 2009 concluded that Cambodia's external public debt remains sustainable and that the risk of debt distress is moderate. Such debt at year-end was estimated at $3.2 billion (up slightly from end-2008), largely on concessional terms. Most external private debt is in the form of trade credits.

3.23.3 Inflation



Source: CEIC Data Company (accessed 1 March 2010).

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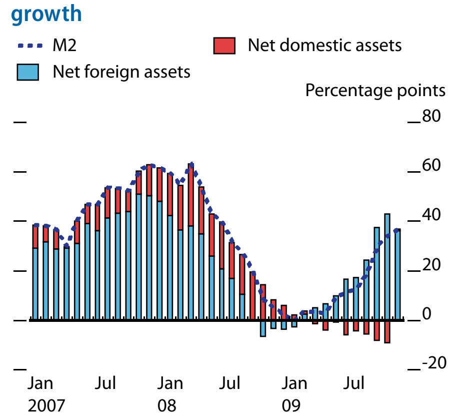
3.23.4 Contributions to money supply growth



Source: CEIC Data Company (accessed 1 March 2010).

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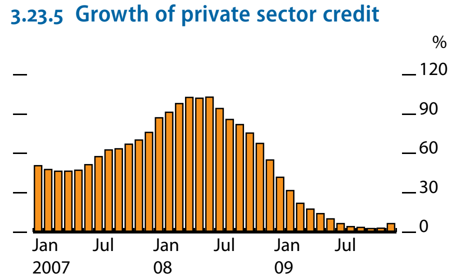
3.23.5 Growth of private sector credit



Source: CEIC Data Company (accessed 1 March 2010).

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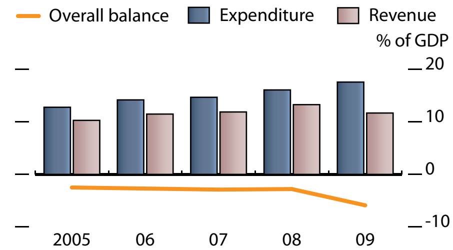
As a result of surging food prices in 2008 and the economic contraction in 2009, it is likely that the incidence of poverty has risen above the 30% rate recorded in 2007. In addition to the short-term relief measures that it introduced last year, the government began preparations for a social safety net system that will involve the expansion of targeted conditional cash transfers and labor-intensive public works programs.

In other policy areas, some progress was made under the public financial management reform program, most notably in enhancing the credibility of the budget through improved medium-term macroeconomic and expenditure frameworks as well as better budget, cash, and debt management. The authorities are implementing a program to restructure and transfer certain roles and responsibilities to provinces, districts, and communes; and to institute fiscal arrangements at those levels to promote transparent and accountable local development and improved service delivery.

Among efforts to enhance the business climate, the authorities extended the reach of financial services; improved the transparency of the financial system; finalized drafts of new laws on commercial contracts, finance, and insurance; and established a commercial arbitration center. An automated customs-processing system is being extended from the port of Sihanoukville to cross-border points.

3.23.6 Fiscal indicators



Source: Asian Development Outlook database.
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Economic prospects

If global economic growth is in line with the *Asian Development Outlook 2010* assumptions and if the weather allows for reasonable crops in Cambodia, GDP is projected to rebound by 4.5% in 2010 (Figure 3.23.7). The assumed lift in US consumer spending will likely result in only a mild recovery in demand for Cambodian garments, however, owing to the industry's loss of competitiveness to other suppliers. The pace of decline in garment exports to the US did ease, though, heading into 2010 (Figure 3.23.8).

Growth in services is projected to resume at around 5% in 2010. Forward bookings suggest fairly weak growth in arrivals of higher-spending tourists, although arrivals of less free-spending tourists are expected to continue to increase. Other services are projected to recover moderately, on a gradual pickup in domestic consumer and business sentiment.

Construction activity will likely grow at a moderate rate of about 4%, as appetite for bank credit gradually recovers and inflows of foreign direct investment, particularly from Korea, resume for some projects. Agricultural output is projected to expand by 4.7%, assisted by efforts to increase irrigation and the greater availability of high-yield seeds.

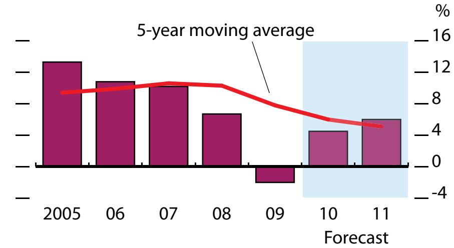
Fiscal policy is expected to be less stimulatory this year than last. The 2010 budget aims to narrow the deficit to 5.2% of GDP, to be achieved by raising tax revenue to 9.7% of GDP (from 9.0% in 2009) and rolling back the public sector wage bill a bit. Assuming a similar proportion of external financing as in 2009, this would enable a reduction in the drawdown of government deposits at banks to 0.6% of GDP. Revenue will get a lift from the strengthening of economic activity and new taxes on luxury vehicles and property.

3.23.1 Selected economic indicators (%)

	2010	2011
GDP growth	4.5	6.0
Inflation	5.0	5.0
Current account balance (share of GDP)	-16.3	-17.0

Source: ADB estimates.

3.23.7 GDP growth



Source: Asian Development Outlook database.
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The planned reduction in fiscal stimulus, coupled with relatively low inflation pressures, is likely to presage an accommodative monetary policy stance, although the monetary authorities have indicated that they will adjust policy if inflation quickens faster than anticipated.

In 2011, a return to higher—though still below trend—growth in garment exports and tourism, together with some expansion of nongarment manufacturing and a pickup in other services subsectors, is projected to raise GDP growth to around 6%. The extent and timing of exploitation of oil and gas reserves discovered offshore are uncertain, but are not expected to have an impact on GDP before 2012 at the earliest.

Inflation of around 5.0% is projected for the forecast period, assuming no renewed surges in oil or food prices or sharper depreciation of the dollar, and assuming a reduction in domestic financing of the budget deficit in 2010. With imports expected to recover faster than exports, the current account deficit is seen widening to around 16% and then 17% of GDP in the next 2 years (Figure 3.23.9). An increase in equipment imports for infrastructure projects will more than offset gradually rising exports. Gross international reserves are expected to remain at over $2.1 billion by end-2010, equivalent to about 4 months of import cover.

This broadly positive outlook is predicated on the government resuming a path of fiscal consolidation, with a higher revenue effort matched by improved targeting of expenditure, and the maintenance of low inflation. Slippage in these areas would put the forecasts at risk. On the upside, growth prospects would be enhanced if key structural reforms were deepened so as to improve the functioning of public administration, to accelerate trade and transport facilitation with neighboring countries, and to attract more private investment.

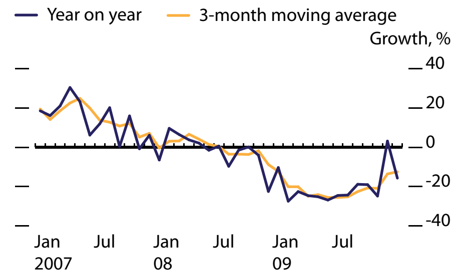
Development challenges

The hit taken by three of the four drivers of growth and, probably, poverty reduction during the global recession demonstrates the need for Cambodia to accelerate the diversification of its sources of growth and to open more opportunities to participate in such growth, especially in rural areas where most of the poor live. The likely increase in poverty also shows a need to institute a social safety net to better protect the most vulnerable during economic slumps.

Among the key challenges to achieving these objectives are improving the competitiveness of garments and tourism, diversifying crops and increasing crop yields, and improving linkages between farmers and markets. Effective implementation of the agricultural and rural development agenda will require a greater degree of coordination among relevant government agencies, and between these agencies and evolving subnational administrations.

While the legal framework for greater private sector development is, on paper, taking shape, more needs to be done to implement laws and regulations and, more generally, to create an environment to attract higher levels of employment-generating investment.

3.23.8 United States imports of textiles and clothing from Cambodia



Source: Office of Textiles and Apparel. http://otexa.ita.doc.gov (accessed 15 March 2010).

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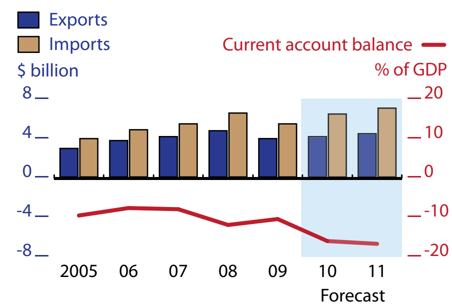
3.23.9 External indicators



Source: Asian Development Outlook database.

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