Cambodia

Consolidating rapid growth over the previous 2 years, the economy expanded strongly in 2006, reflecting robust clothing exports, tourism receipts, and construction activity. Forecast growth averaging over 9% in the next 2 years will be more dependent on strengthened domestic economic activity, itself underpinned by improved rural incomes, larger inflows of foreign direct investment (FDI), and greater government capital spending. The main challenge is to diversify sources of growth away from the current narrow base.

Economic performance

GDP growth in 2006 is estimated at 10.4%, consolidating double-digit growth of the 2 previous years. The outturn was buttressed by stronger industrial production and robust expansion in services and construction activity.

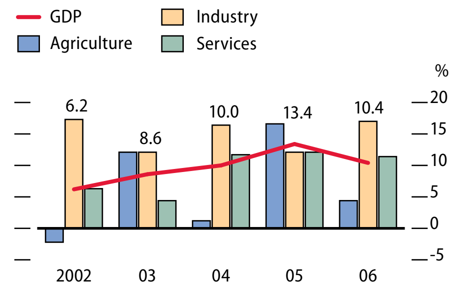
In industry, clothing exports grew by an estimated 32% in volume terms as manufacturers took advantage of temporary safeguard measures imposed against clothing exports from the People's Republic of China (PRC) by the United States (US) and the European Union (EU). Construction activity remained relatively strong due to a boom in residential and commercial buildings in Phnom Penh and Siem Reap. Growth in services was bolstered by solid increases in tourist arrivals. Agricultural production expanded by a stronger than expected 4.4% from the record levels achieved in 2005 (Figure 2.21.1). This was mainly the result of an increase in land under irrigation.

On the demand side, growth was supported by a rise in private investment reflecting growing investor confidence in future economic prospects, and in the Government's ability to maintain economic and political stability. Growth was also helped by a switch to a contribution from net exports (Figure 2.21.2) because of a narrower external deficit.

Budgetary performance continued to improve in 2006 with the overall fiscal deficit estimated at 2.4% of GDP, narrowing sharply from the recent trend deficit. The deficit is 1.5% of GDP if proceeds from the International Monetary Fund (IMF) Multilateral Debt Relief Initiative are included (Figure 2.21.3). Government revenues grew strongly to 11.6% of GDP from 10.4% in 2005, mainly because of an increase in tax collections. The rise in tax receipts compensated for lower capital revenues induced by a lack of privatization activity.

Expenditures are estimated to have risen less rapidly than receipts to 13.1% of GDP, reflecting growth in current spending related to higher outlays on social sectors, defense, and civil-service salaries. Locally financed capital expenditures, however, came in below expectations. Higher than expected revenues and expenditure restraint enabled the Government to reduce its stock of outstanding payment orders to domestic suppliers by about $32 million, or one third. As in the past, the overall deficit was financed by concessional loans and grants.

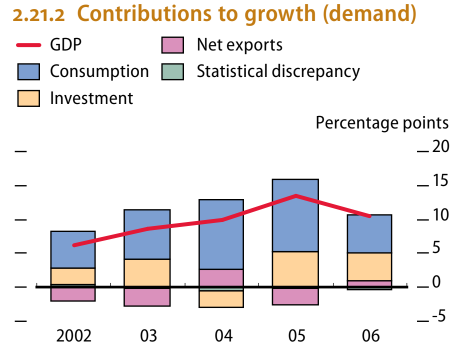
2.21.1 GDP growth by sector



Sources: *Asian Development Outlook* database; staff estimates.

Click here for figure data

2.21.2 Contributions to growth (demand)



Sources: *Asian Development Outlook* database; staff estimates.

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In a sign of growing confidence in Cambodia's nascent financial system, broad money (M2) growth accelerated by 38% in 2006, largely on the back of a 54% surge in credit to the private sector and a 32% jump in net foreign assets of the banking system.

The private credit surge was fueled essentially by greater demand for loans for construction, real estate, and wholesale and retail trade, though an increased number of small and medium enterprises also borrowed for business expansion. The increase in net foreign assets of the banking sector reflected a more favorable external balance, and receipts from IMF's Multilateral Debt Relief Initiative.

In line with the stronger fiscal performance, the Government did not need to tap domestic banks to finance the budget deficit. The central bank continued to intervene in the foreign exchange market to stabilize the riel, which appreciated by 1.3% in 2006 to 4,061/$1 by year-end.

Inflation slowed by about 1 percentage point to average 4.7% in 2006. Its fall was mainly a consequence of more moderate rises in food prices, as rice production increased and world market prices for rice stabilized. An easing of international oil prices in the last quarter of 2006 also helped. Year-end inflation at 2.8% showed a downward trend moving into 2007 (Figure 2.21.4).

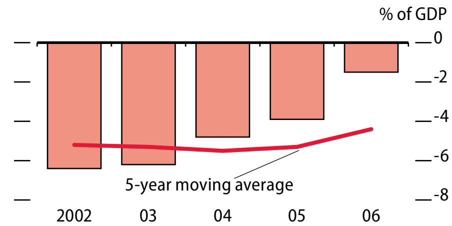
During 2006 merchandise exports expanded by an estimated 26.9%. Clothing shipments, which accounted for 72% of total exports, rose by 20.7% in value terms, despite stronger volume growth, reflecting lower unit prices as a result of stiffer global competition with the end of the Multifibre Arrangement. Exports of natural rubber rose sharply, but from a low base. Imports increased at a lower rate than exports (by 20.3%). The trade deficit, little changed from 2005 levels (Figure 2.21.5), was offset to some extent by significant growth in receipts from tourism, and the current account deficit (excluding official transfers) narrowed to 7.7% of GDP.

As in the past, the 2006 deficit was more than covered by concessional aid and inflows of FDI, leading to a larger overall balance-of-payments surplus. Gross international reserves of $1.1 billion at end-2006 provided about 2.8 months of import cover. External public debt was estimated at $3.3 billion or 46% of GDP, nearly 60% of which is owed to the Russian Federation and the US. Debt from those countries is not being serviced while it is being renegotiated. Most other debt is on highly concessional terms. The debt service ratio relative to exports of goods and services at end-2006 was low at 0.6% on a cash basis.

In policy developments, the Government continued to adopt laws and regulations, both to enhance private-sector activity and to fulfill its World Trade Organization (WTO) commitments. A new law on commercial arbitration provides for a mechanism for alternative dispute resolution and efforts are under way to set up a national arbitration center. The Government also adopted a licensing review plan that would pave the way to remove duplicate and unnecessary licenses affecting businesses.

Progress was also made on financial sector reforms. With a view to reducing the cost of borrowing and improving financial intermediation, a credit information system was introduced, providing commercial banks with credit-related information on prospective borrowers.

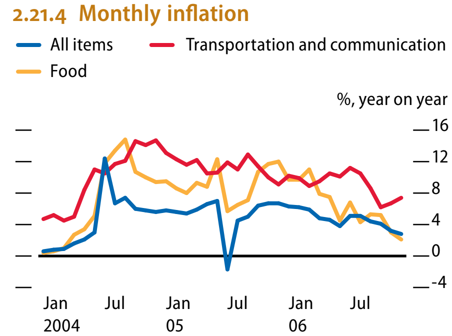
2.21.3 Budget balance



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

2.21.4 Monthly inflation



Source: National Institute of Statistics, available: http://www.nis.gov.kh, downloaded 28 February 2007.

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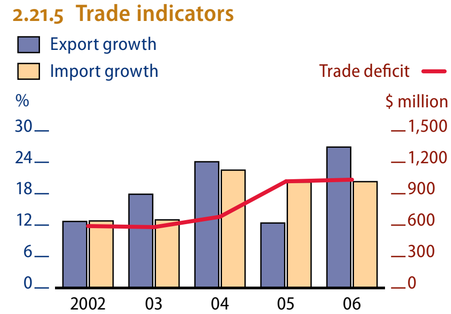
2.21.5 Trade indicators



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Legislation relating to negotiable instruments and payment transactions, which encompasses all noncash payment methods, was passed, and an online secured transaction filing system will be ready for launch some time this year. With a greater number of commercial laws being passed, arrangements are under way to adopt commercial law training material into the curriculum of universities for training lawyers, judges, and legal clerks.

The Government's public financial management reform program, launched in December 2004, also started to yield results, with an increasing proportion of customs and tax revenues being collected through the banking system, and a growing share of treasury payments to suppliers made by check instead of cash. The procurement process was streamlined and tightened, and the Government established internal audit departments in several ministries.

Economic prospects

The following forecasts are predicated on the Government continuing to implement its National Strategic Development Plan 2006–2010, which aims to achieve interim targets of the Cambodia Millennium Development Goals. Toward this end it is assumed that the Government will maintain fiscal discipline and will continue reforming the management of public finances to strengthen revenue collection and increase outlays on social sectors and rural infrastructure, in line with plan priorities. It is also assumed that the monetary authorities will continue to closely supervise the banking sector to ensure that rapid increases in domestic credit do not give rise to balance sheet problems in the banking sector that could undermine the financial system.

In structural reforms, the forecast presupposes that the Government will continue to implement both policies that follow from the country's membership of WTO, and reforms to increase agricultural productivity. The outlook assumes normal weather conditions over the next 2 years, and that Cambodia will not be subject to an economically disruptive outbreak of avian flu.

Based on these assumptions, GDP growth is projected at 9.5% in 2007 and 9.0% in 2008 (Figure 2.21.6). Agriculture is expected to expand gradually because of productivity gains, reflecting an increase in the area under irrigation, the use of improved agricultural inputs, and greater commercialization in farming. With the maintenance of safeguard measures by the EU and US against PRC clothing exports during this period, Cambodia's clothing industry is likely to grow, but at slower pace than in recent years. This deceleration will be attributable to competition from lower-cost producers, including Viet Nam, which joined WTO in January 2007, and slower growth in world trade and in industrial country growth, particularly the US (Cambodia's largest market).

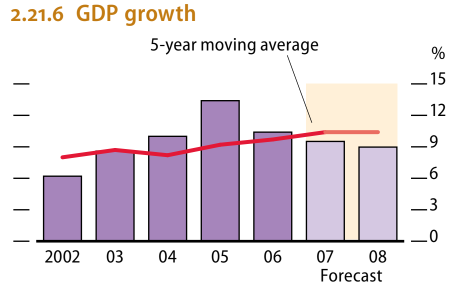
Construction activity is likely to keep expanding with planned construction of a new town, bridges across the Tonlé Sap and Mekong rivers, and a number of special economic zones. These zones will be on Cambodia's borders with Thailand and Viet Nam, where they can take advantage of lower-cost electricity from those countries and transport costs also will be lower.

2.21.1 Selected economic indicators

	2007	2008
GDP growth	9.5	9.0
Inflation	4.2	3.5
Current account balance (% of GDP)	-8.6	-10.1

Source: Staff estimates.

2.21.6 GDP growth



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Tourism growth also is projected to continue: tourist arrivals have increased by an average of 25% over the past 5 years (Figure 2.21.7). On the demand side, domestic economic activity looks set to remain upbeat, underpinned by rising rural incomes, by increased inflows of FDI as the economy becomes more commercially oriented and as oil exploration attracts investment (oil and gas were discovered offshore in 2005; Box 2.21.1), and by higher government capital spending on the back of an improved revenue performance.

Inflation is projected to moderate to 4.2% in 2007 and to 3.5% in 2008 (Figure 2.21.8), provided that farm output expands as expected and the world market price for rice and oil are fairly stable. Year-end inflation is likely to decelerate to 3.5% and to 3.0%, respectively. The expected maintenance of a prudent fiscal policy, with no recourse to domestic bank financing, and a broadly stable exchange rate would assist in damping price pressures.

Export demand will moderate as a result of the expected slowing in growth of clothing shipments. Agricultural exports, particularly non-rice crops and fisheries, are projected to expand owing to efforts to promote processing of food products and increased commercialization of the sector. However, due to a low base, such export growth is unlikely to have a significant near-term impact on export values. Exports of tree crops such as rubber are also likely to expand, in part due to robust demand for raw materials from the PRC. Here as well, though, the production base is low, resulting from years of neglect of the sector.

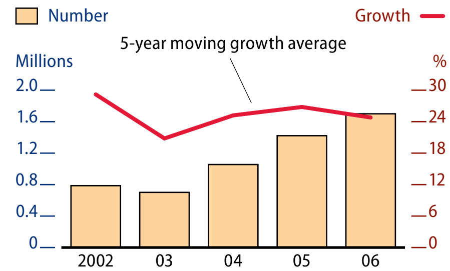
The import intensity of investment projects is likely to mean that import growth exceeds export growth, widening the trade gap and pushing the current account deficit out to 8.6% in 2007 and 10.1% in 2008 (Figure 2.21.9). Continued inflows of concessional loans and grants will partially offset the gap. They will be reinforced by expected higher inflows of FDI for investments related both to nonextractive industries, and to the search for oil, gas, and mineral resources such as bauxite, copper, and gold. Gross international reserves are forecast to be around 3 months of imports in 2007 and 2008.

Development challenges

Robust growth over the past decade and structural reforms have led to a steady decline in the overall incidence of poverty from an estimated 47% in 1994 to a still-high 35% in 2004. The gains have been widespread but not uniform, with the incidence of rural poverty remaining stubbornly high at around 39% and income disparities increasing between rural and urban areas.

An important contributory factor is that economic growth has been narrowly based on clothing and tourism, both of which are urban focused with limited linkages to the rural economy. Moreover, prospects for Cambodia's clothing industry are uncertain. Its manufacturers will face sharper competition for global clothing markets as a result of the accession of Viet Nam to WTO and the scheduled removal in 2009 of safeguard measures against PRC clothing exports to the US. Viet Nam's clothing exports to the US previously came under quota restrictions; the value of items subject to quotas overlapped with 88% of the value

2.21.7 Tourist arrivals



Source: Ministry of Tourism, available: http://www.mot.gov.kh, downloaded 28 February 2007.

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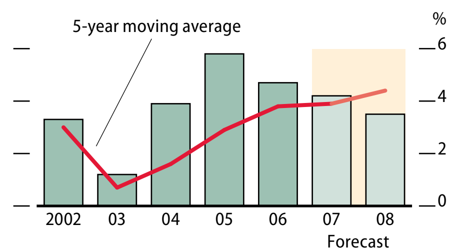
2.21.8 Annual inflation



Sources: National Institute of Statistics, available: http://www.nis.gov.kh, downloaded 28 February 2007; staff estimates.

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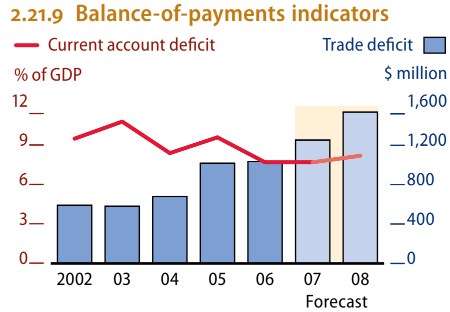
2.21.9 Balance-of-payments indicators



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

of Cambodia's total clothing exports to the US. Moreover, the value of existing safeguard measures against PRC clothing exports to the US overlaps with 70% of the value of Cambodia's garment exports to the US.

Supported by development agencies, the Government has been addressing these challenges through institutional and policy reforms. The unfinished agenda, however, remains large.

In agriculture, the state has pursued a policy of increasing irrigation and land titling to lift productivity. These policies are beginning to yield results, but various deficiencies are threatening to undermine progress. In the area of land management—identified in the National Strategic Development Plan as fundamental for development and poverty reduction—regulations to implement crucial elements of the Land Law passed in 2001 have still not been approved, while some regulations that have been approved are not being implemented as planned. This has resulted in land conflicts, lost livelihoods, a further concentration of wealth, and worsening rural poverty and income inequality.

For the private sector, changes have been made in recent years to reduce the cost of doing business and to improve the business climate through trade facilitation measures and reductions in the cost and time associated with business registration. But little progress has been made to approve the Law on Concessions, which has been before the National Assembly since 2005 and is intended to improve transparency in the management of state assets and to promote private participation in infrastructure.

Progress has also been slow in legal and judicial reform, hindering the effective implementation of laws and forcing the private sector to operate according to uncertain market rules.

2.21.1 Oil and gas discovery

The discovery of oil and gas holds out hope for a substantial injection of revenue into the government budget. Exploration is at an early stage, but some estimates suggest that one of six offshore exploration areas could contain as much as 700 million barrels of oil. That could produce a revenue flow for the Government from this block alone of an estimated \$750 million–\$1 billion a year at full production, or roughly of the same order of magnitude as total revenues collected in 2006.

If significant amounts of oil or gas are brought into production, funding for poverty reduction and for development of social and economic infrastructure would be boosted in the medium term.

However, international experience also shows there is a need to guard against the phenomenon of a natural resource curse, where oil wealth leads, paradoxically, to economic stagnation and political instability. This can happen because hydrocarbons production rarely generates much employment, benefits mainly urban areas, can spur inflation and currency overvaluation, and can create more opportunities for corruption.

Such developments could erode the competitiveness of domestic agriculture and manufacturing, sectors that employ many Cambodians. Consequently, diversification of sources of growth, especially in rural areas, becomes a high near-term priority to ensure broad-based development and to avoid the possible damaging economic effects of natural resource wealth.

Effective legal and institutional safeguards are also needed, to ensure that the state collects and spends such wealth for the benefit of all.