Cambodia

Underpinned by stronger agricultural production, growth accelerated in 2005, buttressing the healthy trend of the previous 2 years. Growth of around 6% is forecast for the short and medium term. However, growth needs to move away from its current dependence on the clothing and tourism industries. Development of agriculture and of the private sector would broaden the expansion, as would progress in legal and judicial reforms as well as in securing farmers’ property rights.

Economic performance

Building on robust growth over the previous 2 years, the economy expanded by an estimated 8.4% in 2005. Growth was bolstered by stronger agricultural production that reflected a recovery from drought, an increase in land under irrigation, and a considerably larger fish catch (Figure 2.21.1). In industry, clothing exports rose by 23% in volume terms, in large part a consequence of temporary safeguard measures against textile and clothing exports from the People’s Republic of China (PRC) imposed by the European Union (EU) and the United States (US). These restraints allowed Cambodia to push up exports to the US. Construction benefited from a boom in residential and hotel building, and services were boosted by an upsurge in tourist arrivals. On the demand side, growth was supported by an increase in private investment in response to an improved investment climate, as government reforms began to show results. Consumption expenditure also rose, reflecting higher agriculture-related incomes (Figure 2.21.2).

Budgetary performance continued to improve in 2005 with the overall fiscal deficit estimated at 3.1% of gross domestic product (GDP), narrower than the average of the previous 5 years (Figure 2.21.3). A gradual improvement in revenue mobilization (up nearly 1 percentage point to 11.6% of GDP in 2005), due to additional tax measures and strengthened revenue administration, was accompanied by lower overall spending. An inability to smooth out spending commitments once again produced an accumulation in payment arrears to domestic suppliers.

Broad money grew by 16.1% in 2005 on account of increases in foreign currency deposits and credit to the private sector. Private sector credit growth of 21.3% was much faster than anticipated and was driven by the boom in hotel and residential construction in Phnom Penh. Mindful of the shallowness of the market and that exchange rate policy has a limited impact on competitiveness in the dollarized economy, the central bank continued intervening to help stabilize the riel, which depreciated by 2.1% in 2005, reaching 4,116 riel to the dollar at year-end.

Inflation averaged 5.8% in 2005, higher than at any time in the previous 7 years (Figure 2.21.4). Food prices rose, despite a lift in food production, because of an increase in fish and paddy exports to Thailand and Viet Nam, where prices were higher. The rise in the domestic price
of fish led to greater demand for beef and pork, pushing up their prices as well. Higher global oil prices also put upward pressure on inflation, although domestic pricing and tax structures and relatively small weights of fuel in the consumer price index ensured only a moderate impact (Box 2.21.1).

Preliminary data show that merchandise exports expanded by about 9% in 2005, with the value of clothing exports up by 12%, half the year-earlier rate. (The rate of increase in the value of clothing shipments was much less than the volume figure, as the end of global quotas spurred competition in world markets, lowering export prices.) Exports of natural rubber and other agricultural produce rose strongly, but from very low levels. Imports rose by 17%, reflecting higher world oil prices and inputs for the import-dependent clothing industry (Figure 2.21.5). These outcomes widened the trade deficit, but with the cushioning effect of buoyant growth in tourism receipts on the services account, the current account deficit (excluding official transfers) is likely to have widened slightly to just above 10% of GDP in 2005. Aid flows and an increase in foreign direct investment offset the current account deficit

2.21.1 Higher oil prices

The impact of higher oil prices on inflation, the current account, and growth prospects have been tempered by several domestic characteristics. High levels of taxation and limited competition in distribution and retailing ensure that retail prices for gasoline and diesel are far higher than in neighboring countries. Import duty, excise tax, and value-added tax are levied on an administrative “reference price,” which has historically been higher than world market levels. Since 2004, however, the global price has exceeded the reference price. As a result, domestic retail prices for fuel have risen less quickly than world prices. Moreover, gasoline and diesel have low weights in the consumer price index. Consequently, the impact on inflation has been relatively light.

A wide gap between retail fuel prices and those in its neighbors encourages the smuggling of oil into Cambodia. The Government has strengthened efforts to clamp down on it, but is constrained from lowering taxes on petroleum products given its narrow revenue base. As a consequence of such contraband trade, formal imports underrepresent the true level of imports, with the result that official external balances have not deteriorated as much as they would have otherwise.

Finally, Cambodia is not an energy-intensive economy: it has the lowest electrification rate in Asia, with only about 17% of the total population served by the power grid. Moreover, the standard mechanisms for transmitting higher imported oil prices to the domestic economy (through increases in the cost of production feeding into a wage-price spiral and, possibly, higher interest rates) do not apply. Given the dollarization of the economy, the authorities have narrow scope for employing traditional tools for monetary management, depending more on fiscal policy to ensure price stability. Formal labor markets are insufficiently developed, and labor organizations are not strong enough to push for higher wages to defray higher costs. The upshot is that the impact of higher oil prices on inflationary expectations and domestic production is more subdued than in more developed market economies.
and led to a smaller surplus on the balance of payments. Gross reserves of $923 million at end-2005 provided about 3 months of import cover.

Nearly two thirds of external public debt, estimated at $3.2 billion or 59% of GDP in 2005, is owed to the Russian Federation and the US. The debt to those countries is not being serviced while under renegotiation. Most of the rest of the external debt is owed to multilateral creditors on highly concessional terms. Little domestic debt has been contracted over the past decade and domestic public debt, all denominated in local currency, amounts to 3.7% of GDP. The debt service ratio relative to exports of goods and services at end-2005 was low at 1.9%, including the debt under renegotiation (Figure 2.21.6).

The incidence of poverty in a 2004 survey was estimated at 35% of the population, ranging from 4.6% in Phnom Penh to 39% in some rural areas. A previous survey in 1993/94 covered only two thirds of households, for security reasons at the time. For the parts of the country that were sampled in both surveys and that can be directly compared, poverty fell from 39% to 28%. The gains have been widespread but not uniform, with rural areas seeing the slowest improvement. Poverty rates are highest in remote rural areas, which generally have limited access to irrigation, roads, markets, and basic services, and lack secure land tenure.

**Economic outlook**

**Prospects for 2006 and 2007**

The Government has completed its National Strategic Development Plan (NSDP) 2006–2010, which aims to achieve the interim targets of Cambodia's Millennium Development Goals. The following forecasts assume that projects identified in a 3-year rolling Public Investment Program accompanying the NSDP are pushed through (reflecting the NSDP’s priorities) and that donor assistance is aligned with the NSDP’s main thrusts. They also assume that the Government takes steps to address constraints on more broad-based growth and poverty reduction, including fiscal reforms to enhance both revenue collection and direct spending for poverty reduction, structural changes to provide an environment more conducive to private sector development, and reforms in agriculture to promote growth and rural livelihoods.

In the fiscal arena, the forecasts adopt the premise that the targets, as agreed with the International Monetary Fund to strengthen revenue collection and reorient spending to social sectors and rural development, will be met. They also presuppose no recourse to domestic bank borrowing to finance the budget deficit. In structural reform, they are predicated on further progress to reduce the cost of doing business, and that the Government will (i) implement the Law on Concessions (approved by the Council of Ministers in mid-2005) to improve transparency in the management of state assets and promote private participation in infrastructure, and (ii) begin to address constraints to agriculture, including insecure property rights, and poor irrigation, power, and roads. Finally, the forecasts assume normal weather conditions in the next 2 years.

On this basis, GDP growth is likely to average around 6.3% in
2006–2007 (Figure 2.21.7). Growth in agriculture will return to more normal, lower rates after the rebound from drought in 2005 (Figure 2.21.8). The safeguard measures against PRC clothing exports imposed by the EU and US for this period suggest that manufacturing in Cambodia can continue growing, but not at the pace seen in recent years. Tourism is likely to keep expanding robustly (Figure 2.21.9). Average annual inflation is projected to moderate to 4.5% in 2006 and 3.5% in 2007 (Figure 2.21.10), partly in view of an easing in the international price of rice. The Government appears set to follow a prudent fiscal policy and a broadly stable exchange rate, which will help damp inflation.

Rising rural production will flow through into higher agricultural exports. Clothing exports are under challenge from lower-cost countries (Box 2.21.2). In 2005, clothing exports to the US, by far Cambodia’s largest market, rose by 12% in volume and 20% in value terms. However, shipments to the EU declined by about 10%, in the face of stiff competition from the PRC and India (Figure 2.21.11). Import growth will probably outpace that of exports because of higher oil prices in 2006 and the import-dependent nature of the economy. This will result in a widening of the trade gap. Although receipts from tourism are likely to outpace profit remittances and interest payments on external debt, this will only partially offset the trade deficit, and the current account deficit will widen to over 12% in 2007 (Figure 2.21.12). Continued inflows of official loans and grants, and a gradual rise in foreign direct investment in line with improvements in the private sector environment, are likely to augment the overall surplus on the balance of payments.

Cambodia’s debt seems to be on a sustainable path, though low revenue collections mean that debt distress is a risk. Assuming that the Government reaches a debt-rescheduling agreement with the Russian Federation and the US in 2006 on terms comparable to the 1995 Paris Club agreement, external debt is projected to decline to 40.5% of GDP by end-2006, though the net present value of public external debt would still represent around 187% of government revenue.

Medium-term outlook

If the country is to achieve the NSDP growth target of 6% a year over 2006–2010 and a reduction in the poverty rate to 25% by the end of this decade, several structural constraints to growth need to be resolved. Existing sources of growth are narrowly based on clothing and tourism. If safeguards against PRC clothing imports are lowered in world markets after 2008, domestic clothing-makers would face heightened competition. Moreover, both clothing and tourism have an urban focus with limited linkages to the rural economy. Agriculture, which employs 72% of the labor force, offers the best potential to accelerate growth and address poverty more directly. Currently, its production is far below potential because much land remains uncultivated and crop yields are among the lowest in the subregion. One way to lift production would be to address the issue of insecure property rights, which discourages farmers from investing in land improvements.

Development of the private sector is hampered by infrastructure bottlenecks, high cost of credit, lack of skilled labor, and weaknesses in governance. A simple and transparent rules-based private sector
2.21.2 Challenges for the clothing industry

Cambodia’s clothing industry is dominated by foreign owners and has no unique cost advantage (although labor compliance with International Labour Organization standards is a positive feature). For the foreseeable future, the industry is likely to depend on preferential access to some major export markets, such as Canada and the European Union. In the US market, the country has quota-free access as a member of World Trade Organization, in contrast to Viet Nam. This advantage may, though, be lost once Viet Nam joins the organization, possibly later this year, or next.

The Government has embarked on a program to improve competitiveness by reducing the cost of trade processing and the time taken for clearance and inspections, and has achieved some success. An assessment of changes made to date found that the cost per transaction of export processing fell from $942 in 2003 to $598 in 2005, and that the average cost of import processing dropped from $2,447 to $673 per import transaction. Also over this period, the time taken for export clearance fell from 6.6 days to just 20 hours. Further improvements are likely in 2006 with the introduction of a single administrative document, a new risk-management approach to clearance of imports and exports, and a single window for trade facilitation in Sihanoukville, the main port.

For the medium term, a draft National Export Strategy 2006–2010 outlines further measures to shorten lead times and improve the environment for the clothing industry. These include strengthening supply chains through closer integration with countries in the Association of Southeast Asian Nations and developing border export processing zones to take advantage of cheaper inputs, such as electricity.

environment is needed to encourage business growth. The Government is adopting laws that will improve competitiveness, facilitate private participation in infrastructure, and promote diversification through export zones. However, progress has been slow in legal and judicial reforms, which has hindered the effective implementation of laws, forcing the private sector to operate according to uncertain market rules.

Increases in public investment are limited by the low revenue base. Oil and gas deposits were discovered offshore in 2005 and, if they turn out to be in commercial quantities, could generate much higher revenues for the Government. Such receipts could promote significant socioeconomic development, if they are used prudently. However, in the absence of mechanisms to improve their use and broaden their impact, oil receipts could lead to a further concentration of wealth and greater social tension. They may also lead donors to curtail their aid.

The biggest risk to achieving the growth and poverty reduction targets in the NSDP stem from delayed or half-hearted implementation of reforms. In particular, foreign and domestic investment on the required scale may not be forthcoming without progress in legal and judicial reforms to ensure a more predictable regulatory environment. Failure to develop rural areas and promote agriculture, especially in the context of land ownership becoming more concentrated, could exacerbate the urban-rural divide and lead to social unrest.