CAMBODIA IN THE WAY TO RECOVERY. THE CHALLENGES AHEAD

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要 旨

近年のカンボジア経済は、政治的な安定性が確保されるなか、全ての産業において力強い成長を達成している。特に、繊維・衣料を中心とする輸出については、中国との競合が当初予想されたほど激化せず、引き続き好調な伸びを維持している。対内直接投資についても、外国資本による繊維・衣料工場の新設が約50件に達するなど、比較的順調に伸びている。また、インフレの低下や財政赤字の削減を実現しており、マクロ経済上も一定の成功を収めていると言えよう。

しかし一方、経済基盤が小さく、輸出の多様化も十分ではないため、対外ショックに脆弱であるという制約条件も抱えている。加えて、金融セクターの未発達、インフラの未整備というボトルネック、若年層の教育水準の低さを背景とする生産性・競争力上の問題といった困難な課題も残されている。

更に、同国の広範な貧困、行政の非効率性や腐敗の蔓延といった問題が、経済発展上の深刻な障害となっている。生活水準をみると、近年の安定的な成長は一定の貧困削減につながり、貧困ライン以下の人口は1995年の47％から35％に低下した。しかしながら、経済成長によりもたらされた利益は均等に配分されているとは言えず、同国は依然としてアジア地域において最も所得分配の不平等な国の一つに数えられる。

I. INTRODUCTION

Ranking among the poorest economies in the world Cambodia struggles to overcome his tragic past and decades of armed conflicts that deprived the country from adequate human capital, a proper infrastructure network, and the basic settings for the development of a modern economy. Granted full support from the donor community the country initiated its first steps towards economic reconstruction after the approval of the 1993 Constitution that followed the Paris Peace Agreement in 1991. Difficult years have been rewarded at present by the long awaited rationalization of the political course, economic growth and moderate poverty alleviation.

In July 2003 Cambodia hold the third democratic elections. In the absence of a majority winner the main political parties struggled to form coalitions. One year later, in July 2004, a two-party coalition comprising the Cambodian People’s Party (CPP), and the National United Front for an Independent Neutral Peaceful and Cooperative Cambodia (FUNCINPEC) was voted into office. The CPP stands as the dominant partner under Prime Minister Hun Sen’s strong leadership with 76 seats against the 26 from the FUNCINPEC. It is noteworthy that the lengthy negotiations unfolded without recourse to violence in contrast to previous
election processes. On 2 March 2006, the National Assembly amended the Constitution to reduce the number of seats required to form a government from two thirds to absolute majority. The measure will help avoiding lengthy post-elections political deadlocks.

Against this background of political stability the economy outperformed all expectations and achieved vigorous growth in all sectors. Trade, dominated by apparel, benefited from less Chinese competition than expected, and Foreign Direct Investment (FDI) flows led to the set up of 50 new garment plants. Moderated inflation and a dramatic reduction in the fiscal deficit rounded a very successful year for the Cambodian economy. The good economic momentum provided an excellent environment for the launching of the new government development plan in May 2006. Presented to the donor community the strategy was well accepted, and the government praised for its ownership of the document.

In spite of the strong economic growth and good prospects for the medium-term the economy remains constrained by its narrow base, lack of export diversification and high vulnerability to external shocks. Aside from that, hindrances exist in the financial sector particularly with regards to access to financial resources and the use of collateral, infrastructure bottlenecks, and widespread poverty among a very young but poorly educated population hampering the productivity and competitiveness of the economy.

The paper is divided in three sections. The first part reviews the recent economic trends in Cambodia, and the second focuses on macroeconomic policy developments and the major structural issues constraining the economy. Lastly, the economic and policy outlook draws some insights on the country’s future development.

II. RECENT ECONOMIC TRENDS

Strong economic dynamism in 2005 led to higher than expected growth rates, outperforming all pessimistic forecast anticipating a production collapse after the phase-out of the Multi-Fiber Agreement (MFA). Steady growth in recent years has contributed to alleviate poverty and according to the World Bank Poverty Assessment 2006, since 1995 the population below the national poverty line has fallen from 47% to 35%. Unfortunately the benefits of growth have been unevenly distributed and, for the same period, the Gini coefficient has worsened from 0.35 to 0.42, making Cambodia one of the more unequal countries in the region.

1. GDP Growth and the Real Economy *

In 2005 GDP grew 11.7% from 7.7% in 2004, boosted by the good performance of the real economy, underpinned by further financial intermediation, growing confidence in the banking system, and a contained fiscal policy. Strong growth lifted per capita income up to

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* Data for the analysis were collected from government sources during a field visit to Cambodia in March 2006.
Favorable weather conditions lifted agriculture output to 17.3% from negative growth in 2004. The sector — still contributing to on third of GDP and 70% of the total labor force — rebounded from the devastating effects of the 2004 draught, and yields flourished in the second and third quarters. Improvements in the irrigation system, but mostly abundant rainfall, led to a 28.6% growth in crops resulting from an outstanding paddy rice harvest, which accounts for 40% of the total sector output. Fishery and livestock grew 7.4% and 6.4% respectively, and forestry 3.6%.

Industry rose by 13.4% driven by growth in garments and construction. The garment sector’s production surpassed all expectations thanks to the temporary safeguards imposed to China by the United States (US) and the European Union (EU). While 20 factories closed down in the first quarter leading to a 10% decline in the production level, the sector resuscitated in the second half of 2005 and the production volume increased 25% by year-end. The rise in production value was lower due to the 10% decline in international prices steaming from higher Chinese competition in the post-quota environment. In terms of affected factories, the set up of 50 new garment plants, all foreign owned — namely from Taiwan, Hong Kong and China —, resulted in a higher number of operating garment factories. Construction grew 13% driven by public spending for infrastructure, and by private sector investments in residential and tourism-related projects.

The service sector activity reached 6.3% down from 9.2% in 2004 owing to the lesser contribution of hotels and restaurants — that are leveling off after the post-SARS rebound in 2004 —, transport and communications, and other services. The tourism sub-sector performed well in 2005 and generated an estimated income of US$700 million. More than 1.4 million tourists visited Cambodia in 2005 recording a 34.7% increase, with South Korea, Japan, and the US standing as the major sources or visitors. To enhance the potential of the tourism sector, which contributes to 12% of GDP, the government is pursuing an expansionary strategy based on diversification. Tourism has been traditionally centered in Seam Reap, but other options in the country are now being developed including eco-tourism in the northeast mountainous region.

![Figure 1 GDP Growth (%) 2002-2006e](source: Cambodian authorities, CEAD staff estimates.)

2. Fiscal Policy and Budget

On fiscal developments, a better management of the public finances and increased tax payments contributed to improve revenue collection to 11.5% of GDP from 10.8% the year before. Although still insufficient, and several percentage points below the regional average, the positive trend is welcomed. The major factor behind the low revenue collection, aside from capacity constraints, resides in the
large size of the informal sector in Cambodia. With an estimated contribution of 40% of GDP, there is no incentive for the informal sector to register given the high cost of corruption. Thus, around 90% of the businesses remain informal.

The fiscal deficit improved from 4.3% in 2004 to 1.5% in 2005 driven by higher revenue collection and lower capital expenditure. The latter results from a decline in foreign funded projects that was triggered by uncertainties linked to the long political deadlock in 2003 and 2004. There are numerous initiatives for tax reform scheduled for 2006 covering diverse issues, both at the policy and administration levels, but progress and implementation is slow. Issues remain with regards to non-tax revenue collection, which declined in 2005 mainly due to the elimination of the quota auction after the phase-out of MFA. Efforts are on the way to improve collection in the telecommunication and civil aviation sectors, which still account for large arrears. The 2006 budget guarantees the continuation of the current fiscal policy moderation.

On inflationary trends, a 5.6% CPI (from 3.8% in 2004) reflects more the increase in food prices than the direct impact of expensive oil. Food has a high weight in the consumer basket in Cambodia; 42% in the Phnom Penh CPI, 62% in the urban CPI, and 70% in the rural CPI, the first being the most commonly used for statistical purposes. Food products became more expensive because of the indirect impact of oil prices on transportation costs, hikes in intermediate inputs’ prices like fertilizers, and high water pumping needs. The latter, which is fuel driven, required extra use in early 2005 to combat the effects reeling from of the 2004 severe drought.

3. Monetary Policy Developments

In a highly dollarized economy like Cambodia there is limited room for maneuver in terms of monetary policy. Money supply (M2) expanded 16.1% driven by growing foreign currency deposits. Confidence has improved in the banking sector as shown by a 21.3% increase in private lending to satisfy the demand from the construction and tourism sectors, and a 16% surge in deposits. There are no major concerns on non-performing loans (NPLs), which declined to 8% of total loans outstanding reflecting, however, a decrease in relative terms only given the fast lending rates. Interest rates for deposits increased slightly to 3.9% but the spread remains large due to the high lending interest rates (11-18%). Gross official reserves rose a modest 1% but declined in terms of import coverage from 3.7 to 3.2 months owing to the impact of the higher oil prices on the import bill. The Cambodian riel (CR) depreciated only marginally vis-à-vis the US dollar and stood at CR4,092 per US dollar. The dollarization of the economy will persist in the long run but the government hopes to bring it down progressively along further improvements in public confidence on the national currency.
4. External Sector

Trade was led by the good performance of garment’s exports, which registered an 11.8% increase up to US$2.2 billion exceeding all expectations. However, foreign sales slowed down as compared to previous years owing to the poor results achieved until the imposition of the safeguards to China in the fourth quarter. The main destination market for apparel was again the US (around 80% of total exports), and its purchases grew over 22% in 2005. On the contrary, exports to the EU declined (-16%) in spite of Cambodia’s eligibility to the All but Arms Initiative, because orders are being shifted to Vietnam on grounds of lack of compliance with the rule of origin and the high cost of corruption in Cambodia. Footwear exports plummeted (-30.5%) due to fierce competition from Vietnam and China. However, the recently implemented anti-dumping regulation by the EU against those two countries might benefit the Cambodian footwear industry.

Export growth (8.9%) was offset by an oil-driven higher cost of imports (15.2%), and the wider trade deficit (-17.7%) led to a slight deterioration of the current account (from -9.2% deficit in 2004 to -9.7%, excluding official transfers). However, large inflows into the capital and financial accounts resulted in an overall balance of payments surplus (US$5 million).

Regional trade is gaining importance in recent times. In March 2006 Cambodia and Vietnam agreed to eliminate tariffs and establish special economic zones at the common border. Hence, Vietnamese tariffs and quotas on 40 agricultural products including pepper, cashew, banana, rubber and sugar cane, will be removed. Milled rice will still be subject to quotas but paddy rice would be quota free. According to the Vietnamese statistics, bilateral trade amounted to US$700 million in 2005 and it is expected to reach US$1 billion in 2006. China has announced intentions to increase bilateral trade from the current US$500 million to US$2 billion by 2010.

FDI flows almost tripled in 2005 up to US$449 million boosted by the set up of the new garment factories and a Thai cement plant. Prospects for 2006 are promising in terms of registered projects; the government is concluding an agreement with China for the construction of a hydropower project, and South Korea is planning a US$2 billion investment in the outskirt of Phnom Penh to construct a satellite city comprising residential, tourism and entertainment components. Growing investments in agro-business, a sector with large potential, are also expected.

Total external debt is estimated at 57.6% of GDP, of which nearly two thirds is owed to the Russian Federation and the United States and is under negotiation and, thus, exempted from service. That is the explanatory factor behind Cambodia’s negligible debt service (0.9% of exports). In contrast, the ratio of foreign debt to government revenue stands

![Figure 3 Main Destination of Export, 2005](source: Cambodian authorities, CEAD staff estimates.)
at 600% placing Cambodia in the category of debt-stressed countries. Domestic public debt is denominated in local currency and amounts to 0.3% of GDP posing no threat.

In sum, while Cambodia’s debt is sustainable the risk of debt distress is still high due to the fragility of the revenue base. However, vulnerability indicators are projected to improve dramatically after the resolution of the US and Russian debts, and the debt burden is expected to continue improving modestly after the rescheduling. The two top country’s vulnerabilities are seen in the weak government revenue collection, and the negative impact of high competition in the garment’s market after 2009. A slight deterioration in the reserve’s import cover is expected reeling from less favorable terms of trade in the medium-to-long term. However, debt rescheduling will clearly reduce its burden and reserves would still exceed 100% of gross financing requirements.

### III. MACROECONOMIC POLICY AND STRUCTURAL CONSTRAINTS

The international community’s confidence in the government’s policy making agenda was boosted with the launching of the National Strategic Development Plan (NSDP) in early 2006. The strategy enjoys donors’ support who pledged over US$600 million to aid projects over the coming year. Despite recent macroeconomic consolidation, the economy, fragile and narrowly based, faces diverse structural constraints ranging from widespread corruption to limited access to financial services, and low competitiveness in key sectors.

#### 1. The Government Development Plan

The government presented the National Strategic Development Plan 2006-2010 during the Donor’s Consultative Group Meeting held in Phnom Penh in March 2006. The NSDP is a broad framework providing the road map for poverty reduction and other Millennium Development Goals (MDGs) achievements. It embodies the main guidelines for policy making for the next years and covers 43 major goals cross-cutting along diverse sectors, i.e. poverty reduction, enhanced agricultural productivity, improved health and education facilities and services, rural development, environmental sustainability, gender equity, infrastructure and energy development, sustained macroeconomic growth, improved governance, etc. A US$1.9 billion Public Investment Program (PIP) for 2006-2008 has been prepared to support the implementation of the NSDP. Solid government ownership leads to the perception that this time the plan has better chances to be successfully implemented.

Another milestone in the government reform agenda is the Public Financial Management Reform Program. Launched in 2004, its implementation is divided into four major stages in order to strengthen public financial management while developing...
capacity for the government officials at all levels. After a slow start due to the political deadlock that followed the last elections, the program is moving ahead and progress has been achieved in terms of better cash management, increasing revenue, and procurement and financial decentralization to line agencies and ministries. The cumulative impact of all the ongoing measures is expected to show its benefits soon. The civil service reform is at an embryonic stage and so far only the merit-base salary program has been implemented. Under the program 300 targeted top performing officials at the Ministry of Economy and Finance already perceive a US$250 salary against a US$38 average. The Ministry of Health is the next candidate for the pilot program. In addition, across the board salary increases are being implemented since last year and are meant to be continued in the years ahead at a pace of a 15% annual increase.

2. The Financial Sector

The sector’s performance has improved in the last two years. Financial deepening is still low with loans and deposits at 10.3% and 17.3% of GDP respectively, but has progressed reflecting the financial stability and wider offer of financial services. Broad money supply (M2) to GDP has risen to 22.1% which is a welcomed structural improvement, and credit to the private sector expanded from 6.5% of GDP in 2000 to 10% in 2005. In the banking system, after 16 banks were closed through the re-licensing program and the remaining banks required to strengthen their capital position, there are currently 15 commercial banks and only two remain state-owned, the Rural Development Bank and the Foreign Trade Bank. Banks are well capitalized and relatively liquid with an average capital adequacy ratio to risk weighted assets of 22.4% and a loan to deposit ratio of 60%. Only foreign participated banks offer modern banking facilities.

Non-bank financial services like insurances, pension funds, and leasing are only at the early stages of development. Rural finance is poorly developed but there is a large informal credit market providing an important but expensive source of funding for small businesses and farmers. The Prime Minister has declared 2006 the year of microfinance and progress is expected given the growing number of licensed microfinance entities. There are no plans to develop a stock market in the immediate future, but some timid initiatives at the level of working groups and commissions are on the way to establish a

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In months of imports 2.9 2.8 2.7 2.7 2.7

Source: Cambodian authorities, CEAD staff estimates.
basic capital market in ten years time.

3. Cambodia’s Competitiveness:
The Cost of Corruption

Cambodia’s fragile competitiveness, a problem closely linked to deeply rooted corruption, stands as a clear structural obstacle in the country’s development. The World Economic Forum ranked Cambodia 112/117 in terms of the Growth Competitiveness Index, and 109/116 as per the Business Competitiveness Index. The constraint is particularly worrying in the garments sector, the country’s major source of growth.

According to a study conducted by the Economic Institute of Cambodia (Cambodia Competitiveness report 2005-2006, September 2005), the country’s macroeconomic environment is hampered by low government revenue collection, high lending-borrowing interest rate spread, difficult access to credit, and misuse of government spending. The judiciary is perceived hardly independent and the legal framework does not enable business dispute resolutions. Consistent with the findings of the World Bank reports (Seizing the Global Opportunity: Investment Climate Assessment and Reform Strategy, 2004, and Doing Business in Cambodia 2006) the study acknowledges that corruption is the leading constraint for doing business in Cambodia, and that bribery to access public services is common and widespread.

The study shows that Cambodia’s competitiveness lags far behind Vietnam, Thailand, China and Indonesia, but is comparable to Bangladesh. The country’s relative weaknesses in terms of the macroeconomic environment are well known, but the uncertain ability of the country to meet its debt obligation is another concern reflecting the lowest country credit rating in the region. In addition, the perceived quality of Cambodian public institutions is among the worst in the world and only comparable to Bangladesh. The quality of the business environment ranks below Thailand, Indonesia, China, Vietnam and Bangladesh. According to the business community corruption is the most problematic factor for doing business in Cambodia, followed by an inefficient government bureaucracy, unskilled labor force, poor infrastructure high transportation and utilities’ cost, and difficult access to financing.

Poor competitiveness is a serious concern in the garment sector. Over 250,000 Cambodians are employed in the garment industry, mainly women from rural areas whose remittances help supporting around 20% of the population. Garment exports increased from US$26 million in 1995 to US$2.2 billion in 2005 with apparel accounting for 80% of foreign sales. Foreign ownership and participation lays behind the dynamism of the sector, and most factories are foreign owned, mainly from China, Hong Kong, Taiwan and Korea.

Cambodia holds a good reputation in terms of labor regulations compliance but after the phasing-out of the MFA good labor standards can not compensate for a lack of

*2 Corruption is rampant at all levels and Cambodia ranks 130/158 in the Corruption Perception Index (Transparency International).
*3 The GCI measures competitiveness based on the quality of the country’s macroeconomic environment, public institutions and technological stance, while the BCI, developed by Professor Porter, focuses on the quality of the business environment.
competitiveness. According to a USAID study addressing the costs of administrative red tape and corruption, estimated to be 7% of total sales value, is one of the keys in rising Cambodian competitiveness. The study suggests that Cambodia’s apparel factories have potential for increased productivity, provided basic production techniques, training, and managerial skills are introduced to the production process. USAID estimates that improvements in productivity of 15-20% can be achieved allowing Cambodia to produce higher-quality and higher-value garments. When analyzing the threat posed by the unbeatable Chinese competitiveness it is noteworthy to mention that Cambodia enjoys some comparative advantages; while inner China offers very competitive advantages in terms of labor costs, distance to markets and ports make Cambodia more appealing to foreign investors.

### IV. ECONOMIC AND POLICY OUTLOOK

Judging from all key macroeconomic indicators 2005 was an exceptional year for the Cambodian economy. Although further macroeconomic consolidation is expected and overall prospects are good, the observed high rates of growth would not be sustained across time. Thus, an average 6% growth is expected in the next years with inflationary pressures curbed down around 4% as oil prices stabilize. A prudent fiscal policy, additional efforts in revenue collection, and the first results of the implementation of the public financial management program will secure further fiscal consolidation and an average fiscal deficit around 4%. On the sources of growth, the garment sector will continue to grow under the protection of the safeguards imposed to China until late 2008, and then is expected to slow down. Tourism will continue expanding based on Cambodia’s reputation as a popular and safe destination. The construction boom will moderate and return to a slower path in the long run when demand saturates. Recent investments in food processing and agro-business will help agriculture productivity but production will remain subject to weather inclemency as shown by historical records.

The government is fast tracking the

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implementation of trade facilitation measures, like, for instance, the establishment of the Single Window and the Single Administrative Document at custom’s units, as well as streamlining the security scanning process, that are expected to reduce bureaucratic bottlenecks and foster trade flows. Being the US the largest destination market for Cambodian exports, trade will also greatly benefit from a positive resolution of the negotiations with the US on the Trade Act 2005 (additional preferential treatment for textiles and garments). Talks were halted by domestic political developments in 2005 but negotiations are meant to resume.

Only unforeseen external shocks might pose a threat to the mid-to-long-term outlook, the avian flu being the most worrying one, not only for its impact on the poultry industry and poverty levels, but mainly for its pernicious side-effect on tourism. The expiry of the temporary textile and garments’ safeguards imposed to China will hit garment’s production and export levels from 2009 onwards if determined measures to increase competitiveness are not promptly taken.

On the policy side, the government appears strongly committed to economic reform as evidenced by its anticipated compliance to the IMF program conditionality ahead of its formal approval. However, in terms of policy-making, there is still room for improvement in the NSDP, particularly regarding the plan’s policy prioritization and costing into the budget. On the public finance management reform process there is a clear need to develop a Medium Term Expenditure Framework (MTEF) to reflect in the budget the cost of the pursued reforms and the PIP.

On structural constraints, even though the financial sector is playing an increasingly role in the emerging market economy and confidence in the banking sector is growing it remains a hindrance for private sector development. The banking sector provides a wider range of services but its cost is high, and access to financial services limited to preferential clients. Thus, SMEs and small business must rely on informal but highly expensive money-lenders. In this context, land reform is vital to facilitate access to credit. Land titling and registration is lagging behind schedule, blocking its use as collateral. Actions and policies to curb down corruption and to increase competitiveness in the country must be expedited in order for Cambodia to increase its competitiveness before the expiration of the safeguards that are containing China’s huge potential.

Cambodia faces a good opportunity in 2006 to accelerate reforms given the consolidated macroeconomic and political stability. Political will is then a key for success, and must be reflected in a tougher line on corruption and committed fiscal reform. However, misgivings about the pace and depth in the implementation of the ongoing reforms lead to a moderately optimistic scenario given Cambodia’s past records. Failure to take timely necessary actions will remove Cambodia from the right track to development in light of the coming political events—elections to the council in 2007 and general elections in 2008—that will divert the government attention from economic reforms to politics.

References


