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Cambodia Outlook Brief*

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Returning to a High Growth Economy—Indicators, Prospects and Policy Priorities[1]

"We have learnt important lessons in going through the storm of economic and financial crisis… With strong political commitment, in a full spirit of ownership and partnership with all stakeholders, we will make the best use of our capabilities… to realise the national vision and the humble aspirations of our Cambodian people."

Prime Minister Hun Sen, Opening Address to the 2010 Cambodia Outlook Conference

After the Storm: Signs of Stronger World Recovery

The global recession is over. The world economy has been recovering more rapidly than initially expected. After shrinking in 2009, real global output is projected by the International Monetary Fund (IMF) to grow by about 4 percent in 2010 (Figure 1). This estimated growth is modestly higher than the earlier IMF forecast. Global trade volume, which dropped for the first time in a quarter century in 2008, rebounded by the second half of 2009. It is anticipated to register about 6 percent growth this year. The overall outlook for 2010 is encouraging, considering the remaining difficulties in the global environment. However, the existing risks should not be underestimated. Output levels remain below pre-crisis levels. Potential serious fluctuations in major currencies and commodity prices also imperil current recovery. The spread of protectionism poses another big problem.

The key developing economies in Asia are leading the global recovery. China and the ASEAN-5 are expected to attain real economic growth of 10 and 4.7 percent respectively in 2010 (Figure 1). These robust economic expansions are anchored in strong domestic demand, improved exports, and aggressive government interventions. In response to the crisis, record easings in monetary policy were implemented while huge fiscal stimulus packages were administered all over developing Asia. Interest rates fell to record lows while fiscal deficits reached record highs.

The growth prospects for advanced economies are less optimistic. After experiencing simultaneous recessions in 2009, the United States, Japan and the Euro area are projected to manage increases in real output of 2.7, 1.7 and 1.0 percent respectively this year (Figure 1). The exceptionally high unemployment rates in advanced economies serve as a major obstacle to stronger recovery, as do huge public debts and weak credit growth. Still in the process of repairing their balance sheets, banks remain cautious about lending. Tight credit has crippled investment growth. Meanwhile, the public debt of advanced economies has been about 100 percent of GDP while that of emerging and developing economies has been only about 40 percent.

Crisis Impact and Recovery: The Cambodian Experience

Hit hard by the crisis, the Cambodian economy suffered a severe slowdown in 2009. Real output

1 *Outlook Brief 1 summarises the presentations and discussions in session 1 of the 2010 Cambodia Outlook Conference. Presenters for this session were: Mr John Nelmes, resident representative, IMF, and Dr Hang Chuon Naron, Permanent Vice Chairman, Supreme National Economic Council.*

* BASED ON 2010 CAMBODIA OUTLOOK CONFERENCE: A PARTNERSHIP OF CDRI AND ANZ ROYAL BANK

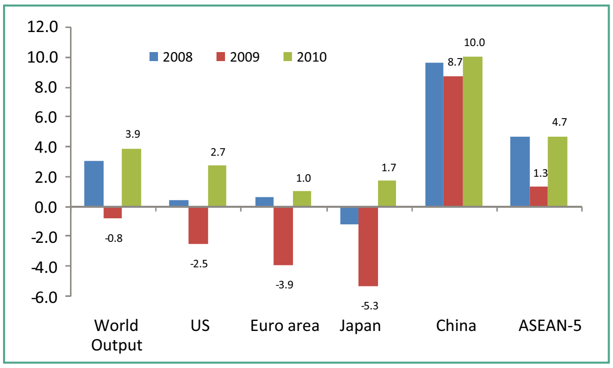
barely grew, with actual growth turning out to be just 0.1 percent according to the government. This figure is nowhere near the government's earlier growth forecast of 2 percent. IMF, on the other hand, projected a 2.7 percent contraction in real output for 2009 (Figure 2). The key sectors of the economy witnessed serious deceleration in activity, with the exception of agriculture. In late 2009, the economy bottomed and started its way to recovery. Domestic inflation also significantly abated before edging up again as a result of higher commodity prices and expansionary policies. This year's growth projection is relatively promising, placed at more than 4 percent by the IMF. It is, however, noticeably well below pre-crisis levels.

Cambodia's garment industry was one of the growth sectors that suffered a terrible blow during the crisis. Both the fall in demand from the US, its leading market, and tougher regional competition caused never-before-seen declines in garment exports. The year-on-year reduction in garment export volumes averaged about 15 percent in the first half of 2009. Greater competitiveness, however, enabled Cambodia's competitors to even improve their export performance amid the US retail sales slump. While the US market share of Cambodia's garment exports faltered during the crisis, those of Bangladesh, Vietnam and, at a later time, China, saw improvements. Towards the end of 2009, Cambodia's garment exports fortunately bounced back. All the same, tougher competition in the global garment business renders the sustainability of this rebound uncertain.

Cambodia's tourism and construction industries were the other seriously hit growth sectors. International tourist arrivals fortunately resurged at the start of 2009 after previously experiencing historic declines. Tourism spending, however, remained relatively depressed, unsurprisingly so because key tourist-source developed countries, South Korea, Japan and Taiwan, were likewise severely affected by the global meltdown. Reflecting the slowdown in construction, imports of construction materials plummeted as the crisis peaked in 2008. They picked up in the second half of 2009 following the upturn in the economy.

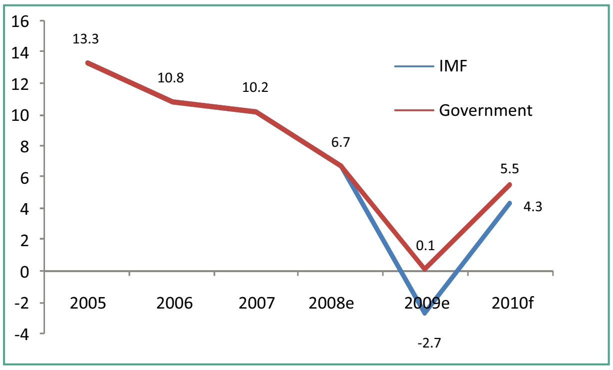
Plunging by more than 50 percent in 2009 relative to 2008, it is yet to be seen whether or not foreign direct investment can recapture its pre-crisis resilience. Investment approvals remain lacklustre. The value of approved investment projects went down by about half between 2008 and 2009. The silver lining

Figure 1: Annual Real GDP Growth, percent



Source: IMF WEO Update, Jan. 2010

Figure 2: Cambodia's Annual Real GDP Growth, percent



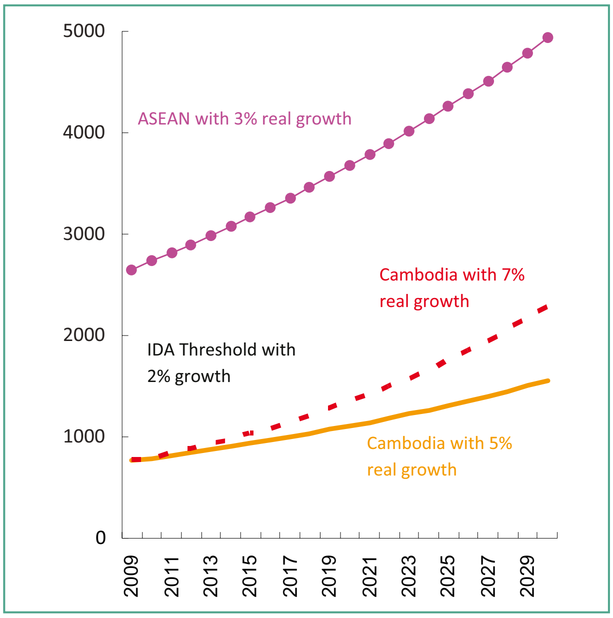
Source: IMF Country Report Dec 2009; MoEF Monthly Bulletin of Statistics Feb 2010

lies in the change in the composition of approved investments. Prior to the crisis, investment inflows to Cambodia exhibited clear bias towards the growth sectors, garments, tourism and construction. In 2009 relative to 2008, the shares of construction and tourism in the value of total approved investments significantly shrank. By contrast, those of agriculture, infrastructure and manufacturing, which have central roles to play in long-term growth, got huge increases.

Liquidity in the financial system was finally regained in the second half of 2009 after dissipating within the past year or so. Year-on-year deposit growth returned to above-zero levels at the start of 2009, though remains well below pre-crisis rates. As a percentage of GDP, broad money increased from around 28 percent in 2008 to 34 percent in 2009. Credit growth, however, is yet to significantly improve as at the end of 2009 it was still far behind the rates during the second half of 2008 which averaged more than 100 percent.

Stable agricultural growth plus the government's responses to the crisis helped prevent a bigger

Figure 3: Per Capita GNI, Illustrative Medium-term Growth Paths



Source: World Bank, and IMF staff calculations

contraction in the economy. Agricultural production continued its steady rise due in part to productivity improvements and infrastructure development. Paddy production in particular grew from 6.73 million tonnes in 2007 to 7.32 million tonnes in 2009. On the fiscal front, the government ran a bigger budget deficit to accommodate greater spending. The government's public financial reform programme enabled continued improvements in revenue collection but, in the end, the impact of the crisis caused domestic revenues to fall by about 11 percent between 2008 and 2009. Domestic expenditures, by contrast, increased by around 10 percent over the same period.

Moving Ahead: Cambodia's Growth Potentials and Policy Imperatives

The Cambodian economy has a promising future but only if its potentials are optimised. Short-term recovery from the global shock depends externally on robust global recovery and internally on modest fiscal consolidation, stability of the financial system, agricultural improvements and renewed domestic demand. Fiscal policy will continue to be a key economic tool in balancing economic rebound with manageable inflation. For 2010, a budget deficit of 5.25 percent of GDP, which is lower than last year's, is considered adequate. Domestic financing of the deficit will have to be limited. The revenue performance in 2009 was commendable but further efforts will have to be made in order to eliminate domestic financing needs and open space for additional high-priority development spending. Also, the banking system must be monitored closely and enforcement of prudential regulations must be strengthened. Another lending boom will have to be avoided in order to lessen the risks of another bust.

Cambodia has potential to graduate from its least income status and become a middle income country in a decade's time. This depends on a more sustainable growth. Per capita GNI will have to sustain an increase of about 7 percent in real terms per year; a growth lower than this would elevate the income status of the country over a much longer period (Figure 3). Sustainable growth hinges on successfully undertaking structural reforms. It depends on undertaking clear policy priorities at both the macro and micro levels. While these actions require active private sector engagement, they are the main responsibility of and thus should be led by the public sector.

At the macro level, the policy priorities are as follows: keeping economic growth stable through such helpful measures as fiscal stimulus provisions and vigilant financial sector supervision; enhancing competitiveness using exchange rate and tax policies; mobilising savings by making new financial instruments available in the market and getting the stock exchange operational; expanding the fiscal space through further enhancing tax and non-tax collection and attracting more aid (though with constant vigilance of repayment abilities); increasing spending on priority sectors, specifically agriculture, infrastructure and education; and further advancing public administration reforms.

The policy priorities with direct implications at the firm level are as follows: deepening regulatory reforms; improving trade facilitation; monitoring and re-appraising policies relating to special economic zones and economic land concessions; establishing such new financial institutions as agri-business clearinghouse; and strengthening the Government-Private Sector Forum.

Economic diversification and development is necessary in six specific areas: human resources; agriculture; tourism; infrastructure; emerging industries and processing industries.

There is consensus that the Cambodian economy is poorly diversified and not well positioned in the global export value chains. The country's comparative advantage has traditionally rested on its natural resource endowments, huge stock of cheap labour, and strategic position in the region. It has to continue tapping these advantages while carving out new ones. Diversification both away from and within existing key industries will have to be undertaken. Potential competitive exports will have to be harnessed and intra-regional trade ought to be intensified.

Cambodia is behind its immediate neighbours in terms of human development index scores. Reaching educational and health targets must be a priority. Furthermore, professional and vocational training must be intensified and enhanced in design in order to improve the match between employer needs and the skills present in the workforce.

Agricultural development in Cambodia has also been held back by such serious constraints as insufficient fertiliser use, poor rural infrastructure, weak systems of research and extension, rudimentary credit system, land tenure insecurity, and adverse weather conditions. The main challenge lies in enhancing agricultural productivity which in turn could be met by augmenting investment in rural infrastructure, promoting improved fertiliser use, intensifying research and extension and improving credit access. Also, Cambodian farmers must be better linked to global food value chains.

Tourism is an important revenue source for Cambodia. The industry, however, is faced with the huge challenge of diversifying its attractions and services. Promoting eco-tourism and beach tourism has good odds of being just as profitable as cultural tourism.

Global rankings show that Cambodia trails behind its neighbours, Thailand and Vietnam, in terms of infrastructure quality. Infrastructure improvement entails the following measures: continuing the renovation of transport networks; improving water and irrigation management; establishing the national grid; further developing the information and communications industry; improving trade facilitation; enforcing property rights; and undertaking systematic land registrations.

Cambodia's economic growth has long relied on established industries, particularly garments. Broadening the economic base calls for supporting emerging labour-intensive manufacturing industries such as toys, shoes, electronics and information technology. Fostering an assembly industry is particularly promising. Aiming for an established processing industry is likewise a worthwhile objective given that in its absence, most of Cambodia's raw produce is sent to other countries for processing. This deprives the country of higher export earnings. There is great promise in promoting processing industries for the following commodities: cassava, palm oil, frozen food, rubber, tropical fruits and agricultural organic products.

Sustainable economic growth is an outstanding objective but certainly not enough for a country that is struggling with problems of high economic inequality and problematic governance. Cambodia's Gini coefficient, which is a measure of inequality, has been at a critical level. Previous gains made in poverty reduction were also wiped out by the global crisis, all the more increasing the pressure on ensuring equal distribution of development benefits. To this end, pro-poor public spending is a must. As mentioned earlier, the government has to channel more spending to agriculture, rural infrastructure, the social sectors–particularly education, and social safety nets. It has to act on the problems of land insecurity and inefficient land use. It has to balance the interests of big land concession holders and the majority of farmers in the country who happen to be smallholders. The needs of the grassroots economy will also have to be attended to. The decentralisation of public service delivery must likewise be pursued vigorously to extend the reach and improve the quality of public services. Gender equity must also be a component of growth strategies, given Cambodian women's huge but unrecognised contribution to national output.

The global crisis was a curse but it was also an opportunity for change. The possibility of another shock occurring any time soon is not remote; hence, Cambodia, and the whole world for that matter, must capitalise on the lessons learned from the past crisis.

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