

Cambodia: A 2008 Macro View—Key Indicators, Major Development Challenges, Our Region, the Private Sector

Dr Hossein Jalilian presents an overview of the four presentations in session one of the 2008 Outlook Conference and the main results of the discussions that followed:*

One important feature of the 2007 Outlook Conference was a session confined to the macroeconomic overview of Cambodia. This was also the case in the 2008 conference, the first session of which was allocated to this important topic. The session was moderated by Dr Hang Chuon Naron.¹ The presenters for this session included John Nelmes,² who presented key macro indicators. Hossein Jalilian presented a brief on major development challenges. Gary Runciman³ discussed a number of issues that related to the private sector, from the point of view of banks and the financial sector. Finally, Zhang Yuyan⁴ discussed issues related to institutional factors in the region. In this brief, a summary of the key messages that came out of this session is presented, followed by the full presentation by John Nelmes.

This session provided an update on the issues addressed at the last Outlook Conference. John Nelmes, providing relevant data on the topic, pointed out that a very strong economic performance in the recent past has now slowed slightly due to a downturn in the garment sector and the US economy. At the same time, inflation has risen significantly, due in part to rising international oil and food prices. Moving on to discuss the local factors that have contributed to this rise, Nelmes attributed it to a rise in local demand that has pushed up labour costs, which in turn has contributed to rising prices, indicating a higher standard of living. The full text of his presentation follows after this summary.

Jalilian's presentation related to the important challenges that the Cambodian economy is faced with. Although the overall growth in Cambodia over the last decade has been impressive, poverty still remains serious, and the reduction in poverty over the period should have been higher than experienced so far. Comparing the growth and poverty performance in Cambodia with a number of regional blocs and China, he argued that, relative to growth, poverty reduction in Cambodia has

been rather limited. This poor performance, he argued, was due to the very narrow basis of growth, which is focussed on garments, construction and tourism. Growth in agriculture, which is critical to poverty reduction, has been erratic and low. He argued that to be more effective, growth needs to be more "inclusive", and there need to be more effective linkages between and within different sectors. Growth is considered inclusive where it creates equal access to the opportunities it creates. He emphasised the important role that the private sector, government and better governance structures can play in this process. Emphasising the importance of improving agriculture as a vehicle for poverty reduction, he stressed the important role of land titling and distribution, clearer property rights, infrastructure development and general market development. A lack of strong institutions and legislative and regulatory frameworks and enforcement is a continuing constraint on growth. It was stressed that regional institutions have an important role in fostering greater standardisation and enforcement and supporting open market development.

Gary Runciman's presentation focussed on the role of the banking sector and capital flow. He pointed out that the financial sector has grown extraordinarily well from a low base; deposits are outstripping lending. With improving trust in the banking sector, FDI in Cambodia is being placed in the banking sector; business surpluses are also being deposited. MFIs are still not generating deposits, and are not a real avenue into the formal sector. He mentioned that there has been a huge increase in lending, most of which is property backed, people leveraging equity in property. Citing the 22 banking institutions competing for business, he argued that the sector is competitive, so businesses can benefit from this.

He pointed out that the recent very rapid growth in the banking sector clearly reflects greater confidence, in terms of both deposits and lending, including greater confidence of local businesses and increasing FDI. However, most loans are still secured with land, and therefore lending is limited as a result of the high costs of land titling and difficulty of using land as collateral. Other limits on access to finance are the lack of enforcement of the commercial legislative framework, difficulty securing loans due to lack of documentary evidence and lack of ability to use other assets (such as business assets) to secure credit. Risks in the banking sector include low returns to the sector as a whole, in part as a result of the high proportion of non-performing loans, as well as lower levels of confidence as a result of non-enforcement.

Other significant challenges and issues that require priority attention include:

- Low returns: non-performing loans are increasing. Although banks' returns are increasing, they are still very low for a developing country.

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- A strong financial sector is critical to growth.
- Lack of financial statements and reliable data, leading to high transaction costs: people cannot show how they are going to repay loans, which increases risk and therefore the price of credit.
- Taxation enforcement, tax statements and returns allow more accurate determination of risk, but they are not readily available for all businesses. Those who have been banking longer get loans because their situation is known.
- High costs of obtaining land title documents restrict credit since only a small pool of banks can lend against land.
- Enforcement of commercial laws: without enforcement, lack of confidence increases. Better enforcement is likely to be accompanied by a move away from reliance on land to other assets as collateral.

Zhang Yuyan took a regional perspective to compare and contrast the experience of a few countries in the region in terms of growth and development. He pointed out that the strong GDP growth in China resulted from reform, the opening up of China and more well-functioning markets. He stressed the importance of regional integration in promoting more open and well-functioning markets across the region.

China, he pointed out, welcomes greater involvement of Cambodia in regional institutional arrangements such as ASEAN and sub-regional cooperation, e.g. Mekong sub-region. To be able to benefit from regional integration, however, member countries would have to take certain steps:

- Strict enforcement of property rights is essential for market development. The question that is posed, however, is which institutions have responsibility for this.
- Increasing regionalisation is likely to lead to standardisation of rules of trade, which supports enforcement of property rights.
- To enhance the role of regional institutions, all countries must be equal, and agreements must serve mutual interests. Strengthening regional economic cooperation takes patience, due to the complexity of relations among the countries involved.

The following is a brief overview of macroeconomic developments, which was presented by John Nelmes. It is based on a PowerPoint presentation to the conference.

Cambodia: Macroeconomic Developments

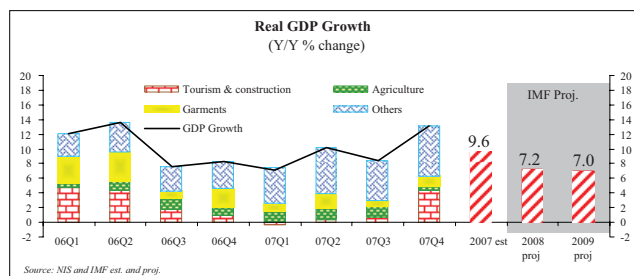
Nelmes addressed some recent developments in the economy as well as offering some policy options to enhance and sustain growth. Following the format of presentation, this note is also divided into two parts. The first deals with the recent developments and outlook, while the second considers some policy options.

Recent Developments and Outlook

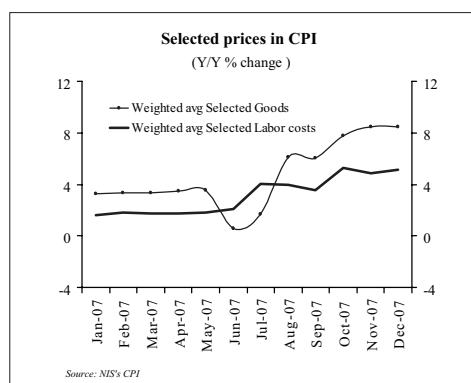
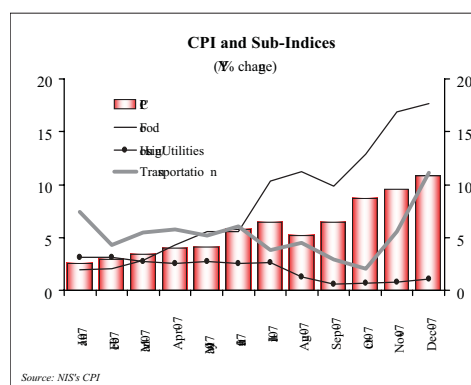
Nelmes' presentation was generally upbeat about the state of economy and its management. He pointed out that

Cambodia grew at a rate of 9.5 percent in 2007. However, it is likely that growth will be slightly reduced in the near term, as illustrated below. There are a number of reasons for this slow-down, increased inflation being one.

Despite strong achievements, Nelmes warned, there are some significant challenges and risks in the medium term, including the likely continued slowing of the garment sector and rising inflation driven by international factors. In this context, it will be difficult to continue to achieve strong growth and poverty reduction.

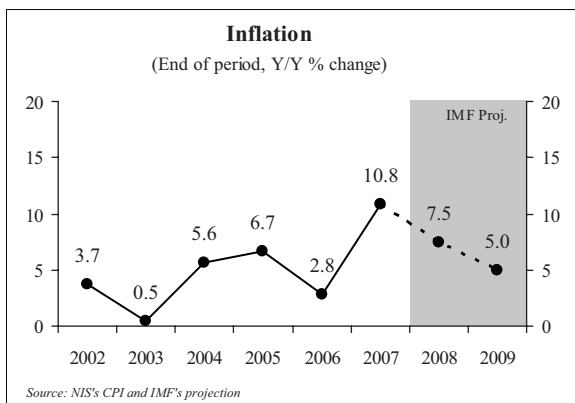


Within the period, the Cambodian economy has experienced higher inflation, which mainly reflects international food and oil price rises. As well, depreciation of the US dollar has added to inflation. There are also signs of domestic inflationary pressures, mainly generated by higher demand for labour.

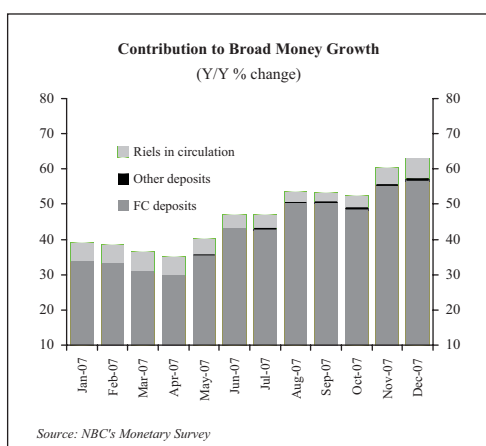
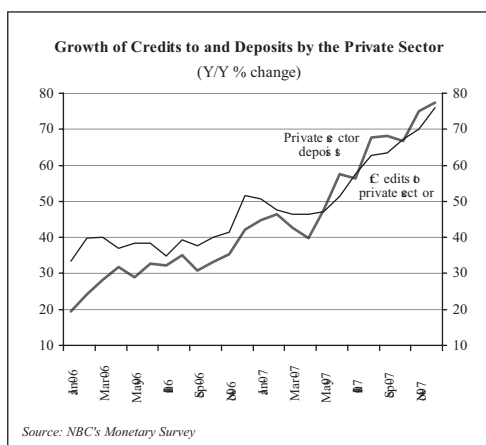


Although inflation is expected to decline in 2008, inflation risks have increased. The sources of these risks are mainly external, but internal factors also play an important role.

One reason offered for this increased pressure is that Cambodia has experienced a rapid expansion of the

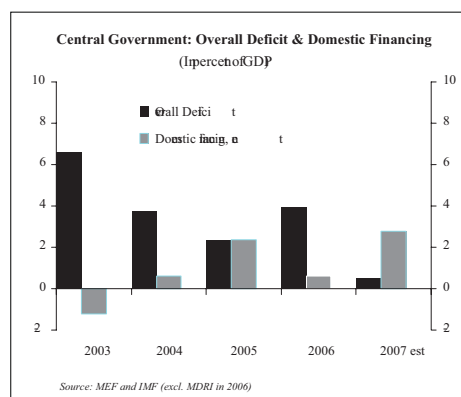
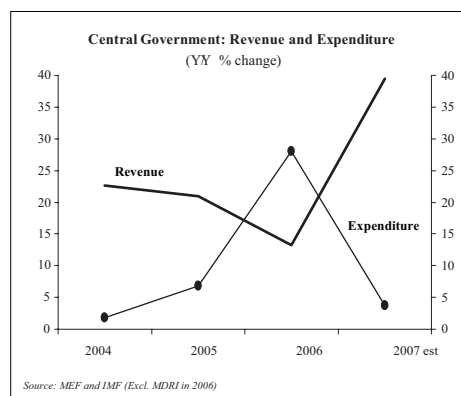


banking system, which has fuelled strong money growth, as shown graphically below. The graph shows a sustained increase in credit creation in recent periods, which in turn has affected the rate of money growth. If unchecked, this is likely to fuel further inflation. Unless monetary growth follows closely real growth in the economy, it is likely to lead to increased inflation.



The government has experienced high revenue growth combined with a slow growth of spending. As a sign of improved management of economic affairs, Nelmes pointed out that government revenue increased 22 percent in 2007, reflecting improved tax collection. This increased revenue has had positive effects for spending on infrastructure, education and health services. However, sustaining this improved condition is likely to become

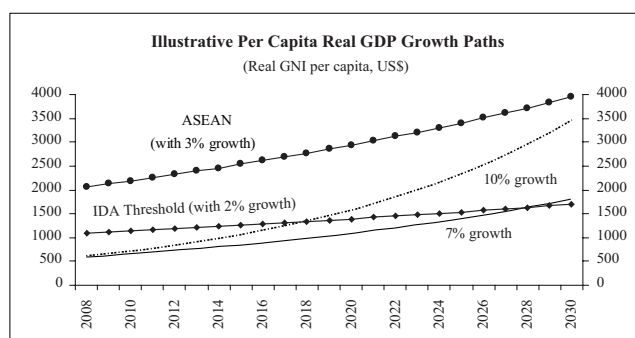
more challenging if growth slows in the medium term. Nelmes pointed out that growth in spending is slower than that in revenue, allowing the government to increase deposits and reduce the deficit, as illustrated below. This could dampen inflation. However, as will be discussed later, it is important that government capital expenditure be increased so that growth potentials are enhanced.



Policy Issues

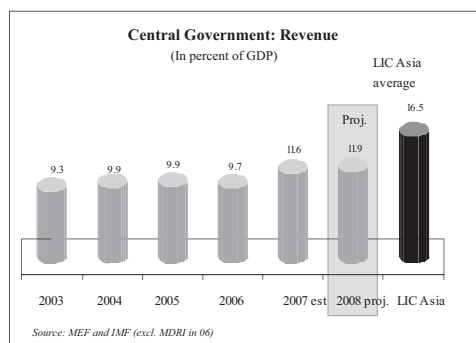
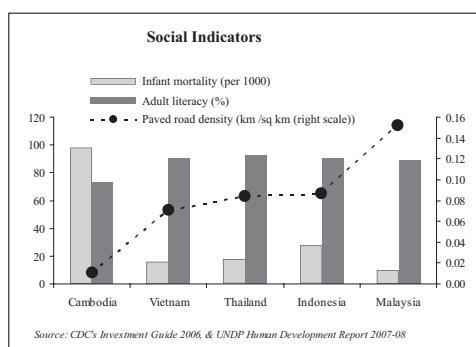
Given the above brief overview of the economy, a number of policy issues and options emerge; a few of these are briefly discussed below.

For a number of reasons, particularly to ensure a higher standard of living, sustaining high growth over the medium to long term is critical. The figure below shows the potential income per capita based on different sustained rates of growth over the next 22 years. As illustrated, a relatively small change in the rate of growth is likely to produce a substantially different level of GDP per capita over a relatively short period of time. The difference between scenarios presented is to a large extent

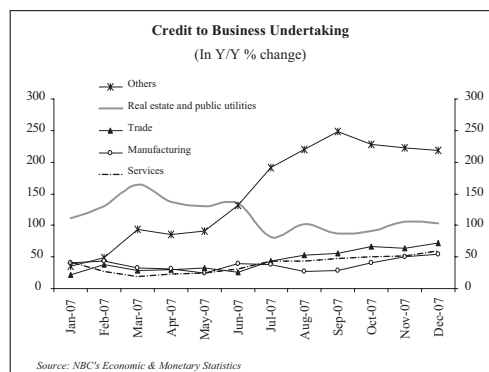
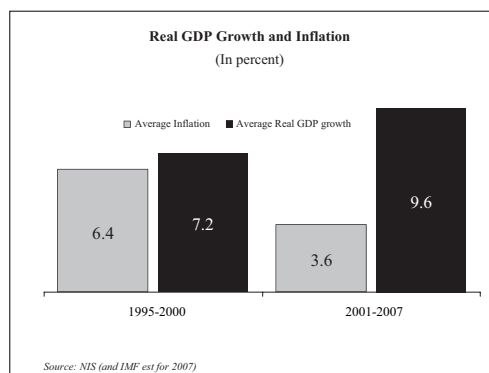


determined by differences in policies adopted. For a high-growth policy option, Cambodia should undertake a number of steps, among which the following are expected to be the most important.

In order to sustain a high rate of growth, it is important that the government spend more on infrastructure, health and education. Given the nature of these services and the reluctance and difficulties that the private sector generally has in investing in physical and social infrastructure, it is important that government take an effective role in these areas. There are serious gaps between Cambodia and some of its neighbours in terms of social and economic indicators, as shown below. These gaps need to be reduced. To be sustainable, however, it is important that such spending be financed by a continued strong revenue effort. The graph below shows a healthy growth in central government revenue in the recent past; the latest figure, however, is still well below the average for comparable countries in Asia.



For sustained economic growth, it is also important to ensure that inflation is under control; low inflation is key for both growth and poverty reduction. The graph below illustrates the link between inflation and GDP growth over the last decade; higher inflation is generally associated with lower growth (1995–2000), or a lower inflation period is associated with higher GDP growth (2001–07). The other important factor that would help growth is continued strong banking supervision. Increased access to finance and financial services is important for a growing economy. Reliance on these services is likely to be directly related to the trust that the users have in the sector. Strong banking service supervision would be one way of increasing this trust.



Concluding Remarks about the Session

The message that came out of this session of the conference was that the economy is generally in good shape, and the macroeconomic outlook remains promising. However, given the very low level of development of the country as measured by GDP per capita, a high growth strategy is important. To sustain this, there are a number of steps needed to make sure that economic stability is not adversely affected; hence the emphasis on the control of inflation. It is also important to make sure that growth is more “inclusive” and shared equally by all potential contributors. In this context, it is important that institutional and governance issues are addressed more effectively. One of the major challenges that Cambodia faces is the high level of poverty and a relatively low speed of poverty reduction. To address this challenge more effectively, agriculture needs to be made more dynamic; CDRI (2008)⁵ provides details on how this could be achieved.

Endnotes

1. Secretary-general, Supreme National Economic Council, Ministry of Economy and Finance, chair of CDRI Board of Directors.
2. Resident representative, IMF.
3. Head of Business Financial Services, ANZ Royal Bank.
4. Professor and director, Institute of Asia-Pacific Studies, Chinese Academy of Social Sciences, People's Republic of China.
5. CDRI (2008), Annual Development Report 2007–2008 (Phnom Penh).