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Cambodia Outlook Brief*

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Driving High Growth and Sustainable Development for Cambodia: Indicators, Prospects and Policy Priorities

"We have recently gone through and mitigated the negative impacts of the global financial crisis and economic downturn of 2008-9 and are moving confidently, but carefully, forward."

Samdech Akka Moha Sena Padei Techo HUN SEN
Prime Minister, Kingdom of Cambodia

The Global Economy in 2011: Diverging Paths, Dependent Futures[1]

2011 has seen the global economy continue to recover from the 2009 crash. Indicative of growing confidence in the resurgence, the IMF revised upwards its forecast for global economic growth from 4.2 percent to 4.5 percent for 2011. But while the aggregate figures are encouraging, it is important to take stock of the significant challenges that remain. The underlying worry is uneven growth: faster growing emerging markets, particularly in Asia, are diverging from the stagnating advanced economies. In an increasingly interdependent global economy, Asian economies could be vulnerable to spillovers. However, appropriate policy action should mitigate these threats and ensure a high-growth and sustainable economic outlook for the region.

Low rates of growth remain the defining trait of advanced economies. The 2 -2.5 percent growth rate of the US, which is similar or better than most European countries, is modest given the amount of output decline in 2009. Many advanced economies still have much excess capacity and high rates of unemployment.

Significant monetary policy support has been required to achieve the low rates of growth that we have seen in the advanced economies. This in turn has led to governments acquiring debts of up to 30 percent of GDP to finance budget deficits and borrowing requirements. In such cases, inability to keep in line with fiscal targets or finance debts could lead to an increase in interest rates, which could put a quick end to the whole recovery.

Other particular threats hang over many advanced regions. The US housing market is still at risk of foreclosures and further delinquencies, which could lead to more financial turmoil. In Europe there have been sovereign credit risks in countries such as Iceland, Greece, Ireland and Portugal. In Japan, the recent earthquake could serve to inflame already deflationary tendencies. In sum, recovery in the industrialised world continues to be slow and fragile in 2011.

Emerging markets have almost the opposite problem and run the risk of overheating. Increasing inflationary pressures, credit expansion and the potential for asset market bubbles, have all brought risks to Asian economies. Rising commodity prices resultant of emerging-market commodity-intensive growth and rising food prices have contributed to increasing rates of inflation. Increasing costs have reduced excess capacity in many Asian economies, closing output gaps and further contributing to inflation.

1 *This is a summary of the 2011 Cambodia Outlook Conference presentations by Mr Milan Zavadjil, Senior Resident Representative for Cambodia and Indonesia, International Monetary Fund (IMF); H.E. Dr Hang Chuon Naron, Permanent Vice Chairman, Supreme National Economic Council, Secretary of State, Ministry of Economy and Finance, and Chair, CDRI Board of Directors; Mr Putu Kamayana, Country Director, Cambodia Resident Mission, Asian Development Bank (ADB).*

* BASED ON 2011 CAMBODIA OUTLOOK CONFERENCE:
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Slow growth in advanced economies presents serious challenges for Asia. The main route of effect will likely be falling demand for manufactured goods. In the medium-term a strong dependence on consumer demand from developed markets means their slowdown will have significant impacts. In addition, capital inflows to Asia have rapidly increased in large part due to the comparatively favourable economic climate. There are dangers that this could lead to inflation and overdependence, which would lead to vulnerability should global conditions change.

Despite these risks, Asia is expected to lead the global recovery with high growth rates across the region. This offers significant opportunities for mutually beneficial outcomes through increased regional cooperation.

Cambodia's Resurgence

In 2011, Cambodia is expected to continue its recovery from the crisis. There have been increasingly positive signs, with strong growth figures and stable macroeconomic indicators supported by proactive government policy (Figure 1). The economic rebound from the recession documented in the 2010 Outlook Conference looks set to continue into this year, with economic growth expected to increase from 5.9 percent to 6-7 percent in 2011.

The current economic recovery has been fuelled by the resurgence of Cambodia's key sectors. Agriculture grew by 4 percent in 2010: milled rice production stands at a record 4.63 million tonnes, up 2.4 percent from 2008/09; rice exports increased more than 50 percent in 2010, largely as a result of the EU removing quotas and import tax. Driven by rising prices and mushrooming exports, rubber production has rapidly increased: cultivated area has gone up from 108,000 ha in 2008, to the current 170.000 ha.

Industry posted 13.5 percent growth in 2010, compared to -9.5 percent in 2009, with garment production soon expected to reach pre-crisis levels. The footwear export industry expanded by 60 percent. This growth has created 55,300 jobs – almost covering the amount lost in the crisis. Substantial increases in tourist numbers has meant that the services sector expanded by 3.1 percent in 2010, compared with 2.3 percent in 2009. However, real estate and construction are still suffering following the asset bubble burst during the crisis. Land prices declined between 10 -20 percent in 2010.

Cambodia's macroeconomic climate remains stable and conducive to investment. Despite growth, inflation has remained very low and though the current account widened in 2010, the World Bank expects it to be reduced to 13.1 percent of GDP in 2011. Foreign exchange reserves increased to USD2.7 billion by the end of 2010 and public debt is manageable. Due to this stability, Foreign Direct Investment (FDI), though not back to pre-downturn levels, still managed an increase of USD42 million from 2010-11.

The characteristics of the global recovery present opportunities for Cambodia to transform strong foundations into high, sustainable growth – but along the way there will be challenges. In response, policy has focused on economic diversification, regional economic integration, deepening financial infrastructure, and monetary and fiscal policy. The government has made promising in-roads and is committed to following through with deeper reforms.

Figure 1: Cambodia's Macroeconomic Indicators

	2008	2009	2010
GDP (nominal, USD million)	10337	10335	11344
GDP (per capita, USD)	773	765	830
GDP (growth rate)	6.7%	0.1%	5.9%
Agriculture	5.7%	5.4%	4.0%
Industry	4.0%	-9.5%	13.5%
Services	9.0%	2.3%	3.1%
Budget revenue (% GDP)	**13.3%**	**11.9%**	**13.3%**
Budget expenditure (% GDP)	15.9%	20.5%	20.7%
Overall deficit (% GDP)	-2.9%	-6.4%	-7.4%
Inflation (average)	19.7%	-0.6%	4%
Gross foreign reserves (USD million)	2164	2367	2650

Source: Dr Hang's presentation to the Cambodia Outlook Conference, 16 March 2011

Driving Diversification

Decreasing demand from developed countries poses risks to Cambodia's export driven industries, particularly garments. The experience of the economic crash showed that relying heavily on external demand for a narrow product base can have devastating consequences if demand slows or terms of trade change. To mitigate such risks and build strong foundations for the future, Cambodia must seize the opportunity to diversify its economy so growth is robust, dynamic and sustainable.

A crucial aspect of the government's rebalancing strategy is tapping into the latent potential of Cambodia's agricultural sector. Future policy should target both micro and macro-level constraints to increased and diversified agricultural output.

On a micro-level, bottom-up local projects, such as small-scale irrigation, developing microfinance and upgrading local infrastructure, have the capacity to increase productivity and reduce rural poverty. This is particularly the case as regards small rice farms.

On a national scale, attention needs to be given to policies that will diversify and increase output in the medium term. In this regard, transparent and coordinated management of land and water resources and large-scale electrification are key areas of future policy action. A key ambition regarding rice production is to move up the value chain through production, processing, export facilitation and marketing of rice.

Policy is needed to nurture the development of new industrial sectors, such as car assembly, electrical appliances etc. The government has laid promising foundations for this in its recent Industrial Policy Paper. Cambodia must seize these opportunities through targeted reforms that improve trade facilitation and investment climate in these sectors. Moving up the value-added chain will increase export revenues and also decrease the risks associated with a narrow export product profile.

As well as rebalancing between sectors, there is also scope for diversification within more traditional growth sectors. Tourism has been based mainly around the draw of the Angkor temples. However, there is great potential for the development of other tourist attractions. For example, beach tourism in Sihanoukville and eco-tourism in Koh Kong have the potential to vastly increase tourist numbers and average length of stay. The garment industry should diversify into high-end, high-quality and high-value merchandise.

There are encouraging signs that diversification is already occurring. One indication is FDI spreading to different sectors. Traditionally FDI in Cambodia has been footloose, concentrated in construction and garment sectors where returns are quick. It is now diversifying into agriculture and mining, with Asian corporations becoming increasingly prominent. The trend towards diversified, long-term investments means that the country is less vulnerable to the shocks stemming from capital flight. It is vital that the investment climate improves so business will feel increasingly comfortable in making these long term investments.

Cambodia is endowed with a demographic profile that should aid restructuring, but that also presents policy challenges. Its young, mobile population is able to migrate in response to the changing structure of the economy. As evidence of this, it has one of the highest rates of urbanisation in the region, at 3.5 percent. Rural to rural migration to areas of more fertile land or plantations is also increasing. Attention will need to be given to social support mechanisms for migrants, and to combat social issues arising from migration.

Regional Integration

As Asia leads the global recovery, Cambodia is ideally placed to benefit from integration into regional economic networks. Regional networks are becoming increasingly important in driving growth in the country's key sectors. Economic integration through ASEAN Free Trade Areas will augment many of Cambodia's agricultural exports, such as rubber and rice, through facilitating greater access to regional and global markets.

Cambodia's strategic location between the manufacturing hubs of Ho Chi Minh City and Bangkok means the country has a unique opportunity to integrate into regional supply chains and move up the industrial value-added ladder. Regional networks are also of increasing importance to tourism – 72 percent of tourist arrivals in 2010 were of Asian origin – and in facilitating increased regional FDI.

Regionalism has been greatly supported by the government. Cambodia has actively participated in ASEAN and Greater Mekong Sub-region (GMS) initiatives. Under its Rectangular Strategy Phase II, the government has set out some clear policy goals. This commitment was confirmed in the 2009-2013 National Strategic Development Plan Update, where policy goals are backed up with priority implementation strategies and clear plans of action. These include strengthening inter-ministerial coordination, adopting laws and regulations required to meet obligations of membership to regional and sub-regional economic networks, and institutional capacity building.

Institutional reforms have already yielded positive outcomes. For example, there has been improved internal coordination of transport and trade facilitation measures. Key here has been the transference of leadership of the national transport facilitation committee from the Ministry of Public Works to the deputy prime minister and minister of economy and finance. Moreover, Cambodia has implemented pioneering regulatory frameworks that have substantial regional impact, for example the public-private railway rehabilitation project.

The Southern Economic Corridor (SEC) has been an important outcome of GMS cooperation. It is an umbrella initiative covering a range of projects designed to facilitate increased cooperation in the GMS. It has included physical infrastructure projects, improving road and rail links between Cambodia and regional manufacturing hubs, cross-border electricity cooperation, and the upgrading of regional telecommunication and ICT infrastructure. "Hardware" projects have been supported by "software", such as institutional frameworks to facilitate the regional power trade and communication networks.

Cambodia has also participated in the Core Agricultural Support Programme. This GMS initiative facilitates cross-border trade and investment in agriculture, enhancing participation and knowledge sharing and cooperative implementation of capacity building programmes. A major benefit of infrastructure development is the extension of transport links to remote landlocked areas, which opens up opportunities for various kinds of investment in places where poverty is greatest.

Regional cooperation can help mitigate "public ills" arising from development such as environmental degradation and the spread of communicable disease. Projects have included HIV prevention and measures against human trafficking. Cambodia has participated in the GMS Core Environmental Programme and flagship Conservation Initiative, helping to establish two biodiversity corridor sites in the country which are in the process of being scaled-up through an investment phase.

Financial Deepening: Increasing the Productivity of Capital

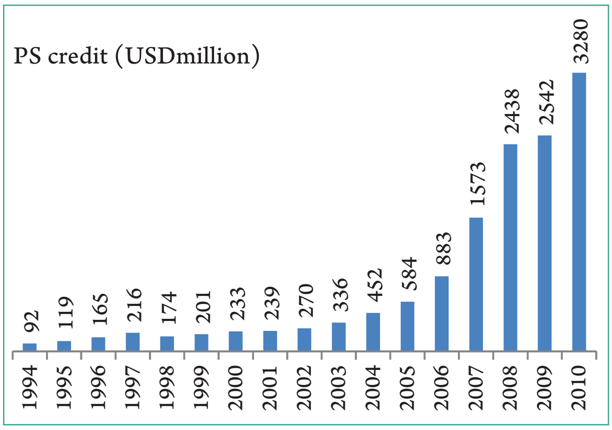
Institutional and regulatory reforms in the financial sector – the nervous system of Cambodia's economic development – have enabled continued financial deepening in 2011. Cambodia now has 30 commercial banks, though there is still much scope for growth in the sector. Liquidity has increased dramatically, with deposits reaching USD4.3 billion at the end of 2010. In tandem, credit supply to the private sector expanded by 30 percent and is playing an ever greater role in the Cambodian economy (Figure 2).

The growth and increasing complexity of Cambodia's financial system will necessitate strong and transparent institutions to optimise outcomes. The three main sources of capital in Cambodia are public investment, private investment and ODA; each have their own characteristics and require regulatory frameworks to realise their productive potential. Critical is policy that facilitates increased private investment in public infrastructure, such as roads, electricity and sewage, and frameworks that extend credit to small and medium enterprises and rural small-holders.

Regarding public-private investment, the on-going railway rehabilitation project provides a model for upgrading public services with private investment, utilising a progressive regulatory framework that promotes competitive and transparent engagement with the private sector. ACLEDA bank is a public-private partnership hailed as a success story, extending credit to many rural households. These examples provide successful models for future interventions.

A key challenge will result from increased credit supply, which may require regulation to mitigate risks and control inflationary tendencies. Again, the emphasis is on developing strong, transparent institutions able to enforce policy.

Figure 2: Private Sector Credit Expansion



Source: Dr Hang's presentation to the Cambodia Outlook Conference, 16 March 2011

Monetary and Fiscal Policy

The government's macroeconomic management has displayed great competence, but pressures look set to increase. So far a proactive response from the National Bank of Cambodia (NBC), appreciating the riel and increasing reserves of foreign currency, has kept inflation at bay. But as rates are rising regionally and pressures stemming from growth, capital inflows and increased public spending grow, the onus is on government to keep inflation manageable.

Poor rates of revenue collection have limited spending on education and health. These are areas where Cambodia still falls short of regional standards, and where improvements are necessary to ensure long-term development. A core challenge is improving rates of state revenue collection. The government is committed to increasing collection revenues by 0.5 percent of GDP each year.

Other fiscal challenges relate to managing Cambodia's future growth. In the next five years, Cambodia hopes to elevate its status to a middle income country, but this path is not an easy one and relies on sound macroeconomic management. Key here is appropriate fiscal management that ensures growth in emerging sectors, like mining, does not harm traditional sectors.

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☞ 56 Street 315, Tuol Kork ✉ PO Box 622, Phnom Penh, Cambodia
☎ (855-23) 881-384/881-701/881-916/883-603/012 867-278 🖷 (855-23) 880-734
E-mail: cdri@cdri.org.kh, Website: http://www.cdri.org.kh