



Cambodia Outlook Brief*

2009, N° 01

The Global Financial and Economic Crisis: Its Implications for Our Region and for Cambodia¹

“The global and regional crisis is not a crisis of Cambodia’s making. It has been caused by external factors beyond Cambodia’s control, and it is a crisis that will have serious impacts on us all ... We must now work together to manage our way through it to ensure that the remarkable development and poverty reduction achievements of Cambodia over the past two decades are not lost ...”

*Prime Minister Hun Sen, opening address to
the 2009 Cambodia Outlook Conference*

The Global and Regional Crisis: Origins and Impact

The global financial and economic crisis started in the United States in the middle of 2007 and soon spread throughout the developed world. As the crisis deepened, its impact extended to the rest of the globe. Even countries initially thought of as capable of overcoming the crisis also fell victim to it in the end.

The initial cause of the crisis was the loss of confidence in mortgage-related assets and the consequent collapse of some major financial institutions. This led to a decrease in credit and liquidity that affected broader economic activity.

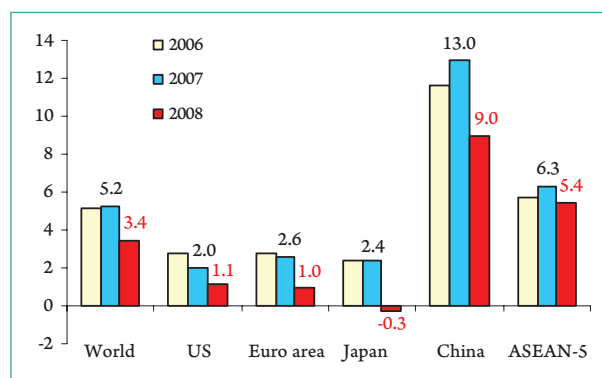
Global growth fell dramatically, and deep recession soon settled onto the most advanced economies. According to the International Monetary Fund, world output grew by 3.4 percent in 2008 compared to 5.2 percent in 2007 (see Figure 1). Available data for January 2009 show that the situation has worsened. Year-on-year world output growth in the said month is estimated at only about 1 percent.

¹ This is a summary of the presentations and discussion in session 1 of the 2009 Cambodia Outlook Conference. Presenters for this session were: Mr John Nelves, resident representative, IMF; Dr Jayant Menon, principal economist, Office for Regional Economic Integration, ADB; H.E. Dr Cham Prasidh, senior minister, minister of commerce; and Dr Hossein Jalilian, research director, CDRI.

Asian markets did not escape the crisis. ASEAN countries’ output grew much less than in past years. The same was true for the newly industrialised economies (NIEs) of South Korea, Hong Kong and Taiwan, whose decline in growth was much sharper. Meanwhile, China’s 2008 real GDP growth dropped about 4 percent from 2007 and Japan’s economy shrank, its output growth falling from 2.4 percent in 2007 to -0.3 percent in 2008.

Industrial production experienced a huge decrease. Data for January 2009 demonstrate an even steeper drop compared with the same month of 2008. In China, year-on-year industrial growth fell to 11.1 percent in January 2008 and to 6.43 percent in January 2009. In Japan, it dropped to an alarming -22.5 percent in January 2009 from its still positive level in mid-2008.

Figure 1: Real GDP Growth (%)



Source: IMF WEO Update, Jan 2009

Business and consumer confidence plummeted. Investors have become less keen to invest, while consumers have become less willing to spend as uncertainties about the state of the global and national economies continue. Fixed investments have declined in ASEAN and more so in the NIEs. While consumption within ASEAN appears to have remained stable, consumption within NIEs was declining by the fourth quarter of last year.

Both exports and imports have underperformed. Merchandise imports and exports of ASEAN countries and NIEs began sharp declines in mid-2008. China's year-on-year export and import growth plunged from around 27 percent and 35 percent sometime in mid-2008 to 4.3 percent and -9.0 percent respectively in December 2008. That of Japan reached -9.9 percent and 6.1 percent respectively at the end of last year.

The commodities boom ended. Agricultural production previously benefited from high food prices caused by the food and energy crises. However, lower world demand has reversed this trend of increasing prices to one of declining prices (deflation). Lower prices in turn have discouraged supply and decreased farmer incomes.

The Crisis and Cambodia: Impact and Policy Responses

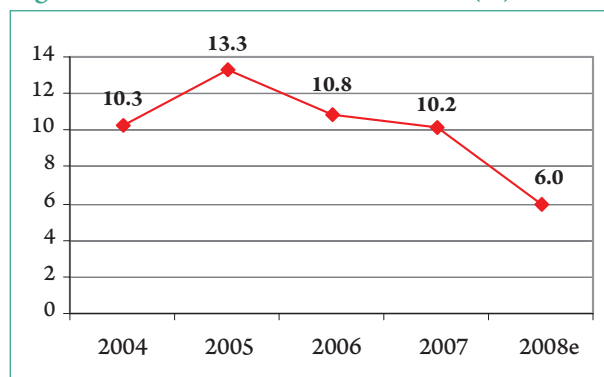
Cambodia met the crisis in a condition of high economic growth, reduced poverty and stable political environment. Over the period 1994–2007, the country achieved an exceptional average GDP growth of 10 percent, reducing poverty by 10 percent over the same period. The return of peace and stability after a long period of civil war and political infighting provided the necessary support to this economic revival.

The country's economic progress was mainly sustained in industry by construction and garments and in services by tourism. Agriculture's contribution to growth has been historically unstable, although in recent years it posted a welcome average growth rate of 5 percent.

The crisis did not directly affect Cambodia because the banks operating in the country had little exposure to the toxic financial products that set it off. But the crisis was felt through its impact on the key growth sectors.

The crisis disrupted Cambodia's exceptional growth record. Estimates have varied, but growth fell, and the country's garment, construction and tourism sectors were badly hit. Agriculture proved to be more resilient but some agricultural exports certainly felt the pinch of the crisis. According to the IMF, Cambodia's GDP growth fell from 10.2 percent in 2007 to an estimated 6 percent in 2008.

Figure 2: Cambodia Real GDP Growth (%)



Source: IMF data

The crisis slowed both exports and imports. In high demand previously, durable goods such as cars and motorcycles experienced a sudden decline in demand from about the middle of 2008 (the previous energy shock may also help explain the lower sales). Meanwhile, exports experienced a serious slowdown, due primarily to reduction in world demand. Cambodian exports have been particularly vulnerable because of their narrow base. About two-thirds of the country's total exports consists of garments.

Growth of the garment sector has been seriously affected. It is estimated to have dropped from around 8 percent in 2007 to 3.3 percent in 2008, mainly because of the decline in demand of its top export market, the United States. Cambodian garment exports closely follow retail sales in the US, which have decreased sharply. The stronger riel did not help the situation, making the country's exports more expensive and therefore less competitive. From October 2008 to January 2009, the year-on-year growth of Cambodia's garment export volumes fell sharply. From a monthly average of around USD200 million in 2008, garment export values dropped alarmingly to USD165 million and USD102 million in January and February 2009. The number of active garment factories decreased from 292 at the end of 2007 to 288 in January 2009 and then 277 in February. The number of garment workers peaked at 352,000 in September 2008, dropping to 301,000 by February as a result of factory closures or cuts in operating costs.

Some agricultural commodities that are major export earners also suffered badly due to lower world demand and declining prices. On the whole, however, Cambodia's agriculture sector performed well in 2008.

The impact on tourism was also serious. Tourist arrivals have declined, Angkor revenue has decreased, and hotel occupancy rates have gone down. The high inflation of 2008 and now stronger riel make Cambodia a more expensive tourist destination. The

sector, which used to grow around 25 percent per year on average, posted only about 9 percent growth in 2008, according to estimates.

The impact on construction and real estate development is visible. In Phnom Penh alone, several major construction projects have been delayed. The key reason has been the slowdown in foreign direct investment (FDI). Construction approvals, a leading indicator, were down 40 percent in 2008.

FDI is very important to Cambodia, comprising almost 60 percent of total investment. The country's growth sectors in particular depend greatly on this type of foreign financing. Many garment factories, tourist establishments and construction projects are financed by FDI. The crisis caused investors all over the world to cut back, cancel or delay their investments as it became harder for them to get credit or any other funding for their investments. The same problem besieged Cambodia's investors and caused investments in the country to slow down. South Korean investors were especially affected because of the severe impact of the crisis in their home country. It is said, however, that their confidence remains and that small and medium projects are still proceeding.

The crisis created challenges for the domestic banking system even though the banks are generally in good financial health and have little exposure to bad assets. Foreign currency deposits, which account for an average 98 percent of total bank deposits, grew by a mere 1 percent in the year to December 2008. This caused concerns about the banks' required reserves. Another concern was their exposure to the real estate sector, which has become more risky because of the crisis and decline in prices (the "bursting of the real estate bubble"). Because of this exposure, bank lending to the sector tightened. Growth of credit to the private sector as a whole has slowed. After peaking at 100 percent in May last year, the year-on-year growth of private sector credit decreased to around 45 percent in January 2009.

Reflecting global trends, prices in Cambodia have dropped although they remain high compared to previous levels. This is good news for consumers, although it caused problems for producers and exporters. The annual consumer price index increase declined to 13.5 percent in December 2008 from a high of 25.7 percent in May of the same year.

The crisis has worsened the condition of Cambodia's poor through its effects on employment and income. Many of the rural poor depend on the garment, construction or tourism sectors for their livelihood or remittances. Some also depend on remittances from

family members or relatives working abroad (legally or illegally) in Thailand. Unfortunately, the crisis has forced factory closures, cutbacks in operations or project delays everywhere. These in turn resulted in job losses or underemployment.

Many of the Cambodians who were able to rise a little out of poverty may have been pushed back to their previous condition by the crisis reducing their income even very slightly. For a large part of the population, a few hundred riels a day make a big difference.

Responding quickly to the crisis, the government implemented specific measures to provide relief to hard-hit sectors. These include an exemption for the garment sector from the 1 percent advance profit tax, reduction of the bank reserve requirement from 16 to 12 percent, removal of the 15 percent cap on lending to the real estate sector, planned simplification of travel for tourists, a planned agricultural fund and establishment of the National Social Security Fund. The government has also urged an end to protectionist policies during slowdowns and emphasised the benefits of trade integration and openness. It has called upon all participants in Cambodian development to join in reforming trade facilitation and the economy as a whole.

The Crisis and the Way Forward: Outlook and Future Policy Directions

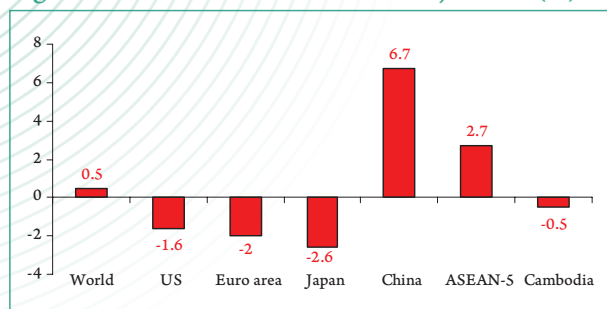
The outlook for 2009 is gloomy. The world economy is expected to slow even further. As the crisis deepens and exports fall, projections of output growth have become more pessimistic. For example, the IMF at first estimated world output growth in 2009 to be 2.2 percent, then changed this to 0.5 percent because of worsening conditions.

The world economy is expected to remain weak in 2010.

The Cambodian economy is seen as heading for recession this year. The latest IMF projection is that GDP growth will fall to -0.5 percent in 2009 (this estimate is however contested) and slowly recover in 2010. Uncertainties and risks will continue to trouble the economy.

The country's key growth sectors will continue to be affected by the unfavourable external environment. Garment exports are likely to continue to suffer given that US retail sales are projected to decline by 10 percent in 2009. Likewise, tourism is expected to decline by 0.5 percent this year.

Figure 3: 2009 Real GDP Growth Projections (%)



Source: IMF WEO Update, Jan 2009; IMF estimate for Cambodia

On the bright side, Cambodia's agriculture is expected to maintain its positive performance this year. However, decreasing prices will continue to challenge agricultural exports.

To help the economy overcome and recover from the effects of the global crisis, the government and its development partners will have to cooperate with one another and coordinate their actions. Certain measures—and sacrifices—are necessary. Where reform has been successful, the efforts of the government and its partners must continue. Rapid disbursement of aid for infrastructure and other projects is also imperative.

Fiscal reforms undertaken in recent years have led to significant progress in revenue generation. Still, the government does not have much room for a stimulus package other than the expansionary budget it has planned for this year. The high dollarisation of the economy limits the effectiveness of monetary policy in providing economic relief from the effects of the crisis.

A bigger budget deficit is set for 2009 to serve as stimulus. The IMF expects the deficit to reach 4.75 percent of GDP. To be effective in energising the economy and helping the vulnerable to cope, the additional funds will have to be spent on infrastructure and social safety nets (e.g. direct cash transfers or food for work). Additionally, progress in revenue generation will have to continue.

Several important lessons have emerged on which other policies can be based. One is the need to redirect trade in order to diversify risks. Strengthened regional trade

may cushion the impact of unfavourable developments in the rest of the world. For the garment sector, this means diversifying into other markets, including enhancing garment trade with the EU, Japan and Canada. Diversification of export products is also a longer term solution to the crisis. Attracting aid for trade can help to finance the necessary infrastructure that will enable the country to take advantage of market access opportunities. Trade finance from banks is also important. Export credit can provide relief to exporters, who suffered a huge blow from the crisis.

Another lesson relates to competitiveness. Although improving, Cambodia remains one of the least competitive countries in the region. This can be explained in part by its high production and trade costs. Addressing infrastructure limitations, improving trade facilitation and reducing the costs of doing business will elevate competitiveness.

The banking sector needs short-term and longer term solutions to the problems caused by the crisis. An immediate relief to the strain on the banking system would be the further reduction of the reserve requirement, releasing more liquidity. Longer term solutions require the strengthening of banking supervision (e.g. improved off-site and on-site surveillance) and development of monetary instruments that facilitate inter-bank transactions.

Another important and more profound lesson is the need to remove structural impediments to broader based growth. Policies are needed that encourage a more inclusive growth so that a larger part of the population can share the fruits. Addressing constraints to agricultural development, such as lack of investment, seems to be the best strategy. However, diversification of the whole economy is needed. The high dependence of the country's economic progress on the four growth sectors made the economy very vulnerable to external shock. Other growth poles will have to be created. The manufacturing sector will have to be expanded beyond garments, for instance. Every year, there are 250,000 to 300,000 new entrants to the workforce. To find a space for these job-seekers, the economy needs to be diversified.