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GOVERNMENT RESPONSE TO INFLATION CRISIS AND GLOBAL FINANCIAL CRISIS

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INTRODUCTION

Cambodia’s, strong growth performance in the last decade relied heavily on exports to world markets, particularly the United States and Europe, and inflows of foreign direct investment and official development assistance under the newly liberalised economic regime. Cambodia, therefore, is not immune to global storm. The twin global crises are a timely wake-up call, highlighting challenges and opportunities for Cambodia’s continued economic stability, growth and future prosperity. This brief takes stock of domestic macroeconomic policy in mitigating the highest inflation and lowest growth Cambodia has experienced since 1994. Drawing on lessons learned, it looks at how the effectiveness of macroeconomic policies could be strengthened.

INFLATION CRISIS

Higher prices due to the unexpected global commodity boom transmitted almost immediately to food prices in Cambodia, rapidly driving up domestic inflation. Year-on-year CPI started rising in June 2007, recording 7.6 percent growth (above the highest average of 5 percent for the last decade), driven mainly by 5.2 percent surge in food prices. By March 2008, CPI inflation had escalated to 26.6 percent, underpinned by 17.1

percent hike in food prices and 3.5 percent rise in transport, and then peaked at 35.4 percent in May 2008 spurred by increases of 23.4 percent in food and 3.46 percent in transport.

Cambodia’s headline and food inflation closely mirror trends in neighbouring trading partners Thailand and Vietnam, and converge with food prices in these two countries within two to three months because of the high volume of cross-border food trade and strongly integrated product markets. Inflation was further exacerbated by overconsumption as illustrated by the output gap, indicating signs of economic overheating stoked by a number of factors: private spending, real estate bubble, accelerated money velocity, and fast credit growth.

Soaring inflation has grave consequences for national development efforts, particularly poverty reduction. Rising food prices disproportionately affect the poor and other vulnerable groups, especially net food buyers and especially the 1.7 million food-insecure people living in the Tonle Sap Basin and Mekong Plains. In Cambodia, the poorest 40 percent of the population spend 70 percent of their income on food (CSES 2004). Higher commodity prices should have benefitted rural producers, but as Chan (2008) reports, just 25 percent of farmers actually gained. This is because only 34 percent of farmers produced

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a surplus in 2008, 21 percent of rural households are landless and 45 percent are land poor (own one hectare or less).

To address the immediate impacts of food inflation, key administrative measures included selling 300 tonnes of rice at 1800 riels per kg, which was well below the market price of 2500 riels per kg, a temporary ban on rice export, and injecting USD12 million of credit into the Rural Development Bank. Key measures to dampen the effect of the escalating oil price involved government subsidies to fix the reference price for tax on diesel and maintain the electricity tariff.

The government promptly deployed macroeconomic policy tools, coordinated by the Price Monitoring Group under the auspices of the Committee for Economic and Financial Policies. Prudential fiscal policy with deposit build-up allowed for tariff exemption on sensitive-products, provided subsidies and kept a tight rein on public expenditure. In terms of monetary policy, increasing oil and food prices led to higher demand for dollars. Without timely intervention by the National Bank of Cambodia (NBC), inflationary pressures would have been heightened by a combination of riel depreciation and pass-through effects. Even with intervention that ensures exchange rate stability, pass-through effects still prevail. Moreover, any intervention that leads to riel appreciation as compared to initial exchange rate will jeopardise trade competitiveness. Therefore, riel depreciation and pass-through effects render monetary policy ineffective in countering externally generated inflation.

There is little that central banks and national governments can do to manage externally generated inflation apart from mitigating adverse impacts and potential second-round effects by managing exchange rates. While exchange rate policy was broadly ineffective in cushioning inflation, reserve requirement and credit ceiling measures helped cool the overheated economy

by capping credit growth. Government deposit build-up during the high-growth period allowed for fiscal flexibility, and consolidated fiscal policy was effective in controlling aggregate demand. Overall, coordination and complementarity between monetary and fiscal policies was laudable, and administrative measures deployed to cope with emerging issues were decisive and timely.

LOWEST GROWTH EXPERIENCE

The outbreak of the global economic crisis, coming hot on the heels of the food price crisis, hit Cambodia severely and stalled the country's exceptional decade-long growth and poverty reduction. Growth held out until the third quarter of 2008, then plummeted to 0.1 percent in 2009 explained by -9.5 percent deceleration of industry and weak performance of the services sector. Nevertheless, the economy started to show signs of recovery in 2010 with 5.9 percent growth underpinned by stronger than expected rebound in the garment sector and recovered FDI disbursement in the fourth quarter of 2010 almost equal to that in the second quarter of 2008, reflecting strong rebound in the real estate sector.

To counter inflation and food security, issues continuing from 2008, the government injected USD18 million into the Rural Development Bank to further promote food security. Economic deceleration caused job losses and underemployment in crisis-hit sectors, namely garments, construction and tourism. Seeing this, the government invested USD6.5 million in a Special Training Fund and USD1 million in a self-created employment scheme, and subsidised occupational risk premium payments to ease garment companies' overheads. Credit to the private sector was eased in an attempt to stimulate growth. The ban on credit to the real estate sector was lifted, and the minimum reserve requirement was reduced from 16 to 12 percent.

As global economic slowdown unfolded, the

spotlight fell on fiscal expansion to stimulate economic activities. Unlike in the second half of 2008 when fiscal expansion was in the form of tax exemption, fiscal measures in 2009 took the form of increasing public expenditure. Current expenditure was increased to about USD219 million (27 percent) and capital expenditure rose to about USD154 million (31 percent). With signs of economic recovery in 2010, the government started to wind down fiscal expansion allowing a rise in current expenditure of USD159 million (15 percent) and rise in capital expenditure of USD86 million (13 percent).

Fiscal expansion, however, was not enough to cope with economic crisis of such unprecedented scale and its spillover effects, and at best could boost domestic demand only slightly (SNEC (2011)). Moreover, government revenue barely responded to increased government consumption. There were several reasons for this. The small stimulus package of around 4.5 percent of GDP in 2009 and 2.8 percent of GDP in 2010 was less than the desired level, let alone enough, to stimulate economic activities (Jalilian & Reyes 2010). The underdeveloped social security system, massive job losses and income uncertainty increased the propensity to save which hindered the multiplier effect of public spending. Increased public spending leaked out in payments for increased imports because of the country's rudimentary manufacturing base. And to a limited extent, weak budget institutions caused expenditure to deviate from desired performance targets. These combined factors raise concern about the effectiveness of the government's strategy and its capacity to implement the rescue package given the limited role of the stimulus (Jalilian & Reyes 2010).

In summary, immediate measures taken by the government to promote food security and maintain productivity in the face of global financial storm were admirable. Moreover, adoption of fiscal

expansion was necessary and timely to prevent negative growth and job loss. Despite its limited effectiveness, monetary policy complemented and was well coordinated with fiscal policy.

GOING BEYOND CRISIS

The crises exposed the limited effectiveness of both fiscal and monetary policy to weather external shocks. Nevertheless, the export-oriented private sector-led growth strategy Cambodia is presently embarked upon definitely remains valid.

Both macroeconomic policy arms need strengthening. Fiscal tightening will replenish government deposit. In parallel, stronger budget institutions, the targeted outcome of the Public Financial Reform Programme will improve revenue administration and expenditure efficiency. Monetary policy will be more autonomous and more options available through the gradual de-dollarisation and establishment of money market.

Sectoral policies could enhance the effectiveness and complementarity of macroeconomic tools. The launch of the Policy Paper on Promotion of Paddy Production and Rice Export and the recently released National Social Protection Strategy are additional milestones. The Tourism Strategic Development Plan 2012-2020 and future package of policies to promote industrial development will lay comprehensive foundations for better macroeconomic intervention in the future.

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