Cambodia

Rebuilding for a Challenging Future

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International Monetary Fund

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The following symbols have been used throughout this publication:

. . .	to indicate that data are not available;
—	to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;
–	between years or months (e.g., 2003–04 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
/	between years (e.g., 2003/04) to indicate a fiscal (financial) year.
"n.a."	means not applicable.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this publication, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Preface

The material presented in this Special Issues was originally prepared as background for discussion at the IMF Executive Board in September 2004. Assessments contained in some of the chapters have in some cases been overtaken by recent events, but the medium-term challenges remain the same. The authors are grateful to the Cambodian authorities for extensive discussions and for their assistance in providing data and other source material.

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The opinions expressed are solely those of the authors and do not necessarily reflect the views of the IMF, its Executive Directors, or the Cambodian authorities.

Abbreviations

ASEAN	Association of Southeast Asian Nations
ATC	Agreement on Textiles and Clothing
CPI	Consumer price index
CDC	Center for the Development of Cambodia
CR	Cambodian riel
CSES	Cambodia Socio-Economic Survey
EU	European Union
FCD	Foreign currency deposits
FCU	Foreign Currency Unit
FDI	Foreign direct investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GIC	Gross incidence curve
GLS	Generalized least squares
GSP	Generalized System of Preferences
ICSID	International Center for Settlement of Investment Disputes
LDC	Least developed country
LIA	Low-income Asian country
LIC	Low-income country
LOI	Law on Investment
LOT	Law on Taxation
MBPI	Merit-based pay initiative
MEF	Ministry of Economy and Finance
MFA	Multifiber Agreement
MFN	Most favored nation
NBC	National Bank of Cambodia
NIEA	Newly industrialized and emerging economy
NIS	National Institute of Statistics
NPRS	National Poverty Reduction Strategy
NT	National Treasury
OLS	Ordinary least squares
PAP	Priority Action Program
PCB	Permanent Coordination Body
PFM	Public financial management
PFMRP	Public Financial Management Reform Program
PMU	Project Management Unit
PPP	Purchasing power parity
PRGF	Poverty Reduction and Growth Facility
RGC	Royal Government of Cambodia

RoO	Rules of origin
SCAC	Supreme Council Against Corruption
SCM	Supreme Council of Magistracy
SIC	Schwarz information criterion
SPS	Sanitary and Phytosanitary
TA	Tax administration
T&C	Textile and clothing
TBT	Technical Barriers to Trade
TCAP	Technical Cooperation Action Program
TRIM	Trade-Related Investment Measures
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UN	United Nations
UNTAC	United Nations Transitional Authority in Cambodia
VAR	Vector auto regression
VAT	Value-added tax
WEO	World Economic Outlook
WTO	World Trade Organization

CHAPTER

1 Overview

Il Houng Lee and David T. Coe

Cambodia's reconstruction and reform efforts have spanned almost 25 years. Beginning after the 1975–79 Khmer Rouge period, early efforts were beset by ongoing internal tension and civil unrest that persisted until 1998. Two coalition governments in 1993 and 1998 made some headway in rehabilitating the economy, but were stymied by the continuing civil unrest. The current coalition government, formed in mid-2004, has announced a strategy aimed at revitalizing economic reforms.

Despite these efforts, the medium-term outlook is highly uncertain. Cambodia remains one of the poorest countries in the region, with about 40 percent of the population still in poverty. The scheduled phaseout of the garment quota system at the end of 2004, combined with a deterioration in external competitiveness and weak governance, could limit medium-term growth to 2–4 percent, implying stagnant living standards.

A. Post-Conflict Restructuring and Economic Recovery

Cambodia's economic reconstruction efforts began within the framework of a centrally planned economy. Rebuilding institutional and physical infrastructure was particularly difficult since most of the educated population had either been killed or fled the country during the Khmer Rouge period. Civil conflict and the withdrawal of external assistance stalled progress on market-oriented reforms introduced in the mid-1980s. Even the coalition government formed following United Nations (UN)-sponsored elections in 1993 could not fully quench internal tensions, which erupted into a violent conflict in 1997. Only after the 1998 national elections was the resulting coalition government able to start pursuing more coordinated reforms, albeit with mixed results.

In the late 1990s, basic institutions were set up and various laws ranging from commercial contracts to accounting were adopted. The Financial Institutions Law (1999) provided the legal basis for successful bank relicensing. New accounting standards were introduced, and the regulatory framework for banks was strengthened in tandem with bank supervision. A buildup in the administrative capacity of the customs and tax services, achieved with substantial foreign assistance, improved fiscal revenue. However, progress in other public administrative reforms, notably the civil service, has been slow, limiting government capacity. Perhaps most important, progress in judicial reform has been stagnant since the mid-1990s, seriously undermining the rule of law.

Reform stalled in the wake of the July 2003 elections when tensions between the former coalition partners delayed the formation of a new government. A power-sharing agreement between the main parties eventually paved the way for the formation of a new coalition government in June 2004. The new government announced a “Rectangular Strategy” reform agenda that focused on nurturing the agricultural sector, developing the private sector, building human capacity, and rehabilitating physical infrastructure. Good governance is the overarching objective of the return strategy, cutting across all issues. The momentum for reform was further boosted in October 2004, when Cambodia joined the World Trade Organization (WTO) as the 148th member.

Macroeconomic performance was generally positive in the decade to 2004. Real GDP growth averaged 6–7 percent, and inflation was kept to single digits, except briefly in 1998 in the wake of the Asian financial crisis. Prudent fiscal policy provided an anchor for price stability, especially since the late 1990s when recourse to domestic bank financing was largely avoided. The external current account deficit (excluding transfers) peaked in 1999 at 13¼ percent of GDP, reflecting increasing reliance on foreign savings during the 1990s, but then stabilized at around 9–10 percent of GDP. The exchange rate was relatively stable against the U.S. dollar. International official reserves rose marginally from 2½ months of imports in 1997 to about 3 months of imports at the end of 2003.

Favorable external developments contributed to the relatively strong macroeconomic performance. In 1996, the effective average U.S. tariff rate for garments produced in Cambodia was reduced from 50–70 percent to 10–20 percent under the bilateral Agreement on Textiles and Clothing. Exports to the United States soared from nearly zero in 1995 to more than $1 billion in 2003—about 70 percent of total garment exports. In addition, large aid inflows, averaging 12 percent of GDP, helped finance domestic investment and fueled construction activities. Finally, the regained political stability in the late 1990s eliminated an important impediment to tourism in Cambodia, a country richly endowed with natural and historic attractions, leading to a sharp increase in the number of tourists.

These favorable developments, however, concealed underlying weaknesses that, if left unaddressed, could limit growth in the medium term to 2–4 percent a year. In particular,

- A deterioration of competitiveness was masked by quotas imposed on garment exports from China to the United States, which boosted Cambodian garment exports.
- Poor public administration and weak governance—partly due to slow progress in legal and judicial reform—have exacerbated uncertainty in the business environment, while inadequate infrastructure and high wages in the formal sector have kept operating costs high.
- Agricultural development has stagnated due to limited access to arable land and markets. Agriculture has traditionally been the main income source for most of the population and accounts for more than 40 percent of real GDP.
- Government capacity remains severely constrained by lack of human capital and entrenched governance problems. The quality of the civil service remains poor, and fiscal revenue, currently at 10½ percent of GDP, is hardly enough to meet basic priority spending needs.

B. Sustainable Growth to Achieve Poverty Reduction

As Cambodia emerges from post-conflict rehabilitation, the main challenge is achieving poverty reduction through sustainable growth. Against this background, Chapter 2 assesses the extent to which recent growth has or has not benefited the poor. According to household surveys, the rural areas, where most of the poor live as subsistence farmers with highly volatile incomes, have failed to benefit directly from favorable external developments and were largely left behind. For example, since 1993/94, average household expenditure in rural areas declined from 33 percent of household expenditure in Phnom Penh to 28 percent in 1999, and is estimated to have declined further to about 25 percent in 2002.

The impact of Cambodia's growth on poverty is reviewed using growth incidence curves developed by Ravallion and Chen (2003). Growth incidence curves plot the cumulative share of the population by daily expenditure per person against the growth rate in that expenditure of each population percentile between two periods. The growth incidence curves reveal that between 1994 and 1999, economic growth in urban areas has been pro-poor, that is, the poor have benefited. By contrast, growth in the rural areas was significantly anti-poor. Most troubling, households in the poorest 20 percentiles of the rural population experienced the largest widening income gap.

The anti-poor growth is not surprising because the sources of recent growth were based on garment exports, tourism, and aid inflows that benefited only a limited segment of the population. As a small open economy with ample unused arable land and a large unskilled labor force, Cambodia's comparative advantage is widely recognized to be agriculture. However, slow growth in this sector—partly due to poor supporting infrastructure, but also because of limited access to land due to hoarding—has pushed Cambodia further away from its stated objective of meeting the Millennium Development Goals. Moreover, slow growth in agriculture reduces the capacity to absorb growing entrants to the labor market. Recent experience clearly argues for greater policy focus on agricultural development, a reorientation of policy that will succeed only if also supported by donors.

Chapter 3 explores the determinants of long-term sustainable growth more generally, based on an analysis of cross-country panel data. A few stylized facts from the data show that Cambodia's initial conditions—with respect to life expectancy and GDP per capita—in the 1970s were among the weakest and have been very slow to improve. Physical and human capital formation has been anemic, negatively affecting growth.

Results from a standard growth model estimated using five-year averages from 1970 for 144 low- and middle-income countries indicate that higher real per capita growth is associated with lower initial income levels, better macroeconomic performance, faster human and physical capital accumulation, smaller government, and stronger institutions and governance. These results imply that higher long-term growth in Cambodia could be achieved by better education, more rapid physical capital formation, and improved governance. This is a formidable policy challenge in an economy suffering from weak public administration and lacking financial resources.

C. Policy Challenges

Uncertainties in the short- and medium-term outlook are intensified by the scheduled elimination of the garment quota system under the Agreement on Textiles and Clothing in January 2005. As discussed in Chapter 4, there are a number of factors suggesting that the effects of the quota elimination on Cambodia and other low-income Asian countries are likely to be severe. Garment manufacturers have rapidly moved production to countries with preferential access to U.S. markets. With the removal of these preferences, production is likely to move to countries where labor costs are relatively low. The impact of a reduction in garment production will be significant because the share of garments in total exports is large: more than 75 percent in Cambodia and Bangladesh, and about 55 percent in Nepal and Sri Lanka, in 2002. Moreover, when approximately 15 percent of restrictive quotas were eliminated in 2002 at the time of "third-phase quota integration," most countries lost substantial market share to China.

Assuming that the impact of the 2005 quota elimination is proportionally similar to what occurred in 2002, the value of Cambodia's garment exports could decline by as much as 12 percent in 2005, potentially reducing GDP growth to 2 percent. Not all of the impact may be realized in 2005 as U.S. buyers may not want to pay the search cost to find new suppliers when there is still the possibility of the U.S. government using the WTO Agreement on Safeguards to impose new quotas on China. Equally, many of the garment factories in Cambodia are owned by Chinese who may continue exporting from their Cambodia-based factories in order to hedge against possible safeguard action by the United States on their China-based factories, as appeared to be the case in early 2005.

Cambodia urgently needs to diversify the sources of growth, for which it will have to rely substantially on foreign financial assistance. As elaborated in Chapter 5, foreign aid flows have averaged 12 percent of GDP a year, reaching $500 million in 2003, and this amount is expected to remain broadly unchanged in the medium term. About 70 percent of aid flows were in the form of official grants, making Cambodia one of the largest recipients of foreign aid (as a percent of GDP) among Asian countries. Reflecting the country's recent history, aid flows were provided initially as food aid and emergency relief, then as investment projects, and increasingly as technical assistance. By 2003, technical assistance accounted for about 40–50 percent of total foreign aid. However, compensation payments to foreign advisors accounted for the bulk of technical assistance, raising questions about the appropriateness of aid allocation in a country with vast investment needs in basic infrastructure.

The policy challenge is to create an environment that will attract foreign direct investment. Foreign investment inflows peaked at 9 percent of GDP during the mid-1990s, but have fallen below 5 percent of GDP since 2000. The decline in foreign direct investment reflects limited economic opportunities after the initial boom in investment to meet pent-up demand for tourism and to export—often illegally—Cambodia's rich forestry resources. However, the needed diversification of the economy, especially following the quota elimination, will require stronger interest by foreign investors than seen in the past few years. Accordingly, serious and worsening governance problems will need to be addressed forcefully if Cambodia is to make headway toward strengthening longer-term growth.

To expand the role of the government and improve its effectiveness, the revenue envelope will have to be expanded. Despite recent achievements, fiscal revenue is hardly enough to meet basic priority spending needs and pay adequate civil service salaries. Although strengthened tax and customs administration helped raise revenue from 8 percent of GDP in 1998 to 11¼ percent in 2002, total revenue remains low compared with an average of 16 percent of GDP in neighboring low-income countries, as discussed in Chapter 6. Consequently, government spending is compressed, civil service wages remain well below private sector wages, and roads and other public facilities are poorly maintained. Moreover, the budgetary process is opaque and inefficient, calling for urgent reforms in public financial management.

Cambodia's public finances have evolved substantially during the past 10 years. In 1992, major reforms were initiated with the help of foreign experts in the areas of tax policy and tax and customs administration. A second wave of reforms were introduced during 1995–96 that included income taxation, a 20 percent excise on gasoline, and raising the turnover tax rate. Despite these efforts, tax revenue stagnated at about 6 percent of GDP, since the impact of new tax policy measures was broadly offset by a deterioration in revenue administration. It was only with the introduction of the 10 percent value-added tax (VAT) in 1999 that revenue clearly improved from 8 percent of GDP to 10 percent of GDP.

During 2001–02, improvements in tax and customs administration, notably assisted by the Technical Cooperation Action Program, contributed for the first time in a decade to an increase in revenue to above 11 percent of GDP. Efforts focused on ensuring a more effective use of preshipment inspection services and increased transparency to reduce hidden costs in customs procedures. Moreover, anti-smuggling operations were strengthened through interagency cooperation and the establishment of anti-smuggling units. Greater information sharing among government agencies, better tax auditing, and strengthened administrative capacity resulted in better tax collection and a decline in tax arrears. Unfortunately, during the 2003 political impasse, government revenue slipped back to 10½ percent of GDP. Continued revenue collection at this low level will severely limit the government's capacity to invest in education and infrastructure. Hence, improving fiscal revenue performance remains one of the key challenges.

Another challenge is to improve competitiveness. A depreciation of the exchange rate, however, is likely to have only a limited impact on competitiveness because most costs, including wages, are denominated in U.S. dollars. Given that most of the poor live in rural areas where incomes, especially of those who do not own land, are denominated in local currency, a depreciation could further reduce their purchasing power through higher inflation of prices denominated in local currency. Chapter 7 reviews exchange rate policy options that could minimize adverse impacts on the poor from an exogenous shock such as the elimination of the quota system.

The exchange rate reflects changes in demand for riel by a small fraction of the urban population who hold riel cash balances for transactions purposes and to pay taxes, and by the government. Although most of the poor in rural areas hold riel cash balances, they appear not to be able to participate in the foreign exchange market due to limited information and lack of access to the foreign exchange market. In such a shallow market, a small imbalance of supply and demand can have a large impact on the exchange rate. An increase in currency risk stemming from an increase in exchange rate volatility will prompt those holding riel to convert them into U.S. dollars, as foreign exchange market participants are mainly concerned with retaining the value of their wealth in U.S. dollar terms.

A vector auto regression model was used to estimate the extent of pass-through from exchange rate depreciation to domestic inflation, using monthly data from January 1996 through December 2003. Tests show that both exchange rate depreciation and partner inflation Granger-cause domestic inflation. The pass-through from exchange rate depreciation to domestic prices is 18 percent on impact, and around 41 percent by the end of the first year. On the basis of these findings, possible responses to a variety of shocks are considered. While exchange rate flexibility should be maintained in order to absorb fundamental changes in the real equilibrium exchange rate, careful consideration needs to be given to the redistributive effects of exchange rate changes.

Over the long run, Cambodia would benefit from de-dollarization since, in addition to loss of seigniorage, the lack of monetary policy independence and the central bank's inability to act as a lender of last resort could eventually threaten financial stability. However, de-dollarization is expected to be a gradual process, and any forceful administrative measures should be avoided. Chapter 8 discusses international experiences of de-dollarization, including options for Cambodia.

A recent IMF study covering 117 countries found that financial dollarization as measured by foreign currency deposits in broad money doubled in the last decade. However, some of the low-income countries in Asia that were able to avoid or contain dollarization shared common characteristics such as low inflation and macroeconomic stability. Moreover, the few countries—Poland and Israel—that managed to de-dollarize their economy had embarked successfully on a disinflation program initially building around a strong exchange rate anchor. It is not certain, however, whether the conditions in these two countries can be replicated by other countries, especially since the initial level of dollarization was not high in the first place.

Many countries, however, failed in attempts to de-dollarize their economies. Often, these attempts involved administrative controls without fully restoring confidence in the local currency. These experiences indicate that restoring confidence in the local currency in Cambodia, a process that will require political and macroeconomic stability for a sustained period, is a prerequisite to de-dollarization. They also suggest that recourse to administrative controls might undermine efforts to reestablish confidence in the local currency.

The new government's Rectangular Strategy reform agenda rightly identifies good governance as the key cross-cutting objective. Good governance, however, cannot take root under a weak judiciary. Chapter 9 examines the status of legal and judicial reform, and what measures can be implemented in the short run to strengthen the judiciary. Although legal and judicial reform has been on the government's agenda for the past 10 years, work has accelerated only recently. Key legislation to strengthen the judicial system, including laws on the status of judges and prosecutors, the organization and functioning of courts, the civil and criminal codes, and the status of clerks, has not yet been adopted. The legal framework will substantially improve once laws related to WTO accession, described in Chapter 10, are adopted. The government is committed to adopting 46 pieces of legislation, of which 14 pieces had been adopted by end-2004. The remaining laws, originally envisaged to be adopted during 2004–06 will now most likely be adopted during 2005–07. These laws are aimed at providing a fair and predictable business environment. However, only the successful implementation of these laws can provide the necessary improvement in the rule of law, which in turn will require an independent judiciary backed by strong political commitment.

Unfortunately, progress was slower in judicial reform. In 2003, the government approved a comprehensive Strategy for Legal and Judicial Reform and circulated an action plan for its implementation. In 2004, these draft action plans were refined into a list of short- and medium-term priorities. Among the short-term priorities are restructuring of the Supreme Council of Magistracy, adoption of the law on the organization and functioning of courts, and enactment of the anti-corruption law. Apart from these, there has been little progress in judicial reform. Unless progress is made on this front, Cambodia's future remains uncertain as investors will continue to stay away.

D. Conclusion

Reconstruction efforts of the past two decades were hampered by the deep scar left behind by the Khmer Rouge and the civil unrest that followed. Ground was slowly gained with the help of sizable foreign aid, in rebuilding human capital, physical infrastructure, and institutions. Yet, considerable efforts are still needed on all these fronts before Cambodia can fully compete with neighboring countries in global markets. Foremost, Cambodia has yet to establish a predictable private sector environment governed by the rule of law, which in turn has to rest on an independent and capable judicial system. Unfortunately, this has been an area where progress has been slowest. Hence, it is not a surprise to find that foreign investment in the nongarment sector has been negligible.

With the elimination of the quota system, development of other sources of growth has become more urgent. Tourism is the only identified source of growth in the foreseeable future. However, tourism by itself cannot provide jobs for the growing population or reduce widespread poverty. To do this will require agricultural development of the large areas of uncultivated land in the rural areas where most of the poor live. Cambodia needs a clear strategy on land use that will spur agricultural development, determined efforts to establish the rule of law and improve economic governance, and a stronger revenue base to finance investment in human capital and infrastructure. These will be key to encouraging foreign investment and economic diversification. In the absence of a strong political commitment to push the reform agenda forward, Cambodia's economic prospects are at best uncertain.