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Reducing Vulnerability in Transition Economies: Crises and Adjustment in Cambodia

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Reducing Vulnerability in Transition Economies: Crises and Adjustment in Cambodia[•]

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Abstract: This paper examines the impact of the global financial crisis on Cambodia, and the lessons learned. Cambodia is an interesting case study: after extremely rapid economic growth 2000-07, it experienced a sharp growth collapse in 2008-09. This highlighted a number of its peculiar vulnerabilities, including a narrow economic base, a pre-crisis asset price boom, a fragile financial system, and the limited array of defensive economic policy levers available to the government. The economy has begun to rebound since early 2010, and the crisis episode provides the government with an opportunity to place the country's economic growth trajectory on a more sustainable footing. Apart from diversifying the economy and creating the preconditions for dedollarization, we also consider policies that could improve the business climate and make growth more inclusive.

Key words: Cambodia, transition economies, economic crises.
JEL codes: O53, P20

[•] We are most grateful to Anna Cassandra Melendez for her able research assistance. The views expressed in this paper are those of the authors and do not necessarily reflect the views and policies of the Asian Development Bank, or its Board of Governors or the governments they represent.

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(1) Introduction

Cambodia's development trajectory and challenges are unusual by any standard. In the second half of the 1970s, the country suffered war, conflict and genocide under the Khmer Rouge regime of the 'Democratic Kampuchea' on a scale unparalleled in recent human history. It was effectively shut off from the rest of the world over this period, and its modern sector economy ceased to function. The restoration of civil order in the 1980s led to a gradual economic revival, but the country remained outside the international mainstream until the Paris Peace Agreement was signed in October 1991. The United Nations Transition Authority in Cambodia (UNTAC) was established in 1992 to oversee elections under the new constitution in 1993. No party obtained a majority in that election, and so a formal power-sharing arrangement was instigated, with two co-prime ministers, one of whom, Hun Sen, has been prime minister continuously since 1985. Economic growth then resumed, until the serious conflict of July 1997 again interrupted the process of recovery. With the cessation of hostilities and a second national election in 1998, the economy enjoyed almost a decade of rapid economic growth, the longest such period in its recorded history. This too came to a halt, in this case owing to the external shock of the global financial crisis (GFC), and the economy experienced a sharp but relatively brief economic slowdown. From an annual average growth of over 10% 2004-07, the economy stagnated in 2009. By early 2010, however, it had weathered the shock and growth commenced again.[1]

This paper examines three interrelated aspects of Cambodian economic development since the 1990s. First, section 2 provides a brief analytical narrative of its development dynamics since the restoration of peace and stability in the late 1990s, when for the first time rudimentary but reasonably reliable national accounts estimates became available. Section 3 examines the impact of the GFC of 2008-09 on the basis of several prior hypotheses about the likely impacts and policy responses. Looking forward, section 4 summarizes some of the country's key development challenges in the post-crisis recovery period, with a view to minimizing vulnerability to future shocks. A final section concludes.

Several themes emerge from this analysis. One is that the country's openness has both propelled its rapid economic growth since the late 1990s, but also rendered it vulnerable to crises, and boom-and-bust growth. The second is the challenge of translating the very large resource inflows in the form of overseas development assistance (ODA), foreign direct investment (FDI), remittances and natural resource exploitation into broad-based development, especially physical infrastructure, education and health services in the rural areas. The third is developing the institutions that underpin a well-functioning modern economy. Given the economy's very small size, and its proximity to

[1] The most comprehensive economic analysis from a Cambodian perspective is provided by Naron (2011). Most of the other major economic analysis has been undertaken by the international financial institutions (IFIs), as referred to throughout the paper.

much larger economies to its east, west and north, its economic policy space is inevitably restricted, for example in macroeconomic and trade policy. But its key institutions lag the country's rapid economic development. Its bureaucracy is bloated and inefficient. Corruption is pervasive. Property rights are insecure, and the judiciary lacks credibility. As a result, growth is highly skewed towards Phnom Penh and the politically connected class, while inequality is rising.

(2) Longer Term Development Dynamics

There are nine broad features of the Cambodian development record since the 1990s that warrant attention.

The first is high growth. The economy grew very rapidly over the period 1999-2007, at about 9% per annum, the fastest among Asia's low-income economies and one of the fastest in the world, albeit from a very low base (Figure 1).[2] Growth was generally also higher than its three Mekong neighbours, although noticeably Cambodia was more severely affected by the 2008-09 GFC. Income per capita more than doubled from 1998 to 2007, driven by the generally peaceful environment, an open economy, reasonably stable macroeconomic management, the dynamic economic neighbourhood, and continuing large capital inflows, both public and private. The government has announced its objective of a further doubling of per capita incomes by 2020.

The second feature is a narrow set of economic drivers, particularly for the non-agricultural sector. By sector, this economic growth had four principal drivers: garments, tourism, construction and agriculture. In 2008, over 40% of non-agricultural GDP originated in just three of these sectors – garments, tourism and related services, and construction.

The third feature, as a corollary, is volatile growth. Excluding Thailand, Cambodia has experienced more variability in its growth rate than its three bordering neighbours (Figure 1). This is mainly a reflection of the relatively narrow economic base, a highly open economy, and occasional political uncertainty.

Fourth, structural change has been rapid, driven by this growth, and the country's economic structure is unusual, especially the large services sector for a country with a very low per capita GDP (Figure 2). From 1990, when the first set of post-conflict national accounts was prepared, to 2009, the share of agriculture in GDP declined from 50% to 35%. The share of industry increased, from 15% to 22%, as did the share of services, from about 35% to 42%. Garments alone accounts for 70% of manufacturing GDP, the highest share in the developing world.

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[2] For example, over the period 1998-2007, Cambodia was the sixth fastest growing economy in the world (Guimbert, 2010).

Fifth, the government has very few of the conventional macroeconomic policy tools at its disposal. The economy is highly dollarized, and so the ability to conduct a discretionary counter-cyclical monetary policy or exchange rate adjustment are not available as instruments (Figures 3 and 4). Figure 4 draws attention to the perhaps puzzling phenomenon that dollarization has actually increased for most of the period since 1998, an issue to which we return in the final section. The scope for fiscal adjustment is also very limited, owing to the weak domestic revenue effort and heavy dependence on ODA. Moreover, the government's capacity to regulate the economy through the financial sector and other interventions is constrained owing to limited institutional capabilities. Thus, the authorities have struggled to manage the impacts of economic shocks, such as the GFC, as well as rapidly increasing food prices in 2007 and again currently.

Sixth, the economy is very open, as indicated by very high merchandise trade flows and stock of realized FDI, both relative to GDP. The country's labour market is also very open. Moreover, like the economy in general, merchandise exports are narrowly based, with garments accounting for roughly 70% of the total between 2000-2008 (Figures 6 and 7). The garments industry, which is almost 100% foreign-owned, is well organized and internationally attuned through its industry association, the Garment Manufacturer's Association of Cambodia, GMAC.

Cambodia's open economic policies are underpinned by accession to the World Trade Organization in 2004 (becoming the first least developed country to join), its membership of ASEAN commencing in 1998, and various bilateral free trade agreements (FTAs). Among the latter is the US-Cambodia trade agreement of 1999, that initially provided preferential access to the US market for garments, and a host of other ASEAN+1 agreements currently being negotiated or implemented (see Menon and Melendez 2011).

A seventh feature is that Cambodia's macroeconomic balances are unusual. Savings are very low, approximately 18% of GDP in 2009, but rising quite fast from negligible levels a decade earlier. Investment levels have also risen quickly, though at about 21% of GDP in 2009, they are still low by regional standards. The savings-investment gap, and hence the current account deficit, is unusually large, in some years as high as 8% of GDP. However, it is mostly funded by long-term capital flows, principally ODA and FDI, and therefore does not threaten macroeconomic management (Figures 9-11).[3]

Living standards have been improving quite rapidly, although not as fast as economic growth, owing to the fact that household and rural-urban inequality has been rising. The Gini coefficient has been rising sharply (Table 1), and the richest 20 percent of the population outspend the poorest 20 percent by about eight times, one of the highest such ratios in Asia. The incidence of poverty is estimated to have fallen from 45-50% in 1993-94 to 30% in 2007,

[3] Senior officials employ the following magnitudes in thinking about the economy: GDP of $10 billion, ODA of approximately $1 billion, and FDI (in 'normal' years) of $500-800 million.

based on the national poverty line. Preliminary estimates from the Commune Database suggest that poverty incidence may have fallen to 25.8% in 2010 (Government of Cambodia 2011). This database also highlights the growing rural-urban divide, with the Plateau/Mountain and Tonlé Sap zones having the highest poverty headcounts at 36.6% and 30.8%, respectively, while the central plains area recording a much lower rate of 21.3%. Many other social indicators have also improved quite substantially.

Nevertheless, Cambodia's progress towards meeting its 2015 Millennium Development Goals (MDG) has been mixed. Areas in which relatively good progress has been made include education (MDG2), HIV/AIDS control (MDG6) and de-mining (MDG9). Advances have also been made in reducing extreme poverty (MDG1), although child malnutrition remains a serious concern. Child mortality (MDG4) and maternal mortality (MDG5) rates continue to be unacceptably high. Rising levels of youth violence and violence against women (MDG3) require urgent attention. Cambodia ranked 97 out of 134 in the World Economic Forum’s Global Gender Gap Report.

(3) The Global Financial Crisis: Adjustment and Recovery

We focus in this section on the effects of the 2008-09 GFC on Cambodia’s economy. The 1997-98 Asian financial crisis is not considered as the country’s economic statistics were then very limited and in any case the country’s political crisis weighed more heavily on the economy.

A priori, how might the GFC have been expected to affect a country such as Cambodia? On the negative side, first, the country’s openness to trade and investment would be expected to lead to a sharp growth slowdown. The country is highly trade dependent, as noted with exports plus imports equivalent to about 122% of GDP. Moreover, the narrow base of its openness, and the export composition, would exacerbate the negative impacts. The major merchandise export is garments to OECD economies, particularly the US, the consumption of which is discretionary and is therefore typically deferred in times of recession. The major service export is tourism from the OECD, with Korea the main source country, although cross-border regional flows have been on the increase. Again, as discretionary expenditure, these flows are likely to experience a major downturn during a recession. Cambodia is more heavily reliant on the US, where the GFC started, than any of its neighbours. The country’s other major trading partners include the open economies of Southeast Asia, Malaysia, Singapore and Thailand, which were also the most affected by the global slowdown.

A second likely negative factor is the country’s limited capacity for defensive macroeconomic adjustment. Given the high level of dollarization, the government has limited discretionary control over monetary policy and, by implication, exchange rate policy. Therefore, it is unable to employ these policy levers as effective tools to cushion adverse external shocks. (We return to this issue in the next section.) The fiscal policy framework also remains rudimentary, and the government has very limited capacity to conduct expansionary fiscal policy, either with respect to government reserves or administrative implementation capacity.

Third, there were very large resource inflows in the years leading up to the crisis, resulting in rapidly rising asset prices, particularly for urban real estate. The banking sector, which was heavily exposed to this sector, is of very recent origins and supervision is still rudimentary. It was therefore likely to be exposed to any sudden decline in asset prices, especially if compounded by low levels of depositor confidence and therefore bank runs.

There are however some strengths which would be expected to protect the economy from a negative external shock. One is that the economy is still heavily agrarian, with agriculture value added accounting for 35% of GDP in 2009 and employing over half the workforce. The shares for the rural economy would be higher still, and as a food surplus economy, in an era of buoyant commodity prices, rural resilience could be expected to insulate much of the population from the global economic downturn.

A second strength is that capital inflows would be expected to remain fairly stable, owing to their composition. The major flows, ODA and FDI (see Figure 11), are long-term in nature and therefore less volatile than other capital flows. Remittances are also growing quite quickly, and they generally hold up in periods of adversity.[4] Moreover, Cambodia's financial sector has very little connection to global financial markets: there is no stock market (although one is planned to open shortly), there are few financial instruments which act as depositories for such inflows, and Cambodia's banks are little connected to global financial markets.

There are some additional positive factors. One is labour market flexibility which, in the absence of exchange rate flexibility, has to accommodate the necessary change in relative prices to accommodate the negative external shock. Rural resilience can also absorb the workers displaced in the modern sector, such as tourism and garments, when skill levels are broadly compatible. There is also the rapidly growing importance of China as a source of trade, investment and development assistance, and whose economy remained buoyant in 2008-09.

[4] Two points with regard to remittances to Cambodia are worth noting in this context. First, the formal statistics understate the true amount considerably, with estimates suggesting that unregistered remittances can comprise as much as 50 percent of recorded remittances. Second, most of the registered remittances to Cambodia are still due to the Cambodian diaspora and only a small share is due to Cambodian migrant workers in foreign countries, although this is slowly changing with increasing out migration (ILO 2008). This feature may also increase the resilience of these flows to global slowdowns since migrant workers, especially those who are unregistered and working in the informal sector, are usually among the first to be retrenched in the event of a crisis.

With these considerations in mind, we now investigate the effects of the 2008-09 crisis.[5] Cambodia's peak to trough growth collapse during the GFC, that is comparing the average growth rate of 2000-07 with that of 2009, was almost 10%. This was among the largest in emerging Asia, exposing the economy's vulnerabilities, and reversing the decade of improved living standards. Indeed, it was one of the sharpest growth collapses in the developing world during the GFC,[6] also raising questions about the economy's resilience and underlying fragility.

The government's major macroeconomic policy weapon was fiscal policy. Although it lacks the capacity to undertake fine-tuned fiscal expansion, there was a net injection from the public sector, with the fiscal deficit surplus of about 1% of GDP prior to the crisis turning into a deficit of about 3% in 2009 (Figure 10).[7] This arose through a combination of increased expenditure and falling revenue. It was funded mainly through recourse to ODA, but in addition there was domestic financing, of about 2% of GDP, which had not been deployed since the early 2000s.

To the extent that the increased deficit was monetized, as the government drew down on its deposits with the National Bank of Cambodia (NBC), the stimulus resulted in an increase in the money supply. Thus in 2009, broad money (M2) expanded by about 37% compared to the increase in the previous year of 5% (Figures 5 and 12).

In January 2009, the NBC lowered the reserve requirement for commercial banks from 16 to 12 percent, and relaxed overdraft facilities. These measures served to ease the liquidity position of the smaller and more fragile banks, although the larger ones were not much affected. Changes to the reserve requirement ratio are a relatively blunt instrument at the best of times;

[5] Note that in spite of the improved statistical data base, Cambodia's key statistical indicators are still rather limited. The national accounts data are revised for over a year after initial release (eg, the 2009 estimates were still subject to revision in through 2011), there is an absence of quick release indicators on the real economy, quarterly data are very limited, a comprehensive economic census has yet to be undertaken, and regional (sub-national) data are practically non-existent.

[6] Among the 64 low-income countries surveyed by the IMF (2010), the average growth decline between 2007 and 2009 was 2.8 percentage points (from 6% to 3.2%). Cambodia experienced the second largest growth collapse, behind only Georgia. Notably, another Asian economy very dependent on tourism – the Maldives – also experienced a very sharp growth decline.

[7] The fiscal policy picture in 2008 was complicated by the fact that, being an election year, there was a significant increase in government expenditure. In the post-election period, the government quickly adopted contractionary policies to cool the economy, which was also over-heating in the first half of the year owing to record private capital inflows and high food prices. However, this contractionary stance had to be quickly reversed as the GFC hit in September 2008.

dollarization coupled with a weak financial system merely exacerbates the problem by further reducing its effectiveness.

Cambodia's external debt (relative to GDP) and its debt service ratios have been relatively stable throughout the period, and continue to be manageable. Low debt service also reflects the highly concessional nature of most of the country's external borrowings. Despite modest increases over 2007-2010, reversing an earlier trend of continuous decline, it is projected to start falling again in 2011 (Figure 13). Since 2008, debt levels have also fallen below that of Vietnam's. China accounted for more than half of total bilateral loan disbursements in 2010.

Economic recovery began to take hold quite quickly in 2010, with FDI rebounding by the first quarter of 2010 (Figure 14). Construction however is recovering more slowly, reflecting the over-build prior to the GFC and financial sector caution.

Inflation increased quite sharply, from -0.7% in 2009 to about 4% in 2010, From Figure 5, we can see that inflation tends to respond mainly to large changes in the money supply, with a lag. This is also born out in the quarterly data presented in Figure 12. Since other factors affecting inflation such as food and fuel prices were also rising during the monetary expansion, it is difficult to isolate their respective contributions to the overall price change. It does appear however that higher food prices rather than the looser monetary policy had the bigger impact on inflation, given the importance of food in the consumption basket and the incomplete level of monetization of the economy.

(4) Increasing Resilience to Future Shocks: Remaining Challenges

As economic growth is restored, some of the key economic policy challenges that had not been resolved during the decade of high growth need to be addressed. We highlight three in particular: currency and exchange rate arrangements, an improved business climate and infrastructure provision, and the importance of a more equitable development strategy with emphasis on rural areas where most of the poor reside.

(a) Currency and exchange rate arrangements:

Cambodia has effectively adopted a pragmatic 'muddle-through' approach to the choice of currency and by extension its exchange rate policy. As a small open economy, with a history of political instability and very little trust in public institutions, the country can hardly aspire to monetary policy independence in the near term. With this approach, there is an implicit recognition of the fact that dollarization is symptomatic of underlying weaknesses, and therefore there is a need to address these factors directly. The causes of dollarization emanate from many of the challenges that Cambodia faces as a transitional economy, including an underdeveloped financial and monetary system, perceptions of political and economic uncertainty, and weak legal and institutional structures, among others (Menon 2008, Duma 2011).

Although political uncertainty has been significantly reduced, especially after the highly unstable power-sharing coalition government came to an end following the 2008 election, concerns relating to governance more generally still remain, especially widespread corruption and the culture of patronage. Economic conditions have also improved but uncertainty in the form of vulnerability to shocks, as discussed earlier, is still a serious constraint limiting confidence. Legal and institutional structures have also been improving, although a lot more needs to be done, especially in the implementation of laws.

Perhaps the greater constraint to overcoming dollarization relates to the level of development of financial and monetary systems. Cambodia continues to struggle with the challenge of developing a viable banking system with emphasis on a solid legal and supervisory framework. Unlike many other transition economies, Cambodia faces a situation of rebuilding rather than transforming its banking system. This is confirmed by surveys that attribute the insufficient lending to the weak credit risk assessment capacity of commercial banks, the limited and often unreliable borrower information, and the absence of financial contract enforceability (Economic Institute of Cambodia, 2005). These are clearly long term constraints, many of which are endogenous in the sense that they depend on progress in other areas, such as the governance and legal systems, human resource capacity, and overcoming all forms of market failure in the assessment of risk.

On the positive side, the fact that the economy is heavily dollarized, and is likely to remain so for some time yet, will most likely work to the country's competitive advantage in the medium-term, given that the US dollar is likely to remain a weak currency. Competitiveness of the traded goods sector has been facilitated by the trend depreciation of the US dollar (Figure 3), even if nominal wages are sticky downwards since they are close to subsistence levels. Since the US dollar is Cambodia's de facto currency, both domestic costs and international receipts are largely determined in US dollars, unlike in most of its competitors where it is only international receipts that are denominated in US dollars. For the latter, domestic costs measured in US dollars will rise, while domestic costs in Cambodia remain unchanged, thus improving its relative competitiveness. Dollarization has also imposed discipline on the monetary authority, and assisted in keeping inflation in check. The current exchange rate and macroeconomic instability experienced by neighbouring Vietnam (see Leung, 2010) serves to remind us not only of the benefits of dollarization, but also the costs of de-dollarizing too quickly.

<u>(b) Improving competitiveness and the business climate</u>:

The fact that the Cambodian reforms have often been sector-specific has created an unhealthy dualistic economic structure. For example, the garments industry has been a great success, but it is somewhat enclave in nature, boosted initially by preferential access to the US market and very generous fiscal provisions. Few other labour-intensive manufactures have prospered, such as handicrafts, the latter in spite of the tourism boom.

Nevertheless, the garments industry has managed the post-MFA transition well. The country now has an international reputation, a crucial pre-requisite for further growth. Chinese firms are now relocating there, with the early beginnings of a few Vietnamese firms also evident.[8] Some ancillary activities are emerging, such as embroidery, buttons, zips and hangers. In footwear there are also some promising developments. The industry now employs about 50,000 workers (compared to the approximately 300,000 in garments). It is a cost-driven industrial relocation without the special export market access provisions that kick-started garments.

Cambodia's logistics and utility costs are high by regional standards. Firms are forced to carry high inventory levels owing to complex border transaction regulations. There is also considerable red tape associated with both export and import. While the number of documents required to engage in either exporting or importing activities have been coming down in neighboring countries, the number of documents required in Cambodia has changed little. Approximately 11 documents required for either export or import, which is estimated to be the highest number in the region (Menon and Melendez 2011, Table 2). Electricity is also a serious problem. Firms generally install their own generating capacity. Only 24% of households have access to electricity, limiting the scope for household industry growth. Access is particularly limited outside Phnom Penh, reinforcing the capital city development bias.[9] Moreover, owing to the prevalence of small-scale diesel generator plants, electricity is expensive, about 20 cents/KWH, compared to Bangladesh (a garments competitor) of 7 cents.

More generally, institutional reform has progressed very slowly, resulting in a bloated bureaucracy and very high levels of corruption. The country has a complicated bureaucratic structure owing to past political compromises and power sharing arrangements, and also its high dependence on ODA. For example, it has nine deputy prime ministers and 16 'senior ministers'; most of the latter also have portfolio responsibilities. Each department has, in addition to the minister, several 'secretaries of state'. In the case of the Council of Ministers, there are 16 such secretaries. Most of the 25 departments have five to nine of these secretaries. This it needs to be remembered is for a $10 billion economy, in which there has already been substantial decentralization of resources and authority to sub-national tiers of government.

Civil service reform has been very slow, owing to inaction on the part of the government, and exacerbated by the very large aid presence. Official salaries are hopelessly uncompetitive. For example, a returning foreign masters graduate can expect to receive about $70/month, rising to about $500 for

[8] A factor that has encouraged the latter is that firms on the Vietnamese border are now part of the Common Customs Control Area of Ho Chi Minh City, and thus border checks are effectively by-passed.
[9] For example, over 80% of the garments industry is located in Phnom Penh, in spite of the capital's higher wage levels as compared to the countryside.

secretaries of state. The ambitious among these graduates can easily earn $1,500-2,000/month working for NGOs.[10]

These challenges have to be seen in the context of the tight political control exercised by the ruling Cambodian People's Party (CPP), which has been in continuous power since the ousting of the Khmer Rouge in 1979, apart from the power sharing interregnum of 1993-98 (Pak, 2010). The country's political economy is somewhat similar to Soeharto's Indonesia: heavily managed elections; the CPP's domination of the political processes, the legislature, the media, the bureaucracy and the judiciary; the personality cult of long-serving leader Hun Sen; the commitment to growth; and very high levels of corruption.

For what they are worth, various comparative surveys classify Cambodia as having one of the highest levels of corruption in the world. Firm-level surveys point to considerable regulatory uncertainty and high compliance costs. Cambodia currently ranks 145/183 on the World Bank's Doing Business survey, and 158/180 on Transparency International's Corruption Perception Index. Anecdotal evidence suggests that corruption among senior officials is egregious.[11] There are very large off-budget accounts, of unknown magnitude. Property rights are very weakly enforced, with widespread allegations of 'land grabbing'. This aspect illustrates how the poor tend to bear a disproportionately high share of the costs of corruption. The lack of trust in formal institutions is pervasive.[12] This corruption increases the costs of most business transactions.[13] In sum, not only does corruption negatively affect economic growth, investment activity, international trade and price stability, it can also bias government expenditure patterns.

Addressing corruption and overcoming its worst aspects will require a long-term commitment that focuses on a radical change in institutions and culture. As a USAID (2004) report lamented, 'large-scale corruption requires broad and diverse institutional support. The Royal Government of Cambodia has developed a full array of outside institutions – captive firms, controlled media, party-affiliated NGOs and unions – as well as the police, military, ministries, judiciary and parliament to support a corrupt system. Until these institutions

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[10] Ear (2009) for example notes the problem that 'talent is siphoned from the private and public sectors to work for donor agencies.' In passing, it is worth noting that Cambodia has an extraordinarily large number of (mainly foreign) NGOs for its population, reportedly the highest per capita in the world.

[11] Comprehensive information on the abuse of office is obviously difficult to obtain and verify. The most startling of the various NGO reports, by Global Witness (2009), a report widely accepted in influential Phnom Penh circles, alleges that one person owns 7% of the country's land.

[12] As is common in post-conflict societies, dual and foreign citizenship is widespread. It is reported for example that half the cabinet has a foreign passport.

[13] For example, garment exporters report that the 'facilitation payments' for a container from factory to port are about $1,000, compared to $500 in Vietnam. (Moreover, this refers to firms in an export zone, where no formal charges should be levied.)

are reformed, and these affiliations opened up, corruption will continue to constrain Cambodia's development.

The government has been responsive to business and community concerns when economic growth is threatened. The Government-Private Sector Forum has been useful, as have various sector specific initiatives. Some progress has been made. An Anti-Corruption Law is now being promulgated, although it is too early to judge the effectiveness of implementation.

(c) Promoting rural development and more equitable development:

While Cambodia's recent impressive growth performance has resulted in a significant decrease in poverty incidence, both income and non-income inequalities have continued to rise (Table 1). Income inequalities are reflected in sharp increases in the Gini coefficient over time, while non-income inequalities are evident in limited progress on realizing some MDGs, particularly health, sanitation and gender,

Apart from the rural-urban divide, rising economic inequalities also threaten the past economic achievements. A recent Word Bank (2011) report notes that " … large disparities, especially when perceived to be generated in ways lacking legitimacy, have the potential to weaken social cohesion and fuel social strife." Therefore, both the size of the measured inequalities[14] and the means by which they have come about matters. In both respects there are concerns about Cambodia. Apart from threatening social stability, rising inequalities can also dampen the pace of poverty reduction, as is already evident in China.

Both the pace and pattern of Cambodian economic growth needs to be more inclusive. Inclusiveness therefore refers not just to the importance of reducing poverty, but also various aspects of equity, equality of access and opportunity, and protection of the most vulnerable. Many of Cambodia's 'non-poor' are only marginally above the poverty line, and may slip below it for all manner of reasons. They also lack access to basic services such as education, health, clean drinking water and sanitation. Inclusiveness must include progress in the delivery of these essential services (Zhuang 2010; Ahluwalia 2011).

Recognizing these challenges, the government has drafted a national social protection strategy to be launched this year (Government of Cambodia 2011). Immediate priorities of this strategy involve the expansion of targeted programs such as free health care for the poor, and the pilot testing of programs including conditional cash transfers and generating employment opportunities through labour-intensive public works (ADB 2011). Although

[14] It is sometimes argued that inequality should not matter as long as the poor are getting better off, and that the poor may be willing to accept some increase in inequality is such circumstances. However, large increases in inequality in the context of relatively modest improvements in living standards of the poor and near poor are unlikely to be sustainable in the long run.

these programs will protect and improve livelihoods of the most vulnerable in the short run, a long-term strategy that targets improvements in governance and the quality of institutions is required to ensure that growth is inclusive in a sustained manner.

Both poverty and inequality have a regional dimension in Cambodia. Although detailed sub-national statistics are not available, there is a large and growing gap between urban and rural living standards. Therefore, any attempt to increase the inclusiveness of growth must target rural development. A major challenge concerns promoting rural dynamics, and a broad-based improvement in living standards. About 90% of the poor live in rural areas. This provides both the case for rural development promotion and also the proximate explanation for the absence of a sharp increase in poverty in times of economic slowdown.

The sharp rural/urban differences are indicated by the fact that agriculture now accounts for only one-quarter of GDP but it still employs about two-thirds of the workforce. In other words, agricultural incomes are about 38% of the national average, a not uncommon feature of highly dualistic developing economies. Indeed, this is what is sometimes referred to as the “Two Faces of Cambodia”. The contrast is stark. Unlike the urban sector, the rural sector is also one where dollarization is largely absent, assets price bubbles and real estate booms are a rarity, the GFC had little impact, and food price crises have little effect for subsistence farmers.[15]

There is considerable scope for raising rice yields, which are currently only about half those of Vietnam. With the majority of the rural population earning their living, in one way or the other, from rice, there are plans to increase both the production and milling of rice for export to 1 million tons by 2015, from the current levels of less than 15,000 tons. There are already signs that Cambodia’s rice producers are moving up from exporting raw paddy, mostly to Vietnamese and Thai middlemen, to exporting milled rice directly to Western and Eastern Europe, with Africa a future target (Trade SWAp, 2009). There is considerable potential for agricultural diversification into cash crops and horticulture, given the country’s relatively favourable labour-land ratios. Cambodia could scale up its exports of primary unprocessed products such as rubber, non-coniferous wood, tobacco, fish and seafood, and fruits and vegetables, and subsequently embark on value-added ventures such as processing and marketing. Developing this cluster of products is critical for rural development (World Bank, 2009b).

But there are major constraints. Rural infrastructure is still very underdeveloped. Energy costs are high, about double that in neighbouring countries. Trade continues to be curtailed by extensive informal trade barriers, mostly illegal levies on road transport. Rural credit markets are poorly developed, in part owing to uncertain land titling. It is estimated that only about 10% of the country’s rice farmers have secure land title. As long as

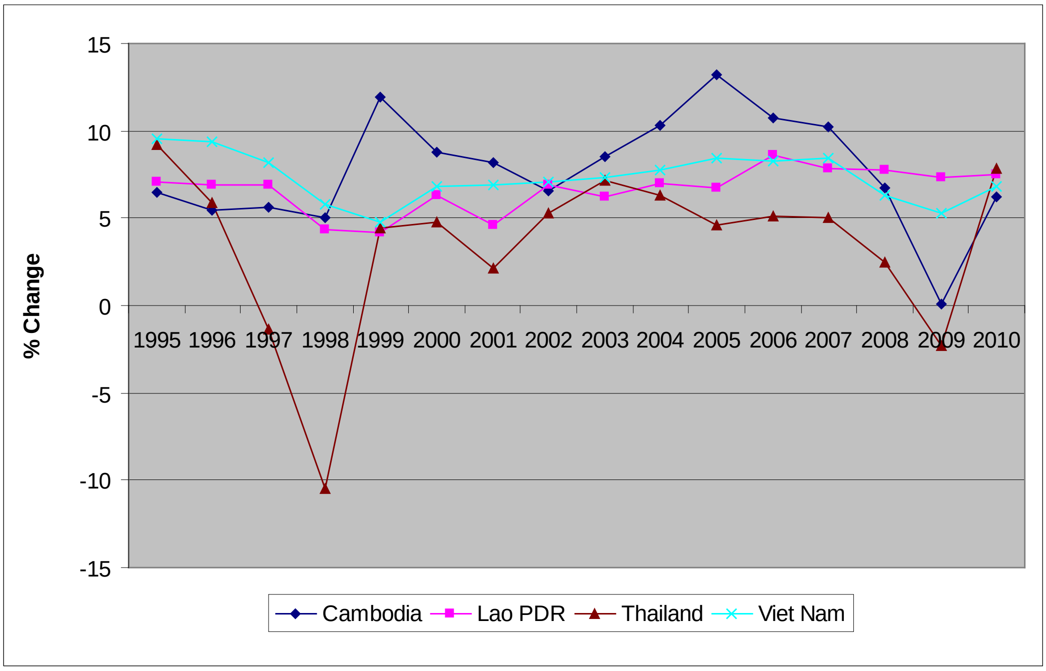
[15] Indeed, as a net food exporter, high food prices are in aggregate a positive for Cambodia, and farmers with a surplus to trade benefit at such times.

these constraints remain binding, Cambodia's economic potential will not be realized.

5. Concluding Remarks

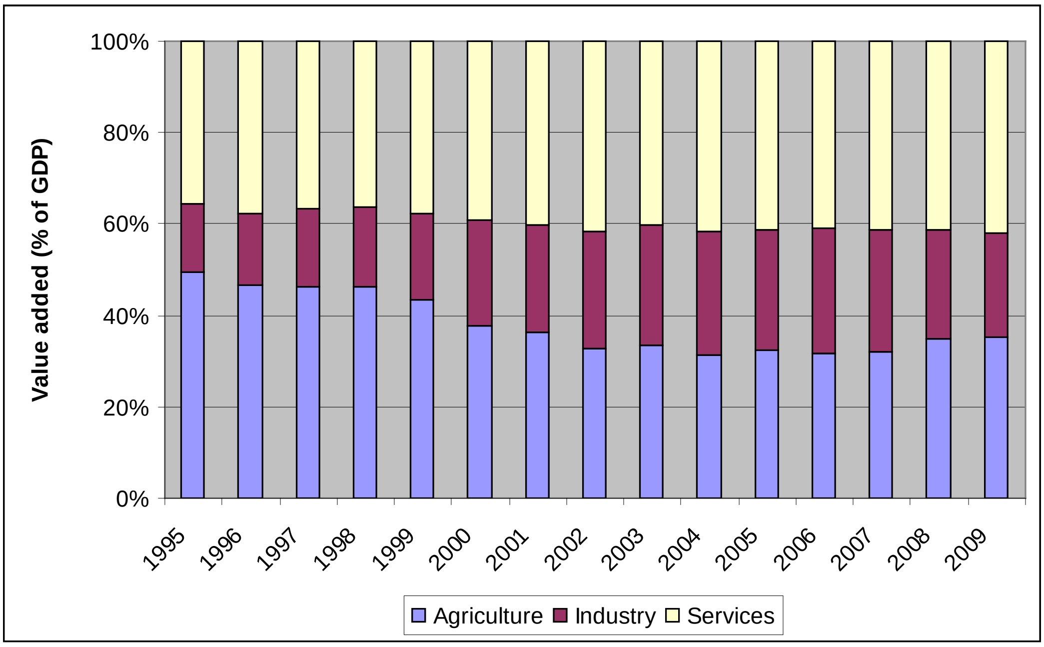
Cambodia has had its fair share of crises over the past two decades, some home-grown while others externally-induced. There will be more in the future, and this is unavoidable. What is possible, however, is to reduce the number of future crises by reducing underlying vulnerabilities and, when a crisis does occur, improve the ability to manage it and thereby limit its negative impacts. The experience with previous crises, especially the most recent GFC, suggests the need to address a number of policy challenges that remain. There is a need to diversify the economy, both in terms of commodity composition and export markets. Pervasive dollarization continues to impair the conduct of discretionary macroeconomic policy, and there is a need to press ahead with reforms that create the preconditions for a natural process of dedollarization. There is also an urgent need to improve the business climate and much of this involves the provision of soft and hard infrastructure, but also addressing widespread corruption. Finally, to ensure that growth is sustainable, it must be more inclusive so that all kinds of inequalities are reduced.

Figure 1: Economic Growth in Cambodia, Lao PDR, Thailand, and Viet Nam, 1995-2010 (%)



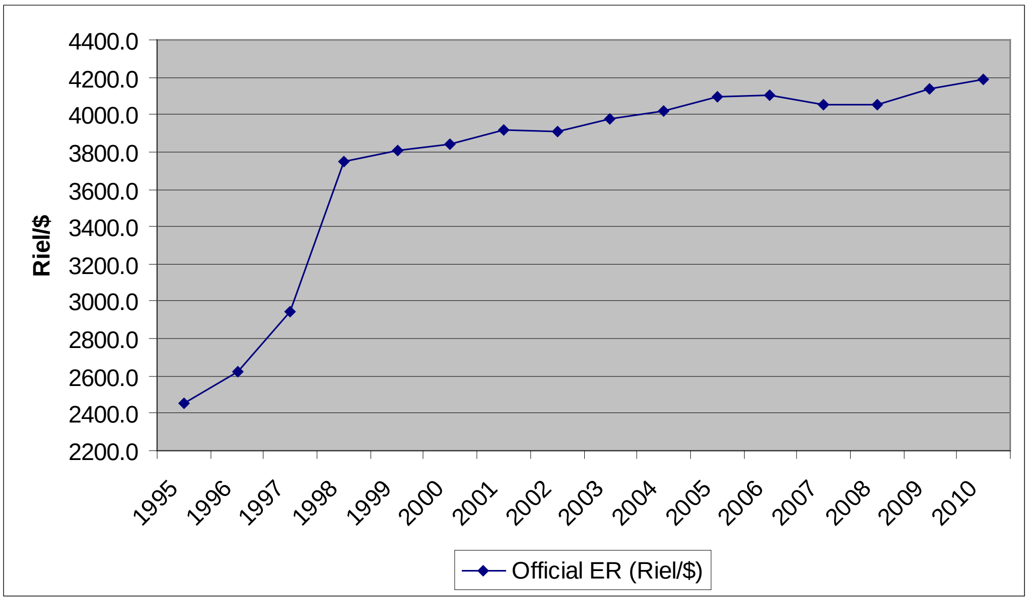
Sources: ADB Asian Development Outlook, 2011 and International Monetary Fund, World Economic Outlook Database, April 2011

Figure 2: The Changing Economic Structure, 1995-2009
(Agriculture, Industry and Service sector shares of GDP, current prices)



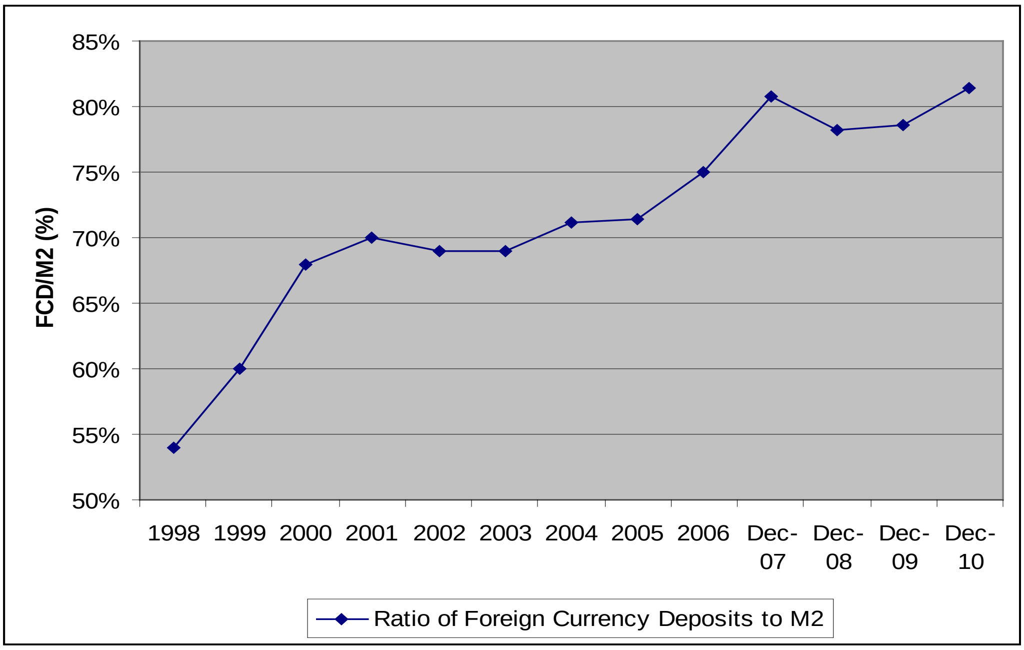
Note: Industry corresponds to ISIC divisions 10-45 and includes manufacturing (ISIC divisions 15-37). It comprises value added in mining, manufacturing, construction, electricity, water, and gas.
Source: World Bank World Development Indicators Online, April 2011

Figure 3: The Exchange Rate, 1995-2010
(Riel per US Dollar, annual averages)



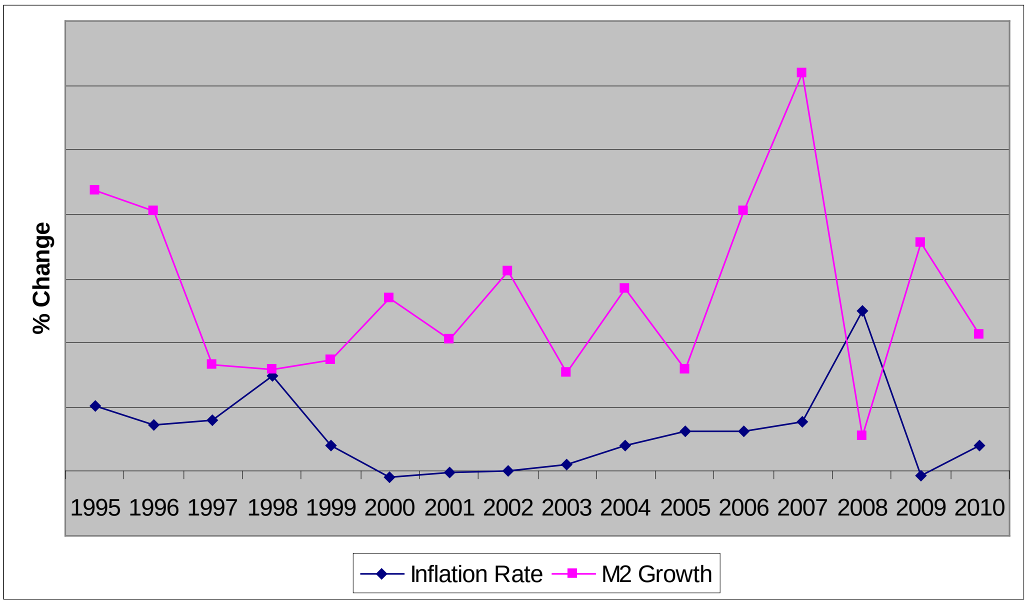
Source: IMF International Financial Statistics Online, May 2011

Figure 4: Dollarization, 1998-2010
(foreign currency deposits as a percentage of M2)



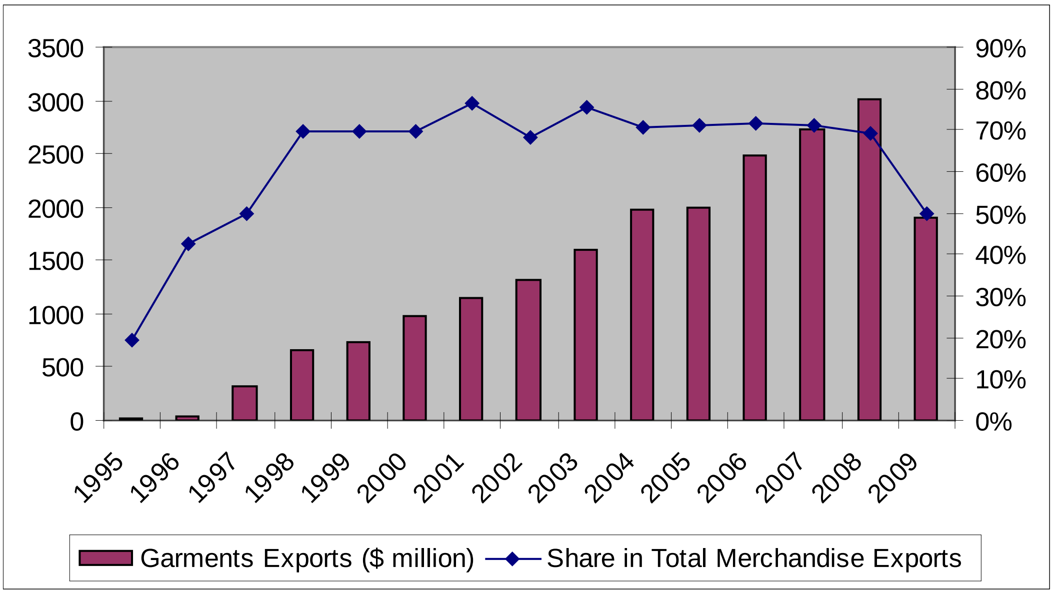
Sources: Menon (2008) for 1998-2006 data; IMF (2011) for 2007 data; and National Bank of Cambodia (2010a and 2011) for December 2007-December 2010 data.

Figure 5: Inflation and Money Supply Growth, 1995-2010
(%)



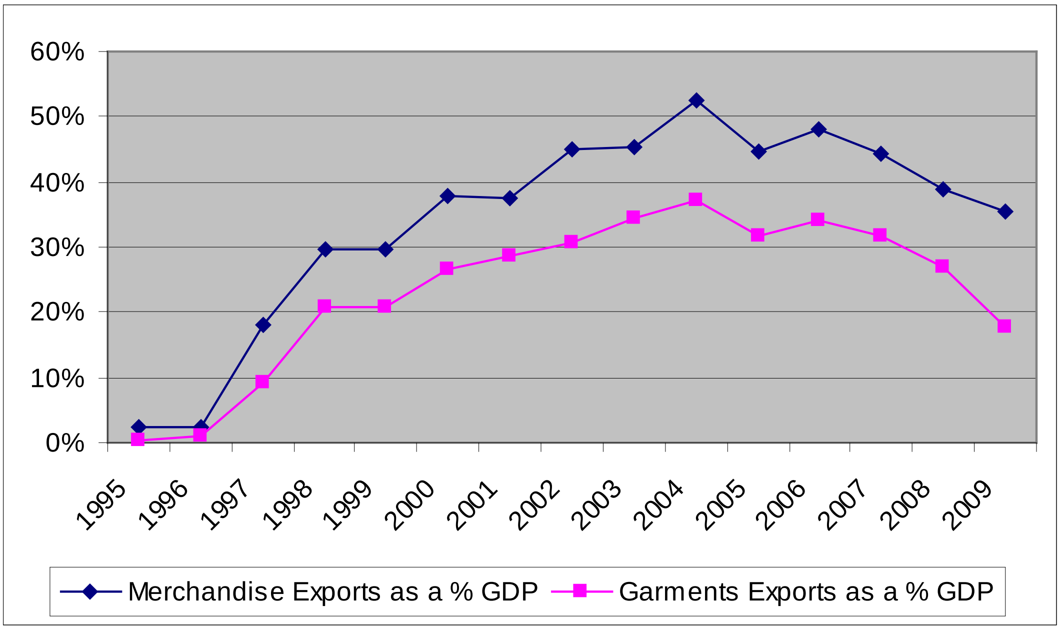
Sources: Inflation data from the IMF World Economic Outlook Database, April 2011; money supply (proxied by M2) growth data derived from the IMF International Financial Statistics Online, May 2011, and World Bank World Development Indicators Online, April 2011.

Figure 6: Garment Exports, 1995-2009
($ million and % of total merchandise exports)



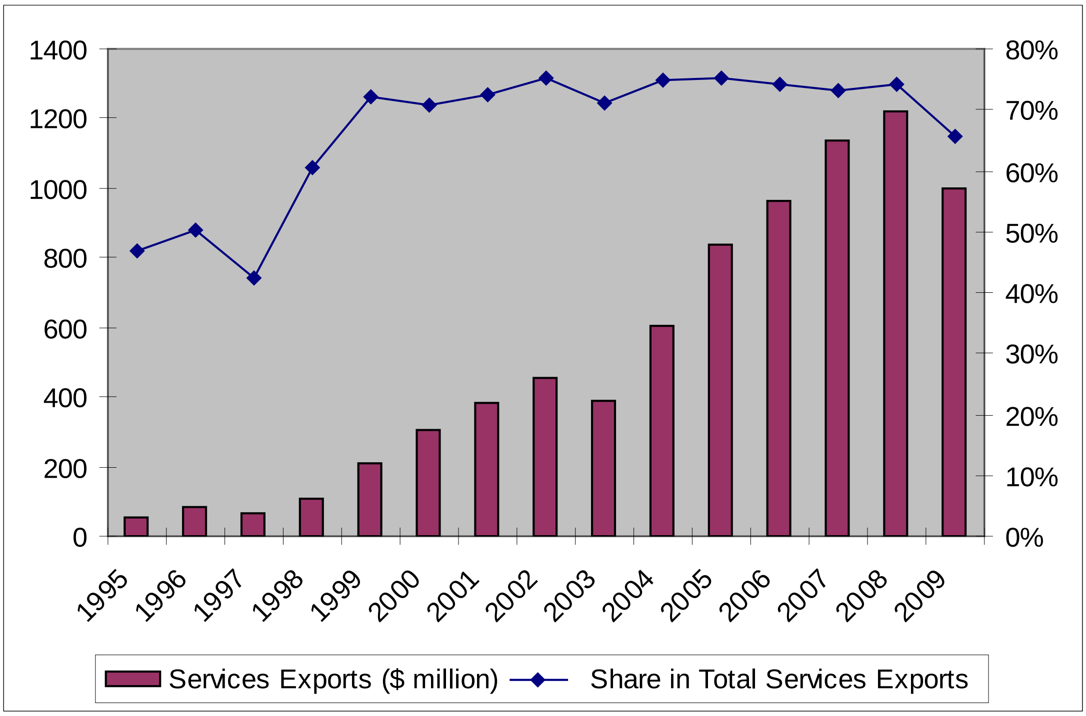
Source: UNCTAD 2011. UNCTADstat, Merchandise trade matrix, exports, annual, 1995-2009

Figure 7: Total Merchandise and Garments Exports as a Share of GDP, 1995-2009 (%)



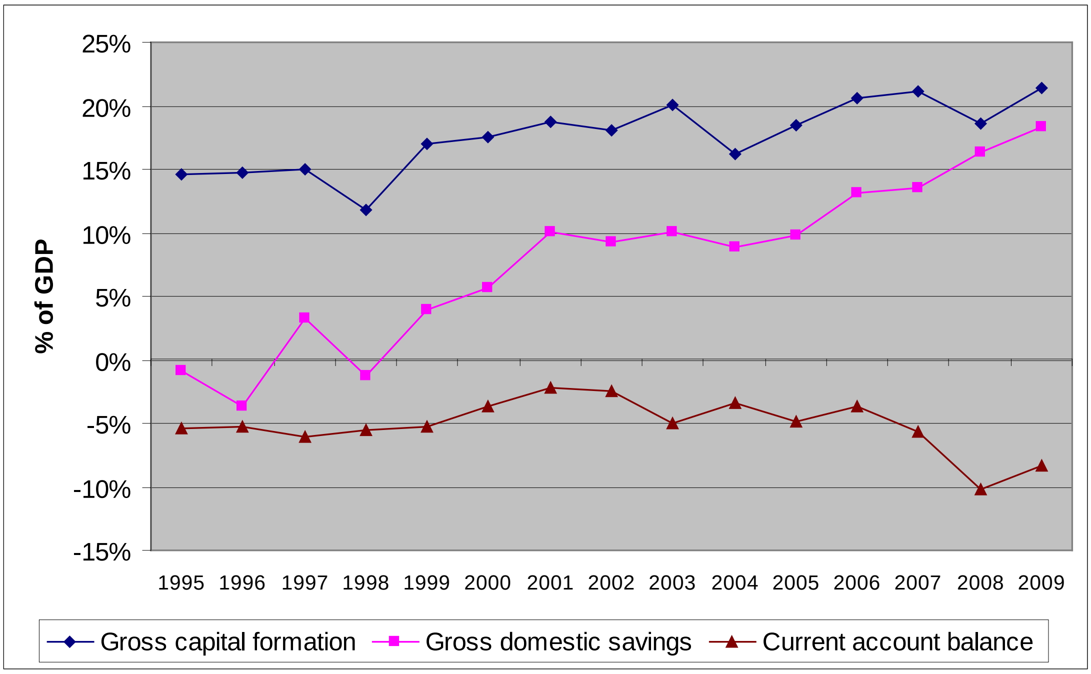
Sources: UNCTAD 2011. UNCTADstat, Merchandise trade matrix, exports, annual, 1995-2009, GDP data from UN National Accounts Estimates of Main Aggregates Database

Figure 8: Tourism Exports, 1995-2009
($ million and % of total services exports)



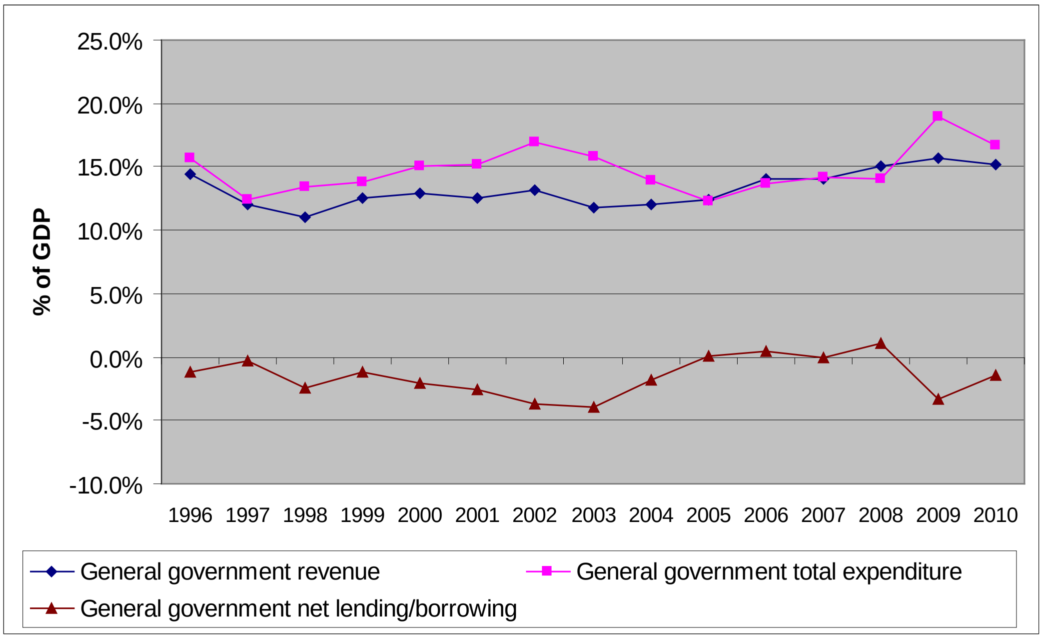
Note: Includes goods and services acquired from an economy by non-resident travelers during visits shorter than one year.
Sources: UNCTAD 2011. UNCTADstat, Trade in services by category, annual, 1980-2009.

Figure 9: Investment, Savings, and the Current Account, 1995-2009
(as % of GDP)



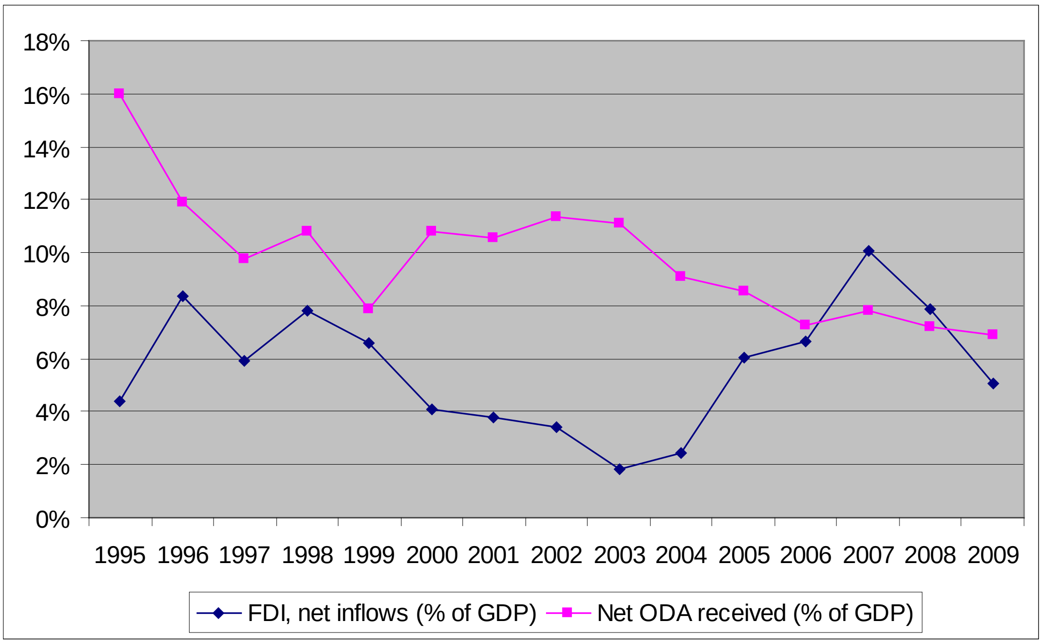
Note: Gross capital formation (formerly gross domestic investment) consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Gross domestic savings are calculated as GDP less final consumption expenditure (total consumption).
Source: World Bank World Development Indicators Online, April 2011

Figure 10: Government Revenue, Expenditure and Deficit, 1996-2010
(as % of GDP)



Note: 2010 data are estimates. Net lending (+)/ borrowing (–) is calculated as revenue minus total expenditure.
Source: International Monetary Fund, World Economic Outlook Database, April 2011

Figure 11: FDI and ODA, 1995-2009
(as % of GDP)



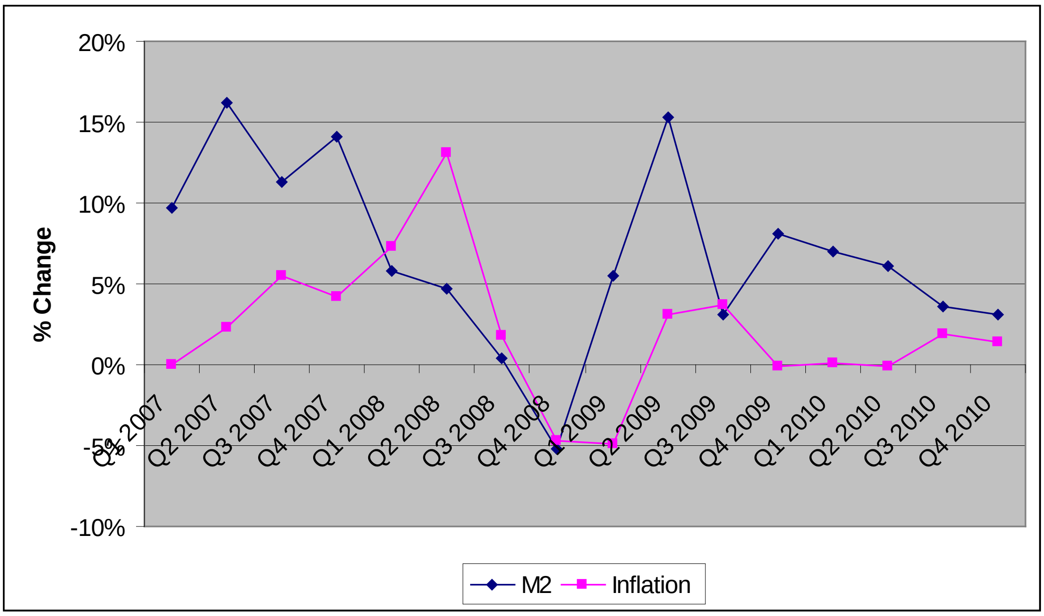
Note: Net official development assistance is disbursement flows (net of repayment of principal) that meet the DAC definition of ODA and are made to countries and territories on the DAC list of aid recipients.
Source: World Bank World Development Indicators Online, April 2011

Table 1: Social Indicators, Selected Years

Indicator Name	1994	2004	2007
GINI ratio	38.28	41.85	44.37
Poverty gap at $1.25 a day (PPP) (%)	13.81	11.32	6.14
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	48.55	40.19	28.27
Poverty headcount ratio at national poverty line (% of population)	47.00	34.70	30.10
Poverty headcount ratio at rural poverty line (% of rural population)		37.80	34.50
Poverty headcount ratio at urban poverty line (% of urban population)		17.60	11.80
Life expectancy at birth, total (years)	55.68	58.69	60.41
Maternal mortality ratio (modeled estimate, per 100,000 live births)	690.00[a]	470.00[b]	
Mortality rate, infant (per 1,000 live births)	85.30[a]	79.60[b]	70.50
Primary school completion rate, total (% of relevant age group)	45.41	76.00	85.00

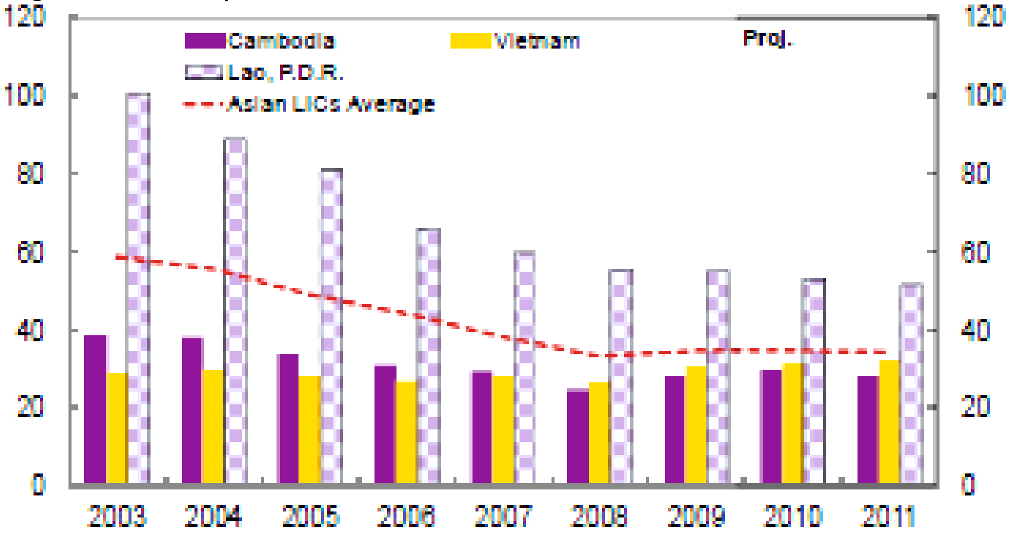
Note: [a] Data for 1990. [b] Data for 2000.
Source: World Bank World Development Indicators Online, April 2011

Figure 12: Quarterly Inflation and Money Supply Growth, 2007-10 (qoq, %)



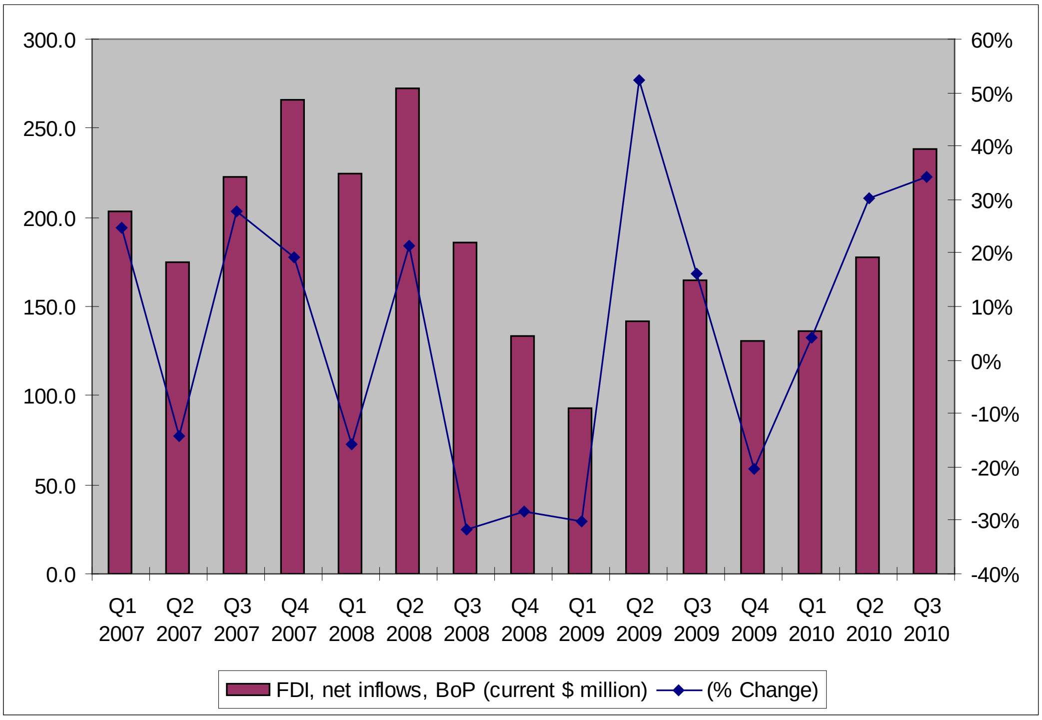
Source: IMF International Financial Statistics Online, May 2011

Figure 13: Comparative External Indebtedness Indicators, 2003-2011



Source: IMF 2011

Figure 14: Quarterly FDI, 2007-2010
($ million and quarter-on-quarter % change)



Sources: Q12007-Q42009 data from the IMF Balance of Payments Database, May 2011; 2010 data from the National bank of Cambodia, 2010b.

Table 2: Wages in the Garments Industry, Selected Asian Countries (2004 $)

Country	Wages		N
	Mean	Median	
Bangladesh	598	591	233
Cambodia	**1025**	**970**	**60**
Indonesia	1242	978	72
Lao PDR	1072	973	12
Philippines	2295	2369	40
PRC	985	805	218
Sri Lanka	970	809	60
Thailand	3001	2488	147
Viet Nam	779	749	59
Average	**1330**	**1192**	**901**

Source: World Bank 2009a.

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