

# Cambodia Economic Update

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## Adapting to Stay Competitive

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**Selected Issue**

**Cambodian Agriculture in Transition: Opportunities and Risks**



**WORLD BANK GROUP**

**October 2015**



# **Adapting to Stay Competitive**

## **Cambodia Economic Update**

**October 2015**



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## **Preface and Acknowledgements**

The Cambodia Economic Update (CEU) is a product of the staff of the World Bank. It was prepared by Sodeth Ly and incorporates comments by Miguel Eduardo Sánchez Martín, both at the Macroeconomics and Fiscal Management Global Practice (MFM GP). Linna Ky served as research assistant. The team worked under the guidance of Mathew A. Verghis, Practice Manager, MFM GP. Sergiy Zorya, Agriculture GP, contributed the selected issue on Cambodian Agriculture in Transitions: Opportunities and Risks. The team is grateful for the comments, advice and guidance provided by Ulrich Zachau, Country Director, and Alassane Sow, Country Manager.

The CEU is produced bi-annually to provide up-to-date information on macroeconomic developments in Cambodia. It is published and distributed widely to the Cambodian authorities, the development partner community, the private sector, think tanks, civil society organizations, non-government organizations, and academia. The update is timed to coincide with the six-monthly publication of the East Asia and Pacific Economic Update by the East Asia MFM GP of the World Bank.

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For information about the World Bank and its activities in Cambodia, please visit our website at [www.worldbank.org/cambodia](http://www.worldbank.org/cambodia).

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## A. Executive Summary

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*Robust GDP growth continues, and real growth for 2014 has been revised up by the authorities to 7.1 percent from an earlier estimate of 7.0 percent. Strong domestic demand, boosted by a construction boom and accommodated by high domestic credit growth, helps offset the moderation in export growth with the slowdown of the garment, tourism and agriculture sectors observed in the first half of 2015. As an oil importer, the country benefits from the slump in oil prices, contributing to savings on petroleum imports. In this setting, growth is projected to ease slightly, to 6.9 percent in 2015. Downside risks to this outlook include potential renewed labor discontent, further appreciation of the US dollar, a delay in economic recovery in Europe, and a hard landing of the Chinese economy.*

### *Recent developments*

**GDP growth is increasingly dependent on consumption and investment.** In a context of low oil prices and upbeat business confidence, internal demand strengthens. This has driven continued strong final consumption, accommodated by rapid consumption credit growth and leading to the expansion in wholesale and retail businesses. Robust gross fixed capital formation growth, at 9.1 percent year-on-year in 2014, has been driven largely by durable equipment and construction.

**Despite strong domestic demand, inflation has eased further after a sharp drop in 2014, reflecting subdued food and oil prices.** Year-on-year inflation declined to 0.8 percent in August 2015, compared with 1.2 percent at the end of 2014, with dampened foods and petroleum prices.

**In this setting, the construction and real estate sector has become the most dynamic engine of economic growth.** The return of business and consumer confidence and the anticipation of opportunities arising from the regional integration under the ASEAN Economic Community (AEC)

are fueling a boom in construction and real estate. Imports of construction materials continue expanding at a strong pace in the first half of 2015: growth rates reached 38.9 percent year-on-year for construction material imports and 32.7 percent year-on-year for steel imports.

**Continued broad money growth, together with rapid expansion of the banking and financial sector, has accommodated economic growth.** Primarily driven by foreign currency deposits, rapid broad money growth continued at 20.6 percent year-on-year by June 2015. Private sector deposits growth also remained healthy at 21.1 percent year-on-year, supporting high private sector credit growth of 28.1 percent year-on-year by June 2015.

**On the external side, US dollar appreciation continues eroding competitiveness, resulting in the moderation of growth in the garment and tourism sectors.** The appreciation of the US dollar respect to the Euro and other Asian currencies, the emergence of low wage competitors in the region, such as Myanmar, and uncertainty surrounding wage negotiations are dampening external competitiveness. As a result, garment exports eased slightly to a year-on-year growth rate of 7.8 percent in value terms during the first six months of 2015, compared with 9.2 percent in 2014. Meanwhile, the tourism sector has continued to underperform, with arrivals during the first half of 2015 decelerating to 4.6 percent year-on-year (reaching 2.3 million visitors), compared with 6.9 percent in 2014.

**The slump in oil prices helped contain import growth during the first six months of 2015, contributing to a slight improvement in the current account deficit.** Weaker exports and tourism receipts resulted in a slight deterioration in the current account deficit which widened to 10.8 percent of GDP in 2014. On the other hand, foreign direct investment (FDI) inflows remained healthy, largely financing the current account deficit. Continued FDI inflows have contributed



to the increase in gross international reserves, which reached US\$5.2 billion, or 4.1 months of imports, by mid-2015.

**Delayed cultivation caused by intermittent rainfall and lower export prices have caused a slowdown in the agriculture sector.** It is worth mentioning that in the period 2004-12, agricultural GDP grew by an annual average of 5.3 percent, among the highest in the world. This was driven not only by crop production, mainly of paddy rice, but also maize, cassava, sugarcane, and vegetables. At the same time, over the past decade, the agriculture sector has undergone significant structural transformation, as the share in GDP and total labor force declined, although land and labor productivity increases were achieved.

**On fiscal performance, consolidation is sustained as high revenue growth and largely contained expenditure continue to curb the overall fiscal deficit.** During the first seven months of 2015, domestic revenue continues to perform well, growing at around 18 percent year-on-year, thanks to improved revenue administration. Disbursements recently picked up and are expected to meet the budgeted target, after an initial slow start in a context of transition to a program-based budgeting system. Cambodia's debt distress rating in a recent World Bank/IMF Debt Sustainability Analysis remained low.

### *Outlook*

**Growth is projected to ease slightly to 6.9 percent in 2015.** Strong domestic demand, boosted by a construction boom and low oil prices, and accommodated by high domestic credit growth, is expected to offset the moderation in export growth with the slowdown of the garment, tourism and agriculture sectors.

**Downside risks to the outlook** include potential renewed labor discontent, further appreciation of the US dollar, a delay in economic recovery in Europe, and a hard landing of the Chinese economy. A hard landing of the Chinese economy

could somewhat dampen growth prospects, mainly due to potentially lower Chinese tourist arrivals and investment inflows, while export dependency is low. There is a risk that the US policy rate "lift-off" may trigger abrupt market reactions, causing currencies to depreciate sharply, bond spreads to rise steeply, capital inflows to fall sharply, and liquidity to tighten. Nonetheless, in a context of limited capital markets, Cambodia should be relatively shielded from financial volatility. It would still suffer from the loss of competitiveness associated to the expected appreciation of the US dollar, which would further dampen growth prospects.

### *Challenges and recommendations*

**There is a pressing need to enhance external competitiveness.** Cambodia may have to rely on addressing key bottlenecks constraining productivity growth, as well as export cost reduction. A better trained and skilled workforce will certainly help. Improving the overall business environment would enhance competitiveness across sectors. Finally, it is essential to support diversification in the manufacturing sector as envisaged in the recently announced Industrial Development Policy (IDP), while also being well prepared to take advantage of the single market and production base goal set by the AEC. To strengthen the business environment, international experience points out to a key attribute -- a legal and regulatory framework that is predictable and based on international norms is a central element.

**As externally financed capital investment declines, it will be important to boost domestically financed public investment.** Continued buoyant collection helps to make this affordable. It is necessary to further strengthen the rules and regulations governing the management of capital investment projects as envisaged under the Public Financial Management Reform Program (PFMRP). Building up institutional quality and capacity to better manage public investment projects will serve to enhance the effectiveness of fiscal policy. International

experience indicates the importance of adherence to the following four broad principles in order to successfully scaling up public investment: (i) achieving “allocative efficiency”; (ii) being grounded in a sound macro-fiscal framework; (iii) having sound public investment management system; and (iv) having appropriate capacity of the construction sector to absorb.

**To safeguard stability in the rapidly expanding banking and construction sectors, further supervision and coordination is needed.** Improved supervisory capacity and the establishment of a crisis management framework, supported by strengthened accounting and auditing practices with close inter-agency coordination, are necessary. Better understanding of the “transmission channels” of potential shocks to the economy, and the linkages between the financial sector and the real sector, in particular the construction and real estate sector, will help to strengthen resilience against external volatility, as well as to avoid a potential construction and real estate sector bubble. International experience points to a framework of minimum standards for sound banking supervisory practices universally applicable which includes: (i) a clearly defined

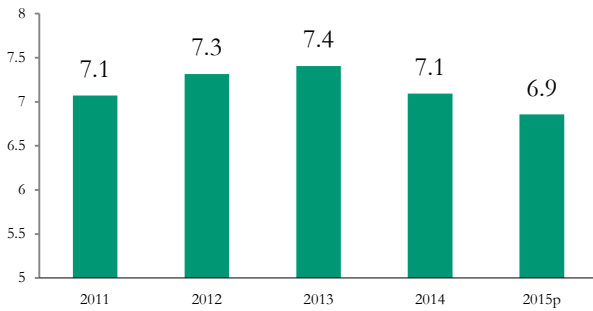
supervisory powers; (ii) responsibilities and accountabilities among supervisory authorities; and (iii) appropriate prudential regulations. A number of preconditions for effective banking supervision are: (i) a well-established framework for financial stability policy formulation; (ii) a clear framework for crisis; and (iii) an appropriate level of systemic protection (or public safety net).

**Revitalizing agricultural growth and supporting further structural transformation in the agriculture sector are possible with four sets of policies.** The first is maintaining a private-sector-friendly agricultural policy environment, with added attention to lowering the regulatory burden of farm input sectors. The second is strengthening the environmental sustainability of agricultural production. The third is improving the quality of agricultural public programs and, as feasible within Cambodia’s total government budget, increasing allocations to the more effective programs. The fourth is helping to develop the agribusiness and agro-processing industry. The selected issue section on “Cambodian Agriculture in Transition: Opportunities and Risks” provides further details.

# THE CAMBODIAN ECONOMY AT A GLANCE

## Sustained high GDP growth ...

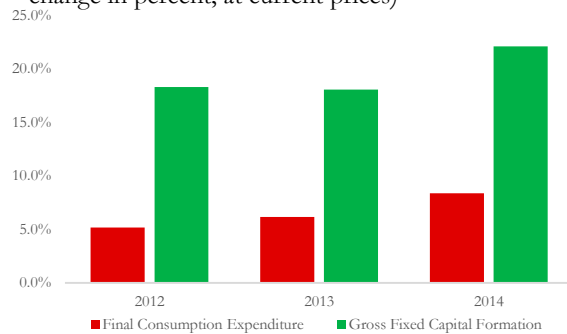
Contribution to real GDP growth.(In percent)



p= projection

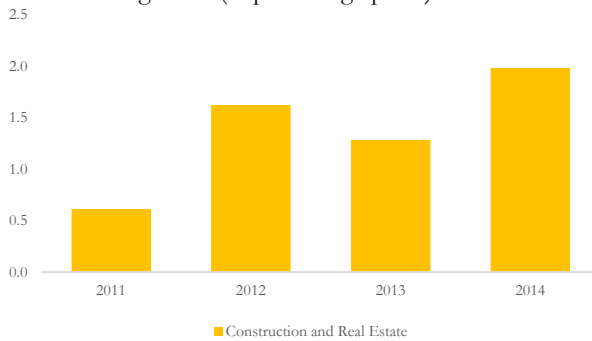
## ...now more dependent on rising internal demand...

Rising final consumption and capital formation accommodated by domestic credit growth (yoy change in percent, at current prices)



## ...as upbeat confidence drives construction boom...

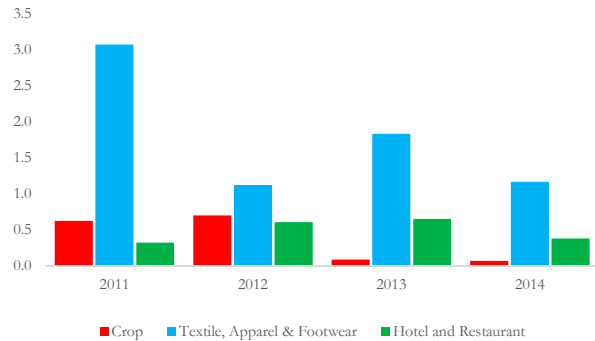
Construction is the most dynamic. Contribution to annual real growth (in percentage point)



Construction and Real Estate

## ...offsetting moderation in exports and tourism...

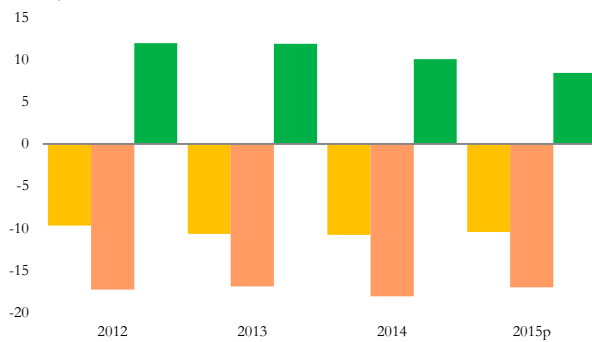
Garment, tourism and agriculture have eased. Contribution to real growth (in percentage point)



Crop Textile, Apparel & Footwear Hotel and Restaurant

## ...while healthy FDI finances the external gap ...

FDI largely finances current account deficits. Trade balance, current account balance, and FDI (In percent of GDP)

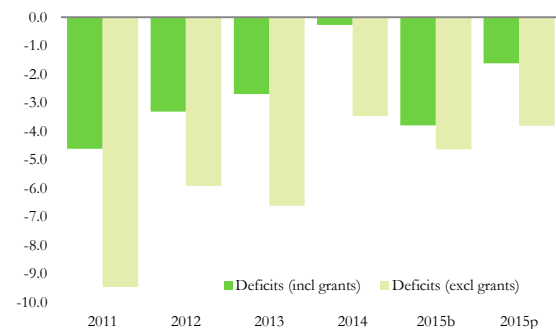


p= projection

Current account excl off. transfers Trade balance FDI

## ...and rising collection enables fiscal consolidation.

Steadily declining general government fiscal deficits. (In percent of GDP)



b = budget; p = projection

## B. Recent Economic Developments

### An overview

**GDP growth is dependent on internal demand.** The return of business and consumer confidence has driven domestic demand. As a result, consumption, accommodated by fast domestic credit growth, has risen significantly, buoying up economic expansion. In a context of low oil prices and increasing confidence underpinning the construction and real estate boom, internal demand keeps strengthening. The latest data available indicates that consumption grew at a healthy rate of 4.3 year-on-year (at constant prices) in 2014, fueled by domestic demand (Table 1). Gross fixed capital formation growth was robust at 9.1 percent year-on-year (at constant prices) in 2014, driven largely by durable equipment and construction.

**Table 1: Rising consumption expenditure and gross fixed capital formation continued.** (Growth rates, in percent, at constant 2000 prices)

	2011	2012	2013	2014
<b>Final consumption</b>	10.2	4.7	5.7	4.3
Households	10.5	4.6	5.8	4.5
Government	7.8	5.7	5.2	2.4
<b>Gross capital formation</b>	10.8	17.4	15.3	9.1
Durable				
Equipment	7.9	15.7	12.9	11.9
Construction	12.8	18.6	16.9	7.5

Source: The authorities

**Rising consumption and investment underpinned by strong internal demand, accommodated by high credit growth, help offset the moderation in export growth with the slowdown of the garment, tourism and agriculture sectors.** Besides the construction and real estate sector which remains vibrant (Table 2), garment exports, capturing almost three quarters of total merchandise exports have eased. The tourism sector has also moderated while agriculture growth remains weak.

**Table 2: The construction and real estate sector made the largest contribution, at 2 percentage points, in 2014.** Contribution to annual real GDP growth (in percentage point)

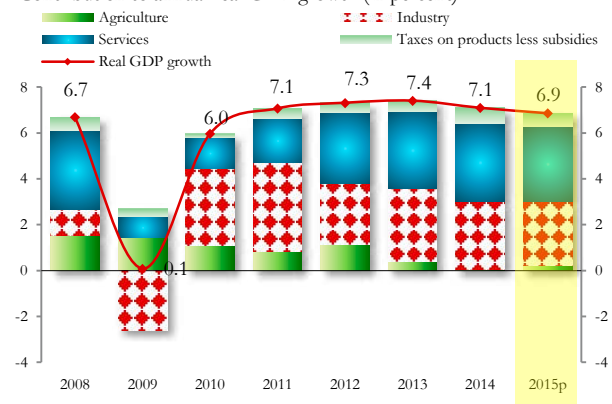
Key contributing sector	2011	2012	2013	2014
Crop	0.6	0.7	0.1	0.1
Garment & footwear	3.1	1.1	1.8	1.2
<b>Construction and real estate</b>	<b>0.6</b>	<b>1.6</b>	<b>1.3</b>	<b>2.0</b>
Trade	0.4	0.5	0.7	0.8
Hotel and restaurant	0.3	0.6	0.7	0.4

Source: The authorities.

As illustrated in Table 2 above, the contribution of crops to GDP growth noticeably declined in 2013, while the moderation in tourism growth, as reflected in the hotel and restaurant sectors, was observed in 2014.

**As a result, growth is projected to ease slightly to 6.9 percent in 2015 (Figure 1).**

**Fig 1: Agriculture contribution to real growth has been declining.** Contribution to annual real GDP growth (in percent)



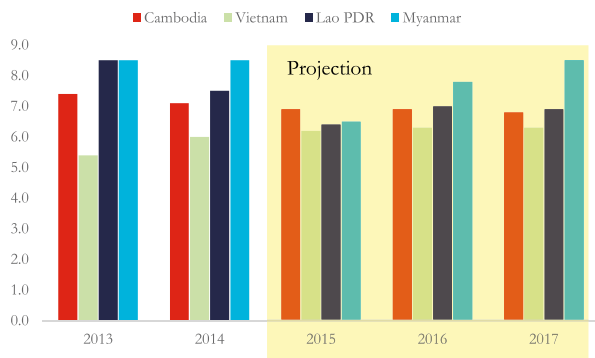
Source: The authorities and Bank staff estimates

**Downside risks**, however, include potential renewed labor discontent, further appreciation of the US dollar, a delay in economic recovery in Europe, and a hard landing of the Chinese economy. A hard landing of the Chinese economy could somewhat dampen growth prospects, mainly due to potentially lower Chinese tourist arrivals and investment inflows, while export dependency is low. There is a risk that the US policy rate “lift-off” may trigger abrupt market reactions, causing currencies to depreciate sharply, bond spreads to rise steeply, capital inflows to fall sharply, and liquidity to tighten. The countries

most at risk are those that rely on portfolio flows and short-term borrowing to finance current account deficits or debt rollovers, such as Indonesia; have a large external debt load, such as Malaysia and Mongolia; have a significant share of local currency debt held abroad, such as Malaysia and Indonesia; or have high levels of household debts, such as Malaysia and Thailand.<sup>1</sup> Nonetheless, in a context of limited capital markets, Cambodia should be relatively shielded from financial volatility, although it would be still suffering from the associated US dollar appreciation. Post-2008 global financial crisis growth has been less volatile but remains below its pre-global financial crisis level.

**Growth for smaller economies of the ASEAN members remain generally strong** (Figure 2) although in general growth in the developing East Asia and Pacific region is expected to ease, from 6.8 percent in 2014 to 6.5 percent in 2015 and 6.3 percent over 2016-17, mainly reflecting a moderate slowdown in China.<sup>2</sup>

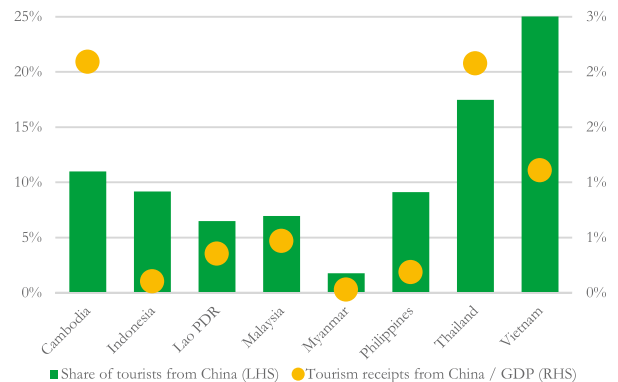
**Fig 2: Robust growth is projected to continue for smaller economies of ASEAN members. Real GDP growth (in percent)**



Source: Staying the Course, East-Asia and Pacific Economic Update, October 2015

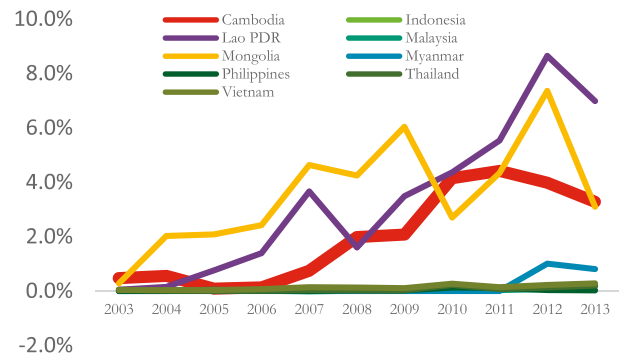
**Like many countries in the region, Cambodia is dependent on Chinese tourism and FDI** which are important for growth, jobs, and foreign exchange (Figures 3 and 4).

**Fig 3: Cambodia is dependent on Chinese tourism as many regional countries do. Tourism flows and receipts from China (2013, in percent)**



Source: Staying the Course, East Asia and Pacific Economic Update, October 2015, WB

**Fig 4: Cambodia, Mongolia, and Lao PDR are among the largest recipients of Chinese FDI; thus they are vulnerable to its volatility (in percent of GDP)**



Source: Staying the Course, East Asia and Pacific Economic Update, October 2015, WB

## The real sector

### a) Construction and real estate



Construction expansion continues to underpin growth.

<sup>1</sup> Staying the course, East Asia and Pacific Economic Update, October 2015, the World Bank.

<sup>2</sup> Staying the course, World Bank East Asia and Pacific Economic Update, October 2015.

Construction remains the most dynamic engine of growth in the first half of 2015. The construction sector continues to expand due largely to the return of business and consumer confidence and the anticipation of opportunities arising from regional integration under the AEC.<sup>3</sup> Construction activity, largely financed by foreign direct investment, focusing in particular on modern high-rise residential and commercial buildings located in the capital, Phnom Penh remains strong. This is evidenced by the rapid expansion in imported construction materials, including cement and steel products (Table 3). The value of approved construction projects during the first six months of 2015, however, has eased.

**Table 3: Construction material imports are rising as a result of continued construction boom.**

Imported items	Jan-Jun 2014		Jan-Jun 2015	
	Volume (metric ton)	YoY% change	Volume (metric ton)	YoY% change
Construction materials	220,929	41.0	306,855	38.9
Cement	751,813	72.3	814,884	8.4
Steel	77,882	28.2	103,339	32.7

Source: The authorities

In 2014, out of 7.1 percent real growth, the construction and real estate sector accounted for the largest contribution, at 2 percentage points (Table 2).

**International experience** indicates that construction plays a unique role in economic growth and is often a key barometer of economic conditions. Construction increases a country's physical infrastructure, critical factor for long-term growth. The performance of the construction sector both affects and is influenced by general economic conditions.

<sup>3</sup> According to AEC blueprint declaration, all ASEAN member countries will abide by and implement the AEC by 2015. The AEC will be the goal of regional economic integration by 2015 which envisages: (i) a single market and production base,<sup>3</sup> (ii) a highly competitive economic region, (iii) a region of equitable economic development, and (iv) a region fully integrated into the global economy (see Box 2 for more details on the AEC). With the following import tariff elimination schedules: (i) eliminate import duties on all products, except for those phased in from the Sensitive and Highly Sensitive Lists by 2010 for ASEAN-6 and by 2015, with flexibilities for some sensitive products by 2018, for Cambodia, Lao PDR, Myanmar and Vietnam in accordance with the provisions of the Protocol to Amend the Common Effective Preferential Tariff (CEPT) Scheme Agreement for the Elimination of Import Duties; and (ii) complete the phasing in of the remaining products in the

Although generally small in size compared to other sectors, its activity has a large impact on output and employment of the whole economy given its close inter-linkages with other sectors.<sup>4</sup>

**Risks associated with the construction and real estate boom are increasing**, given that it has fueled land and housing prices across Phnom Penh and other urban centers, as well as a rapid credit expansion that could eventually lead to the emergence of a bubble inflated by speculation. National accounts data show that real estate (and business) sector growth (at current prices) peaked at 25.9 percent year-on-year in 2014, compared with 9.9 percent year-on-year in 2013.

**Cambodia's liberal trade and investment regime is currently attracting businesses and investment that are anticipating the opportunities arising from the regional integration envisaged under the ASEAN Economic Community (AEC).** As discussed above, this has fueled a boom in modern residential and commercial development located in Phnom Penh. In December 2015, the AEC will be formally established. The associated regional integration process has already had several important beneficial effects: ASEAN tariffs have been significantly reduced, regional trade has been facilitated, trade in services has been liberalized, and FDI has been boosted. There are large potential gains from fully implementing and extending the AEC integration program<sup>5</sup> (see Box 2 for more details on the 2015 AEC).

Sensitive List (SL) into the CEPT Scheme and reduce tariffs on these products to 0-5% by January 1, 2010 for ASEAN-6, by January 1, 2013 for Viet Nam, by January 1, 2015 for Lao PDR and Myanmar, and by January 1, 2017 for Cambodia, in accordance with the provisions of the Protocol on Special Arrangements for Sensitive and Highly Sensitive Products.

<sup>4</sup> The Driving Force behind the Boom and Bust in Construction in Europe, *Yan Sun, Pritha Mitra, and Alejandro Simone, IMF Working Paper, WP/13/181*

<sup>5</sup> Staying the course, East-Asia and Pacific Economic Update, Oct 2015, the World Bank.

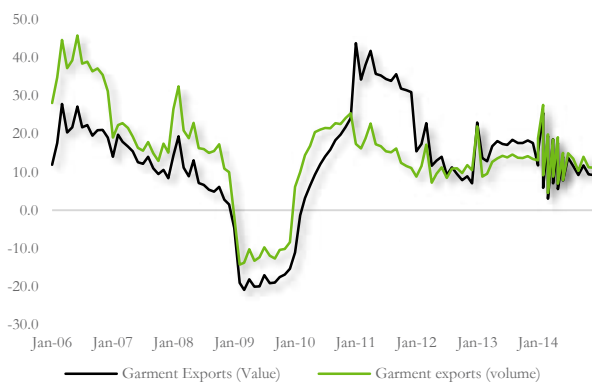
## b) Garments



Productivity improvement and competitiveness enhancement can simply begin with punctual, responsible, honest, and hardworking employees.

**Garment exports, one of the key drivers of growth, eased slightly** to a year-on-year growth rate of 7.8 percent, (or US\$2.8 billion) in value terms, and 7.9 percent in volume terms during the first six months of 2015, compared with 9.2 percent and 11.2 percent in 2014, respectively (Figure 5). As presented in Table 1, in 2014, out of 7.1 percent real growth, the garment and footwear sector was the second-largest contributor, at 1.2 percentage points, second only to the construction and real estate sector.

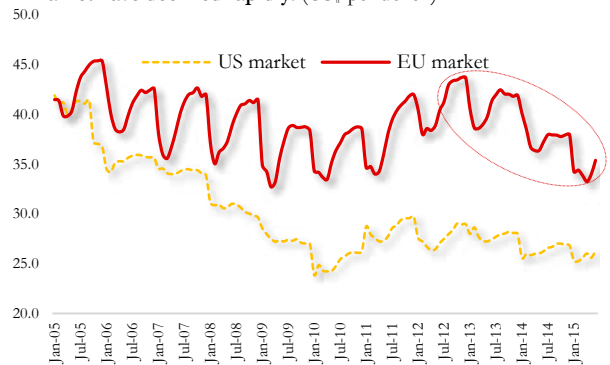
**Fig 5: Year-on-year garment export growth has been declining** (YTD, Y/Y % change)



**Prices of exported garment products, which account for 72.5 percent of total merchandise exports, continue to decline**, as they adjust to tighter competition in the context of an

appreciating US dollar. In particular, prices of garment exports to the EU, which is Cambodia's largest export market absorbing 40 percent of all Cambodian garment exports (Figure 6), dropped by 15.7 percent to US\$35.4 per dozen in mid-2015, from US\$ 42.0 per dozen in 2011 (Table 4). Appreciation of the US dollar and the emergence of low-wage regional competitors, such as Myanmar, together with uncertainty surrounding minimum wage negotiations, continue to exert pressure on the garment sector.

**Fig 6: The prices of garment products exported to the EU market have declined rapidly.** (US\$ per dozen)



Source: The authorities and Bank staff estimates

**Table 4: Garment export prices have declined in all main export markets** due to increased price competition. Garment product export prices (US\$/dozen)

	US	EU	Japan
2011	29.7	42.0	66.7
2012	29.0	43.7	59.9
2013	28.0	41.9	68.8
2014	26.8	38.0	65.5
2015	26.3	35.4	60.1

Source: World Bank staff calculation using data from the authorities

Cambodia currently enjoys the EU's Everything-But-Arms (EBA) preferential treatment for its garment exports.<sup>6</sup> However, much more intense competition is expected once garment tariff liberalization is effective under an agreement on free trade between the EU and Vietnam.<sup>7</sup> In this

<sup>6</sup> Ten least developed countries in Asia namely, Afghanistan, Bangladesh, Bhutan, Lao PDR, Maldives, Cambodia, Myanmar, Nepal, Timor-Leste, and Yemen are the beneficiaries of the EU's EBA (for more details, see [http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc\\_150983.pdf](http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_150983.pdf)). The reinstatement in July 2013 of the EU GSPs allowed Myanmar to enjoy the EU's EBA preferential treatment (For more details, see [http://ec.europa.eu/delegations/myanmar/documents/page\\_content/gsp\\_guidance\\_en.pdf](http://ec.europa.eu/delegations/myanmar/documents/page_content/gsp_guidance_en.pdf)).

<sup>7</sup> The agreement in principle reached on August 4, 2015 for a free trade deal includes the elimination of nearly all tariffs (over 99%). Vietnam will liberalize tariffs over a 10-year period and the EU will

context, with the aim of diversifying the manufacturing sector beyond garments and increasing industrialization by 2025, the authorities launched the Cambodia Industrial Development Policy (IDP) 2015-2025 in August (see Box 1 on IDP for more details).

**A moderate recovery in high-income countries is ongoing, positively impacting the Cambodian economy as the United States and the European Union (EU) are the two main export markets, absorbing 32 percent and 23.5 percent of total exports, respectively.**

In the United States, growth should strengthen modestly to 2.7 percent on average in 2015–16. The US economy grew by a robust 3.7 percent in Q2 (quarter-on-quarter seasonally adjusted annualized rate [qoq SAAR]). While Euro Area growth eased to 1.6 percent (qoq SAAR) in Q2, following a 2.2 percent expansion in Q1, it has been supported by the European Central Bank's quantitative easing program, which helped improve credit conditions and weaken the euro and shelter peripheral economies from contagion risks from Greece.<sup>8</sup>

### c) Tourism



Ecotourism is helping diversify the tourism sector and protect the environment.

liberalize tariffs over a 7-year period. See <http://ec.europa.eu/trade/policy/countries-and-regions/countries/vietnam/> for more details.

<sup>8</sup> Staying the course, East Asia and Pacific Economic Update, October 2015, the World Bank.

<sup>9</sup> According to the Apsara Authority. For more details, see <http://apsaraauthority.gov.kh/?page=detail&ctype=article&id=974&lg=kh>

<sup>10</sup> 2014 and 2013 Annual Reports, Ministry of Tourism.

<sup>11</sup> International tourism receipts grew in all regions: Europe, which accounts for 41% of worldwide international tourism receipts, saw an increase in tourism earnings in absolute terms of US\$17 billion to US\$509 billion (Euro 383 billion). Asia and the Pacific (30% share) saw an increase of US\$16

**The tourism sector in Cambodia continues to underperform, despite some recovery in regional activity** (Figure 7).

Tourist arrivals during the first half of 2015 grew by only 4.6 percent year-on-year (reaching 2.3 million visitors), compared with 6.9 percent in 2014. Arrivals by air moderated most, increasing by 7.3 percent year-on-year during the first half of 2015, compared with 12.7 percent in 2014. International tourists visiting the Angkor Archaeological Park, the largest tourist attraction site in Cambodia, during the first eight months of 2015 increased marginally, rising by 1.9 percent year-on-year to 1.4 million visitors. Gross revenue from the Park's entrance fees was almost flat, increasing by a mere 0.03 percent year-on-year to US\$39.8 million.<sup>9</sup>

**After experiencing double-digit arrival growth since 2010, the tourism sector started to ease in 2014,**

when it grew by only 6.9 percent with the average length of stay decreasing to 6.5 days from 6.8 days in 2013. Consequently, the average hotel occupancy rate shrank to 67.5 percent in 2014 down from 69.5 percent 2013.<sup>10</sup> Average daily expenditure per tourist also contracted to US\$93.4 in 2014 from US\$120.7 in 2013. Despite this easing in Cambodia, it is worth noting that world tourism receipts increased.<sup>11</sup> The contribution to real growth in 2014 by the hotel and restaurant sector which is mainly influenced by tourism arrivals also eased (Table 1).

Recent initiatives on bilateral collaboration with Thailand under "Two Kingdoms-One Destination" and multilateral/regional tourism cooperation, as well as newly established direct flights including the preparation of a Tourism Marketing Strategy 2015-2020 by the authorities, are expected to help boost arrival numbers. Public-private sector collaboration has been

billion, reaching US\$377 billion (euro 284 bln). In the Americas, (22% share), receipts increased by US\$10 billion to a total of US\$274 billion (Euro 206 billion). In the Middle East, (4% share) tourism receipts increased by an estimated US\$4 billion to US\$ 49 billion (Euro 37 billion) and in Africa (3% share) by US\$1 billion to US\$36 billion (Euro 27 billion). See <http://media.unwto.org/press-release/2015-04-15/exports-international-tourism-rise-us-15-trillion-2014>



### Box 1: Cambodia Industrial Development Policy 2015 – 2025 at a Glance

#### Policy and strategy

Officially launched in August 2015, the Cambodia Industrial Development Policy (IDP) 2015 – 2025 strategically aims to: (i) attract investment; (ii) modernize small and medium-sized enterprises; (iii) improve the regulatory framework; and (iv) coordinate supporting policies.

#### Key targets

- (i) Increasing the GDP share of the industrial sector to 30 percent in 2025 from 24.1 percent in 2013 while increasing annual manufacturing sector growth to 20 percent in 2025 from 15.5 percent by 2013;
- (ii) Increasing exports of manufacturing products (non-textile products) to 15 percent of total exports by 2025 (from 1 percent in 2013) and increasing exports of processed agricultural products to 12 percent by 2025 (from 7.9 percent in 2013); and
- (iii) Officially registering 80 to 95 percent of the country's small and medium-sized enterprises (SMEs) by 2025, of which 50 to 70 percent will also have accurate accounts and balance sheets.

#### Priority sectors

- (i) New industries with the capability to break into new markets with high value addition, creative and highly competitive products, focusing not only on consumer products but also on machinery assembly, mechanical/electronic/electrical equipment assembly, transport means, and natural resource processing;
- (ii) SMEs to produce drugs, medical, and packaging equipment for export, and construction materials;
- (iii) Agro-industrial production for export- and domestic markets;
- (iv) Support industry for the agriculture, tourism, and textile sectors, and support regional and global value chains serving both forward and backward linkages; and
- (v) Industries to serve regional production lines and strategic industries such as ITC, energy, heavy industries and others.

#### Leadership, coordination, and implementation

- (i) Strengthen leadership of the Council for Development of Cambodia;
- (ii) Improve functions and capacity of the Cambodia Investment Board;
- (iii) Streamline functions of the Cambodian Rehabilitation and Development Board;
- (iv) Strengthen the Government and Private Sector Forum; and
- (v) Develop monitoring and evaluation mechanisms.

Source: Cambodia Industrial Development Policy 2015-2025.

further strengthened with the establishment of working groups to regularly improve products, marketing, and management in the tourism sector.<sup>12</sup>

**Arrivals from Vietnam, China, and South Korea continue to lead.** All three markets combined accounted for more than 45 percent of the total arrivals. Thai national tourist arrivals to Cambodia rose by 30.8 percent year-on-year during the first six months of 2015, boosted by

<sup>12</sup> For more details, see <http://www.tourismcambodia.org/news/index.php?view=detail&nw=233#comp>

### Box 2: The ASEAN Economic Community (AEC)

**Establishing a single market and production base** appears to be one of the most important objectives envisaged under the AEC. Achieving this objective requires successful implementation of the following five core elements: (i) free flow of goods; (ii) free flow of services; (iii) free flow of investment; (iv) freer flow of capital; and (v) free flow of skilled labor. It will also facilitate the development of production networks in the region and enhance ASEAN's capacity to serve as a global production center and/or as a part of the global supply chain.

**Free flow of trade in services.** There will be almost no restrictions on ASEAN services suppliers providing services and establishing companies across national borders within the region, subject to domestic regulations.

**Freer flow of capital.** Strengthening ASEAN's capital market development and integration with greater harmonization and standardization.

**Free flow of skilled labor.** Facilitating the issuance of visas and employment passes for ASEAN professionals and skilled labor who are engaged in cross-border trade and investment-related activities.

**Cambodia is likely to benefit significantly from the AEC, if the single market and production base target is achieved.** This will provide economies of scale, through which Cambodia's small domestic market will no longer be such an issue. Together with the free flow of skilled labor, an expansion of higher value-added domestic production including the agro-processing industry will be further developed and enhanced while Cambodia's relatively cheap unskilled labor should also be able to continue to support its labor-intensive industrial sector such as in garments and footwear. Cambodia's already open trade and investment regime is unlikely to be significantly affected by the free flow of trade in services and capital. However, it is likely that Cambodia's skilled labor will have to compete with a potential influx of highly skilled personnel from other ASEAN members. It is, therefore, important to improve the quality of education and the appropriateness of skill sets in Cambodia's labor force in order to be ready for regional competition. With good investment targeting as envisaged in the Industrial Development Policy, the free flow of skilled labor should be seen as an opportunity to lower production costs and become more competitive.

Research suggests large potential gains from fully implementing and extending the AEC integration program.<sup>13</sup> In particular, implementing the AEC could lead by 2025 to an increase in GDP of 7.1 percent compared with the baseline, with the largest gains for lower-income ASEAN members. Likewise, employment in the six ASEAN economies of Cambodia, Indonesia, Lao PDR, the Philippines, Thailand, and Vietnam could increase by 14 million, or 2 percent (Indonesia) to 10 percent (Cambodia) of the labor force.

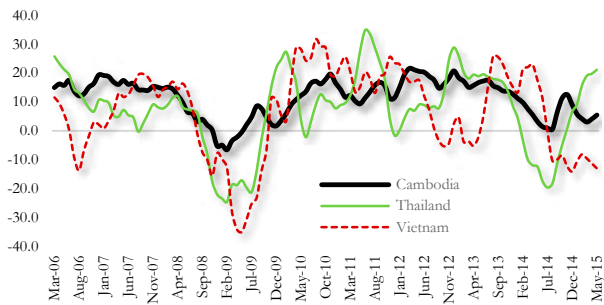
<sup>13</sup> Staying the Course, East-Asia and Pacific Economic Update, October 2015, the World Bank.

Source: <http://www.asean.org/communities/asean-economic-community>

improving stability in the neighboring country, compared with 2014.<sup>13</sup>

<sup>13</sup> This happened before the August 2015 Bangkok bombing.

**Fig 7: Arrivals to Cambodia remain moderate while those to Thailand initially recovered by mid-2015. Arrivals to Vietnam are in negative territory. (3mma, YoY % change)**



Source: The authorities, Tourism Authority (Thailand), and Ministry of Culture, Sports and Tourism (Vietnam).

### d) Agriculture



Waterways are the cheapest means of transportation.

**The agriculture sector remains sluggish as crop production remains heavily reliant on rainfall.** Despite efforts made to improve Cambodia’s irrigation system, the agriculture sector depends largely on wet season rice production, which is in turn heavily reliant on rainfall.

**Table 5: Slower agriculture plantation and production in 2015.**

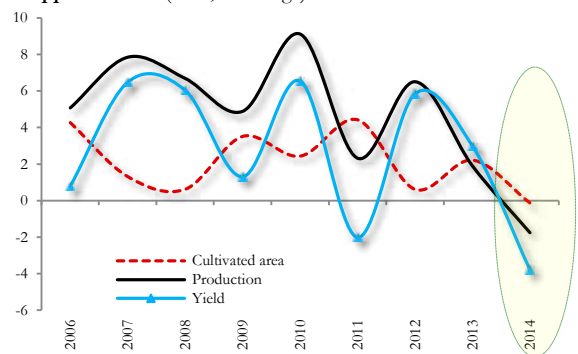
	As of July 2014	As of July 2015	Change (%)
Wet season rice planted (ha)	1,842,460	1,737,046	-5.7
Rice harvested (metric tons)	284,390	191,263	-32.7
Cassava planted (ha)	477,679	527,705	10.5
Other (industrial) crops (ha)	152,705	130,734	-14.4

Source: The authorities

**In 2015, the late onset of monsoon rainfall has slowed wet season rice cultivation** (Table 5). Rice harvest in the rainy season also declined. Cultivation of other crops (except cassava), such as corn, soybean, and vegetables has also been slowed. To mitigate this, efforts have been made to speed up cultivation after adequate rainfall began in July, while technical advice and support has been provided to contain damage caused by the earlier drought.

In 2014, late arrival of rainfall affected wet season rice cultivated areas and a subsequent drought lowered yields. As a result, average yield of wet season rice production dropped by 3.8 percent to 2.81 (metric) tons per hectare (Figure 8), reducing its production by 1.75 percent to 7.14 million tons.<sup>14</sup> Total 2014 rice production during both monsoon and dry seasons decreased to 9.33 million tons, from 9.39 million tons a year earlier. Crop contribution to real GDP growth sharply declined during the period 2013-14 (Table 2).

**Fig 8: Wet season rice cultivation, production, and yield dropped in 2014. (YoY, % change)**



Source: The authorities

**Rice prices declined in 2015.** Falling agriculture commodity prices have been negatively affecting agriculture production and export earnings, in particular for rice and rubber. As shown in Table 6, “free on board” (FOB) prices of various milled rice varieties have been in decline.

<sup>14</sup> For more details, see Annual Report for Agriculture Forestry and Fisheries 2014-2015 and Direction 2015-2016

**Over the past decade, Cambodia’s agriculture sector has undergone a significant structural transformation.** Although it still plays a major role, the agriculture sector has become relatively less “important” in overall GDP and the total labor force, but more “productive”, i.e., agricultural land and labor productivity has increased. This transformation has been driven by vibrant and pro-poor agricultural growth. In the period 2004-12, annual growth in gross production was 8.7 percent. Agricultural GDP grew by an annual average of 5.3 percent during this period. This exceptional growth rate—among the highest in the world—was driven by crop production, mainly of paddy rice (annual average growth of 9 percent), but also maize (20 percent), cassava (51 percent), sugarcane (22 percent), and vegetables (10 percent). Growth in livestock and fisheries, on the other hand, was modest.

See the Selected Issue section on “Cambodian Agriculture in Transition: Opportunities and Risks” to learn more about the opportunities and challenges facing the agriculture sector.

**Table 6: FOB milled rice prices are declining (US\$ per metric ton).**

	Jan-14	Mar-14	Jun-14	Sep-14	Dec-14	Jan-15	Mar-15	Jun-15	Aug-15
<b>Phnom Penh</b>									
Fragrant 5	870	880	850	885	815	795	800	790	830
Mixes 5	490	470	460	470	460	450	450	440	430
IRRI66 5	490	460	440	452	460	435	435	425	420
<b>Sihanoukville</b>									
Fragrant 5	875	885	855	890	820	805	810	800	840
Mixes 5	495	475	465	475	465	458	460	450	440
IRRI66 5	495	565	445	457	465	443	445	435	430

FOB = free on board, Fragrant 5 = Fragrant rice variety with 5 percent broken  
Source: Rice monitor report, 2015, the World Bank.

## e) Income, consumption and employment

**Robust income and consumption growth was also found by the Cambodia’s Socio-Economic Survey (CSES) conducted in 2013, consistent with the national accounts data.** The CSES 2013 findings reveal that the average monthly income of Cambodian households is

estimated to have reached CR1,236,000 in 2013, representing a 21-percent increase over 2012 (Table 7).<sup>15</sup> Among the three geographically classified groups, namely “Phnom Penh”, “other urban”, and “other rural” household groups, the incomes of the “other urban” grew fastest, rising by 40.4 percent during the period.<sup>16</sup>

High income growth has boosted consumption which rose by 15 percent in 2013 over 2012 (Table 8). The consumption of “Phnom Penh” households grew fastest, rising 21 percent during the period. The construction and real estate sector boom is occurring largely in Phnom Penh and this may have fueled rapid consumption growth there.

**Table 7: Incomes of “other urban” households have increased the most.** Household incomes (average monthly, in ‘000 riel)

	2009	2010	2011	2012	2013
Cambodia	747.0	901.0	888.0	1,019.0	1,236.0
(% change)		20.6	-1.4	14.8	21.3
Phnom Penh	2,039.0	1,987.0	1,819.0	1,886.0	2,517.0
(% change)		-2.6	-8.5	3.7	33.5
<b>Other urban</b>	<b>1,101.0</b>	<b>1,504.0</b>	<b>1,172.0</b>	<b>1,504.0</b>	<b>2,112.0</b>
(% change)		36.6	-22.1	28.3	40.4
Other rural	563.0	697.0	728.0	816.0	931.0
(% change)		23.8	4.4	12.1	14.1

Source: Cambodia Socio-Economic Survey 2013

**Table 8: Consumption of Phnom Penh households increased the fastest.** Monthly consumption (in ‘000 riel).

	2010	2011	2012	2013
Cambodia	3,273	3,483	3,794	4,365
(% change)		6	9	15
<b>Phnom Penh</b>	<b>688</b>	<b>794</b>	<b>721</b>	<b>876</b>
(% change)		15	-9	21
Other urban	478	431	665	625
(% change)		-10	54	-6
Other rural	2,107	2,258	2,409	2,864
(% change)		7	7	19

Source: Cambodia’s Socio-Economic Survey 2013

**Cambodia is experiencing a rapidly growing labor force, accommodating expansion of domestic production.** Cambodia’s relatively young population gave rise to an increase in the working age population (15-64 years age group) of 2 million persons in the period 2004-13. Consequently, the dependency ratio declined to 83

<sup>15</sup> Socio-Economic Survey 2013, National Institute of Statistics Ministry of Planning, July 2014.

<sup>16</sup> Note, however, that in other urban areas the sampling error is high.

percent in 2013, from 84.4 percent in 2009.<sup>17</sup> The rising labor force appears to be well absorbed by high employment growth with increased demand for labor, particularly in the “other urban” and “other rural” geographical areas.

**The CSES also indicates an improvement in Cambodia’s employment structure with rising “paid employee” and “self-employed” category shares and shrinking “unpaid family worker” category share.** The “other urban” geographical area has experienced the largest increase in self-employed category share, rising to 52.8 percent in 2013 from 47.8 in 2011 at the expense of the unpaid family worker share, which dropped to 2.2 percent in 2013 from 11.3 percent in 2011 (Table 9). This reflects an increase in economic activity in urban areas and appears consistent with the fastest income growth of “other urban” households discussed above.

**Table 9: For “other urban”, self-employed has significantly increased at the expense of unpaid family worker.** Employment by geographical classification and by type (in ‘000 and in percent).

	2011			2012			2013		
	Phnom Penh	Other Urban	Other Rural	Phnom Penh	Other Urban	Other Rural	Phnom Penh	Other Urban	Other Rural
(’000) Employed numbers	770	793	6,328	848	950	5,908	942	810	6,199
(In percent) Paid employee	64.0	39.9	26.4	55.5	42.9	31.8	63.6	45.0	36.6
Self- employed	26.9	48.7	57.2	33.9	50.3	59.0	30.6	52.8	58.6
Unpaid family worker	9.0	11.3	16.3	10.5	6.6	9.2	5.8	2.2	4.8

**The “other rural” geographical classification experienced a significant increase in its paid employment category share,** which surged to 36.6 percent in 2013 from 26.4 in 2011 at the expense of its unpaid family worker share, which plummeted to 4.8 percent in 2013 from 16.3 percent in 2011. This indicates expanding availability of paid employment in rural areas. “Phnom Penh”, however, received the smallest

increase among the three areas. Unlike “other rural” and “other urban” areas, “Phnom Penh” experienced a decline in paid employment share, dropping to 63.6 percent in 2013 from 64.0 percent in 2011.

In 2013, the total employed population was 7,951,000 out of a total labor force of 7,974,000 and a total working age (15-64 years) population of 9,604,000. Labor force participation rates were 74 percent for “Phnom Penh”, 77 percent for “other urban”, and 85.5 percent for “other rural” in 2013, while employment rates were 73.9 percent for “Phnom Penh”, 76.6 percent for “other urban”, and 85.2 percent for “other rural”.<sup>18</sup> Thus, “other rural” has the highest rates of labor force participation and employment.

## The external sector

**Healthy foreign direct investment inflows remain supportive of Cambodia’s external position and help boost consumption.** The slump in oil prices also has positive impacts on Cambodia’s current account balance as the country is an oil importer. The slump helped to contain import growth during the first half of 2015, partly offsetting the slowdown in merchandise exports as garment exports eased.<sup>19</sup> Current account deficit is, therefore, projected to improve slightly, reaching 10.5 percent of GDP in 2015, compared with 10.8 percent of GDP in 2014 (Figure 9). There have been improvements in net services and net current transfers due to improved confidence, continued vibrant economic activity, and rising remittances during the first half of 2015.<sup>20</sup> On the other hand, trade deficit and negative net income persist. As a result of continued healthy FDI inflows, gross international reserves further improved, reaching US\$5.2 billion or 4.1 months of prospective imports, by mid-2015.

<sup>17</sup> The dependency ratio is defined as the number of children (0-14 years) and elderly (65 and over) divided by the number of people aged (15-64 years).

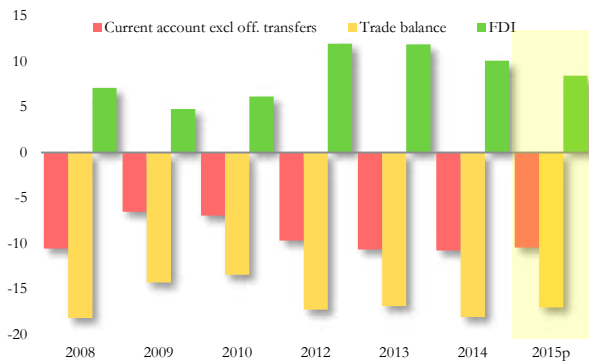
<sup>18</sup> According to Cambodia’s Socio-Economic Survey 2013: working age (15-64) population is divided into: (i) those in the labor force (currently active population); and (ii) those not in labor force (economically inactive). The labor force is divided into: (a) employed; and (b) unemployed. The ratio

of the labor force to working age is called the labor force participation rate, while the ratio of employment to the labor force is called employment rate.

<sup>19</sup> Gasoline and diesel import volume is projected to increase by 12 percent year-on-year in 2015 while their import prices are expected to rise by 10 percent year-on-year only due to petroleum price slump.

<sup>20</sup> According to Q2 2015 balance of payments.

**Fig 9: FDI largely finances current account deficits.** Trade balance, current account balance, and FDI (In percent of GDP)



Source: The authorities and World Bank staff estimates  
p = projection

### a) Exports

Despite some initial successes in export product diversification, garment exports still captured almost three quarters of total merchandise exports in 2014. Increased destination market competition has held back the expansion of garment exports, while dampened agriculture commodity prices have affected agriculture export earnings, in particular for rice and rubber exports, resulting in slower merchandise export growth in 2014. During the first six months of 2015, continued high export growth for footwear products and the resumption of robust milled rice and rubber export growth are encouraging. However, their combined share remains small, accounting for about 11 percent of total merchandise exports.



Clearance times dropped from 6 days (2010) to just 1.4 days (2014) due to automated customs procedures and infrastructure upgrading.

**Total paddy and milled rice exports, second after garment exports, accounted for about 9.5 percent of total merchandise exports in 2014.** The potential gains from exporting milled rice instead of paddy rice remain to be realized. In 2014, milled rice exports were 0.37 million (metric) tons, generating US\$210 million. The country also informally exported paddy rice estimated at around 2.3 million tons or US\$512 million.<sup>21</sup> If Cambodia were to mill the 2.3 million tons of paddy and export this in the form of milled rice, this would generate as much as US\$761 million.

**The large portion of paddy exports (80 percent in volume terms) in total rice exports, reflects Cambodia's strong export price competitiveness at the farm gate.** Due to high milling and logistics costs, Cambodian rice often loses price competitiveness when exported in the form of milled rice. An appropriate rice export improvement measure could, therefore, focus on facilitating a reduction in milling and logistics costs, while continuing to allow paddy rice exports. Any attempt to abruptly impose restrictions on paddy rice exports in favor of milled rice exports will likely hurt rice farmers, rice production, and the economy.

<sup>21</sup> Total rice export in 2014 was conservatively estimated at 2.86 million (metric) tons in paddy equivalent. Of which 2.3 million tons informally exported in the form of paddy rice and 0.37 million ton (or 0.56 ton paddy equivalent) was formally exported in the form of milled rice. Of the total 2.86 million tons, fragrant rice variety covers a third. With fragrant rice already covering half of the formal milled rice exports, informal fragrant paddy rice export is estimate to account for 0.67 million ton (2.86 x 1/3 - 0.56 x 1/2) or US\$187 million with the price of US\$280 per ton. Of the total 2.86 million tons, non-fragrant rice varieties account for two thirds. With non-fragrant rice capturing half

of the total formal milled rice exports, informal non-fragrant paddy rice export is estimated to account for 1.63 million tons (2.86 x 2/3 - 0.56 x 1/2) or US\$325 million with the price US\$200 per ton. Total informal rice (paddy) export is **US\$512 million** (187 + 325). If Cambodia were to mill the 2.3 million tons paddy, and export it in the form of milled rice, it would receive **US\$761 million**, of which US\$321 million (0.67 million tons x 60% x \$ 800 per ton) for fragrant rice and US\$440 million (1.63 x 60% x \$450 per ton) for non-fragrant rice.

## b) Imports



Automation and risk management help improve trade flows.

**Strong domestic demand continues to drive import growth.** While the current construction boom has contributed to construction material imports growth, the recent decline in oil prices is supporting rising demand for petroleum and vehicle imports (Table 10).<sup>22</sup> Domestic demand is also stimulating consumption goods imports such as food and beverages.

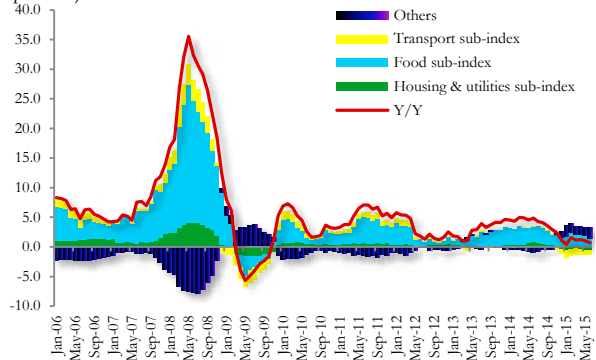
**Table 10: Rising imports of motor vehicles and petroleum products due to strong domestic demand and the decline in petroleum prices.**

Imports (US\$ million)	2013		2014		2015 (6 months)	
	Value	Y-o-Y % change	Value	Y-o-Y % change	Value	Y-o-Y % change
Motor vehicles	543.9	25.8	645.4	21.0	398.5	77.9
Petroleum products	1,052.0	10.6	1,036.6	0.5	554.7	11.0

## Inflation

**Inflation has eased further after a sharp drop in 2014, reflecting depressed food and oil prices.** Year-on-year inflation was subdued, at just 0.8 percent in August 2015, compared with 1.2 percent at the end of 2014 on the back of falling food and petroleum prices (Figure 10). All main inflation sub-indices (except the food sub-index) such as those for housing, utilities, and transport, dipped into negative territory.

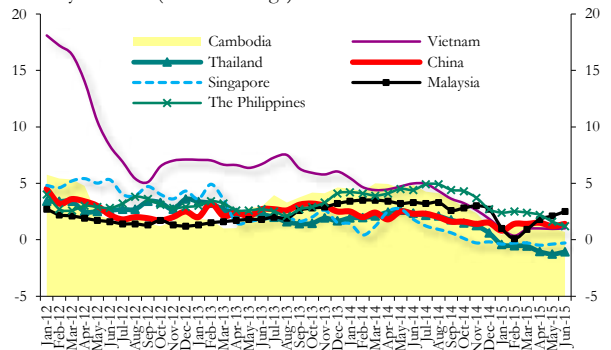
**Fig 10: Transportation, housing, and utilities sub-indices turned negative while food sub-index further subdued, thanks to lower food and petroleum prices.** Contributions to 12-m inflation (In percent)



Source: The authorities

**Regional country inflation has also eased.** Inflation in some regional countries, namely Thailand and Singapore, had already turned negative by mid-2015 (Figure 11). This largely reflects the overall decline in commodity prices which include foods and petroleum. Lower inflation in China, consistent with its slower growth trend, has also helped to subdue regional inflation.

**Fig 11: Regional country inflation has also eased.** Regional country inflation (YoY % change)



Source: The authorities and regional countries' statistics

**While helping to subdue inflation, falling agriculture commodity prices negatively impact the incomes of Cambodian rice producers and exporters.** FOB prices of fragrant rice exports (Table 6), which account for about half of the total milled rice exports, have been hit the hardest, dropping by 7 percent in June 2015 year-on-year. However, given that Cambodia is an importer, the recent sharp decline in

<sup>22</sup> Another main imported item is fabric used in the production of garments that are almost entirely for export.

petroleum product prices has allowed households to spend less on transportation.

### The monetary sector

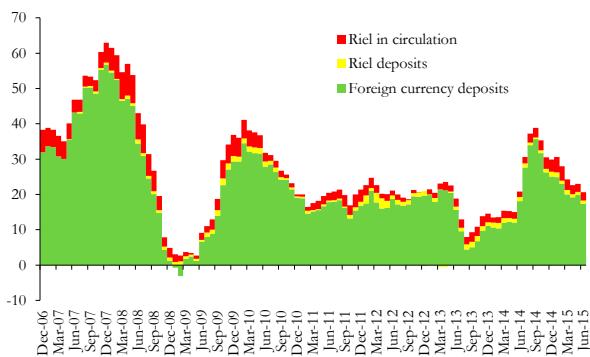


Broad money growth continues to accommodate expansion of the real sectors.

#### a) Monetary aggregates, interest rates, and exchange rates

Accommodating economic expansion, broad money growth continues, albeit at a slower pace, with the rapid expansion of the banking and financial sector. While continuing its expansion, broad money growth decelerated to 20.6 percent year-on-year in June 2015, compared with 29.9 percent in 2014, and this continues to be primarily driven by foreign currency deposits (Figure 12).

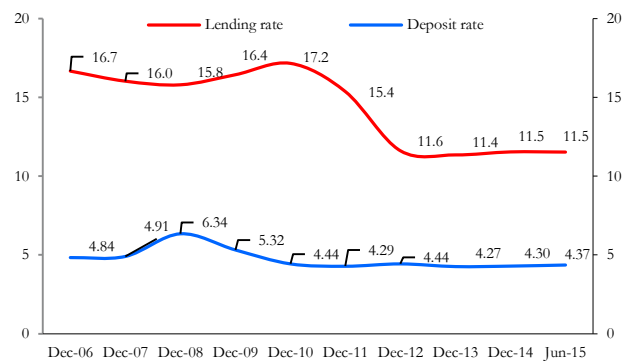
Fig 12: Broad money growth continues albeit at a slower pace, driven by rising foreign currency deposits. Contribution to broad money growth (YoY % change)



Source: The authorities

Both lending and deposit interest rates edged up slightly in 2014 and the first half of 2015 due to rapid domestic credit growth. This trend has to be seen against a background in which heightened competition among banks has resulted in a significant drop in the short-term US dollar lending rate since 2012 (Figure 13). Consequently, the interest rate spread—the difference between the nominal lending and deposit rates—has narrowed substantially.

Fig 13: Competition among banks leaves interest rates broadly stable against the backdrop of rapid credit growth. Weighted average 12-month US dollar interest rates.



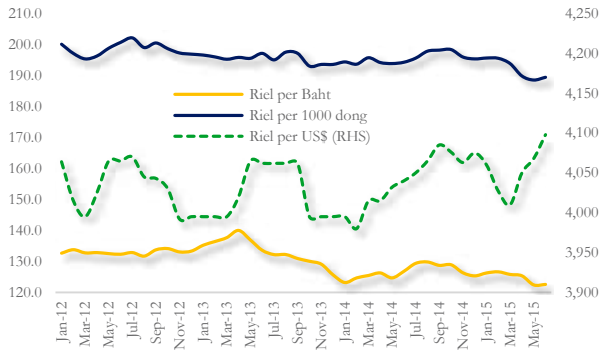
Source: The authorities

It is important to note that continued pressure on short-term interest rates, rapid credit growth and rising import demand do not generate inflationary pressure in the context of dollarization with US dollar appreciation. This, however, does not imply that there is room for monetary policy easing, given persistently high domestic credit growth over the past few years.

The Cambodian riel versus the US dollar exchange rate remains broadly stable, supporting overall price stability. The riel depreciated slightly, reaching CR 4,098 per dollar by mid-2015, which has helped to mitigate some of the losses in external competitiveness in agriculture commodities.<sup>23</sup> Nonetheless, the riel appreciated slightly against the Thai baht and the Vietnamese dong (Figure 14) during the first half of 2015.

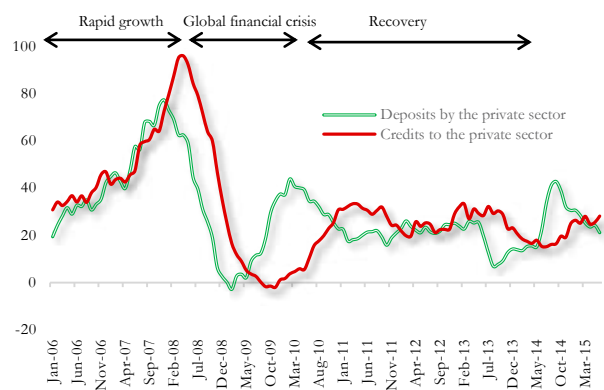
<sup>23</sup> Mainly agriculture commodities whose prices are denominated in local currency.

**Fig 14: Riel is appreciating against baht and dong but depreciating against the dollar.** Nominal exchange rates of riel against dollar, baht, and dong



Source: The authorities, Bank of Thailand, and Vietnam's statistics office

**Fig 15: Private sector credit growth accelerated while private sector deposits growth moderated.** (YoY % change)



Source: The authorities

## b) The banking sector



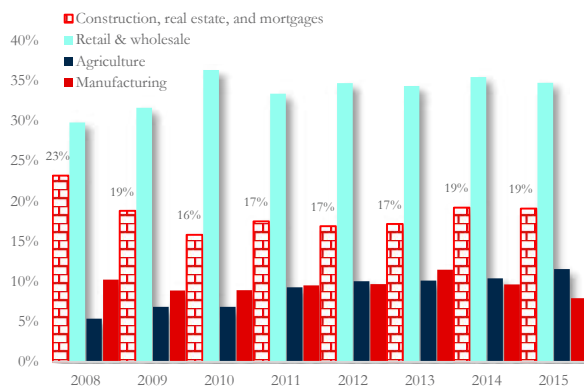
Domestic credit provided by the banking sector has contributed to the construction and real estate boom.

**Rapid financial deepening continues.** Private sector credit growth accelerated further, reaching 28.1 percent year-on-year or US\$8.6 billion, by June 2015, compared with 24.8 percent year-on-year at the end of 2014 (Figure 15). Private sector deposits growth, however, moderated to 21.1 percent year-on-year, or US\$9.6 billion by June 2015, compared with 30.6 percent year on year at the end of 2014. The loan-to-deposit ratio, therefore, rose to 89 percent.

As shown in Figure 16, the construction and real estate sector has received an increasingly large share of total domestic credit in the post-global financial crisis period. The sector captured 19 percent of total domestic credit by mid-2015, compared with only 16 percent in 2010. The share, however, remains below the peak of 23 percent in 2008, in the run up to the global financial crisis when a housing bubble eventually burst. Supporting the authorities' 2010 Rice Policy, the share of domestic credit provided to the agriculture sector has picked up, reaching 11.6 percent in June 2015 from 6.8 percent in 2010. The share of domestic credit provided to the manufacturing sector, however, has steadily declined, accounting for 7.9 percent in June 2015, down from 11.5 percent in 2013. This does not bode well for the targeted advancement of the manufacturing sector as envisaged by the Industrial Development Policy (IDP). The retail and wholesale, construction, agriculture, and manufacturing sectors combined cover almost three quarters of total domestic credit, spurred by vibrant business activity.



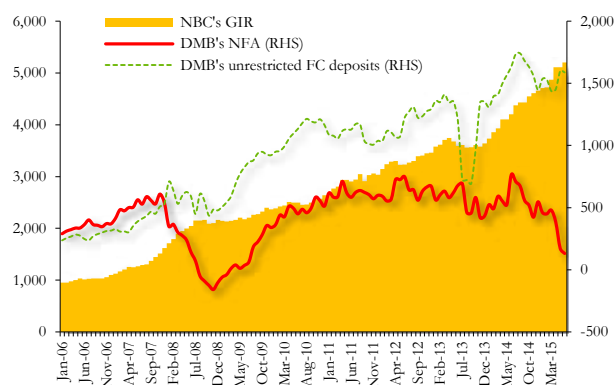
**Fig 16: Loans to the construction and real estate sector have been rising since post-global financial crisis period. Domestic credit by type of business (% of total).**



Source: The authorities.

The expansion of the banking sector has contributed to a decline in net foreign assets of banks, as the rise in foreign liabilities more than offsets the increase in foreign assets (Figure 17). Unrestricted foreign currency deposits by banks at the central bank have also declined. FDI inflows have largely contributed to increasing the central bank's gross international reserves, which reached US\$5.2 billion (or 4.1 months of prospective imports) by June 2015.<sup>24</sup> This compares with US\$4.6 billion at the end of 2014.

**Fig 17: Banks' net foreign assets are declining as the rise in foreign liabilities more than offsets the increase in foreign assets.** (In millions of USD)



Note: FC: foreign currency, GIR: gross international reserves, NFA: net foreign assets, and DMB: deposit money banks.

Source: The authorities

<sup>24</sup> Includes all foreign exchanges including Chinese Yuan used as reserves.

## The fiscal sector



Studying outside of normal school hours can help to improve test scores.

Fiscal consolidation has been sustained as high revenue growth and largely contained expenditure continue to curb the overall fiscal deficit. During the first seven months of 2015, domestic revenue continued to perform well, growing at around 18 percent year-on-year. It is projected that revenue collection will reach 17 percent of GDP (Figure 18) and expenditure will marginally increase to 21 percent of GDP (Figure 20), driven largely by an increase in the wage bill, resulting in a slightly wider overall fiscal deficit including grants of 1.6 percent of GDP (Figure 21).

### a) Revenue composition



Revenue collection through the banking system has reduced leakages and improved transparency.

Continued improvements in revenue administration have enabled high domestic revenue growth to be sustained. As a result,

domestic revenue reached 16.6 percent of GDP in 2014, compared with 15.1 percent of GDP in 2013, overachieving the annual target increase of 0.5 percent of GDP under the PFMRP. The introduction and implementation of the revenue mobilization strategy (2014-18) appropriately set out key priority areas, namely revenue administration and good governance, given the existing capacity of the revenue collecting agencies.

**Fig 18: Domestic revenue markedly improved in 2014 and projected to perform well in 2015 as well.** General gov revenue (In percent of GDP)



**The overall structure of domestic revenue has significantly changed with a rising share of direct taxes, albeit from a low base.** The share of direct taxes in domestic revenue has more than doubled over the past decade.<sup>25</sup> Its share rose to 17.5 percent in 2014, up from 7.1 percent in 2004 (Figure 19), despite the fact that generous tax incentive provisions under the Law on Investment have remained unchanged. Although direct tax collection remains relatively low at around 3.0 percent of GDP (3.8 percent of GDP collected in Lao PDR, 5.6 percent of GDP in Indonesia, and 7.4 percent of GDP in Thailand), the rapid improvement indicates good progress in administration.<sup>26</sup> While continuing to be the largest component, the share of indirect taxes increased only slightly to 47.5 percent from 40.5 percent during the same period, whereas the share of trade taxes actually dropped to 16.3 percent

<sup>25</sup> In the Cambodian tax system, direct taxes include: corporate income taxes (profit taxes), payroll taxes, and property taxes.  
<sup>26</sup> FY 2012/13 for Lao PDR, FY 2013 for Indonesia, and FY 2013/14 for Thailand. See 2014 and 2015 IMF Article IV Consultation- Staff Reports for Lao PDR, Indonesia, and Thailand.

### Box 3: Public Financial Management Reform Program (PFMRP) Go-live of FMIS

The Financial Management Information System (FMIS) is a modern budgeting, accounting and reporting tool providing a set of automation solutions enabling the authorities to plan, execute and monitor the budget. The solution can assist the Royal Government of Cambodia (RGC) in the prioritization, execution and reporting of expenditures, as well as the custodianship, use and reporting of revenues.

“Go-Live 1” of FMIS was successfully launched on July 20, 2015. It represents an achievement of the first major operational milestone with the go-live of the *General Ledger* and *Budget Allocation* Modules for a number of key general departments within the Ministry of Economy and Finance. As a result, all in year budget changes such as transfers and other in-year changes will be performed directly in the FMIS system.

“Go-Live 2”, the second major milestone scheduled for October 21, 2015, will involve *Account Payable*, *Purchase Order*, *Account Receivables*, and *Cash Management* modules. After the second go-live the core functionality in the FMIS related to budget execution will be implemented. At this stage, end users in participating departments will start using the system for the performance of their day-to-day work, and key revisions to the way they perform their business processes will be implemented.

#### What Benefits Can FMIS Provide?

The FMIS supports the streamlining and processing/recording of payments, revenue collection and receipts, and accounting and reporting of the central and provincial treasuries. Spending ministries at the center, and spending departments in the provinces, will submit their payment requests and revenue receipts to the central treasury, or the corresponding provincial treasuries, for processing. Ministries and departments will have easier and timelier access to financial information, from which they will be able to generate financial and management reports. The system will provide better program and financial information to program managers, enabling them to redirect or allocate resources more effectively, efficiently and transparently; and to facilitate the timely receipt of funds by, for example, provincial and district education offices, as well as by clinics and hospitals. Overall, the FMIS will generate immediate benefits by improving the way the RGC monitors, adjusts, and reports on its budget each year.

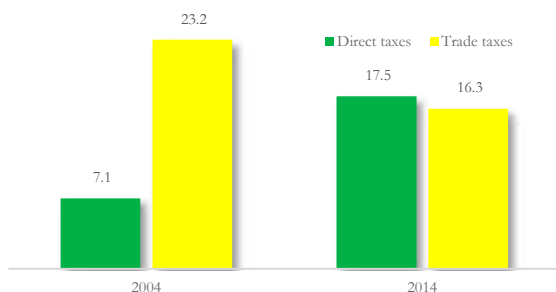
Source: The authorities and World Bank staff.

from 23.2 percent.<sup>27</sup> The authorities’ efforts to gradually transform the previous tax structure, heavily dependent on trade taxes, to a more advanced tax system based on direct and domestic taxes will help to sustain collection as the country

<sup>27</sup> Indirect taxes cover turnover taxes, value-added taxes, and excises. Trade taxes mainly consist of import and export taxes.

pursues free trade policy objectives, such as those envisaged under the AEC.

**Fig 19: Direct tax collection improved significantly, albeit from a low base, while trade tax collection shrank during the past decade. (% of total domestic revenue)**



Source: The authorities

## b) Expenditure composition



Learning to compete regionally and globally is essential.

**Although total spending remains contained, a rapid expansion of the wage bill could jeopardize the fiscal consolidation effort.** Following a rise in the minimum salary, the wage bill was budgeted at 6.4 percent of GDP in 2015, compared with 5.5 percent in 2014. Wages are likely to remain on the rise as the minimum basic salary is targeted to gradually increase and reach up to CR 1 million (equivalent to US\$ 250) by 2018.<sup>28</sup> It is, therefore, important to ensure the affordability of the rising wage bill, and to link this to improvements in human resource management and public service delivery.

A civil service reform initiative aimed at containing the costs of public sector employment through retrenchment and restructuring including establishment control currently being introduced as part of the effort to improve public sector performance, is a step in the right direction. **International experience shows that the following institutional factors may improve public sector performance:** (i) well defined roles, responsibility, and accountability; (ii) appropriate human resource management practices; and (iii) in the education and health sectors, there is evidence that increasing the scale of operations may improve efficiency.<sup>29</sup>

**On the other hand, capital expenditure has shrunk**, due to a decline in the externally financed component, since the end of the fiscal expansionary policy, which had been introduced to mitigate the negative impacts of the global financial crisis. This may pose a challenge in the future, since improved infrastructure is needed in order to enhance the country's competitiveness and achieve a more balanced economic development.

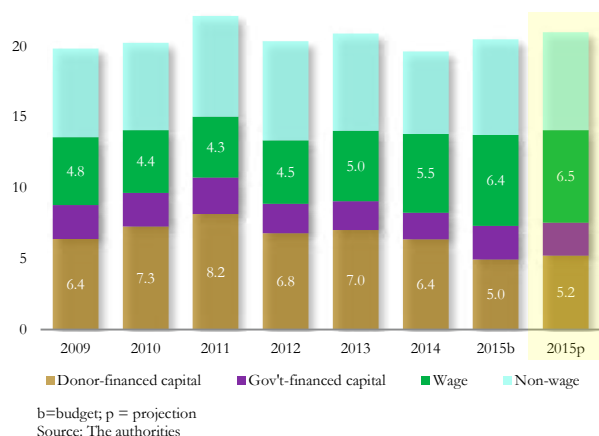
**It is worth noting that a series of efforts has been made to improve spending efficiency and results.** For instance, this has been seen with the introduction of full program budgeting pilots at 10 key ministries<sup>30</sup> and the introduction of the Financial Management Information System (FMIS). The FMIS aims to achieve the timely and comprehensive recording and reporting of government budget performance and results, based on international public sector accounting standards, among other measures under the Public Financial Management Reform Program (PFMRP).<sup>31</sup> See Box 3 for more recent achievements under the PFMRP. The resulting spending efficiency will support any efforts to scale up domestically financed capital investment.

<sup>28</sup> A comprehensive and well sequencing civil service reform aiming at containing the costs of public sector employment through retrenchment and restructuring including establishment control (subdecree 114 dated September 7, 2015) is being implemented.

<sup>29</sup> **Improving Public Sector Efficiency: Challenges and Opportunities** by Teresa Curristine, et al., OECD Journal on Budgeting Volume 7 – No. 1, 2007

<sup>30</sup> The 10 ministries are education, health, rural development, agriculture, women's affairs, labor, land, public works, and finance. For more details, see [www.pfm.org.gov](http://www.pfm.org.gov).

**Fig 20: Development partner-financed public investment is declining while the wage bill is rising. General government expenditures (In percent of GDP)**

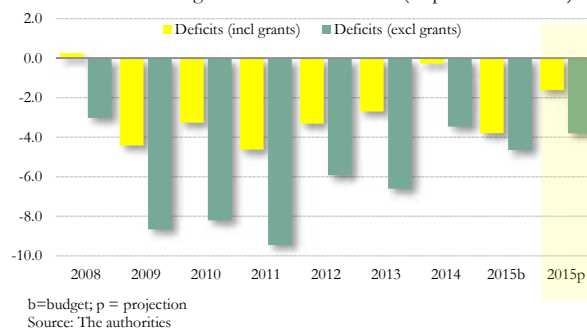


### c) Fiscal balance

**While buoyant revenue collection continues, a marginally wider fiscal deficit** (excluding grants) of 3.7 percent of GDP is projected for 2015, compared with 3.5 percent of GDP in 2014, due to rising current expenditure. Including grants, the fiscal deficit is projected to reach 1.6 percent of GDP in 2015, compared with 0.3 percent of GDP in 2014. The fiscal deficit continues to be financed by external funds.

Meanwhile, government deposits reached 8.7 percent of GDP, or US\$1.4 billion at the end of June 2015. The accumulation of government deposits provides a cushion that the government can use at times of shocks. For instance, Cambodia introduced a fiscal stimulus, amounting to about 2 percent of GDP to mitigate negative impacts of the global financial crisis. Fiscal policy has been largely the sole policy instrument to maintain macroeconomic stability and to mitigate shocks as the country's monetary policy is constrained by its high level of dollarization.

**Fig 21: The fiscal deficit has been improving gradually as a result of fiscal consolidation efforts after the end of fiscal stimulus period mitigating impacts of the global financial crisis. Government government fiscal deficit (In percent of GDP)**



**The World Bank/IMF debt sustainability analysis (DSA) indicates that Cambodia's debt distress rating remains low**, with all debt burden indicators projected to remain below their respective thresholds. The results also indicate that debt sustainability continues to be vulnerable to growth, exports, and fiscal shocks, calling for continued structural reforms to increase the economy's resilience to external shocks, and to mobilize domestic revenues. At the end of 2014, the estimated stock of Cambodia's external public debt, including arrears, stood at around US\$ 5.5 billion or 33 percent of GDP.

## C. Key Messages and Recommendations

**There is a pressing need to enhance external competitiveness.** In the context of an appreciating US dollar (and Cambodian riel) vis-à-vis the Euro and neighboring currencies, and facing increasing competition, Cambodia needs to address key bottlenecks constraining productivity growth as well as export cost reduction. A better trained and more skilled workforce will certainly help to improve competitiveness in the short term. A recent initiative to set up a large scale garment training institution is encouraging. In addition, further improving the overall business environment through the simplification and automation of business registration and trade facilitation processes, and an enhanced investment law, would help sharpen Cambodia's competitive edge across sectors. Finally, it is essential to support diversification in the manufacturing sector as envisaged by the Industrial Development Policy, while preparing Cambodia to take advantage of opportunities as they arise in the medium term under the single market and production base goal envisaged by the AEC. From the medium- to long-term perspective, addressing the unreliability and high cost of electricity with additional power supply available from hydro and coal-fired power plants is a priority. **International experience** attaches a strong business environment to a number of attributes: (i) a legal and regulatory framework that is predictable and based on international norms, a central element; and (ii) a favorable investment environment as well as trade facilitation and logistics, key determinants of competitiveness.<sup>32</sup>

**Boosting domestically financed public investment is necessary.** This is to compensate for the decline in development partner-financed

capital investment as Cambodia moves towards joining the lower middle-income group. First and foremost, this entails pursuing additional domestic revenue. With continued buoyant collection, prioritized public investment project funding may be affordable, and can therefore be appropriated in the short term. In addition, efficiently scaling up domestically financed investment requires appropriate measures and capacity. Thus, it is crucial within a short- to medium-term time frame, to strengthen the rules and regulations, i.e., budgetary, procurement, and auditing rules governing the management of public investment projects with a focus on improving appraisal, implementation and evaluation to achieve value for money, as appropriately envisaged under the PFMRP. Institutional quality and capacity also need to be further strengthened to better manage public investment. This is a time consuming task that requires a high level of commitment and political leadership. **International experience** indicates the importance of adherence to the following four broad principles in order to successfully scaling up public investment: (i) achieving “allocative efficiency” by shifting resources from less productive sectors to more productive ones; (ii) being grounded in a sound macro-fiscal framework to prevent real exchange rate appreciation from an investment spending boom; (iii) the public investment management system should be sound; and (iv) the construction sector has to be able to effectively respond and meet these increasing demands.<sup>33</sup>

**The further strengthening of supervision and coordination in order to safeguard stability in the rapidly expanding banking and construction sectors is essential.** While Cambodia is likely to be shielded from financial volatility due limited capital markets, bank flows in the form of foreign currency deposits remain sensitive to public confidence and perceptions.<sup>34</sup> Further action to enhance banking supervision

<sup>32</sup> Cambodia Trade Integration Strategy 2014-18, 2014 by RGC, World Bank, UNDP, and ADB

<sup>33</sup> Mongolia: Improving Public Investments to Meet the Challenge of Scaling up Infrastructure, World Bank, 2013.

<sup>34</sup> During the period covering June – August 2013, bank deposits (mostly US dollar deposits) dropped by about US\$600 million caused by election-related political uncertainty.

supported by strengthened accounting and auditing practices with improved data integrity and availability is a priority. More importantly, establishing a crisis management framework underpinned by close inter-agency coordination is fundamental. Looking ahead, better understanding of the “transmission channels” of potential external volatility, including a hard landing of the Chinese economy, on Cambodia’s economy, as well as the linkages between the financial sector and the real sector, will help strengthen the economy’s resilience to shocks. A recent effort to improve coordination between public institutions regulating the banking sector, the construction sector and urbanization, and the real estate service sector with collaboration by major construction firms and real estate developers is a welcome first step.

This will help avoid a potential bubble from developing in the construction and real estate sector. **International experience** points to a framework of minimum standards for sound banking supervisory practices universally applicable which includes: (i) a clearly defined supervisory powers; (ii) responsibilities and accountabilities among supervisory authorities; and (iii) appropriate prudential regulations. A number of preconditions for effective banking supervision are: (i) a well-established framework for financial stability policy formulation; (ii) a clear framework for crisis; and (iii) an appropriate level of systemic protection (or public safety net).<sup>35</sup>

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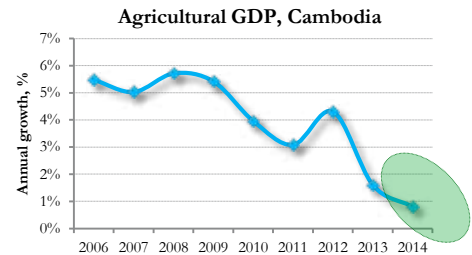
<sup>35</sup> Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision

September 2012, Bank for International Settlements.

## D. Selected Issue – Cambodian Agriculture in Transition: Risks and Opportunities<sup>36</sup>

### Introduction

The agriculture sector has been the most important contributor to pro-poor, shared growth in Cambodia in the 2000s. During 2004-12, agricultural GDP growth averaged 5.3 percent per year. However, in 2013-15 this growth rate has slowed to just 1.0 percent. Does this mean that the country is in an irreversible transition towards slower agricultural growth? Cambodia can ill afford such a scenario because agricultural growth remains critical to continued poverty reduction and shared prosperity. Market- and private-investment-friendly policies and targeted public sector investments in irrigation, agricultural extension, and other “public good” agricultural services, as feasible within the Government’s total budget, can help to secure continued robust agricultural growth.

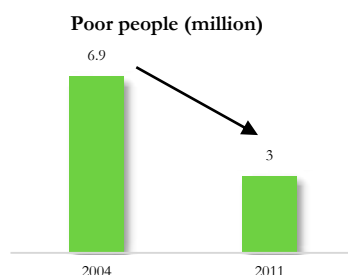


**The past decade’s agricultural growth story is one of many successes...**

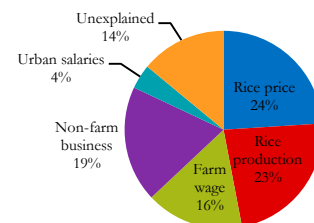
Over the past decade, Cambodia’s agriculture sector has undergone a significant structural transformation, as reflected in the national accounts and observed in the field during the 2005 and 2013 World Bank surveys. Although it still plays a major role, the agriculture sector has become relatively less “important” in overall GDP and the total labor force, but more “productive”, i.e., agricultural land and labor productivity has increased. This transformation has been driven by vibrant and pro-poor agricultural growth.

**Agricultural growth in Cambodia used to be high.** In the period 2004-12, annual growth in gross production was 8.7 percent. Agricultural GDP grew by an annual average of 5.3 percent during this period. This exceptional growth rate—among the highest in the world—was driven by crop production, mainly of paddy rice (annual average growth of 9 percent), but also maize (20 percent), cassava (51 percent), sugarcane (22 percent), and vegetables (10 percent). Growth in livestock and fisheries, on the other hand, was modest.

**Agricultural growth was pro-poor.** Cambodia’s poverty headcount declined from 50 percent in 2007 to 21 percent in 2011, with the number of poor declining from 7 million to 3 million. Most poverty reduction took place in rural areas. More than 60 percent of the poverty reduction was attributed to the agriculture sector: higher rice prices stimulated larger rice



Key Drivers of Poverty Reduction 2004-2011



<sup>36</sup> This annex is based on the World Bank report “Cambodian Agriculture in Transition: Risks and Opportunities”, Economic and Sector Work, Report No. 96308-KH. The full report can be accessed at <http://documents.worldbank.org/curated/en/2015/08/24919384/cambodian-agriculture-transition-opportunities-risks>.

production, which in turn increased farm wages. Further poverty reduction will continue to depend on the success of

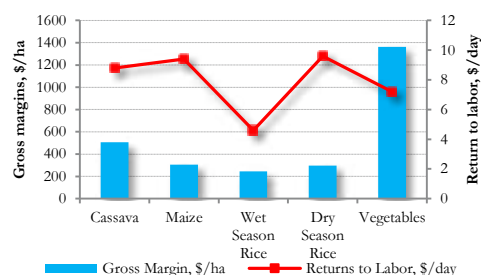
agriculture for many years to come, due to the sector's major role in the labor force, in value added, and in exports, as well as the fact that many farmers are among Cambodia's poorest and more vulnerable citizens.

**Agricultural wages are converging with nonagricultural wages.** Agricultural wages grew by 265 percent between the World Bank surveys conducted in 2005 and 2013, while nonfarm wages increased by 60 percent. As a result, the ratio between per worker nonagricultural to agricultural valued-added at current prices fell to 2.1 in 2012, down from 3.2 in 2004. Returns to farm labor have been increasing.

**The diversification of crop production has started.**

Although production still mainly focuses on paddy, the crop mix has been changing, driven by higher profitability of non-rice crops. In 2013, average farm gross margins (and returns to labor) were US\$506/ha (US\$9.4/day) for cassava, US\$303/ha (US\$8.8/day) for maize, and US\$1,393/ha (US\$7.2/day) for vegetable production, compared with US\$245/ha (US\$4.6/day) for wet season rice and US\$296/ha (US\$9.6/day) for dry season rice. Dry season rice competes well with non-rice crops in terms of returns to labor but its expansion is constrained by limited irrigation. The share of total area planted under paddy declined from 86 percent in 2002 to 74 percent in 2011, while the share of planted area for maize and cassava production increased significantly.

Gross Margins and Returns to Labor, 2013



**Even the paddy segment has started to diversify.** Triggered by the demand from modernized rice mills, more farmers are now growing more profitable aromatic paddy, estimated at 10 percent of the rice cultivated area and 30 percent of total production. Further expansion of farmland under aromatic paddy is possible with improvements in the quality of seed supply, agricultural extension, and irrigation.

**Yields increased for most crops.** With annual growth in cultivated land areas at 4.7 percent and agricultural gross production at 8.7 percent, average growth of yields was 4 percent during 2004-12. This growth in yields was triggered by the widespread adoption of improved technologies, expanded (albeit still limited) irrigation, greater use of modern inputs, and better access to mechanized services, pointing to advances in commercialization. Farmers also have better access to markets.

**Cambodian farm products remain price competitive at the farm gate.** A domestic resource cost analysis of competitiveness shows that despite rising labor costs and prices of farm inputs, the value-added generated by farmers exceeds the costs of domestic factors of production (land, labor, and capital). This high competitiveness explains the significant increase in agricultural exports over the past decade. However, the competitiveness of ordinary rice produced during the wet season has worsened in recent years and many small farmers producing ordinary rice have started to lose their competitive edge.

**Past agricultural growth was driven by several factors.** Among the major factors were open trade and, in general, a market-oriented agricultural policy. Cambodia was one of the few developing countries that did not overreact to the 2008 global food price spike, but instead saw higher food prices as an opportunity to leverage agricultural growth. Other net-exporting countries such as India and Vietnam used export restrictions to limit transmission of the global food price spike into their markets. Higher agricultural prices in Cambodia made farmland expansion profitable. In addition, the agriculture sector benefited from: (i) improved access to overseas markets through the Everything-But-Arms Agreement with the European Union and open cross-border trade with neighbors; (ii) better availability and wider use of mechanization



services triggered by the higher cost of rural labor; (iii) better farm access to finance; and (iv) private sector investment in rice mills.

### ...but there are also challenges

**A large share of the past agricultural growth was driven by farmland expansion.** The average contribution (weighted by crop areas) of land expansion to the change in farm gross margins in real terms between 2005 and 2013 was 60 percent (Table 1). Farmland expanded annually by 4.7 percent, with very large increase (128 percent) for cassava.

**Table 1: Annual changes in farm gross margins, in real terms, 2005-13, %**

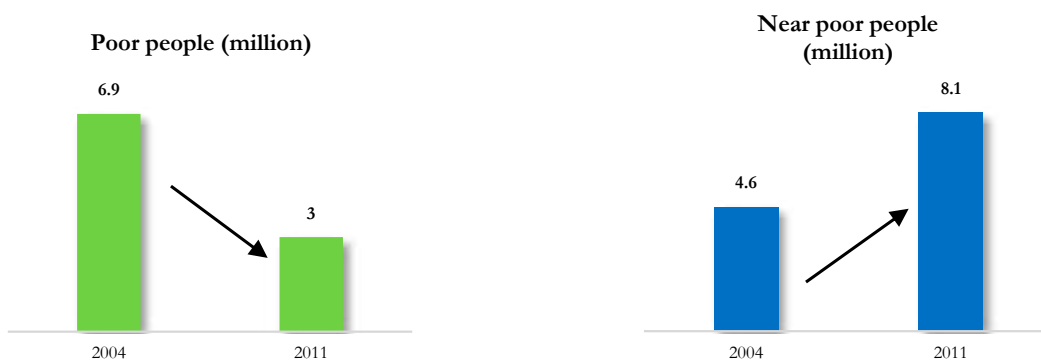
	Change in cultivated areas	Change in per ha gross margin	Change in total gross margin
Wet season rice	2.1	2.4	4.5
Dry season rice	6.7	2.1	8.8
Cassava	128.1	15.1	143.2
Maize	17.2	-10.3	6.9
Vegetables	6.4	44.5	50.9
<b>Weighted average</b>	<b>4.7</b>	<b>3.4</b>	<b>8.2</b>

*Note:* Gross margin is defined as gross revenue *less* intermediate inputs, including hired labor. The farm gross margin includes rice, cassava, maize, and vegetables.

*Source:* 2005 and 2013 World Bank surveys.

**The average increase in per hectare gross margin was solid, at 3.4 percent per year.** But this nonetheless varied between 2.1 percent for dry season rice to 44.5 percent for vegetables. Maize's per hectare margin even declined. In many cases, farmers who expanded their land areas received higher incomes, but farmers with unchanged land areas were unable to substantially increase their incomes. The period of relatively high food prices was largely used to expand land areas rather than to build a strong foundation through productivity increases.

**While poverty reduced significantly, the number of vulnerable people also increased significantly.** Most people who escaped poverty did so only by a small margin. The loss of only CR 1,200 per day (the cost of two small water bottles) would cause Cambodia's poverty rate to double to 40 percent. This high rate of vulnerability is a sign of still modest agricultural productivity increases. Nutritional security has also lagged behind the reduction in poverty: although the prevalence of stunting among children under five declined by 7 percent between 2010 and 2014, it remained at the high rate of 33 percent.



*Poor are those living below \$1.15 per day (poverty line)*

*Near poor or vulnerable are those living above \$1.15 per day, but below \$2.30 per day*

**Vulnerability is greatest among the smallest farms.** Small farmers, with land areas of less than one hectare, reported difficulties in expanding and integrating into emerging modern food value chains. The share of such farms in the total number of rural households owning land was 48 percent in 2011. Over the past decade, there has been a trend in Cambodia for large farms (above 3 ha) to become larger and small farms (less than 1 ha) to become smaller. The average size of the surveyed farms with less than 1 ha in land declined from 0.99 ha in 2008 to 0.88 ha in 2012, while the average size of medium farms (between 1 and 3 ha) increased from 1.55 ha to 2.38 ha, while the larger farms (above 3 ha) increased from 3.61 ha to 7.03 ha. Despite the productivity improvements of some small farms in recent years, the productivity of most small traditional farms has remained low, as agricultural extension and other public services have not reached them to any great extent. It appears that the income increases for this group of farmers over the past decade have come largely from higher production values driven by high agricultural prices and the sale of their labor to larger farms at higher wages, rather than higher land and labor productivity.

**Except for rice, the agro-processing industry has played a limited role in agricultural growth.** Almost all crops were exported to neighboring countries unprocessed. This indicates serious weaknesses in the value chain, particularly in the post-harvest system of supply chain management (collection of raw material, storage, finance, logistics, transportation, and information).

### **What worked in the past will no longer be sufficient in the future**

**With global food prices declining and the land frontier diminishing, Cambodian agriculture is losing its two major growth drivers.** Moreover, agricultural labor is becoming scarcer and more expensive, adding to production costs. Global agricultural prices are projected to decline over the next decade, and selling low-quality ordinary rice on domestic and foreign markets will become less and less profitable. Relying on higher domestic demand driven by the increase in GDP and higher global demand alone, without more efficient use of resources, will not be enough to maintain the high rate of Cambodia's past agricultural growth. Cambodia will need to find new drivers to maintain agricultural growth at or close to 5 percent.

**The recent slowdown in agricultural growth in Cambodia may signal a potential longer-term growth decline.** As global food prices have gradually fallen and the global rice market has become more competitive with the reentry of Thailand and Myanmar, so rice production in Cambodia has stalled. Along with this, total crop value-added declined, from 4.9 percent in 2012 to 0.6 percent in 2013. Growth in

agricultural value-added slowed to 1.6 percent in 2013 after average growth of 5.3 percent in the period 2004-12.

**Returning to a high agricultural growth rate is important.** Agriculture still accounts for a large share of GDP, trade, and the labor force, which means that it will remain the key to further reductions in poverty and vulnerability in the coming decade. If Cambodia’s structural transformation continues, with agricultural growth averaging 5 percent, by 2030 Cambodia will have a relatively smaller but more productive agriculture sector. Agriculture’s shares of GDP and the total labor force are projected to decline to 17 percent and 31 percent, respectively, in 2030, down from 26 percent and 51 percent in 2012. Meanwhile, land productivity will increase from US\$1,300/ha to US\$2,700/ha and labor productivity will rise from US\$1,200/person to US\$3,700/person in the same period (Table 2).

**By contrast, the cost of slow agricultural growth will be huge.** If average agricultural growth is only 3 percent in the period 2012-30, agricultural value-added will be 29 percent lower by 2030 compared with a 5 percent growth scenario. This would have the effect of slicing overall GDP by 18 percent, keeping more people in agriculture, reducing agricultural labor productivity by 34 percent, and slowing any further income convergence between farmers and nonfarmers. Lower agricultural growth would also lead to a much slower reduction in poverty.

**Table 2: Impact of lower agricultural growth in Cambodia**

Indicators	2012	2030	
		3% Ag GDP growth	5% Ag GDP growth
Share of agriculture in GDP, %	26	15	17
Share of agriculture in labor force, %	51	34	31
Agricultural labor productivity, \$/person	1,200	2,450	3,700
Agricultural land productivity, \$/ha	1,300	1,900	2,700
Labor productivity ratio of agricultural to nonagricultural workers	2.1	2.1	1.6

*Source:* World Bank staff estimates.

**A long-term vision for Cambodian agriculture would need to encompass elements of sustainability, productivity, competitiveness, and income growth, while shifting away from the still strong focus on production.** Simulation of different scenarios of future agricultural development reveals that a rise in farm productivity would have the largest positive effect on farm incomes, especially if the shift from traditional to modern technologies is accompanied by greater efficiencies in modern input use and irrigation. Farmers producing fragrant rice, processing cassava into dry chips, and undertaking other value addition activities can increase their incomes further, illustrating the importance of the agro-processing industry. Lowering production costs through better use of existing resources (e.g., productivity increases) and minimizing declines in farm output prices through lower logistics costs are key to maintaining farm competitiveness. Continued land expansion also provides additional income but sustainability considerations will limit large expansions in the future. This constraint makes agricultural productivity, commercialization, and diversification even more critical in ensuring future agricultural growth that reduces poverty and boosts shared prosperity in Cambodia.

## Recommendations

a) **Continued rapid agricultural growth and further structural transformation in the agriculture sector are possible in Cambodia.** Four sets of policies together can help support such continued agricultural growth during the next five years. The first is maintaining a private-sector-friendly agricultural policy environment, with added attention to lowering the regulatory burden in farm input sectors. The second is strengthening the environmental sustainability of agricultural production. The third is improving the quality of agricultural public programs and, as feasible within Cambodia's total government budget, increasing allocations to more effective programs. The fourth is helping to develop the agribusiness and agro-processing industry.

### b) **Maintaining a Private-Sector-Friendly Agricultural Policy Environment**

**Cambodia's market-oriented agricultural policy and open trade policy helped to achieve high past rates of agricultural growth.** The private sector has benefited from minimal, if any, interventions in farm output and input pricing, from the strong commitment to open trade, including across the border, and from the reduction of export costs and time required for export processing. This has created conditions for farmers and other players to invest and generate profits. These open trade and market-oriented agricultural policies remain critical to future growth and need to be protected by all means possible.

**In addition to maintaining a non-distortive agricultural policy, reforms in the seed sector can make an important contribution to agricultural growth.** Currently, only 10 percent of potential paddy seed demand is estimated to be met by the seed supply. Insufficient supply of seeds and their poor quality in Cambodia have been among the main reasons for relatively slow productivity improvements, placing significant constraints on future agricultural growth mainly because investments in fertilizers and machinery pay off only when combined with the use of improved seeds. Many policy distortions exist in the seed sector, ranging from a state monopoly in the supply of foundation seeds to the lack of clear and conducive regulations for trials, releases, production, and the import of seeds. The regulatory and legislative bottlenecks in the seed sector need to be addressed in the coming years.

**Regulations for inputs such as fertilizers can also be improved to reduce costs to farmers.** Cambodia currently has burdensome requirements for importers of fertilizers to register products and apply for import licenses for each imported lot. The procedures should be simplified through the approval of import licenses on the basis of product suitability only, and once received all importers should be allowed to import any quantity of these registered inputs.

### c) **Strengthening Environmental Sustainability**

**Embedding environmental sustainability in agricultural policy will become increasingly important.** The rapid farm land expansion, by 4.7 percent annually during 2005-2013, often at the expense of forests, is not sustainable. There is a need for a more sustainable expansion of cultivated land, through better land-use planning, strengthened land-tenure security, and maintenance of soil fertility through better use of available land and promotion of sustainable land management practices. **International experience** shows that the most effective way to promote such practices is to combine the enforcement of natural resource protection with agricultural extension and other public programs that increase land users' awareness of the longer-term costs and benefits, and promote the adoption of modern technologies.

**With more farmers using agricultural chemicals for vegetable and other crop production, the Government would need to strengthen public health regulations related to their safe use and promote alternative programs that ensure safe, effective and environmentally sound pest management.** These alternative programs include integrated pest management, where the pest population is controlled through biological controls, cultural practices and the development and use of crop varieties that are pest resistant or tolerant.

#### **d) Improving Agricultural “Public Goods” Investment**

**Future agricultural growth will need to come from productivity improvements, commercialization, and diversification, all of which strongly depend on effective “public goods” investment in agriculture.** The relatively small size of most farms in Cambodia and their large numbers (about 50 percent of farms in Cambodia are up to 1 ha) require more resources for service provisions than in countries with large farms and few farmers. Public programs proven worldwide to contribute to long-term agricultural growth include those for irrigation, research, extension, education, vocational training, food safety, and provision of market information. While these programs exist in Cambodia, they have little to show in terms of their contribution to past agricultural growth. The main reason for this is their low efficiency and effectiveness. Many programs are poorly designed and have a weak implementation record. Most expenditure goes towards capital and wages, with little spent on operations and maintenance. Relatively low funding levels are another reason for the weak record of some of these programs in Cambodia.

**Agricultural extension needs more attention.** This program is critical to strengthen farmers’ skills and knowledge to adopt modern farm practices and diversify their rice-based farming systems. The recently adopted Agricultural Extension Policy creates the good enabling environment to pilot alternative approaches to deliver extension services, including through subcontracting of private sector for service provision. Moreover, extension needs to become more gender sensitive as female-headed households and women in male-headed households have different needs than men due to the different roles they play in agricultural production, and given women’s time constraints and limited mobility that affects their access to training.

**Irrigation investments deserve special attention.** Without reliable access to affordable water in a tropical country such as Cambodia, it is hard to expect intensification and commercialization. Farmers’ access to water in the dry season, when it is mostly needed, has improved only marginally. Irrigation coverage in Cambodia is among the lowest in Asia, despite the fact that most resources allocated to irrigation investments have been spent on primary infrastructure. While irrigation coverage needs to be further expanded, this expansion needs to go hand-in-hand with the extension of secondary canals, the rehabilitation and upgrading of the existing systems, investments in participatory management of irrigation and drainage infrastructure and better coordination of irrigation/flood management with the delivery of other agricultural public services.

**Greater attention is also merited to the integrating of small farms into modern food value chains.**

Public extension services are especially important for these farms because they are unlikely to receive sufficient extension services from the private sector, while without improved farm management skills and information they will stay poor and vulnerable, disconnected from economic transformation processes. Small farms, including households participating in social land concessions, can be supported through public services to facilitate stronger links with the agribusiness and agro-processing industry, through productive partnerships (e.g., contract farming and farmer organizations), training in business and other skills, and the provision of market information.

**e) Helping Develop the Agribusiness and Agro-processing Industry**

**Although development of the agribusiness and agro-processing industry should be considered part of the improvement in the overall business environment in Cambodia, several areas with a strong impact on agribusiness development will involve government action.** These include investments in: (i) increased access to and reduced costs of electricity (one kilowatt of electricity in Cambodia costs between US\$0.16 and US\$0.23 compared to US\$0.13 in Thailand and US\$0.08 in Vietnam), to increase profit margins in the processing industry and stimulate private investments; (ii) better food safety and sanitary and phytosanitary capacity, to help Cambodian firms meet importers' requirements and capture foreign markets and help them to compete with the increasing food imports triggered by Cambodians' rising incomes and demand for more diversified diets; (iii) export logistics, to reduce transaction costs; and (iv) improved access to finance, including through warehouse receipts, to create new investment opportunities for the processing and trade industry.

**Future agricultural growth at the previous high rates and further structural transformation are possible in Cambodia.** Slower agricultural growth cannot become the new normal. More attention to sustainability, the quality of agricultural services, an enabling policy environment, and implementation will be critical in turning these possibilities into reality. It is well worth trying.

## Cambodia: Key Indicators

	2012	2013	2014	2015p	2016f	2017f
<b>Output, Domestic Demand and Prices</b>						
Real GDP (% change yoy)	7.3	7.4	7.1	6.9	6.9	6.8
Domestic demand (% change yoy)	14.9	12.1	12.4	11.0	10.7	11.1
Consumer price index (eop, % change yoy)	2.5	4.6	1.2	1.5	2.0	2.0
<b>Public Sector (% of GDP)</b>						
Government revenues	15.3	15.1	16.6	16.9	16.5	17.0
Government expenditures	21.0	21.5	20.1	20.6	20.5	21.0
Government balance excluding grants	-5.7	-6.4	-3.5	-3.7	-4.0	-4.0
Government balance including grants	-3.3	-2.7	-0.3	-1.6	-2.0	-2.3
<b>Foreign Trade, BOP and External Debt (in millions of US dollars, unless otherwise indicated)</b>						
Trade balance	-2,455.7	-2,598.4	-3,010.7	-3,129.1	-3,536.0	-4,058.1
Exports of goods	5,632.8	6,890.2	7,569.1	8,289.2	9,135.1	10,033.2
(% change yoy)	7.9	22.3	9.9	9.5	10.2	9.8
Key export (% change yoy) 1/	7.0	17.6	11.7	12.0	14.0	14.0
Imports of goods	8,088.5	9,488.6	10,579.8	11,418.3	12,671.1	14,091.3
(% change yoy)	20.6	17.3	11.5	7.9	11.0	11.2
Current account balance 2/	-1,376.0	-1,639.0	-1,793.7	-1,920.4	-2,033.2	-2,274.7
(% GDP)	-9.7	-10.7	-10.8	-10.5	-10.3	-10.6
Foreign direct investment	1,697.9	1,826.1	1,676.9	1,549.5	1,652.9	1,747.7
External debt	4,547.4	5,110.7	5,555.4	6,020.0	6,469.3	6,894.5
(% GDP)	32.1	33.3	33.4	32.8	32.8	32.2
Debt service ratio (% exports of g&s)	1.0	1.1	1.3	1.3	1.5	1.7
Foreign exchange reserves, gross	3,463.0	3,642.5	4,657.9	5,665.2	6,398.7	6,847.7
(prospective months of imports of g&s)	3.1	3.5	4.1	4.5	4.5	4.4
<b>Financial Markets</b>						
Domestic credit (% change yoy)	29.6	28.6	28.4	27.0	25.8	25.0
Short-term interest rate (% p.a.)	11.6	11.3	11.5	12.0	12.2	11.8
Exchange rate (Riel/US\$, eop)	3,995.0	3,995.0	4,075.0	4,054.0	4,058.0	4,062.0
Real effective exchange rate (2010=100)	105.4	109.9	112.1	113.5	115.5	117.8
(% change yoy)	0.5	4.3	2.0	1.3	1.7	2.0
Memo: Nominal GDP (in millions of US dollars)	14,188	15,362	16,623	18,363	19,711	21,412

Sources: The authorities, IMF, and World Bank staff estimates

f = forecast

p = projection

1/ Garments

2/ Excluding official transfers.



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