

COPING WITH DOMESTIC PRESSURES AND GAINING FROM A STRENGTHENED GLOBAL ECONOMY

CAMBODIA ECONOMIC UPDATE



SELECTED ISSUE:

IMPROVING PAY FOR THE PUBLIC SECTOR



THE WORLD BANK

April 2014

**COPING WITH DOMESTIC
PRESSURES AND GAINING FROM A
STRENGTHENED GLOBAL ECONOMY**

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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 reviewed and edited by Enrique Aldaz-Carroll, Poverty Reduction and Economic Management (PREM) Sector Department, Cambodia Country Office, the World Bank. The team worked under the guidance of Mathew A. Verghis, Lead Economist and Sector Manager, PREM Sector Department. The team is grateful for the advice and guidance provided by Ulrich Zachau, Country Director and Alassane Sow, Country Manager.

The Update is produced bi-annually to provide up-to-date information on macroeconomic developments in Cambodia. The Update 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 Economic Update by the East Asia PREM Department of the World Bank.

We received valuable comments and suggestions from PREM colleagues, namely Deepak K. Mishra, who also provided inputs for the global economic environment section, and Young Hwan Cha. Good comments and suggestions were also received from Alain W. D'Hoore who also kindly provided information and inputs on Lao PDR wage, and Robert Taliercio and Leah April who kindly commented on the selected issue – Increasing wages in the public sector. We are grateful for insightful comments and suggestions provided by Ratchada Anantavrasilpa and Dyna Heng, the Financial and Private Sector Department. We very much appreciate the support of Linna Ky who serves as research assistant, helps update charts and tables, format the CEU, and provides excellent logistical and administrative support for the preparation and the publication of CEU.

We are very grateful to the Cambodian authorities, in particular the Ministry of Economy and Finance, and the National Bank of Cambodia for their cooperation and support in the preparation of the Update.

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Executive Summary

Cambodia's economy has withstood domestic pressures and managed to sustain its high growth driven by its usual engines of growth. Cambodia's economic growth is estimated to reach a six-year high of 7.4 percent in 2013, despite the adverse effects posed by post-election political uncertainty and labor unrest. This growth has been led by the acceleration of garment exports and continued growth in tourism. Underpinned by a strengthened global economy, garment exports in value terms accelerated increasing 17.6 percent year-on-year in 2013, from 7.0 percent at the end of 2012 despite suffering some losses due to labor market instability. The tourism sector continued its high growth trajectory, with tourist arrivals reaching 4.2 million in 2013, and China overtaking South Korea as the number two source market after Vietnam. Fortunately, last year's floods inflicted only limited damage on rice production.

The external sector improved as a result of slower imports due to dampened domestic demand. The post-election adverse effects slowed down the demand for imports, while export growth advanced. This contributed to a narrowing of the current account deficit (excluding official transfers) to around 9.4 percent of GDP in 2013, compared with 10.1 percent of GDP in 2012. Inflows of foreign direct investment (FDI) have continued but, given the uncertainty, 2013 inflows are estimated to be well below their 2012 peak. Gross international reserves (GIR) increased marginally, reaching US\$3.6 billion or 3.8 months of imports in 2013, compared with US\$3.5 billion in 2012. The nominal exchange rate remained stable against the US dollar, leading to some depreciation in the real exchange rate.

Inflation is picking up, but remains moderate. While prices of staple food items remain broadly stable, inflationary pressure is steadily rising due to the recent pick-up in prices of some food items. Inflation rose to 4.7 percent year-on-year at the end of 2013, up from 2.5 percent at the end of 2012. Inflation is projected to remain in mid-single-digits over the short term.

Financial deepening continues but the gap between credit and deposit growth rates has widened, reducing bank liquidity. Private sector deposit growth has slowed while credit growth has remained elevated. Private sector deposits declined during the post-election period, recovering in November and ending the year with a growth of 14.2 percent year-on-year, from 25.2 percent at end-2012. In contrast, credit growth remained strong, expanding at 26.6 percent year-on-year in 2013, only slightly below the 2012 growth rate of 28.0 percent. This raises the risk of Cambodia experiencing a squeeze in bank liquidity as the loan-to-deposit ratio continues to rise, reaching 90 percent at the end of 2013 from 80 percent at the end of 2012. Broad money growth also slowed as foreign currency deposits modestly expanded, reaching US\$6.7 billion, or a 14.6 percent year-on-year increase in 2013, compared with US\$5.9 billion, or 20.9 percent, in 2012.

Government revenue growth has moderated, resulting in an increase in the fiscal deficit. The 2013 overall fiscal deficit including grants is estimated to reach 3.9 percent of GDP, slightly higher than the 2012 deficit of 3.3 percent, and continues to be over-financed by external funding. After a sharp increase in 2012, domestic revenue growth moderated, expanding 8 percent year-on-year in 2013, compared with 27 percent in 2012, due largely to lower import tax and non-tax revenue collection. In 2013, domestic revenue is estimated to come in at 14.8 percent of GDP, below the 2012 peak of 15.3 percent. Expenditure was contained at around 21.3 percent of GDP in 2013, broadly similar to the 2012 level. Meanwhile, government reserves rose to US\$760 million in 2013, up from US\$690 million in 2012.

Cambodia's debt-distress rating remains low. The latest joint World Bank/IMF debt-sustainability analysis (DSA) conducted in 2013 shows that Cambodia's debt-distress rating remains low, with all debt-burden indicators projected to be below their respective thresholds. Similar to the 2012

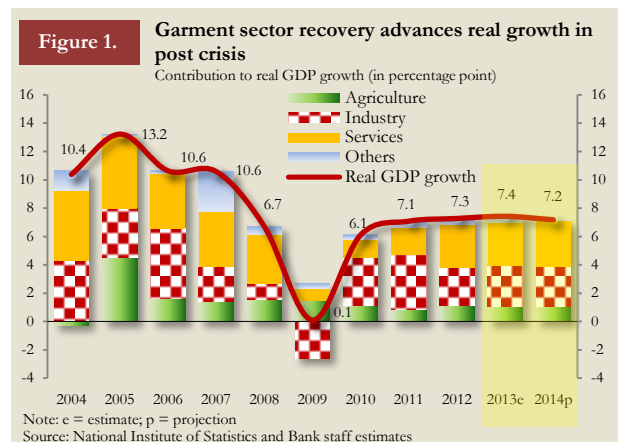
assessment, the results indicate that debt sustainability remains vulnerable to growth, exports, and fiscal shocks, indicating the need for continued structural reforms to diversify growth and to improve revenue collection. The stock of Cambodia's external debt (including arrears) was US\$4.5 billion or 32 percent of GDP, at the end of 2012 and is projected to reach US\$ 5.1 billion or 32.8 percent of GDP at the end of 2013.

The prospects for sustaining high growth appear favorable, and real growth for 2014 is projected to reach 7.2 percent, given expectations of renewed confidence and political stability, underpinned by the strengthening of the economic recovery in developed economies. Global GDP growth is projected to rise from 2.4 percent in 2013 to 3.2 percent in 2014, reflecting stronger growth in high-income economies. Strengthening demand in high-income countries is helping to expand global trade and boost exports of developing countries including Cambodia. Downside risks, however, include potential continuing labor unrest, and China's economic slowdown.

Appropriately managing domestic pressures in order to gain from the improved global economic environment will help maintain macroeconomic stability. Addressing labor unrest by successfully negotiating wage issues would serve the interests of both workers and firms. Given Cambodia's highly US-dollarized economy, building up fiscal space by improving revenue collection is necessary for effective macroeconomic policy tools to be in place to mitigate potential shocks. Likewise, improving banking supervision would further strengthen the financial sector. Enhancing regional integration will also enable Cambodia to benefit more from the growth dynamics throughout the ASEAN region.

While Cambodia does have some fiscal space to increase wages, a cautious and careful approach to pay raise may work best. The 2014 budget envisages an increase in the total wage bill from 40 percent to 45 percent of total current spending, reflecting a 0.5 percentage point increase in its share of GDP, rising to 5.5 percent in 2014 from about 5.0 percent of GDP in 2013. International experience suggests the importance of three key factors in determining public sector wage increases: 1) fiscal affordability; 2) the need for human resource management policies to improve labor productivity; and 3) striking a right balance between a rising wage bill and other priority spending, like spending on the social sectors and operations and maintenance (O&M).

Recent Economic Developments and Outlook



Real Sector

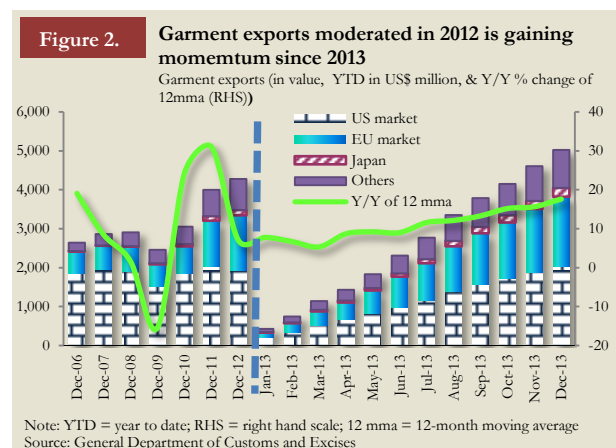
Drivers of growth

Cambodia's economic growth has held up well despite the adverse effects of political uncertainty since the July 2013 general election and labor unrest towards the end of 2013.¹ Underpinned by an improving external economic environment, real growth is estimated to reach 7.4 percent in 2013, driven mainly by the garment and tourism sectors. Although it suffered some losses due to labor unrest, the garment sector managed to grow its exports further, increasing 17.6 percent year-on-year in 2013, from 7.0 percent at the end of 2012, benefiting largely from the EU's "Everything-but-Arms (EBA)" preferential trade treatment, and a recovery in the US market (Figure 2).² As a result, the industrial sector's contribution to real GDP growth in 2013 rose to over 3.0 percentage

¹ Labor unrest during December 2013-early January 2014 demanding for doubling of the monthly minimum wage for the garment and footwear sector from US\$80 to US\$160 (but finally, it is settled at US\$100) forced the Garment Manufacturers Association in Cambodia (GMAC) to send two letters on January 2, 2014. One to the Ministry of Economy and Finance to clarify procedures and to facilitate re-export of fabric, cut fabric pieces, semi-finished products, and unpacked finished product, and factory accessories and equipment to other countries. The other letter sent to the Ministry of Labor informing of continued suspension of garment factories' operations.

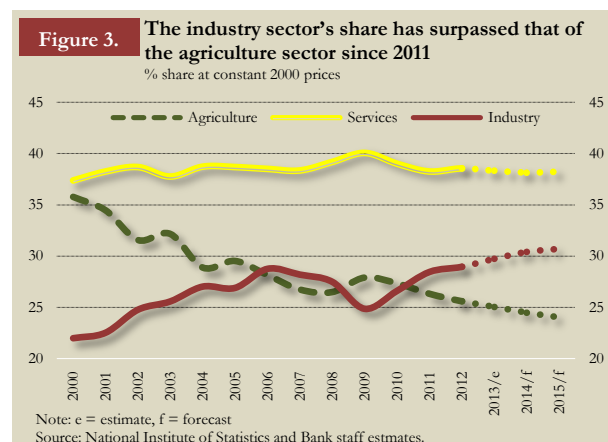
² Garment Manufacture Association in Cambodia (GMAC) reportedly estimated in early January 2014 that the labor unrest demanding for US\$ 160 a month minimum wage (instead of US\$100 a month offered by the Association) cost the garment factories US\$200 million in sales and 70 million in revenue.

points, compared with only 2.6 percentage points contributed in 2012.³



At constant 2000 prices, the industry sector's share reached 28.9 percent of GDP in 2012, surpassing the agriculture sector's share of 25.6 percent of GDP (Figure 3).

The tourism sector continues its high growth



trajectory with tourist arrivals reaching 4.2 million in 2013, an increase of 17.5 percent year-on-year, compared with 24 percent at the end of 2012 (Figure 4). Tourist arrivals by air also improved, growing at 17.2 percent year-on-year in 2013, compared with only 16.2 percent in 2012.⁴ Vietnam, China, and South Korea

³ Data limitations prevented the analysis of increases in labor productivity.

⁴ According Cambodia Airports' newsletter, Issue No 2 of February 10, 2014, Cambodia has emerged as one of the fastest growing markets in Southeast Asia, recording 18 percent passenger growth for the second consecutive year in 2013. Phnom Penh International Airport and Siem Reap International Airport will undergo a terminal extension project to cope with the expected growth. Construction works has started in both

continue to be the major source markets for international tourists coming to Cambodia, contributing more than 40 percent of the total arrivals number. In 2013, China overtook South Korea as the number two source market after Vietnam.⁵ The service sector's contribution is estimated to account for about 3 percentage points of real GDP growth in 2013, broadly similar to the contribution provided in 2012.

Rainy season floods in 2013 caused some damage to agriculture production and the agriculture sector is estimated to contribute close to 1 percentage point to real growth in 2013.⁶ The positive growth in agriculture mainly resulted from increases in productivity as farmers have started to use more fertilizer for their crops and employ modern farming techniques.



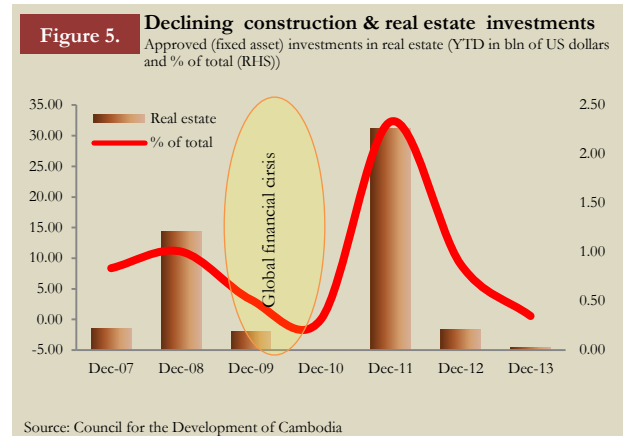
Meanwhile, the adverse effects on confidence have dampened domestic

terminals. Upon completion, scheduled to be around end-2015/early 2016, the capacity of both airports will double to 5 million passengers each. In 2013, Phnom Penh welcomed 2.39 million passengers while Siem Reap received 2.66 million passengers, up by 15 percent and 20 percent, respectively.

⁵ According to the United Nations World Tourism Organization's press release in April 2013, Chinese travelers have grown from 10 million in 2000 to 83 million in 2012. China's expenditure on travel abroad reached US\$102 billion in 2012, becoming the largest spender in international tourism globally. China leaped to first place, surpassing both top spender Germany and second largest spender the US (both close to US\$84 billion in 2012). Spending patterns of tourists may be different; however, it is beyond the scope of this Cambodia Economic Update to analyze the impact on the economy of each tourist country group.

⁶ MAFF reported in November 2013 that rice crop damage due to the recent flood was on 128,421 hectares or 5 percent of the total planted areas. However, the most recent preliminary data show that agriculture production growth decelerated to 1.7 percent in 2013, compared to 4.3 percent in 2012 in constant prices.

demand, and slowed construction and real estate activity. The decline in approved construction and real estate investment projects occurring in 2013 is noticeable (Figure 5).

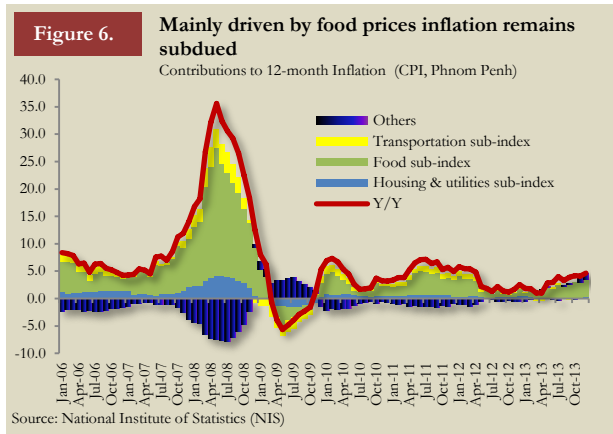


Cambodia's real growth for 2014 is projected to achieve 7.2 percent based on the return of political stability and expectations of renewed confidence. Underpinned by the strengthening of developed economies, the garment sector is back in full swing after the end of the labor unrest period, while the tourism sector remains unaffected and continues to expand (arrivals-by-air growth is accelerating) with more direct flights being arranged. As shown in Figure 1 above, during the post-crisis period, real growth has remained weaker than in the pre-crisis years, but appears to be in line with potential (between 7 to 8 percent). Potential further labor unrest and adverse impacts of China's economic slowdown, however, all may pose downside risks.

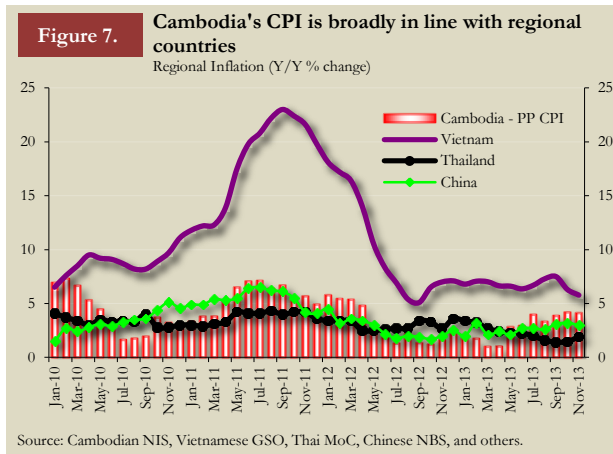
Inflation and prices

Inflation is picking up marginally. As the food component is the main driver of Cambodia's consumer price index (CPI), covering 43.3 percent weight in the inflation basket, stable food prices continue to help contain inflation. Prices of staple food items such as rice and fish remain broadly stable. However, inflationary pressure is steadily increasing due to the recent pick-up in prices of some foods items, notably for meat, poultry and fruit. The CPI reached 4.7 percent year-on-year

at the end of 2013, compared with only 2.5 percent at the end of 2012 (Figure 6).



Inflation is projected to remain in mid-single-digit figures over the short term. An appreciating US dollar and the continued pegging of the Cambodian riel to the US dollar, serve to anchor price levels while the inflation rates of Cambodia’s main import countries remain stable and contained (Figure 7).

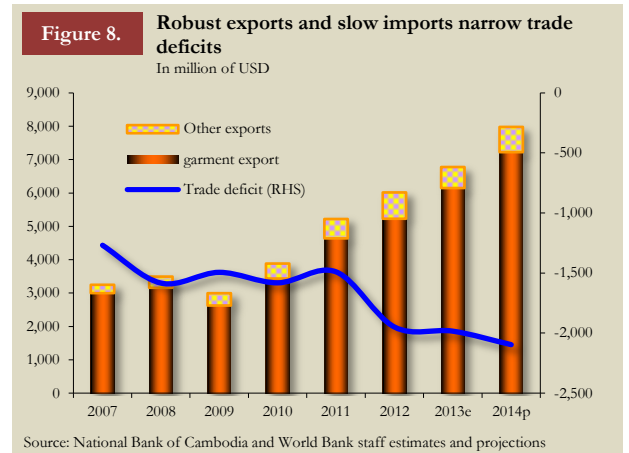


External position

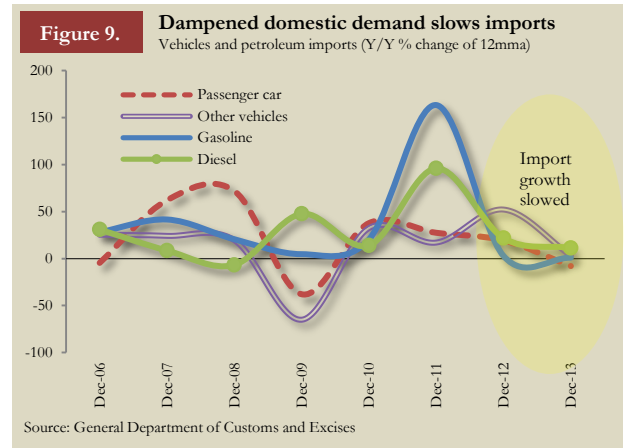
The external position has improved. Slow import growth, caused mainly by dampened domestic demand, and further acceleration of exports contributed to a narrowing of the trade deficit, which is estimated to decrease to 12.8 percent of GDP in 2013, from 13.8 percent of GDP in 2012.⁷ In absolute terms, the trade

⁷ Trade balance equals total export minus total imports. If total export is greater than total import, trade balance is positive or trade surplus. If

deficit is estimated to widen marginally to US\$1.98 billion in 2013, compared with US\$1.94 billion in 2012 (Figure 8).



Dampened domestic demand for motor vehicles, gasoline, and construction materials has largely softened import growth (Figure 9).

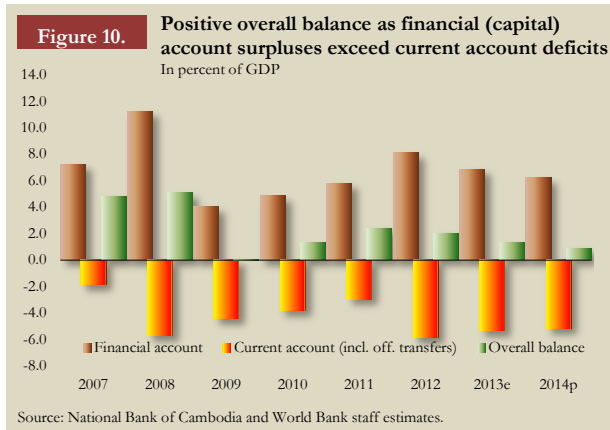


As a result, the current account deficit (excluding official transfers) is estimated to decline to around 9.4 percent of GDP in 2013, compared with 10.1 percent of GDP in 2012.⁸ Including official transfers, the current account deficit also improved, declining to 5.4 percent of GDP in 2013, from 5.8 percent of GDP in 2012. Financial (capital) account surpluses continue to cover current account deficits, resulting in a

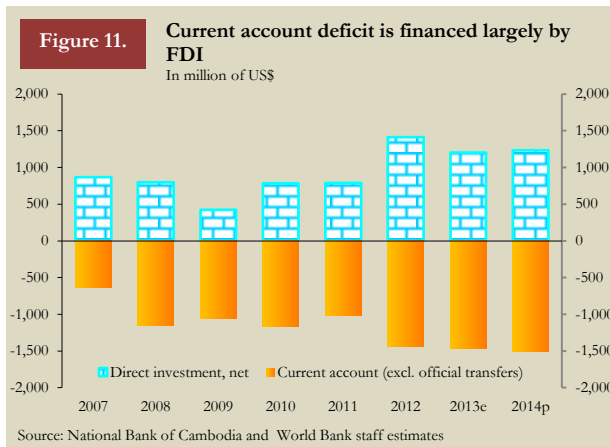
total export is smaller than total import, trade balance is negative or trade deficit.

⁸ Current account deficit (excluding official transfers) equals a sum of trade balance, net service, net income, and net private transfers.

positive balance-of-payments throughout the post-crisis period (Figure 10).



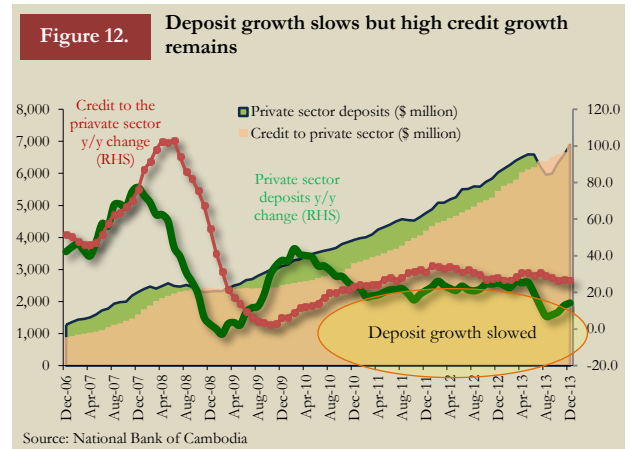
The current account deficit continues to be largely financed by FDI inflows, although in 2013 the inflows are estimated to be below their 2012 peak level (Figure 11). This reflects the vital role of FDI in maintaining Cambodia’s macroeconomic stability.



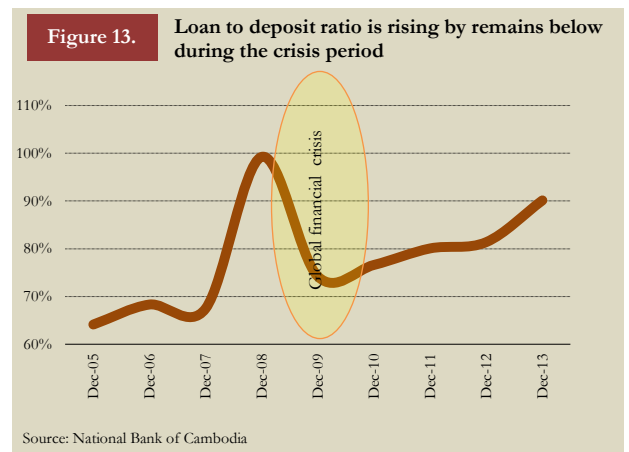
Monetary sector

Adverse impacts on confidence caused private sector deposit growth to slow considerably, decelerating to 14.2 percent year-on-year by December 2013 from 25.2 percent at end-2012 (Figure 12). Private sector deposit actually declined during the post-election period, covering July-August 2013, contracting from US\$6.5 billion in June to US\$5.9 billion in August, but recovered in November 2013. In contrast, credit growth remains elevated,

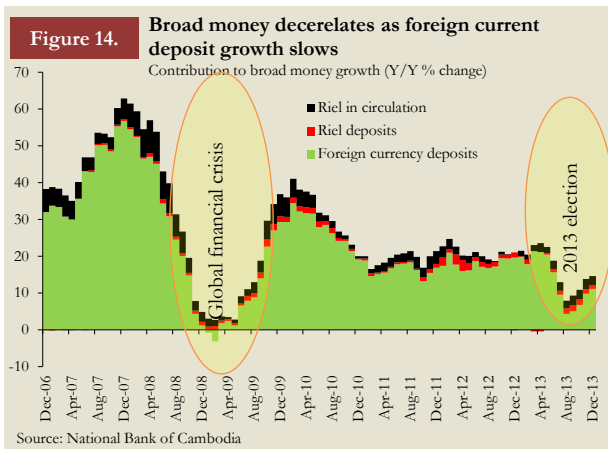
expanding at 26.6 percent year-on-year in 2013, only slightly below the end-2012 growth rate of 28.0 percent.



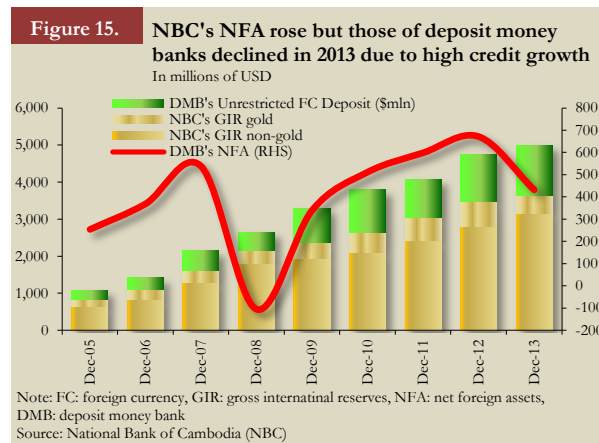
This raises the risk of Cambodia experiencing a squeeze in bank liquidity. Loan-to-deposit ratio continues to rise, reaching 90 percent by the end of 2013 from 80 percent by end-2012. However, it remains below its peak level of 100 percent occurred prior to the crisis period when the construction and real estate sectors were booming (Figure 13).



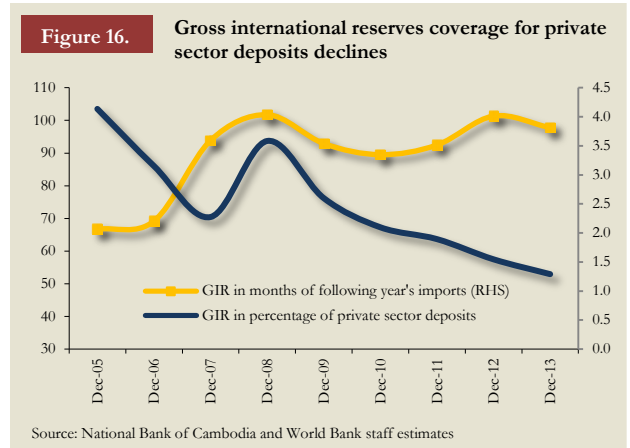
Broad money growth has also slowed as foreign currency deposits only modestly expanded, reaching US\$6.7 billion or 14.6 percent year-on-year in 2013, compared with US\$5.9 billion or 20.9 percent in 2012 (Figure 14).



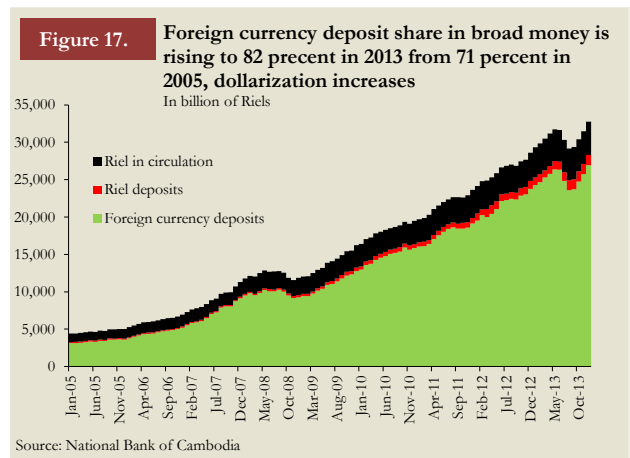
Gross international reserves (GIR) rose marginally to US\$3.6 billion, or 3.8 months of imports, by the end of 2013 from US\$3.5 billion, or 3.1 months of imports, at the end of 2012 (Figures 15 and 16).



As a percentage of private sector deposits, GIR has been declining, reducing its coverage to 53 percent by the end of 2013 from 57 percent at the end of 2012 (Figure 16).

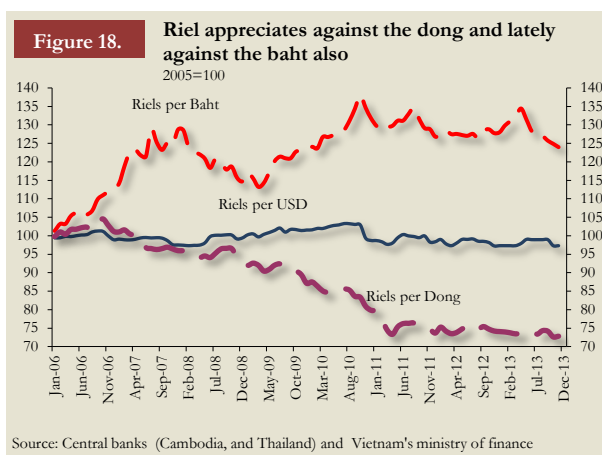


The central bank's role as the lender of last resort is being increasingly constrained by persistently high US dollarization of the economy. The share of foreign currency deposit in the broad money rose to 82 percent by the end of 2013 from 71 percent by end-2005 (Figure 17).



Exchange rate targeting has contributed to a stable riel versus US dollar exchange rate.

The exchange rate remains unchanged at Cambodian riel 3,995 per US dollar at the end of 2013; the same rate was recorded at the end of 2012. The riel remains pegged to the US dollar, and the exchange rate is broadly stable at around riel 4,000 per dollar. As the US dollar has strengthened, so the riel has appreciated against the Vietnamese dong and has also started to appreciate against the Thai baht since mid-2013 (Figure 18).



Due to the peg, the normal appreciation of the Cambodian riel against regional currencies is therefore likely to continue. The real effective exchange rate of the riel, however, continues to depreciate (Figure 19) as the US dollar has been depreciating against other major currencies such as EURO and Chinese Yuan which are also main trading partners of Cambodia.⁹

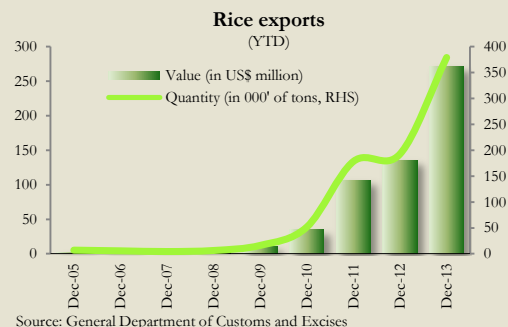
⁹ Real effective exchange rate (REER) is inflation adjusted weighted average value (the weighs determined by the importance Cambodia places on all other currencies traded) of the local currency relative to all major currencies being traded. REER index rose to 131 (2005=100) in 2013 or 1.8 percent year on year, reflecting a depreciation of Cambodia's REER.

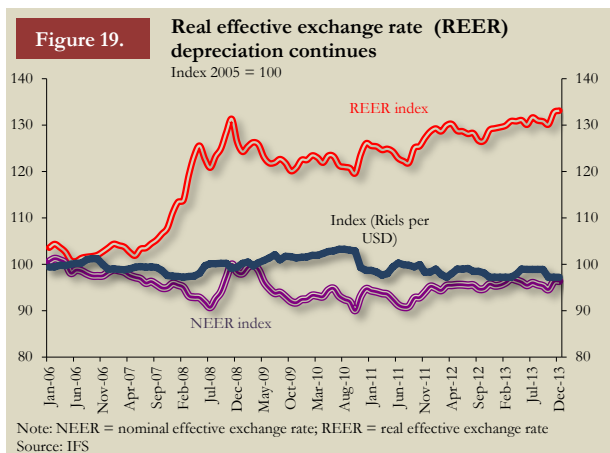
WILL THE RICE POLICY SUCCEED AND THE RICE EXPORT TARGET BE REACHED?

Prior to 2010, Cambodia exported just a few thousand metric tons of milled rice. The rice policy paper adopted in July 2010 provided a boost to milled rice production and exports with a target of at least 1 million metric tons by 2015.

The policy helped to mobilize resources and technology for rice milling and production. The private sector mainly drove this rice export push, while the public sector facilitated trade by establishing one-window service facilities, securing export markets, and providing some lending. Banks in 2013 provided US\$700 million credit or 11 percent of the total credit to the agriculture sector, compared with only a little more than US\$100 million credit received by the sector in 2008. Promotion and awareness efforts have paid off and Cambodia consecutively received world best fragrant rice awards in 2012 and 2013. Milled rice exports in 2013 reached 380,000 metric tons, or almost twice as much as exports in 2012.

While it remains to be seen whether the rice export target will be reached by 2015, successes in mobilizing resources and technology resulting in recent achievements are encouraging.





The central bank continues to strengthen the stability of the banking and financial sectors, and its supervisory and surveillance capacity. Recently, promising initiatives have been undertaken to review the regulatory framework of the banking and financial sectors.

Global economic environment and its implications

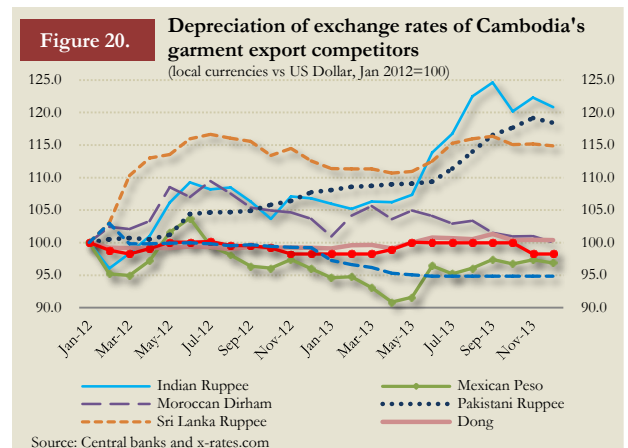
Growth in high-income countries is projected to strengthen from 1.3 percent in 2013 to 2.2 percent this year, and 2.4 percent in each of 2015 and 2016. The US economy is projected to grow by 2.8 percent this year from 1.8 percent in 2013. Growth in the Euro Area, after two years of contraction, is projected to be 1.1 percent this year. In light of the improvement in the economy, the US Fed decided to gradually reduce the pace of its asset purchase program.¹⁰ While strengthening of demand in high income countries will expand global trade, underpinning export growth from developing countries including Cambodia, normalization of long-term interest rates is expected to dampen capital flows to developing countries.¹¹

Low-income countries like Cambodia, seen as being less integrated into global financial

¹⁰ The Fed added to its holdings of agency mortgage-backed securities at a pace of only \$30 billion in February, against US\$35 billion in January 2014, and US\$40 billion a month last year, and to its holdings of longer-term Treasury securities at a pace of US\$ 35 billion in February, against \$40 billion in January 2014 and US\$45 billion per month last year. For details see FOMC press releases: January 29, 2014 and December 18, 2013.

¹¹ Development Prospects Group, the World Bank.

markets, may be potentially affected by the tightening of global financial conditions primarily through trade channels. The depreciation that most developing countries face will generally render their exports more competitive (Figure 20). This, however, will work against Cambodia's exports because of its highly US-dollarized economy.



In addition, there is a risk of having an abrupt unwinding of investment in China, slowing down its GDP growth that may result in knock-on effects in the region and other economies with close trading linkages.¹² While Cambodia's main export partners are the EU and US, China is among the largest sources of FDI in Cambodia (Figure 21).¹³



¹² Cambodia's milled rice exports to China are picking up slowly. In 2013, Cambodia only exported about 28,000 metric tons of milled rice (or 7.5 percent of the total milled rice exports) to China.

¹³ The Council for the Development of Cambodia's data (fixed asset investment) which can be used as a proxy of foreign direct investment shows that China's direct investment covers at least 10 percent of the total investments in Cambodia

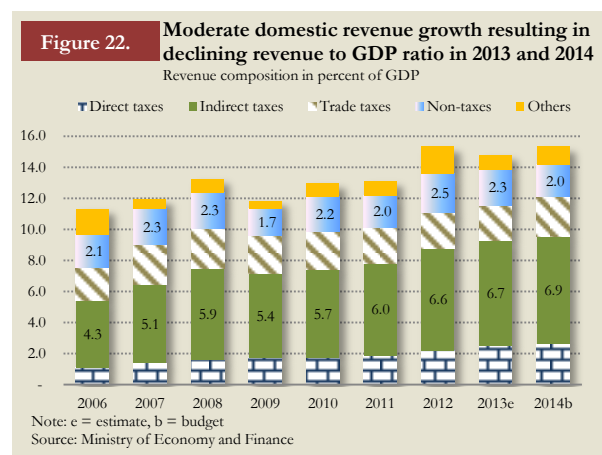
World petroleum and rice prices are easing.

Global oil prices have continued to ease in recent months. Crude oil prices averaged US\$ 104.8/bbl in February 2014, 0.6 percent lower than December, and 2.6 percent lower than a year ago.¹⁴ Nominal oil prices are expected to average US\$103.5/bbl this year (down from \$104.1/bbl in 2013) and decline to US\$99.8/bbl in 2015 due to the rapid expansion of unconventional oil production while demand is also picking up.¹⁵ Ample supplies along with stock releases by Thailand have dampened rice prices in the market. Rice prices reached record 3.5-year lows in December 2013. Rice prices averaged US\$459/ton in February 2014, 1.8 percent higher than December but 18 percent lower than a year ago and half compared to their all-time high of early 2008. Rice prices are expected to average US\$460/ton this year (down from \$505.9/ton in 2013) and decline to US\$450/ton in 2015. For Cambodia, easing petroleum prices are helpful as the country imports 100 percent of the petroleum products it consumes. Declining rice prices, however, are likely to affect the economy as Cambodia is a net rice exporter.

Fiscal space

While the fiscal situation remains under control, general government domestic revenue growth has moderated. After a sharp increase in 2012, domestic revenue growth has moderated, estimated to expand only at 5.0 percent year-on-year in 2013, as opposed to 30.6 percent in 2012. This is due largely to slower import tax collection, and modest non-tax and provincial revenue collection. Import tax revenue did not increase as much as expected because of slower growth of import volumes, despite efforts made by customs authorities to enforce official tariffs. The 2013 revenue is estimated to reach 14.8 percent of GDP, below the 2012 peak of 15.3 percent (Figure 22). However, the authorities were successful in

improving the administration and collection of non-tax revenues. The introduction of a standardized non-tax revenue receiving system, which was rolled out in 2012, and inter-ministerial Prakases (arrangements) implemented in 2013, rationalizing and harmonizing fee and charge rates across non-tax revenue collecting agencies have provided a boost to non-tax revenue collection.¹⁶ This task was supported by the World Bank under the Government's Public Financial Management Reform Program (PFMRP).¹⁷



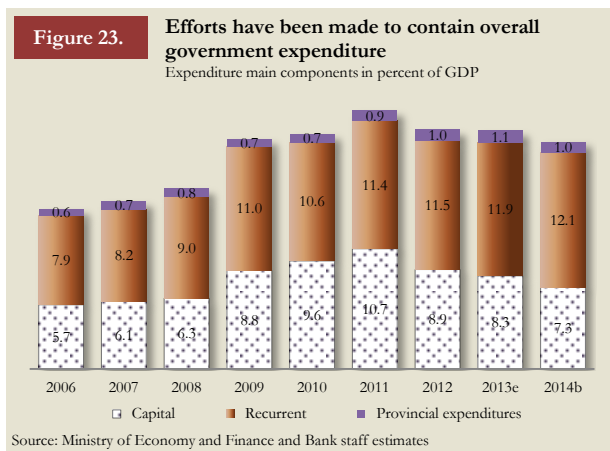
Expenditure, however, is estimated to expand faster, increasing by 9.8 percent year-on-year in 2013, compared with a 3.1 percent increase in 2012, and are estimated to reach at around 21.3 percent of GDP in 2013, slightly higher than the 2012 level (Figure 23).

¹⁴ Weekly Global Economic Brief, Development Prospect Group, World Bank, March 7, 2014.

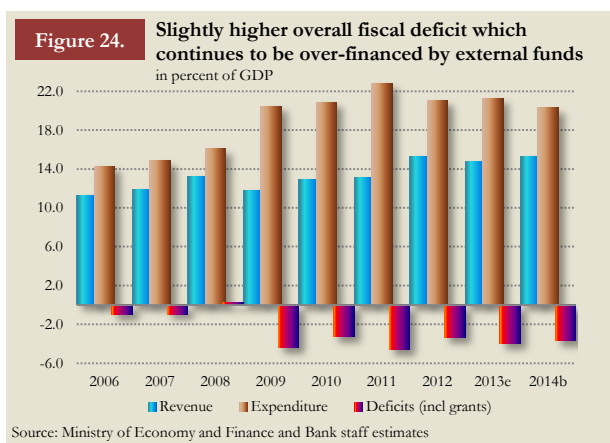
¹⁵ According to the World Bank Commodities Price Forecast, January 2014.

¹⁶ It is estimated that the measures have added about US\$25 million above the non-tax revenue target in 2012 budget. Non-tax rose to 2.5 percent of GDP in 2012 from 2.0 percent of GDP in 2011.

¹⁷ Under the PFMRP, revenue-to-GDP ratio is targeted to be increased by 0.5 percent per annum.

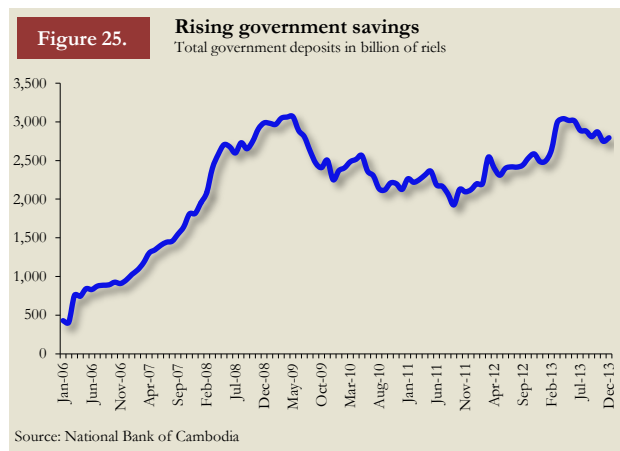


The 2013 overall fiscal deficit including grants is estimated to reach 3.9 percent of GDP, higher than the 2012 deficit of 3.3 percent (Figure 24). In addition, it continues to be over-financed by external funding.



As a result, government savings rose to riel 2,750 billion (or about US\$760 million) in 2013 from riel 2,486 billion (or about US\$690 million) in 2012 (Figure 25).¹⁸ As share of GDP, government savings rose slightly, reaching 4.9 percent in 2013 from 4.8 percent in 2012.

¹⁸ Government savings or (negative) net credit to the government by the banking system, represent savings obtained from surpluses that the Government has accumulated as a result of over-financing of annual budgets' overall expenditures. In the Government's annual fiscal reporting, annual government savings are reflected as negative domestic financing.



Since 2012, fiscal consolidation supported by a marked improvement in domestic revenue collection has allowed the authorities to rebuild fiscal space.¹⁹ With the highly US-dollarized economy, fiscal policy is the main policy tool for macroeconomic management, and fiscal space built by improved domestic revenue collection is thus necessary to serve as a cushion from any future shocks. Building fiscal space, however, will be increasingly difficult due to competing demands for spending, including pressures from the rising public sector wage bill. In the 2014 budget, the public sector wage bill is set to increase from 40 percent to 45 percent of total current spending. The total wage bill in 2014 represents more than 5 percent of GDP. Sectoral allocations, in particular for the education sector, also received substantial boosts in budget allocations in 2014, consistent with recommendations provided in the 2011 Public Expenditure Review.²⁰

Debt sustainability

Cambodia's debt distress rating remains low.

A joint World Bank/IMF debt sustainability analysis (DSA) conducted in 2013 shows that Cambodia's debt distress rating remains low with all debt burden indicators projected to remain below their respective thresholds. The

¹⁹ According to Finance and Development, No 2, Volume 42, June 2005, IMF, "fiscal space" is room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy.

²⁰ This is part of the 2011 Integrated Fiduciary Assessment and Public Expenditure Review (IFAPER).

Government's policy of avoiding non-concessional borrowings helps sustain debt management. Similar to the assessment in 2012, the results indicate that debt sustainability remains vulnerable to growth, exports, and fiscal shocks. This calls for continued structural reforms to diversify growth and to improve revenue collection and prudent contingent liability management. The size of Cambodia's external debt (including arrears) was US\$4.5 billion or 32 percent of GDP at the end of 2012 and is projected to reach US\$ 5.1 billion or 32.8 percent of GDP at the end of 2013.

Key Messages

Appropriately managing domestic pressures in order to gain from an improved global economic environment while also being prepared to cope with potential adverse impacts of US Fed tapering and China's economic slowdown will help to safeguard macroeconomic stability. This requires that the downside risks discussed above are adequately addressed so that the drivers of growth are further strengthened.

From the structural side, upgrading job training and education for workers and students is recommended to increase labor productivity and compensate for wage increases, and to continue to attract labor from rural regions into the manufacturing sector. Addressing labor unrest by successfully negotiating wage issues would serve the interests of both workers and firms. Meanwhile, enhancing regional integration by deepening structural reforms through trade facilitation related to import and export clearances with simplified and harmonized trade procedures, infrastructure and transport linkages for regional connectivity, and logistics services will enable Cambodia to benefit more from the growth dynamics throughout the ASEAN region. This will also allow Cambodia to diversify growth and become more competitive.

It is important to promote a healthy financial sector development. The past years, Cambodia's financial system has expanded rapidly. While financial deepening improves financial

intermediation underpinning economic growth, unsustainable expansion, given the tightening of global financial conditions, can cause instability and negatively impact the real sector of the economy. Therefore, strengthening the central bank's supervision, capacity, and early warning and resolution systems, including good governance, is of the essence. Further enhancing the implementation of risk based supervision using off-site surveillance system and close monitoring to ensure compliance with prudential regulations are key, enabling effective early warning and resolution systems. Good initial steps are being planned. These include preparations to establish a crisis management committee and crisis management teams, a framework for assessing and supervising systemic institutions which entails a mechanism for assisting systemic and illiquid or insolvent banks, crisis management manuals, contingency and communication plans, as well as periodic crisis simulation exercises. In addition, promoting the use of the local currency, the Cambodian riel, would enable the National Bank of Cambodia, the country's central bank, to play an increasingly important role in managing monetary policy. Given Cambodia's highly US-dollarized economy, improving revenue collection by broadening the tax base, improving tax administration, and strengthening governance is necessary to build fiscal space for effective macroeconomic policy tools to be in place to mitigate potential shocks.

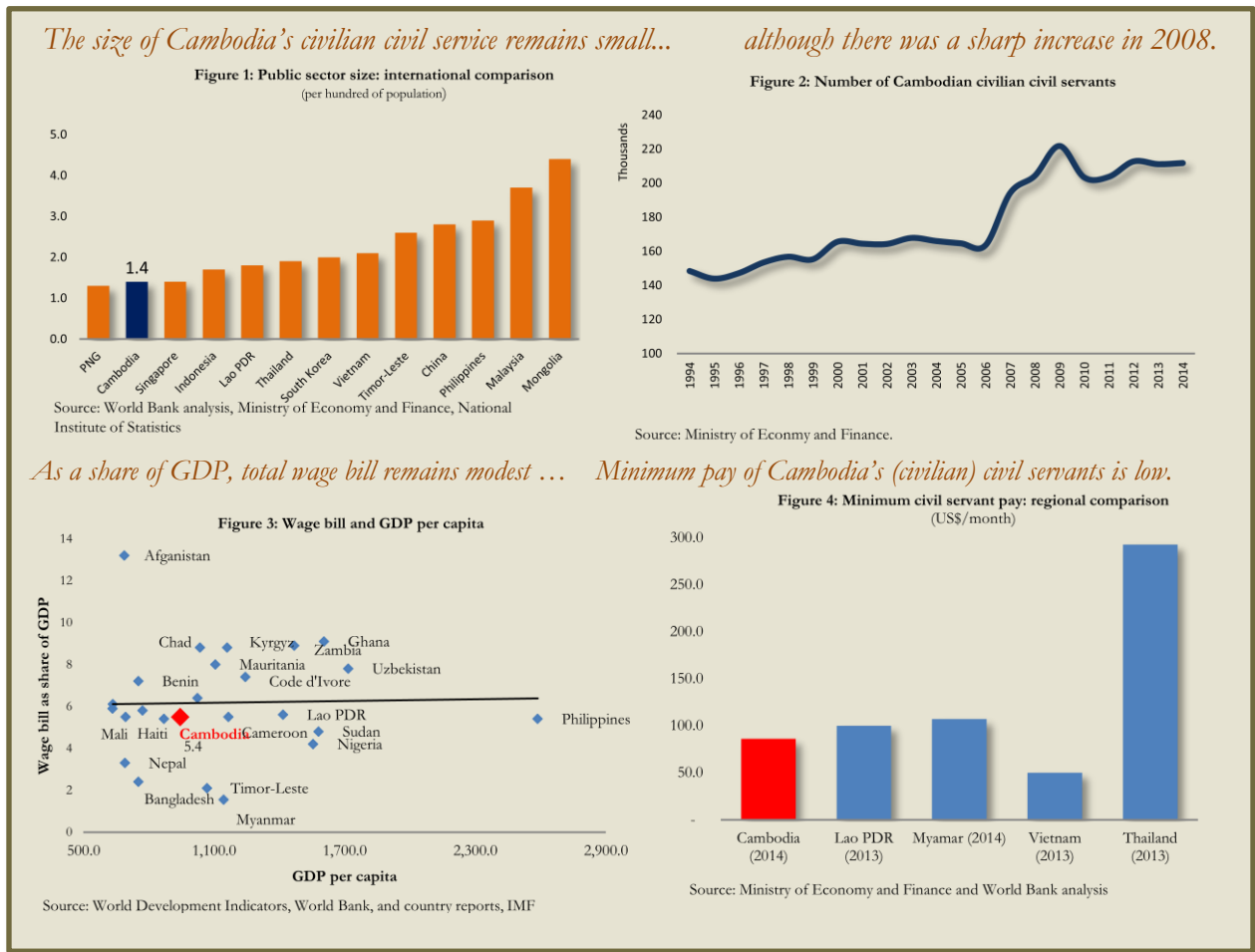
Selected Issue – Increasing Wages in the Public Sector

SUMMARY

1. The size and overall cost of Cambodia’s (civilian) civil servants are on the lower side of other low-income peers. However, due to its relatively low revenue, Cambodia’s wage expenditure as a share of domestic revenue at 36 percent (2012) is high.
2. The 2014 wage increase is modest and estimated to cost an additional US\$42 million a year. This is to increase the civilian civil servant basic pay under Categories B, C, and D (lowest) by riel 80,000 a month and Category A (highest) by riel 40,000 a month. Average basic pay of Category D is now riel 344,371 or US\$86 a month.
3. Further wage increases will likely add more pressure to reduce needed spending for maintenance, which is declining as share of the total capital expenditure, and are not a guarantee of improved public service delivery. Improvements in human resource management are needed for wage increases to effectively address performance, deployment, and optimal sectoral allocations.

The size of the Cambodian civil service

Cambodia’s (civilian) civil service is relatively small in terms of size at around 1.4 civil servants per hundred population. This is lower than most of its regional peers (Figure 1), although the number has nonetheless expanded by 28 percent during the past decade, and by 47 percent during the past two decades (Figure 2).



The cost of the Cambodian civil service

Cambodia's total wage expenditure as a share of GDP remains modest compared to other low-income countries. The total wage expenditure (civilian, security and defense) of 5.5 percent of GDP as budgeted for 2014 is modest compared to countries with similar GDP per capita (Figure 3).²¹

Although it is difficult to compare minimum salaries across countries because of differences in salary definitions, a rough regional comparison appears to suggest that minimum salaries of Cambodia's civil servants may be lower than those of Lao PDR and Myanmar, but may be higher than those of Vietnam's civil servants (Figure 4). Similar to Cambodia, countries in the region are making efforts to increase minimum salaries for their civil servants. These countries including Cambodia, however, are facing common constraints, namely that the level of domestic revenue collection limits their ability to pay their civil servants more.

While Cambodia's total wage expenditure for 2014 budget appears relatively high in terms of the shares of recurrent spending and domestic revenue compared with its low-income country peers in the region, this is due to its low levels of revenue collection and current spending (Figure 5 and Figure 6). Although revenue performance has recently improved, Cambodia's (domestic) revenue to GDP ratio remains low. Current spending, in particular non-wage expenditure, continues to be contained.

Sectoral allocation of civil servants and of wage expenditure

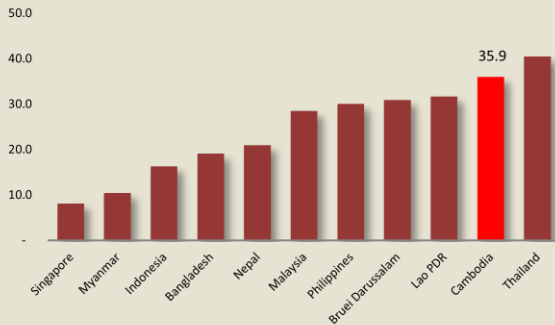
Sectoral prioritization in the deployment of civil servants remains generally appropriate. Aggregate numbers show that the social sector, including health and education, continues to receive the highest share of the total number of civil servants (Figure 7).

But the sectoral allocation of the wage budget does not prioritize the social sectors, unlike the deployment of civil servants. While the share of civil servants working in the social sector remains unchanged (or slightly improved) at around three quarters of all civil servants, the share of wage expenditure allocated to the social sector in the total civilian wage bill, in particular for the education sector, has shrunk, reaching only 44 percent in 2013, compared with a peak of 57 percent in 2001 (Figure 8). This implies that average remuneration in the education sector is trending downwards.

²¹ Wage expenditure discussed in this note covers all staff costs including allowances.

Total wage bill as share of domestic revenue is high....

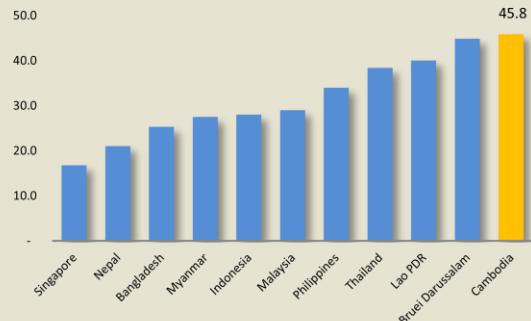
Figure 5: Public sector wages: international comparison
(in percent of domestic revenue, latest available years)



Source: Ministry of Economy and Finance and Bank staff estimates

Total wage bill as share of current spending is the highest.

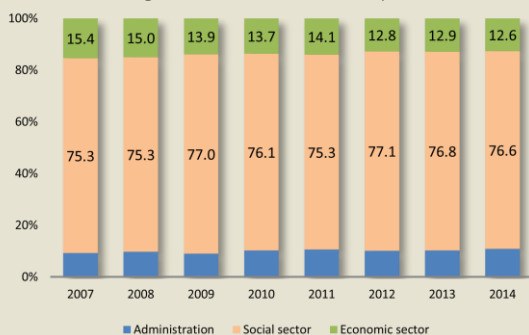
Figure 6: Public sector wages: international comparison
(% of current spending, latest available years up to 2011 except Cambodia)



Source: Ministry of Economy and Finance and Bank staff estimates

And the social sector continues to maintain its share...

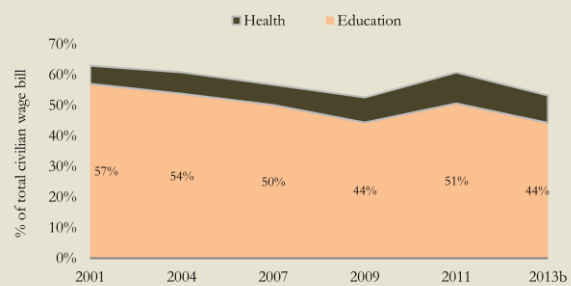
Figure 7: Civilian civil servants size by sector



Source: Ministry of Economy and Finance

Sectoral breakdown of wage bill shows declining share for education.

Figure 8: Sectoral allocation of wage expenditure



Source: Ministry of Economy and Finance

Provincial versus central distribution of civil servants and budgets

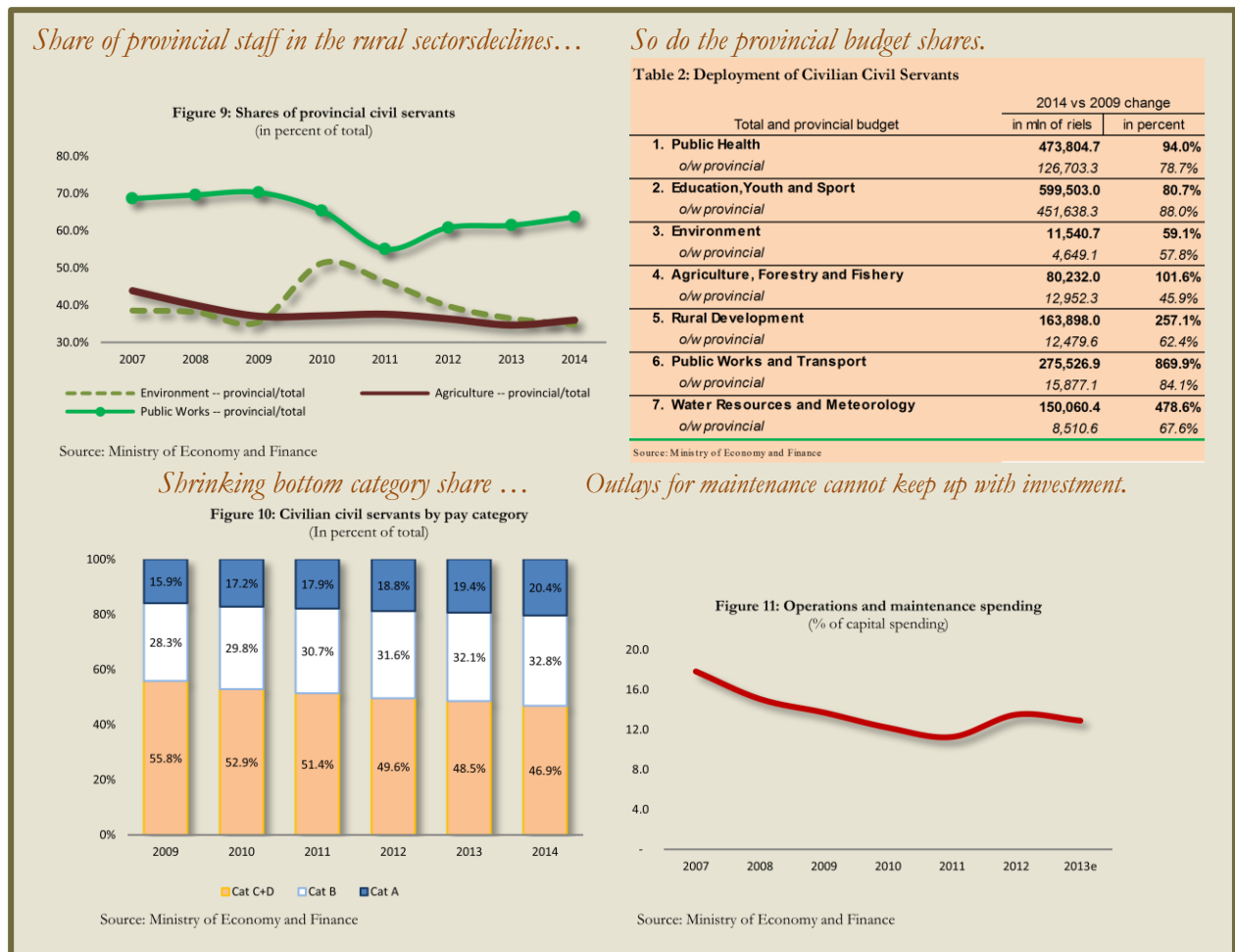
Deployment of civil servants has been centrally focused. Aggregate data on the size of the civil service conceals some of the problems surrounding the geographic distribution of civil servants. Anecdotal evidence indicates that low pay and the absence of “moonlighting” opportunities in the provinces encourage civil servants to work in the cities and provincial capitals. Socio-cultural factors also contributed to the centrally driven deployment; including the perceived lack of social appeal to working in rural areas. The result is inadequate service delivery in the rural areas of the provinces, where most Cambodians actually live.

The shares of civil servants working at the provincial level for a number of key rural sectors, namely agriculture, rural development, and environment, as well as public works, have generally declined since 2007 (Figure 9).²² The increasing concentration of civil servants at the central level for these rural sectors does not appear positive for an equitable broadening of access to public services. For the rural and social sectors illustrated in Table 2 below, provincial budget as share of total budget declines as it grows at a much slower pace than total budget does.

²² Understanding deployment of civil servants within provinces such as those located in the provincial capitals, communes, and districts is not possible because budget data only distinguish between central and provincial civil servants.

Targeted operational and public expenditure reviews (PER) may be needed. Conducting PERs may help to shed some light on why the share of civil servants working at the provincial level, together with the share of budget allocated to the provincial level, are both contracting.

There has been a shift from low- to high-pay-scale categories. The share of civil servants in Categories C and D among total civil servants dropped by about 9 percent, from 55.8 percent in 2009 to 46.9 percent in 2014, while those under Categories A and B rose (Figure 10). This could be a healthy trend, a sign of professionalization of the civil service. But it could also adversely affect efficiency if the ratio of support staff and technical/professional staff is not adequate. A functional review could help to determine if the ratio is appropriate for optimal efficiency.



It is critical to ensure adequate operations and maintenance (O&M) budgets in order to keep the capital stock in sound condition. Rising public investment in absolute terms and as a percentage of GDP—building infrastructure, irrigation, water supply, and power transmission networks—funded mostly by development partners, have contributed to increasing capital stock. However, budgets for supplies and equipment, as well as for operations and maintenance, as a share of total capital spending, have been shrinking since 2008 (Figure 11).²³ This is an issue that merits consideration going forward as it is important to strike a right balance between a rising wage bill and other priority public spending including operations and maintenance (O&M).

²³ Supplies, equipment, operations, and maintenance expenses are under the Chapters 60 and 61 of the current budget classification.

The 2014 wage increase

- The 2014 budget envisages an increase in the total wage bill from 40 percent to 45 percent of total current spending. This represents about a 0.5 percentage point increase in its share of GDP, rising to 5.5 percent in 2014 from about 5.0 percent of GDP in 2013.

Table 3: Estimated cost of additional budget for the wage bill increase in 2014

Category	Rank	Basic pay monthly average		Estimated permanent civilian civil servant numbers	Basic pay increase for 2014		Basic pay new monthly average			Annual additional budget required	
		in Riel	in US\$ equiv.		in Riel	in US\$ equiv.	in Riel	in US\$ equiv.	% change	in Riel	in US\$ equiv.
A	A1	749,613	187	345	40,000	10	789,613	197	5	165,800,727	41,450
	A2	648,280	162	1,612	40,000	10	688,280	172	6	773,736,727	193,434
	A3	561,066	140	36,039	40,000	10	601,066	150	7	17,298,542,545	4,324,636
B	B1	530,733	133	2,414	80,000	20	610,733	153	15	2,317,314,712	579,329
	B2	453,568	113	3,673	80,000	20	533,568	133	18	3,526,348,475	881,587
	B3	373,269	93	55,834	80,000	20	453,269	113	21	53,600,496,814	13,400,124
C	C1	362,520	91	860	80,000	20	442,520	111	22	825,962,127	206,491
	C2	309,472	77	765	80,000	20	389,472	97	26	734,188,557	183,547
	C3	271,971	68	73,897	80,000	20	351,971	88	29	70,940,969,316	17,735,242
D		264,371	66	16,024	80,000	20	344,371	86	30	15,383,040,000	3,845,760
				Total						165,566,400,000	41,391,600

Source: Ministry of Economy and Finance, Ministry of Civil Service, Bank staff estimates.

- An effort to increase base pay for civilian civil servants by CR 80,000 for the wage categories D (lowest), C and B, and by CR 40,000 for the wage category A was made.²⁴ This is estimated to have cost about CR 166 billion, or US\$42 million equivalent (Table 3).
- The above estimate excludes overtime, which would increase as a result of rising base pay. Overtime mostly paid to teachers is roughly estimated to cover about 5 percent of the total wage bill.²⁵ Including overtime, the total wage bill increase as a result of the approved basic wage increase for 2014 could reach about US\$ 44 million.²⁶
- The increase in the wage bill budgeted for 2014 consumes all the expected increase in domestic revenue, not leaving room for increases in non-wage expenditures relative to GDP. The wage bill increase captures all the budgeted increase in domestic revenue of about 0.5 percent of GDP in 2014. The budgeted non-wage expenditure as share of GDP remains at around 6.5 percent of GDP, similar to that of 2013, not leaving room to increase the shares of operation & maintenance and social spending relative to GDP.

Conclusions

- International experience points to the importance of determining public sector wage policy as an integral part of an overall civil service reform, which includes human resource development and management. Important dimensions of such reform could include putting in place robust internal control systems in order to ensure effectiveness and efficiency, and rationalizing public sector remuneration by initially consolidating different types of allowances into basic pay.²⁷ Past annual ‘across the board’ salary increases with limited reform in human resource development and management do not appear to have improved public service delivery.

²⁴ Sub-decree No. 1 dated January 2, 2014. The pay base increase, however, does not cover civil servants employed in legislative, courts, anti-corruption, and national audit entities, agencies, and authorities. The base pay does not include benefits and allowances such as functional allowances which are a few times base pay for upper pay categories.

²⁵ Wage bill also covers benefits and allowances such as functional allowances, which amount to as much as 15 percent of the total wage bill.

²⁶ Assuming an average of 40 hours of overtime a month performed by 80,000 civilian civil servants who are mostly teachers below category A, it is estimated that the total overtime payment increase is US\$ 2.4 million a year as a result of the base pay increase approved in 2014.

²⁷ Consolidating the existing plethora of allowances will ensure consistency in competitiveness of total remuneration and greater transparency in the Government’s pay structure.

- **Next steps that may help inform government wage policy might include:**
 - A pay survey that reviews and compares pay practices of the public sector with those of in-country private sector companies, microfinance institutions, multinational companies, and international non-governmental organizations.
 - A review of existing internal control procedures, human resource functions and performance management practices to provide a more robust analytical framework for the overall civil service reform.

Appendix: Cambodia: Key Indicators

	2011	2012	2013e	2014p	2015f	2016f
	Year	Year	Year	Year	Year	Year
Output, Employment and Prices						
Real GDP (% change yoy)	7.1	7.3	7.4	7.2	7.0	7.0
Domestic demand (% change yoy)	1.0	11.9	8.5	9.7	10.2	11.0
Industrial production index (2000=100)	300.8	315.9	341.1	368.4	396.1	420.0
(% change yoy)	14.5	5.0	8.0	8.0	7.5	6.0
Consumer price index (% change yoy)	4.9	2.5	4.7	5.0	5.5	6.0
Public Sector						
Government revenues (% GDP)	13.2	15.3	14.8	15.0	15.0	15.2
Government expenditures (% GDP)	22.8	21.0	21.3	20.3	20.0	20.0
Government balance excluding grants (% GDP)	-9.6	-5.7	-6.5	-5.3	-5.0	-4.8
Government balance including grants (% GDP)	-4.6	-3.3	-3.9	-3.2	-3.5	-3.3
Foreign Trade, BOP and External Debt						
Trade balance (millions US\$)	-1,490.0	-1,949.2	-1,983.9	-2,096.2	-2,508.9	-2,793.0
Exports of goods (millions US\$)	5,219.5	6,015.7	6,777.5	7,979.4	9,229.2	10,705.8
(% change yoy)	34.4	15.3	12.7	17.7	15.7	16.0
Key export (% change yoy) 1/	31.7	7.0	17.6	17.5	15.5	15.0
Imports of goods (millions US\$)	6,709.5	7,964.9	8,761.4	10,075.6	11,738.1	13,498.8
(% change yoy)	22.7	18.7	10.0	15.0	16.5	15.0
Current account balance (millions US\$) 2/	-1,014.9	-1,436.6	-1,450.9	-1,620.1	-1,824.9	-2,119.6
(% GDP)	-7.9	-10.1	-9.4	-9.7	-10.0	-10.3
Foreign direct investment (millions US\$)	785.4	1,410.2	1,200.0	1,230.0	1,450.0	1,520.0
External debt (millions US\$)	3,840.8	4,486.0	5,052.0	5,559.4	5,948.7	6,310.9
(% GDP)	29.9	31.6	32.6	33.2	32.5	30.8
Short-term debt (millions US\$)	-	-	-	-	-	-
Debt service ratio (% exports of goods & services)	1.2	1.1	1.5	1.6	1.5	1.8
Foreign exchange reserves, gross (millions US\$)	3,031.6	3,463.0	3,642.5	3,879.3	4,267.2	4,608.6
(months of imports of goods & services)	3.4	3.1	3.8	3.5	3.4	3.3
Financial Markets						
Domestic credit (% change yoy)	37.3	29.6	28.5	26.0	25.2	24.8
Short-term interest rate (% p.a.)	15.0	13.7	13.0	13.0	12.5	12.2
Exchange rate (Riel/US\$, eop)	4,039	3,995	4,000	4,065	4,076	4,100
Real effective exchange rate (2005=100)	124.8	128.6	131.0	132.9	134.7	136.9
(% change yoy)	1.9	3.0	1.8	1.5	1.3	1.7
Memo: Nominal GDP (millions US\$)	12,828	14,196	15,491	16,722	18,291	20,486

Sources: National data sources, IMF, and World Bank staff estimates

e = estimate

f = forecast

p = projection

1/ Garments

2/ Excluding official transfers.



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