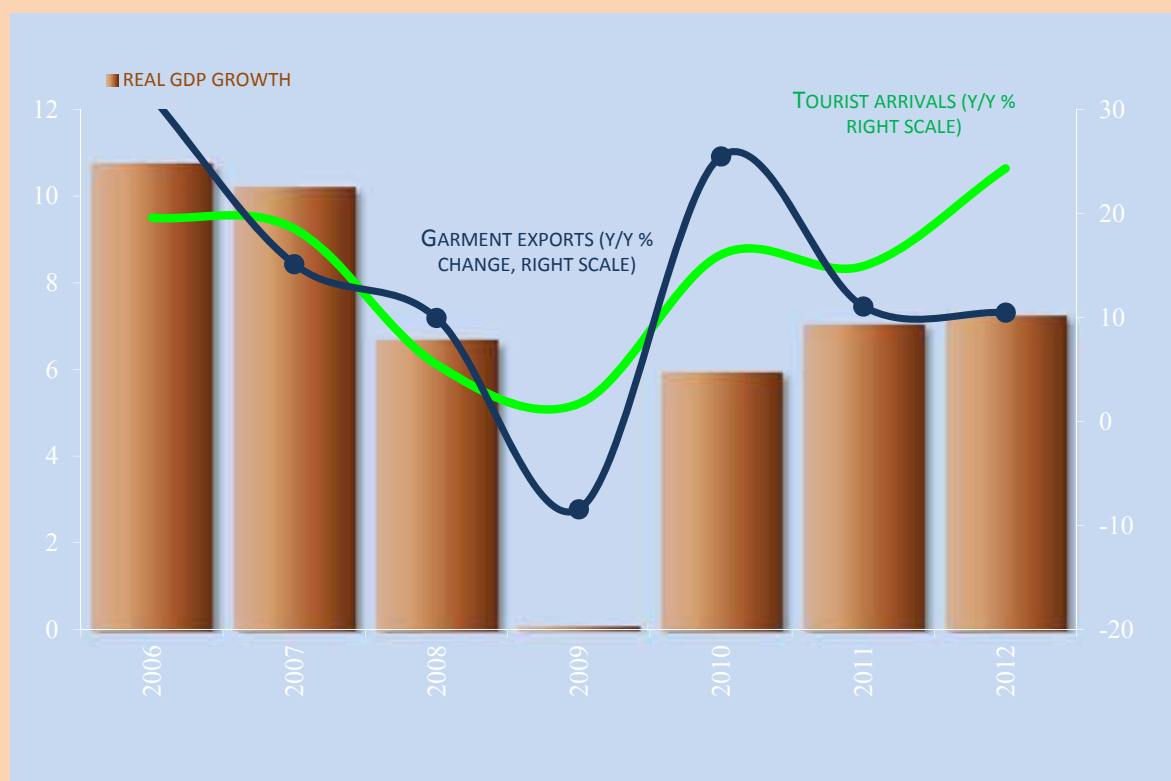


RESILIENCE AMIDST A CHALLENGING ENVIRONMENT

CAMBODIA ECONOMIC UPDATE



THE WORLD BANK

SEPTEMBER 2013

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The Cambodia Economic Update 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 Poverty Team, led by Samsen Neak, contributed the poverty section for the Update. The team worked under the guidance of Mathew A. Verghis, Lead Economist and Sector Manager, PREM Sector Department, and Alassane Sow, Country Manager for Cambodia.

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 Updates by the East Asia PREM Department of the World Bank.

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For information about the World Bank and its activities in Cambodia, please visit www.worldbank.org/kh.

To be included in the email distribution list of the Cambodia Economic Update and related publications, please contact Linna Ky (lky@worldbank.org). For questions on the content of this publication, please contact Saroeun Bou (sbou@worldbank.org).

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A. Executive Summary

- 1. Four years after the onset of the Global Financial Crisis, the world economy continues to struggle.** According to the June 2013 Global Economic Prospects, the global economic environment remains fragile, although the balance of risks is now less skewed to the downside than it has been in recent years. The US has been signaling an exit from quantitative easing. Developing country currencies have come under pressure, and their interest rates have been on the rise, contributing to inflation and weaker growth. *This may complicate in particular those economies that have seen big increases in credit during the period when interest rates were low, or where current account and government deficits are high.* Developing economies remain the main driver of global growth, but their output has slowed compared with the pre-crisis period.
- 2. The Cambodian economy remains robust amidst the challenging global economic environment, and prospects for meeting the growth projection of 7 percent in 2013 appear favorable.** Real GDP growth was 7.3 percent in 2012. The GDP growth has been driven by a sustained strong agriculture sector growth, resilient exports, rebounding construction activity, and a robust tourism sector. However, going forward, the slower growth in China and prolonged sluggish growth in the United States and the European Union may affect demand for Cambodian products and services, and represents an external downside risk.
- 3. Garment exports have expanded by 18 percent year on year as of June 2013.** The tourism sector continues its high growth trajectory. Tourist arrival number reached 19 percent year on year by June 2013. Adaptation to changes in destination markets for garments, expanded cultivated area, and a diversification in sources of tourism have helped Cambodia's three key engines of GDP growth sustain their momentum.
- 4. With moderate imports and robust exports, the current account deficit is projected to be narrower.**¹ This year's current account deficit excluding official transfers is projected to be around 9 percent of GDP, as opposed to 10.1 percent of GDP in 2012. The capital and financial account surplus continues as foreign direct investment remains sustained over the first half of 2013, and investor interest appeared to be strong during the election period, unlike in past elections. It is unclear yet how big an impact the political uncertainty post-elections is having on foreign direct investment. By June 2013, the gross international reserves reached US\$ 3.6 billion, compared to US\$ 3.5 billion by the end of 2012.
- 5. In June 2013, year on year inflation picked up, reaching 2.9 percent due to slightly elevated foods prices.** Inflation is projected to remain at low single digit figures during the short term. The Consumer Price Index (CPI) eased in 2012, dropping to 2.5 percent by the end of 2012, compared to 4.9 percent in 2011 due to stabilization of the main

¹ Current account deficit excluding official transfers

product categories, in particular food prices, which represent 43 percent weight of the inflation basket.

6. **The Dollar has appreciated since the second quarter of this year; and this has forced the Central Bank to intervene.** By June 2013, a loss of about US\$ 150 million of Central Bank's international reserves was recorded. The exchange rate depreciated and reached Cambodian Riel 4,062 per US Dollar in June 2013.² The Riel is pegged to the US Dollar, and the exchange rate has been hovering around Riel 4,000 per Dollar. The financial deepening continues and a growing number of banks are entering the Cambodian market. Competition among banks has contributed to narrowing the US Dollar interest rate spread, and driving some efficiency into the market. However, there are also significant risks to having a large number of banks due to supervision capacity challenges.
7. **During the first five months of 2013, domestic revenue continues to improve but at a slower pace, rising only at 9.6 percent year on year, compared to 24.7 percent in 2012.**³ Public expenditure performance, however, appears slower. Therefore, budget deficit (excluding grants) should remain as budgeted at around 5.4 percent of GDP. Fiscal management remains appropriate and supportive of macroeconomic stability but there is significant room for domestic revenues to be further improved and for greater efficiency in spending. In 2012, Cambodia restored its fiscal space, thanks to a high growth of revenue, estimated to reach 14.4 percent of GDP in 2012, compared to 13.1 percent in 2011. Government, however, continues to depend heavily on donors whose funds account for almost 80 percent of the total public investments or 34 percent of the total public outlays.
8. **Budget allocations for key social sectors like health and education are trending downward in relative terms.**⁴ The shares of the health and education sectors in total domestically financed spending decreased to 8.7 percent and 10.3 percent in 2011 from 9.8 percent and 14.2 percent in 2007, respectively. The shares of general administration, defense and security sectors combined risen very quickly, reaching 60 percent of the total spending in 2011 from 44.3 percent in 2007, reflecting increasing demand for security and defense related expenditures. In percentage of GDP, domestically financed spending for the health sector is slightly trending upward, rising to 1.3 percent in 2011 from 1.0 percent in 2007 while the spending by the education sector has remained at 1.6 percent of GDP since 2007. A recent report found that Cambodia's public spending on education is only half that of its peers; and there is inefficient spending in the health sector.⁵
9. **The overall debt sustainability outlook remains favorable.** The 2012 joint World Bank/IMF DSA shows that Cambodia's debt distress rating remains low. The Government's policy of avoiding non-concessional borrowings has been a key factor to

² Official mid-point exchange rate

³ Preliminary fiscal data for 2013

⁴ 2012 Sectoral spending data are not available yet

⁵ 2011 Integrated Fiduciary Assessment and Public Expenditure Review (IFAPER), the World Bank.

sustainable debt management. Cambodia's external public debt and publicly-guaranteed debt stock is estimated to reach 30.1 percent of GDP in nominal terms by the end of 2012.

10. **As a result of the rapid pace and pattern of growth that shared benefits to a larger number of people, Cambodian poverty has fallen sharply.** Economic growth broadened over the past years thanks in large part to the sustained growth in the agricultural sector favored by increases in rice prices in the global markets. The percentage of poor people was more than halved within seven years down to around 20 percent in 2011. Despite this large poverty reduction, the vast majority of the families who were lifted out of poverty were so only by a small margin, implying that those families moved from being poor to being just near-poor.
11. **In sum, the key messages include: (a) sustain robust growth by promoting diversification and enhancing competitiveness; (b) maintain banking and financial stability with effective supervision; and (c) improve fiscal management by increasing revenue and more efficient spending.** The Update is organized into five sections. Section A provides an executive summary. Section B introduces the global economic environment and outlook. Section C discusses in detail the Cambodian Economy. Section D offers suggestions and way forward. The Update ends with Section E, presenting key findings of the recent Cambodia poverty assessment.

B. Global Environment⁶

World Economic Growth

- 1. The global economy is transitioning toward a more stable period, but slower growth.** Financial conditions in high-income countries have improved, and risks are down. However, their growth rates are expected to slowly accelerate, with GDP expanding only 1.2 percent this year, but firming to 2.0 and 2.3 percent in 2014 and 2015 respectively (Annex 1). It is projected that the aggregate GDP of developing countries will grow by a solid 5.1 percent this year and by 5.6 and 5.8 percent in 2014 and 2015 respectively.
- 2. Challenges, however, are quite diverse.** They include inflationary pressures and asset price bubbles, and weaker than pre-crisis growth rates, in addition to the challenges that the eventual withdrawal of quantitative easing may bring.
- 3. Inflation pressures remain subdued.** Despite the monetary stimulus and an acceleration in developing-country growth in the last quarter of 2012, inflation pressures remain relatively subdued, although East Asia, the Middle East & North Africa, and South Asia are showing signs of rising inflation.
- 4. Capital flows to developing countries have also recovered in nominal terms.** They are close-to-peak levels, and the recovery of bank flows suggests the worst effects of Euro Zone deleveraging on developing countries have passed. Financial market conditions have stabilized, and substantial improvement in global financial conditions since the second half of 2012 has continued. The improvement reflects progress toward fiscal sustainability in the Euro Area. This is in tandem with the extraordinary monetary policy steps undertaken by major central bankers that have flooded markets with liquidity.
- 5. Developing countries are leading a rebound in activity, but their growth eased in the first quarter this year.** The turnaround, which began in the East Asia & Pacific Region, has spread more widely. Developing countries have benefited from quantitative easing, which stimulates high-income-country GDP, lowering borrowing costs, and avoiding a financial-sector meltdown. Moreover, the increased liquidity has not produced excessive capital flows.
- 6. The pickup in growth in the first quarter of 2013 has eased.** This reflects China's rebalancing efforts, the Yen depreciation, lower commodity prices, capacity constraints in many developing economies, and a gradual tightening of macroeconomic policies. As a result, the sharp recovery in trade appears to be losing momentum. Developing-country import demand slowed, and both export and import demand from high-income countries turned negative. Once high-income countries are less actively pursuing quantitative easing, or beginning to unwind long-term positions, interest rates are likely to rise.
- 7. The US has recently been signaling an exit from quantitative easing, and speculation about the timing of the exit has been shaking financial markets.** Yields on US treasuries have already risen, making these less-risky assets much more attractive than they have been in the past.

⁶ June 2013 Global Economic Prospect (GEP), the World Bank

As a result, money has been flowing back into the Dollar. Developing country currencies have come under pressure, and their interest rates have also been on the rise; and this is contributing to inflation and weaker growth. Less investment, and slower growth going forward may affect those countries that have experienced increases in credit during the period when interest rates were low, or where current account and government deficits were high.

World Commodity Prices

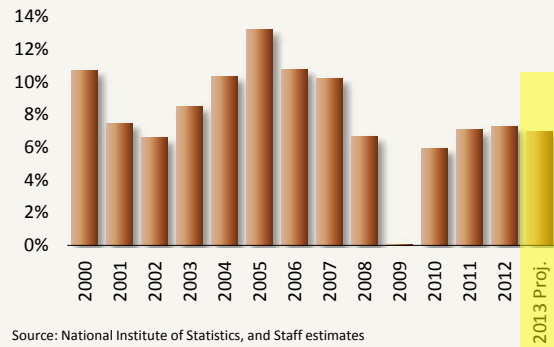
8. **Over the past year, energy and metal prices have been easing in response to new capacity.** This appears to be in response to supply and demand-side substitution, induced by high commodity prices. Since 2000, capital expenditures by major firms in oil and metal markets have quintupled. Demand suppression has also been at work. The combination of increased supply and weak demand has resulted in a buildup in global stocks. As a result, despite the strengthening of the global economy, the prices of most industrial commodities have been declining, e.g. metal prices are down 30 percent since their February 2011 peak.
9. **Commodity prices are expected to continue to ease over the medium term.** The World Bank forecasts the price of a barrel of oil to ease to US\$ 102 in 2013, and to US\$ 101 in 2014. Similarly, metal prices are expected to decline in real terms by 3.7 and 1.4 percent in 2013 and 2014, respectively. Food prices are also projected to decline (7.7, 6.0, and 5.5 percent over 2013–15), reflecting a gradual improvement in supply conditions, and
10. **A decline in commodity prices has been considered as a new risk.** While the decline would benefit global GDP, it could put stress on the current accounts and fiscal balances of commodity exporters. The recent decline in industrial commodity prices is, perhaps, signaling an end to the upward phase of the commodity cycle. Policy makers in commodity-exporting countries need to take a close look at the potential consequences of a sharper-than-anticipated decline in commodity prices, for growth, government finances, and their external financing needs. However, an exit from quantitative easing by the United States, if it occurs, may reverse the decline.

C. The Cambodian Economy

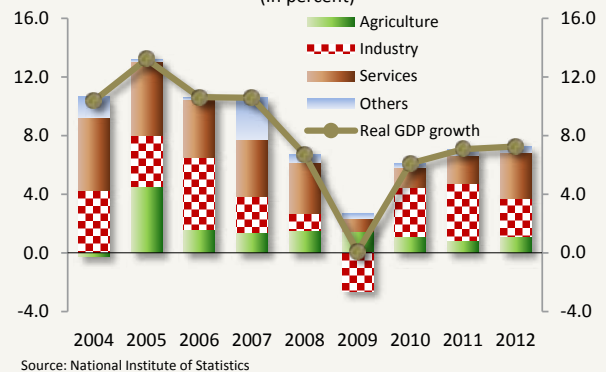
Real Sector

11. **Prospects for meeting the growth projection of 7 percent in 2013 appear favorable.** The economy remains resilient and overall macroeconomic outlook remains positive, having sustained agricultural growth with favorable weather conditions, continued strong performance of the tourism sector, and a resilient garment sector. The sustained agricultural growth helped cushion shocks, while well-adapted garment exports quickly recovered, and successfully diversified tourist markets supporting robust tourism sector growth: these are the reasons why the economy bounced back quickly from 2008 – 2009 Global Economic Crisis. The outlook, however, depends on the external environment, which remains fragile, although the balance of risks is less tilted toward the downside; and on the domestic political environment, given the uncertainty after the July 2013 general elections. In terms of sectoral contribution, the agriculture sector contributed 15.0 percent to the real GDP growth in 2012, compared to 11.3 percent in 2011 and 18.3 percent in 2010. Industry sector's contribution to the real GDP growth was 35.6 percent in 2012, down from 54.9 percent in 2011, and 56.5 percent in 2010. The services sector contributed 42.5 percent in 2012 up from 26.8 percent in 2011 and 21.7 percent in 2010.

Real GDP Growth
(Y/Y % change)



Contribution to real GDP growth
(In percent)

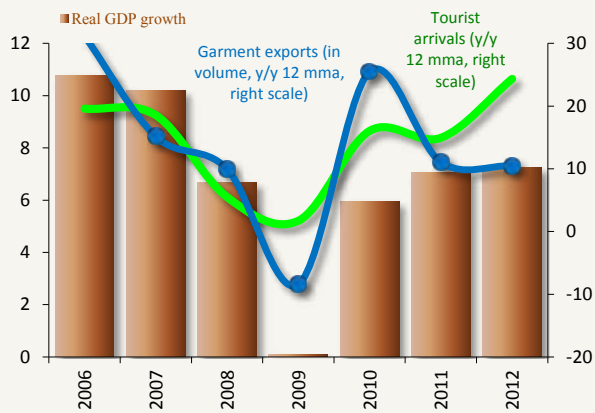


Agriculture

12. **Agriculture growth is projected to remain sustained in 2013 due to favorable weather conditions.** By the end of August 2013, the Ministry of Agriculture, Forestry and Fisheries (MAFF) reported rice planting area increase of 11 percent compared to the same period last year. Agricultural growth at constant prices was 4.3 percent in 2012, comparable to the 2011 and 2010 growth rates of 3.1 percent and 4.0 percent, respectively. The main agricultural production is in rice crops, which continue to provide a contribution of about 10 percent of the total real growth during the last three years (2010-2012). *Due to sustained agriculture growth, after years of agriculture and irrigation investments, the real growth has now*

been largely influenced by the garment and tourist sectors.

Tourist arrivals, garment exports & real growth
(In percent)



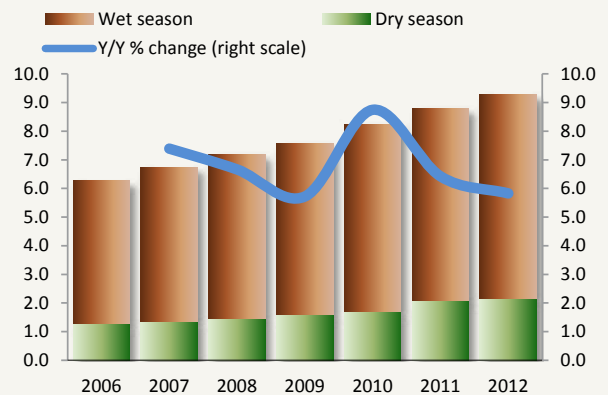
Source: Cambodian authorities

Rice production

13. **Contribution by expanding cultivated areas of rice crops accounts for up to 80 percent of the annual rice production increase during the last four years.** Yield contributes the remaining 20 percent. An important development is the increase in share of the dry seasonal rice production (due to increased access to irrigation systems in dry season), which has gradually grown to 23.3 percent of the total annual rice production in 2012, from 18.5 percent in 2003. Less weather-dependent dry season rice cultivation plays a major role in stabilizing the annual rice output.

Rice production

(In mln of metric tons, and y/y % change of total production)



Source: Ministry of Agriculture, Forestry, and Fisheries

14. **Due to weaknesses in rice milling capacity and financing, Cambodia exports most of its rice surplus unprocessed, in paddy form.** The surplus is estimated at 4.7 million tons in 2012 by MAFF and paddy rice exports are not recorded. Cambodia has recently started to export milled rice. During the first six months of 2013, milled rice exports were more than double those of the same period last year, reaching 185 thousand metric tons and generating US\$ 136 million, a 28 percent increase year on year.⁷ Milled rice exports, mostly destined for Europe, have benefited from Everything but Arms arrangement under the EU's Generalized Scheme of Preferences.⁸ In 2010, the Government, pursuing its rice policy, set up a milled rice export target of up to 1 million metric tons by 2015. Since then both public and private financing has gone to agriculture and agricultural processing. Total credits by the banking system to the agriculture sector and agriculture processing has more than

⁷ June 2013, rice exports data, Ministry of Commerce.

⁸ Everything but arms provides a "bonus" of about EUR 175 per metric ton of milled rice exports.

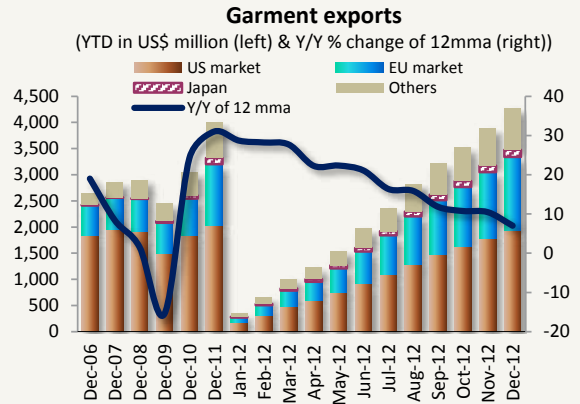
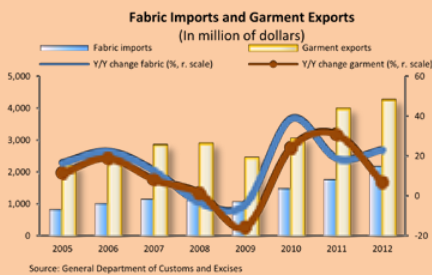
doubled, rising to US\$ 573 million in 2012 from US\$ 221 million in 2010.⁹

Garments

15. **Garment exports growth accelerated further during the first half of 2013, reaching 18 percent year-on-year.** The garment export industry has adapted to export market conditions to grow. *Export strategies, focusing on lower-end garment products for the United States (US) market and higher-end products for the European Union (EU) market, with the comparative advantage of low labor costs, have allowed the industry to grow.* Garment exports grew 7 percent and 31 percent year on year in 2012 and 2011, respectively.

Box 1. Fabric Imports and Garment Exports

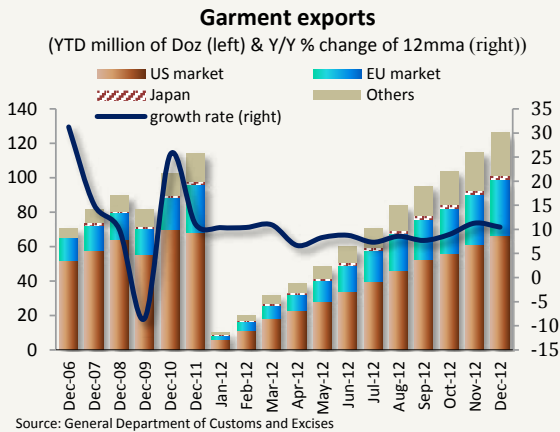
Imports of fabric, a leading indicator for garment production and exports, continue to grow since the 2008 – 2009 Global Economic Crisis. In 2012, the fabric imports grew by 20 percent year on year in value terms, supporting a 10 percent year on year growth of garment exports; and the percentage changes of fabric imports closely in tandem with those of garment exports continue (see the figure below). This reflects persistent absence of import substitution of inputs for the garment sector and therefore, further gains from value chain of garment products remain unrealized.



Source: General Department of Customs and Excises

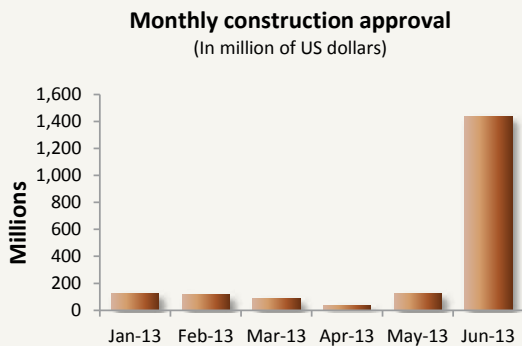
16. **The U.S. remains the largest garment export market destination for Cambodia, but its share continues to shrink.** The US market captured US\$ 1,930.5 million (or 45 percent) of the total garment exports of US\$ 4,274 million in 2012 (see the figure above). The EU market is second, generating US\$ 1,409.8 million (or 33 percent). Benefiting from Everything but Arms arrangement under the EU's Generalized Scheme of Preferences, the EU market share of the Cambodian garment exports gained quickly, capturing 33 percent in 2012, from 29 percent in 2011, and 23 percent in 2010; while the US market shrank from 60 percent in 2010, to 51 percent in 2011, and to 45 percent in 2012. Japan has rapidly emerged as a garment export market destination for Cambodia, and the Japanese market generated US\$ 137 million in garment exports in 2012, compared to only US\$ 24 million in 2010. In volume terms, exports to the US market also dropped from 68 percent in 2010, to 60 percent in 2011, and to 53 percent in 2012; while the EU market share rose to 26 percent in 2012, from 24 percent in 2011, and 18 percent in 2010 (see the figure below).

⁹ 2012 Annual Report, National Bank of Cambodia



Construction and Real Estate

17. **Approved investments in construction rose quickly during the first six months of 2013.**¹⁰ The monthly construction approval skyrocketed in June 2013, reaching US\$ 1.4 billion from US\$ 126 million in January 2013, bringing the total construction investment approval during the first six months to US\$ 1.93 billion. While construction and real estate activity has largely concentrated on smaller and more dispersed residential and commercial areas, latest developments suggest that by mid-2013, there were early signs of bubbles in the real estate sector in the urban areas and domestic credits played a much bigger role in financing the sector.

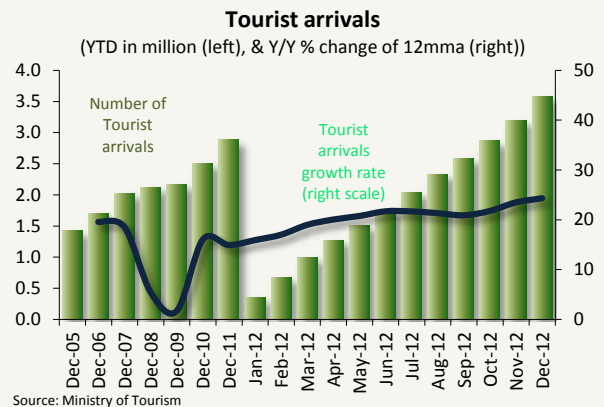


Source: Ministry of Land, Urbanization and construction

¹⁰ Construction projects approved by the Ministry of Land and Urbanization and Construction.

Tourism

18. **Tourist arrivals during the first five months of 2013 reached 1.79 million, or 19 percent year on year increase.** Tourist arrival numbers, as a proxy for the tourism sector performance, has shown a quick recovery, and now continues its high growth trajectory. Tourist arrivals reached 3.58 million visitors, representing 24 percent year on year growth in 2012, compared to 15 percent growth in 2011. Successful diversification of tourism markets, attracting arrivals from Eastern Europe, East Asia and the Pacific regions, has resulted in continued high growth in the tourism sector. Establishing new direct flights from the different regions of the world also supports a higher year on year growth of arrivals by air (which is seen as “quality growth” tourism), from 13.5 percent in 2011 to 16.3 percent in 2012. High growth in the tourism sector allows trade, hotel, and restaurant subsectors combined to contribute more than 15 percent to the total real growth during 2010 – 2012 period.

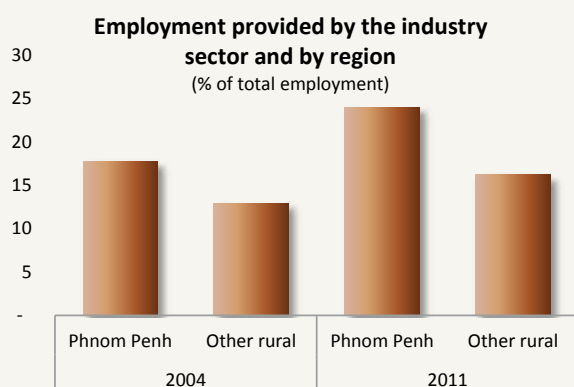


Employments and Labor costs

19. **The agriculture sector employs up to 55.8 percent of the total employed**

population (7.9 million out of 14.1 million population).¹¹ *Of the total rural employment, the agriculture sector provides 66.7 percent, while the rest is provided almost equally by the industry and services sectors.* This reminds policy makers that agriculture should not be the only focus when it comes to improving living conditions and reducing poverty in the rural areas.

20. **The industry sector is absorbing increasingly large proportions of the labor force.** It provided up to 16.9 percent of total employment in 2011, compared to only 13.3 percent in 2004. *The share of employment provided by the industry sector in Phnom Penh rose quickly (close to a one-percent increase per year), from 17.8 percent in 2004, reaching 24 percent in 2011.* This suggests a move toward “industrialization” in the capital city, supported by rural - capital labor migration. In the rural areas the share has also improved, but at a much slower pace, reaching 16 percent in 2011 from 13 percent in 2004, suggesting that the industrialization process in the rural areas is much slower.



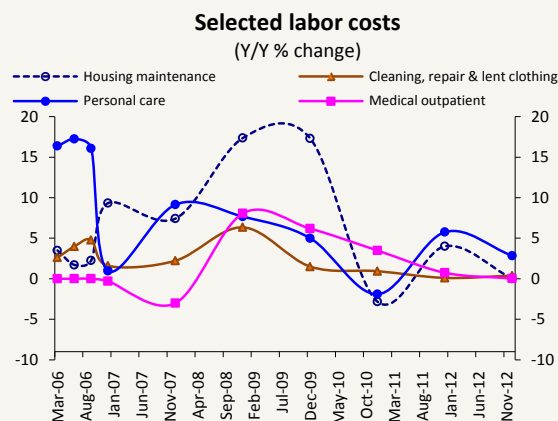
Source: CSES 2011, National Institute of Statistics

21. **The employment share of the services sector has only slightly changed, declining to 27.3 percent in 2011 from**

¹¹ Cambodian Socio-Economic Survey (CSES) 2011, National Institute of Statistics

29.1 percent in 2004. The services sector continues to provide sustained employment at around 17 percent for the rural areas, whereas the share has gradually declined in the urban areas, in particular Phnom Penh, dropping to 73.7 percent in 2011 from 80.9 percent in 2004.

22. **The minimum wage for garment factory workers has recently increased by 31 percent, after a 22 percent increase in 2010.** From May 2013, the monthly minimum salary is US\$ 80, compared to US\$ 61 effective July 2010, and US\$ 50 starting from 2008.¹² This seems to be in contrast to the deceleration of a number of selected labor costs surveyed for the monthly inflation basket, which remain eased since the Global Financial Crisis (see the figure below).



Source: National Institute of Statistics

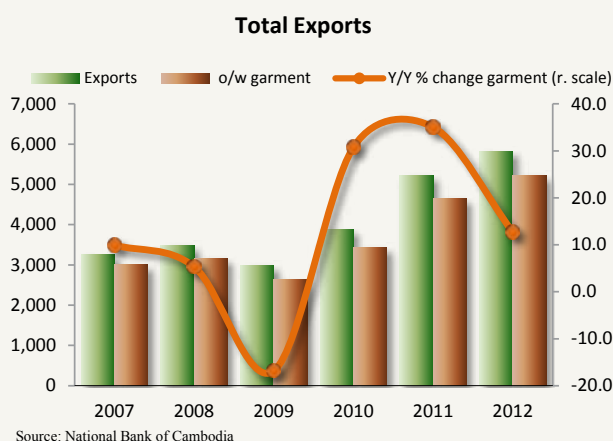
Balance of Payments

Exports

23. **Thanks to further acceleration of garment exports, total exports are projected to improve in 2013.** Exports of

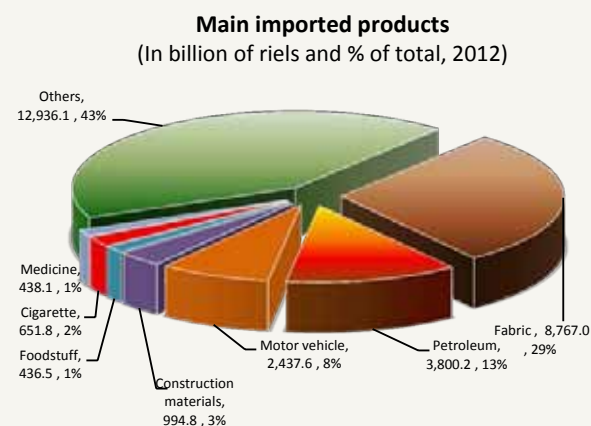
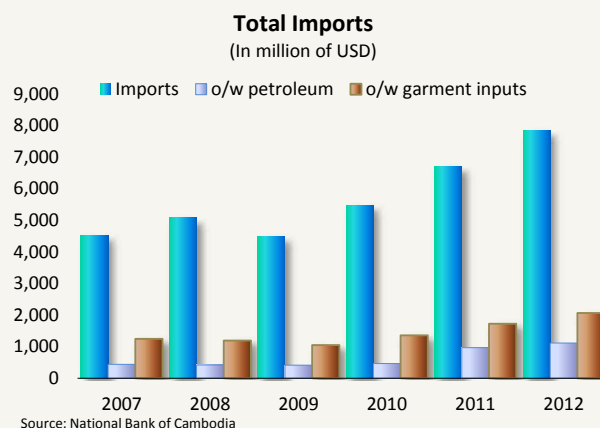
¹² While Cambodia’s minimum wage remains low, the country’s productivity (output per worker = value added per person employed) lags far behind its neighbors. Cambodia’s output per worker is about one-half that of Vietnam, and only one-fifth that of Thailand. See 2010 Labor and Social Trends in Cambodia, International Labor Organization and the National Institute of Statistics for details.

goods are projected to grow at 15 percent year on year in 2013, compared to 11.4 percent in 2012. Exported garment products accounted for 75 percent of total domestic exports in 2012. Exports of footwear and agricultural products, such as rubber and milled rice, are picking up, but remain relatively small. Exports, which shrank by 14 percent in 2008, recovered quickly since the Global Economic Crisis, and grew at 30 percent and 34.4 percent year on year in 2010 and 2011, respectively.



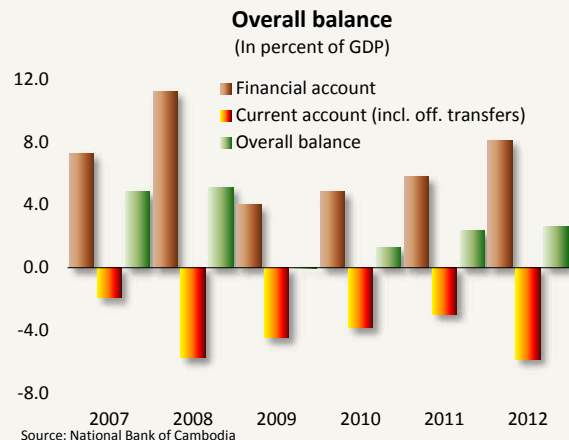
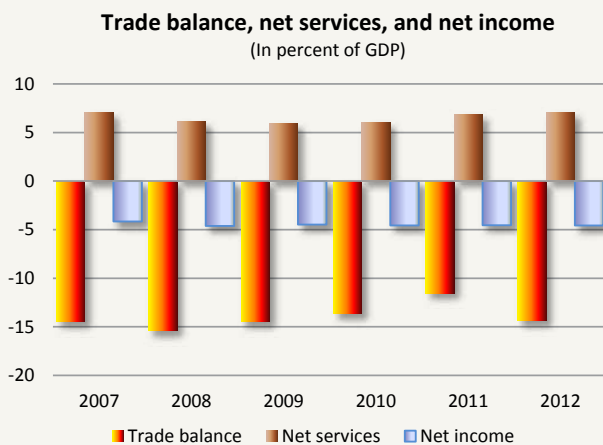
Imports

24. **Imports growth is projected to be moderate in 2013.** Imports of goods are projected to grow at 13 percent year on year in 2013, compared to 18.7 percent in 2012 due to slower consumption goods imports. *Fabric for garment production, petroleum, motor vehicles, and construction materials continue to be the main imported items, accounting for about 50 percent of total imports.* Fabric imports alone cover about 30 percent of the total imports, while petroleum imports account for 15 percent of the total. Other main imported products include medicines, foodstuff, cigarettes, fertilizer, beverages, electronics, and household items.



Trade Balance

25. **With moderate imports and robust exports, this year's trade deficit should be narrower in relative terms.** The trade deficit is projected to be around 13 percent of GDP in 2013, as opposed to 14 percent of GDP in 2012. The widening trade deficit in 2012 was attributed to higher imports growth of 15 percent while exports only climbed by 11.4 percent. The imports growth was driven mainly by a 15 percent rise in petroleum imports, a 36 percent increase in motor vehicle imports, and a 35 percent increase in construction materials imports.

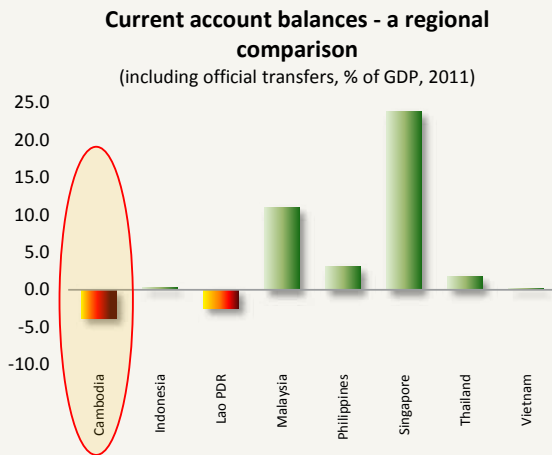


Current Account and Capital Balances

26. **The current account deficit is projected to be narrower.** This year's current account deficit excluding official transfers should be around 9 percent of GDP, as opposed to 10.1 percent of GDP in 2012. The capital and financial account surplus continues as foreign direct investment remains sustained over the first half of 2013, and the overall balance of payments remains positive with increasing international reserves. By June 2013, international reserves already reached US\$ 3.6 billion, as opposed to US\$ 3.5 billion by the end of 2012. Foreign direct investment continued to grow over the first half of 2013, and investor interest appeared to remain strong during the election period, unlike in past elections. It is unclear yet how big an impact the political uncertainty post-elections is having on foreign direct investment.

27. **Compared to other countries in the region, Cambodia continues to run relatively large current account deficits as a percentage of GDP.** The large current account deficit that Cambodia runs is needed to help fuel investment and growth until the domestic financial system can take over more fully. However, it also increases Cambodia's vulnerability and susceptibility to external shocks.¹³ Mobilizing official sector loans and attracting non-official sector investments, in particular foreign investments, have been effective ways of maintaining Cambodia's positive overall balance of payments.

¹³ Cambodia's small, open, and highly dollarized economy is vulnerable, and susceptible to external shocks. Moreover, with large current account deficits, the economy requires correspondingly large capital account surpluses to finance the deficits. As a result, capital inflows, in particular foreign direct investments, are necessary to maintain Cambodia's positive overall balance of payments. Cambodia imports 100 percent of its petroleum products, which account for almost 15 percent of the total imports in value terms. As discussed in Box 1, further gains from value chain (of garment product) remain unrealized, forcing the country to depend entirely on imported fabric and other inputs for its garment production. Fabric import accounts for close to 30 percent of the total imports.

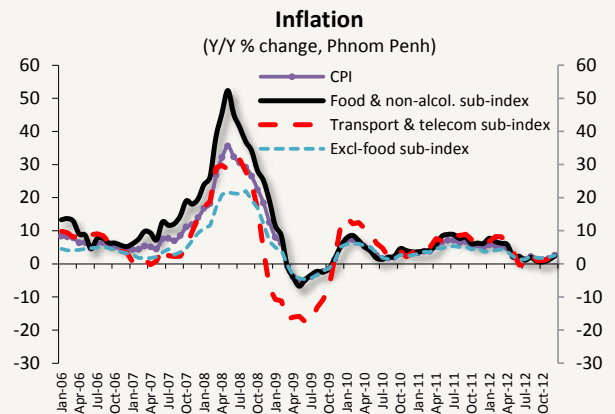


Source: World Development Indicator, World Bank and Cambodian authorities

Inflation

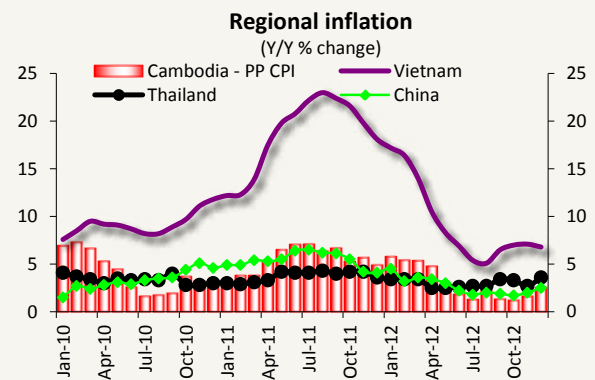
28. In June 2013, year on year inflation picked up, reaching 2.9 percent due to slightly elevated foods prices.¹⁴ Inflation is projected to remain at low single digit figures during the short term. After the food and oil price shocks preceding the Global Financial Crisis, inflation has declined, and continues to be subdued. Inflation eased to 2.5 percent year on year by end-2012, from 4.9 percent in 2011. Prices of both food and fuel have risen and fallen, more or less in tandem in recent years. Modern agriculture uses oil products to fuel farm machinery, to produce fertilizers, and to transport farm inputs and outputs. In addition, as oil prices rise, it increases the demand for biofuels, often made from corn and other agricultural products.

¹⁴ June 2013 CPI, the National Institute of Statistics, Ministry of Planning.



Source: National Institute of Statistics

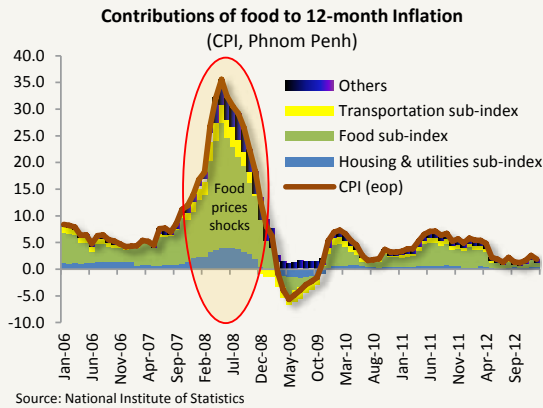
29. The inflation rates of Cambodia's main import countries also remain low. Cambodia's small and open economy is a price taker, which, together with high dollarization and large trade deficits, render the macroeconomic policy makers almost defenseless against exchange rate pass-through and imported inflation. Therefore, stable prices in Cambodia's main import partners in recent years have contributed to low inflation in Cambodia.



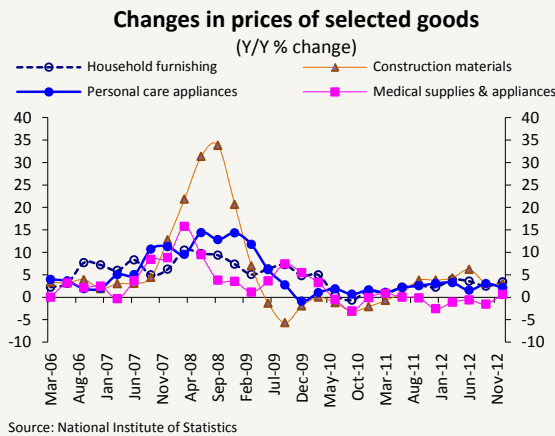
Source: National Institute of Statistics

30. The food component is the main driver of Cambodia's consumer price index. It represents 43.3 percent weight in the inflation basket of goods and services. The food price shocks that occurred during the period between 2007 and 2008 pushed inflation to peak at over 35 percent year on year in May 2008 (see the figure below). In addition to food prices, changes in prices of selected goods and fees in the CPI

basket are discussed below to see how they also influence inflation.

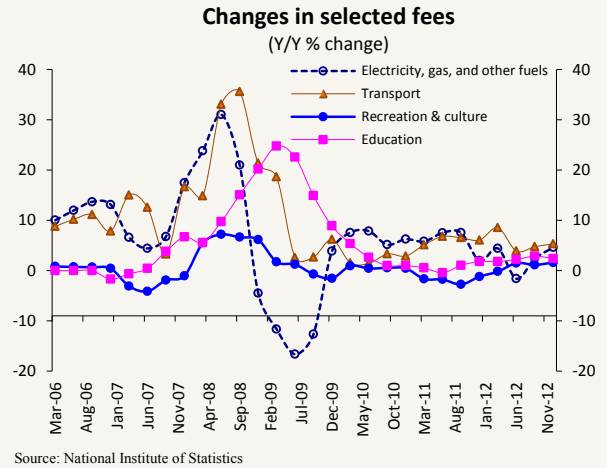


31. **Changes in prices of selected goods, namely household furnishing, appliances, construction materials and medical supplies in the CPI basket have decelerated.** Stable prices of goods have returned since 2010 after the impacts of the Global Financial Crisis and food crisis subsided; this contributed to moderate and low inflation during 2011 and 2012.

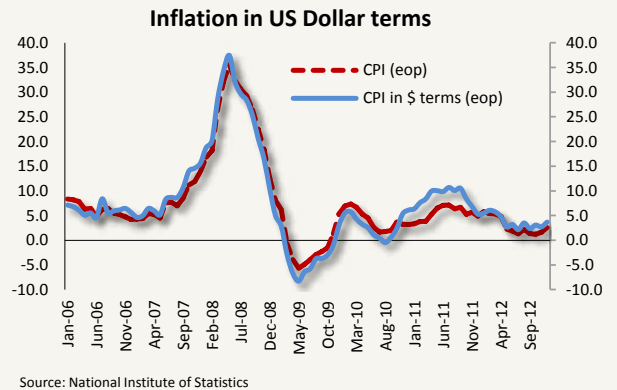


32. **As expected, the selected fees for utilities consumption and transport, closely linked to oil prices, exhibit rather extreme volatility.** Some other selected fees, which are not directly related to oil prices, including educational,

recreational and cultural fees, show only moderate volatility (see the figure below).



33. **Inflation measured in Riel and US Dollar terms are very similar.** As the economy is highly dollarized, it is important to look at the “inflation in US Dollar terms” as well.¹⁵ The figure below shows that, in general, inflation measured in Riel and Dollar terms are quite similar due to stable Riel versus Dollar exchange rate, thus allowing those who receive income in USD and in CR almost exactly the same purchasing power.



¹⁵ “Inflation in US dollar terms” eliminates the effect of the changes in the exchange rate of the Cambodian Riel against the US dollar in the consumer price index. So, it measures inflation as if it is in a fully dollarized economy.

Monetary Sector

34. **The monetary sector plays an increasingly important role as financial deepening continues.** A growing number of banks (rising from 35 banks in December 2011 to 40 banks in April 2013) are entering the Cambodian market, despite the tripling of capital requirements effective January 1, 2011.¹⁶ Improved confidence in the banking sector has resulted in rising foreign currency deposits, reaching US\$ 6.6 or 18.8 percent year on year growth by June 2013, as opposed to US\$ 5.9 billion, or 24 percent year on year growth by the end of 2012. Private sector deposits rose quickly, amounting to US\$ 6.6 billion, or 19.6 percent year on year growth by June 2013, as opposed to US\$ 6 billion or 25 percent year on year. Credit to the private sector has also grown at a very rapid rate i.e. over 30 percent year on year for a third year, amounting US\$ 6.2 billion. The high credit growth triggered an increase in the reserve requirement rate, from 12 percent to 12.5 percent, in

Box 2. Full Dollarization

Do disadvantages of full dollarization outweigh the benefits? The Central Bank has long been promoting the use of the local currency, Riel, to reduce gradually the level of dollarization. However, in spite of various measures that were taken in the past to “de-dollarize” the country, the trend is still towards even greater dollarization. High dollarization undermines the implementation of monetary policy. The costs of dollarization also include interest income loss on dollar denominated money stock held by the people, and seigniorage loss.^a Estimated annual seigniorage forgone as broad money grows is as much as US\$ 100 million.^b

a. Seigniorage is the difference between the value of money and the cost to produce and distribute it.
b. Bank staff estimates. See also March 2007, Dollarization in Cambodia by Tal Nay Im and Michel Dabadie

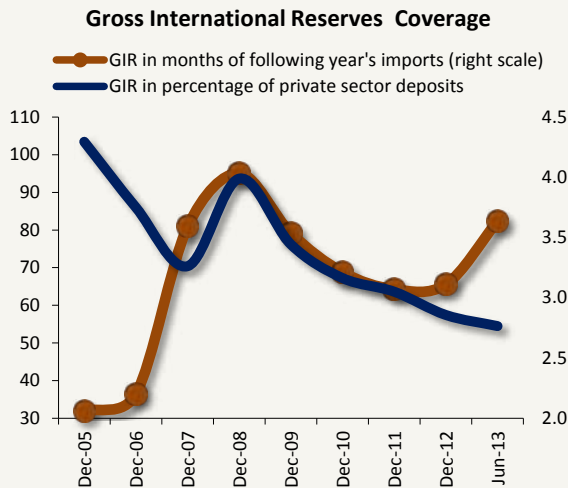
October 2012. While the banking system remains liquid and adequately capitalized, the high growth of private sector credit, of approximately 30 percent year on year since mid-2011, raises a financial risk concern.¹⁷ The credit growth does not appear to be concentrated in a single or a few sectors, and driven also by agriculture sector financing underpinning improved value addition in agriculture production and exports. It, however, is believed to partly fuel the robust recovery and vibrant activity of the real sector in which early signs of bubbles were observed during the first of 2013.

35. **Persistently high dollarization continues to undermine the country’s ability to conduct the monetary policy.** The monetary policy is constrained by high dollarization, while the use of local currency is very limited. The Cambodian Riel (CR) is pegged to the US Dollar, and has been targeted to be around Riel 4,000 per Dollar. *Due to high dollarization, the exchange rate between the Dollar and the Riel no longer fully retains its original meaning, since it matters only for prices of Riel-denominated goods and services that represent a small portion of the economy.* With a highly dollarized economy, the Central Bank has very limited monetary policy tools, leaving fiscal policy as the main instrument to implement macroeconomic policy. There are recent positive developments, the establishment of a national clearing house and the introduction of a new financial security, negotiable certificates of deposits (NDCs). The inter-bank market, however, remains to be established.

¹⁶ A minimum capital is 150 billion riel (US\$ 36.5 million equivalent).

Gross International Reserves

36. **Gross international reserves reached US\$ 3.6 billion by June 2013.** The accumulation of international reserves continues, due mainly to the inflows of foreign direct investments. *However, the reserves remains low by regional standards, and adds another risk dimension to the economy as the Central Bank cannot serve as lender of last resort due to dollarization.* The reserves can only cover approximately 3.6 months of goods and services imports.¹⁸ And in terms of percentage of private sector deposits, the gross international reserves have been declining gradually, from 86 percent by the end of 2006 to only 54 percent by June 2013, because of rapidly rising deposits of the private sector.



Source: National Bank of Cambodia and Bank staff estimates

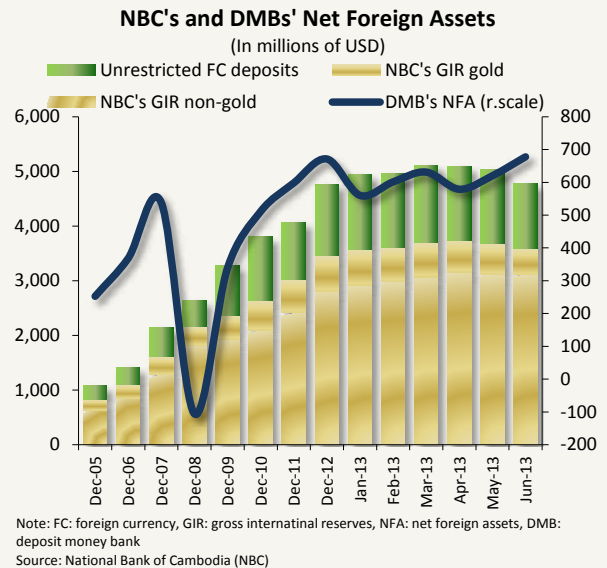
Net Foreign Assets¹⁹

37. **The Central Bank's Net Foreign Assets (NFA) continue to increase, due mainly to the accumulation of the**

¹⁸ Gross international reserves relative to following year's imports of goods and services.

¹⁹ Net foreign asset (NFA) is the balance on the foreign assets account, which is the sum of the foreign assets of the monetary authorities and DMB's less any foreign liabilities.

international reserves. In June 2013, gross international reserves, however, dropped by about US\$ 150 million, reaching only US\$ 3.6 billion, compared to its peak of US\$ 3.75 billion in April, largely reflecting recent invention to prevent nominal depreciation of the Riel as the Dollar has lately appreciated. Net foreign assets of deposit money banks (DMBs) have also risen. Deposit money banks experienced a period of negative net foreign assets in late 2008 through early 2009, when there was a sharp drop in foreign assets, more than offsetting a decrease in foreign liabilities with banks' reserves buildup during the Global Financial Crisis (see the figure below).²⁰

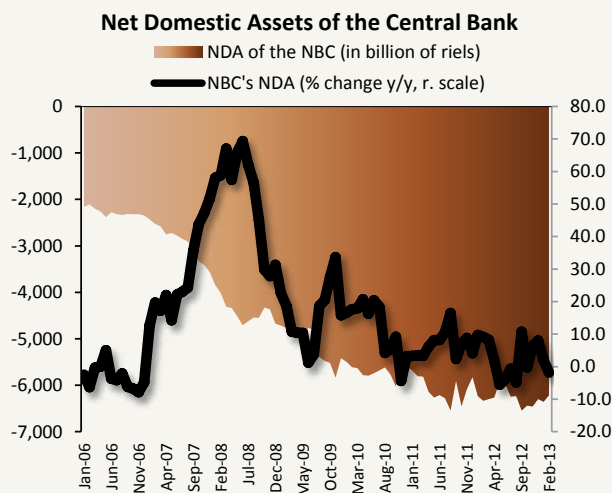


38. **The Central Bank's Net Domestic Assets (NDA) reduce on the back of rising government deposits.**²¹ This is mainly underpinned by an overriding principle of balanced budget of the fiscal position. The Government is not only avoiding domestic bank financing, but also

²⁰ This reflected bank deleveraging during the Global Financial Crisis..

²¹ Net Domestic Assets (NDA) are the sum of net domestic credit (claims on government, claim on DMB's and claims on domestic sector) and other items (net).

accumulating government deposits as revenue collection improves.²² In the late 80s to early 90s, fiscal deficits led to a recourse to Central Bank financing (net claims on the government was 51 percent of the total domestic credits in 1993), resulting in increased Central Bank's net domestic assets, and hyperinflation.



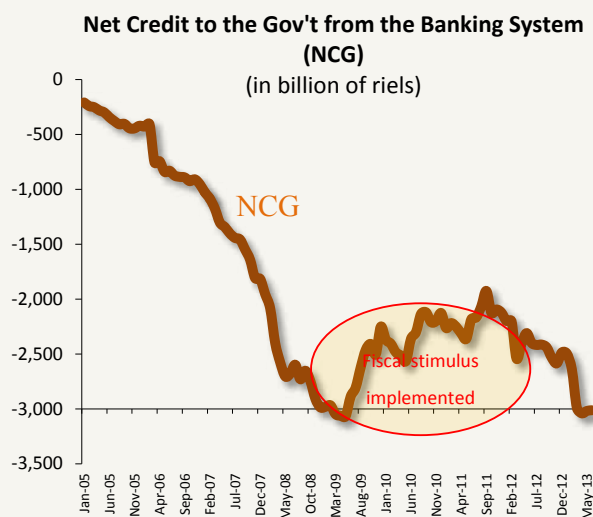
Source: National Bank of Cambodia

39. **Net Credit to the Government (NCG) once again reduced, and by June 2013, it reached the pre-crisis level in absolute terms.**²³ *This is due to the buildup of government deposits, which also strengthens the Central Bank's reserves position that can be used as a buffer against any future external shocks.* Note that, with substantial savings in place, the Government was able to introduce a fiscal stimulus amounting to about 2 percent of GDP, mitigating the negative

²² Fiscal deficit has its implications for economic stability. The sources of fiscal deficit financing have different impacts. Borrowing from central bank is inflationary, while borrowing from deposit money banks crowds out private sector investments, in turn affecting economic output. Borrowing from the non-banking public by issuing securities would exert pressure on interest rates, and increase domestic public debt. Foreign financing leads to external debt burden. Cambodia's fiscal deficit is financed by foreign financing. However, this doesn't lead to a heavy external debt burden, due to the terms of the financing, which remain concessional.

²³ Net Credit to the Government (NCG) is equal to credits to the government minus government deposits.

impacts of the 2008-2009 Global Economic Crisis. See section 3 on fiscal sector for more details.



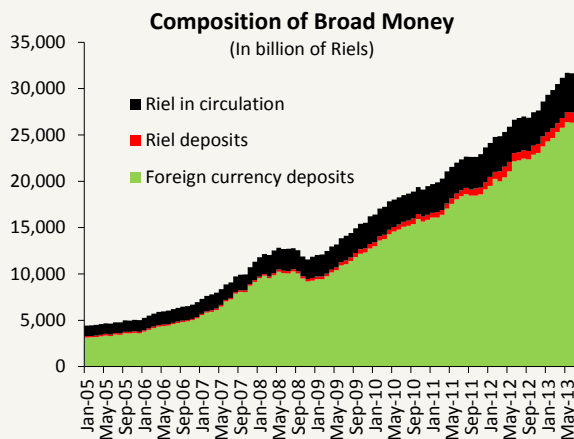
Source: National Bank of Cambodia

Monetary Aggregates, Interest Rates and Exchange Rates

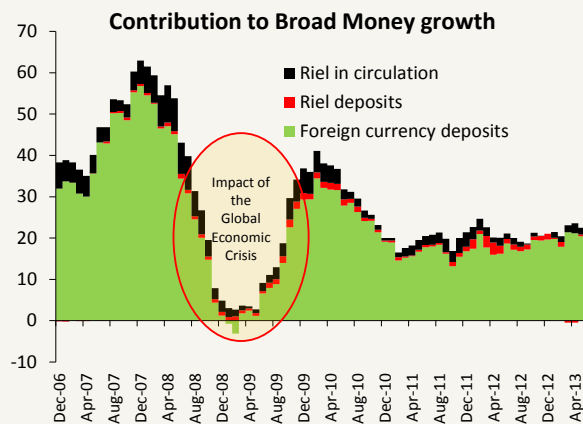
Broad money

40. **Foreign currency deposits, mainly US Dollar deposits, continue to account for 96 percent of the broad money.**²⁴ This reflects a persistent high dollarization of the economy. *The share of foreign currency deposits in the total deposits peaked at over 98 percent during late 2007 and early 2008 associated with large scale capital inflows that occurred several months before the bursting of real estate bubbles.* Foreign currency deposits dropped by almost US\$ 200 million in November 2008 to US\$ 2.2 billion, from US\$ 2.4 billion in September 2008 as the economy was hard-hit by the Global Economic Crisis.

²⁴ Broad money (M2): the widest measurement of the money supply that includes narrow money (M1) (currency in circulation and current account deposits), savings, and time deposits. Note that US Dollar in circulation is excluded, as it cannot be captured.



Source: National Bank of Cambodia



Source: National Bank of Cambodia

Contribution to Broad Money Growth

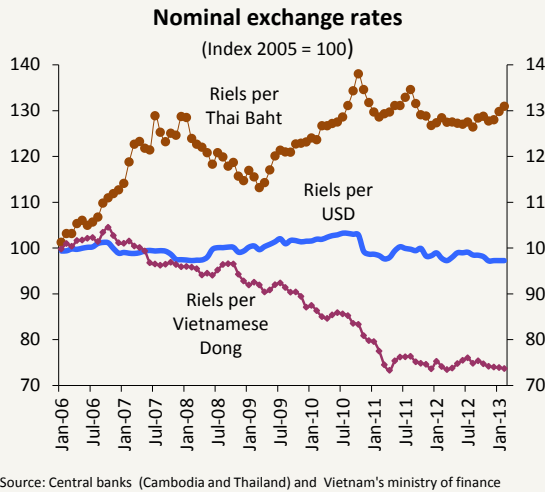
41. **Broad money growth has been largely driven by foreign currency deposits.** By June 2013, broad money grew at 18.8 percent year on year, and rising foreign currency deposits contributed 83 percent of the growth. Rapidly rising foreign currency deposits during the period covering late 2007 and early 2008 contributed up to 90 percent to broad money growth; and as a result broad money growth peaked, increasing by more than 60 percent year on year. *The rises and falls of foreign currency deposits are largely mirroring foreign capital inflows and outflows to the small, open, and highly dollarized Cambodian economy.*

Exchange Rate

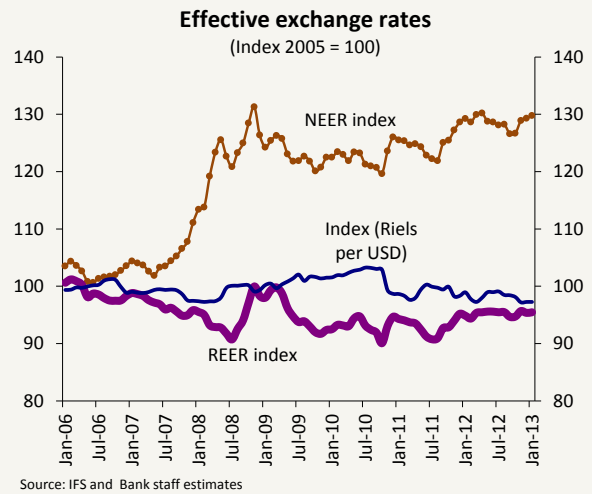
Nominal Exchange Rate

42. **The Dollar has appreciated since the second quarter this year; and this has forced the Central Bank to intervene.** A loss of about US\$ 150 million of the Central Bank's international reserves was recorded. The Riel depreciated and reached Riel 4,062 per Dollar in June 2013. Thanks to the Central Bank's intervention, the Cambodian Riel versus the US Dollar exchange rate remains stable, hovering around Riel 4000 per US Dollar. While the *de jure* regime may be classified as a managed float with the official rate adjusted (through sales and purchases of US Dollar) to be within a narrow band of the market rate on a daily basis, continued anchor of the exchange rate at Riel 4,000 per US Dollar can be seen as a peg.²⁵ Official exchange rates (end of period) were CR 3,995 and CR 4,039 per US Dollar in 2012 and 2011, respectively. The exchange rate intervention is one of the few monetary instruments that the Central Bank has at its disposal to stabilize prices of Riel-denominated goods and services.

²⁵ The band appears to be ± 1 percent of the market rate surveyed on a daily basis. The Central Bank, however, does not explicitly mention it.



products. The real effective exchange rate (REER), however, has appreciated slightly since 2006.



43. **The exchange rate intervention, however, is not sufficient to achieve a de-dollarization objective, if any, given the predominant role of the Dollar.** The popularity of the US Dollar, which is almost a global currency, versus the Riel, is clear, despite Cambodia's stable macroeconomic performance. The Dollar has been a reliable store of value, the most widely accepted means of international transactions, and the dominant currency in financial markets.

Nominal Effective Exchange Rate and Real Effective Exchange Rate

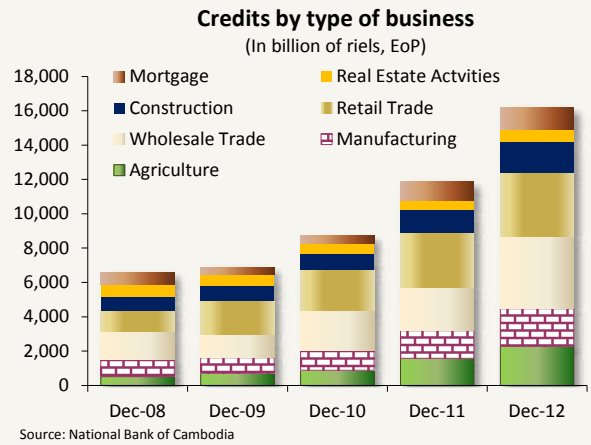
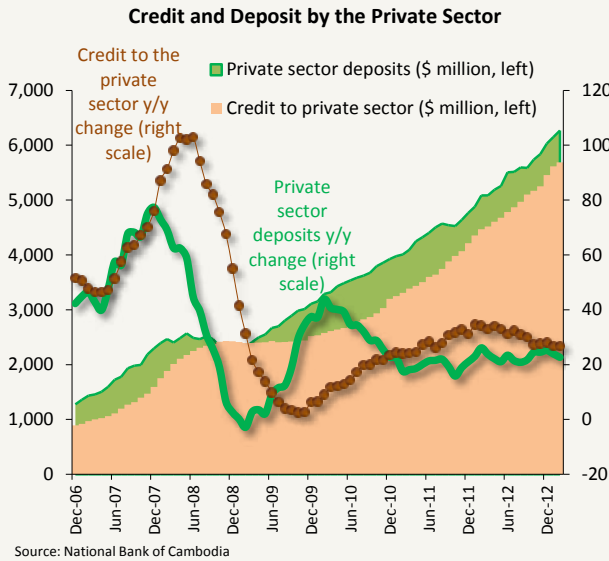
44. **The peg has resulted in substantial depreciation of the nominal effective exchange rate (NEER) of the Riel as the US Dollar depreciates.**²⁶ Weaker local currency (and US Dollar) should have rendered Cambodia's exports more competitive, as the country has diversified its exports with export destinations beyond the United States; and has exported products more than just garments, including footwear and agriculture

The Banking Sector

Credits to and Deposits by the Private Sector

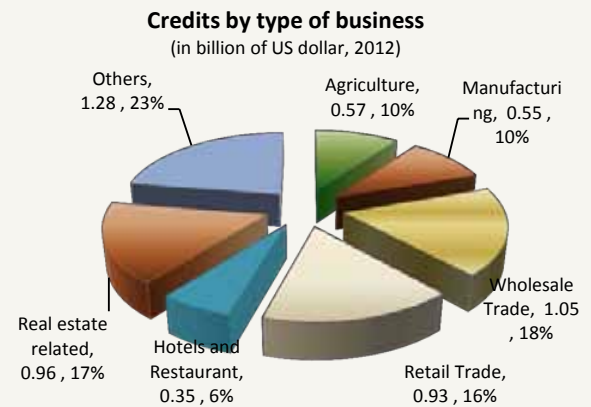
45. **Deposits by the private sector accelerated since early 2010; similarly, credit growth (year on year) also picked up soon after, and then outpaced the deposit growth since early 2011.** Broad money as a percentage of GDP rose to 51 percent of GDP in June 2013, from 20 percent by the end of 2005. *As financial deepening continues, the loan to deposit ratio has risen substantially, reaching over 80 percent by the end of 2012, compared to only about 60 percent by the end of 2005.* During the same period, the credit to capital ratio has jumped, reaching close to 300 percent from about 200 percent.

²⁶ NEER is the unadjusted (while REER is inflation adjusted) weighted average value of the local currency relative to all major currencies being traded. The weights are determined by the importance Cambodia places on all other currencies traded.



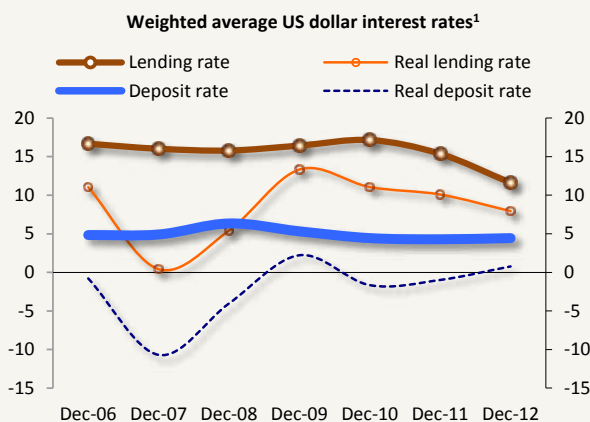
Credit by type of business

46. By December 2012, credits going to agriculture were US\$ 0.57 billion. This represents 10 percent of the total credits to the private sector by end-2012, compared to only US\$ 100 million, or 5 percent of the total credits, at end-2008. Agriculture sector financing contributed as high as 21 percent of the credit growth in 2011, second only to retail financing which accounted for 25 percent of the credit growth. In 2012, the contribution to credit growth by agriculture financing moderately decelerated to 14 percent, while the contribution by wholesale financing, in contrast, rose to 33 percent. By December 2012, wholesale trade financing received the largest share, US\$ 1.05 billion (or 18.4 percent), and retail trade financing, at US\$ 0.93 billion (or 16.3 percent) was second.



47. Competition among banks has contributed to narrowing the weighted average US Dollar interest rate spread.²⁷ The spread, which is the difference in nominal deposit and lending rates, shrank to 7.17 percent in December 2012 from 11.92 percent in January 2007. The spread, however, remains large compared to that in other South East Asian countries. The US Dollar nominal lending rate has drastically dropped to 11.7 percent from 16.6 percent during the same period. During the period of food price shocks preceding the Global Financial Crisis, US Dollar real deposit rates were largely negative, due to high inflation.

²⁷ Interest rate spread is the interest rate charged by banks on loans to private sector customers minus the interest rate paid by banks. The spread discussed above is between weighted average of 12-month US Dollar fixed deposit and 12-month US Dollar lending rates



¹ Weighted 12-month US Dollar deposit and 12-month US Dollar lending rates
Source: National Bank of Cambodia

**Interest rates*
(2012, % per annum)**

	DEPOSITS RATE	LENDING RATE
Cambodia	1.33	13.13
Indonesia	1.97	4.08
Malaysia	2.98	4.73
Myanmar	8.0	13.0
Philippines	0.943	5.485
Thailand	3.35	7.13
Vietnam	9.0	12.47

*Note: **deposit rate** is simple average of rates on domestic-currency saving deposit reported by 10 banks with largest deposits holding. **Lending rate** is simple average on foreign currency loans to private enterprises reported by 10 banks with largest deposit holding.
Source: International Financial Statistics, IMF

Fiscal Sector

Revenue and Its Main Components

Main tax components

48. During the first five months of 2013, domestic revenue continues to improve but at a slower pace, rising only at 9.6 percent year on year, compared to 24.7 percent in 2012.²⁸ By May 2013, preliminary fiscal data showed that the central government collected CR 3,389 billion (equivalent to US\$ 847 million). In 2012, provisional fiscal data recorded general government domestic revenue of CR 8,402 billion (equivalent to US\$ 2.1

²⁸ Preliminary fiscal data for 2013 subject to revision.

billion).²⁹ This represents a revenue-to-GDP ratio of approximately 14.4 percent, the highest level achieved so far. The achievement outperforms the annual increase target of 0.5 percent revenue-to-GDP ratio set by the Public Financial Management Reform Program. The revenue-to-GDP ratio, however, remains relatively low compared to average regional performance. Central government revenue covers 91 percent of the total (or 13.2 percent of GDP) while provincial revenue accounts for the remaining 9 percent. Indirect taxes, mainly domestic and import value added taxes (VAT) and excises, contributed the largest share of 45 percent of the total domestic revenue in 2012. Trade tax, consisting mostly of import duties, is second, capturing about 16 percent of the total. Direct taxes, largely profit taxes (personal income tax has not been introduced yet) remain relatively small, due to tax holidays allowed under the existing investment law.

**General Government Domestic Revenues
(In percent of GDP)**



Note: P = Preliminary; B = Budget
Source: Ministry of Economy and Finance

49. The contribution by direct taxes (and non-taxes which include revenue sharing, charges, and fees) needs to be further strengthened, to at least

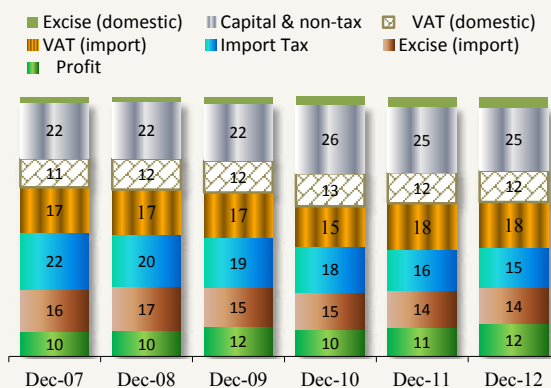
²⁹ Provisional 2012 Government Financial Statistics (TOFE). General government domestic revenue includes both central and provincial government revenue.

compensate for the drop in trade taxes.

Trade taxes, in particular import taxes (including non-tariff barriers), are anticipated to be gradually shrunk, because import tariffs are required to be harmonized and reduced as a result of Cambodia's membership of the ASEAN Economic Community, and the World Trade Organization.³⁰ To partly compensate for a drop in import duties, efforts have been made to improve VAT collection, in particular VAT on imports that contributed about 18 percent of the total domestic revenue in 2012, up from 15 percent in 2010. Profit tax collection is also rising, amounting to 12 percent of the total in 2012, compared to only 10 percent in 2010. There has been also some improvement in non-tax collection, after the introduction of standardized non-tax receipting and collecting systems.

However, there is room for further improvements mainly through enhancing revenue administration.

Central Government: Revenue by main components
(YTD, % of total)



Source: Ministry of Economy and Finance

Main revenue collecting agencies

50. There are two main revenue agencies, namely the General Department of Customs and Excises (GDCE) and the General Department of Taxation (GDT). Combined GDCE and GDT collection captures about 75 percent of the total domestic revenue. The rest, mainly non-tax and capital revenue, is collected by various government agencies, line ministries and provincial authorities. GDCE is responsible for collecting international trade taxes, consisting mainly of duties on imports and exports, and VAT and excises on imports. GDCE continues to be the largest revenue agency, collecting more than 40 percent of the total domestic revenue. GDT is in charge of collecting domestic taxes including profit taxes, domestic VAT and excises, and other taxes such as property and annual motor vehicle taxes.

Box 3. Debt Sustainability

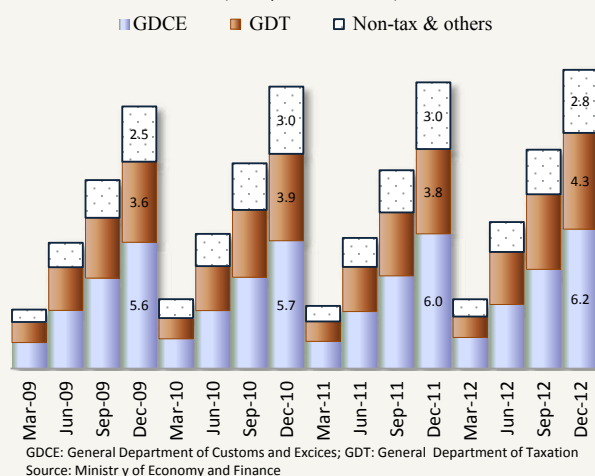
The 2012 debt sustainability analysis (DSA) shows that Cambodia's debt distress rating remains low under the baseline scenario. This is similar to the previous year's risk rating, as debt burden indicators under the baseline scenario did not breach their relevant thresholds.^c Under a scenario of limited reform progress, however, the indicator would "breach" the threshold, showing a lower scope for absorbing risks.^d This underscores the need to continue reforms for sustainable strong growth, like pursuing fiscal consolidation and mobilizing revenue, and improving debt and contingent liability management.

c. The baseline assumes an average of US\$ 500 million debt disbursement a year over the medium term with a macroeconomic assumption as follows: average real GDP growth of 7.2 percent, inflation of 3.5 percent, domestic revenue of 14.7 percent of GDP, expenditures of 19.0 percent of GDP, and BOPs overall balance of 2.4 percent of GDP during the medium term 2013 – 2017. Staff report for the 2012 Article IV consultation, Joint Bank-Fund DSA.

d. This scenario assumes limited reform progress, lower investment, slower real GDP growth of 6.2 percent, slower imports and exports with Balance of Payments overall balance of 1.9 percent of GDP, flat fiscal revenue of 13.7 percent of GDP, and larger disbursement of external loans.

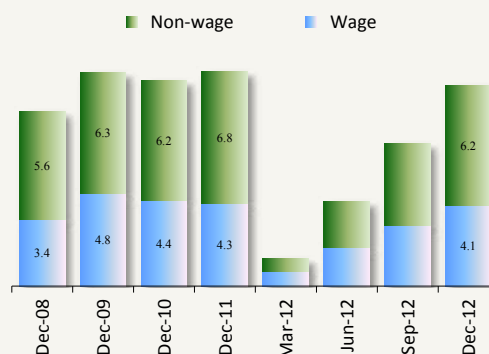
³⁰ The ASEAN Economic Community (AEC) has the goal of regional economic integration by 2015. The AEC will transform ASEAN into a region with free movement of goods, services, investment, skilled labor, and freer flow of capital.

Central Government: Revenue by revenue agency
(YTD, percent of GDP)



total public investment outlay is financed by external funds (donors).

Central Government: Current expenditure composition
(YTD, percent of GDP)



Expenditure and Main Components

51. **Public expenditure performance appears slow during the first five months of 2013, compared to the same period last year.**³¹ In 2012, the total public outlay amounted to CR 11,448 billion (equivalent to US\$ 2.7 billion), and Cambodia continues to heavily depend on donor funds to finance its public investments. The total outlay represents 19.7 percent of GDP, which is relatively large compared to the regional average.³² Due to large donor-funded public investments (financed by concessional loans and grants), Cambodia has been able to maintain an almost 50-50 split between recurrent and capital outlays of the general government.³³ The recurrent outlay is fully financed by domestic revenue, while almost 80 percent of the

Current Expenditures

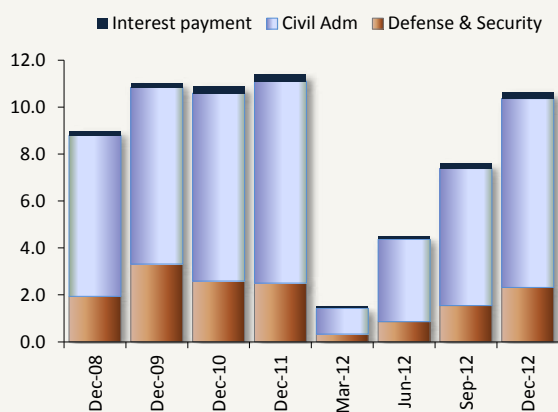
52. **Wage bill continues to cover a large portion of the total recurrent spending.** In 2012, of the total recurrent outlay of CR 6,059 billion (US\$ 1.5 billion equivalent), or 10.4 percent of GDP, the wage bill consumed 40 percent (or 4.2 percent of GDP). As a result, sufficient allocation for non-wage funding, in particular funds for operations and maintenance of the physical infrastructure (built by donor funds), continues to be a challenge. Total defense and security outlay represented 22 percent of the total recurrent outlays (or 2.3 percent of GDP), while security and defense wages captured 40 percent of the total wage bill. Interest payments covered only 0.3 percent of GDP, thanks to the current budget law, which only allows for concessional borrowing.

³¹ Comparison is based on domestically financed spending only as 2013 spending data remains incomplete with missing externally financed capital.

³² The amount excludes “off-budget” public expenditures (the largest component is technical assistance financing by donors) estimated to average around 3 percent of GDP a year.

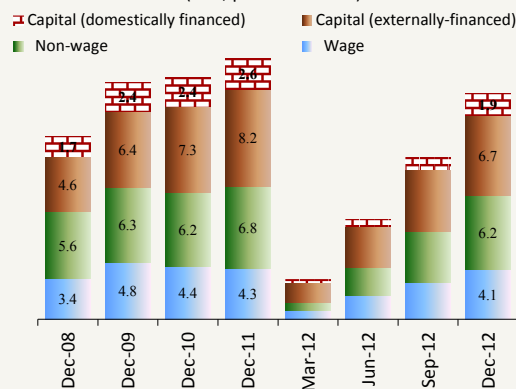
³³ General government revenue (or expenditure) consists of revenues (or expenditure) collected by both the central and provincial governments. Provincial revenue covered between 4 – 9 percent of the total domestic revenues in recent years.

Central Government: Current expenditure composition
(YTD, percent of GDP)



Source: Ministry of Economy and Finance

Central Government: Expenditure Composition
(YTD, percent of GDP)



Source: Ministry of Economy and Finance

Capital Expenditures

53. To finance its public investment requirements, the Government mobilizes substantial overseas development assistance (ODA). Low domestic revenue (Cambodia's revenue to GDP ratio remains low compared to regional standards) limits the Government's ability to use its own funds to finance operations and maintenance activities of its capital investments that are mostly funded by ODA. Donor-financed capital expenditures account for almost 80 percent of the total public investments or 34 percent of the total public outlays.³⁴

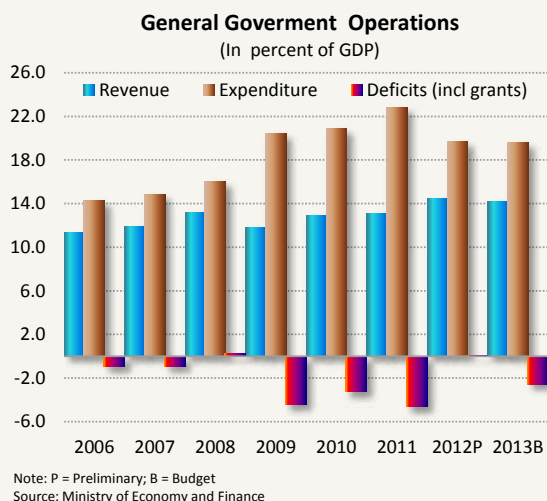
³⁴ The above donor-funded expenditures exclude technical assistance financing.

Fiscal Balance

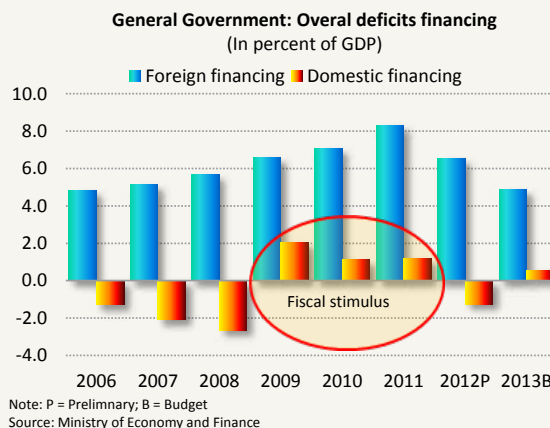
54. Continued revenue growth and slower spending should allow budget deficit (excluding grants) to remain as budgeted at around 5.4 percent of GDP in 2013. While overall fiscal management remains generally appropriate, and supportive of macroeconomic stability underpinned by an overriding principle of balanced budget, domestic revenue performance needs further improvements. Outstanding revenue collection and contained spending achieved in 2012 have resulted in a narrower fiscal deficit in 2012. Excluding grants, the fiscal deficit is 5.2 percent of GDP in 2012, compared to 9.5 percent of GDP in 2011. The fiscal deficit including grants was reduced to only 0.1 percent of GDP in 2012, compared to 4.6 percent of GDP in 2011.

55. Continued large external funds to finance public investments allow Cambodia to accumulate savings. The accumulation of government deposits provides a cushion that the Government can use at times of shock. During the 2008 and 2009 Global Financial Crisis, Cambodia introduced a fiscal stimulus,

supporting laid off workers' retraining programs, self-employment programs, scholarships, and sub-loans for agricultural developments. In 2012, the Government was able to rebuild its deposits, accumulated to approximately US\$ 650 million by year-end (close to the pre-crisis level).

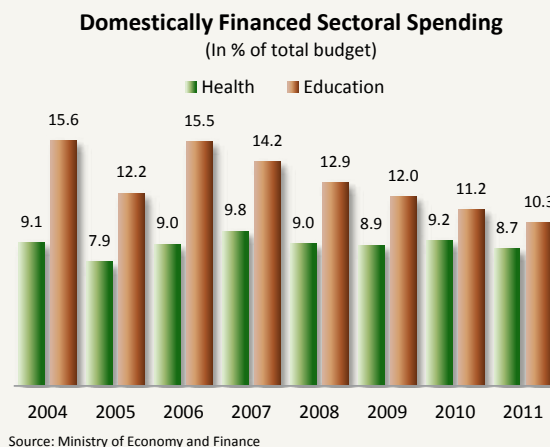


56. As mentioned earlier in the monetary section, Cambodia has to depend almost entirely on its fiscal policy for macroeconomic management, due to high dollarization. Therefore, it is crucial that the sound fiscal policy is well maintained, and the continued large and generous support (even during the Global Financial Crisis) by donors has helped make this possible.



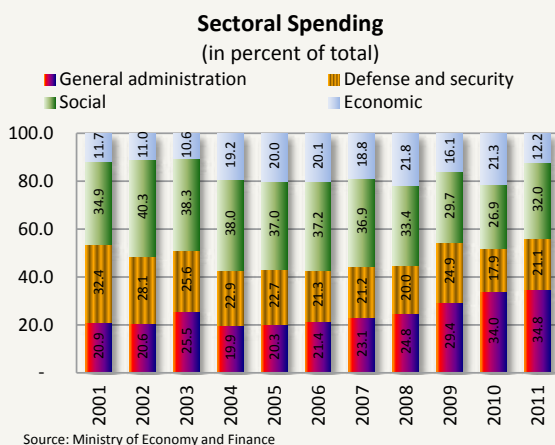
Sectorial Spending

57. The shares of the health and education sectors in the total domestically financed spending decreased to 8.7 percent and 10.3 percent in 2011 from 9.1 percent and 15.6 percent in 2004, respectively. It appears that the education and health sectors have been losing out their priority in budget allocation and appropriation to other competing sectors.

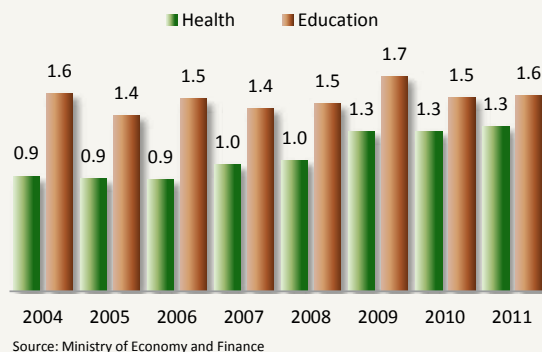


58. Combined shares of the general administration, and defense and security sectors rose quickly to 60 percent of the total spending in 2011 from 44.3 percent in 2007. This reflects increasing demand for general

administration, security and defense related expenditures, crowding out resources that would have been made available to other sectors, in particular the social sector.



Domestically Financed Sectoral Spending
(In percent of GDP)



59. **In percentage of GDP, domestically financed spending on the health sector is trending upward, rising to 1.3 percent in 2011 from 1.0 percent in 2007, while spending on the education sector has failed to pick up, and remained at around 1.6 percent of GDP since 2007.** The shares of the health and education sectors in total domestically financed spending decreased to 8.7 percent and 10.3 percent in 2011, from 9.8 percent and 14.2 percent in 2007, respectively. The latest Integrated Fiduciary Assessment and Public Expenditure Review (IFAPER) report, published in 2011, found that Cambodia's (domestically and externally financed) public spending on education is only half that of its peers. The IFAPER also highlighted potential savings of up to one third of the total health budget; and the savings can be realized by improving the procurement processes for pharmaceuticals. Sectoral spending priorities and efficiency, therefore, may need to be re-examined.

D. Conclusion

60. **The economic growth remains narrow-based, and sustaining robust economic growth by promoting diversification and enhancing competitiveness is necessary.** Further investment in the agriculture sector underpins higher and sustainable agricultural growth, making inroads to the reduction of poverty. A stronger agriculture sector also helps serve as a cushion against external shocks. Liberal and export-oriented trade and investment regimes, currently undertaken to cope with the country's small and shallow domestic market, appear appropriate. However, diversification to widen comparative advantage and competitiveness is needed to succeed globally. Cambodia has been quite successful in diversifying markets for the garment and tourism sectors. However, it has been slow in improving its competitiveness, and its sole comparative advantage, cheap labor, is eroding gradually, due to labor shortages and rising labor costs. To capture further gains, as well as to move up the value chain, the public sector may have to step in and play a greater role. Ensuring the availability of

appropriate, skilled labor, and competitive prices of production inputs (for instance energy) for the market are ways in which the public sector may be able to help nurture the private sector.

61. **Financial stability must be maintained.** While the entry of more commercial banks into the Cambodian market helps improve competition and efficiency, this also entails significant financial risks, due to supervision capacity challenges. Any instability in the banking and financial sector, in particular when the Central Bank is unable to serve as lender of last resort due to dollarization, can easily reverse hard-earned public confidence. High dollarization undermines the conduct of the monetary and exchange rate policies, and leads to losses of seigniorage. Concrete steps may need to be taken to gradually de-dollarize the economy.³⁵
62. **Improving fiscal management by increasing fiscal space and more efficient spending is necessary.** Tightening revenue collection and revisiting spending efficiency should help create room for additional allocations to priority sectors, such as agriculture and education, which are crucial for sustaining robust and inclusive growth. Reviewing spending efficiency for the health sector can help realize potential savings, as recommended by the 2011 Integrated Fiduciary Assessment and Public Expenditure Review report.

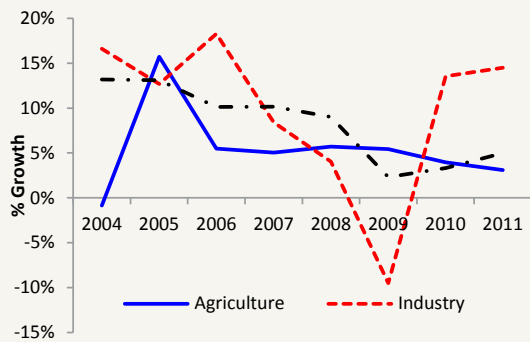
E. Special Focus: Poverty

Economic growth has become more inclusive than in the past

63. **Over seven years from 2004 to 2011, Cambodia achieved high rates of economic growth.** On average, Cambodia's annual growth rate was 8 percent over this period, and growth even reached double-digits for four straight years, achieving an average of 11.1 percent from 2004 to 2007. The only year in which growth was disrupted was in 2009, when Cambodia's main growth drivers were affected by the global financial crisis.
64. **In addition to sustaining high growth, Cambodia has broadened its economic base, spreading the benefits of growth more evenly across the population.** From 2004 to 2007, Cambodia's growth was mainly driven by garments, tourism and construction. Agriculture, which accounts for about one third of the economy and where a bulk of the rural population is employed, was not considered a major driver due to its low growth rate. But, since 2008, agriculture growth has become a significant driver of growth (Figure a). Agriculture growth not only contributes towards sustaining high GDP, but also helps to spread the benefits of growth to the poorest segments of the population (Figure b). This means that Cambodia's growth today is increasingly broad-based and more inclusive than in the past.

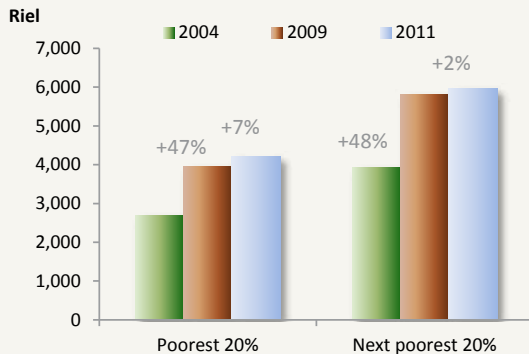
³⁵ There has been a lot of de-dollarization literature advising Cambodia to gradually de-dollarize and how.

a/ Sectoral growth rate 2004-11
(Constant 2000 prices)

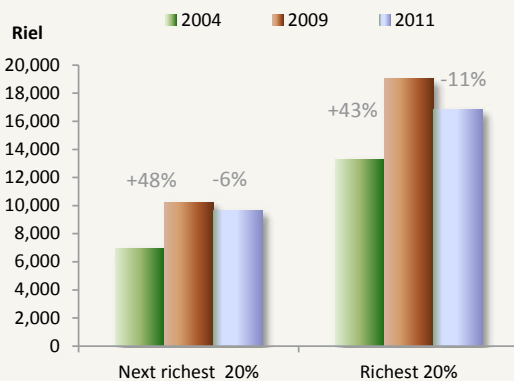


Source: National accounts, NIS, MOP

b/ Per capita daily consumption by quintile
(Constant 2009 Phnom Penh prices)



Source: World Bank staff estimates based on CSES

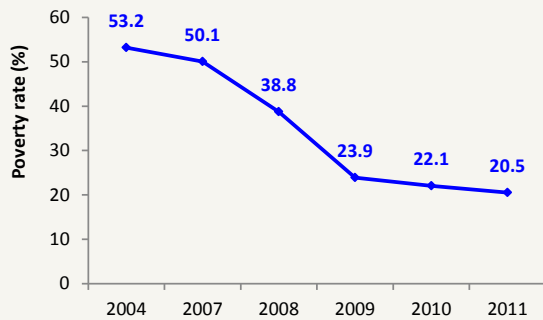


Source: World Bank staff estimates based on CSES

65. As a result of the rapid pace of growth and a pattern of growth that has shared the benefits amongst a larger number of people, Cambodian poverty has fallen dramatically. The poverty rate has halved in seven years from 53.0 percent in 2004 to 20.5 percent in 2011, surpassing all expectations and far exceeding the country's MDG poverty target. The latest figures suggest that the total number of poor people declined from 7 million people in 2004 to 3 million people in 2011. In other words, only 2 out of 10 people were poor in 2011, compared with 5 out of 10 in 2004. Among 69 countries that have comparable data, from 2004 to 2008 Cambodia ranked fourth in terms of the fastest poverty reduction in the world, after the West Bank and Gaza, Bhutan, and Fiji. This meant that Cambodia was the best performer in East Asia.

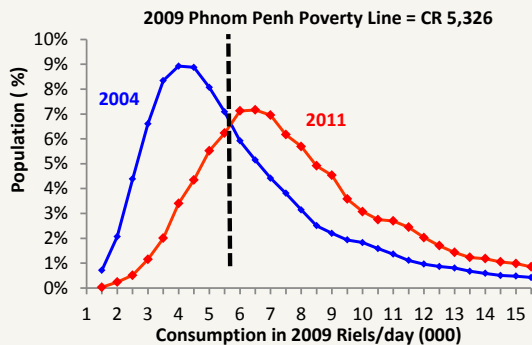
66. This dramatic decline in poverty is also reflected in non-consumption indicators of well-being, such as improvements in housing and the ownership of assets. For example, from 2004 to 2011, access of households to electricity (triple), to sewerage systems or septic tanks (double), and piped water during the dry season (25 percent), together with the following improvements in access to durables such as televisions (37 percent), motorbikes (double), and mobile telephones (quadruple)—all of which reaffirms consumption growth.

c/ Poverty rate



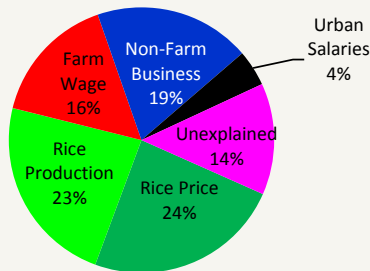
Source: World Bank Cambodia Poverty Assessment 2013

d/ Population shares by consumption



Source: World Bank Cambodia poverty assessment 2013

e/ Drivers of poverty reduction, Cambodia 2004-11



Source: World Bank Cambodia poverty assessment 2013

67. **The latest World Bank Cambodia Poverty Assessment has found that the rapid decline in poverty was largely driven by five contributing factors:** (i) high rice prices; (ii) higher rice production; (iii) higher revenue from non-farm businesses; (iv) higher wage rates of rural

workers; and (v) growth in salaried jobs in urban areas (Figure e). However, these drivers did not all occur at the same time. High rice prices, higher rice production, higher revenue from non-farm businesses and higher wage rates of rural workers played a key role in poverty reduction in 2008 and 2009, when global food price shocks occurred, whereas growth in salaried jobs in urban areas played a key role in period prior to 2008.

68. **But where have all the previously poor gone? Unfortunately, they have not gone very far.** Most families remain disturbingly close to the poverty line. Identified as ‘near-poor’, they are still at high risk of falling back into poverty at the slightest income shock. For example, the impact of losing just CR 1,200/day (only US\$0.30) in income would throw an estimated 3 million Cambodians back into poverty. This would double the poverty rate to 40 percent.

69. **Not only do most families remain at risk of slipping back into poverty, but a significant gap exists between the poor and better off families in terms of health outcomes.** This reflects not only gaps in coverage of lifesaving interventions but also gaps in the quality of care. Another noticeable challenge in health outcomes is the lack of progress in addressing child malnutrition. From 2005 to 2010, the percentage of stunted children under the age of five decreased from 42 to 40 percent only, while underweight children stalled at 38 percent, and children with wasting actually increased from 8 to 11 percent.

70. **In education, late entry into the first grade of primary education and very low enrollment of children from poor and vulnerable families remain a major**

challenge. This causes problems in secondary education outcomes, such as low enrollment, high repetition and high dropout rates. Despite a rapid improvement of 1.7 percentage points per year from 2004 to 2011, the net enrollment rate of upper secondary education remained low at only 20 percent in 2011. Despite making the improvement of the quality of education a priority, existing policies do not respond efficiently to labor market needs. A lack of teachers, textbooks, laboratories for science, and teaching and learning materials remains. Cambodia may wish to improve learning and skills on critical thinking, and core subjects such as science, technology, engineering, art and mathematics.

infrastructure; continuing to invest in human development; and strengthening agriculture growth. Policies to prevent the near-poor from falling back into poverty would include: improving diversification of agriculture; and implementing the social protection strategy.

71. Given that major challenges in reducing poverty and improving human development remain, the mission to reduce poverty in Cambodia is not over.

Not only do many people risk slipping back into poverty, but maintaining such a rapid reduction in poverty has become harder as the key drivers of that reduction from rice price effects are unlikely to continue, at least not at a similar pace. It is unlikely that international rice prices, local rice prices, or wages will experience further sharp rises similar to those seen in 2004-09, which were 134 percent, 119 percent and 200 percent, respectively.

72. Going forward, it would be desirable if Cambodia could design policies to address both categories: helping the remaining 20 percent of the poor to move out of poverty while also preventing the 20 percent of the near-poor from falling back into poverty.

Key policies to lift the remaining poor out of poverty would include: improving access to and the upgrading of basic rural

Annex 1

World Economic Indicators

The global outlook in summary

(percentage change from previous year, except interest rates and oil price)

	2011	2012	2013e	2014f	2015f
<i>Global Conditions</i>					
World Trade Volume (GNFS)	6.2	2.7	4.0	5.0	5.4
Consumer Prices					
G-7 Countries ^{1,2}	5.3	-0.6	-0.1	0.9	1.0
United States	2.4	2.1	2.4	2.5	2.5
Commodity Prices (USD terms)					
Non-oil commodities	20.7	-9.5	-4.7	-1.1	-1.5
Oil Price (USD per barrel) ³	104.0	105.0	102.4	101.0	101.0
Oil price (percent change)	31.6	1.0	-2.5	-1.3	-0.1
Manufacturers unit export value ⁴	8.5	-2.1	2.4	2.2	1.9
Interest rate					
\$, 6-month (percent)	0.8	0.5	0.7	1.1	1.4
€, 6-month (percent)	1.6	0.2	0.5	1.2	1.5
International capital flows to developing countries (% of GDP)					
Developing countries					
Net private and official inflows	5.2	5.0	4.7	4.4	4.3
Net private inflows (equity + debt)	5.0	4.9	4.7	4.4	4.3
East Asia and Pacific	5.7	4.6	4.2	3.9	3.8
Europe and Central Asia	5.5	5.7	6.5	6.1	6.0
Latin America and Caribbean	5.4	6.4	5.9	5.5	5.3
Middle East and N. Africa	1.3	1.4	1.1	1.4	1.7
South Asia	3.3	4.0	3.6	3.4	3.3
Sub-Saharan Africa	4.2	3.5	3.8	3.9	4.2
<i>Real GDP growth ⁵</i>					
World	2.8	2.3	2.2	3.0	3.3
Memo item: World (PPP weights)	3.8	2.9	3.1	3.8	4.1
High income	1.7	1.3	1.2	2.0	2.3
OECD Countries	1.5	1.2	1.1	1.9	2.2
Euro Area	1.5	-0.5	-0.6	0.9	1.5
Japan	-0.5	2.0	1.4	1.4	1.3
United States	1.8	2.2	2.0	2.8	3.0
Non-OECD countries	4.9	2.8	3.1	3.7	3.9
Developing countries	6.0	5.0	5.1	5.6	5.7
East Asia and Pacific	8.3	7.5	7.3	7.5	7.5
China	9.3	7.8	7.7	8.0	7.9
Indonesia	6.5	6.2	6.2	6.5	6.2
Thailand	0.1	6.5	5.0	5.0	5.5
Europe and Central Asia	5.7	2.7	2.8	3.8	4.2
Russia	4.3	3.4	2.3	3.5	3.9
Turkey	8.8	2.2	3.6	4.5	4.7
Romania	2.5	0.7	1.7	2.2	2.7
Latin America and Caribbean	4.4	3.0	3.3	3.9	3.8
Brazil	2.7	0.9	2.9	4.0	3.8
Mexico	3.9	3.9	3.3	3.9	3.8
Argentina	8.9	1.9	3.1	3.0	3.0
Middle East and N. Africa	-2.2	3.5	2.5	3.5	4.2
Egypt ⁶	1.8	2.2	1.6	3.0	4.8
Iran	1.7	-1.9	-1.1	0.7	1.9
Algeria	2.4	2.5	2.8	3.2	3.5
South Asia	7.3	4.8	5.2	6.0	6.4
India ^{6,7}	6.2	5.0	5.7	6.5	6.7
Pakistan ^{6,7}	3.0	3.7	3.4	3.5	3.7
Bangladesh ⁶	6.7	6.2	5.8	6.1	6.3
Sub-Saharan Africa	4.7	4.4	4.9	5.2	5.4
South Africa	3.1	2.5	2.5	3.2	3.3
Nigeria	7.4	6.5	6.7	6.7	7.0
Angola	3.4	8.1	7.2	7.5	7.8
<i>Memorandum items</i>					
Developing countries					
excluding transition countries	6.5	5.0	5.3	5.8	5.9
excluding China and India	4.5	3.3	3.5	4.2	4.4

Source: June 2013 Global Economic Outlook, The World Bank.

Notes: PPP = purchasing power parity; e = estimate; f = forecast.

1. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

2. In local currency, aggregated using 2005 GDP weights.

3. Simple average of Dubai, Brent, and West Texas Intermediate.

4. Unit value index of manufactured exports from major economies, expressed in USD.

5. Aggregate growth rates calculated using constant 2005 dollars GDP weights.

6. In keeping with national practice, data for Bangladesh, Egypt, India, and Pakistan are reported on a fiscal year basis in table 1.1. Aggregates that depend on these countries are calculated using data compiled on a calendar year basis.

7. Real GDP at factor cost, consistent with reporting practice in Pakistan and India. See Table SAR.2, South Asia Regional Annex for details.

Annex 2

Cambodia: Key Indicators

Cambodia: Key Indicators

	2012	2013p	2014f	2015f
	Year	Year	Year	Year
Output, Employment and Prices				
Real GDP (% change yoy)	7.3	7.0	7.0	7.0
Domestic demand (% change yoy)	11.9	9.0	8.3	8.7
Industrial production index (2000=100)	315.9	341.1	363.3	388.7
(% change yoy)	5.0	8.0	7.0	7.0
Consumer price index (% change yoy)	2.5	5.0	6.0	5.0
Public Sector				
Government revenues (% GDP)	14.4	14.2	14.5	14.8
Government expenditures (% GDP)	19.7	19.6	20.0	19.0
Government balance (% GDP)	-5.3	-5.4	-5.5	-4.2
Foreign Trade, BOP and External Debt				
Trade balance (millions US\$)	-1,949.2	-2,082.3	-2,636.8	-2,956.1
Exports of goods (millions US\$)	6,015.7	6,918.1	7,713.6	9,102.1
(% change yoy)	11.4	15.0	11.5	18.0
Key export (% change yoy) 1/	7.0	18.0	15.5	20.0
Imports of goods (millions US\$)	7,964.9	9,000.3	10,350.4	12,058.2
(% change yoy)	18.7	13.0	15.0	16.5
Current account balance (millions US\$) 2/	-1,436.6	-1,499.2	-2,065.7	-2,217.1
(% GDP)	-10.1	-9.6	-12.0	-11.8
Foreign direct investment (millions US\$) 3/	1,410.2	1,452.5	1,626.8	1,748.8
External debt (millions US\$)	4,281.0	4,726.0	5,229.5	5,634.1
(% GDP)	30.2	30.2	30.4	29.9
Short-term debt (millions US\$)	67.0	66.9	66.7	66.5
Debt service ratio (% exports of g&s)	1.2	1.3	1.5	1.5
Foreign exchange reserves, gross (millions US\$)	3,463.0	3,843.9	4,151.4	4,525.1
(months of imports of g&s)	3.3	3.2	3.1	3.0
Financial Markets				
Domestic credit (% change yoy)	34.0	28.0	25.0	25.0
Short-term interest rate (% p.a.)	13.7	13.0	13.5	13.5
Exchange rate (Riel/US\$, cop)	3,995.0	4,000.0	4,063.6	4,076.0
Real effective exchange rate (2000=100)	128.6
(% change yoy)	3.0
Memo: Nominal GDP (millions US\$)	14,195.6	15,649.0	17,213.9	18,844.5

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

e = estimate

f = forecast

p = projection

1/ Garments

2/ Excluding official transfers

3/ From 2011, includes FDI related to public-private power sector projects



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