Cambodia's Economic Prospects and Challenges

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Cambodia's economy is estimated to have contracted in 2009 but is projected to grow again in 2010 and 2011. Real GDP declined 2.7% in 2009, but is projected to grow by 4.3% in 2010.

Growth had been based on a few key sectors. Cambodia experienced high growth between 1998 and 2007 amid a structural transformation that saw a sharp rise in the share of employment in services at the expense of agriculture. The services sector generated jobs mainly through tourism, with rapid rises in visitors since the mid-1990s. Between 1998 and 2007, around 10,000 jobs were created per year. Industry has been the largest contributor to GDP, largely driven by exports of "Cut-Make-Trim" (CMT, i.e. simple, low value-added) garments, which represent over 70% of all Cambodia's exports. Industry generated large amounts of jobs each year between 1998 and 2007, although productivity remained roughly constant. Agriculture's productivity rose during the past decade, although it remains lower than in industry and services. Agriculture remains the highest source of employment in Cambodia.

But these key sectors were affected by the global downturn. Garment production declined substantially in 2009. Garments represent over 70% of all Cambodia's exports, half of which are shipped to the US. The US recession and the increased competitiveness of other Asian producers caused garment exports to the US to fall by 22.5% in the first 8 months of 2009. During this period, 77 garment factories closed down and another 53 suspended operations. It is estimated that over 30,000 jobs were lost in the sector. Foreign investment in construction fell due to global credit reductions and a sharp fall in property prices. Compared to the year before, the number of construction projects approved was reduced by 25%. In the services sector, tourism revenues dropped sharply in 2009 in spite of an increase in the total number of visitors, as the number of tourists from the US and EU, the biggest spenders, shrank.

Although estimates are somewhat imprecise, there are signs that the crisis may reverse the poverty gains of the last decade. Although social and poverty data in Cambodia are limited, it is estimated that poverty has decreased in Cambodia over the last decade, although it remains concentrated in rural areas. Growth had been particularly strong in the garment, construction, and tourism sectors, although this has also meant that it has most likely worsened inequality.

However, private consumption contracted in 2009 as personal disposable incomes shrank due to the fall in the prices of agricultural commodities and real estate, which eroded rural and urban wealth. In addition, household debt has reached substantial levels due to rising prices in 2008 and the reduction in disposable incomes in 2009. A World Bank report estimates that the crisis could add between 1 and 4 percentage points to the poverty headcount ratio between 2007 and 2010.

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This impact is likely to largely hinge on how many of the new labor entrants the economy will be able to absorb (one report estimates 250,000 new job seekers per year). Although only $1/5^{th}$ of the population depends on the sectors that were directly affected by the crisis for employment, these sectors were able to absorb a large portion of new entrants prior to 2009. In addition, although there are signs that private investment is picking up again, the fact that most investment in Cambodia depends on foreign sources means that growth will depend on foreign investor sentiment to a large extent.

The 2009 budget deficit is estimated to have increased, limiting the ability for further fiscal expansion and key investments. The government has followed an expansionary fiscal policy in order to support domestic demand – estimated to have contracted by 1.9% in 2009 – mainly through increases in public sector and military wages. Private consumption contracted in 2009 as personal disposable incomes shrank due to the fall in the price of agricultural commodities and real estate. However, private consumption is projected to rebound in 2010-2011. Public spending has increased overall in 2009 to an estimated 17.5 % of GDP (from 14.3 % in 2008). As a result, the budget deficit is expected to reach 6-7% in 2009, up from 2.5-3% in 2008.

The size of the deficit is likely to limit the extent of further fiscal expansion, especially since the government does not issue securities and revenue mobilization has been weak. So far the government has drawn on its deposits and budget reserves accumulated through good public financial management to finance its expenditures. In addition to their impact on the ability to use fiscal policy to support growth, these constraints mean that investments in infrastructure – electricity, for example, but also transportation and logistics – and other sectors of high potential will probably be limited in the future.

Consumer prices have declined on average in 2009, but will rebound in 2010 and 2011. Consumer prices are estimated to have decreased by an average of 1% through most of 2009 on the back of a sharp fall in the prices of fuel and food globally. But recent consumer price increases suggest that the inflation rate will be 5.9% in 2010 and 5.6% in 2011 due to increasing demand-side pressures and the rise in global commodity prices.

Because inflation was not a problem in 2009, monetary policy was expansionary, as the central bank sought to offset the fall in credit demand. However, the money supply has grown in recent months and a change in policy direction seems necessary in the near future. But the degree of monetary policy effectiveness will be limited by the fact that the economy has been highly dollarized since the 1990s. Overall, this and the constraints on fiscal policy implementation mean that the government and central bank will have limited ability to steer the economy through these mechanisms.

Although central bank intervention has slowed the decline, the exchange rate has depreciated and is likely to continue so in 2010-2011. The riel depreciated in the first four months of 2009, due to reductions in exports and lower FDI inflows. Central bank intervention in the currency markets only reduced the rate of depreciation, which is expected to reach 1.3% in 2010-2011. However, the high level of dollarization of the economy implies that exchange rate fluctuations will have very moderate impacts on the economy. On the positive side, central bank intervention in the currency markets only slowed the rate of foreign exchange accumulation, although foreign exchange reserves in 2009 were estimated to be able to only cover 4 months of imports of goods and services.

The current account deficit narrowed in 2009, on the back of sharp decreases in imports. The current account deficit is estimated at 9.6% of GDP in 2009, down from 15% in 2008. Exports fell, notably garments and tourism, but imports fell to even lower levels, dragged down by the decline in demand for imported inputs for the garment and tourism sectors, and by lower petroleum prices.

Although the increased competitiveness of other regional garment exporters such as Vietnam will slow the growth of the Cambodian garment sector in 2010-2011 (despite the U.S. economy's recovery), tourism is expected to recover significantly in 2010-2011. This will positively affect the current account balance. However, the economy's reliance on imported capital goods and the repatriation of profits and dividends earned by foreign investors means that the current account will remain in deficit, at around 8-10% of GDP. Diversification of Cambodia's exports is thus necessary not only for GDP growth, but also to ensure that external balances remain sustainable.

On the capital side of the balance or payments, financing from abroad has decreased by more than a half in the first six months of 2009, as investor perceptions deteriorated. Although there are signs that investments have begun to flow in again, developments related to the capital account may be unstable.

Vulnerabilities in the banking and financial sector prior to 2009 raised the number of non-performing loans. From 2005 to 2008 the banking sector grew phenomenally as deposits and lending increased, especially in real estate and to some extent construction, but risk management and supervision capacity had been stretched, leading to somewhat excessive risk-taking and a sharp rise in property values. The fall in property prices and deceleration of the economy caused the number of non-performing loans to rise in the first six months of 2009. Statements by the IMF and new regulations passed during 2009 suggest that risk allocation may be better managed in the future.

Significant obstacles to private sector development remain. Cambodia suffers from significant coordination and information failures, a cumbersome and uncertain institutional environment, some degree of corruption, and generally poor governance. While these constraints were in place prior to the downturn, addressing them would go a long way towards helping the economy recover.

Sources

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