

CAMBODIA CONSULTATIVE GROUP MEETING
Remarks on Recent Macroeconomic and Social Developments
Delivered by the IMF Representative
on Behalf of Development Partners
Phnom Penh, March 2, 2006

Excellencies, Ladies and Gentlemen:

I appreciate the opportunity to participate in this year's Consultative Group meeting, and I am honored to deliver some remarks on macroeconomic and social developments on behalf of the Royal Government of Cambodia's development partners. With the National Strategic Development Plan for 2006-10 now endorsed by the Council of Ministers, this is a propitious time to take stock of recent developments, and to assess the outlook and challenges for the period ahead.

Recent economic developments in Cambodia have been much more favorable than anticipated at the previous CG meeting that took place a little over one year ago. At that time, many observers pointed out that higher oil prices and the end of the quota system for garments gave rise to the risk that economic growth would slow sharply, particularly if garment exports were exposed to open international competition.

In the event, this risk did not materialize, and the economy is likely to have expanded by at least 7 percent in 2005. This is indeed a welcome development. There are a number of factors underlying this better-than-expected performance:

- Garment exports have remained strong, in large part owing to the breathing room created by the imposition of safeguards measures by the United States on imports from China, as well as China's bilateral agreement with the European Union to restrain Chinese exports. To give some flavor of the importance of these measures, the safeguards measures imposed by the United States and the EU agreement cover around 87 percent of Cambodia's total garment exports.
- Tourism has continued to expand, and agriculture and fisheries output rebounded very strongly;
- And finally, prudent monetary policy implementation and a deepening of financial intermediation by the banking system has continued to support the expansion of domestic economic activity. Small businesses previously operating in the informal sector are increasingly registering and seeking bank finance, with vigorous construction activity reflecting a broadening of investment demand for real estate.

Higher oil prices, however, had some adverse impact on the Cambodian economy. In particular, along with higher food prices, higher oil prices pushed up inflation to 6¾ percent in the year to December 2005. Moreover, higher oil prices have boosted the cost of fuel imports, such that the external trade balance deteriorated in 2005 and the level of international reserves dropped in terms of import cover.

Underpinning these broadly favorable developments has been prudent management of fiscal policy. The Royal Government deserves to be commended for making steady progress in boosting overall government revenues over the past few years, which are estimated to have reached almost 12 percent of GDP last year. Stronger enforcement of customs revenue and tax collection, along with collection of tax arrears and privatization receipts has more than offset continued shortfall in non-tax revenues. Nevertheless, revenue performance remains well below that achieved in other countries. Expenditures, both current and locally-financed capital spending, were contained in 2005. Partly as a result of lower externally financed capital spending, the overall government deficit is estimated to have fallen slightly, and domestic financing of the deficit continues to be avoided.

Turning to recent poverty and social developments, as reported in the World Bank's 2006 Poverty Assessment, living standards for Cambodians have improved over the past decade, thanks in large measure to robust economic growth averaging around 7 percent per year, combined with the restoration of peace, and improved access to services.

Commendable strides in particular have been made in reducing poverty. Between 1993/4 and 2004, the percentage of Cambodians living below the poverty line fell from an estimated 47 percent to 35 percent. Available data suggests that poverty has fallen in most areas across Cambodia, and both men and women have benefited. Moreover, real per capita consumption has increased by about one third over the last decade, leading to improvements in housing quality, and increased access to electricity and ownership of consumer durables.

Improvements have also been registered in social sectors such as health and education. Primary school enrollment and completion rates have increased, while health indicators — such as immunization rates, infant mortality rates and HIV incidence—have also improved. Progress is also being made in improving gender equality, with women's share of wage employment increasing, particularly in agriculture and industry where it now exceeds 50 percent.

These developments have been supported by an improvement in cash disbursements for Priority Action Programs (PAPs) that aim to facilitate priority social spending. In 2005, PAP disbursements for education and health combined reached 71 percent of budgeted amounts, compared to only 31 percent in 2004. However, the total PAP budget for health and education in 2005 remained similar to that of 2004, and there is room for further improvement in timely disbursement of PAP funds.

While progress has been made, it needs to be recognized that poverty remains widespread, and inequality has in fact risen over the last decade. One third of the population still lives below the poverty line, and fully 91 percent of these poor live in rural areas where the rate of poverty reduction and real per capita consumption gains have been much slower than in the urban areas. To illustrate the extent of the divide that has widened in recent years, poverty fell by one half in Phnom Penh, to 5 percent, while in the rural areas poverty fell by only one fifth, and remains well above 30 percent. The most affluent 20 percent of Cambodians now spend more than 7 times that of the poorest Cambodians on a daily basis.

In large part, this rise in inequality can be traced to the narrow base of economic growth, which has been centered on garments and tourism. But the poor also face other, mutually-reinforcing problems, including lack of secure land tenure and productive assets more generally, difficult access to markets and public services, corruption, low levels of education, inadequate and expensive healthcare, and high dependency ratios.

In hand with this, progress in achieving some of the CMDGs related to human development has been slower than expected. Survival rates at all levels of education remain very low and gender disparities remain, particularly in secondary and tertiary education levels; significant challenges to reducing domestic violence exist; and access to quality healthcare is weak, especially for maternal health and women.

Having reviewed the current conjuncture, what can be said about the near-term prospects for Cambodia? Overall, the macroeconomic outlook for 2006 remains bright. The economy is expected to grow at a pace of around 6 percent in real terms, in line with continued expansion of garment exports, tourism and domestic economic activity. Barring an unforeseen further jump in the international price of oil and food, inflation should begin to subside.

This positive outlook provides a good opportunity, and a supportive environment, for the Royal Government of Cambodia to continue implementing critical reforms needed to entrench macroeconomic stability and sustainable growth, and consolidate and accelerate progress in reducing poverty and improving human development indicators. Equally important, weak governance and corruption need to be tackled if the benefits of growth are to reach the population as a whole. These reforms, aimed at achieving the CMDGs, are imbedded in the NSDP.

In this context, some of the key areas of policy focus in the period ahead include:

- Maintaining macroeconomic stability through continued prudent fiscal and monetary policy implementation, including further revenue collection efforts to meet priority spending needs;
- Broadening the base of growth, in particular by supporting agriculture, on which more than 70 percent of the labor force depends for its livelihood. Here the focus should be on smallholder, rather than large concession-based agriculture, improving access to land for agricultural use through progress on land titling and land management reforms, strengthening land concession procedures, and efforts to extend the coverage of rural irrigation;
- Providing an environment more conducive to private sector activity and foreign investment, including through continued efforts to facilitate trade and reduce excessive public administrative burdens;
- Addressing corruption. An important first step is to strengthen the draft anti-corruption law—before submitting it to the National Assembly—to bring the draft into line with international standards, as suggested by the group of International Technical Experts that have worked closely with the drafting team at MONASRI;

- In line with higher government revenues, increasing spending on well-targeted and productive physical infrastructure projects, healthcare and education, to improve livelihoods and strengthen productivity;
- Improving the efficiency and effectiveness of the government through Public Financial Management (PFM) reforms, and Public Administration Reform (PAR) to increase the efficiency and quality of public service delivery,
- Enhancing the banking system's ability to provide safe and efficient financial intermediation, by continuing to strengthen banking supervision, the financial legal framework, and improving banks' credit assessment capacities;
- Strengthening development partnerships, by aligning aid with the new NSDP, to ensure coherence in supporting poverty reducing programs and policies.

In concluding, I would like to reiterate that the challenges in addressing poverty reduction and inequality simultaneously are complex. There is certainly a need to sustain macroeconomic stability and high rates of economic growth. But there is also a need to broaden the base of growth, in particular by improving agriculture, and implementing other key measures to remove constraints on faster poverty reduction and human development (such as strengthening governance of state institutions, tackling corruption, and raising human capital and physical infrastructure levels). We are confident that, with continued support from their development partners, the Royal Government of Cambodia will be able to build on the past achievements and we wish them every success in their endeavors.