



CAMBODIA CONSULTATIVE GROUP MEETING

Remarks by the Representative of the International Monetary Fund

Phnom Penh, March 2-3, 2006

1. I appreciate the opportunity to participate in this year's Consultative Group meeting. With the National Strategic Development Plan for 2006—10 now being finalized, this is a propitious time to review the implementation of Cambodia's strategy and assess the outlook and challenges for the period ahead.

MACROECONOMIC DEVELOPMENTS IN 2005

2. **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, including ourselves, pointed out that higher oil prices and the end of the quota system under the Multi Fiber Agreement gave rise to the risk that economic growth would slow sharply, particularly if garment exports were exposed to open international competition.

3. **In the event, this risk did not materialize, and the economy is likely to have expanded by around 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 imposed by the United States and the EU agreement cover around 87 percent of Cambodia's total garment exports. Strong garment sales to the US thus helped propel the total value of garment exports to US\$2¼ billion in 2005, an increase of almost 12 percent compared with 2004.
- **Tourism has continued to expand**, with tourist arrivals having increased by around 35 percent in the year to December 2005, to 1.4 million visitors;
- **Agriculture and fisheries output**, which fell owing to the effects of drought in 2004, **rebounded very strongly** in 2005;
- 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

- **And finally, the expansion of domestic economic activity in Cambodia has been supported by a continued deepening of financial intermediation by the banking system.** Bank deposits increased by around 22 percent in 2005, while bank credit to the private sector grew by nearly 30 percent.
- 4. **Higher oil prices, however, had an adverse impact on the Cambodian economy.** Consumer prices increased by 6% percent in the year to December 2005. This was partly because of the direct impact of higher petroleum prices, and also because businesses raised the prices of their products to compensate for the higher fuel costs. Moreover, higher oil prices have boosted the cost of fuel imports, such that the external trade balance deteriorated in 2005 to nearly 19 percent of GDP and the level of international reserves dropped in terms of import cover to 2½ months.
- 5. **Underpinning these broadly favorable developments, fiscal policy was prudently managed.** The 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 a little less than 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 continues to be more than financed by foreign aid.

PROGRESS IN REDUCING POVERTY

6. **Cambodia has made commendable strides in reducing poverty over the past decade.** Between 1993/4 and 2004, the percentage of Cambodians living below the poverty line fell from an estimated 47 percent to 35 percent. As explained in the World Bank's 2006 Poverty Assessment, this reduction would not have been possible without robust economic growth of around 7 percent per annum, combined with the restoration of peace, over the past decade.
7. **However, the narrow base of growth has benefited the urban centers more than the rural areas,** and this is reflected in a more shallow reduction in rural poverty than urban poverty. As a consequence, the rural poor account for fully 91 percent of the poor in Cambodia, and while the rural poor have seen an increase in living standards over the last 10 years, inequality has increased dramatically. This emphasizes the need for growth aid poverty reduction policies that address the geographical divide. Moreover, continued dependence on the garment industry carries major risks if Chinese export restraints are lifted.

OUTLOOK FOR 2006 AND KEY MACROECONOMIC POLICY ISSUES

8. **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, inflation should begin to subside.

9. **This positive outlook provides a vital 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. These reforms, aimed at achieving the Cambodia Millennium Development Goals (CMDGs), are imbedded in the NSDP.

10. In pursuing the objective of broader-based growth, macroeconomic and structural economic policies should focus on:

- **Maintaining macroeconomic stability** through continued prudent fiscal and monetary policy implementation, including further revenue collection efforts to meet priority spending needs;
- **Strengthening the role and effectiveness of the government** through reforms to Public Financial Management (PFM) systems, and civil service reform to improve the efficiency and quality of public service delivery;
- **Enhancing the banking system's ability to provide sound and efficient financial intermediation**, by continuing to strengthen banking supervision, the financial legal framework, and improving banks' credit assessment capacities;
- **Providing an environment more conducive to private sector activity** including by strengthening governance and addressing corruption—starting with the introduction of an anti-corruption law that is consistent with international best practice;
- **Raising agriculture growth** by, among other things, improving access to land for agricultural use through progress on land titling and management reforms, and strengthening land concession procedures and with efforts to improve rural irrigation.

THE ROLE OF THE INTERNATIONAL COMMUNITY

11. **Donors and the Royal Government of Cambodia are working together in many of these areas to deepen and widen poverty reduction and help attain the CMDGs** As its part of the Multilateral Debt Relief Initiative, the IMF recently granted Cambodia 100 percent relief of its debts owed to the Fund, amounting to around US\$82 million. The additional resources available to the Royal Government of Cambodia as a result are intended to help it tackle poverty and achieve the CMDGs. In this context, the Royal Government has indicated that it will use the proceeds of IMF debt relief for rural irrigation projects, complementing projects that are already actively funded by other donors.

12. **In the medium term, Cambodia will also benefit from its efforts to lessen its external debt burden and improve debt sustainability.** Currently, the joint IMF and Bank assessment is that Cambodia's debt is sustainable, but the risk of debt distress is high. Much

of the current level of debt reflects overdue official bilateral obligations to two creditors. The Fund thus supports the Royal Government's commitment to take a major step forward in regularizing its international financial relations, by rescheduling those outstanding obligations. Such a step would also signal an undertaking to honor financial contracts, and strengthen further Cambodia's integration into the global economy, essential in the longer term.

13. **Debt rescheduling would pave the way for the IMF's Executive Board to consider very shortly the Royal Government's request for support under the Fund's Poverty Reduction and Growth Facility (PRGF)** in implementing a package of macroeconomic and structural reform policies. The focus of the package would be strengthening the finances and effectiveness of government and improving financial intermediation. Even while there has been some delay in finalizing this arrangement, the Royal Government has moved ahead on both the macroeconomic and structural agendas that were agreed with the Fund staff and it is commended for maintaining this reform momentum.

CONCLUDING REMARKS

14. **In concluding, I would like to reiterate that the challenges for addressing poverty reduction and inequality simultaneously are complex.** There is certainly a need to sustain high rates of economic growth, but also to broaden the base of growth, in particular as noted above by improving agriculture, upon which more than 70 percent of the labor force depends for its livelihood. Other key measures include strengthening urban-rural linkages, improving rural infrastructure, broadening access to healthcare and education to raise human capital levels, and strengthening governance of state institutions. We are confident that, with continued support from their development partners, the Royal Government will be able to build on the past achievements and wish them every success in their endeavors.