Development Partner Statement on Macroeconomic Developments and Their Socio-Economic Impacts
delivered by HE Ambassador Desmazières (France)

at the
15th Meeting of
|The Government-Development Partner Coordination Committee
Phnom Penh, September 29, 2009

Excellency Deputy Prime Minister and Minister of Economy and Finance Keat Chhon,
Excellencies, Ladies and Gentlemen,

Economic growth has in Cambodia taken a sharp downturn since the onset of the global financial crisis. Real GDP is set to contract this year, and income per capita, after increasing by some 8 percent per annum during a decade, will stagnate. The immediate causes are well known – less demand for Cambodia's exports, slower growth in tourism, less foreign direct investment, weaker competitiveness due to high inflation last year, lower agriculture prices, and the adverse impact of the fall in real estate prices. The symptoms of lower growth are visible: garment exports are around 25 percent below last year's levels; tourist arrivals are not growing much and air arrivals are down significantly; only 150-200 new firms are registered every month (against 250-300 firms before the downturn); construction has slowed, etc. Up until late August this was compounded by fears of drought, whereas now concern is shifting to the risk of floods, which highlights the vulnerability of farmers and those dependent on agriculture and in turn on the weather.

The downturn will have a widespread impact on Cambodians. First to feel the effects will be those dependent on the garment, tourism and construction sectors. Those families are mainly living in cities, although rural families dependent on vulnerable sectors tend to have a large share of their income at risk. Workers affected by the crisis tend to be women in the garment sector and men in the construction sector. But the impact of this downturn is broader, as it gets transmitted through lower remittances sent by garment workers to their rural homes; lower income from tourism-dependent informal jobs; and lower land prices for those hoping to sell land, and losses for those that purchased land when prices were skyrocketing. Data gathered in July and August suggests that, indeed, income has stopped increasing for many jobs and, as a response, many households have accumulated further debt and are likely to fall below the poverty line.

As the GDCC meets, several Asian countries are showing tentative signs of a recovery. Cambodia has a lot to gain from this through trading with the region and attracting regional investors. Nevertheless, Development Partners agree with the Royal Government that, at the moment, the prospect for Cambodia is that of a more modest recovery, perhaps in the order of three to five percent annual growth for 2010 – well below the 10 percent of the past decade. In a survey of 300 firms in July and August, more than 40 percent of the firms felt less confident about future growth now than six months before. Hence it is vital for Cambodia to address the deeper roots of this year's slowdown, by increasing export diversification, increasing competitiveness realizing the potential of agri-businesses, strengthening the tourism sector, and improving the business environment.

The Royal Government of Cambodia's macroeconomic and financial policies can play a vital role in supporting recovery and providing targeted assistance to those most vulnerable. At the same time, however, policies must ensure that macroeconomic stability and low inflation are maintained, as these are preconditions for renewing growth and poverty reduction. In this context, Development Partners welcome the recent actions taken by the National Bank of Cambodia to safeguard the health of the banking system, and urge that close supervision of banks and strong enforcement of prudential regulations continues.

With respect to fiscal policy, Development Partners note that the Government's 2009 budget deficit is projected to rise significantly more than budgeted this year, to around 6¾ percent from about 2¾ percent last year. Revenue efforts have been commendable, and capital spending has increased. However, a large portion of the deficit overshoot reflects very large increases in spending on military and civil service wages and allowances. While some expansion of the deficit is certainly warranted, a deficit of 6¾ percent implies the Government will need to draw down significantly on its government deposits, a practice that in the past has contributed to macroeconomic instability, placing pressure on the exchange rate and consumer prices. Measures will be needed to bring the overall deficit down in 2010 to around 5½ percent of GDP to avoid a situation where macroeconomic instability could take root.

At the same time, efforts to prioritize spending should be enhanced. In particular, there is a high risk that excessive increases in wages and allowances could become entrenched, and crowd out spending on priority sectors. Development Partners urge the Royal Government to ensure wage measures are undertaken in the context of a well-defined civil service reform strategy, and to make efforts to rationalize less productive spending and protect budget allocation to priority sectors. Prime Minister Hun Sen made clear earlier this year the Royal Government's commitment to maintain the budgeted level of public resources to priority sectors such as health and education, for example at the Cambodia Health Conference in March. Development Partners support the continued implementation of this commitment. Development Partners also urge the Royal Government to increase efforts to mobilize domestic revenues, a condition necessary to deliver social services and infrastructure, and *would appreciate an update on measures planned to increase revenue collection to provide the needed fiscal space for priority expenditures such as rural infrastructure for agriculture*. Development Partners recognize the challenges we face in increasing ODA disbursements: we remain committed to the December 2008 indicative financing framework. We also acknowledged the important monitoring of priority projects and the discussions under agenda item 1.

Development Partners are also committed to support the Royal Government's response to the economic downturn through their own economic policy. Exports have been extremely important for the development of Cambodia's economy. In this regard, preferential access to Development Partners' markets has been critical for the growth of the garment sector. Going forward, it will be critical to diversify the export base to, for example, agricultural products and light manufacturing. Recently, the EU expanded the coverage of its preferential access scheme to include rice and, from 1 October, sugar, hence offering preferential access to all Cambodian products with the sole exception of arms. Cambodia also receives preferential zero-tariff access for all its exports to Australia. Many Development Partners are also providing trade-related assistance to support the Royal Government in enabling and promoting further trade diversification. Development Partners also note the Royal Government's leadership in global aid-for-trade and in trade negotiations, as evidenced by the ongoing LDC roundtable.

Development Partners support the Government's ongoing work on the development of a national integrated social safety net strategy and congratulate CARD for their leadership of the successful National Forum in July where the Prime Minister emphasized the Government's commitment to strengthening the social safety net system for vulnerable groups.

Development Partners are encouraged by a number of measures taken over the past six months to address the root causes of the slowdown, as evidenced in the joint review with the Royal Government of actions agreed at the April 2009 GDCC.

Noting the many opportunities to improve the conditions for sustained growth and the bold packages adopted by some of Cambodia's competitors, we would like to emphasize opportunities in two areas:

- We are encouraged by the continuing dialogue between the Royal Government and representatives of the private sector at the Working Group level, while *urging a deepening of the dialogue in areas that are lagging* (for instance by soon convening a Government Private Sector Forum). In particular, reviewing and streamlining the *trade processes* is critical for SMEs and agri-businesses. Development Partners would appreciate an update on this review. Based on discussions in the Government Private Sector Forum SME working group, simplifications in duplicate licensing requirements and in the inspection regime, as well as dissemination of standards and creation of professional certification bodies, would boost SME growth and enable diversification in particular in new agro-processing: Development Partners would like to know the timeframe for this process.

- With respect to encouraging trade (especially for agro-processed products) and tourism within the Greater Mekong Subregion, the recent agreements with Viet Nam and Thailand, respectively, on the exchange of traffic rights is a welcome step in the effective operationalization of the cross-border transport agreement that was signed a few years ago with both countries. Beyond that, it would be important to make further progress in implementing single window and single stop inspections with both countries, including through finalization of the necessary service level arrangements between the relevant line ministries. *Development Partners would welcome an update on this process*.