REMARKS ON MACROECONOMIC DEVELOPMENTS

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on behalf of Development Partners
at the
CAMBODIA DEVELOPMENT COOPERATION FORUM

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Excellencies, Ladies and Gentlemen:

I appreciate the opportunity to participate in this year's Cambodia Development Cooperation Forum (CDCF), and I am honored to deliver some remarks on macroeconomic developments on behalf of the Royal Government of Cambodia's development partners.

Recent Macroeconomic Developments

Much has happened on the macroeconomic front since development partners and the Royal Government met at the last CDCF in June 2007. The economy continued its impressive record of double digit growth last year, at around 10¼ percent, and this momentum carried into the first half of 2008: growth in garment exports and tourism, while easing somewhat, was relatively robust; agriculture output was favorable; and foreign investment combined with very high growth in commercial bank lending fueled rapid construction activity and rising property prices.

As the first half of 2008 progressed, the high level of demand in the economy exerted increasing upward pressure on consumer prices in Cambodia. Coupled with a marked increase in international prices for oil and food, and higher imported-goods prices related to a depreciation of the riel and U.S. dollar against the currencies of Cambodia's other major trading partners, inflation rose to a peak of 26 percent by mid-2008.

Since mid-year, however, the macroeconomic environment has shifted abruptly, particularly in the last few months, as Cambodia has increasingly begun to feel the effects of the global financial crisis and the associated deceleration in global growth. Garment exports and tourist arrivals are slowing, reflecting not only the rapid downturn in key trading partners' economies, but also the strain on Cambodia's competitiveness as a consequence of high domestic inflation and the now sharp appreciation of the riel and U.S. dollar. Construction activity and foreign investment are also slowing, reflecting tighter global and domestic liquidity conditions. Taken as a whole, these factors are expected to lead to an easing in growth to around 6½ percent in 2008.

On a more positive note, headline inflation has begun to fall, in line with the recent decline in oil prices and the strength of the riel and U.S. dollar. With growth easing, inflation pressures stemming from domestic demand should also abate, and inflation can be expected to fall to around 15½ percent by the end of 2008.

Key Macroeconomic Policy Issues

Needless to say, the environment for formulating macroeconomic policies in 2008 has been complex. The Royal Government has had to deal with domestic demand pressures, large external shocks to commodity prices and exchange rates that reversed themselves around mid-year, and most recently a rapid deterioration in external demand and financing conditions.

Throughout 2008, macroeconomic stabilization efforts have been underpinned by a stable fiscal policy stance, including through the election period, and the Royal Government of Cambodia deserves to be commended for this effort. Government revenues have grown strongly in 2008, and are projected to reach 12½ percent of GDP, due in large measure to continued improvements in tax administration. Expenditure has been maintained in line with the budget target, and together these factors are expected to lead to a decline in the overall government budget deficit (excluding grants) to about 1¾ percent in 2008, while government deposits in the banking system have increased.

More recently, monetary policy also helped to play a stabilizing role. During the first half of 2008, strong foreign inflows and growth in domestic deposits contributed to private sector credit growth that peaked at over 100 percent year-on-year in June, and this consequently fuelled inflation pressures. The National Bank of Cambodia (NBC) responded appropriately by doubling the reserve requirement on foreign currency bank deposits to 16 percent. Development partners also commend the NBC for raising banks' minimum capital requirement, which will help to put the system on a stronger footing. Since mid-year, and as external inflows have slowed, credit growth has moderated, helping to reduce inflation pressures.

Looking forward, the economic outlook is expected to remain challenging over the near term. The global economic slowdown is expected to affect adversely the key pillars of Cambodia's economy, with growth now projected at around 4¾ percent in 2009. Inflation should continue to decline to single digits in 2009 as commodity prices recede and domestic demand pressures ease.

The economic headwinds are certainly strong, and in fact, the risk is that they may intensify before they subside. Given the near-term outlook and the risks, a key priority will be to ensure that macroeconomic and financial policies are conducive to mitigating the impact of the external shocks buffeting Cambodia. Now is also the time to accelerate reforms that strengthen the fundamental underpinnings of Cambodia's economy, and not to back away from the more difficult areas. Here, the focus should be on improving the investment climate, including by tackling corruption and strengthening governance, to mitigate the slow-down in

global foreign direct investment; addressing losses in regional competitiveness, for instance through accelerated progress in trade facilitation; bolstering the health of the banking system through continued improvements in regulations and supervision; and fast tracking domestic development objectives such as infrastructure spending for rural areas and agriculture. Regaining macroeconomic stability and implementing key structural reforms will help broaden Cambodia's production base and remove constraints on growth, all critical ingredients for countering the slowing of growth in the near term, and for continued progress in reducing poverty and attaining the Cambodia Millennium Development Goals.

Development Partners also welcome the Royal Government's commitment to continued progress in implementing the Public Financial Management Reform Program, including merit based pay incentives. Looking ahead to Stage Two, there is an urgent need to accelerate progress on key reform elements, including: (i) strengthening integration and de-concentration of the budget; (ii) implementing financial management and accounting systems that support expenditure tracking and reporting, particularly for capital and poverty-reducing expenditures; and (iii) improving accountability through transparency, for instance through disclosure of the annual external audit, and related to revenues from extractive industries. These measures will further enhance the credibility of the budget and strengthen confidence that public monies are being used productively.

Against this background, development partners would like to raise the following issues, on which the views of the Royal Government would be most welcome:

- Some countercyclical easing of fiscal policy in 2009 will help to cushion the impact of lower growth. Government revenues, measured as a share of GDP, will likely decline slightly as import growth slows, and this is appropriate because it works as an automatic stabilizer. However, even after the welcome gains made in 2008, revenue performance remains well below that in other low-income countries, so slippages in hard-won revenue administration gains need to be avoided. Development Partners support the Royal Government's ongoing efforts to strengthen further revenue administration, and thus to continue to take on an increasing responsibility for financing critical spending needs. What steps can the government implement to ensure that continued improvements in revenue collection are achieved?

- While higher government spending will help combat slowing growth, careful prioritization and focus are required. Current spending should prioritize pro-poor social outlays, and address short-term vulnerabilities, including through well-targeted social safety nets for the most vulnerable. There is a need to address the low level of government salaries, although higher wage expenditures, including those related to a recently expanded cabinet, should be linked to a comprehensive reform of the civil service that raises the efficiency and quality of public service delivery (an issue that will be discussed in a later session of the CDCF). Military spending should concentrate on critical needs to avoid crowding out other essential spending, unnecessarily widening the deficit, and potentially weakening the external position. Capital spending on high-quality infrastructure projects would provide both a near-

term growth boost, while raising the economy's medium-term growth potential and attracting FDI. How can the MTEF and the budget ensure that both current and capital expenditures prioritize the essential areas?

- Finally, experience has shown the importance of transparency and accountability in the management of revenues from extractive industries, both to deal with the complex macroeconomic challenges that they bring, and to get the most out of the revenues that they generate. Development partners welcome the Royal Government's commitment to transparency and accountability in this sector. Recognizing the continued uncertainty over existing offshore and underground resources, and acknowledging the limited capacity that currently exists, what are the Royal Government's concrete plans to increase transparency and accountability in this area?

In conclusion, let me express my appreciation once again for the opportunity to participate in the Cambodia Development Cooperation Forum today. While the near term macroeconomic environment looks increasingly complex, we are confident that the Royal Government of Cambodia can address the challenges. Indeed, looking beyond the near term, Cambodia's outlook remains bright, owing in no small measure to the ongoing commitment to prudent macroeconomic management. On behalf of development partners, I would like to wish the Royal Government every success in your endeavors.