Session IIA Macroeconomic Developments and Policy Options

Delivered by Mr. John Nelmes, IMF Resident Representative in Cambodia
On behalf of Development Partners at the
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Excellency Keat Chhon, Deputy Prime Minister and Minister of Economy and Finance,

Excellencies, Ladies and Gentlemen,

Let me begin by thanking the Royal Government of Cambodia for inviting us to this year's Cambodia Development Cooperation Forum (CDCF), and for the opportunity to deliver some remarks on macroeconomic developments and policies. The CDCF certainly comes at a timely juncture. With the global economy emerging from the most severe downturn in recent history, and signs mounting that Cambodia is also recovering, now is an ideal time to draw lessons from the recent past, and to focus attention on policies that will help Cambodia return to a path of sustainable robust economic growth and improvements in the health and welfare of its citizens.

Available data indicate that Cambodia's economy experienced a contraction last year, with GDP declining by 2½ percent. However, a recovery began to take root late in the year, and it has continued to gain momentum in the first half of 2010. Our latest projections are for real GDP to expand by around 4¾ percent this year, very close to the Royal Government's outlook. In concert with the recovery in global economic activity, garment exports are strengthening and tourist arrivals are growing, while construction is resuming and improvements in agriculture continue.

This positive outlook is very good news for Cambodia. However, the global economic rebound is likely to be more subdued than past recoveries, and numerous challenges and risks remain. In addition to structural reforms to enhance competitiveness and broaden the base of economic activity, one of the principle macroeconomic challenges for the Royal Government now is to ensure the economic recovery is sustained without re-igniting inflation pressures or creating external vulnerabilities.

Achieving this goal will require a move to a more sustainable fiscal position that begins to unwind last year's expansion of the budget deficit, and in the near term eliminates its domestic financing component—an increase in which has already pushed up riel liquidity and could fuel inflation and put pressure on the exchange rate if not addressed. The Royal Government made worthy efforts to safeguard revenue collection during the downturn, and the 2010 budget foresees moderate gains. However, more concerted efforts to improve administration and broaden the revenue base, including by eliminating tax exemptions and holidays, would reduce domestic financing needs and provide additional fiscal space for spending on priority sectors. *Is consideration being given to reining in tax holidays, given they have adversely impacted revenue collection, but have not generally delivered broader economic diversification?*

At the same time, the widening of the fiscal deficit also reflected a surge in expenditure levels. Part of this increase came in the form of higher infrastructure spending, which helped to cushion the downturn, and over time should contribute to enhancing economic diversification and potential growth. However, large increases in wage and defense expenditures also contributed. While there is certainly a need to address government salary levels, progress should be matched by advances in civil service reform to improve service delivery. Care also needs to be taken to safeguard spending on priority sectors such as health and education.

More broadly, one of the key lessons emerging in the aftermath of the global crisis is the need to pay close attention to public debt dynamics and external debt sustainability. This is particularly true for countries whose economies are primarily based on a foreign (or a common) currency, because in such cases monetary and exchange-rate policies are not freely available to assist with macroeconomic stabilization and adjustment. Cambodia's public debt to GDP ratio is relatively low, however as the recent joint IMF-World Bank debt sustainability analysis shows, there is nevertheless a moderate risk of debt distress and some indicators are flashing warning signs. The analysis also indicates that a delay in reining in the fiscal deficit, or the realization of government contingent liabilities, could negatively affect debt sustainability and jeopardize poverty reduction efforts.

Turning to public financial management (PFM) reforms, Development Partners welcome the steady progress that has been made in a number of areas, and fully support the Government's approach in focusing on a subset of measures to accelerate implementation of stage two of the PRM reform program. Developing a package of interlinked reforms in a limited number of priority line ministries would help to focus scarce resources on producing sustainable results, lessons from which could inform government-wide implementation. At the same time, efforts to consolidate reforms that improve the credibility and transparency of the budget should remain top priority, including importantly in the management and accountability of revenues from extractive industries, and further improvements in budget classification, government accounting, and budget integration. *Development Partners would welcome an update on measures that have been implemented to increase transparency in the budgeting and reporting of revenues from extractive industries.*

Another of the enduring messages from international experience over the last two years is that strong supervision of banks and enforcement of prudential regulations mean fewer risks and a more stable financial system over the whole cycle. As for most countries, this has been a challenging period, and the National Bank of Cambodia has generally managed the circumstances well. Continued efforts to ensure banks adhere to reporting and regulatory requirements are key to safeguarding the system as the economic cycle progresses.

Let me once again thank the Royal Government for the opportunity to participate in these discussions this morning. On behalf of the IMF and Development Partners, let me reiterate our continued support for your efforts in implementing prudent macroeconomic policies, and our commitment to assisting you in these endeavors.