CHAPTER 8
CAMBODIA

Introduction. Cambodia—one of the poorest countries in the world—continues to struggle.

- In 2001 the economy is achieving only a 4%-4.5% growth rate, compared with an initial target of 5.5%.

Economic Aftermath of War

No Dent in Poverty. This 4% figure is well below the 7% - 8% required to make a real dent in poverty.

- Cambodia's poverty rate—estimated at 36% of the population—is not budging.

Not Enough Jobs. Nor is the 4% growth rate high enough to absorb Cambodia's rapidly growing labor force.

- The garment industry—which accounts for 90% of the country's exports—only employs about 100,000 people, less than the estimated 150,000 new entrants to the job market each year.
- Admittedly, the country's rice farmers have produced a surplus this year in spite of severe flooding late in 2000.
- Yet foreign investment projects, which could be a means of modernizing the agricultural sector, slumped dramatically from $41M in 1999 to $4M in 2000.[1]

Homegrown Projects? Given the disinterest of foreign governments, Cambodia needs to make a greater effort to develop its internal capacity to fund its own development projects.

- But indigenous projects are a non-starter until Cambodia develops more efficient tax collection.
- It will also be hard for the government to boost tax revenues without tackling corruption.
- Foreign businesses in Phnom Penh already complain that they pay their fair share, while local companies pay almost nothing.

Figure 8-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	3.2	2.8	3.0	3.2
Purchasing Power	13.0	7.8	15.1	17.2
Real Growth (%)	3.7	1.8	5	4
Inflation (%)	8	14.8	4	1
Exports	0.9	0.9	1.0	1.3
To U.S.	0.1	0.4	0.6	0.8
Imports	1.1	1.1	1.2	1.5
From U.S.	0.02	0.01	0.02	0.03
FDI from U.S.	0	-0.001	-0.003	0
In U.S.	-.002	0	0	0
Cur Account /GDP %	0.7	-0.3	-1.7	-4.6
Fiscal Balance /GDP %	-0.4	-2.7	-2.0	-7.0
External Debt /GDP %	70.0	77.7	73.3	..

Sources: IMF, ADB, World Bank, U.S. Commerce

War-ravaged Economy. To be fair, Cambodia is struggling to dig itself out of a huge economic hole.

- Decades of war virtually destroyed the Cambodian economy.
- This dismal situation slowly began to change following the end of civil conflict and UN-sponsored elections in 1993.

Economic Transition. The country made meaningful progress in the transition to a market economy.

- Economic reform supported macro-economic stability and increased trade and investment flows.
- Between 1993 and 1996 economic growth averaged a commendable 6%.
- Inflation, which had averaged 140% a year during 1990-92, was reduced to single digits during 1995-97.
- Per capita income doubled, from about $150 to nearly $300 in 1997.

Political Insecurity

Political Vulnerabilities. Yet below the surface, all was not well.

- Externally, Cambodia's economic growth relied too heavily on the East Asian economic miracle for exports markets, large foreign savings and trade tax receipts. In short, it was overly vulnerable to the Asian economic crisis.
- Internally, the reform momentum in Cambodia slowed considerably in 1997.

- A coup led by Hun Sen, Cambodia's current Prime Minister, threw the country into turmoil.
- As a result of this political instability, Cambodia's structural reforms lost steam during the first half of 1997 and decelerated considerably in the second half of 1997.

Economic Impact. The impact of political insecurity on the economy was significant:

- GDP fell 1.7% in 1998, but then grew 5% the following year.
- Governance problems exacerbated public finances.
- Donors began to halt disbursements.
- Too many weak banks undermined the financial system.
- Cambodia's currency, the riel, lost value.

Falling Foreign Direct Investment (FDI). Private investor confidence also weakened.

- Investment flows dropped by an estimated 45% drop in 1997.
- New investment commitments fell by roughly 35% in 1997, compared with 1994-1996.
- The decline of investment flows to Cambodia in 1997 was caused by two dramatic events in July 1997: the fall of the Thai baht and the overthrow of First Prime Minister Prince Norodom Rannaridh, including the subsequent domestic political upheaval.

Double Whammy. In 1998, the economy fell victim to a similar double whammy:

- The recessionary impact of the Asian economic crisis.
- The uncertainty and political instability surrounding the national elections in November of that year.

Mitigating Factors. Fortunately, Cambodia was partially insulated from the worst of the Asian economic crisis:

- It received virtually no volatile, short-term capital flows.
- Garment exports to the U.S. and Europe remained strong, thus boosting currency reserves.
- De facto dollarization of the economy—70% - 90% of all transactions in U.S. dollars—helped to limit inflationary and exchange rate shocks.

Responsible Fiscal Policy. Since the Asian economic crisis, Phnom Penh has demonstrated fiscal restraint.

- Responsible fiscal policy has helped to limit recourse to excessive bank financing.
- It has also kept inflationary pressures in check.

A New Political and Economic Era

Stability and Growth. The collapse of the Khmer Rouge as a threat and the formation of Hun Sen's coalition government ushered in a new era of stability. After years of conflict and political instability, the poverty-stricken country of Cambodia is starting to dig itself out of a deep economic hole.

- While it will take years to repair the damage inflicted by decades of conflict, Cambodia experienced two years (1999 and 2000) of renewed, albeit less than spectacular growth.
- During this period, Cambodia has been slowly but surely moving beyond simply relief and post-war rehabilitation.
- Despite severe floods and an oil shock, Cambodia's macroeconomic discipline and generous donor aid are successfully keeping the economy afloat.

Progress in 1999. The relative calm of 1999 helped the economy exceed expectations. For instance:

- Cambodia increased economic growth to a relatively strong 5.0% in 1999 due to:
  - continued expansion of garment exports and
  - a 40% jump in tourism revenues—to $90M in 1999 from $64M in 1998.
- Inflation was tamed, dropping to 4% in 1999 from almost 15% in 1998.
- The currency, the riel, remained stable at about 3,800 to the U.S. dollar.
- Government revenues rose to $346M or 11% of GDP, in 1999, up from $247M in 1998.

Bad News: Falling FDI. On the negative side, attracting FDI is proving tough for Cambodia. The coalition of former foes forged amid the acrimonious aftermath of the 1998 election is having slim success in wooing foreign investors back.

- FDI commitments in 1999 totaled just $482M, little more than half the level of the mid-1990s.
- FDI continued to be low in 2000. In the first nine months of 2000, FDI was $213M—the lowest since the political turmoil of the early 1990s.
- The figure for the same period in 1999 was $230M.

Factors Behind Low FDI. Why has FDI remained so low?

- People are unwilling to invest long term, largely because there is no rule of law. There is no independent judiciary, so if there is a problem with a contract, there's no recourse.
- In addition to this poor legal framework, many potential long-term investors are deterred by poor infrastructure, a lack of skilled labor, corruption, and widespread problems over land ownership—a remnant of years of war and Cambodia's tragic past under the Khmer Rouge.

Budget/Donor Link. Weak economic governance in Cambodia also turns off foreign investors. Take governance of the budget, as an example.

- Revenue performance has been very poor. This shortfall, which is due to poor tax collection and compliance, limits the government's capacity to increase public spending.
- Faced with this shortfall, foreign assistance must fill the gap, which represents 61% of government expenditure.
- Money in the budget is also misallocated.
- The government still spends almost 50% of its budget on security and defense, a staggering figure for a weak developing economy.
- Excessive military spending is a serious opportunity cost that crowds out spending on health, education, and rural development.
- Spending on health, education, and rural development is lagging in 2000, as was the case in 1999.

Good News in 2000. In many ways, however, Cambodia's economic performance was commendable in 2000. For instance:

- Inflation was non-existent.
- The exchange rate of the riel was stable at around 3,880 to the U.S. dollar.
- Foreign exchange reserves (currently equivalent to three-and-a-half months of imports) was adequate.
- The government's budget deficit was manageable.

Flooding. Unfortunately, floods hit Cambodia in September 2000. The impact was significant.

- The rising waters of the Mekong River produced the worst floods in 80 years.
- 3 million people—out of a total population of 12 million—were affected by the floods.
- At least 252 Cambodians died and 1.3 million were left in urgent need of food, shelter and medicine.
- Flood damage affected 102 irrigation projects, 988 schools, 121 clinics, 2,200 kilometers of road and over 544,000 hectares of rice land.

Costs of Flooding. The flooding required emergency finance of between $30M and $35M to carry out repairs. The total damage was in the ballpark of $79M.

- These are not huge sums by international standards, but significant in a country that is still recovering from decades of destruction linked to war and genocide.
- The floods have also hit trade with neighboring Thailand and, thus, the collection of customs revenue along the border.

External Support

Jittery Investors. Meanwhile, investor confidence, which had been ebbing, has now dried up because of the authorities' impotence in the face of the flooding.

- International relief agencies, not the government, took care of the victims.
- The absence of good governance continues to haunt this country.

Donor Support. The floods made Cambodia even more reliant on external assistance to help stay afloat.

- ADB's loan portfolio in Cambodia now totals almost $500M.
- The IMF resumed loans to Cambodia in October 2000, while the World Bank continues its support.
- In May 2000, bilateral and multilateral donors pledged $548M in aid to Phnom Penh.

Donor Aid/Budget Link. Cambodia remains heavily indebted to the World Bank and ADB. In fact, its addiction to foreign aid is more comparable to the desperate plight of some sub-Saharan African nations than Asia's growing economies.

- For instance, in 2000 the entire budget deficit of 637B riel ($166M) was covered by foreign aid.
- And external contributions as a proportion of Cambodia's GDP keep rising: 11.7% in 1993, 14.4% in 1999, and 16.4% in 2000.

More Charity? The fifth meeting of the Consultative Group—which brings together the major bilateral and multilateral aid agencies—is well aware of this negative trend. At a meeting in June 2001, Cambodia's finance minister, Keat Chhon, asked for continuing funding of $500M for each of the next three years. In the end, he may get even more aid than that.

Quid pro Quo. But foreign aid is not a sure thing. It's conditional.

- It's dependent on the government implementing economic reforms.

- These include pledges to cut military spending, crack down on illegal logging in order to generate tax revenue from legal logging activity, and trim the bloated civil service payroll.

Reforms

Slippage in Reforms. Unfortunately, the government is slipping in key areas of economic reform:

- Social sector spending as of the end of August 2000 only reached 40% of annual IMF targets.
- Too much money is also spent on "asphalt farming." For instance, 86% of the national budget is spent in the capital, which is home to just 10% of the population.
- Not enough money is spent on rural development. That has hurt rice production, which is among the lowest in Asia.
- Cambodia still is not meeting IMF conditions on reducing the size of the bloated civil service.

Military Demobilization. IMF describes the status of Cambodia's military demobilzation as "very worrisome."

- Unless the dithering pace of military de-mobilization speeds up, the government will be unable to meet IMF's condition of bringing security spending to below 2% of GDP by the year 2002.
- This will crowd out increased spending in the social sector.

Needed: Tougher Line. Cambodia is now faced with some tough conditions in return for foreign assistance.

- Donors are now expecting more than rhetoric and promises from the Cambodian government. The ADB is now calling for Cambodia to demonstrate a track record of concrete reforms.
- In short, Cambodia has to shape up or cope with a shrinking aid pie.

USG Role in Reforms. The USG has been unable to engage directly in the reform process.

- The USG should closely monitor Cambodia's performance under its economic reform program and try to persuade the International Funding Agencies (IFIs, i.e., IMF and World Bank) to hold a harder line.

- U.S. congressional restrictions—which require the USG to oppose IFI lending to Cambodia except for basic human needs—do not prohibit the USG from using its leverage with the IFIs to insist on better programs.

Conclusion

Wanted: More US Activism. The USG should consider the following:

- The U.S. can and should do more—even within the confines of existing congressional restrictions on assistance—to support military demobilization which is arguably one of the most important areas of Cambodia's economic reform program.
- The U.S. could tap into existing programs to provide in-kind assistance—food, civil engineering projects, medical assistance—to help support the demobilized soldiers and their communities, as envisioned in the demobilization program which the U.S. played a part in creating.

Endnotes

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1 Cambodia Development Resource Institute (CDRI). CDRI is a private think-tank based in Phnom Penh.