

More promise ahead

07 June 2007

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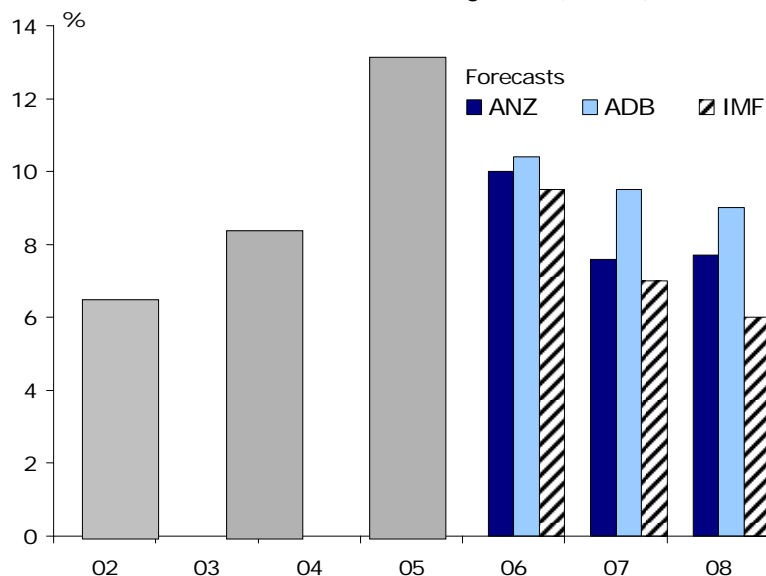
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Key points

- Growth in the Cambodian economy has run at over 7% per annum, on average, since the late 1980s. Market-oriented economic reforms and prudent macroeconomic settings have promoted rapid growth in exports and investment. Ongoing financial and prudential support from international organisations and foreign governments has also helped to promote Cambodia's stability and economic and social development.
- The outlook for Cambodia is strong, with growth expected to average above 7% per annum through to 2009. Continued solid export and investment growth will be the main factors supporting growth. Longer-term, Cambodia's resources sector is also poised for significant expansion following the finding of significant oil and gas reserves.
- The Cambodian economy continues to face many challenges in the period ahead including: high vulnerability to external shocks; low public revenue raising abilities; relatively high debt; high rates of poverty; and poor governance. Moreover, Cambodia continues to rely on international donors to maintain domestic solvency and to meet local development needs.
- Standard and Poor's recently issued an inaugural long-term foreign currency rating for Cambodia's of B+ (stable). Moody's has also assigned its first-ever ratings to the government of Cambodia, placing foreign-currency and local-currency government bonds at B2 (stable).

The Cambodian economy is performing strongly

Cambodian economic growth (annual)



Source: National Institute of Statistics of Cambodia, IMF, ADB, Economics@ANZ

Cambodia's young democracy is relatively stable

Politics

The Cambodian political framework is described officially as a constitutional monarchy. King Norodom Sihamoni is the head of state, performing what is largely a ceremonial role. The Prime Minister is appointed by the King, subject to approval by the representatives from the National Assembly; the Prime Minister exercises executive power in government. Cambodia has a two-tier parliamentary system: the National Assembly (lower house) has 123 members that are elected from the 24 provinces and municipalities. The Senate (upper house) is comprised of 61 members.

The last National Assembly election took place in July 2003. Voting produced a hung parliament, leading to the formation of a coalition government between the Cambodian People's Party (CPP), a two-party coalition between the dominant partner, and the National United Front for an Independent, Neutral, Peaceful and Co-operative Cambodia (FUNCINPEC). The next general election will be held in 2008.

The first Senate election took place in January 2006, with voting performed by members of the National Assembly on behalf of their constituents. The CPP won the majority of votes and increased its representation in the upper house. Hun Sen, the vice-chairman of the CPP, is Cambodia's prime minister.

After a long period of civil conflict, Cambodia has a young democracy and is widely viewed as having a fair degree of political stability. This environment has allowed Cambodia to retain significant economic policy continuity. In contrast to many of its peers, political and social instability and/or policy risk therefore do not significantly constrain Cambodia's ratings¹. Nevertheless, the IMF describes Cambodia's political situation as 'fragile'², as tensions between the CPP, FUNCINPEC and other political parties remain and corruption is an ongoing issue.

The structure of the Cambodian economy

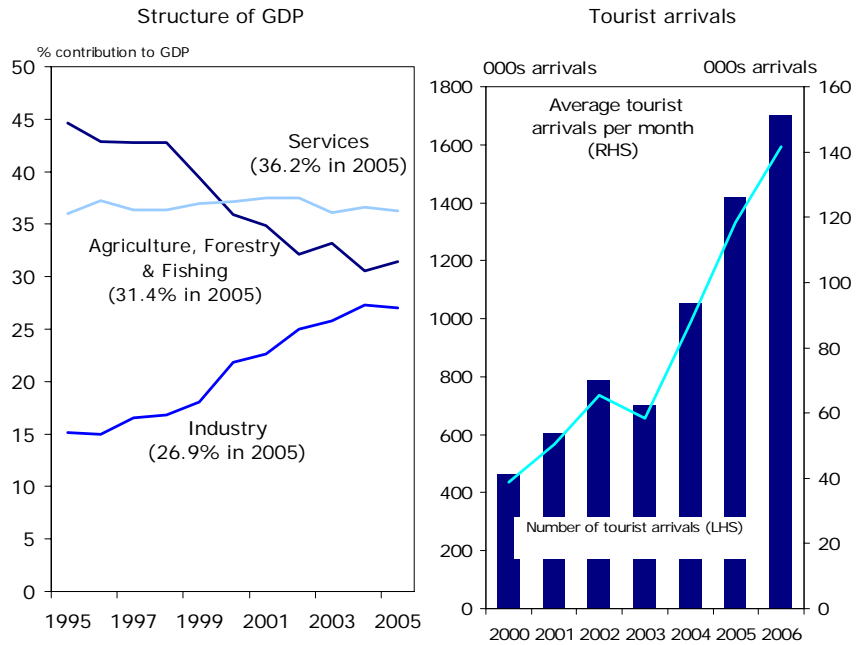
The Cambodian economy has, and continues to make, a significant transition from a traditionally agrarian economy to one based on industry and services. Nevertheless, the economic profile of Cambodia is narrow. Agriculture remains the dominant industry in Cambodia, accounting for 31% of GDP and 70% of employment. Rice is grown by approximately 80% of rural families and accounts for 90% of Cambodia's total cultivated land. Government initiatives to improve the productivity of agriculture are having some success and strong growth in this sector has been important to Cambodia's recent robust economic performance. Nevertheless, the performance of the agricultural sector is volatile as it remains significantly exposed to varying weather conditions as well as to commodity price swings. Moreover, there is minimal value-add in agriculture. Most farms are small-scale with low productivity and Cambodia has little downstream processing industries to support this sector.

Cambodia is making a significant transition from an agrarian economy

¹ In its April 2007 credit rating, Standard and Poor's sees Cambodia's political stability as setting the nation apart from many of its ratings peers, such as Sri Lanka and Pakistan.

² IMF Article IV, July 2006

Agriculture losing its dominance as textiles and tourism take over



Source: National Institute of Statistics of Cambodia, Cambodian Ministry of Tourism

The rapidly expanding industrial sector has been a key driver of recent economic growth for Cambodia, increasing from 15% of GDP in 1995 to around 27% of GDP in 2005. This largely reflects strong growth in manufacturing, and in particular garments/textiles production. The garments industry has grown from just over 1% of GDP to around 15% in the last decade to be Cambodia's major manufacturing industry and its key export. Relatively low wages as well as government tax concessions have kept garments competitively priced, and these products are now Cambodia's largest earner of foreign exchange as well as its single largest non-agricultural employer, with around 230,000 employees and 200 factories. Significantly, the industry has been able to weather the ending of the Multifibre Agreement (MFA) in January of 2005, which had given the industry preferential treatment in US and EU markets. The conclusion of the MFA had been widely expected to severely impact the industry. However, since its end the Cambodian garment industry has actually been able to increase its market share of imports into the US, and domestically more garment factories have opened than have closed.

The tourism sector is another key driver of Cambodian economic growth. Visitor arrivals continue to flock to Cambodia, increasing by around 43% per annum in 2005 and 33% in 2006. Tourists predominantly come from the Asian region and the United States, with the Angkor Wat temple complex the major draw card. Tourism is now Cambodia's second largest export industry and is also an important support for other industries, including transport and hospitality.

One sector poised for significant expansion in the future is Cambodia's resources industry. Cambodia has large proven reserves of oil (estimated at 700mn barrels) and gas (estimated at two to three trillion cubic feet) and there are also potentially large but as yet unquantified deposits in various stages of exploration. There remains uncertainty over when hydrocarbon extraction can start, although initial estimates suggest it could be as early as 2010. Over the medium term, hydrocarbon extraction is expected to supplant the country's traditional resource industries of timber and gemstone mining. This sector has the potential to become a key export earner and source of government revenue in the future, although this remains a medium-term not a short-term prospect.

On the expenditure side of GDP, private consumption continues to grow strongly as per capita incomes increase. That said, per capita income in

Garments have become a significant driver of growth

The tourism sector is booming

Consumption and exports are growing rapidly

Cambodia is still very low. At just US\$503 per annum in 2006, per capita income in Cambodia is comparable to one of its neighbours the Republic of Lao (US\$567) but well below another neighbour Vietnam (US\$723). Indeed, per capita income in Cambodia is the lowest in South East Asia after Myanmar (US\$230) and with agriculture the dominant personal income-earner, remains vulnerable to variable harvest results.

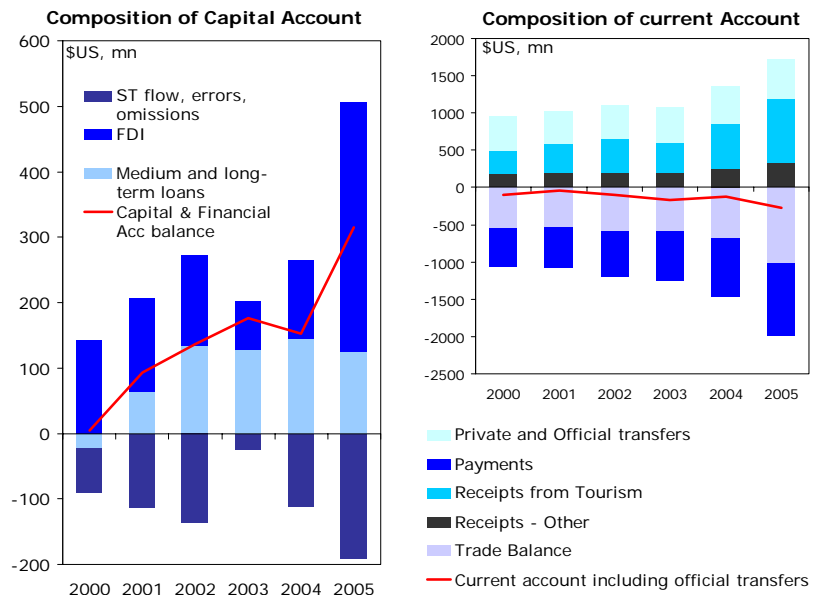
Composition of GDP - expenditure (% of total, figures in parenthesis denote annual growth rate)

	2003	2004	2005
Private consumption	84.1 (8.1)	83.7 (12.5)	85.7 (12.3)
Government consumption	5.5 (6.2)	5.4 (-5.7)	4.6 (2.7)
Investment	19.2 (4.7)	18.5 (9.0)	18.4 (15.4)
Exports	67.8 (13.7)	70.9 (19.8)	77.3 (18.0)
Imports	57.5 (11.3)	59.0 (28.4)	68.9 (16.8)

Source: National Institute of Statistics of Cambodia

Private investment continues to expand consistently, reflecting an improved investment environment due to government reforms. Foreign direct investment (FDI) increased significantly in 2005 to US\$395mn from US\$131mn in 2004, greatly assisted by the implementation of the Trade Facilitation and Competitiveness Project. The majority of FDI has come from China, Korea Thailand, Malaysia, Taiwan and Vietnam on projects largely concentrated in the garments and tourism sectors.

Large current account deficits partly offset by foreign investment



Source: National Institute of Statistics of Cambodia, IMF

Growth in exports has improved consistently thanks primarily to the garment industry and tourism as well as a relatively open and liberalised trade regime. Imports have also increased significantly in recent years, partly due to relatively high oil prices but also because most of Cambodia's major exports, especially garments, are reliant on imports. Consequently, the trade deficit has worsened in recent years. With

Foreign investment is picking up...

But not quickly enough to offset a large current account deficit

Cambodia has a prudent and stable policy framework

Cambodia has trouble raising enough revenue

income flows from overseas, including remittances, extremely low, the poor trade performance means that Cambodia's current account deficit is routinely above 10% of GDP. Despite strong increases recently, foreign investment to Cambodia is still not large enough to completely offset these current account deficits. As a result, Cambodia relies on international donor assistance to meet the shortfall and thus maintain solvency in its external accounts.

Policy Framework

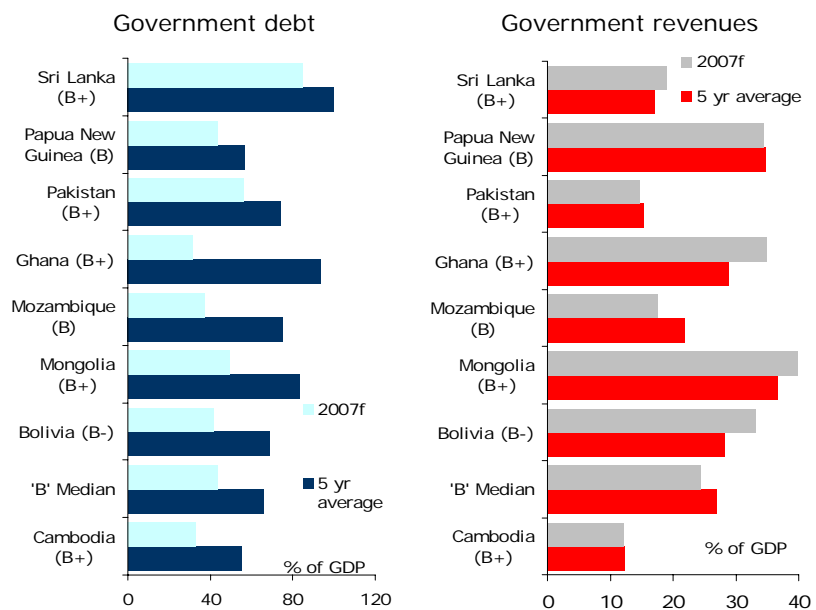
Relatively prudent and stable fiscal and monetary policies have played an important role in Cambodia's recent strong economic performance. These policies promote price stability and liberal and open markets.

Fiscal policy has improved in recent years, with the government committed to restraining public expenditure growth and to targeting this spending to high priority areas, such as poverty reduction. Despite more subdued expenditure, the government sector still routinely runs budget deficits. This largely reflects Cambodia's low revenue raising capabilities. Budget revenues have failed to keep pace with the rate of economic growth, mainly because large parts of the economy, such as informal agriculture, are untaxed and also because administration and collection of tax is very poor. General government revenues were below 11% of GDP in 2005, the lowest among rated sovereigns in the Asia-Pacific region³.

Public debt is high, but largely concessional

The Central Bank promotes a stable exchange rate

Cambodia's revenue raising capabilities are poor



Source: Standard and Poor's

Cambodia also has a high level of government debt with public sector debt exceeding 60% of GDP in 2005. About 95% of this debt is external but it is also largely concessional, sourced by bilateral and multilateral lenders. The average interest rate on the debt is therefore just over 2%, the weighted average maturity is 29.5 years and the grace period is 8.9 years⁴. As a result, despite Cambodia's low revenue-raising capacity, the country's large public sector debt is generally considered to be sustainable.

The National Bank of Cambodia (NBC), the central bank, aims to maintain a stable exchange rate, while allowing the rate to gradually adjust to any shifts in underlying market developments. In order to prevent excessive fluctuations in the national currency, the riel, the NBC intervenes in the market to vary the amount of local currency on issue to keep the exchange rate within a band of +/-1% of the market rate. The riel is freely convertible for both current and capital account transactions.

³ See Standard and Poor's April 2007

⁴ See Standard and Poor's April 2007

The rate of dollarisation is high

But inflation is well contained

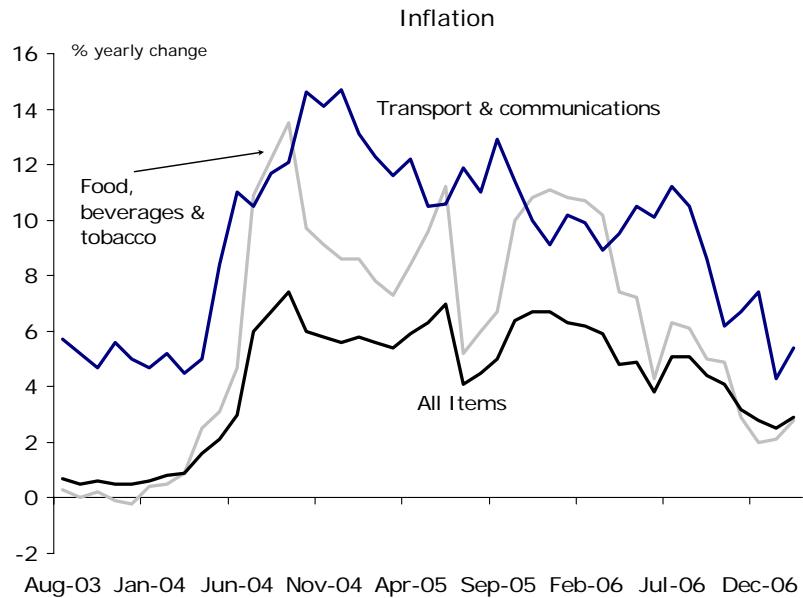
Economic growth should remain strong in the coming years

However, the Foreign Exchange Law does allow the NBC to impose exchange controls in a crisis.

Cambodia has no official policy interest rate and the effectiveness of monetary instruments available to the NBC is limited. This is mainly due to relatively low levels of monetisation, which refers to the extent to which local currency is used in economic activity, and the high rate of dollarisation in the Cambodian economy with more than 70% of broad money made up of foreign currency deposits. Cambodia's undeveloped banking operations also limit the effectiveness of monetary policy. As a result, the link between price movements and monetary developments is relatively weak.

Dollarisation means that the central bank can, in practice, have little hope of controlling local prices. Nevertheless, inflation in Cambodia is well-contained. The impact of sharply high oil prices has been relatively limited. In 2006 inflation ticked up to a high of 6.3% mid-year before easing to 2% by year-end, below the central bank's 5% target. Inflation has remained modest in early 2007, average a 2½% annual rate rises in the first few months of the year. In the past six years, inflation has averaged just 2.9%.

Inflation is well contained



Source: National Institute of Statistics of Cambodia

Economic Forecasts

The outlook for the Cambodian economy is favourable. The economy is expected to have expanded by around 8% in 2006, driven by the strong performance of the garments sector and tourism. In 2007 and 2008, economic growth is expected to moderate slightly to around 7¾%, mainly as slower global growth dampens demand for Cambodian exports. The trade and current account deficits are anticipated to deteriorate over the coming few years on the back of continued high oil prices and strong domestic demand for imported goods as local incomes rise. The fiscal balance in contrast is expected to slightly improve as the government continues efforts to rein in the budget deficit by keeping a lid on expenditure and improving revenue and tax collection. Inflation should remain relatively contained. However, due to the high weighting of food in the CPI index, the inflation rate can be subject to significant non-economic forces, including the weather and avian flu.

Cambodia: Economic Forecasts

	2005	2006f	2007f	2008f
GDP growth (%)	13.4	10.0	7.6	7.7
Nominal GDP (US\$ bn)	6.3	7.1	8.0	8.9
Inflation (% year average)	5.8	4.7	5.0	5.1
Fiscal balance (% GDP)	-5.6	-5.8	-6.0	-6.1
Exports (US\$ mn)	4017	5021	5925	6813
Imports (US\$ mn)	4559	5561	6674	8009
Current account (% GDP)	-10.9	-10.6	-10.3	-10.2
Foreign exchange reserves (US\$ bn)	0.94	1.09	1.20	1.30

Source: National Institute of Statistics of Cambodia, IMF, Economics@ANZ

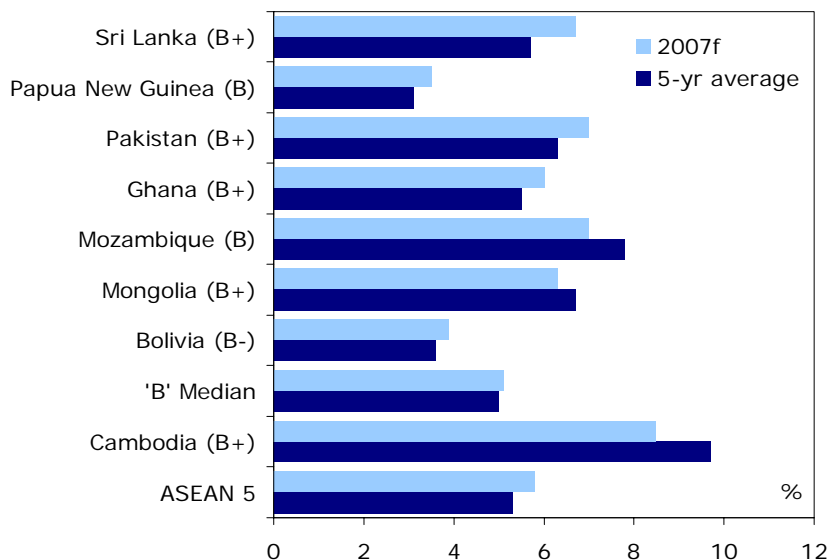
Cambodia has a B+ (stable) rating

Country Rating

In April 2007 Cambodia received a long-term foreign currency rating of B+ (stable) from Standard & Poor's (a local currency rating of B). The rating, four notches below investment grade, puts Cambodia on par with Pakistan and Mongolia, above PNG and Fiji, but below all other South East Asian nations. Standard & Poor's advised that a ratings upgrade would require Cambodia to reduce the barriers to investment and improve the government's revenue-raising measures. On the other hand, fiscal slippage or reduced donor support because of a departure from current prudent macroeconomic policies or a change in debt management strategy could cause the outlook on Cambodia's ratings to be downgraded.

Strong economic growth underpins Cambodia's rating

Real GDP growth versus ratings and regional counterparts



Source: Standard and Poor's, National Institute of Statistics of Cambodia, IMF

Moody's has also recently assigned its first-ever sovereign rating to Cambodia. The country received a long-run foreign currency rating of B2 with a stable outlook, five notches below investment grade. Moody's has assigned a slightly higher foreign currency bond ceiling of B1 to Cambodia, reflecting the high likelihood that a payments moratorium would be put in place in the event of a government bond default.

Challenges for the economy

The key risk to the performance of the Cambodian economy lies in its lack of diversity. This leaves the economy extremely vulnerable to exogenous shocks. The three drivers of Cambodian growth - agriculture,

Continued reforms are essential...

... to promote growth and to diversify the economy...

the garments industry and tourism – are exposed to significant risk from weather extremes, increased competition from the region, avian flu and global consumer demand. Efforts to expand the narrow economic base have commenced and should improve medium to long-term prospects.

...develop the finance sector...

Cambodia's financial sector is relatively small, in line with the economy's relatively small bankable sector. The absence of both reliable borrower information and enforceable financial contracts will continue to hamper the development of the banking system. Asset quality is not strong, but is in line with other developing nations with the nonperforming loan ratio at 8-10%. Standard and Poor's has assessed that the banking sector asset quality poses only a minor contingent risk, given that outstanding credit to the private sector and non-government private enterprises are less than 10% of GDP. Nevertheless, with private sector credit growth accelerating, to around 20% per annum at present, there is a risk that asset quality may deteriorate. Reforms to strengthen financial intermediation and enforce prudential requirements must be accelerated.

...encourage foreign investment...

Foreign direct investment (FDI) is crucial for the further development of the country. However, the so far measured pace of implementing government reforms has acted as a potential deterrent for foreign investors, particularly with regard to the underdeveloped legal system. The government is generally welcoming of FDI, and increased political stability and Cambodia's accession to the WTO in 2004 have gone some way to allay investor concerns by accelerating the reform process. The government has also announced that in 2007 a court will be created with the sole purpose of hearing trade disputes with the aim that this will further encourage foreign investment. Nevertheless, the corporate governance environment remains weak and corruption is high. In 2006 Cambodia was ranked 151st (out of 163) on Transparency International's corruption perception index. Improved governance is essential to not only securing higher rates of FDI, but also in preserving Cambodia's relationship with international donors.

...improve living standards...

Low per capita income and low levels of human capital are also challenges for Cambodia. The United Nations Human Development Index, which measures a country's average achievements in health, knowledge and standard of living, ranks Cambodia 129th out of 177 countries. Low levels of human capital, particularly in terms of formal education and skills, are a constraint on local productivity and economic growth and also act as a deterrent to foreign direct investment.

...raise the government's revenue raising capacity...

The Cambodian government's low revenue raising capability is a significant constraint on this economy. Higher rates of revenue collection are required to fund increased government expenditure to reduce poverty and build infrastructure. Both of these spends will directly benefit the domestic economy and population but also help to attract large-scale foreign investment. Moreover, improvements in revenue collection are essential to reduce Cambodia's vulnerability to debt distress, given the nation's very high level of public liabilities. The government aims to increase revenue to 12½% of GDP by 2009 by broadening the tax base through improvements in tax administration and enforcement. However structural improvements to tax policy, including increased efforts to reduce tax exemptions and the development of new revenue raising tools, such as increasing excise rates or reconsidering urban property taxation for example, are required. In the medium-term, the development of a local petroleum and gas industry could provide a potentially large source of future government revenues and help Cambodia's fiscal position significantly.

...reduce Cambodia's reliance on international aid..

Cambodia must do more to reduce its reliance on international aid. As already outlined, Cambodia runs a large current account deficit and, with foreign investment inflows still relatively low, requires ongoing donor support to maintain external solvency. Moreover, about one third of Cambodia's public spending is financed by aid. Over the long-run stable and solid economic development and local institution building is the key

..to ensure a bright future

to reducing Cambodia's reliance on donor support. In the short-run, the public and private sector must ensure that government and non-government financial and non-financial assistance is used effectively and efficiently.

The short-term economic outlook for Cambodia is bright. Over the longer-term, a continued commitment to promoting private sector investment, local competitiveness, export growth and economic diversification is required to secure Cambodia's socioeconomic development. Authorities are making commendable steps in this direction, suggesting that further promise lies ahead.

This report was compiled using information from Economics@ANZ, IMF, Standard and Poor's, Moody's, World Bank, CIA World Fact book, the Australian Department of Foreign affairs and Trade, the National Institute of Statistics of Cambodia and the Asian Development Bank

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