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Economic Outlook and Development Challenges

by TONG Kimsun and Srinivasa MADHUR[1]

1.1 THE ECONOMY IN 2012

The Cambodian economy continued to gather momentum and remain robust. GDP in 2012 grew by an estimated 6.5 percent, somewhat slower than the 7.1 percent rate of the previous year yet vigorous by regional standards. Among the ASEAN countries, only Laos has grown faster than Cambodia over the last year. There were two distinctive offsetting trends at sectoral level. Growth in agricultural production, which had slowed to 3 percent in 2011 due to the unprecedented floods, reverted to its long-term trend rate of about 4.5 percent in 2012. In contrast, non-agricultural output growth slowed by about 1.4 percentage points – from 8.6 percent in 2011 to 7.2 percent in 2012. Within the non-agricultural sectors, construction – going by the rise in the number and value of construction projects approved in the first 10 months of the year – seems to have contributed strongly to GDP.

The slowdown in the non-agricultural sectors, especially in industrial output, was primarily due to the deceleration in export growth. Indeed, there is a strong correlation between Cambodia's exports and industrial performance (Figure 1.1). Continued global economic slackening coupled with weaker-than-expected outcomes in China and the ASEAN region led to a softening of demand for Cambodia's exports. Exports, which had risen by 36 percent in 2011, posted a much lower figure in 2012 – in the first 10 months of the year, the sector grew by about 26 percent. Garment exports, which account for more than 80 percent of total exports, grew at 21 percent in the first ten months of 2012 compared to 33 percent in the corresponding period of the previous year.

Although rice exports gained an impressive 39 percent in the first ten months of 2012, it was still a much slower rate than the triple digit growth of the previous year. In terms of quantity, rice exports were about 0.16 million tonnes in the first ten months of the year, up from 0.14 million tonnes in the previous year. On current trends, achieving the government's target of exporting 1 million tonnes of rice by 2015 would require a huge acceleration in rice exports over the next three years. However, it is encouraging that Cambodia has been able to diversify its rice exports away from traditional markets such as the European Union towards newer ones in the ASEAN region.

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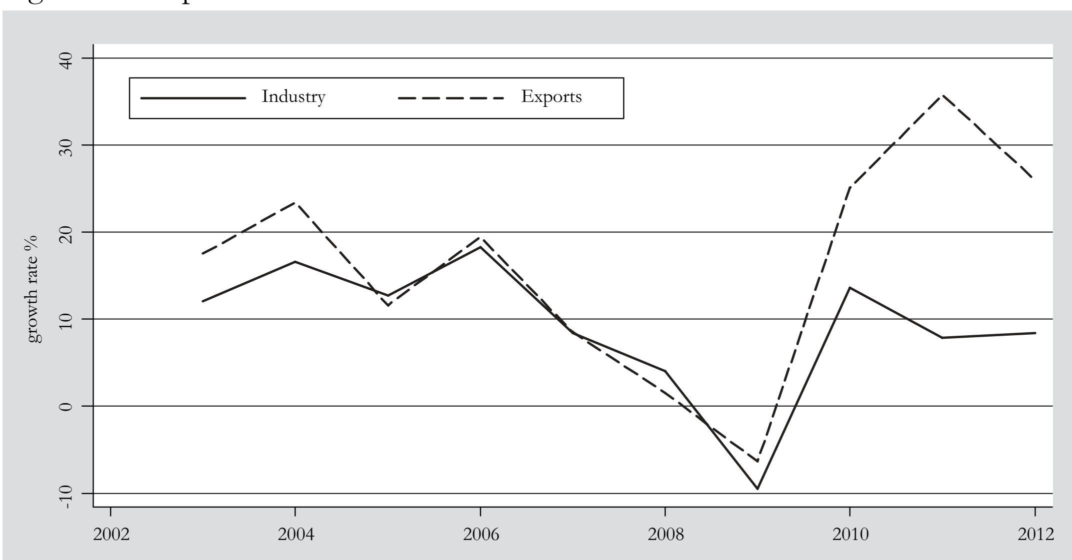
In the first ten months of 2012, there were 2.9 million tourist arrivals to Cambodia. Estimated at 3.5 million, tourist arrivals for the full year were up by 12.5 percent, a sharp deceleration from the 32 percent growth in the previous year. Estimates place tourism receipts at around USD2 billion, which means an almost halving of the growth in tourism receipts from 37 percent in 2011 to 20 percent in 2012. Cambodia's tourism sector is undergoing profound changes, with the composition of tourist arrivals shifting away from western countries towards Asian ones partly reflecting the rising prosperity in Asia in recent years. In 2012, for example, Vietnam, South Korea, China, Laos and Thailand constituted the top five countries from which Cambodia received its tourists.

Figure 1.1: Exports and Industrial Growth



Partly mirroring the deceleration in the industrial and service sectors, inflation moderated from about 5 percent in 2011 to 3.4 percent last year. The downtrend stemmed imports, but by less than the decline in export growth. As a result, the current account deficit increased from about 12 percent of GDP in 2011 to over 13 percent last year. Given that Cambodia's external debt is largely of long-term maturity and the country's foreign exchange reserves cover about 4 months' worth of imports, the widening current account deficit should not endanger macroeconomic stability. Moreover, International Monetary Fund (IMF 2013) predictions indicate that the current account deficit could gradually narrow in the near future.

1.2 ECONOMIC OUTLOOK FOR 2013

Being a small open economy, Cambodia's immediate outlook is contingent on the external environment. Indeed, the Cambodian economy seems to have embarked on a slower growth path since the 2008-09 global financial crisis, even if the sharp downturn of 2009 is excluded. Growth during the four years 2008-12 (excluding 2009) averaged about 6.6 percent, much lower than the average annual rate of 11 percent posted in the pre-crisis years of 2004-07. The slowdown is even sharper in the non-agricultural sectors, particularly the industrial sector. Yearly industrial growth, which had averaged 14 percent during 2004-07, decelerated to 8.5 percent during 2008-12 (excluding 2009). The immediate economic outlook thus very much depends on the strength of the global economic recovery.

In its October 2012 World Economic Outlook, the IMF predicted global GDP growth of about 3.6 percent in 2013, a modest pickup compared to the estimated growth of 3.3 percent in 2012. Overall, this marks a significant downward revision of the IMF's global GDP forecast for this year from the estimates of 3.9 percent and 4.1 percent it made in July 2012 and April 2012, respectively. While growth in the United States is expected to hold up at a little over 2 percent in 2013, the euro zone's growth is forecast to be feeble, and Japan's GDP growth is expected to decelerate from 2.2 percent in 2012 to 1.1 percent this year. Forecasts for the emerging economies of Asia are somewhat better, but their high interconnectedness with both the United States and Europe means that none of them are likely to post sizeable growth acceleration this year. Overall, therefore, there is consensus that the global economy will continue to grow at a sub-par rate in 2013.

Given the rather subdued forecast for the global economy, a major turnaround in Cambodia's exports seems unlikely in 2013. As of now, the United States accounts for about 38 percent of Cambodia's exports (down from 70 percent in 2000), the European Union for about 35 percent (up from about 20 percent in 2000), and the rest of the world for the remaining 27 percent (up from 10 percent in 2000). The continued sluggish recovery in the United States and Europe thus does not augur well for Cambodia's exports. Going by current trends, exports are likely to go up by about 26 percent – similar to the 2012 figure. Tourism income could hold up for some time, partly because of the increased diversification of Cambodia's tourists in recent years. Implementation of the common visa programme between Thailand and Cambodia (ASEAN's version of the European Union's Schengen Visa scheme) introduced in December 2012 and the new flight routes of Tiger Airways between Phnom Penh and Singapore started in October 2012 should give a helping hand to the tourism sector.

With continued strong performance in the real estate and construction sectors, the country should be able to maintain non-agricultural GDP growth of about 7.5 percent. Disruption by major natural disasters aside, agricultural GDP growth of about 4.5 percent could reasonably be sustained. Overall GDP growth for 2013 could then work out to be about 7 percent. A growth rate of this magnitude should not put undue pressure on either inflation or the current account deficit. That should help maintain macroeconomic stability.

However, as the IMF has cautioned, several emerging trends – the rapid expansion of bank credit, shrinking fiscal space in the face of sluggish tax revenues, and the potentially large contingent liabilities (incurred by the government in relation to public-private partnership projects in the power sector) – could pose risks to macro-financial stability in the coming years. Certainly, financial regulators need to be vigilant and monitor credit developments more closely. However, the high rate of credit growth in recent years may have been largely due to structural reforms – the 2009 secured transactions law (removes barriers to using movable property as collateral), the new regulation that allows credit bureaus to collect and distribute positive and negative credit information, and the establishment of the country's first credit bureau in 2012.

1.3 LONG-TERM VISION AND DEVELOPMENT CHALLENGES

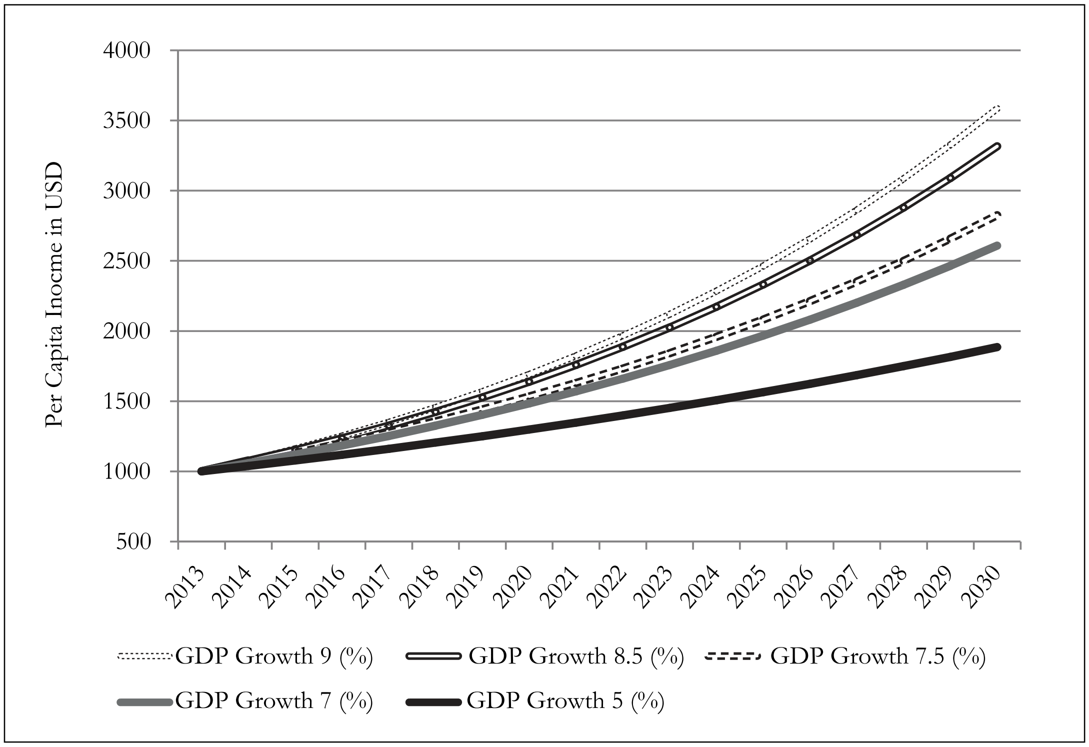
If the above GDP forecast is realised, Cambodia stands to reach a four-digit per capita income of about USD1000 by the end of this year – a feat achieved by Vietnam in 2008 and Laos in 2010. From a long-term perspective, that implies a quadrupling of the country's per capita income (at market exchange rates) in the last twenty years, from USD240 in 1993. Thus, Cambodia is now on the verge of graduating to the status of what the World Bank refers to as a lower middle-income country (LMIC) – a country with a per capita income of above USD1025 but below USD4035.

A recent IMF Working Paper (by combining a small quantitative macroeconomic model of the Cambodian economy with a more qualitative growth diagnostics approach) estimates long-term potential growth for Cambodia of about 7.5 percent with an associated investment rate of about 20 percent (Rungcharoenkitkul 2012). For every additional percentage point of growth over the 7.5 percent benchmark, the country's investment rate has to go up by about 5 percentage points. In other words, to raise GDP growth to about 8.5 percent, the investment rate has to increase to about 25 percent. Such a nexus between investment and long-term growth is broadly in line with global development experience.

"Strong, enduring growth requires high rates of investment. By investing resources, rather than consuming them, economies make a trade-off between present and future standards of living. That trade-off is quite steep. If the sustained, high growth cases are any guide, it appears that overall investment rates of 25 percent of GDP or above are needed… they often invested at least another 7-8 percent of GDP in education, training, and health…, although this is not treated as investment in the national accounts" (Commission on Growth and Development 2008: 34). The high-performing East Asian countries also maintained investment rates of above 25 percent, indeed closer to 30 percent, during their rapid growth phases (World Bank 1991 1993; Gill & Kharas 2007; Yusuf 2009).

If a GDP growth rate of 7.5 percent is maintained over the next 17 years, by 2030 Cambodia's per capita income will likely be more than USD2800 – close to a tripling of the country's per capita income. At that level, Cambodia's per capita income in 2030 would be similar to what Indonesia had attained by 2010. On the other hand, if a higher growth rate of 8.5 percent is achieved, per capita income in 2030 could reach about USD3300 – comparable to what Indonesia had in 2011. A 2012 CDRI paper calculated Cambodia's per capita income trajectory using three GDP growth scenarios for the period 2010 to 2030: (i) a high growth scenario of 9 percent, (ii) a moderate growth scenario of 7 percent, and (iii) a low growth scenario of 5 percent (Strange *et al.* 2012). Reworking the per capita income trajectory under these scenarios using the 2013 per capita income (of USD1000) as the base yields a 2030 per capita income of USD3600 in the high growth scenario, USD2600 in the moderate growth scenario, and USD1900 in the low growth scenario (Figure 1.2).

Figure 1.2: Income Per Capita under Alternative Growth Scenarios



Note that using the 5:1 investment-growth relationship, rapid GDP growth targeted at 9 percent under CDRI's high growth scenario would require raising the investment rate to 27-28 percent. Although Cambodia's investment and savings rates show large yearly variations, during 2005-10 they averaged about 20 percent and 15 percent, respectively. Hence, achieving GDP growth of about 9 percent would require a 7-8 percentage point increase in the investment rate. "Fast growth has a high price tag" (Yusuf 2009: 85). Therefore, growth that is much higher than the benchmark potential rate of 7.5 percent is not outside the realm of possibility, but it would require a substantial increase in Cambodia's investment rate. Considering this and other constraints, it is perhaps more pragmatic for Cambodia to set a long-term goal of maintaining GDP growth of 7.5 to 8.5 percent. That in itself is a strong growth target by any standards, global or regional. Anything beyond that range would likely put undue pressure on the country's savings-investment balance and could endanger macroeconomic and financial stability.

There is another possible snag in a country like Cambodia that has been prone to large income inequalities and income polarisation aiming for too high a growth path. Although the dynamics of the relationship between growth and income inequality are not yet fully understood, there is some evidence that many countries during their super-growth phases have seen worsening income inequality and stark income polarisation between the rich and the poor (Basu 2011; ADB 2012; Stiglitz 2012). It is also possible that by focusing too much on simply maximising gains from super-growth, policy makers risk depriving overall human development and social inclusion of the attention they deserve. If that happens, crucial areas such as health and education could be neglected – areas in which Cambodia has made impressive progress since the mid-1990s, though formidable challenges remain.

Despite the impressive improvements in a whole set of health indicators, Cambodia has a significant unfinished agenda – in containing contagious diseases, improving reproductive healthcare, reducing child mortality, and providing sanitation facilities and clean drinking water. In the area of education too, Cambodia has done admirably well in achieving close to universal primary education, but large gaps remain in secondary, tertiary and vocational education. Even within the country, poorer families have far less access to healthcare and education than richer ones, just as there are large disparities in access to healthcare and education between rural and urban households. Attending to these pressing human needs should thus take priority over a singular focus on achieving a super-strong GDP growth target. "Money matters, but the evidence shows overwhelmingly that great improvements can be achieved in other aspects of human development without going flat out for economic growth" (UNDP 2010:.63).

Even realising a yearly GDP growth closer to 8.5 percent, the upper bound of the above range, would be quite challenging as it would require stepping up the investment rate by about 5 percentage points. Keeping the current account imbalance within manageable limits, in turn, would require a substantial increase in the country's savings rate from the recent average figure of 15 percent, especially with the inevitable decline in external aid looming on the horizon. A large increase in the investment rate would also require substantial upgrading of infrastructure, major improvements in the business environment, huge investments in human capital, credible natural resource management, prudent macro-financial management, and, above all, continued strengthening of governance and institutions (Strange *et al.* 2012; CDRI 2013 forthcoming).

Without doubt, Cambodia has made huge strides in almost all these areas since the mid-1990s. The country's extraordinary rebuilding of its economy, society, and political system from the ground up amid extremely adverse initial conditions in the mid-1990s to where they are today is almost unparalleled, whether one looks at it from a global or an Asian perspective. Indeed, Cambodia has travelled a long distance on its rather arduous development journey – not only in terms of growth, but also in terms of progress in poverty reduction, human development, gender equity, healthcare and education – but the distance to destination of, say, a poverty-free, healthy, educated, and inclusive society is also quite long (CDRI 2013 forthcoming).

Cambodia is thus at a critical juncture on its development path. The unfinished socio-economic development agenda is quite large and demands deft yet pragmatic handling. Cambodia will have to do this in the context of a post-crisis global economy that may remain less buoyant for some time to come. The regional setting is also undergoing profound changes with the emergence of Myanmar and the soon to be established ASEAN Economic Community – both of which may offer fresh opportunities for Cambodia but will also shrink the country's policy space.

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