De-dollarize economy?

**IMF Concludes 2004 Article IV Consultation with Cambodia**

*On September, 13, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Cambodia.*[1]

**Background**

Macroeconomic performance in the past few years was generally good, reflecting both favorable external developments and prudent fiscal policy. Annual real GDP growth averaged 6-7 percent. With the advent of political stability in 1999, private sector activities flourished in urban areas. Exports soared following a bilateral trade agreement with the U.S., and large aid inflows helped finance domestic investment and spurred construction activities. Prudent fiscal policy, including strengthened tax and customs administration, has also been key to ensuring price stability.

These favorable developments, however, have masked underlying structural weaknesses. Competitiveness has deteriorated on account of poor governance—in part due to lack of progress in legal and judicial reform—which exacerbated uncertainty in the business environment, while rudimentary infrastructure and high wages have kept operating costs high. Government capacity remains severely constrained by lack of human capital and entrenched governance problems. At the same time agricultural development has stagnated due to limited access to arable land and markets. Slow growth in agriculture, a sector where most of the poor make their living, has pushed Cambodia further away from meeting the Millenium Development Goals (MDGs).
In 2003, non-agricultural growth slowed due to the SARS-related drop in tourism and election-related uncertainties. Overall GDP growth, however, was robust mainly because of a strong rebound in agricultural production following a reduced harvest the previous year. Prices remained stable reflecting low trading partner inflation and prudent fiscal policy, although some of the earlier gains in fiscal revenue collection were lost in the election year, severely constraining priority spending.

The pace of reforms stalled in the run-up and aftermath of the July 2003 elections. The government has recently produced an action plan to implement its strategy for legal and judicial reform, but not much has been done from this reform agenda in the last 10 years. Reform of the Treasury slowed in 2003: about two thirds of line ministries still do not provide timely reports of their transactions to the Treasury, and there was yet another late-year bunching of spending commitments. The 2004 budget law, along with a range of legislation needed to complete WTO accession still await parliament approval.

Growth is expected to slow in 2004-2005. While tourism is rebounding, agricultural growth is expected to be lower than the exceptionally high growth rate of the previous year. A further slowdown, possibly to below 2 percent GDP growth, is expected as Cambodia will be exposed to direct competition from China following the elimination of the garment quota system in January 2005. It will take some time before Cambodia's exports could recover, even with accelerated reform implementation given the higher input costs and governance problems.

The Ex-Post Assessment of performance under previous Fund-supported programs noted that macroeconomic developments were generally good, but growth remained volatile and narrowly based. There was little progress in alleviating poverty and progress in improving governance, civil service reform, and demobilization was slow. As such, while quantitative targets presented no problems, compliance of structural conditionality under the Fund programs was mixed.

**Executive Board Assessment**

Executive Directors noted that Cambodia has made progress in rebuilding its economy from the ruins of the decades-long civil strife. They commended the authorities for the generally good macroeconomic performance of the past few years, which reflects prudent fiscal policy as well as favorable external developments. However, they expressed concern that growth has been narrowly based and poverty has not fallen. Accordingly, Directors emphasized the importance of increasing the pace of reforms, and in particular, addressing governance issues, strengthening the legal and judicial system, and nurturing the agricultural sector. They saw these reforms as essential to encouraging investment, growth, and product diversification. They noted that these measures are all the more important in view of the difficulties Cambodia will face in competing in the garment sector after the elimination of the quota system in early 2005. Directors welcomed the government's continued commitment to poverty reduction as discussed in the first annual progress report of Cambodia's National Poverty Reduction Strategy (NPRS) Paper. They noted with concern that the reform process has been largely put on hold during the post-election political impasse and looked forward to rapid progress to achieve the poverty reduction targets established in the NPRS. They cautioned that further delays could reduce donor assistance and threaten fiscal sustainability. They acknowledged that these reforms will require strong political commitments, and in this regard, welcomed the new government's emphasis on these priorities.

Directors urged the government to attach high priority to agricultural and land reform, which they saw as an effective and direct way to address poverty since most of the poor live in rural areas. To improve land use, they advised auditing already-awarded economic concessions, reviewing the transfers of ownership of de-mined and deforested land, and speeding up land registration for rural farmers. Policies should be implemented to enhance land tenure security and eradicate illegal settlement and grubbing. They encouraged the government to review, together with donors, the current allocation of foreign aid flows, with a view to refocusing it on agricultural development. Directors observed that Cambodia needs to intensify efforts to attract foreign investment in order to promote diversified growth. While recognizing that significantly improving infrastructure and human capital and establishing a sound regulatory environment can only be achieved in the long run, they suggested that there is considerable scope for improving the business climate in the short run by cutting cumbersome red tape and high informal fees, and by allowing greater wage flexibility.

Directors urged the authorities to accelerate judicial reform to address governance problems that are deeply rooted in all aspects of economic activities. They looked forward to the adoption of the Anti-Corruption Law and the Law on the Status of Judges and Prosecutors, which will strengthen the independence of the judiciary, and to the establishment of a commercial court. Directors welcomed ratification by the National Assembly of Cambodia's entry to the WTO, and the impetus it will give to putting in place a legal framework for a market economy.

Directors emphasized the critical importance of strengthening revenue mobilization in order to attain the government's medium-term fiscal objectives. They urged the government to take additional tax policy measures and further strengthen tax and customs administration to meet the 2004 revenue and medium-term NPRS targets. In this respect, they noted the crucial importance of broadening the tax base by reducing exemptions, and to strengthening enforcement by computerizing the revenue departments and passing the Law on Customs. They noted the potential contribution of good management of natural resources to the revenue base.

Directors agreed that another key component of fiscal reform is improving public expenditure management. They pointed to the establishment of the Ministry of Economy and Finance reform committee as promoting ownership and internalization of technical assistance. They recommended that the National Audit Authority audit the operations of existing fiscally-important contract holders to verify compliance with the terms of the contracts, and making the audit reports public.

Directors recommended overhauling the civil service and its wage structure to improve government effectiveness. They called for an early completion of the ongoing but substantially delayed studies on civil service reform as a critical step in preparing a comprehensive reform strategy, in consultation with the World Bank.

Most Directors supported the National Bank of Cambodia's policy of intervening in the foreign exchange market to stabilize excessive fluctuations of the exchange rate. In view of the highly dollarized economy, they noted the limitation of exchange rate policy in affecting competitiveness. They therefore suggested maintaining a broadly stable exchange rate relative to the U.S. dollar, barring fundamental changes in market conditions.

Directors agreed that Cambodia would benefit from de-dollarizing the economy over time, and saw greater use of the national currency as facilitating the reorientation of monetary policy to controlling inflation and the use of indirect monetary control instruments. They suggested that de-dollarization initiatives, such as requiring that all government transactions be conducted in domestic currency and issuing a larger denomination note, should be considered, but cautioned that forceful and abrupt administrative de-dollarization measures or political uncertainty could immediately translate into capital flight.

Directors highlighted the key importance of further strengthening financial supervision. They welcomed the progress made in this area and looked forward to early passage of laws to facilitate sound intermediation of banks, reduce payment system risks, and ensure a legal basis for collateral-based lending, among other initiatives. Directors welcomed progress made in the preparation of a new comprehensive anti-money laundering law and looked forward to its adoption.

Directors encouraged the authorities to continue to pursue prudent debt management policies in order to ensure fiscal sustainability. They welcomed continued dialogue with the United States and the Russian Federation to seek ways to complete debt rescheduling negotiations, and looked forward to their early completion. The importance of resolving these negotiations satisfactorily to ensuring continued access to Fund financing was noted.

Directors welcomed the opportunity to review Cambodia's performance under Fund arrangements since the early 1990s, and agreed that Fund involvement has been effective in maintaining macroeconomic stability. They noted, however, that despite important progress achieved in many areas, poverty remains pervasive and governance what does this mean?

problems widespread. Looking ahead, Directors considered that a new arrangement with the Fund would help strengthen Cambodia's official international reserve position, contain possible adverse effects from the forthcoming elimination of the garment quota, underpin a framework for donor coordination, and encourage domestic reform efforts. Directors stressed that sound policies by the authorities would also be needed to catalyze international support for Cambodia's poverty reduction strategy.

In view of substantial weaknesses in Cambodia's statistical framework, Directors welcomed the work to upgrade it, and saw, in the coming years, a need to rely more on domestic resources and training to strengthen technical capacities. They observed that if donor financing is lacking, this may require a shift of resources within the current budget.

a gentle warning that donor $ won't last forever?