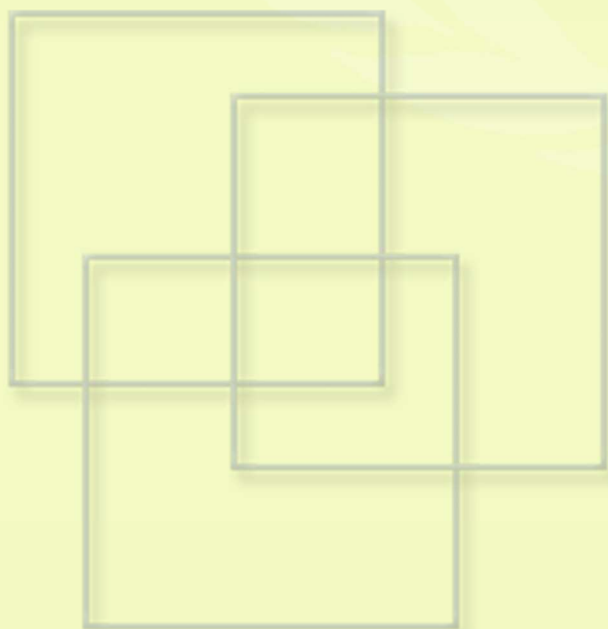


ILO Asia-Pacific Working Paper Series

Cambodia: Designing macroeconomic policies for an employment-friendly growth strategy

Muhammed Muqtada and Luyna Ung
October 2013



Country Office for Thailand, Cambodia
and Lao People's Democratic Republic

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Preface

“To address the labour market challenges, the Royal Government will further deepen reforms of policy, and regulatory and institutional frameworks to ensure that all the components of the labour market are collectively consistent, responsive and reinforcing each other [...] to boost economic growth, create jobs and promote livelihoods.”

Rectangular Strategy Phase III (2013-2018), Royal Government of Cambodia, paragraph 107

The International Labour Organization’s tripartite constituents in Asia and the Pacific - governments, employers’ and workers’ organizations - have committed themselves to an “Asia-Pacific Decent Work Decade 2006-2015”. In doing so they reaffirmed their commitment to achieving full, productive and decent employment for their people. The commitment shown by the Royal Government of Cambodia in developing a national employment policy with a focus on young women and men forms part of the policy efforts toward attaining the goals of Cambodia to consolidate its future development path, as well as those of Asia-Pacific Decent Work Decade 2006-2015.

Cambodia has grown at a remarkable average annual rate of over nine per cent during the decade prior to the onset of global financial crisis in 2008. Since then, the economy has recovered well, albeit more modestly than in the pre-crisis period, with the economy growing at little less than seven per cent on average between 2010 and 2012. While a decade of rapid growth has notably improved the livelihoods of the Cambodian people, with the headcount poverty rate falling from 39 per cent in 1994 to 30 per cent in 2007, poverty remained pervasive in the rural areas at 35 per cent in 2007. At the same time, employment has grown at 4 per cent per year between 1998 and 2008, but much of this growth has been in the rural areas and in the informal segments of the economy. Furthermore, productivity, as measured by output per worker, has been one of the lowest in the region and grew only modestly in the late 2000s. In 2010, output per worker in Cambodia was less than 4,000 in constant purchasing power parity dollars; this was two-third that of Viet Nam and less than one-fifth of Malaysia’s. As Cambodia grows into a middle income country, as envisaged by statements made in relation to Cambodia’s Vision 2030, there is a recognized need to diversify its economic base and to undertake higher value-added activities. Attaining such aspiration requires strategic policy approach, including an employment policy, to enhance productivity of and returns to work in the existing economic activities and to adequately skill and mobilize workers, particularly those currently engaged in vulnerable forms of employment, toward emerging sectors. This would ensure that the growth process is more equitable, generated through broad-based participation and empowerment of the Cambodian people.

To support the Government in developing an employment policy, the ILO has responded by providing policy advice. This first led to a generation of background analyses in areas that are pertinent to employment outcomes and employment policymaking. The ILO has also supported consultation meetings on the background analyses and their policy recommendations in 2012 and 2013, with active participation of the national stakeholders.

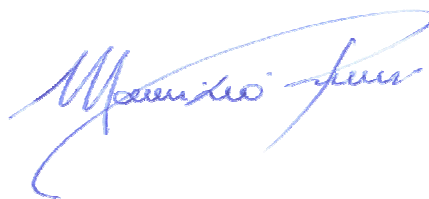
In this regard, we are grateful to the financial support provided by the Sweden-ILO Partnership (2009-2013) that has been contributing to the attainment of ILO’s outcome: *More women and men have access to productive employment, decent work and income opportunities*. It is also closely related to the work envisaged by the ILO on the areas of critical importance included in the programme and budget for the next biennium (2014-2015), namely *promoting more and better jobs for inclusive*

growth and *jobs and skills for youth*. In conducting this background research, we are also grateful to the strong commitment and support provided by the Employment Policy Department, ILO Geneva.

This paper authored by Muhammed Muqtada and Luyna Ung represents one of the background analyses. It argues for a proactive stance on macroeconomic policymaking, if Cambodia wishes to grow in a sustained and diversified manner toward full and productive employment for all. It notes that the current policy space is restricted, partly due to the additional conditionality that the de facto dollarization of the economy imposes. The paper suggests a possible nexus of mutually reinforcing macroeconomic and structural reforms, through examples of policy actions that could be taken in the spheres of monetary, fiscal, and exchange-rate policies.

The new Rectangular Strategy Phase III (2013-2018) has been presented by the government as the policy framework for the Fifth Legislature. By maintaining the central themes of growth, employment, equity, and efficiency, the strategy shows a strong commitment by the Royal Government of Cambodia to promote employment as central part of their medium-term development strategy and institute a policy framework such that productive employment generation and economic development occur in tandem.

This paper is part of the ILO Asia-Pacific Working Paper Series, which is intended to enhance the body of knowledge, stimulate discussion and encourage knowledge sharing and further research for the promotion of decent work in Asia and the Pacific.



Maurizio Bussi
Officer-in-Charge
Country Office for Thailand, Cambodia and
Lao People's Democratic Republic

Table of contents

	Page
Preface	i
Acknowledgements.....	v
Abstract.....	vii
Abbreviations	ix
1. The context: Objectives of a macroeconomic policy	1
2. The employment context in Cambodia's macroeconomic framework.....	3
2.1 Cambodia: Poverty, employment, and labour markets	3
2.2 Employment strategy and macroeconomic policy: The challenges.....	5
3. Cambodia's macroeconomic policy framework: A brief narrative	7
3.1 Macroeconomic reforms: The uni-dimensional objective	7
3.2 Stability in a 'dollarized' regime: An additional conditionality?	9
3.3 Macroeconomic planning: An afterword	13
4. Macroeconomic strategy: Threats and challenges.....	14
5. Macroeconomic policy options for increasing growth and employment.....	19
5.1 Towards a nexus of macroeconomic and structural reforms.....	19
5.2 Monetary policy options	22
5.3 Fiscal policy	28
5.4 Exchange-rate policy and trade liberalization	33
6. Concluding remarks	35
References	37

List of figures

1. Percentages of the rural and urban populations below the national poverty line.....	3
2. Labour productivity in Cambodia and selected countries	6
3. Macroeconomic stability in Cambodia: Long-term trends	8
4. Foreign currency deposits, by residents	10
5. Investment trends in ASEAN countries	15
6. Trends in foreign direct investment in Cambodia.....	16
7. Manufacturing value-added: Shares of sub-sectors	17
8. Public spending: Share of foreign resources	18
9. Growth of aggregate demand in Cambodia.....	20
10. GDP growth and inflation	22
11. ASEAN: The inflation-GDP growth relationship	23
12. Riel and US dollar lending rates (six-monthly maturity, weighted average).....	25
13. Growth in microcredit lending in Cambodia, in foreign currency	26
14. Long-term debt-to-GDP ratio in Cambodia.....	29
15. Trends in public revenue and expenditure (percentage of GDP).....	30
16. Generating fiscal space through fiscal space	32

17. Exchange rate: Riels per US dollar, 2000-2011.....	33
18. Cambodia's relative competitiveness in ASEAN	34

List of tables

1. Proportion of the working poor	4
2. Cambodia's development phases and selected macroeconomic indicators.....	9
3. Deposits in deposit money banks, riels versus foreign currency (in KHR billion).....	10
4. Structure of investment in Cambodia (per cent of GDP)	16
5. Extent of dollarization in the Cambodian economy.....	27
6. Allocations of public spending (per cent)	31
7. Estimated average firm performance in the Cambodian garment industry	34

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Abstract

Over the past 15 years, Cambodia has made significant progress in terms of economic growth, job creation and poverty alleviation. Nevertheless the incidence of poverty, and its regional variations, is still relatively high; since most jobs created are in the informal economy, and offer low incomes, the bulk of the population remains vulnerable. Furthermore, given that there has been inadequate structural change in the economy (e.g. changes in sectoral shares of employment), and that the Cambodian Government is committed to attaining the Millennium Development Goals (MDGs), this paper argues there is a strong need to adopt an employment-friendly development strategy. In this context the paper explores the specific role and design of macroeconomic policies in supporting such a structural transformation of the economy and in generating productive employment.

Since the late 1990s, Cambodia – largely following the stabilization tenets of the so-called “Washington Consensus” – registered remarkable macroeconomic stability both in terms of prices as well as debts and deficits (except during the period of global financial crisis from 2007 to 2008). However, with the huge influx of US\$ – introduced via the United Nations Transition Authority in Cambodia (UNTAC) operations – overwhelming the unstable riel, the economy gradually became “dollarized”; the dollar has now become pervasive in circulation and deposits. The paper argues that such dollarization, which has been favourable in sustaining growth so far, has rendered the macroeconomic policy framework rather reactive, and the use of traditional policy instruments restrictive. Price stability remains a conditionality of dollarization, and the authorities are unable to use such policy instruments as policy rates to control prices. Strict fiscal and exchange-rate regimes are in place to support inflation targeting. Thus, the policy space is rather restricted for the economy to move towards higher and sustained growth, which is likely to require more investment and infrastructure development.

While acknowledging the Government stance that sudden de-dollarization would be disruptive, and that this is a long-term goal, this paper observes that the current wait-and-see efforts are rather ineffective and ambivalent. In order to enhance investment for higher growth and employment, domestic savings and investment need to be encouraged, which in turn will require major public and private investments in infrastructure, skills and vocational training, and other structural reforms. Also needed is income and social protection to sustain aggregate demand.

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The responsibility for opinions expressed in articles, studies and other contributions rests solely with their authors, and publication does not constitute an endorsement by the International Labour Office of the opinions expressed in them, or of any products, processes or geographical designations mentioned.

Despite the good growth of the economy, Cambodia's policy space is restricted (fiscal deficits, as well as development expenditures, still continue to be mitigated by external assistance), and is unable to introduce any expansion that the above would warrant. In this context, the paper suggests a possible nexus of mutually reinforcing macroeconomic and structural reforms. It provides examples and options in the spheres of monetary, fiscal, and exchange-rate policies that would likely strengthen the use of macroeconomic policy instruments, and at the same time allow the space for structural reforms to take place. One such example is the use of fiscal space to create further fiscal space through undertaking targeted demand management – for example, greater allocation to sectors (rural in particular) that would play a critical role in the future restructuring process, as well as in integrated social protection and employment interventions such as vocational skills and training. The above nexus is suggestive in nature, and policies and reforms need to be carefully articulated within the broader framework of Cambodia's longer-term goals of sustainable growth, full employment, and poverty alleviation.

Abbreviations

ADB	Asian Development Bank
ALMP	active labour market policy
ASEAN	Association of Southeast Asian Nations
CARD	Council for Agricultural and Rural Development
CDC	Council for the Development of Cambodia
CPI	consumer price index
CSX	Cambodia Securities Exchange
FCD	foreign currency deposit
FDI	foreign direct investment
GDP	gross domestic product
ICOR	incremental capital-output ratio
ILO	International Labour Organization
IMF	International Monetary Fund
KHR	Cambodian riel
LDC	least developed country
M2	money supply M2
MDG	Millennium Development Goal
MEF	Ministry of Economy and Finance
MFI	Micro-finance institution
MOC	Ministry of Commerce
MOLVT	Ministry of Labour and Vocational Training
MSA	Ministry of Social Affairs
NBC	National Bank of Cambodia
NCD	Negotiable certificate of deposit
NEP	National Employment Policy
NIS	National Institute of Statistics
NSPS	National Social Protection Strategy
ODA	overseas development assistance
PFM	public financial management (programme)
PPP	public private partnership
REER	real effective exchange rate
RMG	ready-made garments
SNEC	Supreme National Economic Council
SOE	state-owned enterprise

UNDP United Nations Development Programme
UNTAC United Nations Transition Authority in Cambodia

1. The context: Objectives of a macroeconomic policy

The search for the context of an employment-focused macroeconomic strategy almost begs the question what precisely are the objectives in the design of macroeconomic policy-making in an economy. For policy-makers there is never a simple answer, i.e. one that will have full consensus. Although economic outcomes have been strongly influenced by individual countries' macroeconomic regimes, the experiences have been far too varied and complex to conclude any linear correspondence between the policies pursued and the desired objectives. In particular, adopted policies can lead to trade-offs between objectives. As a result, there continues to be intense debates, both among academics and practitioners, on the role and objectives of macroeconomic policies.

It is beyond the remit of the present study to go into the details of the debates, on which there is a vast literature, analytical as well as empirical.¹ For the present purpose, it may be sufficient to note that some of these debates are often ideologically charged, essentially concentrating on whether macroeconomic policies ought to remain confined to the supply-side considerations, or whether these should also influence demand-management in the economy. In practice, the relative weight of the policies that these ideological positions entail have political overtones and define political agendas, such as the relative roles of governments and the principles of the free-market economy.²

Although the practices of macroeconomics in modern times recognize and engage both the government and private sector, there are still conflicts in articulating the dominant policy instruments in macroeconomic management, both in developed and developing economies. It may be recalled that the advanced economies, in the aftermath of the Second World War, pledging to build full-employment societies, sought to adopt stability and employment as their macroeconomic objectives. They sought to sustain not only price stability but also to smooth economic fluctuations through demand-management policies. This policy stance supported the high-growth and near full-employment scenarios of the 1950s and 1960s, until the two oil-price shocks of the 1970s, which precipitated a period of high inflation and subsequently a global recession.

Amid the economic and political imperatives of the period that followed, inflation-control became the overriding objective to induce stability and growth, thus relegating the importance of employment as a central objective, and the associated demand-side policies such as the size of public investment and expenditures. The subsequent period – often dubbed the period of stabilization and structural adjustments, which started in the industrialized countries – influenced the developing countries almost immediately. The various measures, encapsulated in the Washington Consensus, came to define, often under the influence of conditional lending from the Bretton Woods institutions, the macroeconomic agenda of developing countries. The overwhelming focus of these measures was on urging governments to adhere to strict targets on inflation and fiscal debts and deficits. The 1980s and 1990s saw the developing countries, almost across the board, embrace these measures like a one-size-fits-all mantra. The tough reform measures had a tangible effect in controlling inflation and deficits, but also

¹ See, for example, Fischer (1993) and Tobin (1996) for contrasting views of the role and objectives of macroeconomic policies. Also see Williamson (1997), Blanchard et al. (2012).

² See Stiglitz (2010) and Krugman (2009), on the one hand, and Mauro ed. (2011) on the other, for a discussion, from different standpoints, of the themes in current times.

came to be associated with a significant slowdown of output growth.³ More significantly, the incidence of poverty and unemployment and underemployment remained persistently high.

The varied national experiences with stabilization and structural adjustment programmes have brought into focus an empirical dimension to the debate, and the need for greater nuances (instead of one-size-fits-all measures) and pragmatism in policy-making. In fact, even the Bretton Woods institutions that have heralded the stabilization reforms and monitored their implementation, have, through their extensive research and evaluations, acknowledged the need for greater flexibility and prudence in the design of macroeconomic policies, although this has not yet been adequately reflected in their lending programmes at the country level.⁴ Many countries have reverted to medium- and long-term planning in order to seek stability through a flexible policy space that also supports the development objectives of higher growth, job creation, and poverty reduction.⁵ Nevertheless, countries that depend on international loans for financing development, in particular from the Bretton Woods institutions, have to still contend with conservative policy conditionalities, the centre-piece of which is inflation targeting.⁶

Cambodia, like many other developing countries, has been pursuing an orthodox version of macroeconomic planning since the reconstruction phase of the country started in 1999.⁷ However, unlike many countries, stabilization reforms in Cambodia have not only yielded price stability but also fairly good growth of output since 1999, except for the slowdown from 2008 to 2009. The context of an employment-focused macroeconomic strategy in Cambodia will depend on how critical the employment question is, and how far past growth has been able to generate productive jobs and reduce poverty. Further, can Cambodia continue to depend on stability alone for sustained and accelerated growth in the future?

This paper will, in the sections to follow, examine the evolution and particular characteristics of the Cambodian macroeconomic framework, and assess the challenges and threats to this framework for higher growth, structural change, and employment generation. Section 2 provides a brief situation analysis of poverty, employment, and labour market characteristics in the economy, and some example of the broad magnitude of the employment challenge. Section 3 traces the evolution of the macroeconomic framework focused solely on inflation targeting. The section contends that the embrace of dollarization has not only placed an additional conditionality in maintaining price stability, but restrains the use of conventional instruments to deal with inflation. Section 4, given the dollarized nature of macroeconomic policy-making, examines the various threats and challenges to the framework in the planning towards structural transformation and higher growth rates. Section 5 provides the context of a proactive macroeconomic policy that will be needed to strengthen the drivers of growth and employment generation. Given the restricted space in a dollarized policy milieu, this study argues for the need to develop an appropriate nexus of mutually reinforcing macroeconomic and structural reforms. Samples of such policy options are explored in the monetary, fiscal, and exchange-rate policies, especially in support of critical interventions in employment, skills, and social protection programmes. Section 6 contains some concluding observations.

³ See Easterly (2001) for a detailed account on how policy reforms failed to resume growth across the developing world, especially in Africa; he calls the period one of the “lost decades”. Also see Muqtada (2010).

⁴ See, for instance, Blanchard et al. (2012), World Bank (2006).

⁵ Long-term perspective plans such as *Liberia rising 2030*, *Botswana 2016*, and *Nigeria vision 2020* are cases in point.

⁶ See, for instance, the detailed account of IMF’s Article IV Consultations in 50 countries, in Islam (2012).

⁷ As Naron (2009) states: “The economic reform undertaken ... during 1999–2003, in particular the consolidation of market reforms, reflected the economic orthodoxy of the “Washington Consensus ...”, p.54.

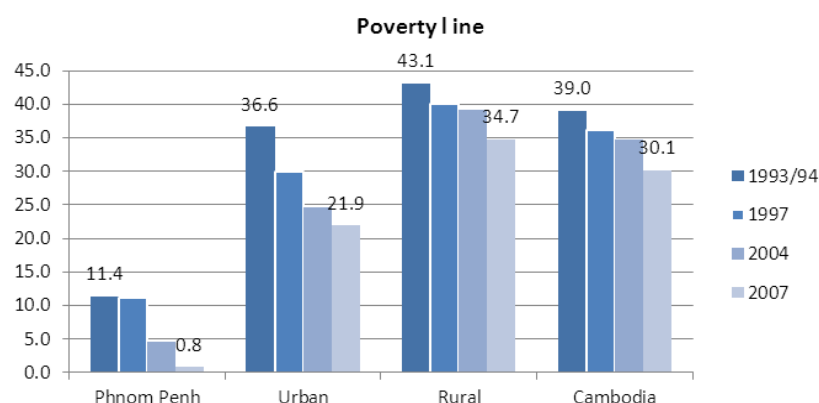
2. The employment context in Cambodia's macroeconomic framework

2.1 Cambodia: Poverty, employment, and labour markets

In order to appreciate the need for incorporating employment as an objective in the macroeconomic policy of Cambodia, it is necessary to assess how urgent the employment question is in the economy.

Cambodia's robust growth over much of the past decade has helped reduce poverty in the country as a whole. By the World Bank's criterion of US\$1.25 a day, headcount poverty declined on average from 48 per cent in 1994 to about 26 per cent in 2007.⁸ Thus, Cambodia appears poised to meet the poverty related goal of the MDGs, to which the country is fully committed. According to the national poverty line, the incidence was higher – at 30 per cent – in 2007. According to the Royal Government of Cambodia (RGC), this latter figure further declined to 25 per cent in 2010.⁹ It must be noted, however, that the aggregate incidence hides the wide variations in poverty among the various regions and among occupational groups.¹⁰ Given the estimates of "poverty gaps", as in the International Labour Organization (ILO) (2012), there appears to be a high degree of vulnerability. For instance, if poverty was estimated by the US\$2 per day criterion, poverty in Cambodia would rise to nearly 58 per cent. In the rural-urban divide, as figure 1 shows, poverty in Cambodia is concentrated much more in rural areas. This is largely due to the fact that the bulk of the low-income groups, such as self-employed farmers and unpaid family workers, are concentrated in the rural areas. In short, poverty in Cambodia has indeed declined, and can be associated with the near double-digit growth rates, but there are large proportions of people in specific segments who are vulnerable. In fact, according to the ILO definition of vulnerable population, which consists of own-account and unpaid family workers, nearly 82 per cent were in this category in 2008.

Figure 1: Percentages of rural and urban population below the national poverty line



Source: NIS (2010).

⁸ See ILO (2012) for further details of poverty estimates and their variations across regions and economic activity groups.

⁹ Cf Chandararat and Dannet (2011), Table 2.

¹⁰ ILO (2012), *op. cit.*

The reason for such high vulnerability is often found in the occupation and earning patterns of the workforce. Apart from the fact that the poverty incidence, by the national poverty line, declined by only 11 percentage points between 1997 and 2010,¹¹ (less than one percentage point a year despite high growth), the relatively modest poverty elasticity of growth would perhaps be explained by the extent and nature of job creation in the economy. In other words, since other avenues of income (such as remittances or public transfer schemes) are not so significant, employment-based earnings and incomes would tend to define movements in the poverty incidence.

As one observes from the ILO–National Institute of Statistics (NIS) detailed study on *Labour and social trends in Cambodia 2010*, there was reasonably high employment growth of nearly 3.7 per cent between 1998 and 2008, which was higher than the labour-force growth rate of 3.3 per cent.¹² However, despite a spurt in formal-sector jobs, much of this growth has been in rural areas and in informal occupations. In the latter, incomes, especially in farm-related occupations, have risen, but owing to significant seasonality, average annual incomes are relatively low, and the workforce remains vulnerable.¹³ While open unemployment, according to official estimates, declined to 1.6 per cent in 2008, from 5.3 per cent in 1998, the percentage of informal employment is estimated at around 72 per cent. Similarly, the phenomenon of high-employment and low-income growth can also be observed from various other characteristics of the labour market. One such characteristic is the incidence of the working poor, meaning those in the workforce who work normal hours in a day but are unable to earn an income above the poverty threshold. Table 1 shows that although the incidence of the working poor has declined over the years, there were still approximately 1.9 million employed people who did not earn enough to cross the poverty line in 2010.¹⁴

Table 1: Proportion of the working poor

	2005	2008	2010
Employed persons (million)	6.9	7.3	7.6
Working poor persons (million)	2.4	2.2	1.9
Percentage of employed people living below the poverty line	34.7	30.1	25.0

Source: Chandararot and Liv (2011), p.23.

The employment question in Cambodia is hence not simply an issue of monitoring employment growth. It is important to assess the quality of job creation, especially with regard to how productive and remunerative the jobs are. It is equally important to recognise that while the quantity matters in an employment-generating strategy, there must be a close understanding of the specific characteristics and functioning of the labour markets, and how job generation is affecting the various groups in the workforce.

A detailed characterization of the labour markets is beyond the scope of this study. ILO (2012) provides details of a comprehensive National Employment Policy (NEP) for Cambodia, which the country will have to pursue to realize a sustained reduction in poverty. Since the unemployment rate is only 1.6 per cent or less, the NEP will need to articulate policies and programmes that address the specifics of the labour market – for instance with respect to rural labour markets, and youth and gender participation in various sectors. It must be noted that there is also widespread reporting of

¹¹ Chandararot and Dannet (2011), *op cit*.

¹² For details, see ILO-NIS (2010), pp.16–20.

¹³ For an interesting account of the seasonality factor in agriculture, and its implications for rural employment and incomes, see Chandararot and Dannet (2012).

¹⁴ Also see Chandararot and Dannet (2011).

labour shortages in some sectors. For instance, there appears to be a labour shortage in agriculture, especially during peak farming seasons, which is reversed during the seasonal troughs.¹⁵ This seems to suggest that in Cambodia's agricultural sector there is a lack of "transferable" workers coexisting with surplus labour.¹⁶ Similarly, the ready-made garments (RMG) sector that has been responsible for generating the bulk of formal-sector jobs in Cambodia has been growing fast, and is currently reporting a shortage of labour and appropriate skills.¹⁷ Thus, the NEP will have to address market-specific labour requirements, as well as ensure the workforce is upgraded with skills appropriate to those needs.

2.2 Employment strategy and macroeconomic policy: The challenges

Given the above observations, it is apparent that the NEP needs to address not only the growth of productive and remunerative jobs, but also the demands of job creation associated with the patterns of growth, and the dynamics of the labour market. In order to size up the challenges, far more detailed statistics are necessary than currently exist. For instance, in the absence of time series data on employment growth, by sectors, it is difficult to establish detailed employment elasticities, and assess the employment content of sectoral growth, and their specific contributions.

For the purposes of the present study, some descriptive statistics, and assumptions, are taken to portray the broad order of the employment requirements of the economy. Thus, with respect to the employment requirements (E_r), the planning framework could set targets of productive job creation that would potentially absorb the unemployed (U), the net additions to the labour force (ΔLF), and reduce by, say half, the number of the working poor (WP). The latter is used as a proxy indicator of underemployment. We estimate the employment challenge for a five-year period. Thus, this would imply E_r as:¹⁸

$$E_r = U + \Delta LF + 1/2 WP = 1.81 \text{ million}$$

This is an illustrative figure rather than a precise employment target, to demonstrate that the actual productive job requirements are far greater than suggested by the unemployment rates, or the net additions to the labour force. If we took a retroactive example, 2007–2012, and the 1998–2008 employment and gross domestic product (GDP) growth rates (which give an average employment elasticity of 0.36),¹⁹ it would have required the economy to grow at more than 10 per cent to produce adequate jobs to absorb the 1.8 million productively. The average growth rate of less than 6 per cent over the past five years would thus have been inadequate. A higher growth rate of 10 per cent would, in turn, require a higher investment rate than currently obtained in the economy – that too, assuming that the incremental capital-output ratio remains the same.

As stated earlier, an employment strategy is not only about seeking higher growth for higher employment. It also seeks to promote patterns of growth that enhance employment-intensity of growth as well as improve productivity. Labour productivity, which is a crucial factor in growth and competitiveness,²⁰ is relatively low compared with neighbouring Member countries of the Association

¹⁵ An interesting presentation of the labour shortage case is given in Chandararot and Darnet (2012).

¹⁶ For implications of the distinction between surplus workers and surplus labour, see Amartya Sen (1973).

¹⁷ See D'Amico (2012) on the nature of labour and skills shortages, as well as skills mismatches in the Cambodian economy.

¹⁸ U at 1.6 per cent = 114,000, assumed constant over the five-year period, (ILO-NIS, 2010); ΔLF = 900,000 (based on ILO-NIS projections of 1 million additional LF over six years; Table 2.2); and $+1/2 WP$ = $1/2$ (1.8 million), as given in Chandararot and Darnet (2011).

¹⁹ Cf. ILO-NIS (2010), *op cit*.

²⁰ For details of Cambodia's competitiveness situation in various sectors, see UNDP (2009).

of Southeast Asian Nations (ASEAN), as shown in figure 2. The United Nations Development Programme (UNDP) (2009), ILO (2012), and Chandararot et al. (2012) have all emphasized the need to improve labour productivity, in particular in agriculture and in rural areas.

Figure 2: Labour productivity in Cambodia and selected countries



Source: World Development Indicators, online data, World Bank.

Improvements in agriculture and rural development would not only contribute to overall growth of GDP and employment, but also support aggregate demand through increased investments and purchasing power. This would imply the need for a significant move towards diversification and structural change, which would require an appropriate incentives structure, as well as major interventions in the development of physical and social infrastructures. In Cambodia, the latter is a critical constraint, since increasing the demand for labour will have to be matched by the challenge of skills shortages, and the employability of the workforce.

An employment strategy, as argued in ILO (2012), would thus require an integrated development policy framework and articulation of multi-dimensional policies, including macroeconomic, sectoral, and institutional. An important consideration will be to minimize the potential trade-off that may exist in the design and implementation of these policies, especially in defining budgetary allocations. The role and responsibility of the macroeconomic framework would hence need to be seen in line with the above considerations and the employment and poverty alleviation priorities set by the development plans and the Rectangular Strategy.

In fact, the macroeconomic framework assumes paramount importance since it needs to engage directly in measures to encourage higher investment (especially domestic); to seek sources of financing (especially domestic savings); to create an incentive structure via its monetary and fiscal policies; to allocate resources towards priority sectors; to create a fiscal space to boost infrastructure; to support active labour-market policies; and to provide social safety nets. Some of the above measures would require a focus on demand-management.

The following sections provide an elaboration of the current macroeconomic framework in Cambodia, and the challenges it is likely to face should the development agenda require a proactive stance on higher and sustained growth, structural transformation and productive employment for all.

3. Cambodia's macroeconomic policy framework: A brief narrative

3.1 Macroeconomic reforms: The uni-dimensional objective

It is widely acknowledged that the formation of Cambodia's macroeconomic policy framework is intricately linked to the country's political and economic history over the past four tumultuous decades.²¹ In an almost literal sense, the framework evolved from a near-barter economy during the Khmer Rouge regime between 1975 and 1979, to a fully functioning macroeconomic system. This not only involved a continuous programme of policy reforms, but also the development of financial institutions as well as the legal and regulatory frameworks that had to be rebuilt after their destruction during the 1970s.²² Thus, it is important to bear in mind that the current macroeconomic policy framework has evolved within a rather short time frame and from a rather chaotic political and economic system during the 1970s and 1980s. Naron (2009) aptly provides a historical account of the macroeconomic policy developments and various structural adjustments in terms of three distinct phases of Cambodia's economic development, namely the rehabilitation phase (1989–1998), the reconstruction phase (1999–2003), and the more recent “take-off” phase, since 2004.

The initial development objectives of Cambodia's rehabilitation phase centred around dismantling the socialist system, and restoring a market economy by following what has been dubbed the “first generation of reforms”. Aside from a range of structural adjustment measures such as restoring private property rights and denationalization, this was closely associated with a spurt of economic liberalization reforms. The liberalization reforms had some intended and unintended consequences for macroeconomic performance. A critical example was the rapidly increasing fiscal deficit, largely due to loss of revenues because of the processes of denationalization and de-control of prices. In other words, privatization efforts initially did not yield the revenues that used to come from the state-owned enterprises (SOEs). Similarly, de-control of prices ushered in an initial period of higher costs for goods and services. With a growing fiscal deficit, in an incipient market economy, further coinciding with the collapse of the commodity agreement with the Soviet Union, the Government was obliged to undertake monetary financing of the growing deficit.²³ The fiscal deficit rose from 100 billion riels (KHR) in 1991 to more than KHR650 billion in 1995. The money supply (M2) rose concomitantly.²⁴ This was the proximate factor that led to runaway inflation in the economy, with the consumer price index (CPI) rising to 121 per cent during the period. Reining in inflation thus became the overriding objective of the macroeconomic decision-making in the early 1990s.

During the reconstruction phase (1999–2003) and beyond, macroeconomic reforms closely followed the need to consolidate the market economy reforms, and conformed to the economic orthodoxy of the Washington Consensus.²⁵ The overwhelming focus of such reforms was on maintaining price stability.²⁶ Such a stance naturally warranted that various other stability variables, such as fiscal and

²¹ For a detailed account of some of the historical antecedents, see UNDP (2004), Naron (2009), Zamaroczy and Sa (2002), and Im and Dabadie (2007).

²² For some details see Im and Dabadie (2007) *ibid*.

²³ See UNDP (2004).

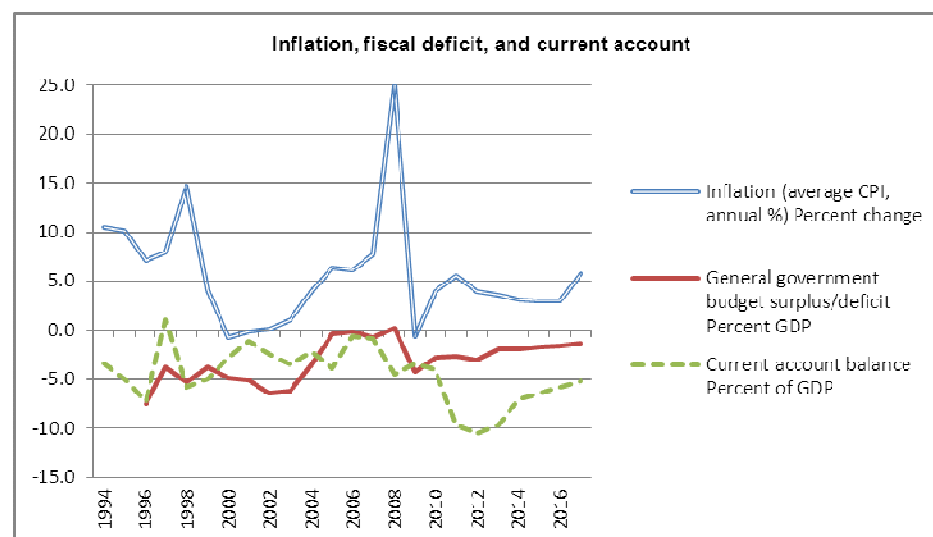
²⁴ See Im and Dabadie (2007), Chart 4.

²⁵ See Naron (2009), p. 254.

²⁶ “NBC targets inflation at less than 5 per cent in the near term, and at about 3.5 per cent over the medium term”, *cf. ibid.* p. 93.

current account balances, needed to be consistent with the price stability objective. The policy efforts at maintaining stability have been credited for the subsequent phase of GDP growth rates, which were commendable during both the reconstruction and take-off phases. Figure 3 shows the basic trends in the conventional indicators of macroeconomic stability since the mid-1990s.²⁷

Figure 3: Macroeconomic stability in Cambodia: Long-term trends



Source: IMF: *World economic outlook* (April 2012).

Barring the phase of excessive growth of liquidity during the 1990s that led to high inflation, prices remained mostly stable during the reconstruction phase. Inflation shot up again between 2007 and 2009 largely due to rising oil and food prices in the international market, and subsequently due to the global financial and economic crisis. The sharp adverse impact of the latter on output and incomes among vulnerable groups necessitated a substantial fiscal stimulus programme, which brought increased prices in the economy.²⁸ However, with a fairly rapid growth recovery, Cambodia managed to bring down the inflation rate to the desired target of less than 5 per cent. An important point to note in this context is that while price stability in most countries is usually influenced through variations in the policy rate – the rates of interest and associated monetary instruments – Cambodia, while pursuing the *orthodox goal* of inflation-targeting, has not necessarily applied the *orthodox instruments* of monetary policy (for reasons that will be explained later).

Macroeconomic stability, though often equated with price stability, also needs to be secured from fiscal and current account balances, and the economy's overall debt-to-GDP ratio. Figure 3 also traces the trends in budget and current account deficits of the Cambodian economy. Table 2 provides a further breakdown of the performance of various macroeconomic indicators, disaggregated by the phases of development mentioned earlier.

²⁷ Also see IMF (2012a), which carries projections until 2017.

²⁸ For a detailed account of the impact of the global financial crisis on Cambodia's economy and vulnerable groups, see Kang et al. (2009), and Jalilian and Reyes (2010).

Table 2: Cambodia's development phases and selected macroeconomic indicators (%)

Period	Inflation	Exchange rate	Budget deficit	M2 growth	Dollarization (FCD/M2)	Growth	Current account	TFP growth
1993–1998	14.9	10.3	-5.5	30.4	54	6.3	-11.3	0.02
1999–2003	1.0	1.1	-5.3	22.1	67	8.8	-10.3	1.96
2004–2007	6.5	0.1	-3.1	32.5	72	11.1	-8.2	1.71
2008–present	6.5	-0.3	-7.5	20.8	80	5.4	-9.8	-2.80

Source: Ung (2012).

Understandably, and for reasons mentioned above, the rehabilitation phase, which was also essentially a transition towards consolidation of the market economy, witnessed an unstable macroeconomic situation. While the budget deficit on average was sustained at close to 5 per cent, this was achieved largely through monetization of deficits (as seen in the figures on growth of liquidity, M2). It is instructive to observe that, since then, there have been stable rates of inflation and strict budget and exchange-rate discipline. During the first seven years of the past decade, Cambodia's GDP grew at nearly 10 per cent on average. However, this sustained high-growth period placed pressure on the growth of credit for the private sector. This, together with rising fuel prices and the fiscal expansion necessitated by the financial crisis, caused inflation to rise again to more than 25 per cent in 2008. GDP growth fell quite drastically during this crisis period. Since then, macroeconomic stability has been restored and growth has recovered, though not at the peak rates of the past decade.

Thus, in the case of Cambodia, one observes a coincidence in the periods of stability with that of growth. This has led to the orthodox claim that an adherence to strict macroeconomic targets has provided rich growth dividends in the economy.²⁹ There are, however, contrary views, which generally contend that while stability was important, there were various other fortuitous factors, including external conditions, that contributed perceptibly to the remarkable growth period.³⁰

3.2 Stability in a 'dollarized' regime: An additional conditionality?

During the initial phase of rehabilitation – that is, the early 1990s – the arrival of the UNTAC peace force proved to be a crucial turning point in macroeconomic policy-making in Cambodia.³¹ The UNTAC brought in its wake a huge influx of US dollars estimated at nearly US\$1.7 billion. This represented a “new shock against the national currency”, and one that the National Bank of Cambodia (NBC) was ill-equipped to cope with. The riel, which was struggling to gather confidence, gave way to the dollar as the dominant currency. This, together with the subsequent flow of other private transfers via overseas development assistance (ODA) and foreign direct investment (FDI) precipitated the growth and consolidation of the dollar as the dominant currency in circulation. The dollar was soon not only a medium of exchange but also became a unit of account and a store of value.³² Although the riel retains, by law, the status of the legal tender, the economy is de facto dollarized. It must be pointed out that unlike in many economies where dollarization has taken place due to market uncertainties and macroeconomic instability (such as hyper-inflation or chronic balance-of-payment difficulties, as in many Latin American countries) Cambodia's dollarization process appears

²⁹ See, for example, IMF (2012a), World Bank (2011), Naron (2009), and others.

³⁰ See, for example, ILO (2012), UNDP (2004), and Jalilian and Reyes (2010).

³¹ See, for a historical account of dollarization in Cambodia, and its subsequent growth, Im and Dabadie (2007), Zamaroczy and Sa (2002), among others.

³² See UNDP (2004).

circumstantial. That is to say, it was not necessarily the price instability of the early 1990s that invoked a conscious decision to dollarize.³³

Without resorting to various methodologies to estimate the extent of the dollarization in the Cambodian economy, it is perhaps adequate to track the growth of foreign currency deposits to understand the pervasive nature of the dollar's presence in the economy.³⁴ Table 3 shows the most current status of deposits in foreign currency in the deposit money banks (DMBs), which make up around 96 per cent of total deposits with the DMBs.

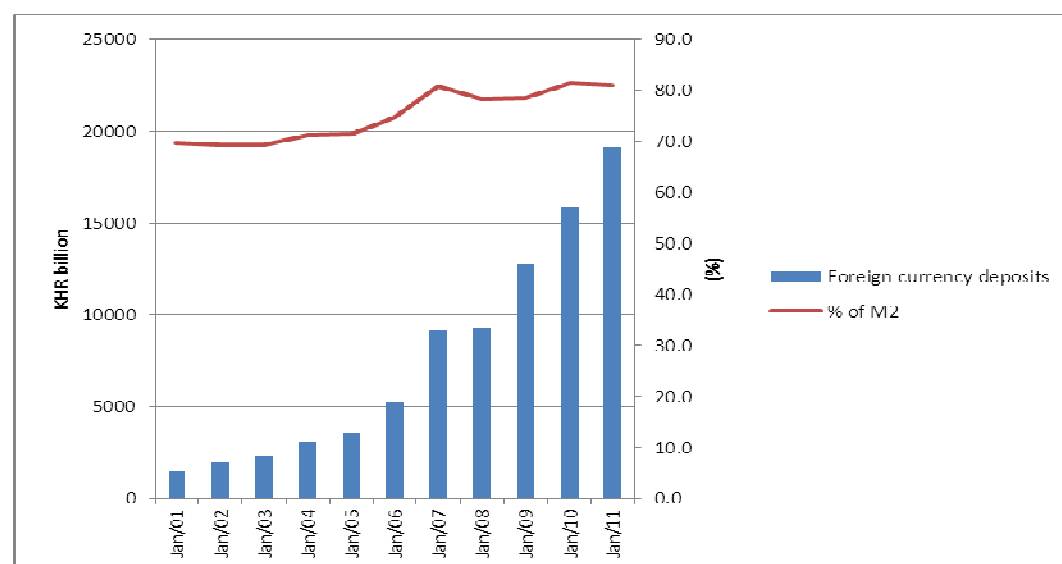
Table 3: Deposits in deposit money banks, riels versus foreign currency (in KHR billion)

Deposits in DMBs	Dec. 2009	Dec. 2011	May 2012
1. Deposits in KHR	475.6	725.1	976.1
2. Deposits in foreign currency	13 366.4	20 880.8	23 465.4
3. Total deposits	13 841.9	21 605.9	24 441.5
4. $(2) \div (3) \times 100$	96.6	96.6	96.0
5. Percentage of private-sector credit (in foreign currency)	96.9	97.5	99.0

Source: NBC: *Economic and monetary statistics* (May 2012).

Furthermore, the percentage of private-sector credit in foreign currency was nearly 99 per cent. The growth of dollar deposits also implied its growing dominance in money in circulation. The growth of foreign currency in absolute and relative terms is shown in figure 4. The extent of foreign deposits as a per cent of liquidity in circulation (M2) was around 81 per cent in mid-2012.

Figure 4: Foreign currency deposits, by residents



Source: NBC: Annual reports (2006-2011).

³³ Zamaroczy and Sa (2002) contend through analytical tests that the dollarization was not necessarily linked to price instability.

³⁴ For a detailed account, see Naron, pp. 55, 96.

It must also be noted that the precise figures on M2 are not available because there is a substantial number of dollar bills in private hands and transactions, which are not intermediated by the commercial banks. Further, private-sector lending, which is overwhelmingly in foreign currency, is largely confined to urban and industrial-sector transactions, and to those who have adequate collateral. In contrast, the riel remains in significant use in the rural areas through informal and non-bank modes of exchange. In general, although there has been a significant increase in the riel's circulation, the share of foreign currency deposits in total money circulation continues to remain dominant.

There is a sizeable amount of literature on the advantages and disadvantages of dollarization, and Cambodia has certainly had its share of the advantages that helped to promote stability and growth, such as through the prevention of capital flight, and through promotion of financial deepening (Naron, 2009). The ratio of M2 to GDP has increased, so has the loan-to-deposit ratio.

In the context of the present study, it is important to assess how dollarization affects macroeconomic decision-making, and the use of the conventional macroeconomic policy instruments in Cambodia. In other words, how does macroeconomic policy planning in Cambodia vary from that in other developing countries which are not dollarized? Further, can such a dollarized framework conduct any policy leverage to ease trade-offs between stability and growth, or, as we have noted previously, can it accommodate employment and, by extension, support the sustenance or expansion in aggregate demand?

As noted above, many countries have embraced dollarization largely in order to tackle extended periods of hyper-inflation, through, among other measures, a pegged exchange rate. In the case of Cambodia, it was less a case of hyper-inflation and more the unprecedented influx of dollars in the early 1990s (and associated adjustments) that initiated the process of dollarization. Nevertheless, the central tenet behind invoking a dollarized regime – the containment of inflation and sustaining price stability – came to be central focus of subsequent macroeconomic policy reforms and the formation of the policy framework. While policy-makers have maintained that macroeconomic reforms that evolved in Cambodia have been inspired by the Washington Consensus,³⁵ there are indeed certain particularities in the economy's approaches to stabilization. Unlike other countries where stabilization reforms (in particular, inflation control) were conditionalities of lending from the Bretton Woods institutions, the objective of price stability in Cambodia was reinforced as an *additional* conditionality from its embrace of dollarization. The latter defines certain restraints on the use of the usual policy instruments.

Let us take the example of monetary policy in achieving and sustaining price stability. Recently, the NBC has been pursuing an inflation target of 5 per cent in the near term, and 3.5 per cent in the medium term.³⁶ While, in principle, it is the declared objective of monetary policy to control inflation, the NBC, due to dollarization, does not quite have full control over the policy instruments.

Fischer (2006), in his essay on dollarization, pointed out that monetary policy can be effective in controlling prices via: (i) the quantity theory mechanism ($MV = PY$) if the monetary authorities have full control on M (i.e. money supply); (ii) the policy rates and how they are determined; and (iii) curbing of “fiscal dominance”.³⁷ As shown in table 3, the extent of foreign currency deposits in the total money supply is so high that the NBC is unable to determine the money supply. Similarly, the

³⁵ See Naron (2007).

³⁶ *Ibid.*

³⁷ Cf. Fischer (2006).

NBC has no influence on the policy rates, which are usually used by central banks to control money supply, prices, and aggregate demand. By the same token, the NBC cannot influence the interest rates used by the commercial banks in their deposits and loans transactions, since the latter are almost wholly conducted in foreign currency,³⁸ an arrangement where the NBC cannot underwrite or guarantee the transactions. The measures adopted by Cambodia to control and maintain inflation targets are through interventions in the foreign exchange market, and aligning the market and official exchange rates.³⁹ Thus, through dollar auctions the NBC smooths foreign-exchange fluctuations to maintain foreign-exchange stability, which, in turn, sustains price stability.

This brings us to the third policy element as mentioned in Fischer (2006): the relative position of the fiscal stance in controlling inflation. In the case of Cambodia, Naron (2009) emphasizes that since the NBC has a limited role in the use of interest rates, regulation of money supply, and the value of money (i.e. the exchange rate), it is the fiscal policy that takes on a significant role in maintaining macroeconomic stability. Fiscal restraint, as a principle, is always a critical consideration in every economy, in maintaining stability. What varies from country to country is the size of the fiscal deficit or the overall debt-to-GDP ratio which the individual economies are able to accommodate. Further, there are the policy choices and policy instruments that can vary in attaining the fiscal balances, and which can have different secondary outcomes. For instance, narrowing the fiscal deficit by raising revenues can have a different impact than doing so by restraining public expenditure. In the case of Cambodia, table 2 and figure 3 show that the budget deficit since the early reconstruction phase was largely restrained, below 5 per cent of GDP, until 2008 when the Government resorted to a fiscal stimulus programme to offset the adverse effects of the global financial crisis.⁴⁰

Barring crises and contingencies, the Cambodian economy has maintained strict fiscal discipline. What is interesting to note is how such fiscal discipline is enforced, and what instruments Cambodia applies to finance its deficits. Dollarization restrains the economy from printing riel, and the Government is restrained from borrowing from the NBC since both of these would lead to exchange-rate fluctuations by affecting demand and supply of the dollar-dominated money market. In fact, in Cambodia, deficit financing through borrowing is restricted by legal statutes. Deficits have so far been largely financed by rationalization of the revenue-expenditure balance sheet (i.e. higher taxes, lower expenditures) and substantial donor support (discussed later in further detail). Thus, one observes, in the case of Cambodia, the amount of “claims on government deposits” is relatively small, and has been nearly constant over the years. During the 2008 global financial crisis, the relatively larger fiscal deficit was partially financed by drawing down on Government deposits with the NBC (domestic public savings).⁴¹ As we shall see later, this can be a rather risky measure.

We observe that Cambodia’s macroeconomic policy framework is not only uni-dimensional in nature, focused overwhelmingly on price stability, but also influenced by conditionalities that are linked to dollarization. Such conditionalities restrain the choice of policy instruments that are usually at play in countries that are non-dollarized. Thus, while Cambodia pursues orthodox stability goals and targets, which are fairly strict, the choice of policy instruments and their “leverage” is fairly restricted.

³⁸ See Table 3.

³⁹ Cambodia currently has a managed floating exchange rate system.

⁴⁰ See Jalilian and Reyes (2010).

⁴¹ Government deposits came down from 8 per cent of GDP in 2008 to 4.5 per cent in 2011, *Cf.* IMF (2012a).

3.3 Macroeconomic planning: An afterword

Cambodia's macroeconomic policy-making, and the various reforms, started in earnest only in the 1990s, when the economy was beginning to emerge from immense uncertainties and to embrace a market-oriented policy framework. Financial institutions were fragile and confidence in the riel was shaky. A combination of factors provided a rationale to adopt orthodox policies, which were entrenched through rapid dollarization. Stability has been maintained, and the past decade and a half has been marked by robust growth. As noted previously, this growth was underscored by various fortuitous factors as well. Nevertheless, the framework has served the economy well. The economy is certainly growing, but so too are the demands of a growing economy. In a subsequent section, this study will examine how far the current framework will stand the test of a growing economy, and equally address various goals; for example, those set by the country's commitment to achieving the MDGs.

In the above context, it will be necessary to explore the real drivers of Cambodia's economic growth, and the extent to which the existing macroeconomic policy framework is enabling the strengthening of those factors. As it currently appears, the economy is relying simply on being a custodian of price stability, and on living within its means (i.e. fiscal discipline), trusting that growth will follow. The growth that is being registered is still hugely dependent on foreign financing of investment and savings, as well as continued assumptions of favourable trade and external conditions. This is tantamount to what one might call a "trickle down" perspective, and a reactive approach to growth. Major interventions to strengthen the drivers of growth would require major expenditures (and hence revenues). The latter can increase through introducing efficiency in the revenue-expenditure plan, which in turn is largely dependent on growth itself. The macroeconomic framework is far from being a proactive agent of growth. The following section examines some challenges and vulnerabilities that may be associated with a reactive macroeconomic framework.

4. Macroeconomic strategy: Threats and challenges

Various analysts have pointed out, from the experiences of countries that have focused on strict target-based stabilization reforms, that there is no automaticity that stability will lead to growth and that growth will yield employment. Even the protagonists of such a strategy, the Bretton Woods institutions, have acknowledged that such economic reforms have not yielded dynamic gains in investment and growth, although stability may have been achieved.⁴² In Cambodia, as noted, one can observe a reasonable association between stability and growth. However, because there have been a host of fortuitous factors, largely external, that played a part in the robust growth of the economy, it would be difficult to assert that stability by itself can continue to sustain, and enhance, the growth and structural transformation that Cambodia requires.⁴³ The latter would require a search for, and an understanding of, the sources and foundations of Cambodia's growth.

While there are genuine prospects of growth in the Cambodian economy, analysts are equally concerned over the current threats to, and vulnerability of, the economy. Many of the concerns come from Cambodia's dependence on external factors for growth, and that the economy will require much stronger domestic foundations of growth. Some of the sources of the economy's vulnerability come from the following:

- 1) Cambodia has been a recipient of generous ODA and concessional loans, which have been critical components of development, especially in the social sectors. In a number of ways, these have also helped bridge the economy's fiscal deficit. Cambodia will have to weather the wide apprehensions regarding the future flow of ODA and loans, and the relative loans-to-grant ratios, especially now that its economy is stable, has registered good growth, and has demonstrated resilience during crisis.
- 2) While good economic growth is likely to reduce expectations that donors will continue to provide current levels of ODA flows, Cambodia will soon be faced with constraints to deficit financing. As mentioned, the fiscal deficits are largely met by donor funds and concessions, and some through increased taxation. A growing economy is most likely to make increasing demand on public interventions (e.g. on infrastructure, and so on); yet, given legal statutes and dollarization, Cambodia lacks a credible path to creating a "fiscal space" (this is elaborated upon in the next section). With the current macroeconomic framework in place, this is likely to posit vulnerability.
- 3) The above scenarios also render Cambodia vulnerable to crises whether internally or externally induced. One may recall the impact of the global financial crisis on the economy, and the vulnerable groups in society. The fiscal stimulus that was implemented, in the absence of an adequate fiscal space, led the Government to draw down on its deposits with the NBC. The International Monetary Fund (IMF) (2011) and the World Bank (2011) have already pointed to the urgent need to rebuild these reserves, which will be critical in coping with any future crisis.

The above threats and vulnerability essentially stem from the restricted choices that are available in the current macroeconomic policy framework. The scope of this framework will need to be sized up in light of the country's planning for consolidation of growth, the anticipated structural transformation of the economy, and provision of jobs for all working-age men and women. Such a stance has also

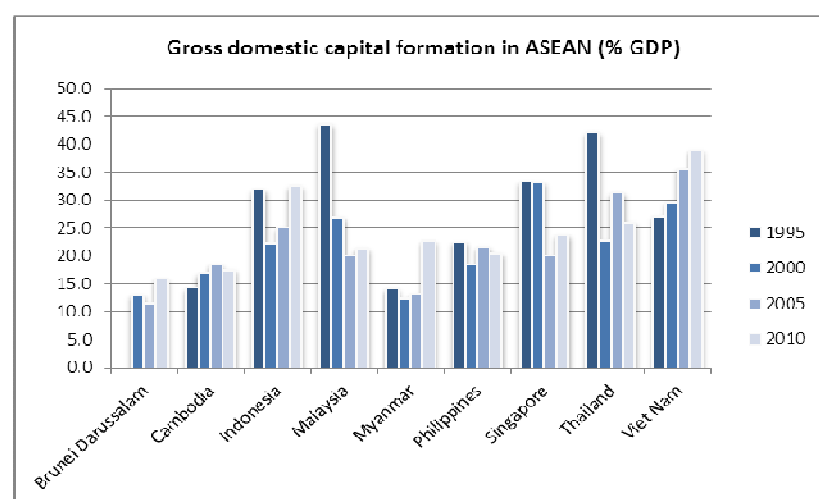
⁴² World Bank (2005) for a candid evaluation of the limited outcomes of the policy reforms during the 1990s.

⁴³ See UNDP (2004), Jalilian and Reyes (2010), *op.cit.*

been underscored by various analysts and agencies. Jalilian and Reyes (2010), ILO (2012), World Bank (2011), IMF (2012), and UNDP (2004) have all stressed the need for such structural change to consolidate further growth and job creation in the Cambodian economy and to foster the Cambodia Vision 2030. This, in turn, will require addressing several challenges, and will warrant an integrated development strategy, and a coherent set of macroeconomic, sectoral, and institutional policies. A few illustrations of these challenges are in order.

First, in order to move towards a sustained growth path, there is a critical need to enhance the levels of investment. The current investment-to-GDP ratio of just over 20 per cent appears inadequate to sustain higher growth. Although IMF (2012a) endorses expectations that potential growth, at current levels of investment, could be sustained at more than 7 per cent, the realities on the ground tend to cast doubts on such an assumption.⁴⁴ The East Asian economies during their high growth period of the 1970s and 1980s, registered investment-to-GDP ratios greater than 30 per cent to 35 per cent. Even in several of the advanced ASEAN economies, domestic capital formation, as a proportion of GDP, is much higher than that in Cambodia, as shown in figure 5.

Figure 5: Investment trends in ASEAN countries



Source: ADB: *Key indicators for Asia and the Pacific*.

With the likelihood that capital will deepen in the future, and potentially cause an increase in the incremental capital-output ratio (ICOR), the investment requirement to maintain, or increase, Cambodia's GDP growth rate of 7 per cent, will be much higher. Much will also depend on the efficiency of investment, and relative productivity. Figure 2 shows that among the selected ASEAN countries, productivity in Cambodia is much lower than say, Thailand or Malaysia. While capital deepening, as occurs in the process of growth, is likely to increase productivity, this will also imply higher ICORs and a higher rate of investment than currently prevails. To move the economy on a higher growth path, to say around 10 per cent – in order to cope with the employment challenges stated previously – there need to be purposive measures to enhance the investment-to-GDP ratio beyond 30 per cent.

IMF (2012a) also makes the case to step up investment in the economy, and points to the various constraints that are impeding private-sector investment.⁴⁵ These, among others, are the lack of

⁴⁴ See IMF (2012a) p.17.

⁴⁵ See IMF (2012a); box on p. 17.

infrastructures, including power paucity, and non-availability of appropriate skills.⁴⁶ These will, in turn, require close review of, and investments in, infrastructure and skills planning for future strategies of industrialization and economic diversification. Hence, the more immediate constraints lie in sourcing investible funds for both economic and social infrastructures.

Second, one of the critical challenges to moving the economy along a higher growth path lies not only with the investment levels, but also with the structure of investment. As table 4 shows, there are several elements in this structure that need a close review, in particular the level and growth of *domestic* private investment.

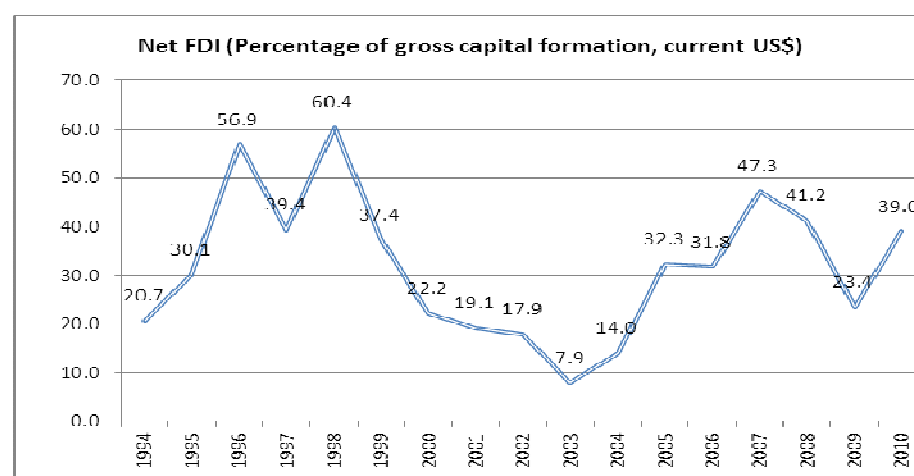
Table 4: Structure of investment in Cambodia (per cent of GDP)

	2006	2007	2008	2009	2010	2011	2012
Total investment	22.7	26.6	24.6	25.7	28.5	26.1	24.3
Public investment	5.9	6.2	6.5	9.1	10.3	9.3	7.6
Domestic financed	0.8	0.7	1.0	1.8	2.5	2.2	2.2
Foreign financed	5.1	5.5	5.5	7.3	7.9	7.2	5.4
Private investment	16.9	20.4	18.1	16.6	18.2	16.8	16.7
Domestic financed	10.4	10.4	10.4	11.6	11.6	11.6	11.3
Foreign financed	6.5	10.0	7.7	5.0	6.5	5.2	5.3
Total domestic financed	11.2	11.1	11.4	13.4	14.1	13.7	13.5
Total foreign financed	11.6	15.5	13.2	12.3	14.4	12.4	10.7

Source: MEF: Economic database (2012).

The level of domestic private investment is around 11 per cent of GDP, and has remained rather stagnant over much of the past decade; it was 11.2 per cent in 2006, rising only up to 13.5 per cent by 2012. Nearly one-third of the private investment is foreign-financed, as shown in figure 6.

Figure 6: Trends in foreign direct investment in Cambodia



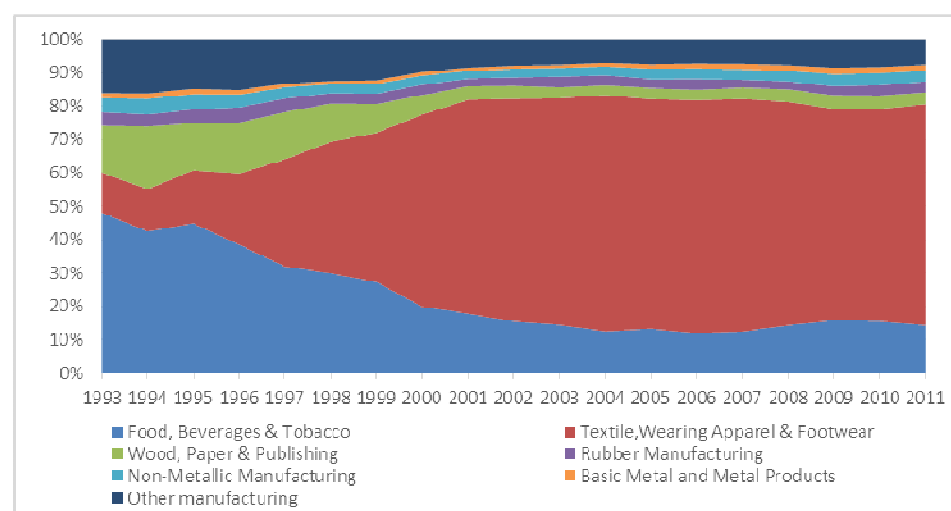
Source: Calculated from World Bank, world development indicators.

⁴⁶ See Berg and D'Amico (2012).

This calls for stepped-up measures to provide impetus to private investment, not only for FDI, but more engagingly for *domestic* entrepreneurs. If the private sector, as envisaged, remains the major agent of growth and job creation, there needs to be, in addition to attracting FDI, specific measures to boost domestic investment. Cambodia is short on domestic entrepreneurial class. But, as observed in countries that have transited to higher domestic investment and domestic entrepreneurship (e.g. Bangladesh, which also started its industrial progress with RMG), such a process can be effected through appropriate incentives and support. Aside from support to inculcate an entrepreneurship culture, and to provide access to credit and other facilities, there is a need to boost domestic savings and investment through policy rate variations. However, this last measure poses a challenge of a different kind, one that is currently lacking but requires to be introduced in a long-term design of macroeconomic policies.

Third is the challenge of structural transformation. The economy, especially in terms of sectoral shares of employment, has seen some structural change, but this is hardly adequate to build a higher-growth strategy. Empirical observations show that the East Asian economies and the advanced ASEAN economies all experienced major structural changes as they moved to higher-growth paths. This path will be dependent on the patterns of growth that an economy opts to follow. Currently the Cambodian economy is still largely agricultural, and the share of manufacturing, though expanding, is still relatively modest compared to its ASEAN neighbours. Even more significant, within the manufacturing sector itself, RMG holds an overwhelming share, as illustrated in figure 7.

Figure 7: Manufacturing value-added: Shares of sub-sectors



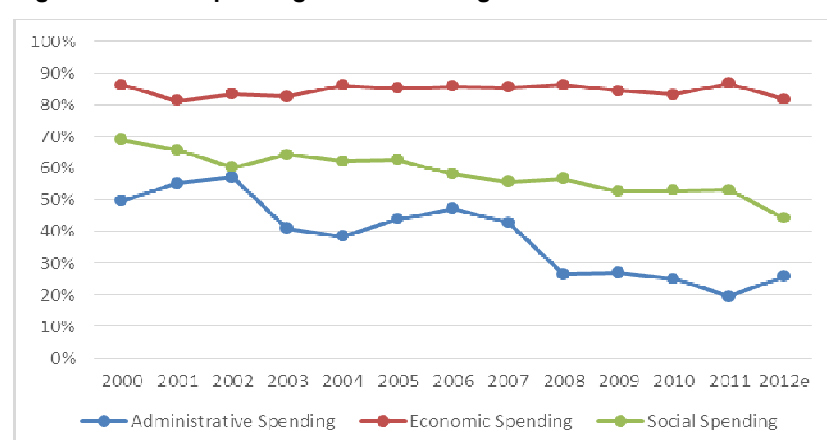
Source: Ung (2012), mimeo.

This is where public investment is of paramount significance. There is empirical evidence to support the contention that public investment has had a crucial influence in *crowding in* private investment, and also in setting the priorities towards employment-intensive and, often, export-oriented patterns of industrialization in trade.⁴⁷ As table 4 shows, public investment, which rose in the post-crisis period to nearly 10.3 per cent in 2010, declined tangibly to 7.6 per cent in 2012. Moreover, much of the public investment is financed by donor funds; more than 70 per cent in 2012. Raising *domestic* public, as well as private investment, will remain a great challenge because both are essential in a process of higher growth, economic diversification, and structural transformation.

⁴⁷ For an account of the role of public investment and public policy, and patterns of industrialization, see World Bank (1993).

Fourth is the challenge of establishing mechanisms to support planned development of the social sectors. In a development strategy, both the economic and social sectors need to grow simultaneously to lift employment and household incomes. In recent years, given the limitations of adequate resources, there have been difficult trade-offs in expenditure sharing between the economic and social sectors. Social-sector development, including the development of a social protection and safety net programme, is not only a key element in inclusive growth, as envisaged in the Rectangular Strategy for Growth, Employment, Equity and Efficiency, but also significant in supporting aggregate demand, especially in an economy with a very large proportion of low-income earners in the population. It should be noted that public expenditures and allocations to both the economic and social sectors are currently highly dependent on donor assistance. Figure 8 shows the overwhelming role of foreign assistance in the broad sectors of the economy.⁴⁸ Most infrastructure spending – including for roads, irrigation schemes, ports, and water supply – is largely foreign financed.

Figure 8: Public spending: Share of foreign resources



Source: CDC: *Aids effectiveness report 2011*; MEF: Economic database (2012).

The above are illustrations of the many challenges that the Cambodian economy currently faces, and ones that need to be squarely addressed in order for the country to stay on course for an accelerated-growth and job-creation strategy. While several policy and institutional measures, including sectoral and labour-market policies, will be necessary to confront these challenges, the role of macroeconomic policies in this task is examined in the following sections.

⁴⁸ The data for the graph is from the CDC. The total current spending from the government budget is taken from the MEF, excluding investment. It is assumed that given the limited revenue of the government, capital expenditure is overwhelmingly financed by foreign funds.

5. Macroeconomic policy options for increasing growth and employment

5.1 Towards a nexus of macroeconomic and structural reforms

The previous sections essentially point out that there could be, in principle, potential tensions between the broad development goals that Cambodia espouses and the *reactive* nature of the current macroeconomic policy framework. At the risk of simplification, the latter is currently confined to the role of being a custodian of strict inflation targets, trusting that predicted (not planned) growth will follow. This growth is then expected to provide the bulk of the revenue growth, and enlarge the resource envelope to undertake structural measures. It is not so much the debates on whether this supply-side approach is most appropriate for Cambodia's state of development. More significantly, the issue is in respect of how far the restricted macroeconomic framework can be seen as compatible with a fast-growing economy, and how far the latter needs to undergo further reforms to support public policies towards growth, employment, and structural change. Further, the effect of recent crises has shown that this macroeconomic framework could run into severe constraints, especially if it required major fiscal interventions.⁴⁹

Given Cambodia's stance on long-term perspective planning towards a higher and dynamic growth pattern, and potentially a full-employment society,⁵⁰ there are a few critical issues that would warrant, *inter alia*, macroeconomic policy interventions.

- 1) First and foremost, is the need to accelerate investments and to devise policies that support financing such investments. In other words, as observed in the case of East Asian "miracle" countries, necessary macroeconomic instruments must be in place to encourage higher domestic savings and investments. This would in turn require a hold on the policy rates, and equally the appropriate development and positioning of money and financial markets. In Cambodia, as we have observed, the NBC has little or no control over policy rates, nor on the money supply.
- 2) Second, proactive policies towards growth and employment will also require sectoral and institutional reforms, and the necessary incentives and sectoral allocations that would help a programme of diversification, and enhance labour demand and labour mobility. Major investments in infrastructure, both social and physical, will be necessary to "crowd in" private investments. In Cambodia, given a legally binding fiscal rule, the level of public investments are limited. Much will depend on reforms of the revenue and expenditure programmes, and, of course, on the future rates of growth.
- 3) Third, in a growing economy, import costs are most likely to increase, for which it is necessary to increase the export capacity of imports. The East Asian economies and many of the ASEAN economies have undertaken, albeit under a favourable external climate, a concerted labour-based industrialization and export-led growth strategy, which includes export incentives and support. In Cambodia, even though there is an implicit "look East" policy – i.e. a labour-based export strategy – it is not firmly grounded on a broad-based

⁴⁹ See IMF (2012a) on the leverage Cambodia's debt-to-GDP has on such fiscal stimulus initiatives.

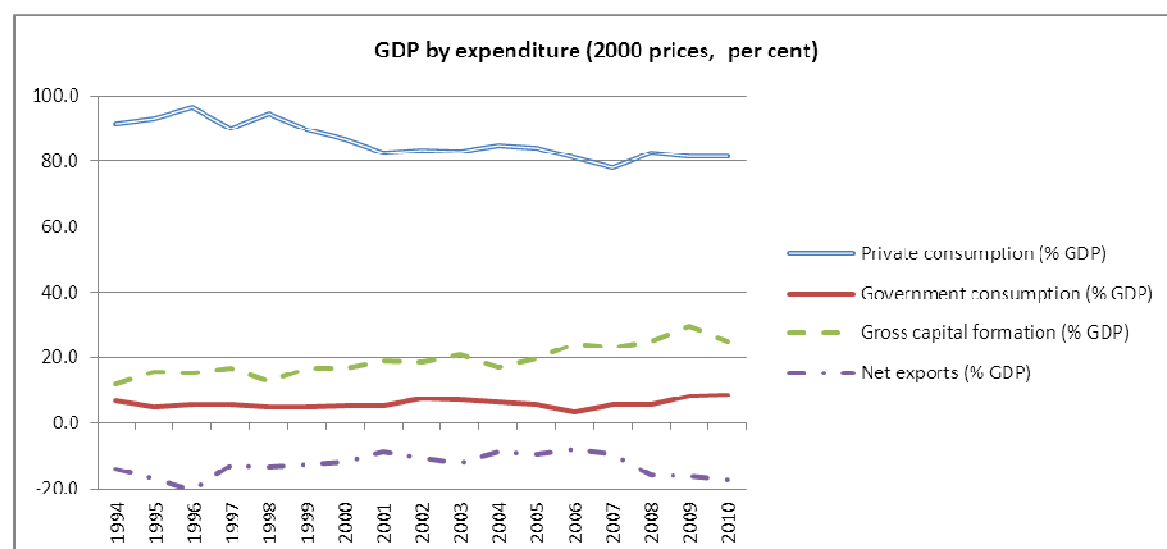
⁵⁰ Cambodia is on course to prepare a long-term perspective plan, Cambodia Vision 2030, where "employment for all" as part of the MDGs, is likely to be a significant feature towards reducing poverty.

development strategy, and given the current enclave nature of industrial development and exports, there are inadequate forward and backward linkages.⁵¹

- 4) Fourth, in countries where poverty is still fairly pervasive and the economy is largely informal, there is a constant need for income and employment support, i.e. an appropriate safety net and social protection measures. There are many such examples, though not necessarily adequate, of public interventions and non-contributory social protection measures in Asia, especially the South Asian countries. In Cambodia, increasing attention is being paid to these (though sectoral allocations are low), and a National Strategy for Social Protection has been formulated. However, there are no clear indications of how the strategy will be financed;⁵² there is, currently, a great degree of reliance on donor funds for some of the elements.

Irrespective of whether an economy pursues largely a supply-side or a demand-management approach, its macroeconomic framework will usually have, in principle, the mechanisms to influence both. The lack of the usual instruments, e.g. those required in curbing excess demand, makes it difficult for an economy to pursue an expansionary policy.

Figure 9: Growth of aggregate demand in Cambodia



Source: Calculated from ADB: *Key Indicators for Asia and the Pacific*.

Figure 9 shows the recent trends in expenditure disaggregates of Cambodia's GDP. Private consumption appears stagnant, and the current account deficit is widening. This possibly reflects the impact of the global financial crisis. This is also reflected in increased Government consumption, perhaps owing to the drawing down on Government reserves with the NBC. However, following growth recovery, capital formation is on an upward trend, and credit flow to the private sector is increasing, as would be expected in an economy's growth momentum. This is already causing alarm on the potential effect on price stability.⁵³ A lack of control on excess demand on the one hand, and a

⁵¹Cf. UNDP (2004) for a detailed account of the implications of a narrow industrial and export base in Cambodia; the present author also examined the inadequacy of the "look East" policy, see ILO (2012).

⁵²See ILO (2012), also the ILO-EU's draft report on *Coordinating social protection and employment policies. Experiences from Burkina Faso, Cambodia, and Honduras* for an analysis of the constraints and suggested pathways towards an integrated social protection and employment strategy, and its financing.

⁵³ The IMF's Consultation on Article IV 2012a, 2012b has repeatedly warned on the need to rein in the growth of private-sector credit.

lack of instruments to mop up excess liquidity on the other, define some of the limitations of a reactive macroeconomic policy framework.

What then, are the likely macroeconomic options for Cambodia's agenda for future growth, employment, and structural transformation? While there is generally a growing consensus on, and advocacy of, the need for greater fiscal space and structural reforms, there is scarcely any review or assessment of the extent of the fiscal space that is needed, or an identification of the priority areas for which the fiscal space is required, or the nature of the structural reforms that would support Cambodia's future development and employment goals.

As we have noted, the current government planning towards increasing fiscal space and public spending, given the lack of adequate policy instruments, is contingent on better administration and efficiency of the revenue expenditure system. This is also in line with the advocacy of the Bretton Woods institutions, especially the IMF's Article IV consultations.⁵⁴ The World Bank (2011), titled *Cambodia: more efficient government spending for strong and inclusive growth*, in fact, emphasizes the need for fiscal space, but is mostly confined to advocating greater fiscal prudence and shifts in expenditure priorities and budgetary allocations.

On the other hand, IMF (2012a and 2012b) largely considers structural reforms of the tax system as a primary means to raise further revenue.⁵⁵ In other words, it appears that should the fiscal rule remain strictly enforced, a fiscal space would largely come through higher growth (and hence revenues), and revenue expenditure reforms. It is not certain whether the pace at which such a fiscal space will be augmented could match the speed of Cambodia's anticipated structural transformation. This will also depend on the assumption that growth will be steady and not volatile.

It must be noted that structural reforms can be effected not only through public resources and interventions, but also through mobilizing private savings and resources, and encouraging investments (e.g. also through public private partnership [PPP]) in a number of areas such as infrastructures, rural industrialization, health and education, among others. Again, the macroeconomic regime lacks the instruments to direct market policy rates, or other means to direct credit or control excess liquidity.

This study contends that since the current conditions of dollarization limit the possibilities for major macroeconomic policy changes, conducting the much-needed structural reforms will require a review of existing policies and the introduction of innovative policies and programmes geared towards enhancing *policy and resource space*. Similarly, the design of structural reforms and demand management should be such as to provide positive feedback to growth, and hence to a stronger and more resilient macroeconomic framework. In other words, there is the need to design a nexus of macroeconomic and structural reforms that are mutually supportive and are able to provide some time-bound support to the development agenda of higher growth, employment, and poverty alleviation. This study explores the possibilities of developing such a nexus. The following section takes a cursory look at some potential options.

⁵⁴ See IMF (2012a) and the background documents in IMF (2012b).

⁵⁵ The Cambodian Government is currently preparing a Medium-Term Strategy of Revenue Mobilization, in line with the aim of raising revenue by 0.5 per cent of GDP annually.

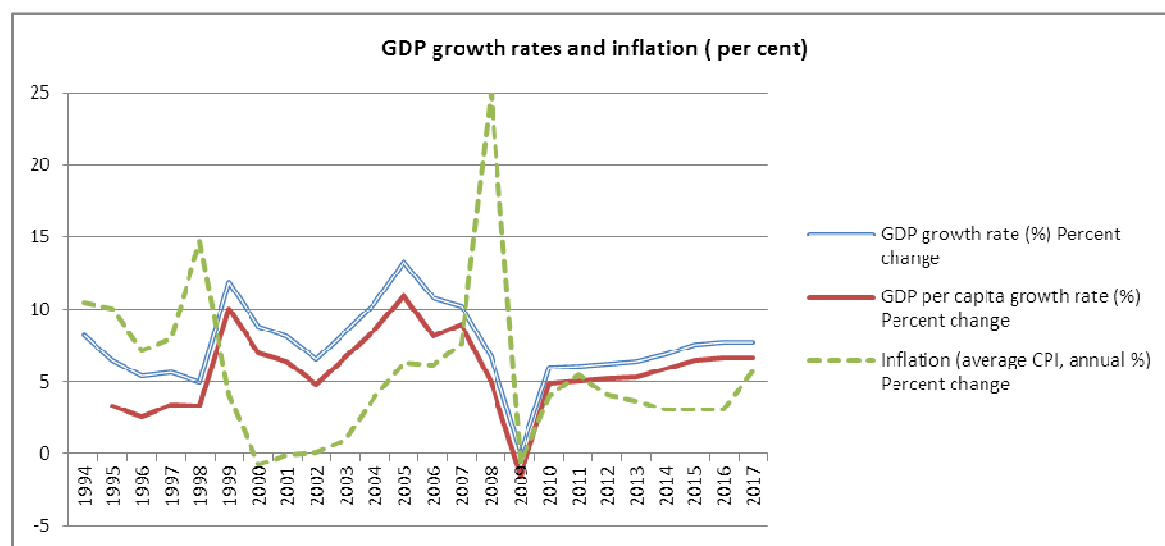
5.2 Monetary policy options

As alluded to in the previous section, given the apparent impasse of the macroeconomic framework with regard to the dynamics of a growing economy, there needs to be a careful articulation of both macroeconomic and structural reforms, as well as their ability to reinforce each other. While stability is required in the macroeconomic environment, there is also the need to strengthen the macroeconomic framework itself, and the related institutions. However, in the context of monetary policies, any discussion of reforms appears to be inextricably related to a discourse on de-dollarization (see below). While dollarization has provided *an additional reason* for maintaining price stability, it equally provides additional constraints on the monetary policy. As noted, the NBC has a limited role to play. In this context, let us examine some monetary policy options that can be pursued within the current framework, to facilitate the dynamics of growth and job creation in the economy.

Review inflation-growth trade-offs

The monetary authorities in Cambodia are pursuing a less than 5 per cent inflation target, which they have successfully done since 1999, except for the period between 2007 and 2009 when the economy was hit first by the hike in global food and fuel prices, and subsequently by the global financial crisis. The peak inflation rate of more than 25 per cent fortunately fell as global prices of food and fuel fell sharply. Barring this period, inflation has remained low, in fact near zero per cent from 2000 to 2003, as shown in figure 10. How low should the inflation rate be for the economy to continue to be dubbed as “stable” and for growth to be not adversely affected? Can the economy accommodate an incremental rise in inflation?

Figure 10: GDP growth and inflation



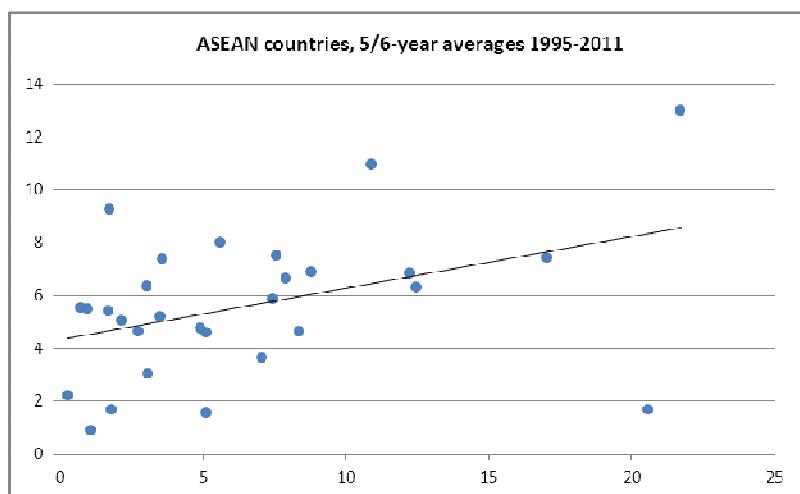
Source: IMF: *World Economic Outlook* (April 2012).

Regarding the latter, one has to closely review the various factors that affect inflation. Apart from cost-push factors, fluctuations in the exchange rate and fiscal deficit can cause an immediate impact. Hence, any designs on fiscal expansion, unless through increased revenue collection, are likely to raise prices. Therefore, if fiscal expenditures are needed for proactive development planning, it will be necessary to calibrate the extent of inflation that the economy can accommodate without a negative influence on private-sector investment.

Regarding the first question above, low inflation, i.e. price stability, by itself may not be the trigger for investments; several other features of money and credit policies, as well as various institutional and infrastructural constraints, need to be addressed. Moreover, a strict inflation target can also induce compression of aggregate demand, and hence the economy might be in need of what UNDP (2004) calls a “grease”; hence, a rethink of the inflation targets.

In fact, if one takes a closer look at the time trends in inflation and growth rates in figure 10, the relationship is not always clearly inverse, as one would expect. From 1999 to 2002, when inflation was declining sharply, output fell; and when inflation was rising between during 2003 and 2007, output was rising significantly. It was largely during the crisis that a sharp inverse relationship was discerned. Moreover, there are now several studies, based on country experiences, to suggest that the inflation threshold beyond which growth is adversely affected could, in effect, be much higher than the 5 per cent target rule.⁵⁶ In fact, other studies show that there is a weak relationship between the two when inflation is modest. As figure 11 on ASEAN countries shows, there may be variations, and not a linear inverse relationship.⁵⁷ In the context of Cambodia, this warrants an appropriate review of not only the inflation and growth trade-off, but also of other factors that closely cooperate with stabilization measures to produce good growth.

Figure 11: ASEAN: The inflation-GDP growth relationship



Source: IMF: *World Economic Outlook* (April 2012).

Support incentives to boost domestic investment

It has been noted that investment is a critical driver of growth, and the design of employment-friendly investment is likely to enhance the job content of growth. While FDI has played a significant role in such investments, especially in the garment and tourism sectors, it is extremely important for the Cambodian economy to substantially increase the existing levels of *domestic* private investment. It must be noted, from various country experiences in East Asia and South-East Asia, that a full programme on industrial development and growth of capital in an economy cannot be sustained without the growth of a domestic entrepreneurial class. Should the incentives and environment be

⁵⁶ See, for example, Khan and Sehnadji (2001), which contends that economies can withstand inflation thresholds of up to 12 per cent without growth rates being affected. For a meticulous analysis of the IMF’s Article IV Consultations on inflation and other stability targets, see Islam (2012). Also see Blanchard et al. (2010).

⁵⁷ See Muqtada (2010) for some empirical analysis.

appropriate, the latter carries better prospects of a diversified industrial and export base than would be possible through FDI, especially since FDI need not necessarily follow a national strategy of industrial and trade growth. Moreover, it has been empirically observed that FDIs are funnelled to economies where domestic investment itself is productive. Currently, Cambodia appears to rank rather low in terms of productivity, especially against its ASEAN neighbours.

In order to foster domestic investment and enhance productivity, a comprehensive policy of industrialization and trade is necessary, which Cambodia has recently embarked on.⁵⁸ While this integrated framework is likely to contain a host of measures cutting across various sectors and ministries, the role of monetary policy must be seen as equally significant. A few such policy directions are noted:

- 1) At present, the monetary instruments are limited, especially in relation to setting the policy rates for loans and deposits from the commercial banks. Within such limitations, the foremost measure for the NBC is to gradually establish *confidence* in the lending market, keeping in context the risks and incentives of depositors, investors and commercial banks. Indeed, several measures are being taken, and others are being proposed, a detailed discussion of which is beyond the scope of this study.⁵⁹ One significant proposal is on building a base for guaranteeing inter-bank transactions, which, at present, does not exist. The proposal aims to provide collateralization in some measure to the banks' fixed deposits with the NBC, through the issue of negotiable certificates of deposits (NCDs).⁶⁰ Irrespective of whether domestic investors borrow in riel or foreign currency, a securitization of inter-bank transactions would be necessary. NCDs are also likely to be instrumental in mopping up excess liquidity.
- 2) The monetary authorities, in close collaboration with the commercial banks, will need to gradually develop a better grip on the demand and supply of money. The NBC will need to survey the needs of domestic investors' profiles, and signal and encourage banks to respond accordingly. Similarly, it needs to maintain close supervision over banks, and a close track of money in circulation. Means must be found to resolve the paradox of excess liquidity in the market and the potential consequences of high growth of credit.⁶¹
- 3) Although the NBC has limited influence on the lending rates, whether in riel or foreign currency deposits (FCDs), it can step up the growth of riel and its use, and indirectly bring about favourable influences on the deposit and loan rates. As figure 12 shows, currently loans in US dollar denominations have a lower interest rate than those in riel. Nevertheless, the lending rates in general have shown a downward trend, including in riel. The Government has indeed been implementing some measures to strengthen the growth and use of the riel, through budget operations and public-sector transactions, including payment of salaries of Government employees and payment of utilities. In short, the costs and benefits of the differential policy rates need to be closely reviewed, and instruments such as the "reserve requirements" may need to be *discriminatingly* used to align bank and borrower interests closer in respect of riel transactions. Various other measures to extend riel-denominated transactions, such as the currently contemplated use of ATMs and other modes of electronic riel exchanges, may prove to be effective in the increased circulation, and confidence in, the riel.
- 4) The NBC will need to develop its capacity in carrying out surveys and evaluations, and rationalization of the dual currency regime, though currently dominated by FCDs. Developing a greater freedom and incentive to use the riel through the development of financial

⁵⁸ A comprehensive industrialization policy is currently being finalized by the SNEC.

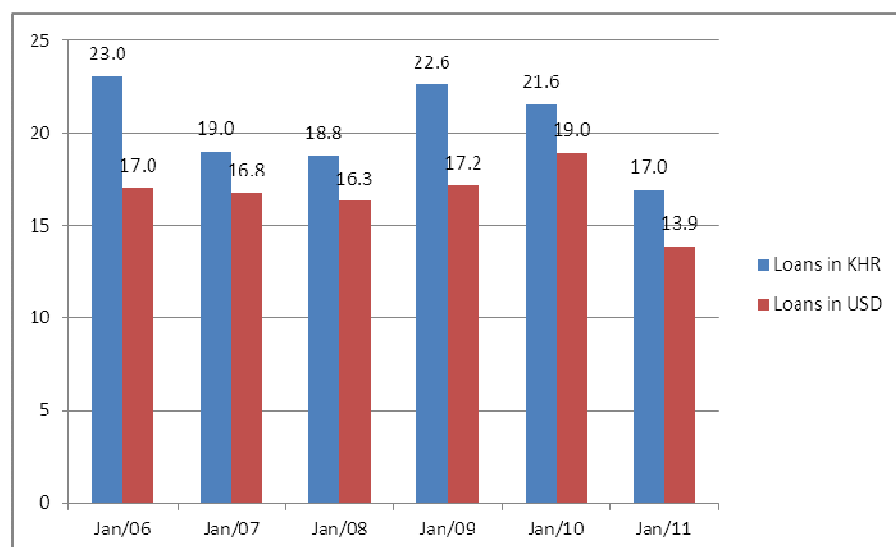
⁵⁹ For further details, see various proposals contained in the IMF's *Welding financial development and de-dollarization: negotiating the policy dilemma* (2012), a background note for Article IV consultation discussions in Cambodia. Also see Dumas (2010), UNDP (2004), and for a general analysis, Fischer (2006), *op cit*.

⁶⁰ See IMF (2012), *ibid*.

⁶¹ See IMF (2011), World Bank (2011).

intermediation mechanisms will likely attract local investment, especially among small and medium-sized firms both on the demand and supply side of the money market.

Figure 12: Riel and US dollar lending rates (six-monthly maturity, weighted average)



Source: IMF: Online database.

Development of the financial and capital markets

In order to develop an effective monetary system, and to encourage domestic investment, the monetary authorities will need to establish a sound financial market through strengthening financial institutions and developing an appropriate regulatory framework. While the fairly strong growth of M2/GDP is seen as a sign of financial deepening, it has not been able to connect and foster local investment. Yet, as noted, there is reported excess liquidity in circulation amid fairly high lending rates.

The Government has initiated the development of the stock market to raise capital, and also to mop up idle liquidity. The Cambodia Securities Exchange (CSX) started trading in earnest in early 2011, and it remains to be seen how the various stakeholders support and contribute to its functioning. There are several associated issues that need to be addressed as trading takes root. In particular, should the stock prices be listed in riel, and transactions allowed to be settled in either local or foreign currency, there would be a need to develop and strengthen the current weak foreign exchange market.⁶² Such a step will also be necessary if the economy is to move further towards de-dollarization. Of course, sufficient safeguards will have to be put in place against exchange-rate risks, since stability in the exchange market is essential to maintaining price stability.⁶³

Extending financial inclusion

In the so-called dollarized economy of Cambodia, it is interesting to note that while more than 90 per cent of monetary and financial transactions are carried out and recorded in dollars, the majority of

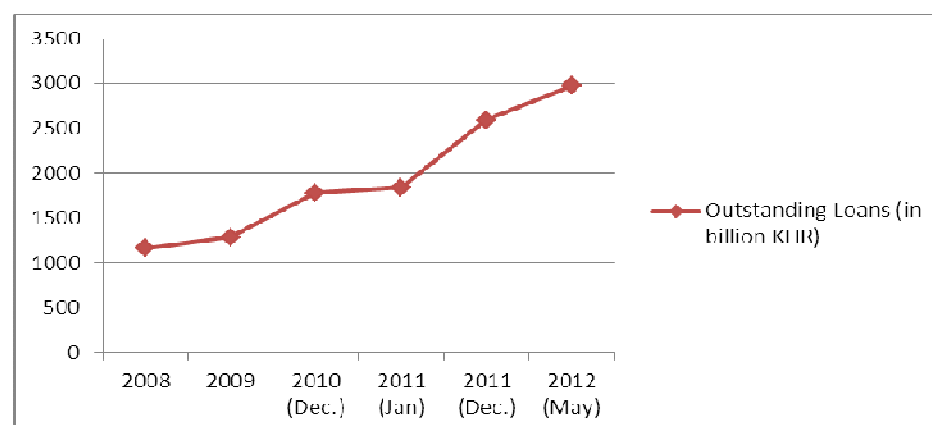
⁶² See background paper to IMF (2012b).

⁶³ On this, and related issues of capital and exchange markets, see IMF (2012), *op cit*.

Cambodians use the riel for day-to-day purposes. The rural population in particular, and those engaged in farm and informal-economy activities – which formal financial institutions rarely intermediate – are riel-dependent. In fact, at the risk of some exaggeration, the dollar-riel divide almost approximates an urban-rural divide in financial transactions. This is largely because the commercial banks find intermediation in small- and micro-lending a high risk with higher costs of operations and supervision. In particular, small-scale borrowers have difficulty in providing collateral.

At the same time, if rural development and agricultural productivity are reckoned to be significant in the growth and resilience of the economy, measures need to be devised to ensure access to finance for the small and medium-sized operators in the rural areas. Apart from some public-sector support in stimulating rural and agricultural growth (for example, provision of incentives to agro-based industries and exports), the commercial banks as well as non-commercial financial institutions may be urged to expand operations, as has been done in many other countries in Asia.⁶⁴ Such an initiative in Cambodia, albeit subject to the easing of constraints and conditions, would not only provide opportunities for greater financial inclusion, but also allow greater use of the riel. At present it is the non-governmental organizations (NGOs) and micro-finance institutions (MFIs) that are the predominant institutions of financial intermediation in the rural areas. Figure 13 shows the progress they have made in their lending programmes in recent years.

Figure 13: Growth in microcredit lending in Cambodia, in foreign currency



Source: NBC.

Although the lending has expanded, especially during the last couple of years, measures need to be taken to ease some of the constraints facing these MFIs and the small loanees (e.g. collateral requirements) to extend and expand their operations. Financial inclusion policies should also help to support those dependent on safety nets to take up productive activities. Planning towards invigorating rural and agricultural investment and greater financial inclusion of these activities (i.e. beyond the existing MFIs) through a nexus of monetary and structural reforms would offer Cambodia a development approach to the growth of the riel, and a riel-approach to much-needed rural development and employment generation.

⁶⁴ For example, Bangladesh Central Bank has instructed all commercial banks to make at least 2.5 per cent of their credit disbursements to small agricultural and rural operators. See, Bangladesh Bank, *Recent reforms initiatives*, n.d. Chapter 4.

De-dollarize (or not to de-dollarize)

Cambodia did not deliberately choose to dollarize its economy, but dollarization has become entrenched over the past two decades. Indeed, the macroeconomic framework is so conditioned by dollarization that any abrupt steps to withdraw from it could have disastrous consequences, as international experiences have shown.⁶⁵ In the case of Cambodia, analysts contend that the economy is too vulnerable to a sudden run on the riel and withdrawal of FDIs that support the manufacturing exports and employment.

Is de-dollarization necessary? Officially, the Government appears committed to de-dollarization, but only as a long-term goal.⁶⁶ The immediate policy contemplation is on enhancing the use and spread of the riel. Such a stance is generally endorsed by analysts and donor agencies alike, i.e. putting in place necessary conditions to de-dollarize.⁶⁷ However, a current dilemma is that while the riel has been growing substantially, the extent of dollarization has not diminished; in fact, as table 5 shows, it has increased. The percentage of foreign currency in total money in circulation (M2), which was around 74 per cent in 2006, rose to nearly 82 per cent in early 2012, despite the four-fold growth in the riel during the same period.

Table 5: Extent of dollarization in the Cambodian economy

	Dec. 06	Dec. 07	Dec. 08	Dec. 09	Dec. 10	Dec. 11	Jan. 12	Feb. 12
Liquidity (M2) in KHR billion	6 942.3	11 310.7	11 858.9	16 228.3	19 476.8	23 654.7	24 146.4	24 773.2
Money (M1)	1 657.7	2 052	2 399.6	3 120.2	3 220.9	3 956.2	3 916.4	3 970.6
Currency outside banks	1 599.6	1 989.7	2 294.8	3 001.6	3 098.6	3 771.7	3 667	3 756.1
Demand deposits	58.1	62.3	104.8	118.6	122.3	184.6	249.4	214.5
Quasi money	5 284.6	9 258.7	9 459.3	13 108.1	16 255.9	19 698.5	20 230	20 802.5
Time and savings deposits	88.6	121	184.8	358.8	408.3	557	720.1	556
Foreign currency deposits	5 196	9 137.7	9 274.5	12 749.3	15 847.6	19 141.5	19 509.8	20 246.6
Per cent of M2	74.8	80.8	78.2	78.6	81.4	80.9	80.8	81.7

Source: NBC.

There have been studies to suggest that Cambodia's continuous surge towards dollarization, despite attempts at boosting the growth and spread of the riel, can be seen as a consequence of the relative stability of the exchange rate vis-à-vis the inflation rate, and hence the continued confidence in the dollar (Cf. Dumas, 2010). This has implications on the order of policy reforms and policy sequencing.⁶⁸ A more recent set of alternative policy proposals on the measures and their potential sequencing are offered in a background paper by the IMF (2012b). There is a need to establish strong financial institutions and fiscal positioning in developing a resilient macroeconomic framework, as emphasized by Fischer (2006). While "it remains highly contentious whether it [dollarization] is the right framework going forward",⁶⁹ a lot will depend on how the Government defines its short-, medium-, and long-term policies, and how it benchmarks and monitors the outcomes. In other words,

⁶⁵ See, for example, Zamaroczy and Sa (2002), Im and Dabadie (2007).

⁶⁶ See RGC (2012).

⁶⁷ See Naron (2009), IMF (2012b), Im and Dabadie (2007) *op.cit.*

⁶⁸ See, for instance, Fischer (2006) for some of the basic pre-conditions towards de-dollarization; also Zamaroczy and Sa (2002).

⁶⁹ IMF (2012b).

strong, purposive, time-bound measures are needed – beyond the simple growth of the riel – towards a programme of de-dollarization.

5.3 Fiscal policy

As widely observed in dollarized economies, and as noted in the case of Cambodia, fiscal discipline is critical to maintaining price and exchange-rate stability.⁷⁰ In the case of Cambodia, Naron (2009) emphasizes that “the only mechanism available to manage the exchange rate is the budget”.⁷¹ Cambodia, through a number of important measures, including implementation of the public financial management (PFM) programme in 2004, has largely maintained a strict fiscal deficit target of below 5 per cent. Nevertheless, this fiscal discipline is also marked by a degree of fragility, since much of the deficits are financed by donor funds and concessional loans, which in recent years appear to be trending downwards. In addition, as observed during the global financial crisis, the Government had to draw down on its reserve deposits, which, unless quickly replenished, exposes the economy to various vulnerabilities. More significant, in the context of this study, the current and projected growth of the economy have started imposing demands on structural change, and social and physical infrastructure development. Unless much of these are financed by donors (in fact, a disproportionately large part of capital expenditure comes from grants and concessional loans), there is likely to be enormous difficulties in carrying them out through existing budget savings; contingent liabilities are likely to grow.

The need for a fiscal stance

Even before a discussion of details on fiscal policies and instruments, it is important to appreciate the need for a fiscal stance, a resolve on which is as much economic as political, especially in the context of Cambodia’s development ambitions towards the Vision 2030. The previous sections of this study have pointed to the challenges and threats; in order to address these, sound policies and a bigger resource envelope will be warranted. This has been underscored by policy planners, analysts, and international agencies, in particular on the need for fiscal space to conduct structural reforms.⁷² However, these reports are thin on how to size up the needs of projected growth, and the processes by which the resource gap can be bridged. While recognising the need for “restoring and increasing fiscal space”, the World Bank posits priority recommendations on “rebuilding stocks of government deposits” to pre-crisis levels and on narrowing “fiscal deficits over the medium term”.⁷³ The remaining recommendations are on revenue collection and efficiency in tax administration. At the risk of some repetition, it may be mentioned that while these are extremely necessary for stability, the fiscal stance seems to revolve largely around growth of revenue and efficiency of public expenditure. This incremental approach is likely to be volatile, and may not be adequate for a proactive fiscal stance necessary for structural reforms.

Creating a fiscal space

The creation of a fiscal space would have a bearing with regard to the macroeconomic stability of the economy, i.e. the extent to which the space can be accommodated within the tolerance limits of

⁷⁰ See Dumas (2010).

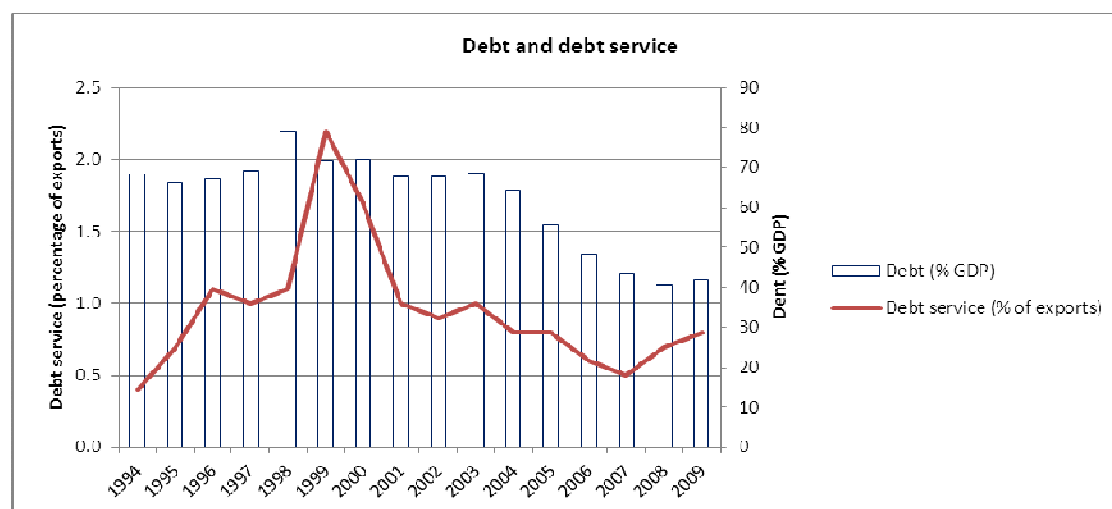
⁷¹ Naron (2009), p.100.

⁷² See, for example, Naron (2009), UNDP (2004), World Bank (2011), and IMF (2011).

⁷³ World Bank (2011), *ibid.* p.13.

budget deficits and the debt-to-GDP ratio. Currently, as figure 14 shows, the debt-to-GDP and debt service ratios of the Cambodian economy are well below the oft-recommended 40 per cent cap.⁷⁴

Figure 14: Long-term debt-to-GDP ratio in Cambodia



Source: ADB: *Key indicators for Asia and the Pacific*.

Moreover, the fiscal deficits in Cambodia are lower than in some of its ASEAN neighbours, although the implications and consequences of relative deficits would vary from country to country. The IMF estimates that, given current debt and reserve scenarios, any fiscal stimulus that may be required in the event of a future crisis, should not exceed more than 1 per cent of GDP.⁷⁵ As in the case of inflation-growth trade-offs, there are evaluations to show that trade-offs between growth and debt are also not strictly defined, and need to be reviewed at the country level.⁷⁶

Apart from the above, what are the alternative options for generating an enhanced fiscal space in Cambodia? As often suggested, there are usually four broad sources of generating fiscal space:

1) *ODAs (grants and concessional loans):*

IN the case of ODAs, we have already noted a tangible decline in recent years. According to recent figures, ODA declined from a peak of around US\$1.2 billion in 2009 to about \$600 million in 2012. At the moment, it is difficult to ascertain how far future flows will continue to provide the latitude that Cambodia has had in financing its deficits.

2) *Public borrowing (domestic or international):*

Public borrowing in the current dollarized regime is extremely restricted. The window of such an opportunity lies with the extent of budget savings and the extent of reserve deposits that the economy can build during its current and projected growth scenarios. This was resorted to during the fiscal expansion that took place between 2008 and 2009, to cushion the impact of the financial crisis.

3) *Raising tax and non-tax revenues:*

The real sources of building fiscal space lie in revenue generation, together with rationalizing public spending. Figure 15 shows the recent trends in growth of revenue and expenditure as a

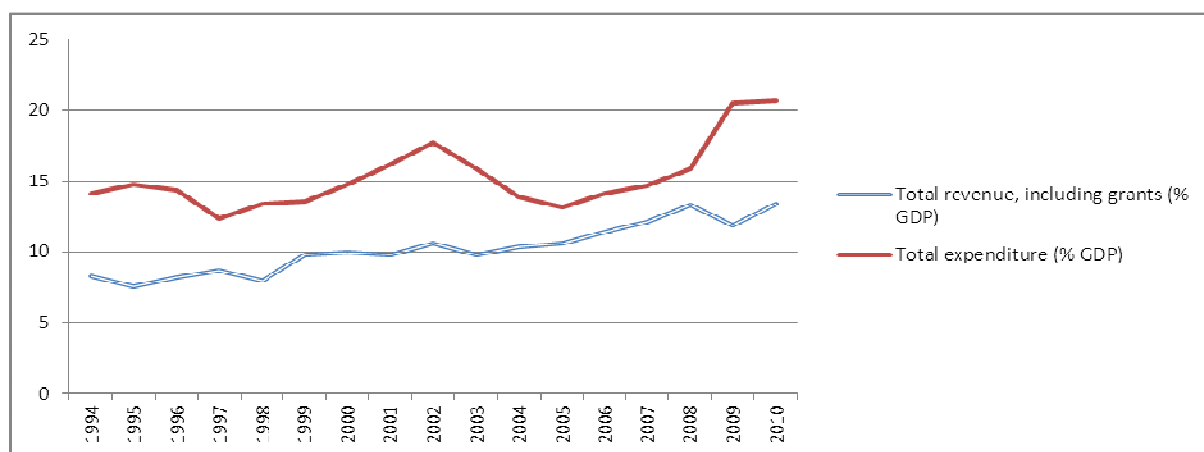
⁷⁴ See Islam (2012), which queries the sanctity of such nominal anchors.

⁷⁵ IMF (2012a), *op cit*.

⁷⁶ Islam (2012), *op.cit*.

percentage of GDP. The deficit widened during the global financial crisis, but has more recently stabilized below 5 per cent. Nevertheless, it has been pointed out that the revenue-to-GDP ratio is still very low in Cambodia compared to countries at a similar level of development.

Figure 15: Trends in public revenue and expenditure (percentage of GDP)



Source: ADB: *Key indicators for Asia and the Pacific*.

The real sources of building fiscal space lie in revenue generation, together with rationalizing public spending. Figure 15 shows the recent trends in growth of revenue and expenditure as a percentage of GDP. The deficit widened during the global financial crisis, but has more recently stabilized below 5 per cent. Nevertheless, it has been pointed out that the revenue-to-GDP ratio is still very low in Cambodia compared to countries at a similar level of development.

4) *Reducing or re-prioritizing expenditures:*

The other measure, not necessarily an alternative, is to re-prioritize public spending, either to divert resources to other priorities, or simply to sustain a fiscal space. A major example in the past has been the tangible reduction in spending on defence and security. Such a move – though depending on changing economic and political perspectives – needs to be reviewed in the light of the efficiency of public expenditure, and medium-term goals of development planning.

The upshot of the above is that the need for a fiscal space, and measures to enhance it, will require closer scrutiny not only of the revenue-expenditure programme, but also greater efforts in linking budget allocations to development priorities, both economic and social.

Is the existing allocation structure consistent with the above priorities? Table 6 is instructive. The defence budget increased substantially between 2005 and 2010. One observes that while allocations to education and health have increased, and as needed to meet the related MDGs, there has been a decline in allocations to agriculture, industries, and transport and communications.

Table 6: Allocations of public spending (per cent)

	2000	2005	2010
Total	100.0	100.0	100.0
General public services	16.6	13.5	14.7
Defence	40.3	17.1	26.7
Education	16.2	13.3	15.5
Health	10.7	8.5	11.3
Social security and welfare	2.4	3.6	4.0
Economic services	7.4	6.8	7.9
Agriculture	2.3	1.8	1.6
Industry	0.5	0.3	0.3
Transport and communications	3.7	1.7	1.4
Other economic services	0.9	3.0	4.5
Others	6.3	37.2	20.0

Source: ADB: *Key indicators for Asia and the Pacific*.

This is rather puzzling given that the latter sectors are crucial in effecting the structural transformation that is needed to get Cambodia out of its least developed country (LDC) status.⁷⁷ In recent years, agriculture has been a major contributor to the overall growth of the economy. Given that the vast majority of the poor and vulnerable are in rural areas, and that great potential lies in raising agricultural productivity⁷⁸ and diversification towards Cambodia's land-intensive comparative advantages,⁷⁹ a much higher allocation is warranted. It may also be pointed out that even in these relatively low allocations in agriculture, nearly 67 per cent of public spending in 2008 and 2009 was financed by foreign funds (World Bank, 2011, table 8). Thus, the existing allocations will need to be reviewed in the light of the priorities in Cambodia's development planning and the structural changes that the policy planners anticipate.

Generating fiscal space through fiscal space: The employment-social protection-development perspective

As we have noted, Cambodia's fiscal discipline has been focused fairly strictly on living within one's means; that the dollarized economic framework does not allow much room for manoeuvre. This fiscal discipline and the manner in which it is maintained, is thus fragile. The need for a fiscal space is becoming inevitable to support future growth, employment, social protection, and poverty alleviation.

An ILO-European Union report (2012), in the context of developing integrated employment and social protection policies in Cambodia proposes a "growth diamonds" strategy framework that would incorporate the following mutually reinforcing clusters: (i) the investment regime; (ii) infrastructure and technology development; (iii) social protection programmes, both universal and targeted; (iv) skills enhancement programmes; and (v) an industrial relations regime.⁸⁰ Adopting and implementing such an integrated strategy will require focused public policy as well as fiscal support to various programme measures that are warranted in each of the clusters. The report further provides some broad cost estimates of some of these measures that relate to the National Social Protection Strategy

⁷⁷ For a detailed account of the paradox of the importance of the agricultural sector, and the relatively low budget for the sector, see UNDP (2004), World Bank (2011).

⁷⁸ See Chandararot and Dannet (2012), *mimeo*.

⁷⁹ See ILO (2012), in which the present author has argued that, at the current stage of development, Cambodia would do well to reap its land-intensive comparative advantage.

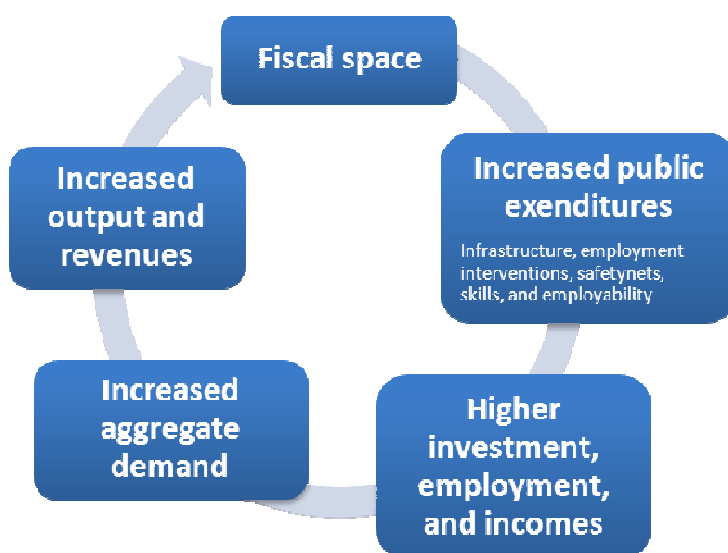
⁸⁰ See, ILO-EU, *Towards integrated employment and social protection policies*, ILO, 2012.

(NSPS), i.e. on interrelated social protection, employment, and training interventions.⁸¹ These estimates are far higher than what is currently allocated to such activities, the bulk of which currently depend hugely on donor support.

As noted in an earlier section, while multifaceted interventions are necessary for job generation, equally important is the need to devote resources to skills development and training, especially among the rural youth and women. The fiscal preparedness for such interventions in skills and vocational training, which are critical for planning economic restructuring, is rather feeble, and the revenue-based allocation is nearly insignificant.⁸²

A fiscal space will be needed to support these measures, which are all equally important as contributors to growth. The fiscal expansion, of course, will have to be targeted to areas that enhance aggregate demand and employment. Figure 16 shows, as an example, how a fiscal space could be planned to help generate further fiscal space through enhanced growth of output and employment.

Figure 16: Generating fiscal space through fiscal space



In brief, this would require a fiscal expansion in order to support a range of public expenditures on employment-intensive infrastructures, various employment interventions (e.g. self-employment through microcredit lending), social safety net transfers to support the massive proportion of vulnerable people in rural areas, and other active labour market policies (ALMPs) to enhance the skills and employability of the workforce. Implicit in such spending is support for growth of skills and much-needed training, job creation programmes (especially for youths and women), social protection and social safety nets, and sustaining of aggregate demand. Further, spending on physical and social infrastructures (e.g. skills) is part of the structural reform that will help boost private-sector investment. The expansion of output and employment that is likely to be induced can potentially trigger a virtuous cycle of higher fiscal space and further rounds of structural reform.

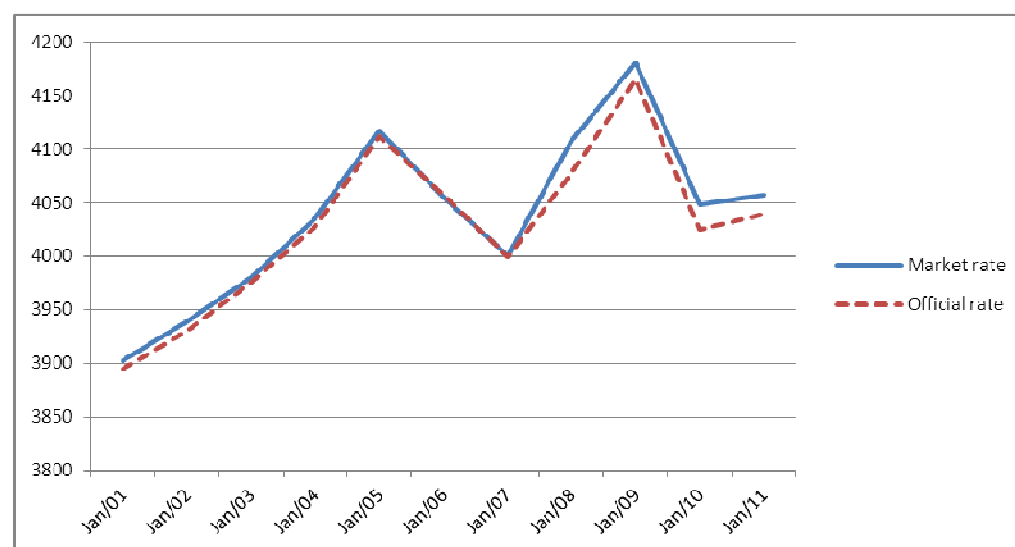
⁸¹ Ibid. approximately 5–7 per cent of GDP would be needed for a universal scenario, while a targeted approach would require 1.2–2.3 per cent.

⁸² In fact, the total budget expenditures of the MSA and MOLVT range from 0.46 per cent of GDP in 2009 to 0.61 per cent in 2012. Most of the training and skills development programmes are sponsored by donors such as the ADB.

5.4 Exchange-rate policy and trade liberalization

In Cambodia's dollarized economy, with the NBC having little control over the monetary instruments, especially the policy rate, it is almost imperative that the exchange rate remains stable. As noted in our discussions on price stability, the Government uses the auction market to buy or sell its foreign currency reserves, simultaneously to stabilize the exchange rate, and to maintain control over the money supply and prices. With the riel still the legal tender, Cambodia has a managed exchange-rate policy. Thus, there exists a dual exchange rate – one official and the other market-determined. The Government closely monitors divergences between the two rates, and attempts to keep these divergences as low as possible, as shown in figure 17.

Figure 17: Exchange rate: Riels per US dollar, 2000-2011



Source: NBC.

Among others, two potential threats to sustaining such stability are likely to come from trade deficits and the financial markets' exposure to external shocks. Fortunately, however, the generous influx of ODA and FDI have so far helped to mitigate trade deficits, and the current shallow financial and capital markets have very limited exposure to external shocks. The maintenance of a stable exchange rate has helped Cambodia attract FDI largely in the garment and tourism sectors, which earn the bulk of foreign earnings and generate jobs. A stable real effective exchange rate (REER), together with trade liberalization and generous incentives to FDIs, have enabled the development of the garment industry and exports. In general, while there are country experiences to suggest that a stable REER can help the growth of exports and employment, this may not be sufficient. Other conditions are needed. In Cambodia, these are structural in nature. The export base is far too concentrated on garments, and the industry is far too dependent on FDIs (table 7).

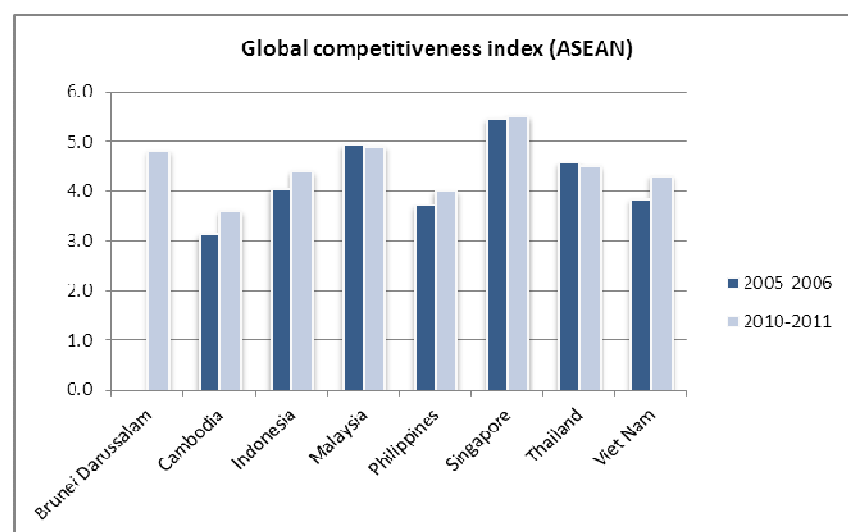
Table 7: Estimated average firm performance in the Cambodian garment industry

	Source	2002	2003	2004	2005	2006	2007	2008	2009	2010
Gross product	MEF	100	122	140.7	143.4	145.1	150.1	146.6	143	184.8
Value added	MEF	100	123.7	144.9	143.6	144.4	145.7	144.7	136.4	155.9
Profit	MEF	100	125.6	148.8	149.4	149.8	147.3	145.1	134.5	152.7
Number of workers	MOC	100	108.5	115.4	107.3	106.7	111	107.7	105.9	112.4
Labour productivity	MEF	100	114	125.5	133.8	135.4	131.3	134.4	128.8	138.7
Labour cost per worker	MOC	100	106.7	111.3	110.9	114.5	125.4	132.6	136.1	150.7
Material cost share	MEF	38.5	37.6	36.7	38.4	38.7	40.3	39.3	41.3	48.1
Unit garment export price	MEF	44.2	45.9	46.3	41.9	37.8	36.6	33.7	32.0	31.1

Note: MEF = Ministry of Economy and Finance. MOC = Ministry of Commerce. Values are indexed to those of 2002 for 'gross product' to 'labour cost per worker'. Gross product = garment exports of Cambodia per garment factory. Value added = garment exports of Cambodia / material imports of Cambodia per garment factory. Material cost share is in percentages. Unit garment export price is US\$ per dozen.

Source: Asuyama and Neou (2012).

Although the industry's profitability is growing tangibly, its contribution to employment is rising albeit slowly at the margin. Moreover, the economy's export capacity to meet growing import demands through the narrow export base would remain shaky. There are also very limited backward-forward linkages to the garment industry that could broad-base industrial growth and employment. Similarly, although labour costs are still relatively low and attractive, FDI has not quite ventured into other labour-intensive industries and other potential export sectors, nor has price and REER stability boosted *domestic* investment. In other words, stability and trade liberalization, while necessary, will need to be backed up by various structural measures. Cambodia's competitiveness is still relatively low compared to many of the other ASEAN countries, as shown in figure 18.

Figure 18: Cambodia's relative competitiveness in ASEAN

Source: World Economic Forum: Public data site.

Thus, with regard to raising FDI and domestic investment, greater competitiveness will be necessary, and this will be determined as much by a stable REER and low labour costs as raising labour productivity. The latter will depend on a host of factors, including easing of investment and infrastructure constraints, and restructuring the low-skills profile of the workforce. Macroeconomic and structural reforms will need to go hand in hand in an integrated industrial and trade diversification strategy.

6. Concluding remarks

Since the second half of the 1990s, and particularly during the subsequent reconstruction and take-off phases, Cambodia experienced robust GDP growth. This period also witnessed a tangible reduction in the incidence of poverty, and an increase in employment and real wages. Nevertheless, there are large variations in the incidence of poverty across the regions, and poverty still remains high in the rural areas. Further, there is a very large proportion of vulnerable population (more than 70 per cent) who have low incomes, and more than a quarter of the employed population can be categorized as “working poor”. Hence, despite the employment growth rate exceeding the labour-force growth rate, the bulk of this job growth appears to have been in the informal sector, with many workers being inadequately remunerated. This study also notes that in agriculture, the largest employer, *surplus labour* seems to coexist with an apparent widespread *shortage of workers*, especially during agricultural peak seasons. The proportion of formal-sector jobs, especially in manufacturing, is still relatively modest, much of which is accounted for by the RMG sub-sector. Even within this narrow industrial base, there is an alleged shortage of appropriate skills, implying the need for a major upgrade of the skills base of the workforce.

Given the Cambodian Government’s commitment to the MDGs, in particular poverty reduction and productive employment for all, there appears to be a need to pursue the integrated national employment strategy. As articulated in ILO (2012), this will require not only high and sustained growth, but also a pattern of growth and structural change that will enhance the employment content of growth, and indeed the employability of the workforce. This study notes, by way of illustration, that if the economy were to absorb the stock of currently unemployed workers, and the net additions to the labour force, as well as reduce underemployment (say, half of the working poor within the next five years), the economy would have to grow at double-digit rates. Such a rate of growth would require, assuming ICORs as constant, and a much higher investment-to-GDP ratio, as observed in many East Asian and ASEAN economies during their early phases of high growth. The latter countries also demonstrated that higher growth rates are predicated on structural change, and a gradual shift of labour to more productive sectors. The latter will require major interventions on incentives and infrastructures for a greater participation of private-sector investment, both domestic and foreign.

Should the NEP be an integral part of Cambodia’s medium- and long-term development goal, this would, of course, require all sectors and policies to play their part. In this context, this study has attempted to assess the role of the macroeconomic policy framework and how far it can play its part in an employment-focused growth strategy. The study observes that the current macroeconomic framework has evolved within the Washington Consensus, and is overwhelmingly focused on price stability. The rapid growth of dollarization in the economy since the early 1990s has further “conditionalized” price stability as a uni-dimensional goal. In consequence, the macroeconomic framework appears to be reactive, inasmuch as growth is a derivative of stability, and employment is predicated on growth. As observed during the recent global crisis, and in many other country experiences, stability, though a necessary condition, may not always yield growth, and growth will not automatically yield employment.

Further, this study argues that the macroeconomic framework itself, based on conditions of dollarization, is somewhat vulnerable. The NBC has very limited control over the money supply, which is predominantly composed of foreign currency deposits, and thus resorts to dollar auction instead of policy rates to maintain money market equilibrium and exchange-rate stability. Trade deficits are mitigated through ODA and FDI. Fiscal deficits, which are usually tightly capped, are also often met by donor funds, since the Government cannot borrow from the banks. Hence, stability is

maintained with a lot of leaning on donor assistance and concessional lending, although Cambodia's record of good growth has also supported the Government's stability measures (such as higher revenues). In this context, it must be noted that the healthy growth of the Cambodian economy has not only been helped by its macroeconomic stability but also by several fortuitous circumstances. It is a matter of debate whether these largely favourable external conditions, such as the generous inflows of foreign funds and market access, are likely to continue in the future; ODA is already on a downward trend.

More importantly, macroeconomic policy will need to be somewhat proactive if Cambodia is to consolidate its growth and move towards higher growth and productive employment. These will require purposive interventions towards structural reforms, and a degree of demand management. The present dollarized framework limits the scope of any monetary and fiscal expansion, and de-dollarization, though a long-term aim of the Government, cannot be attained in the immediate term. The current position on de-dollarization – to bring down the proportion of FCDs in money circulation – is hardly working, despite the four-fold increase in the riel. In fact, the proportion of FCDs is increasing.

Given the above, this study highlights the need to move towards a nexus of macroeconomic and structural reforms, in that macroeconomic reforms can be focused to engage in structural changes, and that targeted structural changes can help strengthen the macroeconomic framework itself. Examples of such options are explored within the spheres of monetary, fiscal, and exchange-rate policies (see section 4). For instance, on the riel question, there is on the one hand a need for monetary and financial policy reforms (e.g. greater financial inclusion through MFIs and other credit extensions, and gradual measures to support interbank transactions, among other measures) and, on the other, fiscal and other interventions (including budgetary allocations) to encourage investments in agriculture and rural-based enterprises that are likely to step up riel-based transactions.

Similarly, on fiscal policy, there needs to be a greater effort at creating a fiscal space, and greater allocations to sectors that will play a critical role in the future restructuring process, as well as in integrated social protection and employment interventions, for example in vocational skills. A fiscal space that ensures such interventions is likely to generate further fiscal space through supporting the growth of aggregate demand, output, and employment. These measures, which are illustrative in nature, and other possibilities, need to be articulated within the broader policy framework of Cambodia's anticipated structural transformation, growth consolidation, and employment and poverty alleviation objectives.

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Cambodia: Designing macroeconomic policies for an employment-friendly growth strategy

Over the past 15 years Cambodia has made significant progress in terms of economic growth, job creation, and poverty alleviation. Since the late 1990s, Cambodia registered remarkable macroeconomic stability both in terms of prices as well as debts and deficit (except during the period of global financial crisis from 2007 to 2008). However, with the huge influx of US dollars, the economy gradually became “dollarized”. The paper argues that such dollarization, which has been favourable in sustaining growth so far, has rendered the macroeconomic policy framework rather reactive and the use of traditional policy instruments restrictive. Price stability remains a conditionality of dollarization. Strict fiscal and exchange-rate regimes are in place to support inflation targeting. Thus, the policy space is rather restricted for the economy to move towards higher and sustained growth, which is likely to require more investment and infrastructure development. The paper suggests a possible nexus of mutually reinforcing macroeconomic and structural reforms.

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