CDRI – Cambodia's leading independent development policy research institute
Royal University of Phnom Penh
Ministry of Planning
IDRC CRDI
Office of the Council of Ministers
Supreme National Economic Council
Policy brief
2012, No. 03

Government Response to Inflation Crisis and Global Financial Crisis

HAY Sovuthea[1]

INTRODUCTION

Cambodia's, strong growth performance for the last decade relied deeply on export to world market particularly United States and Europe, foreign direct investment and official development assistance under liberalized economic regime. Its markets, therefore, are not immune to global storm. The twin global crises are a timely wake-up call, highlighting challenges and opportunities for Cambodia's continued economic stability, growth and future prosperity. This brief takes stock of domestic macroeconomic policy in mitigating the highest inflation and lowest growth Cambodia has experienced since 1994. Drawing on lessons learned, it offers how effectiveness of macroeconomic policies could be strengthened.

INFLATION CRISIS

Higher prices due to the unexpected global commodity boom transmitted almost immediately to food prices in Cambodia, rapidly driving up domestic inflation. Year-on-year CPI started rising in June 2007, recording 7.6 percent growth above the highest average 5 percent for the last decade, driven mainly by 5.2 percent surge in food prices. By March 2008, CPI inflation had escalated to 26.6 percent, underpinned by 17.1 percent hike in food prices and 3.5 percent rise in transport, and then peaked at 35.4 percent in May 2008 spurred by increases of 23.4 percent in food and 3.46 percent in transport.

The prime causes of food and oil price hikes are drastic increase in world commodity and oil prices. Cambodia's headline and food inflation closely mirror trends in neighbouring trading partners, Thailand and Vietnam, and converge with food prices in these two countries within two to three months because of high volume of cross-border food trade and strongly integrated product markets. Additionally, inflation was exacerbated by overconsumption as illustrated by output-gap indicating signs of economic overheating that were stoked by a number of factors: private spending, real estate bubble, accelerated money velocity, and fast credit growth.

Soaring inflation has grave consequences for national development efforts, particularly poverty reduction. Rising food prices disproportionately affect the poor and other vulnerable groups, especially net food buyers, particularly 1.7 million people who are food-insecure households dwelling at Tonle Sap and plain regions. In Cambodia, the poorest 40 percent of the population spend 70 percent of their income on food (CSES 2004). Higher commodity prices should have benefitted rural producers, but as Chan (2008) reports, just 25 percent of farmers actually gained. This is because only 34 percent of farmers produced

[1] Mr Hay Sovuthea is a researcher for Social Policy Division at the Supreme National Economic Council. The views expressed in this policy brief are those of the author and do not necessarily represent those of any organisationthe author is affiliated with.

a surplus in 2008, 21 percent of rural households are landless and 45 percent are land poor (own one hectare or less).

To address the immediate impacts of food inflation, some key administrative measures included selling 300tonnes of rice at 1800 riel per kg below market price 2500 riel per kg, a temporary ban on rice export, and injecting USD 12 million of credit in Rural Development Bank. Key measures on the escalating oil price involved fixing reference price for tax and maintaining electricity tariff with government subsidy.

In addition, the government promptly deployed macroeconomic policy tools, coordinated by the Price Monitoring Group under the auspices of the Committee for Economic and Financial Policies. Prudential fiscal policy with deposit build-up allowed for tariff exemption on sensitive-products, provided subsidies and kept a tight rein on public expenditure. In terms of monetary policy, increasing oil and food prices led to higher demand for dollars. Without the timely intervention by the National Bank of Cambodia (NBC), inflationary pressures would be exacerbated by a combination of riel depreciation and pass-through effect. Even with intervention that ensures exchange rate stability, pass-through effects still prevail. Moreover, any intervention that leads to riel appreciation as compared to initial exchange rate will jeopardise trade competiveness. Therefore, riel depreciation and pass-through effects render monetary policy ineffective in countering externally generated inflation.

There is little that central banks and the government can do to manage externally generated inflation apart from mitigating adverse impacts and potential second-round effects by managing exchange rates. While exchange rate policy was broadly ineffective in cushioning inflation, reserve requirement and credit ceiling measures helped cool down the overheated economy by capping credit growth. Government deposit build-up during the high-growth period allowed for fiscal flexibility, and consolidated fiscal policy was effective in controlling aggregate demand. Overall, coordination and complementarity between the monetary and fiscal policies was laudable, and administrative measures deployed to cope with emerging issues were decisive and timely.

LOWEST GROWTH EXPERIENCE

The outbreak of the global economic crisis, coming hot on the heels of the food price crisis, hit Cambodia severely and stalled the country's exceptional decade-long growth and poverty reduction. Growth held out until the third quarter of 2008, then plummeted to 0.1 percent in 2009 explained by GDP compositions that -9.5 percent deceleration of industry and weak performance of the services sector. Nevertheless, the economy started to show signs of recovery in 2010 with 5.9 percent growth underpinned by stronger than expected rebound in the garment sector and recovered FDI disbursement in the fourth quarter of 2010 almost equal to that in the second quarter of2008, reflecting strong rebound in the real sector.

To counter inflation and food security, issues continuing from 2008, USD18 million was injected into Rural Development Bank to further promote food security. Economic deceleration caused job losses and underemployment in crisis-hit sector, namely garment, construction and tourism sectors. Seeing this, the government spent USD 6.5 million for Special Training Fund and USD 1 million for self-created employment and also shared occupational risk premium payment to ease burden of garment companies. To reignite growth through easing credit to private sector, cap on credit to real estate sector was lifted and minimum reserve requirement was reduced from 16 to 12 percent to urge flow of credit.

As global economic slowdown unfolded, the spotlight fell on the adoption of fiscal expansion to stimulate economic activities. Unlike in the second half of 2008 when fiscal expansion was in the form of tax exemption, fiscal measures in 2009 took the form of increasing public expenditure featuring current expenditure increasing about USD 219 million (27 percent) and capital expenditure rose about USD 154 million (31 percent). With signs of economic recovery in 2010 the government started to wind down fiscal expansion allowing for rise in current expenditure of USD159 million (15 percent) and rise in capital expenditure of USD 86 million (13 percent) (Annual budget law).

Fiscal expansion, however, was not enough to cope with an economic crisis of such unprecedented scale and its spillover effects, and could at best only slightly boost domestic demand (SNEC 2011). Moreover, government revenue responds little to increased government consumption. There were several reasons for this. The small stimulus package of around 4.5 percent of GDP in 2009 and 2.8 percent of GDP in 2010 was less than the desired level, let alone enough, to stimulate economic activities (Jalilian and Reyes 2010). The underdeveloped social security system, massive job losses and income uncertainty increased the propensity to save which hindered the multiplier effect of public spending. Increased public spending leaked out in payments for increased imports because of the country's rudimentary manufacturing base. And to a limited extent, weak budget institutions caused expenditure to deviate from desired performance targets. These combined factors raise concern about the effectiveness of the government's strategy and its capacity to implement the rescue package given the limited role of the stimulus (Jalilian and Reyes 2010).

In summary, immediate measures taken by the government to promote food security and maintain productivity in the face of global financial storm were admirable. Moreover, adoption of fiscal expansion was necessary and timely to prevent negative growth and job loss. Despite its limited effectiveness, monetary policy was well coordinated with and accommodative to fiscal policy.

GOING BEYOND CRISIS

The crises exposed the limited effectiveness of both fiscal and monetary policy to weather external shocks. Nevertheless, the export-oriented private sector-led growth strategy Cambodia is presently embarked upon definitely remains valid.

Both macroeconomic policy arms need strengthening. Fiscal tightening will replenish government deposit. In parallel, stronger budget institutions, the targeted outcome of the Public Financial Reform Programme will improve revenue administration and expenditure efficiency. Monetary policy will be more autonomous and more options available through the gradual de-dollarisation and establishment of money market.

Sectoral policies could enhance the effectiveness and complementarity of macroeconomic tools. The launch of the Policy Paper on Promotion of Paddy Production and Rice Export and the recently released National Social Protection Strategy are additional milestones. The Tourism Strategic Development Plan 2012-2020 and future package of policies to promote industrial development will lay more comprehensive ground for better macroeconomic intervention in the future.

CDRI – Cambodia's leading independent development policy research institute

56 Street 315, Tuol Kork
PO Box 622, Phnom Penh, Cambodia
(855-23) 881 384/881 701/881 916/883 603
(855-23) 880 734
E-mail: cdri@cdri.org.kh
Website: http://www.cdri.org.kh

REFERENCES

Chan Sophal (2008), *Impact of High Food Prices in Cambodia*, CDRI Policy Brief No. 2 (Phnom Penh: CDRI)

Chea Ravin & Ung Luyna (2011), "The Effectiveness of Macroeconomic Policies in Cambodia: An Empirical Study", Draft Report

Ginting, Edimon & Kelly Bird (2009), *Explaining Inflation in Cambodia,* Asia Development Bank, paper presented at Cambodian Economic Forum. 5 February 2009 Working Paper

Hang Chuon Naron (2008), "Three Essays on Macroeconomic Management of Cambodia", (Phnom Penh: Ministry of Economy and Finance)

Jalilian, Hossein, Chan Sophal, Glenda Reyes, Saing Chan Hang, Phann Dalis & Pon Dorina (2009), "Global Financial Crisis Discussion Series - Paper 4: Cambodia" (London: ODI)

Jalilian, Hossein & Glenda Reyes (2010), "Global Financial Crisis Discussion Series - Paper 14: Cambodia Phase 2" (London: ODI)

Plata, P.V. & A.G. Herrero (2008), "To Dollarize or De-dollarize: Consequences for Monetary Policy", Discussion Paper (Berlin: German Institute for Economic Research)

Supreme National Economic Council (2011), *Enhancing Fiscal Reform and the Counter-Cyclical Aspects of Fiscal Policy in Cambodia*, Draft Working Paper (Phnom Penh: RGC)