

Higher Inflation, Larger Deficits Will Not Reduce Poverty

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A report prepared under the auspices of the UNDP—*The Macroeconomics of Poverty Reduction in Cambodia*—stimulated lively debate at a recent workshop in Phnom Penh, co-hosted by the Royal Government of Cambodia (RGC). The report provides a useful diagnosis of poverty. But some of its key policy prescriptions are at odds with the RGC's *National Poverty Reduction Strategy* (NPRS). That strategy was elaborated through extensive and open *dialogue between the government and a broad cross section of society, including the poor*. Although well intentioned, the report's policy recommendations could pose risks for Cambodia, and possibly hurt the poor.

The report asserts that the macroeconomic framework agreed between the International Monetary Fund (IMF) and the RGC has been unsuccessful in reducing poverty. It calls for higher inflation (to grease the economy) and boosting demand by increasing government investment, financed by selling government bonds to commercial banks.

Achieving economic stability does not preclude poverty reduction; stability has been shown in many countries to be pro-poor. Poverty in Cambodia has not been solved because there are many obstacles to poverty reduction—economic, social and political.

Reducing poverty is an objective shared by everybody in Cambodia, including the IMF. The government and the Fund agreed on a program of economic and financial policy reforms in late 1999, which was supported by the IMF's *Poverty Reduction and Growth Facility* (PRGF; the IMF's concessional lending to low-income countries) and substantial IMF technical assistance.

Reform under the program has concentrated on securing macroeconomic stability, accelerating economic reconstruction, and improving governance, all aimed ultimately at reducing poverty. Macroeconomic stability has largely been achieved, with inflation below 5 percent and the ensuing exchange rate stability conducive to growth. Indeed, real GDP growth averaged 7 percent during 1999-2001. Key objectives under the program were to raise revenue to rebuild the economy, and to shift defense spending to priority sectors: health, education, rural development and agriculture. Progress has been made. Military and defense spending declined from 4 to 2.7 percent of GDP during 1998-2002, while priority spending rose from 1.3 to 3.6 percent of GDP. During the same period, public investment averaged about 7 percent of GDP (not low by international standards), and the fiscal deficit 5.5 percent of GDP, hardly "tight" policy.

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Despite these positive results, poverty remains disturbingly high. As the IMF stressed in its recent review of performance under the PRGF, the disappointing poverty results are due to the narrowness of the economy's production base, benefiting only a small portion of the population.

Durably reducing poverty requires high and diversified growth. That hinges on investment and the tapping of potential sources of growth, including agriculture. Sustained economic stability is a prerequisite for attracting private investment, whether foreign or domestic. But seriously boosting investment requires the removal of the colossal impediments to business activity in Cambodia, including a weak judiciary, rampant and costly facilitation fees, an unpredictable regulatory environment, and an uncompetitive labor market. Trying to compensate for these impediments with generous tax exemptions has done little for broad-based growth. However, together with an almost complete unwillingness to pay taxes, they have reduced government resources, seriously limiting government's ability to pursue needed policies. Against this background, the UNDP's recommendations are unlikely to succeed.

First, on boosting demand through higher public investment. Public investment has already been relatively high in recent years. But the key issue at present is whether such investment can be productively raised, given the government's still weak implementation capacity.

Second, on financing increased spending via the sale of bonds to commercial banks. This would increase government indebtedness. But IMF debt analyses demonstrate that higher levels of debt than currently anticipated would not be sustainable even at the hoped-for growth rates of 6.5 percent a year. Since the proposed additional debt would be on commercial rather than concessional terms, the budgetary burden would be even more onerous. Moreover, the higher interest costs would squeeze out other vital public spending, including for the poor.

Third, on boosting inflation to "grease the economy." Increasing domestic demand in the face of the many production bottlenecks in Cambodia would drive inflation higher. Somewhat higher inflation by itself would not be a concern if it were associated with higher and more diversified growth. Otherwise, it would only raise the interest costs of financing the higher deficit. Moreover, expectations of higher inflation would raise interest rates, further harming already low investment. And in the highly dollarized Cambodian economy, higher inflation would result in a rapid decline in the exchange value of the riel against the U.S. dollar. Since the riel is used most widely by civil servants and the poor, higher inflation would immediately punish them. Exchange rate instability would also fuel further dollarization.

Relieving Cambodia's poor of their daily squalor and giving them hope is the most urgent challenge for all who care about Cambodia. Although daunting, the challenge can be met. The preliminary road map—the *NPRS*—is not a static document. Instead, it is to be improved as new information becomes available and experience is gained. But it seems premature to revamp an agreed macroeconomic policy framework that has served Cambodia relatively well thus far, especially with an alternative strategy that could even be harmful to the poor. Far more helpful would be to accelerate and deepen structural reforms and drastically improve governance.