

INTERNATIONAL MONETARY FUND

CAMBODIA

Staff Assessment of Qualification for the Multilateral Debt Relief Initiative

Prepared by the Asia and Pacific Department

In Consultation with Other Departments

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Cambodia is not a HIPC country because its debt levels were below the relevant thresholds. It is, however, eligible under the MDRI because it had per capita annual GDP of below \$380 as of 2004. No IDA relief is currently expected under the MDRI for non-HIPC countries.

Macroeconomic Performance

1. **Status of Fund arrangement:** Cambodia's last PRGF arrangement ended in February 2003 following the disbursement of all loans. Resolution of a political impasse in 2004 enabled discussions on a successor arrangement. These discussions culminated in a PRGF request, which will be brought to the Executive Board once debt rescheduling issues are resolved between the Cambodian and United States authorities. Of the nine proposed prior actions (all structural), eight have been completed and sufficient progress made on the remaining action to meet its purpose. It is hoped the Board could consider the request in January 2006.
2. **Recent Macroeconomic Developments:** During 1999–2004 under the last PRGF-supported program and subsequent period, growth averaged 7¾ percent annually, supported by prudent macroeconomic policies, large aid flows, and greater openness to trade (Table 1). Inflation has been kept low, although rising to 5–6 percent recently as oil prices soared, and the external current deficit was reduced. This compares favorably with the period prior to the PRGF when growth was lower and high bouts of inflation were common. So far this year, these favorable trends have continued, although growth may dip a little as the garment sector is affected by the quota removal. Revenue receipts have increased this year with improved enforcement and stepped-up arrears collection but continued efforts are needed to improve on the very low revenue-to-GDP ratio to finance higher social spending and infrastructure development. The overall fiscal deficit (after grants) is expected to be 3 percent of GDP, fully foreign financed. Monetary aggregates are below targets set for the program, while the exchange rate is broadly stable, based on a managed float operating in a highly dollarized economy. Gross international reserves have increased steadily in dollar terms but declined in terms of import cover from 3 months in 2003 to 2¾ months of imports in 2004 as the oil price shock sharply increased imports. The information available to staff indicates that

Cambodia is current on its obligations to the World Bank—there are no obligations to the African Development Bank.

3. **Outlook:** The macroeconomic prospects for 2006 and the medium term are generally positive. Even with demand constrained by the current high level of petroleum prices, real GDP is expected to increase by 6 percent in 2006, with similar growth in later years. The overall fiscal deficit (after grants) is projected to be 4 percent of GDP, as investment increases. Based on the latest draft DSA agreed with the World Bank, Cambodia's external debt (estimated 61 percent of GDP at end-2005) is on a sustainable path but risk of debt distress is high due to the low revenue receipts—in 2005 the revenue ratio is estimated at only 11¾ percent of GDP (Table 2). The authorities are considering low-concessional AsDB loans to finance critical power projects in the medium term that would worsen the sustainability somewhat if the revenue base is not expanded.

4. **Summary Assessment:** Given satisfactory macroeconomic performance since 1999, including the last 6 months, and the outlook for 2006, staff is of the view that the related criterion to qualify for MDRI debt relief is met.

Implementation of the Poverty Reduction Strategy

5. **Recent Developments:** Cambodia prepared its first National Poverty Reduction Strategy in December 2002, through a consultative process, to achieve its Cambodian Millennium Development Goals (CMDGs) for poverty alleviation and human development. Specifically, Cambodia added goals relating to de-mining. There was an update and JSAN which was considered by the Fund's Executive Board on September 13, 2004. The authorities have recently updated their poverty reduction strategy with a National Strategic Development Plan (NSDP)—released for public consultations in November 2005, and expected to be completed in early 2006—that combines the poverty reduction strategy and the national development plan. Overall implementation of the poverty reduction strategy has been positive and participation by civil society broadened. Recent data indicate the share of the population living below the poverty line has fallen since 1999 from 36 percent to 28 percent in 2004 in the nonconflict areas, continuing the trend since 1993. However, rural poverty remains higher—the estimate for the whole country is 35 percent in 2004. Other gains include improved health since 1998, with infant mortality rates declining by a third. Net primary education enrolment has also risen from 87 percent in 2001 to 92 percent in 2005.

6. **Outlook:** Some important challenges remain, however. As noted in the PEM section below, it is currently difficult to monitor poverty-reducing spending in sufficient detail so that the better expenditure classification and tracking system being developed is critical. Income inequality appears to have increased, and a number of CMDGs are unlikely to be attained without a considerable increase in resources and policy focus.

7. **Summary Assessment:** Given the satisfactory implementation of poverty reduction policies over the past six months and the ongoing implementation of the strategy, staff is of the view that the relevant criterion to qualify for MDRI debt relief is met.

Public Expenditure Management System

8. **Recent Developments:** Steadily improving in a number of areas over the past few years, Cambodia's core PEM systems function reasonably well, but many challenges remain. Cambodia's PEM system was not formally assessed in the manner of HIPC countries. Nevertheless, during the World Bank's Integrated Fiduciary Assessment and Public Expenditure Review (IFAPER) in 2002–03, a tentative assessment of the PEM system using HIPC AAP guidelines suggested that Cambodia met only three benchmarks out of 15. The current assessment of PEM shows that Cambodia meets 5 out of 16 PEM benchmarks¹ and has made progress toward meeting some of the other goals, suggesting improvement over the past 2–3 years.² This assessment is comparable to, or better than, those for a number of HIPCs.

- **Weaknesses:** While there is in place a reasonable regulatory framework that applies to PEM, there are some weaknesses in coverage, quality of fiscal data, reporting and auditing. The budget coverage of projects financed by donors is incomplete, ministries often finance spending out of their non-tax revenue collections, and it is difficult to monitor specifically poverty-reducing spending. Payment arrears remain a problem and the stock at end–2004 was large. In general the internal control system needs enhancing, and the role of internal auditors vis-à-vis the general inspectorate needs to be clarified. For the past two years, the audit reports on annual financial statements were presented late to the National Assembly, in part because payments were made after the close of the fiscal year.
- **Progress:** The main areas of advancement have been: (i) developing a new budget classification (expenditure categories) for implementation with the 2007 budget; (ii) addressing the problem of accumulated expenditure arrears and developing a medium-term strategy for their payment; (iii) stocktaking of government bank accounts with the central bank and commercial banks; (iv) developing a computerized financial management information system; and (v) building capacity to monitor Priority Action Programs focused on poverty reduction, including public expenditure tracking surveys.

¹ The Cambodian authorities questioned the assessment of a sixth benchmark, but could not provide, in time, evidence that it was met.

² An FAD mission conducted the assessment, and discussed and broadly agreed the findings with the authorities during a November 23–December 1 staff visit.

9. **Outlook:** Despite this progress, Cambodia requires substantial upgrading in its public expenditure and financial management capacity, but the government has a clear commitment. To tackle the issues, a comprehensive public financial management reform program was adopted in close consultation with the IMF, World Bank and other donors in December 2004, with sequencing of reforms over a period of ten years. The reform program envisages strengthening through four successive stages, with each stage aimed at establishing a platform as a basis for the next stage. Key actions to be implemented under the proposed PRGF-supported program include a quarterly in-year expenditure reporting system for priority ministries, strengthening management of nontax revenues, establishing the timely submission of quarterly project expenditure reports, enhancing the linkage between the NSDP and the annual budget process by clearly identifying and listing in the budget document poverty-reducing activities, maintaining a database on the stock of verified arrears, and regular reconciliation of all bank accounts. The authorities intend to increase resources devoted to the PEM program to effect the necessary improvements.

10. **Summary Assessment:** Staff is of the view that the quality of the PEM system in Cambodia has improved in recent years and that the country meets the relevant criteria to qualify for debt relief.

Other

11. **Provision of information to the Fund:** The staff is satisfied that the authorities collaborate with the Fund and provide appropriate information in the context of surveillance and use of Fund resources. Although the statistical base is poor, work is underway to develop further a suitable monthly reporting system.

12. **Payments to the IMF:** Cambodia is current on its obligations to the IMF.

Overall Assessment

13. Staff is of the view that all three criteria are met, and recommends that the Board determine that Cambodia qualifies for immediate relief under the MDRI.

Table 1. Cambodia: Selected Macroeconomic Indicators, 2000-05
(annual percent change; unless otherwise indicated)

	1994 - 98	2000	2001	2002	2003	2004	2005 (Est.)
Real GDP	6.3	8.4	5.5	5.2	7.0	7.7	6.3
Inflation (e.o.p)	8.4	-0.8	0.7	3.7	0.5	5.6	5.5
Real effective exchange rate	3.8	1.1	5.2	1.2	-6.9	-5.6	-3.3
Broad money	27.7	26.9	20.4	31.1	15.0	30.4	20.3
Overall fiscal balance including grants (in percent of GDP)	-1.3	-2.1	-2.7	-3.8	-4.2	-3.2	-2.9
Current account balance including grants (in percent of GDP)	-4.3	-2.9	-1.2	-1.2	-3.2	-3.4	-4.7
Foreign exchange reserves (in months of imports)	1.9	2.6	2.7	3.0	3.0	2.7	2.5

Table 2. Cambodia: Public and Publicly Guaranteed (PPG) External Debt and Debt Relief 1/
(in millions of U.S. dollars; unless otherwise indicated)

	2004	2005 (Est.)	2006 (Proj.) 4/		2007 (Proj.)
			Before MDRI	After MDRI 2/	After MDRI
PPG External debt	3,152	3,282	3,550	3,473	3,736
<i>of which owed to the Fund</i>	97	83	93	16	33
<i>of which owed to IDA</i>	464	479	534	534	585
<i>of which owed to AfDF</i>
NPV of PPG external debt to exports 3/	79.1	72.3	70.5	68.8	67.5
Debt service to exports 3/	0.9	0.9	0.8	0.6	0.7
PPG External debt to GDP (in percent)	64.5	61.5	61.4	60.0	59.6
NPV of PPG External debt to GDP (in percent)	52.5	50.1	49.8	48.7	48.4

1/ After HIPC assistance. No debt rescheduling to the U.S. and Russia is assumed.

2/ Assuming delivery on January 1, 2006 for the Fund. No IDA operation is currently envisaged and AfDF is not relevant.

3/ Exports of goods and services for the year under consideration.

4/ The PPG external debt to GDP under rescheduling with the U.S. and Russia is 19 percent lower than the above case.