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REBUILDING CAMBODIA'S ECONOMY: UNTAC AND BEYOND

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Contents

Rebuilding Cambodia's Economy: UNTAC and beyond

Cambodia has a per capita income level of USD 200,[1] about the same as that of Viet Nam and Laos. But the human and infrastructural losses resulting from war and isolation make it the poorest of the Asian centrally-planned economies attempting marketisation. Unlike Viet Nam, communism in Cambodia produced neither land reform, infrastructure development nor even a literate, skilled population. Two decades of war and isolation dislocated traditional agriculture, decimated the country's middle class and left its infrastructure in ruins. Although the Hun Sen government's reconstruction effort in the 1980s was praiseworthy, its resources were extremely limited and it remained cut off from official Western aid for most of the period. The Paris peace accord and the arrival of UNTAC has brought a semblance of prosperity, but the transition to democracy envisaged by the Paris Accords is deeply flawed and economic recovery is at risk.

Below, we explore the particularly fragile nature of Cambodia's transition to a market economy and a democratic polity. Following a brief summary of the effects of the country's two wars in Section I, Section II sketches the logic of a stabilisation programme and the particular institutional barriers to adjustment in the ex-centrally planned economies. In Sections III and IV, the general structure of the economy and the current state of public finance are examined in detail. Relying on UNTAC's own projections, section V sets out two alternative post-electoral "scenarios," the second (and more likely) scenario involving economic contraction and rising inflation. The article concludes that in the absence of well-targeted, quick-disbursing aid, Cambodia's slide into hyperinflation cannot be checked, leading to a further setback in the recovery process and possible political disintegration. Since the post-electoral environment is likely to be far less stable that envisaged by the donor community, the danger is too little of what has been pledged will be disbursed in time to avoid such an outcome.

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[1] See UNTAC (1992b).

I. Summary Background

In the 1970s, Cambodia experienced a two-phase war---beginning with the US bombing campaign in 1969 and the Lol Nol coup in 1970, followed by the internal bloodbath inflicted by the Khmer Rouge (DK) regime of 1975-79.[2] The war resulted in catastrophic damage to the country's economic and social structure. Using demographic projections of the 1968 census, the estimates loss of population from all causes was of the order of 2 millions (about a quarter of the total), including most of the middle class.[3] The UNICEF-sponsored economic survey of Cambodia immediately after the overthrow of the DK regime suggests that in 1980, total output had fallen to one-quarter of its 1968 level, the last pre-war year for which there was reliable data. The particularly disastrous fall in rice production would have led to mass starvation but for UN Emergency Assistance (1979-81). Traditional export activity (rubber, timber, fishing, rice) had virtually ceased. "Modern" industry and infrastructure (including irrigation) lay in ruins; even money was abolished by Khmer Rouge who literally blew up Phnom Penh's Central Bank. However, in 1982, following the decision to hand Cambodia's UN seat to Khmer Rouge-led opposition,[4] all international aid was cut off despite an appeal by the UN Secretariat.

By the late 1980s economic activity was back to perhaps two-thirds its pre-war level---an economy in "low level" equilibrium and dependent on USD 100 mn per annum in CMEA aid and donations from Western NGOs. In 1989, the Paris Accords were signed, and

[2] There are many accounts of this period and the events leading up to it; I have found the following particularly useful: Evans, G. and K. Rowley (1984); Shawcross, W. (1984) and Vickery, M. (1984).

[3] Of the estimated 5000 teachers, only 450 survived; of the estimated 500 doctors, about 50 remained. All school books had been destroyed, and is was necessary to rebuild education virtually from scratch. Good accounts of the post-war phase are given in Curtis, G. (1989) and in Mysliwiec, E. (1988).

[4] The opposition was known as the Coalition Government of Democratic Kampuchea (CGDK) and comprises three main groups: (1) Pol Pot's DK (Democratic Kampuchea) forces; (2) the KPNLF (Khmer Peoples National Liberation Front), an alliance forces loyal to Lol Nol under his ex-Minister, Son Samm; and (3) the FUNCINPEC party of Prince Norodom Sihanouk (now headed by one of his sons, Prince Norodom Ranariddh). The CGDK's "Foreign Minister" was Khieu Samphan, who had succeeded Sihanouk as Head of State under Pol Pot.

Vietnamese troops left the country. The Hun Sen government embarked upon a programme of major reform, the process accelerating with the arrival of UNTAC[5] in late 1991. By early 1993, Cambodia had returned to a per capita income level of USD 200 (1988 prices), roughly that prevailing twenty years earlier when Cambodia had been at the same income level as Thailand. The production of rice (the main staple) and rubber and timber (the main exports) had returned to approximate prewar levels. Nevertheless, both development in general and "aid absorptive capacity" in particular is severely constrained by absence of skilled labour and professionals. A growing government proportion of the government deficit is unfunded, inflation is accelerating and the external trade gap had widened. In the rural areas where 80 percent of the population lives, the multilateral organisations report high infant mortality, and the return of epidemic diseases.[6]

II. Some General Problems of Market Transition

Before examining the current state of the Cambodian economy in more detail, it will be useful to sketch the economic logic of stabilisation as it pertains to the ex-centrally planned economies. Broadly, stabilisation and adjustment is hampered by three characteristics of the "transitional economy": the weakness of its fiscal-financial system, the economy's poor supply-response to price incentives and its vulnerability to external trade shocks.[7] Such problems are particularly acute in a small, low-income economy such as Cambodia's.

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[5] UNTAC (originally UNAMIC) stands for United Nations Transitional Authority in Cambodia.

[6] See World Bank (1992), p.9, "social indicators".

[7] More generally, it can be argued, these are facets of the problem of a "weak state". Contrary to received wisdom of the cold-war area, centrally planned economies did not in general have a strong (or even a particularly coercive) state apparatus. The socialist camp was largely held together by a modernising, secular ideology which promised much and delivered little. As the opening of Eastern Europe in 1989 revealed, armies were ill-trained, public administration was weak, the legislative process cumbersome and the judicial branch inoperative, all reflecting the weakness of civil society itself.

In general terms, structural adjustment involves major changes in the aims and modalities of macro-economic policy such that the economy becomes competitive in the world market. Since such changes take time, an IMF-sponsored stabilisation programme is normally required. Government adopts a set of measures---often quite deflationary---designed to reduce its internal and external deficit; in return, the IMF provides foreign exchange support and its "good housekeeping" seal.

The logic of stabilisation is based on the ex post identity which says that national income is in equilibrium where gross savings and investment are equal.[8] The savings-investment relationship can be thought of as comprising of three balances, and if any balance is negative (or a "savings gap" exists) it must be offset by a positive balance elsewhere. The first balance is that between private domestic savings and investment; the second is between current government revenue and expenditure and the third is between export revenue and import expenditure. Since the sum of these three "gaps" must total zero, any deficit in one must be offset by a surplus in some other.[9]

If equilibrium is upset by, say, an external shock, it can always be re-established where the authorities are willing to accept a cut in national income and employment. But if government increases the budget deficit and wants to maintain the current level of national income, it must either (a) fund the deficit from extra foreign savings (obtain money abroad) and/or (b) fund the deficit from extra domestic savings. If investment and growth are not to be sacrificed, this means cutting somebody's consumption by means of taxes or inducing

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[8] Algebraically, let C = private consumption, I = total investment, S = domestic private savings, T = tax (and all other) revenue, G = current government expenditure, X = exports and M = imports (ignoring net factor services and transfers). The national income identity is:

$$Y = C + I + G + (X - M)$$

while income is disposed of as C, T and S; or:

$$Y = C + T + S;$$ so by substitution,

$$T + S = I + G + (X - M)$$

rearranging and using brackets for emphasis:

$$(S - I) = (G - T) + (X - M)$$

these are the three "gaps" and they must sum to zero. From left to right they are the "domestic savings gap" the "budget gap" and the "trade gap".

[9] The usual illustration is to suppose the first gap to be zero: if the government budget is in deficit (ie, "government savings" is negative), it must be offset by a positive inflow of "foreign savings". Another way of saying the same thing is to say that the budget deficit is "mirrored" by trade gap.

savers to save more by means of higher interest rates. The salient point---and it is a point always made by IMF and the World Bank missions---is that if government does nothing, inflation will cut the consumption of society's most vulnerable groups.

What has all this to do with the transition to a market economy, and particularly with the three problem areas mentioned: fiscal-financial weakness, supply-response weakness and foreign trade vulnerability? First, as the state moves from central planning to a market economy, the budget gap tends to widen because the state both spends more and looses traditional sources of revenue; ie, the state experiences a "fiscal crisis."[10] Since the growing deficit is not usually matched by an equivalent inflow of foreign private capital or development assistance, the unfunded gap is bridged by monetary emission, leading to inflation. Second, because proper financial institutions do not exist, people cannot save more; indeed, as inflation accelerates they tend to lose faith in the currency and try to spend more thus aggravating the spiral. Third, there is usually a hiatus between the decline of the old central planning system and the rise of the market economy in which neither the plan nor the market functions effectively. While waiting for fiscal reconstruction, price liberalisation, decentralisation and other reforms to take effect, output may in fact decline. Fourth, since exports also suffer, the external balance deteriorates while, because of inflation, the real exchange rate appreciates. The inflationary spiral gets worse until the only remaining remedy is "shock treatment"---a very large dose of deflation causing widespread unemployment.

The above provides a rudimentary economic framework for understanding the problem of stabilising an economy in transition towards a market system. Consider the problem of fiscal-financial weakness in slightly more detail. The transition to a market economy increases the fiscal-financial strain in a number of ways. Decentralising state-owned enterprises (SOEs) typically results in a fall in budgetary revenue since their profits can no longer be skimmed off fully by turnover tax. On the expenditure side, the tendency to free wholesale prices while maintaining fixed retail prices for essentials is equivalent to increasing

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[10] In the words of McKinnon (1990: 133) "as in the other liberalizing economies of Eastern Europe and Asia, the Soviet Government's ability to collect tax revenue has greatly diminishes as a result of the liberalisation itself." Ironically, the phrase "fiscal crisis of the state" is associated with O'Connor (1973) who used it to refer to growing budget deficits in advanced capitalist countries, particularly the United States.

enterprise subsidies. Additionally, the state must either continue to subsidise loss-making SOEs or else, where it hardens the soft-budget constraint,[11] it must assume central responsibility in the form of unemployment benefit for a range of services previously provided at enterprise level.

The fiscal crisis is usually accompanied by a financial one associated with the unfunded budget deficit, and inflation in turn exacerbates the fiscal problem.[12] Excess private liquidity---the so-called "overhang"---could in principle be mopped up either through an increase in voluntary savings, an increase in retail prices or a rise in output. But the authorities, fearful of jeopardising enterprise investment, are usually unwilling to raise real interest rates. Moreover, they see the freeing of prices as fuelling inflation, and are usually under pressure to accede to compensatory wage rises leading to a "populist" wage-price spiral.[13] Cambodia has been particularly vulnerable in this regard since its fiscal system has effectively collapsed and its financial institutions are primitive, even by the standards of low-income LDCs.

Next is the problem of supply response. While stabilisation is meant to contain inflation while waiting for adjustment to take place, the success of adjustment depends ultimately on raising output. In practice though, output in transitional economies has tended initially to stagnate or (as in the ex-USSR since 1989) to decline.[14] The reasons are complex but, briefly, inelastic price response will be widespread initially in SOEs where managers have little incentive to produce for profit, and where rapid decentralisation under conditions of inflation and foreign exchange scarcity dislocates supply channels for industrial inputs.

The most serious facet of supply response concerns agriculture's marketed surplus. Contrasting examples are the case of the ex-USSR, where the inelastic supply of wage goods lies at the heart the stabilisation problem, and cases as diverse as Poland, China and Viet

[11] This is Kornai's (1986) well-known phrase.

[12] The inflationary erosion of tax revenues is called the "Tanzi effect" after Tanzi (1977).

[13] For a good account of this problem in the ex-USSR, see Aslund (1992).

[14] For figures see Ellman (1992).

Nam where the freeing of agricultural prices was perhaps the single most important enabling factor in accomplishing successful stabilisation and adjustment.[15] In this area, although Cambodia has done reasonably well in terms of overall output, part of this must be attributed to the UNTAC-generated expansion in services and construction. As shown below, agricultural output has recovered as unutilized land is reclaimed, but there is no strong evidence of a favourable shift in agriculture's terms of trade.

The third problem area is foreign exchange availability (foreign savings). Just as LDC adjustment was hampered in the early 1980s by a severe foreign exchange constraint, adjustment in the centrally planned economies has been made all the more difficult by the collapse of barter (CMEA) trade, the deterioration in hard-currency terms-of-trade and an appreciating real exchange rate.[16] The obvious exceptions, again, are China and Viet Nam; the former was not a CMEA member while the latter was cushioned from the shock by its export surplus in rice which followed the 1988 reforms. In general, though, countries in transition to a market economy need a large foreign exchange injection to sustain them through the adjustment period if they are to avoid a dramatic decline in living standards; contrasting examples are Poland, Hungary and Czecho-Slovakia where generous aid was forthcoming, and the ex-USSR where it was not.

In Cambodia, although major liberalisation began in 1978, very little aid has been received. Instead, aid has been made contingent upon signing a peace accord, forming a transitional government and holding elections. About USD 850 mn. has been pledged to date by the international donor community, but less than $100 mn of this has been disbursed, much of it for balance of payments support and refugee resettlement. The foreign aid

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[15] Poland's agriculture was distinctive amongst the communist countries in being largely private; output response has proved an important in the relative success of "shock" therapy applied in 1990. In China, which "pioneered" agricultural reforms in 1978, inflation has remained under control with only a brief period of stabilisation required in the late 1980s. Viet Nam provides perhaps the most vivid case of successful, rapid stabilisation resulting from the agricultural price-reform measures of 1988; a good discussion of the latter is Wood (1989).

[16] This is true for all net oil importers when in January 1991 CMEA trade was put on a hard currency basis and in consequence collapsed. Thus the ex-USSR, which was to have been the main beneficiary, suffered along with its other partners.

injection represented by the UNTAC effort has been far larger; hence, as UNTAC withdraws, the need to accelerate disbursement will become acute.

III. The Current Situation

Ostensibly, Cambodia's economy has grown relatively rapidly since the beginning of the reform process in 1988, the average 5-year figure being 5.8 percent.[17] Looking at Figure 1, agriculture contributes over half of GDP, services another third and industry's share is about 15 percent. The broad picture is a of strong overall growth in 1988, a slowdown in 1989 and 1990 and a recovery thereafter. However, much of this growth has been in the urban services sector, driven by the buildup of the UNTAC operation----estimated at a level of USD 200-250 mn per annum or about 10 percent of Cambodia's 1992 GDP.[18] In agriculture, although severe flooding affected the 1990-91 harvest, overall growth has outpaced that of population[19] and food output per capita has increased. Industrial growth slowed after 1988 and turned negative in 1990 under the combined impact of the loss of Soviet supplies and the reform of public enterprise. But growth now appears to have resumed. Despite adjustments, these figures probably under-report the growth of services (many of which fall outside the official economy) and over-report the growth of industry, still dominated by state enterprises (SOEs) and where the freeing of prices has had more impact on output value than on volume.

It is difficult to judge how far the resumption of growth is due to the foreign exchange injection provided by the arrival of UNTAC in 1991. However, it is clear that

[17] The revised estimates in Figure 1 are somewhat lower than those obtained from the Ministry of Planning by the UN Survey and IMF Missions which visited Cambodia in the first half of 1992 whose figures are used in World Bank (1992). In particular, the 1991 estimate has been revised from 13.5 percent to 7.6 percent, mainly because of the revised estimate of agricultural growth. All agencies agree that Cambodian data are woefully inadequate, the margin of error falling well outside the usual +/- 10 percent range.

[18] See UNTAC (1993b), p 10.

[19] Population growth is currently estimated to be 2.8 percent per annum.

Figure 1: GDP Growth and Composition

	1988	1989	1990	1991	1992*
GDP: Real percentage growth rates					
GDP	9.8	3.5	1.2	7.6	6.9
Agriculture	5.9	7.1	1.2	6.7	4.8
Industry	15.0	1.8	-2.1	8.9	8.4
Services	13.6	-1.1	2.7	8.4	9.5
GDP by Sectoral Share					
Agriculture	50.5	52.2	52.3	51.8	50.8
Industry	15.7	15.4	14.9	15.1	15.3
Services	33.8	32.4	32.8	33.1	33.9

Source: UNTAC, (1992b) and World Bank (1992).

private capital has flowed in from neighbouring countries[20] has flowed in provide the hotel, restaurant, banking and other modern services which have mushroomed in the past two years. The presence of nearly 20 000 UN troops has undoubtedly boosted the earnings of many Cambodians too, but much of that injections leaks directly and indirectly into imports. This emerges from estimates of trade account deficit (Figure 2) which has trebled since 1989 and is currently running at nearly USD 300 millions. Although the value of exports has nearly doubled---because of both increased production volume and price for natural rubber---imports have grown by a factor of three. Moreover, according to some observers, the degree of non-recorded trade may be nearly as great as that in the official figures.[21]

Figure 2: Current trade balance (USD mn)

	1989	1990	1991	1992
Exports of Goods & NFS	44.2	34.7	63.0	70.0
Imports of Goods & NFS	135.0	115.3	243.0	360.0
balance	-90.8	-80.6	-180.0	-290.0

Source: State of Cambodia (1993).

[20] The main countries involved are Thailand, Singapore, Malaysia and Hong Kong.

[21] According to one source, some USD 50 millions per annum in timber and precious metals are being exported illegally to Thailand from the Northern and Western provinces where the Khmer Rouge are active.

Just as important as the growth of the external deficit has been the change in its finance. Broadly speaking, UN and private direct investment has replaced CMEA aid as the main source of foreign exchange. This change has had a serious impact on structure of public finance and, in particular, on public investment. Prior to 1988, Cambodia's average annual trade deficit was of the order of USD 100 mn per annum, the bulk of which was financed by CMEA aid piped through the state sector; revenue from aid-financed imports was consolidated into the state budget thus forming the backbone of state finance.[22] Cheriyan and Fitzgerald (1989) estimate the share of tax in GDP to have been 3 percent, one of the lowest in the world.

As aid from the CMEA countries dried up in the late 1980s, a growing proportion of the deficit was monetised and inflation accelerated (Figure 3). Monetary emission rose to 20 percent of the budget in 1989 and since 1990 has covered about 40 percent of budgetary expenditure. Inflation, combined with the relative decline of state enterprises, has further

Figure 3: Retail price inflation

1989	1990	1991	1992	1993/Q1
70%	157%	121%	200%	20%

Source: State of Cambodia (1993) and UNTAC (1993a).

eroded budgetary revenue. Hence the unfunded portion of the deficit rose from 1.2 percent of GDP in 1989 to 5 percent in 1991. The Central Bank, lacking reserves, effectively floated the exchange rate which in 1989 had been R.200 to the dollar. In consequence, the riel depreciated from 800 to the dollar in 1990 to 2600 by March 1992, where it stabilised until its further dramatic fall in March 1993.

Although the IMF does yet have an official programme with Cambodia, an agreement on stabilisation was reached in mid-1992, the fear being that unchecked monetisation would result in hyperinflation. According to UNTAC (1983b), in 1992 the State of Cambodia

[22] For details see Cheriyan, K.C and E.V.K. Fitzgerald (1989); also Coady, D. and M. Desai (1989).

(SOC) Government[23] made remarkable efforts to reduce the unfunded deficit. Despite the difficulty of demobilising given renewed Khmer Rouge attacks and pressures to raise real wages in the civil service before the general elections, the SOC set budgetary caps which were adhered to, resulting in a dramatic deceleration of inflation in early 1993---although, for reasons explained below, high inflation has since returned.

This brief period of stabilisation was achieved by cutting the most vulnerable items of budgetary expenditure: capital and social spending. Capital spending on infrastructure ceased, maintenance expenditure was cut to the bone and payments to SOEs for services were deferred. The results are all too visible. In Phnom Penh and other urban areas, rubbish goes uncollected, the sewers have clogged, water is polluted, essential services including hospitals are deprived of power and so on. In the rural areas, access to health and education has declined and transport and communications are virtually non-existent. It is estimated that only about half the population has access to any form of health care, and that only 12 percent of the rural (and 20 percent of the urban) population has access to safe drinking water.[24]

Although bilateral donors pledged some USD 850 mn for Cambodian reconstruction at the Tokyo meeting in May 1992, as of March 1993, only about 10 percent of the total had begun disbursement. Most disbursements have gone to financing the repatriation costs of some 200 000 refugees from the border camps. The only multilateral organisation to have begun disbursing aid for infrastructure and balance-of-payments support is the ADB, in the form of a USD 65 million loan.[25]

In a word, the main economic consequences of the peace accords has been to divert foreign exchange from the public to the private sector and from capital to consumption

[23] This acronym is now used both for the Hun Sen administration and its Cambodian People's Party.

[24] The current World Bank country report states the problem in stark terms: "At present ... the delivery of services is deteriorating rapidly under fiscal pressures: social infrastructure maintenance and rehabilitation have almost ceased; production and distribution of textbooks have virtually come to a standstill; suppliers of pharmaceuticals to the public sector are stopping their deliveries. Salary payments have become sporadic, the more so in the primary social systems ....(World Bank 1992; p v).

[25] It is unlikely that more aid will flow in before the elections scheduled for the end of May, 1992; at the time of writing, it is still uncertain that the elections will be held.

expenditure. This has brought growth, but in the absence of sufficient aid, the cost has been an unfunded budget deficit leading to a cycle of inflation and devaluation. To reduce the deficit, government effectively disinvested. In consequence, the problem of rehabilitating Cambodia's basic infrastructure is more acute in 1993 than it was in the late 1980s.

IV. Market Reforms

Although the decollectivisation of agriculture and decentralisation of industry began in the early 1980s, it was not until 1989 that the transition to a market economy began in earnest. The main areas of change can be grouped under three headings: agriculture, pricing policy and the decentralisation and privatisation of state-owned enterprise (SOEs).

Central to the process of agricultural transformation has been the distribution of private, transferable land titles. It is estimated that by June 1991, applications had been filed for land titles covering some 3.7 million hectares.[26] In addition, forced deliveries to the

Figure 4: Alternative estimates of changes in agriculture's terms of trade

Implicit price deflators: (1989 = 100)

year	1987	1988	1989	1990	1991	1992
1. GDP	27.9	84.0	100.0	245.6	509.5	877.7
2. industry	65.0	73.7	100.0	183.7	408.6	551.6
3. agriculture	41.0	103.8	100.0	261.5	490.2	784.3
4. ToT (3/2)	100	223	159	226	190	225
5. ToT (3/1)	100	84	68	72	65	61

Source: UNTAC (1992b).

state of rice have been abolished and the two-tier pricing system (administered and market) has been largely unified. Foreign trade in most agricultural commodities has been liberalised and the movement of products between provinces is no longer restricted. "Land-to-the-tiller",

[26] See World Bank (1982), p 19.

price reform and the clearing of land mines appear to have resulted in increased production, particularly of rice.

Can one conclude that the peasantry is economically better off? In the absence of household consumption survey data, evidence can be obtained from data on the domestic terms of trade. As shown in Figure 4, using implicit price deflators for GDP suggests that agricultural prices have moved favourably relative to industrial prices (row 4), but unfavourably relative to services and to GDP as a whole (row 5). (The terms of trade calculations have been rebased to 1987 for convenience.) If one takes the GDP price deflator as the best proxy for changes in price of agricultural producers' consumption, the conclusion is that the position of agricultural producers has declined steadily since 1987. Such a hypothesis is confirmed by casual evidence on the deterioration of educational, health and other social services in rural areas. More generally, the data-series suggests that service sector workers (largely private trade plus government employees) have gained at the expense of peasants and industrial workers (the latter mainly in the SOE sector).

In the SOE sector, state enterprises were in principle granted full financial autonomy within a framework of indicative planning with a view towards their gradual privatisation. Budgetary subsidies were abolished for operating costs and capital expenditure, while SOEs were granted the right to retain all profits and half their depreciation funds. Prices were freed, and short and long-term capital requirements were to be met through bank loans at commercial rates. In practice, however, such is the state of their capital stock that few SOEs are commercially viable. However, large scale closures or redundancies were considered unacceptable by the Government given the volatile political situation. Equally, most output price changes still need administrative approval, a process which can take months. The upshot is that loss-making enterprises continued to receive subsidies. In the absence of an effective fiscal administration, the few profit-making SOEs have paid over a far smaller portion of their profits to the state. To "claw back" revenue, the state in turn has either resorted to administrative pricing or run up large arrears with those SOEs from which it purchases goods and services, and this has had a knock-on effect as enterprises run up arrears with each other. Examples are the state rubber plantations which delivers its output to the state marketing board and receives a price far below the international price, and the state electricity company which at the end of 1991 was owed arrears by central government and SOEs equivalent to its entire sales for that year.[27]

Nor has the banking sector been able to provide much credit to SOEs, mainly because under highly inflationary conditions real interest rates have turned negative and the banking system has been unable to mobilise savings.[28] In consequence, the SOE share in industrial and services value added has fallen and capital investment in the sector is virtually non-existent. Under such circumstances, not surprisingly, privatisation has made little headway as a revenue-spinner and has mainly taken the form of leasing at fixed nominal rates. Additionally, the absence of a well-defined code of company law and the weakness of the judicial system tend to deter domestic and foreign purchasers.[29]

V. Monetary and Fiscal Policy and Stabilisation

The above suggests that reform has been accompanied by a deterioration in state finances and, indeed, the figures show a dramatic widening of the fiscal gap. Over the period 1989-92, budgetary expenditure remained about 8.5 percent of GDP while budgetary revenue fell from 7.7 percent to just over 4 percent of GDP, leaving an unfunded gap of 4.5 percent of GDP. The bulk of this erosion is attributable to the rapid decline in the net budgetary contribution of the SOE sector---the World Bank estimates that at the end of 1991, this contribution had declined by nearly 95 percent in real terms relative to 1989.[30] Inflation has

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[27] See World bank (1992), p.23.

[28] In 1992 it is estimated that demand and savings deposits together accounted for only 7 percent of total liquidity. See UNTAC (1992a), p. 17.

[29] The one area in which "privatisation" has made considerable headway is commercial and residential property. In Phnom Penh alone, since 1989 some 100 000 units have been made private. Too often, the new "owners" have been well-placed party officials who in effect have transferred state assets to themselves, often leasing them to foreigners at a handsome profit. Lest one pass judgement too hastily, the monthly salary of a high-level civil servant in 1981 was of the order of 10-12 US dollars.

[30] See World Bank (1992), p. 40.

in turn exacerbated the budget gap since indirect taxes are fixed largely in nominal terms, and much company and personal taxation appears to be "negotiable".[31]

The expenditure side shows why recent cuts have fallen on infrastructure spending. The continued conflict with the Khmer Rouge has blocked any significant reduction in defence expenditure. Most important, civil service salaries in 1991 were raised in line with inflation and though Government pledged to reduce public employment, it has been reluctant to do so in light of the political repercussions of large-scale cuts.

In mid-1992 the multilateral agencies, sensitive to the dangers in the situation, took the unusual step of negotiating directly with the SNC and the SOC prior to the elections. In October, the SOC reached agreement with the IMF on an economic stabilisation programme. A meeting of the Cambodian support Group of donors was held on 25 February 1993 to arrange payment of Cambodia's USD 50 mn arrears with the Fund, paving the way for resumption of IMF operations in the country.[32] In October 1992, the ADB concluded negotiations on a USD 67.8 mn loan to support activities in the transportation, power, agriculture and education sectors.[33] A World Bank Mission had also visited Cambodia in September 1992 at the request of the SNC to outline implementation arrangements for a USD 75 mn emergency rehabilitation loan, USD 35 mn of which was intended for financing essential imports, and another USD 40 mn to improve delivery of essential services through rehabilitation of key sectors including transport, public utilities, health and education.

Finally, in the final quarter of 1992 an attempt was made to strengthen the fiscal system. A number of measures were introduced including a tax on hotel services, vehicle

[31] With the exception of SOEs, most businesses keep no books, tax legislation is generally hazy and fiscal collection capacity is in any case limited. It is not unusual therefore for taxes to be "negotiable"; a small sweetener will usually ensure that this year's tax liability is much the same as last years. The same appears to be true of customs duties. Travellers by road report that duties on cars imported from Thailand appear to be negotiated according to circumstances. A notable exception has been the UNTAC operation which accounts for a large proportion of the substantial increase in port traffic and customs receipts in 1992.

[32] See UNTAC (1993b).

[33] The loan disbursement agreement (signed on 2 February 1993) is being complemented by technical assistance grants and additional small loans, mainly from Japan, Sweden, Austria, The Netherlands and the UK.

licensing and the introduction of a new dollar-based price list for assessing customs duties (until 1992, tariffs were levied on a Riel basis). Most important, under the tutelage of UNTAC officials, cash limits were placed on wages and salaries. These measures, together with budgetary support from donors, served to stabilize the situation in early 1993. According to UNTAC, between September 1992 and January 1993 monetary emission was effectively frozen, consumer prices rose only 1.7 percent while the exchange rate remained in a band between 2200 and 2400 Riels.[34]

However, the events of March 1993 amply illustrate the fragility of stabilisation policy in the current political climate. Early in March, the World Bank returned to finalise with the Supreme National Council (SNC) the disbursement arrangement for the USD 75 mn loan agreed upon the previous September. But the SNC refused to sign, the representative on the SNC of the Funcimpec opposition party having insisted that the loan would favour the SOC.[35] The Bank Mission returned to Washington empty-handed.

The second shock came on Friday 19 March, 1993.
In the space of 24 hours, the parallel-market[36] value of the Riel fell by 80 percent from 2600 to 4800, subsequently settling at 3700 to the dollar. Explanations for this "spike" ranged from economic sabotage by the opposition parties---accused of dumping bushels of riels on the market----to a run on the dollar by ethnic Vietnamese prompted by repeated Khmer Rouge attacks on ethnic Vietnamese villages in the Tonle Sap region. (It is indicative of Sihanouk's "mercurial" political style---as the international press calls it---that instead of

[34] See UNCTAC (1993a).

[35] One family member, Prince Norodom Radariddh, now heads the opposition Funcimpec Party while another, Prince Norodom Chrakrapong, has joined the ruling Cambodian People's Party and is Deputy Prime Minister. Prince Norodom Sihanouk is Head of State and Chairman of the Supreme National Council which, in principle, represents all the fractions and rules the country.

[36] Like many countries, Cambodia tolerates a legal parallel market. This would amount to a dual exchange rate system but for the fact that the Central Bank, lacking any reserves to defend the Riel, generally lags the parallel market by about a week, in effect "floating" the exchange rate.

appealing for calm, he called for all ethnic Vietnamese to leave Cambodia on the grounds that their safety could be guaranteed neither by the Government nor by UNTAC[37]).

Whatever the reasons, an open economy such as Cambodia, a 40 percent devaluation feeds through to the domestic price level very quickly. It is unlikely that the SOC will (or can) adhere to its 1993 spending targets. In short, months of effort by UNTAC and the multilateral agencies to stabilise prices was undone at a stroke.[38]

VI. Some Alternative Scenarios

All the multilateral agencies agree, as does the SOC Government, that the imbalance between private consumption and the provision of basic public services is a serious problem, one which can only be addressed within a coherent macroeconomic framework. Based on UNTAC (1992a), the 1992 World Bank country report[39] sets out two macroeconomic scenarios for meeting core rehabilitation requirements based on alternative assumptions about external financing which give rise to different projected budget deficits and levels of inflation. It is worth examining these since they illustrate how delicate a balance exists between reconstructions, aid absorption and inflation.

An initial point to note is that the scenarios are not "best case" and "worst case" projections. The Bank uses the terms "rehabilitation scenario" and "freewheeling scenario", arguably to underscore the point that the continuous "wheeling a dealing" which characterises political dialogue between the main factions could undermine the credibility of the elections leading to the withdrawal of the donor community. A realistic "worst case scenario" would include not only donor withdrawal, but the collapse of the Paris Accords and the resumption of fighting, with assistance for the Khmer Rouge coming from Thailand and perhaps China.

[37] See the Cambodian Times, Mar 22-28, 1993.

[38] As one relief worker observed, the Khmer Rouge having humiliated UNTAC militarily by seizing its troops virtually at will, now proceeded to humiliate UNTAC economically by forsing devaluation virtually at will.

[39] See World Bank (1992).

Under such circumstances, inflation would accelerate more rapidly than foreseen in the Bank's second scenario.[40]

Projected budgetary expenditure (in 1992 dollars) over the period 1992-94 for the rehabilitation programme is shown in Figure 5. Administration and development investment would absorb about one-half and one-third of the budget respectively, the balance going to defence. The bulk of development investment would go to education, health, transport and utilities. Budgetary finance of SOE capital spending would be phased out. Current expenditure on public administration would rise sharply in these same sectors, though total wages and salaries would remain nearly flat; per contra, defence expenditure would fall by nearly half.

Annual shares and percent changes in key macroeconomic, budgetary and monetary variables for the period 1992-94 under the "rehabilitation" scenario are summarised in Figure

Figure 5: Budgetary Expenditure provisions for Rehabilitation

(all figures in mn. 1992 USD)

	1992	1993	1994
Total expenditure	293.9	313.5	323.3
Economic Development			
Investment	39.2	88.9	89.2
of which:			
agriculture	0.1	11.5	11.2
transport	0.9	12.5	22.6
utilities	10.5	13.8	25.5
health	5.5	31.0	9.9
education	15.0	26.8	20.7
SOE capital	6.3	3.2	--
SOE losses	3.4	1.7	--
Export purchase*	21.8	21.8	21.8
Subsidies	--	--	--
Administration	81.7	138.1	151.7
of which salaries	70.4	76.3	81.5
Defence	101.0	59.7	60.6

[40] An analogous example is the case Nicaragua in the 1980s where, despite very substantial assistance from Western donors and the CMEA, monetisation of the deficit required for the war effort sent inflation from 150 percent in 1984 to 32 000 percent in 1988.

Figure 6: The "Rehabilitation" Scenario

	1992	1993	1994
Production and Income (percentage growth rates)			
Real GDP growth	9.0	11.0	8.5
Nominal GDP growth	93.2	53.8	24.3
Population growth	4.9	4.8	2.8
GDP per capita growth	4.0	6.0	5.5
Prices (% change)			
GDP deflator	77.2	38.5	14.5
Consumer prices	70.0	20.0	10.0
Public Finances (% of nominal GDP)			
Public Investment	1.6	2.9	3.1
Current expenditure	8.6	7.3	8.2
- of which:			
civilian	6.4	6.3	7.1
military	2.1	1.0	1.1
Revenues	4.4	4.5	5.6
Overall deficit	-5.7	-5.6	-6.0
Liquidity			
Money supply (bn riels)	185.8	247.5	295.4
Money supply (% change)	82.7	33.2	19.4
External Financing (USD mn)			
Project aid	22.1	56.5	85.5
Programme aid (CMEA)*	8.9	--	--
Programme aid (other)	40.9	63.5	76.5

*CMEA aid represents the proceeds from sales of commodities left after cessation of programme.

Source: UNTAC (1992a).

5.[41] Real GDP growth for the period would average 9.5 percent, though slowing in per capita terms because of the large bulge in population growth caused by the inflow of refugees. External financing would allow the rate of money supply growth to fall sharply while at the same time facilitating a marked rise in the share of public investment: from 1.6 percent of GDP in 1992 to 3.1 percent in 1994, the bulk going to health, education and public utilities as seen in the previous figure.

[41] These projections were derived by UNTAC and the Bank using a simple model whose core consists of two equations and three unknowns: the nominal value of the public deficit, external financing and the price level, one of which must be set exogenously. In the rehabilitation scenario, inflation is a target and the external financing requirement derived; in the alternative scenario, external financed is assumed zero and inflation is derived. A constant velocity of circulation is assumed, even under conditions of high inflation. See World Bank (1992), p. 145.

Note, too, the projected rise in the share of revenue in GDP from 4.4 to 5.3 percent.

Figure 7: The Alternative Scenario

	1992	1993	1994
Production and Income (percentage growth rates)			
Real GDP growth	5.5	3.5	1.5
Nominal GDP growth	119.0	98.0	92.1
Population growth	4.9	4.8	2.8
GDP per capita growth	0.6	-1.2	-1.3
Prices (% change)			
GDP deflator	107.6	91.3	89.3
Consumer prices	116.3	79.8	94.6
Public Finances (% of nominal GDP)			
Public Investment	0.3	0.3	0.3
Current expenditure	8.1	6.1	6.0
- of which:			
civilian	6.3	4.4	4.4
military	1.8	1.7	1.6
Revenues	3.8	3.2	2.8
Overall deficit	-6.6	-3.2	-3.5
Liquidity			
Money supply (bn riels)	228.8	425.7	840.7
Money supply (% change)	124.4	86.1	97.5
External Financing (USD mn)			
Project aid	--	--	--
Programme aid (CMEA)*	8.9	--	--
Programme aid (other)	--	--	--

*CMEA aid represents the proceeds from sales of commodities left after cessation of programme.

Source: UNTAC (1992a).

In the alternative scenario, by contrast, external financing is assumed to be zero except for refugee repatriation. In consequence capital spending would remain an insignificant share of GDP while the share of current expenditure would fall. Even assuming a cut in the absolute level of defence expenditure, the unfunded deficit would remain greater than 3 percent of GDP over the period leading to a continuing annual inflation rate around the 100 percent mark. Under such conditions, with the drying up of repatriation and the departure of UNTAC, per capita GDP growth would turn negative.

1993, the opposition either believes the Bank to have overestimated the costs of delay or else is impervious to economic logic. In fact, it is now clear that the "rehabilitation scenario" is far too optimistic, essentially for three reasons.

First, the GDP growth rates used by the World Bank for 1991 and 1992 have since been revised downwards (and the estimated GDP deflators upwards)[42] implying that extent of monetisation in 1992 is greater than assumed in the projections. Second, the Bank admits that while the scenario provides for paying off arrears (Central Bank net assets are currently negative), no allowance is made for building reserves; a three months' import provision would equal approximately USD 70 mn, giving the authorities some leverage in managing the exchange rate. Third, the rate of disbursement for core rehabilitation investment assumed in the initial scenario now seems too high. Assumed disbursements of project and programme aid 1992 are assumed to total USD 72 mn, excluding humanitarian aid and technical assistance. According to UNTAC officials, the actual disbursement achieved by November, 1992, was about USD 90 mn. However, this includes much of this aid was tied to the refugee repatriation programme. Hence while the total may have been met, it is unlikely that the core investment allocation target has been met.

Fourth, the 1993 target is unlikely to be met given Cambodia's refusal of the USD 75 mn World Bank loan. And even if it were, this would not guarantee staying within the monetary emission and inflation targets assumed. Inflation as measured by the CPI, targeted to fall to 20 percent in 1993, now seems set stay at three digit level. Even according to UNTAC, January 1993 prices were up 164 percent compared to January of the previous year.[43] Finally, the Bank's revenue projections are based on dubious assumptions. Only half the total projected increment in revenue collection is accounted for by new taxes; the remainder appears under the rubric "improved administration". For fiscal reform to work, inflation must first be brought under control, thus stabilising fiscal administrators' real wages and making the system less vulnerable to corruption.

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[42] See UNTAC (1992b).

[43] See UNCTAC (1993a).

Using UNTAC's own figures, it is difficult to escape the conclusion that the assumptions used in drawing up the rehabilitation scenario in 1992 were far too optimistic. While the first two months 1993 were a period of respite, the events of March 1993 have effectively derailed strategy envisaged. As we have argued, there are in any case structural features of an economy "in transition" which make any conventional stabilisation package extremely difficult to implement. That is not to say that the task is impossible; clearly stabilisation can be accomplished providing the supply of aid is infinitely elastic. Ultimately, though, the supply of aid is a political matter, a question we consider in the concluding section.

VII. Conclusion

Officially, the Paris Accords treat the Cambodian conflict as an internal matter, its guarantors acting as disinterested brokers attempting to bring stability to a country torn by years of war. But behind this masquerade of UN evenhandedness, the emperor's lack of clothes is embarrassingly obvious. As everyone knows, the Khmer Rouge were largely the creation of two of the major players, The United States and China. The core donors group---chiefly Japan, Australia and Europe---and being asked to nurse a incidental casualty of the geopolitics of the 1970s and 1980s. And donors have generally put on a brave face, officially pretending that with goodwill on all sides, the election can produce a stable governing coalition, UNTAC can withdraw and aid can be disbursed. This view diplomatically ignores the genocidal gulf separating the protagonists. In particular it is assumed that, given time, the Khmer Rouse will fade away and Cambodia will transform itself into a dynamic market economy on the model of its Asian neighbours.

It should be clear that such assumptions are now dangerously facile. We have argued that the economic outlook is bleak and that income distribution has worsened. The boom in speculative activity which accompanied UNTAC's arrival created a windfall of wealth for urban traders, and even in some cases for party officials and managers. A rapid, unreflective transition to the market economy has driven a relatively weak state into fiscal crisis, produced raised inflation to three digit level and weakened the country's social and economic infrastructure, particularly in the rural areas. In this sense Cambodia's poor, punished by years of isolation, are now being asked to pay the further costs of re-integration into the international mainstream.[44]

Most important, whatever one's view of Cambodia's likely economic future, the political arrangements envisaged in the Peace Accords are now clearly unworkable. In theory, the elections were expected to produce a victory for Funcimpec, the party of Norodom Sihanouk, which could then govern in coalition with the current SOC government and reformed members of the Khmer Rouge. But the political process has not gone as planned. Funcimpec---run from Thailand by Prince Norodom Radariddh--is internally divided, and in any case lacks the cadres to run the civil service. The Khmer Rouge have rejected the electoral process and humiliated UNTAC's forces with impunity, dispelling any facile notion of their re-integration into democratic politics. It now seems likely that, unable to retake Cambodia by force of arms, they will attempt its partition. Indeed, sections of the Thai military are calling openly for Cambodia's partition and the establishment of a "buffer state" in the country's northwest provinces under DK (Khmer Rouge) control.[45] Since an alliance of anti-DK forces can only be built around the army, controlled by the SOC (Cambodian People's Party), the likely political scenario is one of an elected SOC government once more at war with the Khmer Rouge, with or without the whimsical support of Norodom Sihanouk.

Donors will need to reflect on such unpleasant realities if they are to stay the course, else growing frustration with Cambodia slow and tortuous road to recovery will result in aid fatigue. The danger is that the international community, faced with a post-electoral situation

[44] The first point is put forcefully in Mysliwiec (1988).

[45] At the beginning of March 1993, the Bangkok Post carried an unsigned article which discussed the relative merits of partitioning Cambodia in order to create a "security zone" along the Thai frontier. On March 11, the Thais held a 12-day military exercise "based on the hypothetical premise of a new Vietnamese invasion of Cambodia...In past weeks, senior Thai military leaders accused UNCTAC of not investigating properly KR claims of a Vietnamese military presence in Cambodia" (Cambodia Times, 22-28 Mar, "Thai war games foresee new Vietnamese invasion")

in which a previously "communist" government has retained power, the war has resumed and the economy is in chaos, may simply withdraw. In such an event, the full cost of the Paris Accord would be borne by the poorest of all the players, the Cambodians themselves.

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