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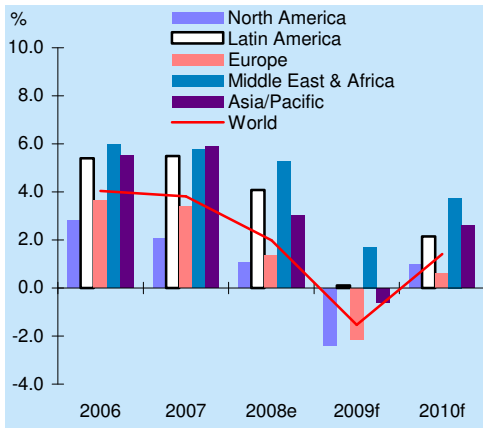
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Global Outlook

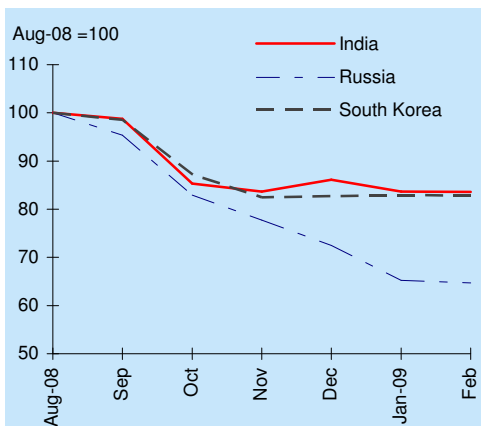
Real GDP growth forecast	2009f	Interest rates and oil price	Mar. 2009
World, %	-1.8	US interest rate, %	0.00-0.25
US, %	-2.5	ECB interest rate, %	1.50
Euroland, %	-2.4	Japan interest rate, %	0.10
Japan, %	-6.7	Oil price (Brent crude), USD/b	45.21



Sources: International Monetary Fund; D&B

World Growth

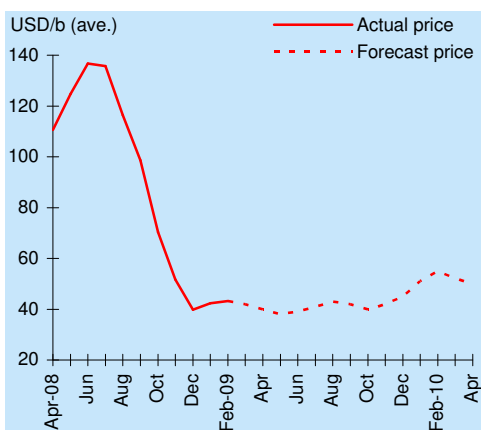
In February, US President Barack Obama signed a USD787bn fiscal stimulus package into law. The package should help the economy, but is unlikely to put the global economy, or even just the US, on the path to recovery. US real GDP fell by 1.6% quarter on quarter (6.2% annualised) in Q4 2008. Meanwhile, the labour market situation continues to deteriorate, with unemployment jumping to its highest level in 25 years. In an update to its *World Economic Outlook*, the IMF has warned that a sustained recovery will not be possible until the financial sectors begin to work normally again. Our latest forecast is for world GDP to contract by 1.8% in 2009, the largest contraction since 1945.



Sources: Central Bank of the Russian Federation; Reserve Bank of India; Bank of Korea

Emerging Markets' FX Reserves

FX reserves in many emerging markets have fallen rapidly since late 2008, raising the spectre of further strong downward pressure on emerging markets' currencies and, in some cases, FX shortages and balance of payments crises. Four reasons stand out for the fall: a collapse of export earnings, as both demand and prices for exports (often commodities) have slumped; a plunge in remittances; large outflows of foreign investment and lending; and the use of FX reserves to prop up currencies and financial sectors. To enable the IMF to support the growing number of countries facing the threat of financial distress, the US has called for a tripling of the around USD250bn that the Fund currently has at its disposal for this purpose.



Source: D&B

Oil Price (Brent Crude)

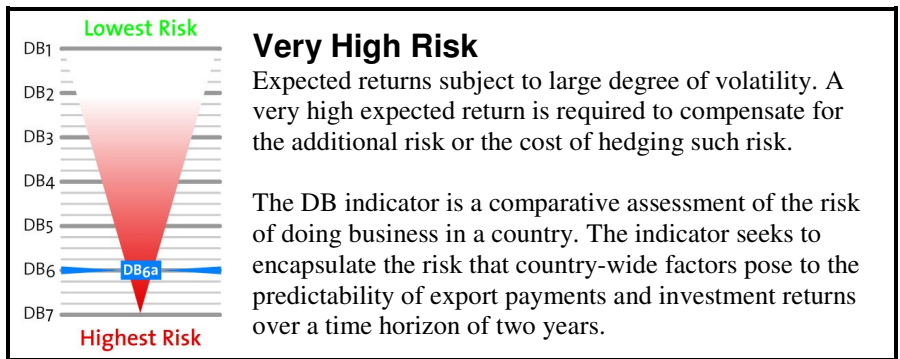
After months of falling prices, the price for Brent (dated) has stabilised around USD42-45 per barrel. Over the next year, we expect lower demand as a result of the continuing global downturn to maintain downward pressure on prices. However, upward pressure occurs because of threats of further cuts in supply by OPEC, despite their failure to do so at their March 2009 meeting. Two cuts in OPEC production quotas were implemented in late 2008 totalling 14.5% from their actual September output of over 29m barrels per day; at that time, OPEC supply accounted for around 40% of total world supply. Looking forward, we expect prices to remain muted throughout 2009 and into 2010.

Country Risk Indicator

DB6a

For Country Risk Indicator definition see page 58

Regional Risk Indicators	
Australia	DB1d
Hong Kong	DB2b
Japan	DB2b
Singapore	DB2b
New Zealand	DB2c
Korea (South)	DB3a
Taiwan	DB3a
Malaysia	DB3c
China	DB3d
India	DB3d
Philippines	DB4c
Thailand	DB4d
Vietnam	DB4d
Indonesia	DB5a
PNG	DB5a
Fiji	DB5b
Bangladesh	DB5d
Pakistan	DB5d
Sri Lanka	DB5d
Cambodia	DB6a
Nepal	DB6a
Myanmar	DB6c
Afghanistan	DB7
Cambodia's Risk Indicator History	
End-2006	DB6a
End-2007	DB5d
End-2008	DB6a
Comparative Risk Indicators	
Sierra Leone	DB6a
Ukraine	DB6a
Venezuela	DB6a



Overall Outlook

- The political environment remains reasonably stable following the National Assembly election in mid-2008.
- However, after years of double-digit real GDP growth, the economic outlook is increasingly poor for 2009, with 2010 likely to see only a moderate recovery.

Positive Risk Factors

- + Political risk has improved markedly compared with the past, as the ruling Cambodian People's Party (CPP) has further consolidated its grip on power.
- + Relations with the country's key aid donors are stable, which should allow Cambodia's fiscal and current account deficits to be easily financed from a combination of aid and multilateral support: this greatly reduces macroeconomic and external country risk.
- + Inflation is slowly dropping back to more manageable levels after rising over 20% year on year in 2008.
- + The discovery of significant offshore oil reserves could transform the country from a net oil importer to a net oil exporter, significantly increasing national income and reducing the government's dependence on aid financing.

Negative Risk Factors

- Real GDP growth is expected to contract by 1.0% in 2009 and rise only 3.5% in 2010, far below the double-digit growth rates seen from 2004 to 2007.
- Cambodia's narrow economic base makes it very susceptible to external shocks. In particular, the level of dependence on subsistence farming makes Cambodia vulnerable to adverse weather conditions.
- Outside of agriculture, economic activity has been focused in just three main sectors, all of which are currently seeing sharp downturns: the property sector has been hit by the global collapse in asset prices; the garment industry has been impacted by a drop in demand from the key US market; and the tourism sector has been impacted by both a weaker global economy and political instability in neighbouring Thailand.
- In addition, the garment sector faces the threat of rising competition, as the US and EU lifted limits on garment imports from China at the end of 2008.
- The Cambodian banking system, while not exposed to the global 'sub-prime' debacle, is nonetheless experiencing liquidity problems, falling profitability, and rising levels of non-performing loans alongside a downturn in the economy. Given that confidence in the financial sector is already low, D&B regards this development with concern.
- Corruption makes Cambodia an extremely difficult country in which to do business; there is a risk that oil revenues may be misappropriated.

Key Information

Economic and Development Information

	2006	2007	2008e	2009f	2010f
GDP (nominal)					
KHRbn	29.8	35.0	44.1	45.5	49.4
USDbn	7.3	8.6	10.7	10.7	11.4
Breakdown of GDP					
Agriculture (%)	31.5	29.0	30.0	29.0	28.0
Industry (%)	29.0	30.0	29.0	29.5	30.0
Services (%)	39.5	41.0	41.0	41.5	42.0
Economic indicators					
Real GDP growth (% change)	10.8	10.2	6.0	-1.0	3.5
Inflation, annual average (%)	4.7	5.9	19.8	4.3	5.0
Government balance (% GDP)	-2.0	-3.1	-2.1	-4.1	-2.9
Debt service ratio (% GDP)	0.6	0.5	0.6	0.5	0.5
Current account balance (% GDP)	-0.4	-3.2	-6.9	-5.1	-6.2

Long-term real GDP growth potential, annual average, 2009-18: 6-7%

Development indicators	Cambodia	Hong Kong	Indonesia	Thailand	Vietnam
Population, 2005 (m)	12.7	6.7	206.3	60.7	78.5
Population, 2015 (m)	16.4	7.0	246.8	66.3	92.4
Population, 2050 (m)	23.2	6.0	312.0	70.4	116.7
Internet users (m)	0.5	278.3	9.2	37.4	2.5
GNI per capita (USD)	350	26,660	1,140	2,490	540
GNI per capita (USD PPP)	2,310	31,560	3,480	7,930	2,700
Life expectancy (years)	56	81	66	69	69
Adult literacy (%)	75	91	88	93	94
Dependency ratio, 2005	0.74	0.36	0.52	0.41	0.52
Dependency ratio, 2015	0.58	0.35	0.46	0.40	0.39
Dependency ratio, 2050	0.46	0.93	0.56	0.64	0.57

Political Information

Head of state	King Sihamoni
Head of government	Prime Minister Hun Sen
Political system	Parliamentary monarchy
Ruling coalition	Cambodian People's Party (CPP) in coalition with United Front for a Peaceful, Co-operative and Independent Cambodia (FUNCINPEC)
Last election	National Assembly: July 2008; Senate: January 2006
Next election	National Assembly: by July 2013; Senate: by January 2011

Miscellaneous Information

Religion(s)	Theravada Buddhism (95%); Islam (5%)
Capital (population)	Phnom Penh (0.9m)
Timezone	GMT +7 hours

Sources: International Monetary Fund, *International Financial Statistics*; World Bank, *World Development Indicators*; Organisation for Economic Co-operation & Development, *Economic Indicators*; *Statesman's Yearbook*; D&B

Executive Summary

Political Risk

The National Assembly election held in July 2008 has strengthened Cambodia's political risk environment. The fact that the vote saw less political violence than previous polls is a positive development. Moreover, the poll was convincingly won by Hun Sen and the Cambodian People's Party (CPP), which took 58.1% of the vote, translating into 72 seats in the 123 seat National Assembly. Although the CPP has opted not to govern alone in line with changes in the constitution introduced in 2006, and has instead formed another coalition administration with the royalist United Front for a Peaceful, Co-operative and Independent Cambodia (FUNCINPEC) party, in reality the CPP commands almost total power.

Monitored by international donors, the CPP will continue to implement a slow, compromised reform of its political and economic institutions. D&B does not expect the government to launch any meaningful drive against corruption, however, because of the involvement of many senior officials, and because the CPP uses a system of patronage to retain its followers' support. Consequently, on a structural level Cambodia still suffers from a high level of political risk. Despite a veneer of liberal democracy, the country effectively functions on patronage, corruption and coercion. Controls on official criminality and misgovernment are virtually non-existent or at best notional. Corruption and opaque links between politicians and businessmen can make business dealings for foreigners difficult.

Possible shocks to the political status quo over the forecast period, if any, are likely to be primarily economic. In 2008 rapid inflation due to higher international oil and food prices greatly reduced voters' living standards. Notably, however, the CPP actually increased its electoral support in the July 2008 election, which coincided with the peak of the inflation surge. Inflation pressures have now started to subside, but a weak economy in 2009 and 2010 will also test the patience of the Cambodian population. However, D&B believes that the relatively passive Cambodian temperament (political violence tends to be led from above, rather than percolating up from below), the CPP's firm grip on power, and the lack of a popular political opposition, mean that there is likely to be little direct threat to government stability over the forecast period.

Macroeconomic Risk

Despite recording double-digit growth rates from 2004 to 2007, the Cambodian economy still bears the legacy of decades of war and internal strife, which destroyed much of the country's infrastructure, displaced millions of people, and left landmines scattered throughout the country. In short, it is one of the poorest countries in the world.

In 2008 the economy was impacted by high inflation, then by a synchronised downturn in property construction, tourism income, and garment exports. We expect the global economic downturn to continue to depress activity in all of these sectors in 2009, while agricultural production remains subject to weather conditions. Such a backdrop will more than outweigh the beneficial impact of a marked reduction in inflationary pressures. Meanwhile, the government has only limited room for counter-balancing fiscal expansion given its slim resources, while monetary policy is also unlikely to be of much support to the economy as the high degree of dollarisation in Cambodia means that the National Bank of Cambodia lacks true operational autonomy. Overall, we anticipate that real GDP growth will fall in 2009 before expanding just 3.5% in 2010.

In short, the economy remains narrowly based, raising its vulnerability to downturns in either agriculture, tourism, or the garments sector, and will remain dependent upon foreign aid for years. However, the long-term outlook for the Cambodian economy is improving as investor interest in the country grows, and we believe that long-term growth potential is in the range of around 6-7% a year.

External Economic Risk

A sharp rise in oil prices in 2008 saw the current account deficit widen from 3.2% to 6.9% of GDP. Although energy prices have since fallen back, the external accounts are now threatened by the economic slowdown in Cambodia's major trading partner, the US, along with an almost-certain decline in the tourist arrivals – the country's second major source of FX earnings. However, imports should also fall alongside slower local consumer demand and lower exports (most of which have an imported component). Official transfers from multilateral lenders will also help support the external accounts, as in previous years. Overall, we expect current account deficits of 5.1% of GDP in 2009 and 6.2% in 2010.

In terms of counterbalancing capital inflows, FDI is likely to fall back from an estimated USD800m level in 2008 to just USD250m in 2009, before rising back to USD400m in 2010: few other sources of private capital inflows are expected over the forecast period. Nonetheless, Cambodia remains cushioned by additional support from multilateral lenders: official aid inflows should help to cover the country's current account shortfall, which means that there is a lower level of risk attached to these external deficits than would otherwise be the case. Notably, D&B does not believe that aid flows will be impacted by the economic downturn, and hence the overall balance of payments should remain in surplus in 2009 and 2010.

Meanwhile, the local currency, the riel, is likely to see a nominal depreciation of around 6% against the US dollar in 2009 in order to maintain export competitiveness, after recording a significant real appreciation in 2008. The unit should then see a slight nominal and real appreciation in 2010 in line with an expected increase in global risk appetite from current low levels.

Commercial Risk

Cambodia remains an extremely difficult country in which to do business. Corruption is often cited as a major barrier, and a number of foreign companies have scaled down their operations or withdrawn from the country, citing endemic corruption. Despite promising to introduce an anti-corruption law for a number of years, the government still shows no signs of adopting such legislation. The government is, however, drawing up new commercial laws and will be required to speed up reform of Cambodia's civil service, police and judiciary in line with WTO membership obligations. Nevertheless, D&B seriously doubts that the ruling CPP is capable of reforming the system of institutionalised corruption, which has guaranteed the party's almost two-decade rule.

Regulation of the local banking sector banks is improving but remains poor. The National Bank of Cambodia has a very limited regulatory capacity, which has been strained by recent expansion in the sector. Overall, Cambodian banks remain subject to incompetent and corrupt management, and there have been widespread allegations of money laundering. Meanwhile, the broader financial infrastructure is also weak, with the development of a modernised payments system badly needed. There is also little effective legal protection allowing for the recovery of assets in the case of bankruptcy. Moreover, risks associated with the banking sector are rising in line with economic downturn: the levels of bad assets held on banks' books are rapidly rising, while their profitability is being squeezed. Indeed, some smaller banks are already experiencing liquidity issues, which D&B regards with concern.

Political Risk

Key Point: D&B views Cambodia's political risk profile for the next two years more positively than in the past; this reflects the further consolidation of political authority in the hands of the pragmatic Hun Sen, the CPP secretary and prime minister.

Recent Developments

Cambodia has a history of political turbulence. The country was colonised by the French from 1863 to 1953; destabilised by the Vietnam War (1953-75); and approximately 25% of its population died under the genocidal regime of Pol Pot's Khmer Rouge between 1975 and 1978. Pol Pot was toppled by Vietnamese invasion in 1979, but fighting between the Khmer Rouge and pro-Vietnamese forces continued until the signing of a peace treaty in 1991. Since then a fragile democracy under a constitutional monarchy has been established. The first national elections since the 1970s were held in 1993, with further polls every five years since.

2003 Election and New King

The outcome of the 2003 election resulted in considerable political uncertainty. The former communist cadres of the Cambodian People's Party (CPP) had difficulty gaining the then-requisite two-thirds support of the National Assembly required to form a government, instead achieving 47.3% of the vote. As a result, it was forced into coalition again with its erstwhile rival, the royalist United Front for a Peaceful, Co-operative and Independent Cambodia (known by its French acronym, FUNCINPEC), while the other major political party, the eponymous Sam Rainsy Party (SRP) assumed the role of opposition.

In 2004, the elderly King Sihanouk, who had been involved in Cambodian politics in many roles since 1941 (including two terms as King; two as sovereign prince; one as president; two as prime minister; one as non-titled head of state; and leader of various governments-in-exile) abdicated following threats by Hun Sen to declare Cambodia a republic. His son, the relatively inexperienced Prince Norodom Sihamoni, was then made king.

Meanwhile, the CPP government's tactic of exerting pressure on the SRP culminated in the decision to strip parliamentary immunity from three SRP members, including the party leader, Sam Rainsy, in 2005. Rainsy fled into exile and was subsequently convicted in absentia for defamation. By early 2006, the treatment of the SRP and other government critics led to international condemnation of the government and raised concerns over the future of international aid. Under this international pressure, Hun Sen requested that King Sihamoni pardon Rainsy and others. Presumably as a returned favour for the pardons, the SRP supported the government's motion to change the constitution and remove the need for the two-thirds of the house's votes for the election of a government in favour of a simple majority (the former arrangement was designed to encourage co-operation and power sharing between antagonistic political parties.)

Table 1

Results of the January 2006 Senatorial Elections

Party	% of vote	Seats
Cambodian People's Party (CPP)	69.3	45
FUNCINPEC	20.5	10
Sam Rainsy Party (SRP)	10.3	2
Total	100	57

Source: Cambodian National Election Commission

In 2006 Cambodia held its first elections for its Senate. However, senators were not elected by universal suffrage, but rather by the members of Cambodia's 1,621 local commune councils, which are dominated by the CPP. In 2007, the latest set of local elections saw the CPP secure 7,993 commune seats out of 11,353, while the SRP won 2,660; FUNCINPEC managed just 274. Opposition parties attacked the outcome, claiming that widespread vote-buying and obstruction of opposition supporters had marred the vote. Nevertheless, the local election results confirmed the eclipse of the royalists as a political force, cementing the CPP's grip on power.

2008 Election

The political environment in early 2008 was dominated by the lead-up to the July parliamentary election, and tensions with Thailand (see **Relations with Thailand**). The CPP took 58.1% of the vote, gaining 72 seats in the 123 seat National Assembly. The SRP claimed second place with 21.9% of the vote (27 seats), while FUNCINPEC only mustered 5.0% (worth just six seats, down from 26 in the 2003 election), coming fifth. Official EU election observers stated that while the election process did not meet international standards, the result was reflected the will of the populace. The CPP was able to form the first single-party government since the establishment of democracy in the 1990s. However, it chose to again seek a coalition with FUNCINPEC, albeit with the royalists holding very little influence in the administration (Hun Sen actually ordered its leadership to resign after the scale of his victory became clear). The decision to continue with a coalition framework was taken to ensure political stability was maintained.

Table 2

Results of the July 2008 Parliamentary Election

Party	% of vote	seats
Cambodian People's Party (CPP)	58.1	72
Sam Rainsy Party (SRP)	21.9	27
Human Rights Party (HRP)	6.6	8
Norodom Ranariddh Party (NRP)	5.6	7
FUNCINPEC	5.1	6
Others	2.7	3
Total	100	123

Source: Cambodian National Election Commission

Political Environment

Political Parties

Cambodia's political institutions remain largely based on personal patronage, corruption and coercion. Nonetheless, political parties, if not ideologies, have established themselves around key personalities.

The Cambodian People's Party (CPP): The CPP is the successor to the communist party. As such, it is less a true political party than a governing apparatus. It has an extensive, organised network and around 3m members. Hun Sen, who dominates the party, is an enigmatic figure. He started out with the Khmer Rouge in the 1970s before defecting and being given a leading role in the rebel army by the Vietnamese. In 1979, he was appointed foreign minister in the Vietnamese backed post-Khmer Rouge government before becoming the head of the CPP in the 1990s.

Hun Sen is intolerant of criticism and presides over a regime that routinely resorts to violence and intimidation to silence political opponents, although Hun Sen no longer needs to deal with his foes as harshly as he once did. He has become skilful in provoking splits among his foes and bullying them through the courts. Both Hun Sen and the CPP have established legitimacy not only domestically but internationally, predominantly because they have brought political stability. Despite its level of corruption, the party has the power to implement policies.

United Front for a Peaceful, Co-operative and Independent Cambodia (FUNCINPEC): By contrast, the CPP's royalist rival the United Front for a Peaceful, Co-operative and Independent Cambodia (known by its French acronym, FUNCINPEC) has become increasingly marginalised. In March 2006, its leader, Prince Norodom Ranariddh, resigned as president of the National Assembly under pressure from the CPP. FUNCINPEC replaced him as its leader. He faces 18 months in jail after being found guilty of defrauding FUNCINPEC over a land deal. He is currently in self-imposed exile. The prince's eponymous Norodom Ranariddh Party (NRP), formed in response, actually received more votes than FUNCINPEC in the last election. In July 2008 Bhun Chhay, an army general, became the first non-royal to head the party.

In early 2008, a number of leading members of FUNCINPEC including several senior party officials and ministers left to join the CPP, despite Hun Sen reconfirming that FUNCINPEC would remain a coalition ally. In January 2009 a further 35 key members defected to the CPP; however, it has stuck with a coalition government structure. In response, FUNCINPEC has suggested a merger with the NRP, although the NRP was split by bitter factional infighting in early 2009.

The Sam Rainsy Party (SRP): The SRP has overtaken royalist factions in terms of popularity. It did well during the local elections in 2007, and again in the July 2008 national poll, and now presents itself as second political party. It is the only party with enough grassroots support to pose a realistic challenge to the CPP in future elections. The SRP has focused its attacks on the government's record, particularly the prevalent culture of corruption and impunity. However, the party currently wields limited power in parliament. It has also attracted criticism for being too narrowly focused on its leader Rainsy, a former finance minister with FUNCINPEC in the early 1990s. The SRP's populist, anti-Vietnamese rhetoric has also caused concern among some liberals but keeps the party popular.

In January 2009, the SRP announced that it was exploring a merger with the Human Rights Party, with a plan to form a new opposition grouping calling itself the Democratic Movement for Change (MDC).

The Monarch's Influence

The absence of royal opposition facilitated Hun Sen's political triumph in 2006, when he changed the constitution to allow governments to take office with a simple rather than a two-thirds parliamentary majority. Such a dramatic change would not have occurred during the reign of King Sihanouk. The latter's influence, which stemmed from his grassroots popularity, virtually guaranteed protection for the royalist FUNCINPEC party from overt CPP repression. However, the ailing 81-year-old's abdication on 7 October 2004 removed an obstacle to the further centralisation of power by Hun Sen. Sihanouk's successor, his son Norodom Sihamoni, is politically inexperienced and has thus far shown that he does not have the confidence or support-base necessary to influence the workings of government.

Political System

The Constitution: The country's constitution, which restored the monarchy, created a strong executive and provided for a National Assembly, was drawn up only in 1993 (subject to amendments in 1999 concerning the creation of the Senate). However, the weakness of state institutions means that anyone who manages to seize control of the executive has a strong grip over the country.

The Monarchy: The monarch's powers are limited. The monarch is thus a symbol of national unity. The king appoints the prime minister on the recommendation of the National Assembly. The king can also dissolve the assembly if a government loses a vote twice in one 12-month period. Moreover, the king can declare a state of emergency but only in agreement with the prime minister and the president of the National Assembly. The king is supreme commander of the armed forces and can grant an amnesty at the prime minister's request.

Under the constitution, the monarch is forbidden from appointing a successor. Instead, a nine-member Royal Council of the Throne is charged with choosing a new king, who must be over 30 years of age and a male descendant of one of the three branches of the royal family.

The Prime Minister and Council of Ministers: The constitution vested the most important executive powers in the Council of Ministers, to be led in normal times by the prime minister, and to include deputy prime ministers, state ministers and state secretaries. Membership of this body is technically incompatible with any outside business interest, although this statute is widely abused. Members of the government are collectively responsible to the assembly and each member is individually responsible to the prime minister and the assembly. In February 2006, the National Assembly approved a constitutional reform removing the need for a two-thirds quorum to form a government.

The Legislature: Cambodia's legislature consists of a 123-seat lower house, the *Radsprea* (National Assembly), and a 61-seat upper house, the *Senat* (Senate). Members of the National Assembly are elected for a five-year term by universal suffrage. Biannual sessions last three months at a time. The king, prime minister or one-third of lower house members can call for an extraordinary session. A simple majority will suffice to pass legislation on some issues and a two-thirds majority on others (two-thirds is necessary for a vote of censure or a vote of confidence leading to the dismissal of the government). In practice, the National Assembly is rarely a forum for genuine public debate. It offers little balance to the powers of the executive, given the government's overwhelming control of the assembly.

Cambodia's upper house was formed in 1999 after wrangling between the two main parties. Seats were initially allocated in accordance with the number of seats held by the parties in the lower house. Hence, the CPP received 31 senators, FUNCINPEC 21 and the SRP seven. However, the Senate held its first elections in January 2006, with 57 members indirectly elected and four appointed for a five-year term. Only members of the National Assembly and commune councillors were eligible to vote. The Senate's role remains unclear, amid suspicion that it exists to satisfy political ambitions.

The Judiciary: The constitution places judicial power in a Supreme Court and a unified system of courts of general jurisdiction. The court system consists of lower courts, an appeals court and a Supreme Court. The constitution also mandates a Constitutional Council, which has the power to review the constitutionality of laws, and a Supreme Council of the Magistracy, which appoints, oversees and disciplines judges. The composition of both councils heavily favours the CPP.

There is a separate military court system, which suffers from deficiencies similar to that of the civilian courts. In practice, the authorities sometimes ignore the legal distinction between the military and civil courts, and civilians have been called for interrogation by military courts with no apparent jurisdiction in their cases.

Policy Agenda

Broadly speaking, the CPP government embraces a free-market ideology. Major structural reforms undertaken over the past decade include: the privatisation of many state-owned enterprises; de-collectivisation of agriculture; price reform and currency convertibility; the introduction of a commercial banking system and central bank; and the reduction of trade and investment barriers. However, corruption has limited the impact of many of these reforms and prevented the much needed adoption of policy on other reforms, particularly in terms of the legal system, despite regular appeals from foreign donors.

The Economy: The government has adopted measures to improve macro-economic management, particularly in the sphere of fiscal policy. The government is implementing a Public Financial Management Reform Programme with the aim of improving the management of public finances and, in particular, improving revenue collection and eliminating wasteful spending and corruption. The programme, which commenced in 2004, continued with a second wave of reforms, in 2007, which included a streamlining of budget execution procedures to speed disbursements to spending agencies. The programme has started to yield results, with an increasing proportion of customs and tax revenues being collected through the banking system, and a growing share of treasury payments to suppliers made by cheque instead of cash. In 2006, the procurement process was streamlined and the government established internal audit departments in several ministries.

The government also adopted laws and regulations in 2006 to enhance private-sector activity and to fulfil its WTO commitments. A new law on commercial arbitration provides a mechanism for dispute resolution, and the government adopted a licensing review plan that would pave the way to remove duplicate and unnecessary licenses affecting businesses. Progress has also been made on financial sector reforms. In an aim to reduce the cost of borrowing, a major constraint on the economy, and improving financial intermediation, a credit information system was introduced, providing commercial banks with credit-related information on prospective borrowers.

A primary challenge for the government will be dealing with the effects of an economic slowdown in 2009 and 2010 (see **Macroeconomic Risk**). This is likely to prove a difficult to deal with given limited fiscal resources. Nonetheless, there is no sign that this will damage the government's legitimacy and so lead to greater political instability: despite very high inflation (see **Inflation**) the CPP saw its vote increase in the July 2008 election.

Infrastructure development: Many new aid packages have been earmarked to help remove infrastructure bottlenecks. A railroad improvement project, funded in part by a consortium of international donors, got underway in 2008. Work on a World Bank funded project to build power lines from Vietnam and Laos to Cambodia has also started. In addition, China has pledged money to support a new hydroelectric dam and USD70m to build highways across the country in 2009. The government has also been attempting to press ahead with the development of potential off-shore energy reserves. However, territorial disputes with Thailand (see **Relations with Thailand**) as well as a collapse in global energy prices since mid-2008 have meant that foreign interest in Cambodia's oil and gas fields has diminished.

Socio-Political Risk

Internal Stability

Cambodia's internal stability has improved dramatically since the early 1990s, when the Khmer Rouge disintegrated as a result of defections and internal schisms. Most areas of the country are now under central government control. Few areas are considered dangerous, although the presence of landmines, small arms and banditry create a low level of instability. Political violence remains a problem, with international observers expressing concern over violence and intimidation in the run up to the July 2003 general election. There was also a lower level of violence in the run up to the July 2008 election.

The military forces and police have been responsible for both political and non-political killings. Politically-related crimes, such as physical attacks on political opponents, are rarely prosecuted. Mob attacks on people suspected of committing crimes such as theft are commonplace.

Meanwhile, land-grabbing by well-placed individuals, sanctioned by the government through land concessions, has created a lawless and predatory environment. Across Cambodia, growing numbers of small farmers and slum dwellers are falling victim to the practice. Demonstrations and protests against the concessionaires are invariably forcibly suppressed, despite Hun Sun's public rebuke in March 2007 of those in the upper echelons of the CPP involved in land seizures. The problem stems from the Khmer Rouge regime doing away with property rights. Many titles and land deeds were destroyed creating a free-for-all vacuum over the past two decades. A 1989 law allows persons who occupy land for at least five years to claim ownership, but so far, only a small fraction of the millions of rural householders entitled to claim the deeds to their land has actually received them.

Large, violent demonstrations are rare. Moreover, police routinely prohibit any form of public protest by those opposed to government policies, although pro-government groups occasionally receive permission to demonstrate. However, rioting does sometimes occur. Several days of violent protests by low-paid clothing workers in the run-up to the ASEAN summit in June 2002 undermined Cambodia's claims to being a stable, investor-friendly location. An attack by mobs on the Thai embassy and Thai-owned businesses in Phnom Penh in January 2003 (after a Thai television star had been misquoted as saying that Cambodia's national icon, Angkor Wat, belonged to Thailand) further harmed its reputation.

Crimes such as muggings, rapes and robberies, fed by poverty and corruption, are commonplace, however. The western border with Thailand is a thriving zone for illegal commerce. Prostitution and human trafficking have been particular problems. The authorities have launched programmes to stop the culture of impunity surrounding human trafficking and the sex trade in general, with the recent arrest and conviction of a number of foreign sex tourists. Cambodia has concluded multilateral agreements designed to stymie cross-border human trafficking with regional countries, in particular Vietnam, in 2005-06. In April 2007, it launched the country's first national task force, bringing together numerous government ministries, law enforcement groups and international agencies, to reduce duplication, improve law enforcement and help combat trafficking. However, these efforts are often considered ineffective by rights advocacy groups as the military and officials, their families and friends have been reportedly implicated in everything from illegal logging to drug smuggling and human trafficking.

The proliferation of small arms is a major problem. Cambodia is among the most important source for illicit arms in the region. The UN disarmament programmes at the end of the war only succeeded in retrieving a fraction of the weapons transferred to the country by the Chinese, Thais, US and Russians. Subsequent attempts to decommission and destroy the arms were partly successful, with 158,000 weapons destroyed since 1999. There are estimated to be 22,000 to 85,000 weapons still circulating illegally. The easy availability of such weapons has been exploited by organised and petty criminals, as well as terrorist groups like Sri Lanka's Tamil Tigers and the Philippines' Moro Islamic Liberation Front, which have sourced weapons from Cambodia since the early 1990s.

Khmer Rouge Tribunal

In early February 2008, the highest ranking surviving member of the Khmer Rouge regime, Nuon Chea, appeared in court for war crimes and crimes against humanity in the UN-backed tribunal that started work in 2006: the actual trial itself finally began in February 2009. The Khmer Rouge regime is alleged to have overseen the deaths of 1.7m people. The tribunal has made slow progress given budget concerns and management problems. There are serious concerns that eight key defendants could die before they have been tried. The original outline of the joint UN-Cambodian court was that the trial would over three years cost donors USD53m, in early 2008 the court estimated that costs would soar to USD170m in trying eight defendants by 2011. Unsurprisingly, the Khmer Rouge Tribunal has little popular appeal amongst a population where 90% of people earn less than USD2 a day.

Interest Groups

Buddhists: Buddhism was an ingrained part of the Cambodian national psyche prior to the Khmer Rouge. Despite years of suppression, the religion survived and is regaining its status as the nation's moral compass. The demise of the Buddhist Liberal Democrat Party has reduced Buddhism's direct political power; however, monks and their superiors retain considerable influence within their communities. In addition, senior clergy such as the Venerable Tep Vong, head of the main Buddhist order in Cambodia, are close to the CPP.

Chinese: The Khmer Rouge attacked Cambodia's ethnic Chinese, who account for about 4% of the population. Now that peace has returned, Sino-Khmers are returning to their former pre-eminent positions in commerce and even in politics.

Vietnamese: Ethnic Vietnamese constitute about 1% of the population. Ethnic Vietnamese remain a target of suspicion. Several populist opposition parties pursued xenophobic electoral campaigns in 2003, and again in 2008. Vietnamese businessmen and illegal immigrants are often accused of exploiting Cambodia's forests and rivers. At least one minor party called for the expulsion of ethnic-Vietnamese from Cambodia. In 1993, pogroms against ethnic-Vietnamese villages caused 21,000 people to flee to Vietnam. Cambodia's ethnic-Vietnamese community tends to support the CPP.

Labour Relations

Strikes, demonstrations and labour violence have become increasingly common. Protests against the government in recent years have focused on the poor treatment of textile workers in the garment industry, where around 25% to 30% of the over 350,000 workers are union members. Workers are paid on average USD50 per month. While the sector thrives on being largely deregulated, social and international pressure encourages a minimum level of workers' rights, which pushes up costs and potentially prices the sector out of the market.

A number of strikes have reduced productivity and curbed foreign interest. There are about 1,100 different unions operating in Cambodia's 300 garment factories. Labour violence can be vicious. High profile union leaders have been killed: in 2007; Hy Vuthy a union official with the Free Trade Union of the Workers of the Kingdom of Cambodia was murdered. Several foreign manufacturers have said that labour related violence needs to stop for them to remain in Cambodia.

External Political Risk

Relations with Vietnam

Official ties between Hanoi and Phnom Penh are good. The CPP descends directly from the government installed by Vietnamese forces in 1979, and Hun Sen is keen to maintain sound relations. Co-operation manifests itself in several forms, ranging from military pacts to plans to develop the Mekong as a regional transport hub.

However, the two countries also have a long history of enmity, linked to a series of historical conflicts, and particularly following Vietnam's military occupation of Cambodia between 1979 and 1989. Although maritime disputes continue, primarily over Cambodia's claims in the Gulf of Thailand, military conflict is unlikely. A previous land border dispute was contentiously resolved in October 2005 after Hun Sen had signed an additional accord to a 1985 treaty, allowing for the full demarcation of the border by 2009. Cambodian opposition figures strongly attacked the accord as ceding land to Vietnam. Although parliament eventually ratified the treaty, the degree of opposition reflected strong, anti-Vietnam sentiment among sections of the political class and general population. Border issues continue to elicit an emotional response from the public. Many Cambodians regard a large part of southern Vietnam as part of Cambodia.

The presence of minorities on the two countries' respective borders can also cause friction. Hanoi claims that 1m Khmers live in southern Vietnam, whereas Cambodia puts the figure at 12m. The issue remains a rallying cry for nationalist politicians willing to play to anti-Vietnamese sentiment.

Relations with Thailand

Relations between the two countries have historically been uneasy. The embryonic Thai state was once a part of the ancient Khmer Empire, while Cambodia was incorporated into a later Thai empire between the 15th and 19th centuries; as recently as the Second World War the Thais still controlled areas of present-day Cambodia, including, for a brief period, the temple complex of Angkor Wat. Moreover, during the Khmer Rouge period, Thailand, backed by Beijing and Washington, funnelled weapons and supplies to Khmer troops through its eastern border with Cambodia, and Thai businessmen helped the guerrillas dispose of their illegal logs and gems. Inevitably this affected relations between Thailand and the CPP-dominated government.

Some members of Cambodia's political and business elite perceive Thailand as taking advantage of Cambodia's comparative weakness and its need for foreign investment and trade. The two countries took several years to negotiate a bilateral trade deal. Relations deteriorated in January 2003 following violent anti-Thai riots in Phnom Penh. It has been reported that the CPP was complicit in organising the riots as a nationalist tool in the run up to elections. In the aftermath of the riots, Thailand closed its border with Cambodia and both countries recalled their ambassadors. Relations normalised in April 2003, after Cambodia paid Thailand almost USD6m in compensation for damage to Thai state property. Subsequently, Thailand reported that most Thai private businesses had also been compensated.

Relations took a significant turn for the worse in June 2008 when Cambodia took the seemingly-innocuous step of applying to UNESCO to list an ancient Khmer temple, Preah Viharn, that lies on the Thai-Cambodian border (sovereignty over Preah Viharn was awarded to Cambodia by the International Court of Justice in 1962, and Thailand failed to appeal during the 10-year legal window). This request set off a fire-storm of Thai nationalism, with the mood exacerbated by the fact that former Thai Prime Minister Thaksin Shinawatra had just announced plans to invest in Cambodia: anti-Thaksin supporters saw a conspiracy to 'sell out Thai sovereignty'. Thailand and Cambodia both sent troops to the region, and clashes at one point threatened to escalate. However, both governments managed to maintain calm and organise troop withdrawals. Nonetheless, the issue remains unresolved, as do similar claims to a second Khmer temple along the border and to areas of the Gulf of Thailand that could hold significant energy reserves.

Relations are unlikely to be helped in the near term by the fact that the new Thai foreign minister openly insulted Hun Sen on several public occasions prior to assuming his post. Cambodia did attend the 27 February 2009 Association of Southeast Asian Nations (ASEAN) summit in Thailand. In early March the two countries agreed to try to solve their border dispute based on a memorandum of understanding signed in 2000; this states that the basis for negotiations for the delineation of the border should be maps drafted in 1904 and 1907.

Relations with China

Cambodia's relationship with China has improved markedly in recent years following China's withdrawal of support for the Khmer Rouge in the 1990s. Beijing has sought to expand its influence in the region, and in April 2006, during a visit to Cambodia by Premier Wen Jiabao, it offered USD600m in aid, loans and grants, much of it earmarked for the construction of dams and bridges. Chinese businesses have invested heavily in its clothing industry. In 2007, Chinese investors contributed the largest share of FDI to Cambodia. Several large scale energy and infrastructure projects are going ahead with the backing of Chinese investors.

In September 2005, Beijing gave six naval patrol vessels to Cambodia, which is a major regional hub for drug and human trafficking. China is also keen to strengthen ties with south-east Asian countries that have sea ports that can serve Beijing's growing hunger for oil from the Persian Gulf. For China, oil shipped from Cambodia has strategic value, for it would not have to pass through the US-controlled Malacca Straits on its way to the mainland. Cambodia in turn hopes that its closer ties with China will help to counter the influence of Vietnam.

Cambodia has publicly accepted the 'one-China' principle (under which mainland China and Taiwan are both part of the same political entity). The government has repeatedly refused to allow the Taiwan External Trade and Development Council to set up an office in the country, despite Taiwan being one of the largest foreign direct investors in Cambodia.

Relations with the US

Following the 1999 US-Cambodia Bilateral Textile Agreement, Cambodia's textile exports grew enormously. Cambodia is now the 12th largest exporter of textiles to the US. However, Cambodia remains of marginal interest to the US, owing to the size of its market. Conversely, Cambodia's reliance on the US buying its garments exports (garments comprise over 70% of Cambodia's exports, and over 75% of garments manufactured are exported to the US) require Phnom Penh to maintain cordial relations with Washington. In 2006, the US opened a purpose-built embassy in Cambodia and signed an agreement to increase trade and investment flows.

In early 2008, an issue re-emerged which showed Cambodian mistrust of the US, or at least the willingness of Cambodian politicians to use history as a way of maximising access to aid flows. After a US State Department official urged Cambodia to sign an agreement on repaying USD340m of US loans incurred during the early 1970s, a Cambodian government spokesman responded that Cambodia could not pay because it would severely affect the country's financial position. There remains some apparent mistrust of the US. This reflects US support for the 1970 military coup and subsequent partial invasion and massive bombardment as well as its backing for the Khmer Rouge and its anti-Vietnamese stance. The presence in the US of Chhun Yasith, a Cambodian exile who organised a failed coup in late 2000, also irks the government.

Washington's criticism of the government is likely to remain muted. The US's Federal Bureau of Investigation opened its first office in Cambodia in early 2008 to keep a watch over developments in regional terrorism. Recent anti-terrorism laws enacted by the Cambodian government have pleased US officials. A member of regional Islamic group Jemaah Islamiyah, Riduan Isamuddin alias Hambali, is reported to have tried to use Cambodia as a base for terror attacks in 2002. He was subsequently captured in Thailand and is now being held at the US navy's Guantanamo Bay base. The US is happy to receive the co-operation of Cambodian officials. Other regional countries, such as Vietnam and China, are less keen on co-operating with US security agencies.

Relations with ASEAN

The Association of Southeast Asian Nations (ASEAN) has warmed to Cambodia after initially delaying its accession in protest at the 1997 coup. Since 1999, when ASEAN approved its membership, Cambodia has begun reintegrating itself in Southeast Asia both politically and economically. Phnom Penh held its first ASEAN summit in November 2002, and also hosted an ASEAN Regional Forum in June 2003. Further integration is expected following a November 2004 agreement to form a political alliance akin to the EU by 2020. ASEAN members have been among the country's first investors, and the ongoing creation of the ASEAN Free-Trade Area, with import duties in Cambodia to be removed by 2015, promising a deepening of regional economic integration.

Political Risk Outlook

The National Assembly election held in 2008 has strengthened Cambodia's political risk environment. The fact that the vote saw less political violence than previous polls is a positive development. Moreover, the poll was convincingly won by Hun Sen and the Cambodian People's Party (CPP). Although the CPP has opted not to govern alone in line with changes in the constitution introduced in 2006, and has instead formed another coalition administration with the royalist United Front for a Peaceful, Co-operative and Independent Cambodia (FUNCINPEC) party, in reality the CPP commands almost total power.

Monitored by international donors, the CPP will continue to implement a slow, compromised reform of its political and economic institutions. D&B does not expect the government to launch any meaningful drive against corruption, however, because of the involvement of many senior officials, and because the CPP uses a system of patronage to retain its followers' support. Consequently, on a structural level Cambodia still suffers from a high level of political risk. Despite a veneer of liberal democracy, the country effectively functions on patronage, corruption and coercion. Controls on official criminality and misgovernment are virtually non-existent or at best notional. Corruption and opaque links between politicians and businessmen can make business dealings for foreigners difficult.

Possible shocks to the political status quo over the forecast period, if any, are likely to be primarily economic. In 2008 rapid inflation (see **Inflation**) due to higher international oil and food prices greatly reduced voters' living standards. Notably, however, the CPP actually increased its electoral support in the July 2008 election, which coincided with the peak of the inflation surge. Inflation pressures have now started to subside, but a weak economy in 2009 and 2010 (see **Macroeconomic Risk**) will also test the patience of the Cambodian population. However, D&B believes that the CPP's firm grip on power, and the lack of a popular political opposition, mean that there is likely to be little direct threat to government stability over the forecast period.

Macroeconomic Risk

Key Point: A weak global economy over the forecast period will impact on Cambodian economy's growth engines of garment exports, tourism and construction. Meanwhile, adverse weather conditions in 2009 will impact on agricultural production. Overall, real GDP growth is likely to be minus 1.0% in 2009, with only a sluggish recovery to 3.5% in 2010.

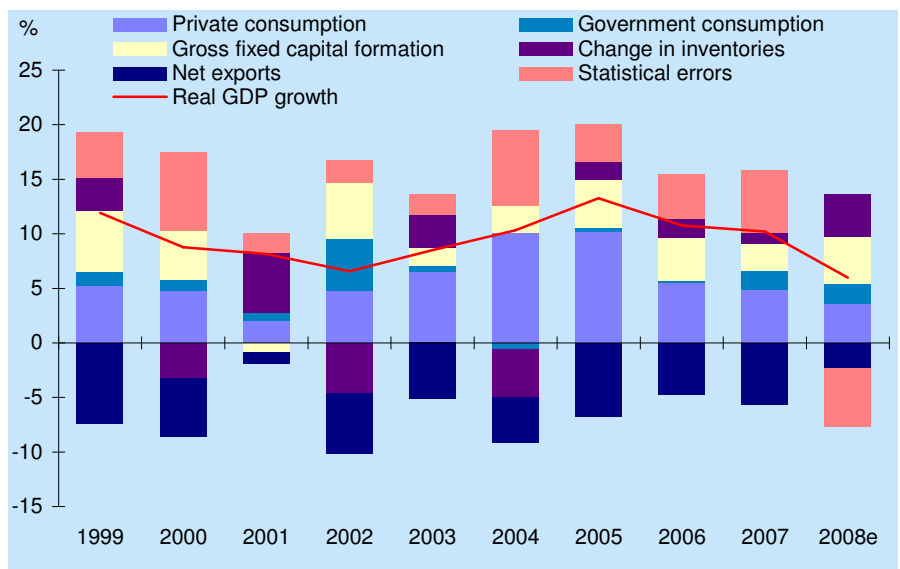
Short-Term Economic Performance

The economy continues to be affected by a legacy of the Khmer Rouge regime: the country's infrastructure and socio-economic indicators greatly lag other countries in the region. Nearly 69% of the population depends on agriculture for their livelihood, while 90% of the country's 14m people live on less than USD2 per day, according to the World Bank. The economy remains narrowly focused; the garment sector accounts for about 13% of GDP, tourism accounts for nearly 15% and agriculture around 30%. This leaves the economy very exposed to external shocks.

Cambodia has experienced an economic boom over the past few years led by strong garment exports, burgeoning tourist receipts, and a boom in construction, all of which have been aided by greater political stability (see **Political Risk**). Real GDP growth rate averaged 9.3% year-on-year (y/y) in the decade to 2007. Moreover, from 2003 to 2007 the rate of growth rose to double digits, a performance more usually associated with China. However, Cambodia's growth has been from a very low base, and the fruits of this expansion have not been widely distributed, with most development still concentrated around the capital, Phnom Penh, and tourist centres such as Siem Reap; even within those areas, it is largely figures connected to the ruling Cambodian People's Party (CPP) that have benefited the most.

Chart 1

Yearly GDP Growth Contribution by Demand



Sources: Asian Development Bank, *Key Indicators of Developing Asian & Pacific Countries*; Ministry of Planning, National Institute of Statistics; D&B.

We estimate that the economy expanded by a moderate 6.0% y/y in real terms in 2008, well below the 10.2% rate of expansion recorded in 2007. In particular, Cambodia's private consumption was undermined by the surge in inflation seen in the first half of 2008 (see **Inflation**); state consumption spending likely rose at a brisk pace as tax revenues rose in the earlier part of the year. Gross fixed capital

formation showed an exceptionally strong start to the year, but moderated significantly in the second half of 2008. Meanwhile, exports also had a positive start in 2008, but this trend was reversed alongside the rapid deterioration in the global economy from mid-2008 onwards.

For 2009, D&B forecasts a contraction in real GDP of 1.0% y/y as consumption, investment and export growth slow in tandem with a global economic downturn (see **Global Economic Outlook**). In 2010 the economy should recover, with real growth rising to 3.5% helped by the low base of comparison in 2009.

Components of Growth

Table 3
Contributions to Growth

	2006	2007	2008e
<i>Real growth rate (%):</i>			
Private consumption	6.8	6.2	4.7
Government consumption	1.7	19.5	20.0
Gross fixed capital formation	16.7	10.1	17.0
Exports	19.2	10.1	10.0
Imports	16.0	12.1	8.0
Real GDP	10.8	10.2	6.0
<i>Share of GDP (%):</i>			
Private consumption	81.0	78.2	75.2
Government consumption	5.3	5.7	10.8
Gross fixed capital formation	19.3	19.4	27.5
Exports	68.6	65.3	62.3
Imports	76.0	72.9	74.1
<i>Contribution to real GDP growth (percentage point):</i>			
Private consumption	5.5	4.9	3.6
Government consumption	0.2	1.7	1.9
Gross fixed capital formation	4.0	2.5	4.2
Inventories	1.8	1.1	3.9
Net exports	-4.7	-5.6	-2.3

Sources: Asian Development Bank, *Key Indicators of Developing Asian & Pacific Countries*; Cambodian Ministry of Planning, National Institute of Statistics; D&B.

Private Consumption

Given that Cambodia is a very-low income economy, private consumption accounts for the majority of GDP, estimated at 76% in 2008, albeit an improvement on the 90%-plus levels of the late 1990s when GDP per capita was even lower. Moreover, the economy's low level of development means that swings in consumption are still driven to a large extent by the agricultural sector (see **The Agricultural Sector**). In recent years, the weather has been favourable, agriculture growth has been stable, and real consumption growth has shown steady increases (from a very low base).

In 2006 and 2007 real consumption rose by 6.8% and 6.2% y/y, respectively; this accounted for respective growth contributions to real GDP of 5.5 percentage points (pp) and 4.9pp. In 2008 we estimate that real consumer spending rose by a more moderate 4.7% y/y, marking a contribution of 3.6pp. This is due to the fact that while rural incomes were initially boosted by a global surge in commodity prices, they were also squeezed by subsequent rises in the rate of inflation (see **Inflation**). Indeed, food price hikes in 2008 were exacerbated by border restrictions on pigs and poultry aimed at preventing the spread of avian influenza, and by many farmers' preference for selling their rice for higher prices in Vietnam and Thailand than in the local market.

Chart 2

Private Consumption

Sources: Asian Development Bank, *Key Indicators of Developing Asian & Pacific Countries*; Ministry of Planning, National Institute of Statistics; D&B.

In 2009 and 2010 inflationary pressures should gradually ease, which will help consumers somewhat. Nonetheless, a concurrent easing in agricultural commodity prices (a sharp reversal of the trend in early 2008) will impact farmer incomes. Outside of agriculture, we also expect consumer incomes to be impacted by a fall in key garment exports and tourism receipts (see **The Garments Industry and Tourism**) over the early part of the two-year forecast period. Notably, the International Labour Organisation (ILO) estimates that up to 1.5m Cambodian workers (around 9% of the total population) may ultimately be affected by the global economic downturn. Notably, the impact will not be concentrated only in lower income households: sales of Toyota vehicles (representing 70% of the very small automobile market in the country) were down 50% y/y in January 2009.

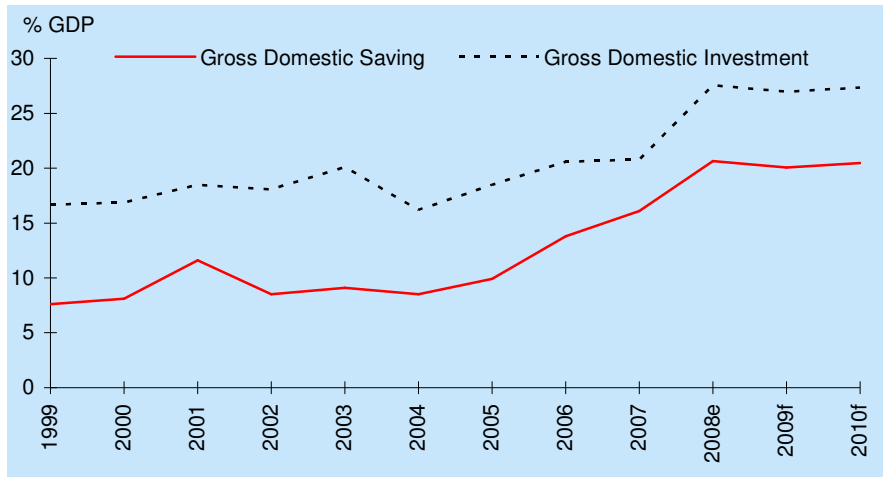
Overall, D&B forecasts real private consumption to increase 3.5% in 2009 and a slightly higher 4.0% in 2010, as the global economy slowly recovers from the current downturn: this would translate into positive growth contributions of 2.6pp and 3.1pp, respectively.

Gross Fixed Capital Formation

Cambodia's fixed asset formation remains low by regional standards, reflecting the fact that very low per capita incomes and savings rates leave little capital available to invest. Indeed, in 2007 gross investment accounted for just 19.4% of GDP, although we estimate that this had finally risen to around 27% in 2008 as investment surged in the early part of the year (by comparison, however, China invests around 40% of GDP each year).

Aid-financed projects are still a major component of overall investment. Between 2002 and 2008 total budget support, project grants and loans from international donors averaged around 18% of GDP, although not all of this is channelled into investment. In 2009 and 2010 pledged funds worth around USD170m from the World Bank and Asian Development Bank will help to improve roads and rail lines, as well as energy and water management. In recent years there has also been a marked upswing in private sector investment (see **Foreign Direct Investment**), primarily into the garment, tourism, and property sectors. In particular, 2007 and early 2008 saw a surge in residential construction in the capital, Phnom Penh, with the country's first skyscrapers finally breaking ground.

Chart 3

Gross Domestic Savings and Investment

Sources: Asian Development Bank, *Key Indicators of Developing Asian & Pacific Countries*; Ministry of Planning of Cambodia, National Institute of Statistics; D&B.

Overall, in 2007 gross fixed capital formation rose a healthy 10.1% y/y, the third consecutive year of double-digit annual growth, and making a contribution of 2.5pp to GDP growth. In 2008 we expect that the pace of investment growth increased to 17.0% y/y, making a positive contribution of 4.2pp. However, this figure masks a very sharp increase in spending at the start of the year but a subsequent rapid decline towards the end of the period. In particular, there was a collapse in the property sector, with asking prices for projects falling 30-40% from their mid-2008 peak and activity lower by up to 80% as of early 2009 as leveraged speculators tried to exit the market *en masse* (this has potential implications for the stability of the banking sector: see **Financial Sector Risk**). For example, in February 2009 South Korean investors have since both scaled back and delayed by at least a year a previously-announced USD1bn skyscraper project in Phnom Penh.

For 2009 we expect a sharp drop in investment growth for all of Cambodia's major growth sectors, excluding aid-related infrastructure, with only a mild recovery at best in 2010; no further progress is likely to be made in developing the country's untapped oil reserves (see **The Petroleum Sector**). Overall, real investment growth is likely to fall 3.0% y/y in 2009, and only rise to 5.0% y/y in 2010: this would equal respective growth contributions of -0.8pp and 1.3pp over this period.

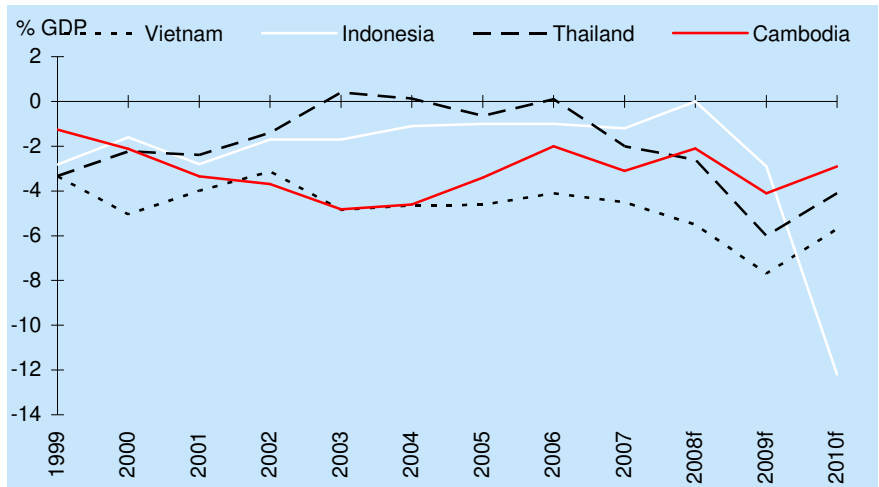
Government Consumption

Given that the central government has only recently established effective control over the whole country, it is no surprise that state spending accounts for a small share of the economy. The total government revenue base rose to an estimated 12.3% of GDP in 2008 from 10.3% in 2004 helped by the introduction of an Automatic SYstems for CUsoms Data (ASYCUDA) for customs payments in late 2006. However, actual direct tax revenues still account for only around 2.4% of GDP. Moreover, the overall positive trend in revenue growth is likely to be reversed in 2009 as the economy and import growth (which provide customs revenue) slow (see **Net Exports**). Moreover, the government's decision in early 2009 to close the country's only licensed chain of football gambling premises, and also to impose an outright ban on all venues offering slot and electronic gaming machines, will crimp tax revenues from the gaming industry, which have risen in importance in recent years (they totalled an estimated USD20m in 2008, around 9% of the tax take).

In terms of expenditure, over the past decade there has been a limited peace dividend as soldier demobilisation has seen a resulting drop in the military wage bill in real terms. However, the IMF warned the government against a planned sharp increase in defence spending in the 2009 budget. Elsewhere, current spending

predominates relative to the share allocated to capital projects. D&B believes that the government will respond to an economic slowdown with limited additional current and capital fiscal expenditure. Overall, the fiscal deficit for 2008 is expected to narrow from 3.1% to 2.1% of GDP, but we forecast a further widening to 4.1% in 2009 before narrowing to 3.1% in 2010. Importantly, we expect that an increase in foreign aid flows will fund most of these wider deficits. Cambodia is a successful example of economic development in a very poor and post-conflict environment, but one where hard-fought gains could be easily reversed by economic adversity. As such, international aid agencies are unlikely to abandon it despite the troubling global economic backdrop; crucially, the total extra sum of aid required to fund the level of deficit we expect in 2009 is still small in real terms at less than USD200m.

Chart 4
Government Balance¹



Sources: International Monetary Fund, *International Financial Statistics & Staff Reports*; Asian Development Bank; Bank of Thailand, *Economic and Financial Statistics*; D&B
 Note: ¹Government balance figures do not include donor funding.

Nonetheless, it will be many years before the state is in a position to play a major role in supporting the economy (a sharp contrast with the huge fiscal injections being seen in other economies). The impact of government spending on total GDP growth averaged just 0.2pp per year in the decade between 1998 and 2007. For 2008 we estimate it was 1.9pp, and are expecting further contributions of 1.1pp and 1.0pp in 2009 and 2010 respectively.

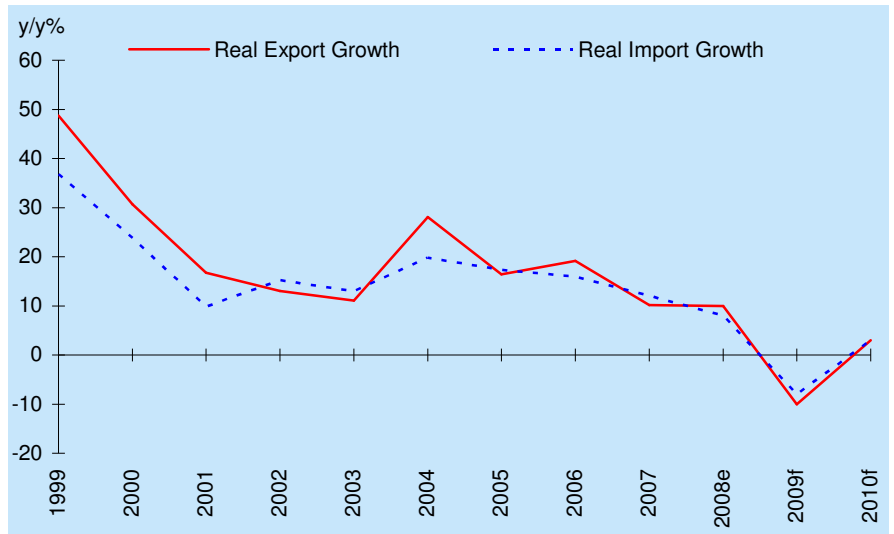
Net Exports

Cambodia has maintained an average deficit in merchandise trade of about 13.7% of GDP for the last decade as the growing manufacturing base has relied on the import of capital goods; even including services (mainly from tourism income), the overall net export gap as a percentage of GDP is around 9.7%. From a low base, overall real import growth averaged a brisk 16.5% y/y in the decade from 1998 to 2007. In 2006 real import growth was 16.0%, but in 2007 this slowed to 12.1% as a rise in oil prices reduced demand for other imported goods; in 2008 we estimate overall real import growth slowed again to just 8.0% as consumer purchasing power was dented further by rising inflation, and as investment and exports (which have an imported component) started to fall back sharply in the latter half of the year.

Meanwhile, real export growth averaged 19.1% from 1998 to 2007. In 2006 real export growth was a brisk 19.2%, but in 2007 this dropped back to 10.1% as foreign demand for Cambodian goods dipped. We expect that 2008 saw lower export growth of 10.0% y/y once again as demand for textiles slowed in the US (which is Cambodia’s major export market, see **Export Profile**), and as tourism income growth moderated compared to recent years (see **Tourism**). On this basis, net exports are estimated to have made a growth contribution of minus 2.3pp in 2008.

For 2009, D&B forecasts sharp declines in both real export and real import growth of 10.0% and 8.0%, respectively, as overall global trade and tourism flows are impacted by a deep economic slowdown (see **Global Economic Outlook**): this would mark a positive growth contribution of 2.2pp given that imports would make much less of a drag on growth than usual. In 2010 we expect that real export and import growth will recover weakly in tandem to rise 3.0% y/y: this would still see net exports act as a drag on growth equivalent to 1.2pp of GDP.

Chart 5

Export and Import Growth

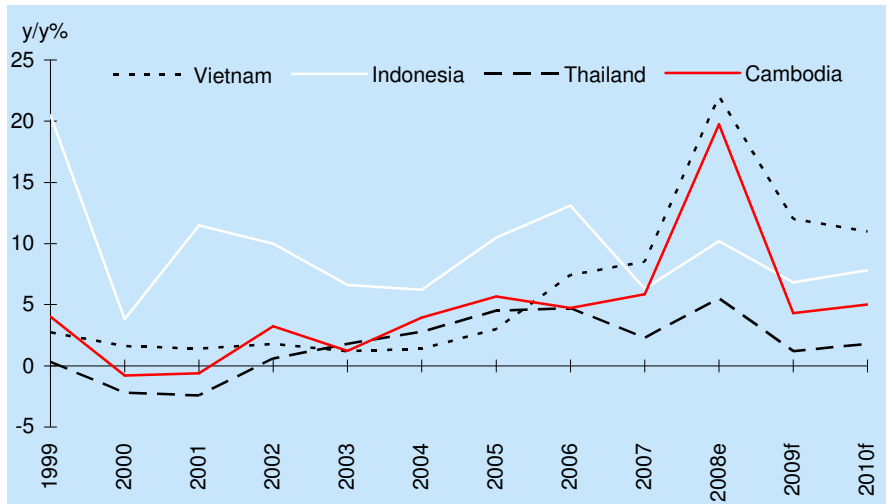
Sources: Asian Development Bank, *Key Indicators of Developing Asian & Pacific Countries*; D&B

Monetary Environment*Inflation*

Severe inflation sapped the economy during much of the second half of the past century, with triple-digit inflation notable in 1988-92. However, since the early 1990s, foreign aid (and a high degree of dollarisation) has seen the government forego domestic financing of its deficit through printing riel. Inflation has generally remained below the rate in other countries in the region. Since 1993, inflation has been heavily influenced by more traditional factors such as supply chain problems, infrastructure constraints, seasonal variations in agricultural output and Cambodia's terms of trade. In a small and open economy that is highly dependent on imported inputs like petroleum (personal generators are popular due to poor coverage of the national grid), fertilizer, and basic foodstuffs and consumer goods, imported inflation can exert a powerful impact on domestic prices.

CPI inflation jumped 1.2pp to average 5.9% y/y in 2007, but accelerated to 10.8% y/y in December led by a rise in food and energy prices and a weaker US dollar (Cambodia is highly dollarised). In early 2008 this trend continued, with inflation continuing to escalate, to a peak of 25.7% in May 2008. The Cambodian authorities' attempts to cool the economy with the limited monetary policy tools available (see **Money Supply**) were ineffective given the exogenous nature of the price shocks (although state price controls on rice exacerbated the problem as local farmers opted to sell to Thai and Vietnamese millers instead). Indeed, as an alternative response the government stopped publishing inflation data completely for several months, only resuming in September when the global price of commodities started to reverse, and Cambodian inflation moderated with it; nonetheless, average annual inflation was still nearly 20% y/y in 2008.

Chart 6
Consumer Price Inflation¹



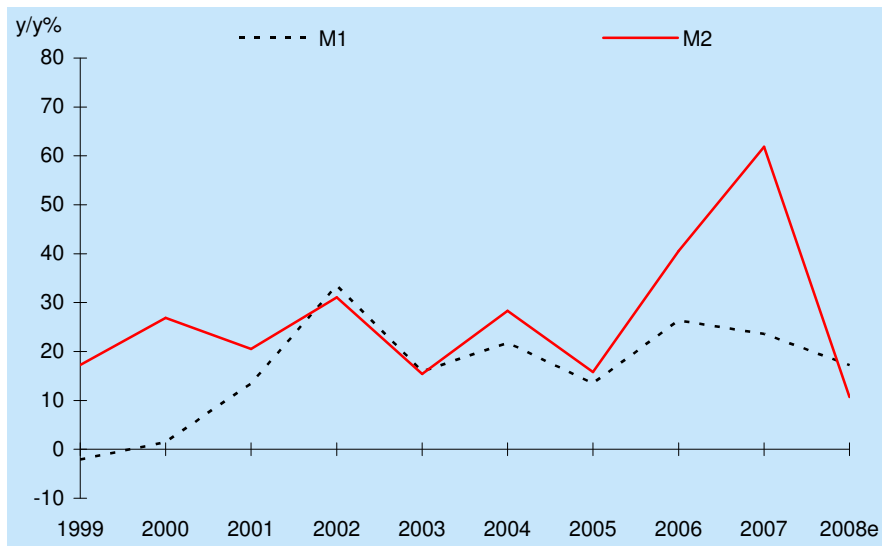
Note: ¹Data for Vietnam are for year end; all other data are annual average.
 Sources: International Monetary Fund, *International Financial Statistics*; D&B

Looking ahead to 2009 and 2010, stabilisation in food and energy prices are likely to see a significant moderation in inflationary pressures to 4.3% and 5.0% y/y, respectively. Overall, inflation is not likely to be a source of country risk failing an unexpected fall in the value of the riel (see **Exchange Rate Risk**).

Money Supply

Cambodia's economy remains highly dollarised; up to 95% in effective terms according to the IMF. The riel has only a limited place in the economy, being mostly used for small-scale transactions in the countryside. However, the government is committed to using it for its own transactions. Overall, money supply growth is dictated by seasonal factors, notably the disbursement of the government budget and the level of agricultural output, as well as occasional speculation.

Chart 7
Money Supply



Source: International Monetary Fund, *International Financial Statistics*

The money supply grew quickly in 2007. Broad money (M2) growth accelerated to 54.1% y/y, largely on the back of a 45% surge in credit to the private sector and a 29% jump in net foreign assets. The private credit surge was largely driven by

greater demand for loans for construction, real estate, and wholesale and retail trade, but an increased number of small- and medium-sized enterprises also borrowed for business expansion: the IMF has flagged the pace of bank lending to the real estate sector in particular as a risk to the stability of the very young banking sector (see **Banking Sector Risk**). Money supply growth continued to accelerate in the first few months of 2008, hitting over 100% y/y in the first half of the year. This was a clear sign of over-heating, and in June 2008 the central bank was forced to use the limited measures it has available to try to cool the economy (see **Interest Rates**). Following this, overall money-supply growth slowed sharply. Indeed, M2 growth was just 10.7% y/y as of October, and the IMF has estimated that in December it was only around 5%.

D&B expects that money supply growth will continue to slow in 2009, and may possibly contract y/y, as the local and global economies weaken and as lower export earnings result in a decline in the pace of accumulation of foreign currency. In 2010 the growth rate of monetary aggregates should accelerate once again, but is still likely to remain well below the buoyant pace seen in 2006 and 2007.

Interest Rates

Notably, as a result of the high degree of dollarisation, the National Bank of Cambodia (NBC), the central bank, has virtually no independent control over monetary policy. The central bank is largely relegated to:

- resisting pressure from politicians to print money to finance deficit spending (which it has successfully done for a decade);
- supplying riel in exchange for foreign currency in response to demand;
- a *de facto* policy of trying to maintain a stable nominal exchange rate versus the USD (see **Exchange Rate Risk**);
- making changes over the required level of banks' reserve requirements, which can operate as a monetary policy lever. However, Cambodian banks often hold excess reserves, which limits the effectiveness of this tool; and
- in extreme circumstances, actual imposing credit rationing to particular economic sectors: this occurred with real estate loans in June 2008.

The NBC has plans for eventually issuing Treasury bills at market-determined interest rates. This (and the government's assignment of a sovereign credit rating, see **Foreign Aid, Debt and Default Risk**) are laudable steps towards gradually establishing a riel-based yield curve. However, in order to be fully effective these measures will still require a greater degree of de-dollarisation in the economy.

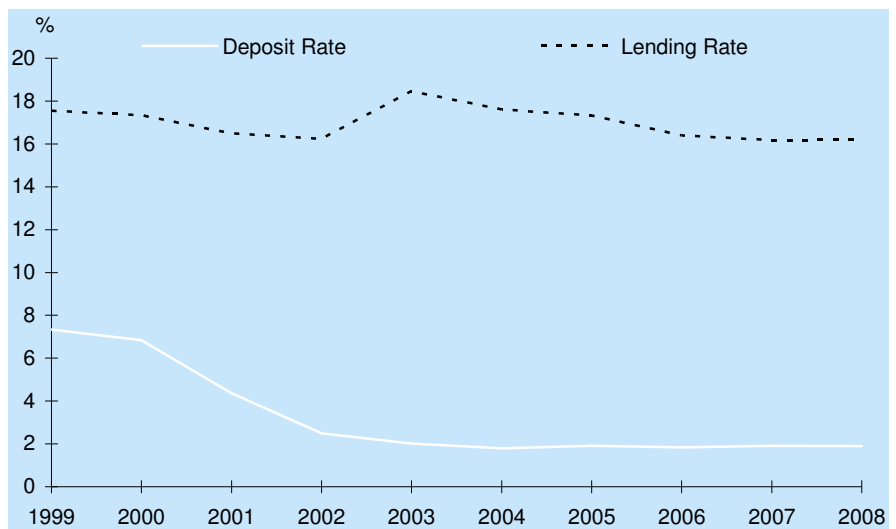
In terms of the present market structure of interest rates, lending rates are stubbornly high (around 16% in 2008), reflecting perceived high risk premiums in the lending market and the risk for Cambodian banks of lending in foreign currency (almost all lending is in US dollars rather than riel). The rates charged on microfinance loans and loans in the informal sector, which are more widely used, are even higher, although the International Finance Corporation is collaborating with the NBC on regulations to establish a private credit bureau in late 2009, which will help banks and microfinance institutions (MFIs) better assess risks in lending. Banks also maintain a wide interest rate spread by usually offering low deposit rates (less than 2% in October 2008), which is indicative of a lack of competition. However, a growing liquidity shortage that began in late 2008, and which worsened in early 2009, has forced banks to raise their deposit rates sharply to try to attract funds: this is narrowing their interest margin and lowering their profits at a time when there are already concerns about the strength of their asset base (see **Financial Sector Risk**).

Notably, in June 2008 the NBC doubled the bank reserve requirement from 8% to 16% to try to cool out of control M2 money supply growth (see **Money Supply**). However, a subsequent rapid decline in both the global and local economy saw this

policy partially reversed in February 2009, with the reserve requirement cut back to 12% again; previously-imposed restrictions on real estate lending were also removed in a bid to boost the ongoing crash in the local property market (see **Gross Fixed Capital Formation**).

D&B believes that the NBC will further loosen reserve requirements over the course of 2009 to try to support the banking system. However, we also believe that such measures will only have limited impact given the synchronised global collapse in real GDP growth and asset prices. Indeed, given that most of the Cambodian economy is effectively either outside of the domestic banking system (most working and equity capital is still financed from relatives and informal networks), or driven by exogenous demand, monetary policy is likely to offer little direct support to real GDP growth over the forecast period.

Chart 8

Nominal Interest Rates

Source: International Monetary Fund, *International Financial Statistics*

Short-Term Economic Forecasts

Cambodia's robust economic performance up until the second half of 2008 was based upon growth in agriculture, construction, tourism and garment exports. However, agricultural production remains subject to weather conditions, while the other three major economic sectors are likely to experience a synchronised slowdown in 2009 in line with a sharply weaker global economy. Such a backdrop will outweigh the beneficial impact of a marked reduction in inflationary pressures on consumer spending.

Meanwhile, the government has only limited room for any counter-balancing fiscal expansion given its slim resources. Monetary policy is also unlikely to be of much support to the economy as the high degree of dollarisation in Cambodia means that the National Bank of Cambodia lacks true operational autonomy; moreover, the inefficiency of the financial and legal systems mean that the ultra-low interest rate regime adopted by the US Federal Reserve Bank has not translated into significantly lower US Dollar lending rates in Cambodia.

Overall, we anticipate that real GDP growth will shrink by 1.0% in 2009 before expanding by a sluggish 3.5% in 2010 as the global economy slowly recovers some momentum.

Table 4
Short-Term Economic Forecasts

<i>Forecast</i>	<i>2009f</i>	<i>2010f</i>
<i>Real growth rate (%):</i>		
Private consumption	3.5	4.0
Government consumption	10.0	8.0
Gross fixed capital formation	-3.0	5.0
Exports	-10.0	3.0
Imports	-8.0	3.0
Real GDP	-1.0	3.5
<i>Contribution to real GDP growth (percentage point):</i>		
Private consumption	2.6	3.1
Government consumption	1.1	1.0
Gross fixed capital formation	-0.8	1.3
Change in inventories	-6.1	-0.8
Net exports	2.2	-1.2
Inflation, annual average (%)	4.3	5.0
Interest rate, lending (%)	18.0	17.0
Interest rate, deposit (%)	1.0	1.0

Source: D&B

Long-Term Economic Potential

Political turmoil and civil war from the 1970s until the 1990s has left a mixture of long-term economic constraints. Under Pol Pot's Khmer Rouge regime of the late 1970s, there was a tremendous socio-economic upheaval that left a poisonous legacy for the country: up to one quarter of Cambodia's population died during this time and many of the well-educated sections of the population were specifically targeted by the regime. In addition, the long-term effects of the regime's economic policies have also been devastating: the regime instituted an agrarian barter system and banks and currency were abolished. The Cambodian currency has yet to recover from these measures. The country's industrial base and infrastructure were destroyed and are still being rebuilt.

Nonetheless, in recent years the economy has started to show brisk growth, albeit it from a low level and on a very narrow base. Over the period 1998-2007, real annual GDP growth averaged 9.3%, and D&B believes that over the decade from 2009 to 2018 the economy is capable of expanding at around a 7-8% pace.

Structural Factors

Despite a very troubled legacy from the 20th century, Cambodia is well positioned geographically, holding a strategic position in Southeast Asia. The integration of China into the WTO is creating forces in favour of regional economic liberalisation; a spill-over of robust Chinese GDP growth into Cambodia is likely over the medium term. Meanwhile, at the sub-regional level, the Association of Southeast Asian Nations' (ASEAN) efforts to create a single market should eventually take hold despite the fact that particular interests have delayed full implementation of the ASEAN free-trade agreement.

The Agricultural Sector:

Agriculture is central to the Cambodian economy. It accounts for about 30% of GDP and 69% of the population is dependent on farming. Given its arable land, ample rainfall and proximity to the major markets like Thailand, Vietnam and China, Cambodia has the potential to develop an export-oriented agriculture sector.

However, although the government and donors have re-emphasised the importance of agriculture to the economy, only about 11% of overseas development aid goes to agriculture.

Currently, most farming activity remains at subsistence level; despite rice production accounting for nearly 20% of GDP and 88% of the cultivated crop area, it is still the least productive in the region; Cambodian rice yields are typically about 75% lower than those in Thailand, and only about 50% of those in Vietnam. Nevertheless, yields have risen since the de-collectivisation of farms and privatisation, the easing of import and export licensing requirements, improvements in irrigation and the introduction of new varieties of rice.

Binding constraints on agriculture remain weak property rights: land deeds were all but destroyed by the Khmer Rouge and only 10% of farmers have formal title to their cultivated land, preventing long-term investment in their assets and restricting access to collateralised lending. Moreover, officials from the ruling Cambodian People's Party (CPP) have used their position of authority to proceed with official and unofficial land grabs.

A paucity of inputs also contributes to poor productivity. Each hectare of Cambodian crop only gets about 3kg of fertiliser, whereas Thai crops get 113kg. Meanwhile, only about 10% of Cambodian cropland is irrigated, compare with nearly 27% in Thailand. Moreover, poor governance places a major constraint on agri-business companies. Informal fees and bribes inhibit the growth of a thriving dynamic and competitive agribusiness sector. The cost of capital (see **Interest Rates**) also remains a serious barrier to financing expansion, or even to the purchase of fertiliser for small-scale producers.

Cambodia has one of the world's largest inland fisheries (ninth largest in 2004 according to the FAO). About 2m Cambodians depend on fishing and related activities according to the World Bank. The Mekong River and Tonle Sap Lake are the source of much of Cambodia's fish. However, population growth has put the fishery under stress. Infrastructure programmes in the upper Mekong, including dams in China's Yunnan province, Vietnam and Laos, threaten to deplete the flow of the Mekong further and disrupt entire ecological systems.

Tourism:

The tourist industry's contribution to the economy has grown rapidly over recent years. Since 2005, it has expanded by more than two-thirds and accounted for over one-third of Cambodia's economic growth. Tourism now contributes almost 17% of GDP, and is a larger source of income than the value-added component of the garment industry. The country received 2.0m foreign tourists in 2007, up from 1.7m in 2006, due to the rapid development of the hotel sector in Siem Reap, the northern town that services the 800-year-old Angkor Wat temples. Moreover, from January to October 2008, visitor arrivals to Cambodia were also 1.7m, showing an 8.5% y/y increase over the period. Tourism brought in nearly USD1.4bn in revenue in 2007 up from USD1.0bn in 2006, with 2008 likely to see this grow to around USD1.5bn. However, the government needs to greatly expand current infrastructure if the tourist industry is to rival regional competitors like Thailand (which saw over 14m visitors in 2007) and Malaysia.

An economic downturn in 2009 and the impact of a drop in tourist arrivals to neighbouring Thailand (which acts as a gateway to Cambodia for many tourists) in the aftermath of political turmoil there suggest that tourism income is likely to decline near term; visitors to the country's major tourist attraction, the ancient temple complex of Angkor Wat, fell slightly in 2008 for the first time since the SARS scare of 2003. However, the longer-term prospects for the sector remain very good. For example, a huge USD12bn joint Cambodian-Korean eco-tourism project involving the establishment of a satellite city near to Siem Reap was proposed in

2008, although actual work has yet to begin. Plans to finally finish an intended USD516m 200-hectare horse-racing complex south of Phnom Penh were also been announced by a consortium of international developers in early 2009 (although this project has been mooted since 1995).

The Garments Industry:

Given the low cost of production in Cambodia, labour-intensive garment manufacturers from Hong Kong, China and Taiwan steadily flocked to Cambodia from the mid-1990s onwards. Until 2005 concessionary access to the US and EU was also an attractive perk for Cambodian producers. However, when the textile Multi Fibre Arrangement ended in that year the industry shed 22,000 jobs in the space of a few months; fortunately, both the EU and US imposed quotas on the Chinese imports later in 2005, offering the Cambodian industry a reprieve from the competition.

Overall, annual garment export receipts rose from just USD28m in 1995 to USD2.9bn in 2007, the last year for which full data are available. However, the industry's total output plunged 46% quarter-on-quarter in Q4 2007 due to a sharp decline in demand from the US, Cambodia's largest market (see **Export Profile**); this left total exports up just 2.4% for 2007 as a whole, compared with growth of about 20% in 2006. In 2008, preliminary garment export contracted 2% according to the chairman of the Garment Manufacturers Association in Cambodia (GMAC) – although this was actually a better performance than the 5 to 7% decline that had been projected by the association.

The outlook for the garments sector is mixed. Cambodia remains a low-cost producer. However, at the end of 2008, US restrictions on textile imports from China were removed, which will see greater competition from China; Vietnam is also emerging as a key rival. Moreover, a deepening global economic downturn is likely to see a further decline in global demand for the clothing items Cambodia exports. Following a period of adjustment, a more efficient industry will likely emerge, but textiles will no doubt lose importance in Cambodia's economic growth.

The Petroleum Sector:

In 2005, Chevron discovered oil about 145 kilometers from Sihanoukville, the southern port. Conservative estimates suggest that there are 500m barrels of oil, however there is much speculation that they could be considerably larger with up to 2bn barrels and 10trn cubic feet of natural gas.

The oil field has been separated into six blocks. The process that the government used to award the blocks has been criticised for its lack of transparency. Cambodian officials have said that the blocks were allotted according to 'geostrategic considerations'. Block A was awarded to Chevron, Block B to the Singapore Petroleum Company; Block C to the Hong Kong-based Polytec; Block D to China's Petrotech Holdings; Block E to Indonesia's Medco; and, block F to the Chinese National Offshore Oil Company.

The government had hoped production would start in 2009. However, this will not occur for several reasons, including both issues with bureaucracy and the sharp drop in global energy prices in the latter half of 2008. D&B believes that little movement will be made towards tapping Cambodia's energy potential over the forecast period, with initial production most likely in late 2011 or early 2012. Nonetheless, over the longer term the royalties and revenues from oil will provide an important source of revenue for the government, which still relies on donor funding to fulfil its budgetary spending plans. The IMF has estimated that oil revenue could reach USD175m at their onset and peak at USD1.7bn by around 2021, based on the estimate of a production capacity of 50,000 barrels per day.

The World Bank and Asian Development Bank have been busy advising officials on how to avoid the 'resource curse'. Oil wealth in other developing countries has frequently been mismanaged. Many are concerned, given Cambodia's track record of corruption, that oil revenue may be misappropriated by well-placed officials (see: **Corruption**); Cambodia's largest business conglomerate, Sokimex, which has been widely criticised for its opacity and corruption, appears certain to be central to any activity in the petroleum sector. The prime minister, Hun Sen, and government officials have stated that oil revenues will be used to reduce poverty, promote economic diversification and social development. The government had previously stated it would prepare an oil and gas management law in anticipation of the revenues, but has since reversed this position.

Legal and Judicial Reform:

Cambodia's constitutional provisions to secure the independence of the judiciary are not implemented. In practice, both the government and individuals regularly ignore the rule of law. Clerks, who function as gatekeepers to judges and write court records, are reportedly a major source of corruption. Although judges were given a tenfold salary rise in 2002 bringing their monthly wage above USD300, court clerks who earn about USD1 per day can hold disproportionate power. Moreover, many judges are closely connected to the CPP, potentially compromising their independence and impartiality. The judiciary is perceived as weak, incompetent, corrupt and dominated by the rich and powerful, with negative implications for the business environment. Although multilateral lenders have highlighted this area for urgent reform, and the IMF has promised funds to strengthen and modernise the institution, little progress can be made without political leadership. At the most basic level, laws and judicial decisions are not made public, obviating even a modicum of transparency.

Population

The population has been profoundly affected by the past three decades of social upheaval, war and desperate poverty. Although relative normalcy returned in the 1990s, poverty remains endemic. 85% of Cambodians still live in the countryside, and over 70% depend on agriculture for their livelihood. Fast economic growth is beginning to have an impact with levels of poverty falling, but these gains are not being evenly distributed (see **Political Risk** and **Corruption**).

The average life expectancy of 57 years is considerably shorter than the East Asian average of 70. However, indicators of social wellbeing are improving, even if they do remain much worse than in the rest of East Asia. For example, infant mortality fell from 95 per 1,000 live births in 2000 to 65 in 2005 according to the UN Development Programme. Nevertheless, this remains relatively high as does the level of food insecurity. Moreover, only 41% of the population has access to reliable, safe sources of drinking water. Population growth in 2007 was estimated to be 2.6% by the IMF. The UN estimates that the Cambodian population will grow by 1.8% a year until 2018.

Notably, Cambodia has one of the highest HIV/AIDS rates in the region, with at least 247,000 HIV positive people out of a population of 13m. AIDS has orphaned over 70,000 children, according to the National AIDS Authority. However, infection levels among the adult population dropped to 1.9% in 2004 from 3.3% in 1998. The population has been the target of several years of government- and donor-funded safe-sex campaigns: according to the National AIDS authority over 2m condoms are sold every year. However, a lack of resources is hampering the authorities' efforts, and standards of sexual and reproductive health remain low. Gender inequality and a thriving commercial sex industry also shape the epidemic, which could be more widespread than figures suggest.

Literacy and educational attainment is poor compared with in other East Asian countries. However, there has been an improvement. Between 1997 and 2005, adult literacy increased from 57% to 74%. Net primary enrolment rates increased from only 67% in 1990 to 91% in 2005. Public education is free and officially compulsory for the first six years. Youth literacy is about 83%. The next generation of Cambodians will be better prepared for a modern economy.

Technological Progress

Given its troubled history, Cambodia is unsurprisingly still at a very low level of technological development. Indeed, much of the population is still illiterate. The foreign businesses that have invested in Cambodia are generally at the very lowest end of the technology ladder, and have provided little in the way of technology transfer. With education levels slowly rising among the country's youthful population, the situation should slowly improve with time.

Investment

Investment levels have remained low compared with surrounding countries; although investment is now around 20% of GDP in Cambodia, it can be up to 40% in neighbouring countries. Low levels of investment reflect grinding poverty, which leaves little capital left to invest. Moreover, there are serious institutional impediments and day-to-day operational problems in Cambodia that act as disincentives to investment. Business costs are pushed up by the payment of bribes and kick-backs, crime and security problems, burdensome regulatory inspections (see **Commercial Risk** and **Investment Environment**).

Ironically, a scarcity of capital in Cambodia means that actual capital productivity is high (returns need to be high in order to mitigate the high cost of borrowing, see **Interest Rates**). However, labour productivity in the country is extremely poor, ensuring that total factor productivity is negligible. As a result, overall output growth is driven by inputs, such as longer working hours in the garments sector or additional land, water and fertiliser in the agricultural sector. Moreover, there has been little progress in producing higher value-added products despite the increased manufacturing base. For instance, although Cambodia's textile earnings have grown considerably since the 1990s, the amount earned per article of clothing has fallen.

The economy relies on the public sector capital investment funded by overseas grants and lending to upgrade key infrastructure. Positively, this has allowed the government to keep credit risk low, as the terms are highly concessionary. However, public sector investment in Cambodia is a misleading term: many projects in the past have been of questionable socio-economic value to the wider public, and have often proved lucrative for businesses of either the political elite or their friends and families.

Infrastructure

Cambodia's infrastructure lags far behind its neighbours. Only 4% of the country's roads are paved; only 17% of Cambodians have access to electricity via national grid; only 8% have telephone access; and only 0.2% use the internet, according to a 2005 World Bank survey. According to the UNDP, 59% of Cambodians use unimproved water sources, like tanker trucks or unprotected wells. About 71% of Cambodians live without access to toilets. As a result, worker productivity is curtailed by avoidable infectious ailments like diarrhoea. The World Bank estimates that poor sanitation costs the country USD450m annually. The government is aiming to provide proper hygiene for all Cambodians by 2025.

Many new aid packages have been dedicated to help to remove infrastructure bottlenecks. A multi-year railroad improvement project, partly funded by international donors, got underway in 2008. Work on a World Bank funded project to build power lines from Vietnam and Laos to Cambodia also started in 2008. In April 2007, two Chinese companies launched two major power projects in the country with a combined investment of USD300m. A USD5bn 3,660 megawatt coal-fired power plant, the Koh Kong Power Light, is planned to come on stream only in 2014. However, energy shortages will remain over the short term. The government is looking for USD3.0bn to finance hydroelectric projects, with China apparently interested in providing funding. Meanwhile, in January 2009 a memorandum of understanding was signed with the Kuwaiti government for the construction of a USD350m irrigation system and a hydropower project in Kampong Thom province that is planned to start operations in 2016.

Nonetheless, until infrastructure substantially improves and speeds up Cambodia's supply chain, firms will have to continue to maintain relatively large inventories, tying up their working capital and management. Indeed, a reduction in transport costs is crucial if Cambodia is to successfully follow a path of export-led growth.

Long-Term Economic Outlook

Overall, the economy remains narrowly based, raising its vulnerability to downturns in either agriculture, tourism, or the garments sector, and will remain dependent upon foreign aid for years. However, the long-term outlook for the Cambodian economy is improving as foreign investor interest in the country grows: numerous infrastructure projects are either breaking ground or at an advanced evaluation stage. Overall, we believe that Cambodia's long-term growth potential is in the range of around 7-8% a year.

External Economic Risk

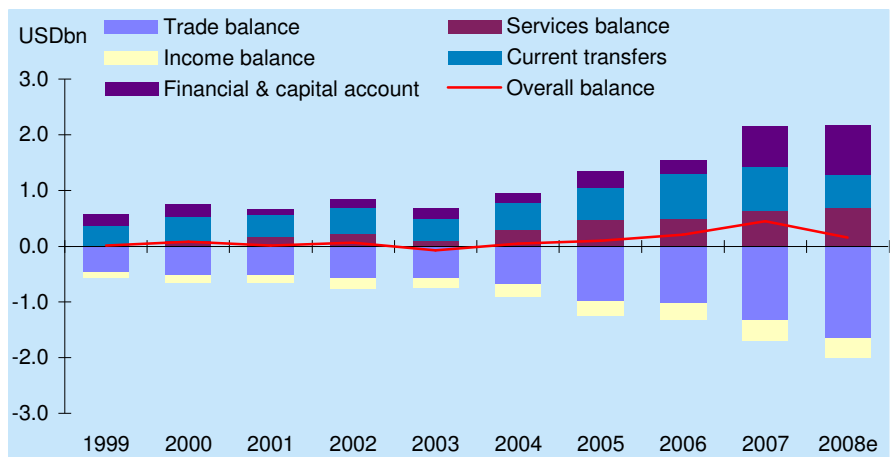
Key Point: The current account deficit is likely to narrow from 6.9% of GDP in 2008 to 5.1% in 2009 before widening out again to 6.2% of GDP in 2010. Notably, falls in FX earnings from garment exports and tourism will be mitigated by lower imports, declining net income outflows, and from rising transfers in 2009. Increased support from international donors and FDI should continue to fund these current shortfalls. Longer term, the development of oil fields could eventually transform the external position.

Balance of Payments Performance

Cambodia's statistics for the balance of payments data remain incomplete due to high levels of smuggling. Nonetheless, it can be seen that the country has consistently maintained overall surpluses since it returned to relative political normality following the Paris Peace Accords in the early 1990s (see **Recent Developments**). Indeed, in 2007 the overall external balance saw a surplus equivalent to 5.2% of GDP, and in 2008 we estimate that the balance of payments was equal to 1.5% of GDP. Nonetheless, the outcome would have been consistently negative over this period had it not been for the substantial levels of foreign aid and grants that support both investment and the state budget (see **Gross Fixed Capital Formation** and **Government Consumption**): in 2006 and 2007 these totalled around USD650m (7.5% of GDP). While this is a structural concern, there is no indication that either multilateral organisations or donor countries will reduce their assistance to Cambodia over the forecast period: indeed, around USD1.0bn has already been pledged for 2009. As such, the country's external balance is not seen as a major source of country risk, and in both 2009 and 2010 we look for overall external surpluses equivalent to 1.9 and 1.7% of GDP, respectively.

Chart 9

Balance of Payments



Sources: International Monetary Fund, *International Financial Statistics*; D&B

Current Account

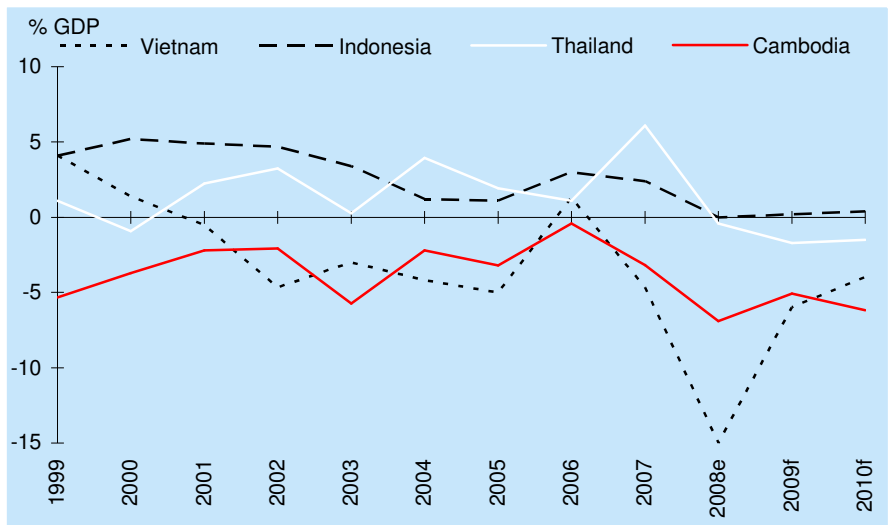
While the balance of payments has been positive in recent years, the current account has been in regular deficit. From 1998 to 2007 this shortfall averaged 3.4% of GDP. However, the deficit would have been higher if not for official transfers: without these the current account was equal to 8.0% of GDP in 2007, and to an estimated 9.1% in 2008. Although D&B does not expect any reduction in such official assistance over the forecast period, the composition of the current account is still a concern, with foreign exchange earnings highly concentrated in just a few key economic sectors that are highly vulnerable to swings in global demand.

One of the primary drivers of the current account is the trade balance: this records structural deficits given Cambodia’s still fledgling export sector, and its inability to produce most of the consumer and capital goods a growing economy demands. Over the last decade the trade deficit has averaged a worrying 13.7% of GDP, and in 2007 it widened to USD1.3bn (15.4% of GDP) on rising energy costs. D&B estimates that a further increase in energy prices in early 2008, together with a disappointing performance from exports, led the trade balance to widen even further to USD1.6bn (15.1% of GDP). In 2009, we expect a fall in both imports and exports (see **Net Exports**): this should translate into a lower trade shortfall of USD1.5bn (equal to 13.9% of GDP). However, by 2010 a recovery in domestic import demand is likely to see the deficit widen once again to USD1.6bn (although it will be slightly narrower in real terms at 13.8% of GDP).

The services account, by contrast with the trade position, runs regular surpluses, primarily due to the burgeoning tourism sector. Over the decade 1998 to 2007 services’ contribution has risen from just a slight deficit to a surplus of USD640m, equal to 7.5% of GDP. Although 2008 tourism numbers were up 6% y/y to 2.2m, this was well below the government’s targeted expansion of 20%: nonetheless, the services surplus was still worth 6.5% of GDP. The global economic downturn contributed to this underperformance, although the temporary closure of neighbouring Thailand’s airport (a major gateway to Cambodia for international arrivals) also played a role. In 2009, we expect that tourist arrivals will see an outright decline before a slight recovery in 2010. Consequently, the services surplus will dip to just 4.7% of GDP in 2009, and rise to 4.8% in 2010.

The current account is also supported by aid from donor countries and organisations. In 2000 the level of overall net current transfers (including remittances from overseas Cambodians) was USD440m, equivalent to 11.6% of 2000 GDP. Since then the level of net transfers has increased in nominal terms (to USD775m in 2007) but relative to GDP it has decreased in importance (to 8.4% of GDP in 2007). In 2008, D&B expects that net transfers equalled 5.5% of GDP, and in 2009 and 2010 we forecast that they will be equivalent to 6.5% and 6.4% as multilaterals and aid donors step up their support for the country.

Chart 10
Current Account Balance



Sources: Asian Development Bank, *Key Indicators of Developing Asian & Pacific Countries*; D&B

The income balance is another structural negative for Cambodia, equivalent to an average of 3.6% of GDP each year over the decade from 1998 to 2007, and an estimated USD350m (-3.3% of GDP) in 2008. This largely reflects the payment of dividends to foreign owners of Cambodian factories, and is a trend that will

continue given Cambodia's lack of any overseas assets: in 2009 and 2010 we forecast smaller net income deficits of USD250m and USD300m as profitability declines, equal to 2.3% and 2.6% of GDP, respectively.

Overall, D&B expects the current account deficit widened from USD280m (3.2% of GDP) in 2007 to USD742m (6.9% of GDP) in 2008 due to a larger trade deficit and lower tourism income. However, we expect that the current account deficit will narrow to USD544m (5.1% of GDP) in 2009 on lower energy prices, falling import volumes, a decline in net income outflows, and a rise in official transfers, which should mitigate lower garment exports and tourism receipts. In 2010, the trade deficit should remain stable as a percentage of GDP, and the services balance should improve, while the income and transfers position are likely to worsen; overall, we forecast a current account deficit of USD705m (6.2% of GDP).

Naturally, large current account deficits, especially amid high levels of risk aversion in international capital markets, could translate into an increase in Cambodia's level of country risk; this is especially true given the relatively low level of import cover (see **Foreign Exchange Reserves**). Nonetheless, aid inflows should help ensure that such shortfalls are still financed on the financial and capital accounts (see **Financial and Capital Account**), which mitigates the risk backdrop to a large extent. Moreover, when oil revenues finally start to arrive (see **The Petroleum Sector**) the outlook for Cambodia's external accounts will be much improved.

Export Profile

The garment industry dominates foreign trade, overshadowing contributions from other sectors such as rubber and rice. In 2006, the last year for which detailed data are available, garments accounted for almost three quarters of exports, compared to just 9.0% for rice and 4.7% for rubber. The rubber industry has received Chinese investment in recent years, but still struggles to compete with neighbours such as Malaysia and Thailand. Another major export is illegal forestry products. Officially recorded forestry exports have declined in recent years to negligible levels reflecting pressure from donors concerned about the environmental impact of unrestrained logging. However, these figures underestimate total exports owing to large-scale smuggling, with which customs officers frequently connive.

In terms of country risk, Cambodia clearly has an exceptionally narrow export base. Moreover, it is focused in a field (garments) that is highly vulnerable to swings in foreign consumer demand, and which is exceptionally competitive: garment investment can shift rapidly following changes in the relative cost of production. In early 2009 a USD1.6m World Bank-funded Export Market Access Fund (EMAF) program was launched to increase the value and variety of local exports, but D&B does not expect this to have a major impact on the country's export profile over the forecast period.

Table 5

Principal Exports

% total exports	2005	2006	2007
Domestic exports	95.3	97.0	94.7
<i>Of which:</i> garments	77.7	73.8	72.0
rice	6.1	9.0	10.1
rubber	4.1	4.7	3.8
Re-exports	4.7	4.2	5.3
Total	100.0	100.0	100.0

Source: International Monetary Fund, *Cambodia: Statistical Annex*

The total value of exports varies considerably between national sources and the IMF. Moreover, a considerable amount of unregistered cross-border trade with Vietnam and Thailand make determining exact trade relations impossible. Nonetheless, overall it can be seen that until the mid-1990s, Cambodia's main

export markets were other Southeast Asian economies: Singapore and Thailand alone accounted for over 50% of exports in 1995. However, following Cambodia's 1999 bilateral trade agreement with the US, which cut import tariffs on Cambodian products from an average 50-70% to just 10-20%, shipments to the US rose from USD350m in 1998 to USD2.5bn in 2007. D&B estimates that the US and Hong Kong (a re-export hub) now account for 70% of exports: the US alone received 58% of shipments in 2007 (the last full-year for which data are available) according to the IMF. Official US trade data show that in 2008 Cambodian exports to the US fell 2.1% y/y due to a marked deceleration in demand from the month of November onwards. However, trade with ASEAN grew sharply (up 23% y/y) to USD2.2bn, albeit it ran a USD2.0bn trade deficit with the regional grouping in 2008.

Table 6

Exports by Destination

% of total exports	2006	2007	2008e
US	53.3	58.1	38.0
Germany	6.6	7.3	3.4
UK	4.3	5.2	3.3
Canada	3.2	4.6	3.4
Vietnam	2.1	4.5	3.2
Japan	1.0	3.1	1.9
Spain	2.4	2.8	4.2
France	1.5	1.2	0.8
Others	25.6	13.0	41.8

Source: D&B

This geographic export profile is a major area of country risk for Cambodia. Although over the medium term, Cambodia's trade is likely to increase with regional trade partners, since it is part of the Association of Southeast Asian Nations (ASEAN) Free-Trade Area, at present no other market for Cambodian goods is large enough to compensate for a sharp drop in demand from US consumers. Unfortunately, this is exactly what was seen from late-2007 onwards. D&B expects weak US demand to continue over most of the forecast period, while Asian demand also dropped sharply in late 2008 and early 2009. There will consequently be a significant negative impact on Cambodia's export performance, although given that most Cambodian exports have a significant imported component, import volumes are also likely to shrink (see **Net Exports**).

Import Profile

As with Cambodia's exports, many of its imports are not registered due to smuggling, and there are wide discrepancies among sources. However, according to the IMF, Thailand, Vietnam, China (the mainland and Hong Kong together) and Singapore accounted for around 75% of Cambodian imports in the year to July 2008: developed economies such as the US accounted for only a small fraction (2.6%) of Cambodian imports.

Table 7

Imports by Source

% of total imports	2006	2007	2008e
Thailand	13.9	23.1	28.6
China	17.5	15.0	15.0
Vietnam	9.0	16.9	14.9
Hong Kong	18.1	10.4	8.9
Singapore	5.3	7.5	7.2
US	0.9	2.4	2.6
Japan	4.3	1.9	2.0
Others	31.0	22.9	20.8

Source: D&B.

Notably, the domestic garment and tourism industries both rely extensively on imports. Imported materials account for 55-60% of the garment industry's inputs, while in the tourism sector this rises to an estimated 75%. 2006 data show that garments accounted for around 25% of the total import bill. Petroleum, mainly from Thailand and Vietnam, also accounted for around 25% of imports in 2006. This figure was likely much higher in both 2007 and early 2008 as prices soared: such energy price increases were largely responsible for the wider trade deficits in 2007 and 2008. However, energy prices have since eased to lower levels (moreover, Cambodia may become a net energy exporter, see **The Petroleum Sector**).

Cambodia also has a strong appetite for imported consumer goods, reflecting the poor state of domestic consumer goods industries. Since 2001, there has also been strong growth in imports of construction materials; this trend is expected to continue over the medium term as the authorities continue to develop the country's infrastructure, largely through overseas development projects (see **Infrastructure**).

Table 8

Principal Imports

% total imports	2005	2006
Garments sector	27.0	26.4
Petroleum	25.6	28.1
Vehicles	2.3	2.2
Cigarettes	2.0	2.2
Motorcycles	1.4	2.0
Cement	1.1	1.1
Clothing	1.1	1.0
Steel	0.5	0.7
Other construction materials	0.7	0.6
Other	38.1	35.8

Source: International Monetary Fund, *Cambodia: Statistical Annex*

Financial and Capital Account

Cambodia's large external deficits are partially financed on the capital account by direct budgetary support from multilateral lenders (see **Government Consumption**) such as the IMF, the Asian Development Bank (ADB) and the World Bank: these were worth USD250m in 2007, and we expect these sums will rise over the forecast period as extra financial support is made available to the government during the current economic downturn. Notably, considerable funding has been provided on concessionary terms, giving Cambodia some room to manoeuvre while it rebuilds its economy. Bilateral creditors have also provided concessional loans to Cambodia; such lending is likely to increase as official lenders strive to reward Cambodia's integration with the regional and world economies, and to encourage pro-business reform. In this regard Cambodia has a lower level of risk on its balance of payments than the size of its very-large current account deficits would ordinarily suggest.

Foreign Direct Investment

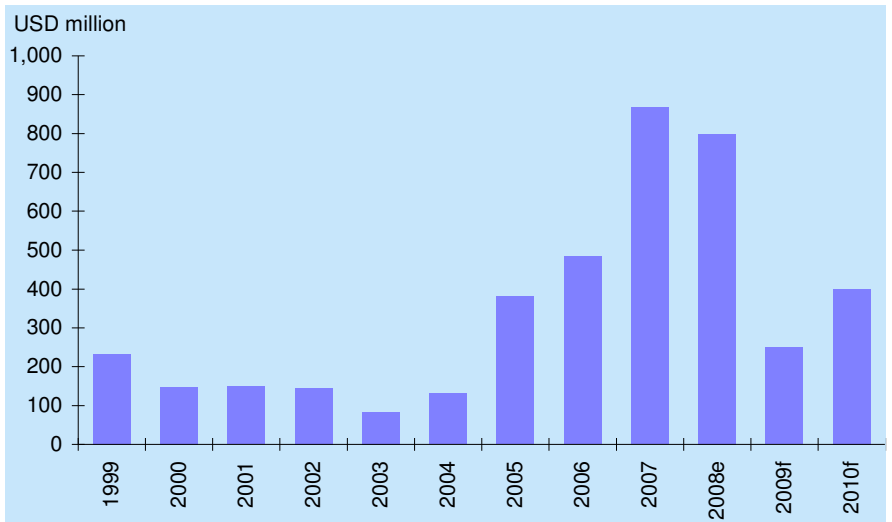
Besides foreign aid, FDI is also an important component of the capital account. FDI flows have fluctuated over recent years, and actual investment is only a fraction of what is approved by the Council for the Development of Cambodia (CDC): official investment figures in 2006 were USD4.3bn while actual investment was just under USD500m, for instance, although in 2007 the gap narrowed somewhat with officially recorded FDI of USD2.7bn, and that delivered USD867m. In the year to 2008 D&B estimates FDI inflows were slightly lower at USD800m. In terms of the origin of FDI, in 2007 China was the largest foreign investor in Cambodia with approved investments worth USD461m. Thailand and South Korea followed with USD174m and USD152m, respectively.

On a sectoral basis, infrastructure, tourism, agriculture and industry have been the top four sectors for FDI. Between 1994 and 2007, industry took around 34% of net FDI inflows. However, Cambodia is still a long way from a developing a viable manufacturing base outside the garments sector. Given its lack of adequate infrastructure and trained staff, its small domestic consumer base, as well as rampant corruption and high crime levels, it will struggle to continue to attract FDI into manufacturing, particularly given intense competition from China and neighbouring Vietnam. By contrast, the tourism sector, which has taken 27% of all inflows from 2004 to 2007, holds strong potential. D&B believes once the current global economic downturn has eased, foreign interest in tourism-related projects in Cambodia will accelerate.

There has also been significant investment into residential and non-residential construction in recent years. However, this sector saw a sharp reversal from mid-2008, with the trend exacerbated by new Cambodia investment laws requiring builders to apply for numerous additional licenses, as well as deposit large sums of cash with the Cambodian government, before starting a project. Meanwhile, there have been some tentative signs of a broadening out of FDI into wider areas of the economy. 2008 and early 2009 saw investment declarations from firms as varied as Thai securities firm Seamico, MTV, the entertainment channel, and telecoms firms MobilityOne (from Malaysia) and Vimpelcom (from Russia).

Overall, D&B expects that actual delivered FDI inflows will drop back sharply in 2009 to around USD250m, the lowest since 2004, although there should be a slight improvement in 2010 to around USD400m.

Chart 11
Foreign Direct Investment



Sources: Asian Development Bank, *Key Indicators of Developing Asian & Pacific Countries*; D&B

Equities and Debt

At present, no stock market exists in Cambodia, although the government plans to open one late in 2009. While such a development would be positive, the level of risk aversion towards emerging market assets that is accompanying the global economic downturn means that there is unlikely to be any significant additional capital inflows into the country as a result. Indeed, D&B believes that in practical terms an equity market will remain a negligible factor in the broader economy for a decade at the very least given that Cambodia’s financial and corporate sectors are both still very immature.

Bank Lending

Foreign bank lending to Cambodia is limited due to the high cost of credit for Cambodian firms, and also given continued concessional lending growth commitments from the World Bank, bilateral lenders, and a Poverty Reduction Partnership Agreement with the ADB, which obviate the need for private-sector borrowing. Consequently, there is a low level of country risk associated with Cambodia's level of private-sector foreign borrowing.

Table 9

Maturity and Sectoral Distribution of Bank Lending to Cambodia

<i>USDbn</i>	<i>Jun-07</i>	<i>Dec-07</i>	<i>Jun-08</i>
<i>Maturities:</i>			
Up to & including one year	47.0	62.0	95.0
Over one year & up to two years	5.0	7.0	19.0
Over two years	29.0	33.0	35.0
Unallocated	1.0	-1.0	5.0
Total	82.0	101.0	154.0
<i>Sectors:</i>			
Banks	2.0	2.0	3.0
Public sector	3.0	3.0	3.0
Non-bank private sector	74.0	88.0	141.0
Unallocated	3.0	8.0	7.0
Total	82.0	101.0	154.0

Source: Bank for International Settlements, *BIS Quarterly Review*

Foreign Debt and Default Risk

Cambodia sees significant inflows of foreign aid each year. Between 2000 and 2006 such aid accounted for no less than 15.5% of GDP, and as much as 24.1% in 2002. These capital inflows are critical to the stability of both the external balance, and for the overall economy. Fortunately, these inflows have continued even as real GDP has grown rapidly; indeed, in January 2009 Kuwait pledged a concessional loan for USD546m, the second largest aid pledge in the country's history.

All the major Cold War players in Cambodia had renegotiated or forgiven bilateral debt by the end of 2004. In 2006 the IMF granted 100% debt relief to Cambodia on its total liability of USD82m to alleviate poverty and aid public finances. The US and Russia account for much of Cambodia's external borrowings, and in December 2008 Russia forgave 70% of USD1.5bn still outstanding: this reduced external debt levels to 15.2% of GDP from 28.5% previously. Debt from other countries is not being serviced while it is being renegotiated, or is on highly concessional terms.

Table 10

External Debt

<i>USDm</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	<i>2007e</i>	<i>2008e</i>
Total public external debt	2,038	2,120	2,254	2,582	1,615
Public debt service, including IMF	28	29	28	28	37
Total public debt (% of GDP)	38.2	33.7	31.0	29.9	15.2
Public debt/service Ratio (%)	0.9	0.8	0.6	0.5	0.6

Source: International Monetary Fund, *Staff Report*

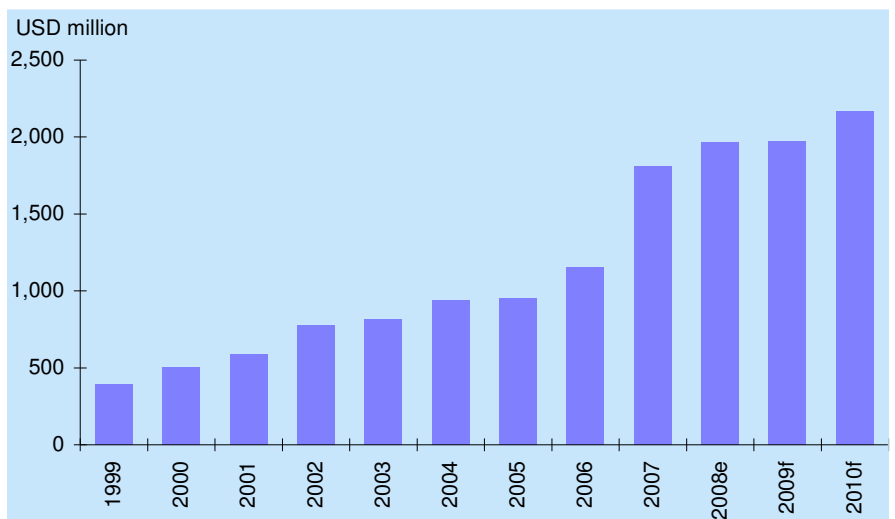
This combination of donor support, debt forgiveness, and strong economic growth has led to a reduction in Cambodia's debt to GDP and debt service ratios. The ratio of external debt to GDP fell to an estimated 25.2% in 2008 from 38.9% in 2003. Debt servicing declined from 2.6% of GDP in 2003 to an estimated 0.6% of exports of goods and services in 2008. As such, in 2007, S&P assigned Cambodia a 'B+' long-term and 'B' short-term foreign and local currency sovereign credit ratings.

Foreign Exchange Reserves

Consistent with multilateral support and rising exports, Cambodia has seen its FX reserves rise steadily over recent years. At end 2007 they stood at USD1.8bn, up from USD1.2bn the year before, and D&B estimates that FX reserves were as high as USD2.0bn at the end of 2008. We expect a wider current account deficit in both 2009 and 2010 (see **Current Account**). This will halt the growth of reserves in 2009, as FDI inflows also wane, but D&B expects them to again expand in 2010. A rapid fall in reserves remains unlikely, as Cambodia should be able to rely on the support of international financial institutions. In terms of actual import cover, foreign currency reserves provided for 3.2 months of overall goods and services by the end of 2007. This rose sunk to 3.0 months by end-2008, but we expect will increase (as import costs ease) to 3.3 months by end-2009 and to 3.5 months in 2010. Nevertheless, these are potentially worrying levels in terms of import cover, leaving little buffer should access to external financing disappear.

Chart 12

Foreign Exchange Reserves



Source: International Monetary Fund, *International Financial Statistics*

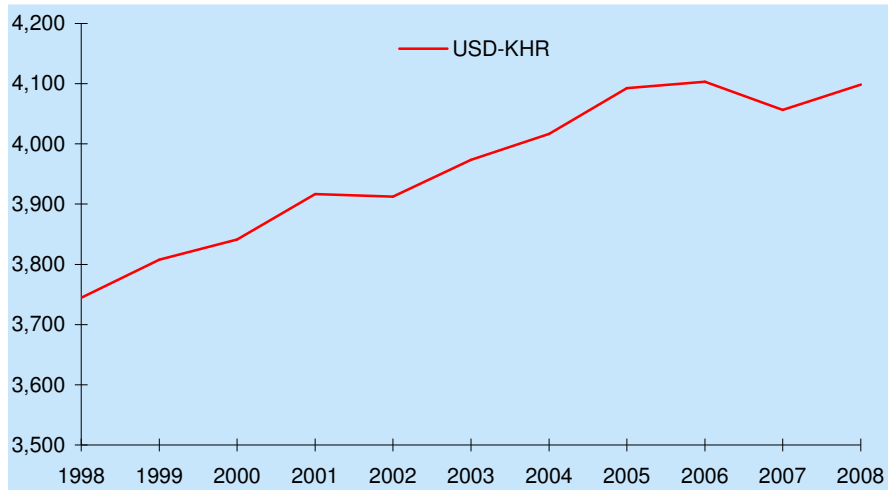
Exchange Rate Risk

Exchange Rate Regime

The role of exchange rate policy is limited owing to Cambodia's highly dollarised economy: the US dollar has become a de facto second legal tender along with the riel. Dollarisation was not encouraged by the monetary authorities, but came about as a result of lack of trust in the local unit after years of government seignorage to cover large budget deficits, which was followed by massive inflows of foreign currency. The National Bank of Cambodia's (NBC) long-term plan is to encourage confidence in the riel in order to foster a decline in the dollarisation of the economy, thereby enabling the bank to conduct an independent monetary policy. However, the population's experience of the riel has been so negative that it is likely to be many years before US dollars are eliminated from day-to-day business activities. A policy of gradual de-dollarisation had increased the amount of riel in circulation from 2.5% of total money supply in 1994 to just 10% as of 2007.

The exchange rate arrangement for the riel has consisted of the official rate, which applies to all official exchange rate transactions conducted by the government and state enterprises, and the market rate since 1992. The NBC now adjusts the official rate daily to limit the spread between with the market to less than 1%.

Chart 13

Riel: US Dollar Exchange Rate (Inverted Scale)

Sources: International Monetary Fund, *International Financial Statistics*; D&B

Exchange Rate Trends

After a sharp depreciation versus the USD in 1998 during the Asian crisis, the riel stabilised in 1999 along with the regional economy. The Cambodian unit then displayed a gradual nominal depreciation against the US currency averaging 1.5% per year from 2000 to Q3 2005, largely accounting for the inflation differentials between the two countries. However, from late 2005 onwards the riel reversed direction to show a clear trend towards nominal appreciation against the US dollar in tandem with the US dollar's decline against most global currencies. The riel nominally appreciated 1.3% in 2006 and 1.4% in 2007 against the US dollar, and slightly more in real terms. However, the US dollar started to rally again in mid-2008, and the riel ended the year 3.2% lower in nominal terms, albeit inflation of around 20% over the year (see **Inflation**) meant that there had been a substantial real appreciation. Indeed, in early 2009 the IMF estimated that the riel was around 10% over-valued, which may well hamper Cambodia's export competitiveness in the price-sensitive textile sector vis-à-vis Vietnam, China and South Asian producers. D&B expects the currency to depreciate against the US dollar during our forecast period, as export earnings, tourist receipts and FDI inflows wane.

External Economic Risk Outlook

A sharp rise in oil prices in 2008 saw the current account deficit widen from 3.2% to 6.9% of GDP. Although energy prices have since eased, the external accounts are now threatened by the economic slowdown in Cambodia's major trading partner, the US, along with an almost-certain decline in the tourist arrivals, the second major source of FX earnings. However, imports should also fall alongside lower energy prices, slower local consumer demand, and lower exports (most of which have an imported component). Help from multilateral lenders in the form of official transfers will also support the external accounts, as in previous years. Overall, we expect current account deficits of 5.1% of GDP in 2009 and 6.2% in 2010.

In terms of counterbalancing capital inflows, FDI is likely to fall back from an estimated USD800m level in 2008 to just USD250m in 2009, before rising back to USD400m in 2010: few other sources of private capital inflows are expected over the forecast period. Nonetheless, Cambodia remains cushioned by significant support from multilateral lenders: official aid inflows should help to cover the country's current account shortfall, which means that there is a lower level of risk attached to these external deficits than would otherwise be the case. Notably, D&B does not believe that aid flows will be impacted by the economic downturn, and hence the overall balance of payments should remain in surplus in 2009 and 2010.

Table 11

External Forecasts

% of GDP	2009f	2010f
Current account balance	-5.1	-6.2
Financial & capital account balance	5.1	7.9
Overall balance of payments	0.1	1.7
Import cover (months)	3.3	3.5

Source: D&B

Meanwhile, the local currency, the riel, is likely to see a nominal depreciation of around 6% against the US dollar in 2009 in order to maintain export competitiveness, after recording a significant real appreciation in 2008. The unit should then see a slight nominal and real appreciation in 2010 in line with an expected increase in global risk appetite from current low levels.

Trade Environment

Key Point: Cambodia's membership of the Association of Southeast Asian Nations and the WTO heavily influences its trade regime. Although the government has implemented reforms, trading with Cambodia can be hampered by difficulties with local officials.

Trade Overview

Although Cambodia has implemented some reforms, customs procedures remain complicated. Both local and foreign businesses have complained that the Customs and Excise Department engages in opaque practices that can appear arbitrary. Importers frequently cite problems with undue processing delays, excessive paperwork and formalities driven by discretionary practices.

In 2006, a customs system was launched by the Customs and Excise Department in co-operation with the UN Conference on Trade and Development. The reforms shortened the time and cost of importation. According to the World Bank's 2009 *Doing Business Survey*, Cambodia had moved up 15 places in the rankings to 135 from 181 countries surveyed. In particular, import processing time has fallen from 55 days in 2006 to 30 days in 2008, while export processing time has fallen from 43 days to 22 days. In 2007, the Single Administrative Document was implemented via a pilot programme in the port of Sihanoukville and has also helped further decrease processing time for imports and exports.

WTO

In September 2003, Cambodia became one of the first least-developed countries to gain admittance to the WTO. Ratification was subsequently delayed by a year because of the absence of a government (see **Political Risk**), but Cambodia finally became a member of the WTO in October 2004.

In theory, Cambodia's entry opened up new export markets and the opportunity for higher inflows of FDI. However, while FDI has accelerated since 2004 (see **Foreign Direct Investment**) it is not clear how much of this was due to WTO membership; moreover, Cambodia's exports remain narrowly focused on just a few products in just a handful of major markets (see **Export Profile**). WTO membership has also not resolved the country's structural economic problems (see **Long-Term Growth Potential**). Rather, the premature opening of agricultural markets and dilution of barriers against industrial imports may weaken the economy. Manufacturers are struggling to match China's economies of scale, and may need to rely on tax incentives to attract broader investment, something the government is ill placed to offer (see **Government Consumption**). Moreover, in signing up to the WTO, Cambodia has had to make concessions. It was forced to comply with the trade-related intellectual property rights (TRIPS) protocol by January 2007; other developing nations have been given until 2016 to comply.

Multi-Fibre Arrangement (MFA)

The associated end of the Multi-Fibre Arrangement in January 2005 also caused a brief, but sharp, downturn in key garment exports. The industry avoided serious damage due to the decision by the US and the EU to implement quotas on imports from China to protect countries such as Cambodia, but the US and the EU relieved the restrictions on Chinese garment exports to their markets at the end of 2008, putting further competitive pressures on Cambodian producers. However, there is a chance that Cambodian garments will get renewed preferential market access to the US if the New Partnership for Development Act, which was introduced to the US Congress in October 2007, finally becomes law in 2009.

ASEAN

Cambodia became a full member of the Association of Southeast Asian Nations (ASEAN, comprising Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam) in 1999. As part of the ASEAN Free-Trade Area (AFTA), the government is committed to implementing a common effective preferential tariff scheme and moving towards becoming a single trade and investment area by 2015.

This offers Cambodia the opportunity to become an important export base for the region, particularly in agricultural products such as rice, but for this opportunity to be utilised, greater infrastructural resources will be necessary. Currently, rice yields are far below those in Thailand and Vietnam. Although Cambodia benefits from relatively cheap labour, more sophisticated farming methods, better transport links and energy sources in Thailand and Vietnam mean their industries are far more competitive than Cambodia's. For the near term, Cambodian farmers will continue to rely on small-scale agriculture. Many prefer to sell their rice for higher prices in Thailand and Vietnam, illegally, rather than to the government at set prices.

The November 2002 summit of ASEAN leaders in Phnom Penh also saw an agreement to create a China-ASEAN free-trade zone by 2010. In the same summit, the ASEAN+3 members (China, Japan and South Korea) also agreed to study and formulate options for the establishment of an East Asia Free-Trade Area. However, movement towards achieving these goals has been limited.

US

In July 2006, Cambodia signed a Trade and Investment Framework Agreement (TIFA) with the United States that is intended to promote greater trade between and investment in the two countries, as well as to provide a forum to address bilateral trade issues and coordinate on regional and multilateral issues. A new trade deal was due to be signed between the two countries in early 2009. Cambodia is also waiting to see if the US Congress will pass the New Partnership for Development Act later in 2009. This would provide for the duty-free treatment of Cambodian exports articles without quantitative limitation provided if Cambodia continues to adhere to fair labor practices; makes progress to eliminate trade barriers and to establish a market-based economy and the rule of law; and does not engage in gross violations of internationally-recognised human rights.

Current Account Exchange Regulations

Acceptance of Article VIII of the IMF's Articles of Agreement in January 2002 suggests that Cambodia will not impose restrictions on external payments in the foreseeable future. Section 2 of Article VIII promises that a country will not impose restrictions on making payments and transfers for current international transactions; while Section 3 of Article VIII stipulates avoidance of discriminatory currency practices. Before this, no restrictions applied in practice, but Cambodia had not formalised this position.

Responsibility for the management of FX rests with the Ministry of Economy and Finance and the central bank, the National Bank of Cambodia. In theory, minor controls remain: the import or export of raw gold is subject to prior declaration to the national bank if the value equals or exceeds USD10,000; and a ceiling of USD10,000 applies to travellers crossing the border (for both foreign and domestic currency). In practice, there are no limits on the exchange allowance for any type of travel, although the official allowance remains USD10,000.

Tariff Barriers

The custom tariff system is based on a four band system, with rates ranging from zero to 50%. Raw materials, including cement, iron and steel, and essential products, including clothing, shoes, meats, fruits, tea, sugar, soap and eyeglasses, are subject to a 7% tariff. Machinery and equipment are charged a 15% tariff. Finished products (televisions, radios, cassette players, household furnishings etc.) and goods from government-protected industries are subject to a 35% tariff. Goods considered as luxury items, such as automobiles, wines, cigarettes, perfume and cosmetics, are subject to a 50% tariff. Under its WTO agreement, Cambodia will ensure that custom duties, tariff-rate quotas and tariff exemptions comply with WTO provisions. Agricultural equipment and inputs, school materials and equipment, pharmaceutical products, construction materials, machinery and other equipment and sporting goods are exempt from import duties; however, these products are still subject to payment of VAT.

Since 1 January 2003, over 85% of goods traded among ASEAN members have been subject to tariffs of 0-5%. The members have also adopted a gradual timetable to include items previously excluded from tariff reduction, including agricultural products. In addition, under the ASEAN Bali Accord II signed in October 2003, 11 sectors have been designated for accelerated integration and removal of tariff barriers. These sectors, including electronics, textiles, air travel and tourism, will be fully integrated by 2010.

Non-Tariff Barriers

Cambodia has eliminated most non-tariff barriers. However, it prohibits the commercial importation of the following products: narcotics, psychotropic substances and their precursors, toxic wastes and poisonous chemicals and substances, and pesticides. Some goods are also subject to import restrictions and importers are required to have approval from relevant government agencies depending upon the nature of goods. For example, imports of pharmaceutical products are subject to prior permit from the Ministry of Health. Importers also need to secure import licenses from the Ministry of Agriculture, Forestry and Fishery for imports of agricultural inputs such as fertiliser and live animals and meat. Imports of weapons, explosives and ammunition require a license from the Ministry of Defence, while the National Bank of Cambodia approves imports of precious stones.

Documentation

Bill of Lading: A bill of lading is required. An airway bill is required in lieu of a bill of lading for air shipments.

Certificate of Origin: This is not required; however, importers may request such a document, or it may be stipulated in an LC etc. At such times, it should be issued in duplicate (general form as sold by commercial stationers) and certified by a recognised chamber of commerce (which will usually require an additional notarised copy for file purposes).

Commercial Invoice: A commercial invoice (in three copies) is required. The invoice must contain a detailed description of the goods and conditions of delivery. When there is no consular representative of Cambodia in the place of shipment, invoices may either be notarised or certified as to current export market prices and country of origin by a chamber of commerce (which will usually require an additional notarised file copy).

Consular Fees: When required, the commercial invoice can be legalised by officials at a Cambodian Embassy or other representative office of that nation or from such an office of a nation empowered to act on Cambodia's behalf. Any additional information should be obtained from such source.

Export Controls: Cambodia is subject to only standard restrictions.

Packing List: A packing list is required by Cambodian Customs.

Preshipment Inspection: All goods with a value of USD5,000 carriage, insurance and freight (c.i.f.) or more (USD4,000 free on board, f.o.b.) require preshipment inspection and a report of findings before the shipment can clear customs in Cambodia. The inspection programme has been implemented by Societe Generale de Surveillance (SGS).

Pro-Forma Invoice: A copy is required for goods subject to pre-shipment inspection.

Sanitary Requirements: If sanitary or phytosanitary inspection is required, information on inspection procedures may be obtained from the Animal and Plant Health Inspection Service (APHIS) of the US Department of Agriculture.

US Shipper's Export Declaration (SEDs): Required if value is more than USD2,500 (USD500 for shipments through the US postal system). SEDs are required for all shipments requiring an export licence.

Commercial Risk

Key Point: The overall business environment is anarchic and relatively expensive. Due to rampant corruption, bribes are required if basic business procedures are to proceed without hindrance. The banking sector is currently a source of risk: besides poor regulation, it is suffering from rising bad assets, falling profitability, and a concurrent liquidity squeeze.

Credit Risk

Cambodia's commercial environment, in which the few laws that exist are ignored or circumvented through bribery and corruption, makes evaluating credit risk difficult. In addition, market deregulation has seen a proliferation of low-quality firms, while insufficient public sector wages force many bureaucrats to resort to bribes to augment their incomes. Most companies are privately owned and face no pressure from investors to enforce even minimal standards of corporate governance, while the concept of maximising shareholder value is irrelevant in the country. The legal framework is incomplete and unevenly enforced. The judicial system is often arbitrary and subject to corruption. The majority of commercial transactions are carried out on a CiA basis, while most commercial disputes are solved by negotiations facilitated by the Ministry of Commerce, Cambodian Chamber of Commerce and other concerned institutions.

The government is making sure it is seen to work closely with organisations such as the Asian Development Bank (ADB) to strengthen the legal framework of the country. Cambodia's entry into the WTO in September 2003 has added impetus to efforts to improve corporate governance and other related issues. Indeed, a new bankruptcy law was passed in 2007. However, corruption remains the leading constraint on those doing business with Cambodia.

In 2008, according to the World Economic Forum, Cambodia ranked 114 out of 131 economies, far less competitive than regional players like Thailand, Indonesia, China and Vietnam. The World Bank also ranked Cambodia 135 out of 181 countries surveyed for their overall business climate, below every ASEAN member except Myanmar in regards to corruption, government effectiveness and rule of law. However, this is an improvement on previous years' rankings.

Payments Experience

Usual Terms: D&B's minimum and recommended terms remain CLC. The overall business environment remains anarchic and quite expensive, with corruption meaning that bribes are necessary if basic business procedures are to proceed without hindrance.

Usual Terms

Minimum Terms:	CLC
Recommended Terms:	CLC
Usual Terms:	30-90 days

Transfer Situation: Strong export earnings and the dispersal of aid from international donors underpin the country's FX reserves, which we estimate are sufficient to cover 3.3 months of goods and services in 2009.

Transfer Situation

Local Delays:	2-3 months
FX/Bank Delays:	2-3 months
Import Cover:	3.3 months

Export Credit Agencies: Cover ranges from being unavailable to limited cover with restrictions.

Export Credit Agencies	
US Eximbank	No cover available
Atradius	Cover available subject to CLC, no discretionary limits
ECGD	Short-term cover subject to CLC, medium-term refer to underwriter
Euler Hermes UK	Restrictions will apply

Financial Sector Risk

Notably, the banking system still plays a limited role in the economy due to a lack of public confidence as a result of the political turmoil and violence of the past three decades (Cambodia is one of the only countries in the world to have experienced a government policy of de-monetisation under the Khmer Rouge regime in the 1970s). Most locals still do not use banks, either because of poverty or mistrust.

Cambodia allows foreign banks to operate as either 100% foreign-owned subsidiaries or as branches. The 1999 Law on Banking and Financial Institutions and subsequent regulations guarantee foreign banks rights and obligations equal to local banks: the law imposes no restrictions on foreign ownership of banks. After a burst of expansion in 2008 there were a total of 28 banks in operation (compared with 24 at end-2007). Of these, just six banks accounted for over 75% of all assets, making the banking system highly concentrated.

Regulation of banks is improving but remains poor. The National Bank of Cambodia (NBC) has a very limited regulatory capacity, which has been strained by recent expansion in the sector. Although the NBC has announced that it will increase the frequency of its bank audits in 2009, actual enforcement of regulations still remains weak, especially in regards to capital adequacy and loan provisioning. There is also concern at the relative ease with which new banking licenses are granted, with the IMF suggesting that the NBC needs to pay greater attention needs to the background of institutions wishing to enter the Cambodian financial market. Overall, Cambodian banks remain subject to incompetent and corrupt management, and there have been widespread allegations of money laundering. Meanwhile, the financial infrastructure is also weak, with the development of a modernised payments system badly needed. There is also little effective legal protection allowing for the recovery of assets in the case of bankruptcy.

From a capital perspective, Cambodian banks look healthy. Official capital adequacy ratios were 25.6% as of end-September 2008, little changed from the level of recent years. However, this figure arguably fails to capture the true risk-weighting of bank assets. Through to mid-2008 there was rapid loan growth at local banks, with an average y/y increase of more than 40% y/y, hitting a peak of over 100% in early 2008 (see **Money Supply**). Notably, in the World Bank's *Doing Business 2009* survey Cambodia was described as the world's top reformer in terms of easing access to credit over the past year. In particular, a new law on secured transactions has made it much easier for businesses to qualify for loan by allowing them to use moveable assets such as vehicles, equipment, inventory and agricultural commodities as collateral. As a result, from December 2006 to September 2008 total banking assets rose from 26% of GDP to 43.1%, a vast improvement but still well below the average of 90% in other Asian emerging markets.

However, rapid loan growth has generated concern over asset quality. Officially, non-performing loans remained manageable in 2008 at just 3.7% of the total, down from 9.9% at end-2006. Nonetheless, D&B believes that the actual figure is likely to be much higher. Notably, when a detailed loan audit was undertaken by the NBC in mid-2008, it found that actual NPL rates at Cambodian banks were some 2

percentage points higher than the stated total at some banks. Moreover, this assessment was taken before the economy weakened sharply. Loans to the collapsing real estate sector (see **Gross Fixed Capital Formation**) account for 7.6% of total lending officially (and higher at some lenders), but a further 15% of loans are tied to property in some form. D&B believes that loans to the textile industry are also likely to turn into NPLs at a high rate given the weakness in exports (see **Net Exports**). Indeed, the IMF estimates that under a relatively benign economic scenario the NPL ratio will rise to around 6.5% going forward; however, under a more severe downturn NPLs could rise to as high as 13%, which would technically make some banks insolvent.

Meanwhile, some banks are also suffering from a liquidity squeeze. Deposits, particularly of foreign currency, rose sharply up until late 2007 as the economy boomed and as mistrust of the banking sector slowly moderated. However, since the start of the economic downturn there have been some large cash withdrawals from firms that were active in the property development sector, especially from Korean-owned banks. As such, the loan to deposit ratio rose to above 100% in October 2008, versus just 68% in October 2007, which is a worrying prudential indicator. Consequently, banks have been forced to raise deposit rates to try to obtain funding: deposit rates have now risen as high as 8% at some banks. However, banks have been unable to further increase their already-high lending rates due to the weak economy, which is seeing their interest margin squeezed: lower profitability at a time of rising NPLs is obviously a further negative for the sector.

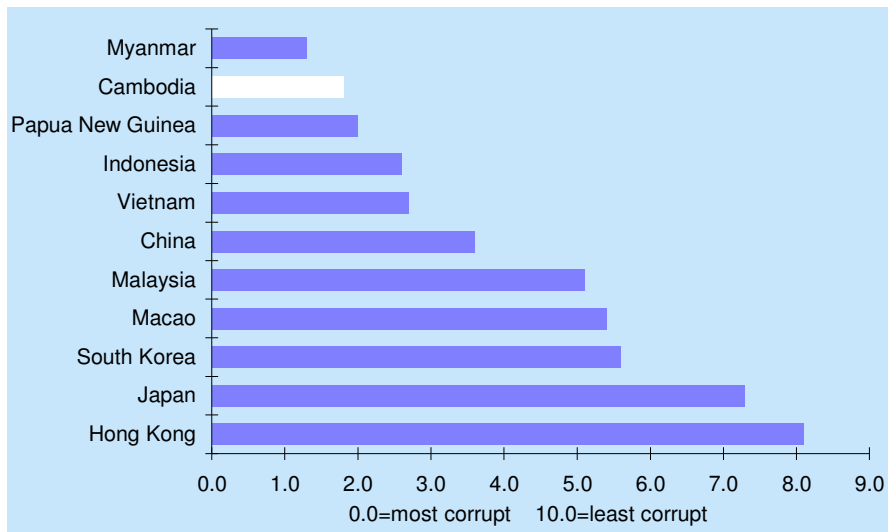
Overall, D&B regards the banking system as a structural weakness for the Cambodian economy over the forecast period, and continues to recommend that those dealing with Cambodia do so only with a CLC.

Corruption

Corruption is pervasive throughout the Cambodian government and business sector, and poses the main obstacle to foreign investment. Some companies have complained that it is impossible for them to operate in the country because of the culture of corruption. Over the last three years, Transparency International’s *Corruption Perceptions Index* rating for Cambodia has consistently worsened. In 2008, Transparency International ranked Cambodia 166th most corrupt economy in the world, tied with Zimbabwe and Turkmenistan. Indeed, in 2006, the World Bank asked the government to return USD12m worth in funds due to financial mismanagement; it resumed lending in February 2007.

Chart 14

Corruption Perceptions for Selected Countries, 2008



Source: Transparency International, www.transparency.org

Many foreign businesses have reported that they are at a disadvantage compared with Cambodian or other foreign rivals that engage in acts of corruption or tax evasion. Firms such as Alcatel, Nestle and Telstra have cut back their operations in the country because they say it is impossible to operate in such an environment, with competitors benefiting from unfair advantages. Companies such as Coca-Cola and Nestle have complained that their production facilities in Cambodia fight a constant battle against lower-priced smuggled versions of their own products that enter the country from Thailand and Vietnam owing to the complicity of corrupt border guards. Corruption in the judiciary can also be a major problem for foreign investors, with judges refusing to enforce laws or rulings against law-breaking parties. This discourages potential foreign investors from making sizeable investments in property or infrastructure.

Prime Minister Hun Sen has publicly emphasised the need to fight corruption and has acknowledged that corruption takes a toll on economic performance and poverty alleviation. However, the involvement of senior government officials in such corruption represents a formidable barrier to reform. Graft among the bureaucracy is widespread. In 2007, anti-corruption group Global Witness reported on the links between the prime minister's relatives and other senior officials to illegal logging.

The IMF estimates that resources valued at between 5% and 7% of GDP are diverted from the financial sector and government funding into private bank accounts (USD700m per annum). Such corruption makes anti-corruption measures unlikely to succeed. Cambodia tried to draft and enact anti-corruption legislation in 2004. Nevertheless, the government has failed to implement the legislation.

Other Commercial Risks

Crime

Crime, theft and disorder typically number second only to corruption, among firms' everyday concerns. Low confidence in the police is reflected in the relatively low crime reporting rate. Although the economy has improved, poverty has remained relatively high, encouraging armed robbery and theft. For the moment, most urban crime lacks central control, but as greater opportunities arise through economic growth, the probability of involvement of Asian organised crime gangs increases.

Land Concessions

Land-grabbing also continues with impunity, causing occasional unrest and detracting from the investment environment. Even some of the monarch's estates have been seized by allies of the prime minister in recent years. Foreigners with weak connections to the authorities are at a disadvantage in protecting their assets. Increasing land seizures by business allies of the ruling party have followed a rise in foreign investment. There could be longer-term political repercussions as ethnic minority groups are dispossessed of their customary land in relatively remote areas such as Rattanakiri province in the northeast.

Intellectual Property Rights

Cambodia has adopted legislation concerning IPR protection, including the Law on Copyrights and Related Rights and Patent and Industrial Designs. Cambodia became a member of the World Intellectual Property Organisation (WIPO) in 1995 and became a member of the Paris Convention for the Protection of Industrial Property in 1998. The country is making progress in implementing the WTO TRIPS Agreement, but comprehensive enforcement remains problematic. The government has taken law enforcement action against the piracy of domestically-produced music or video products but not against piracy of foreign optical media. Cambodian copyright law allows IPR rights holders to file a complaint with the authorities to take action. However, rights holders requesting crackdowns on IPR pirating operations must pay support costs to the authorities for conducting the operation.

Cambodia enacted a copyright law in January 2003. Responsibility for copyrights is shared between the Ministry of Culture, which audio recordings; and the Ministry of Information, which deals with printed materials. Although Cambodia is not a major centre for the production or export of pirated CDs, videos, and other copyrighted materials, these products are widely available in Cambodian markets. Pirated computer programs, DVDs, and music CDs are widely used throughout the country. However, as of March 2008, Cambodia was not on the US' intellectual property rights priority watch list.

Regulatory Weaknesses

Investors continually complain about the lack of transparency of the regulatory regime, with issues arising from the lack of legislation and the weakness of key institutions. Investors often complain that the decisions of Cambodian regulatory agencies are inconsistent, irrational, or corrupt. Positively, a USD2m Commercial Arbitration Centre is due to open in 2009 after more than a year's delay. Employee training will take place in Singapore.

Contractual Risk

Cambodia's weak rule of law means that relationships with powerful figures are more important than contracts. However relationships can change quickly in Cambodia's opportunistic political environment. So negotiating at the right level and with the right person is vital when concluding business deals.

Smuggling

Widespread smuggling of everything from vehicles, fuel, soft drinks, cigarettes and timber has undermined competition and legitimate investments. Though the government has issued numerous orders to suppress smuggling and created various anti-smuggling units within governmental agencies, particularly the Department of Customs and Excise, government officials and political figures have been implicated in smuggling schemes. Unsurprisingly, enforcement efforts remain weak and inconsistent.

Commercial Risk Outlook

Cambodia is one of the most corrupt countries in the world, and as a result a challenging country in which to do business. A number of foreign companies have scaled down their operations or withdrawn from the country, citing endemic corruption. Despite promising for a number of years to introduce an anti-corruption law, the government still shows no signs of adopting such legislation. Corruption pervades both the business and government sectors with many senior officials participating in illegal activities, including, allegedly, the head of the country's police service. Cambodia's institutions remain weak. The legal environment is haphazard and unevenly enforced. Many business-related draft laws are still pending. The judiciary can be arbitrary and corrupt. Many Cambodian and foreign business representatives perceive the court system to be unreliable and susceptible to external political and commercial influence.

The government is drawing up new commercial laws, but this is happening slowly. Despite Cambodia's obligations to reform its civil service, its police and judicial systems in line with WTO membership responsibilities. D&B has doubts that the ruling Cambodian People's Party will effectively reform the system of institutionalised corruption, as it has helped to ensure the party's rule for almost two decades.

Investment Environment

Key Point: Cambodia has a liberal foreign investment regime but factors like corruption presents hidden barriers. Investment has increased significantly in recent years, but a negative impact from the global economic backdrop is almost certain to see a sharp decline in 2009 FDI inflows relative to 2008.

Investment Overview

Cambodia has one of the most liberal and competitive investment laws in the region, and the country has the potential to receive business investment in almost all sectors. All sectors of the economy are open to foreign investment, there are no performance requirements and there are generous incentives. However, the government particularly encourages investment in agriculture and agro-processing industries, environmental protection, export-oriented industries, tourism and infrastructure.

Cambodia's 1994 Investment Law, amended in 2003, is liberal and accords national treatment to all foreign investors; however, the Constitution restricts foreign ownership of land. Foreign investors may use land through concessions, unlimited long-term land leases and renewable limited short-term leases. The authorities have attempted to boost foreign investment through reforms intended to improve the investment climate. The government has reduced business registration fees from USD635 to USD177 and has decreased the registration period from 30 days to 10.5 days. Other reforms are under way to improve the business environment, including a World Bank-funded trade facilitation reform programme.

Nevertheless, potential investors are often deterred by excessive bureaucracy and endemic corruption, and the country's investment climate remains poor. The World Economic Forum's 2008 *Competitiveness Survey* ranked Cambodia 109 from 134 (little changed from 114 of 131 in 2007). The World Bank 2009 survey also ranked Cambodia poorly in terms of its business climate at 135 out of 181. Various factors deter investors, including:

High Levels of Bureaucracy and Corruption: Poor wages and a system whereby officials pay to maintain their jobs encouraged a culture of corruption. Companies such as Alcatel and Nestle have cut back on their investments in the country, complaining that it is impossible to operate in such an environment (see **Corruption**).

An Inadequately Educated Workforce: Decades of instability and civil war took a heavy toll on the country's stock of well trained Cambodians. This is only very slowly being replenished (see **Population**).

Poor Infrastructure: Decades of war destroyed much of the country's infrastructure. Outside the capital and other major urban centres, utilities and telecommunications connections are highly unreliable or non-existent. The need to pay bribes at every stage of a project means that infrastructure projects are frequently delayed, of poor quality and costly (see **Infrastructure**).

Political instability: Just two months after Cambodia announced a new era of peaceful development as the host of the November 2002 Association of Southeast Asian Nations (ASEAN) meeting, mobs burnt and looted the Thai embassy and Thai-owned businesses in Phnom Penh. Possession of small arms and banditry are commonplace. Violent labour relations mar the industrial sector. This curbs foreign investor enthusiasm.

Weak Judicial System: Cambodia's court system is weak and the judiciary is susceptible to corruption and political influence. Local and foreign businesses have reported frequent problems with inconsistent judicial rulings as well as corruption (see **Legal and Judicial Reform**).

Unattractive Domestic Market: Foreign investors in other regional economies such as Thailand and China can count on a growing domestic market of urban consumers with rising disposable incomes. However, Cambodia's population remains predominantly rural, with high poverty rates.

In September 2003, Cambodia became one of the first least-developed countries to be admitted to the WTO, a development that the government hopes will attract new inflows of FDI, although paralysis surrounding the formation of a new government delayed ratification for a year. (see **Trade Environment**).

Capital Account Exchange Regulations

In January 2002, the Cambodian authorities formally accepted the obligations of Article VIII, Sections 2, 3 and 4 of the IMF's Articles of Agreement. This formally restricts FX regulation from impeding external payments, engaging in discriminatory currency arrangements or multiple currency practices.

The Ministry of Economy and Finance and the National Bank of Cambodia are responsible for the management of FX. Cambodia allows for the full remittance of profits from investments and full repatriation of capital, as well as payment of royalties. Foreign currency is also freely available for payments for import and export services. In addition, there is no withholding tax on the principal and interest on dividends and full allowance is made for the repayment of foreign loans (subject to prior payment of domestic creditors).

Foreign Direct Investment Environment

Foreign investment has been sourced primarily from the Asian region: China and Malaysia are the largest investors, while other major investors include South Korea, Taiwan, Singapore, Hong Kong, the US, France and Thailand. Initial investors in 1993, following the formation of the first royal government, were attracted to the construction and tourism industries, with Cambodia's cultural heritage perceived to have strong potential. A second wave of investors between 1996 and 1998 focused on the logging sector, while the bilateral trade agreement with the US signed in 1996 encouraged substantial FDI in the garment sector. Meanwhile, from 2003 onwards the country saw a rising level of investment into both the infrastructure, tourism and property sectors (see **Gross Fixed Capital Formation** and **The Tourism Sector**).

However, although the overall long-run trend for FDI is generally positive, in the short term the very weak global economic backdrop is likely to impact on the progress of projects in many sectors.

Foreign Investment Laws

Cambodia's investment law was promulgated in 1994. A 1999 sub-decree provides some restrictions on foreign investment. Publishing, printing, radio and television activities are limited to 49% foreign equity and there must be an unspecified amount of local equity in gemstone exploitation, brick making, rice mills, wood and stone carving manufacture and silk weaving. While other sectors are eligible for 100% foreign investment, investment incentives vary according to the nature of the investment project. All foreign and domestic investors are treated in a non-discriminatory manner (except in matters of land ownership, although this is changing with new land legislation. Investment applications are generally reviewed and processed within 45 days.

Amendments to the investment law in 2002 instituted the following changes to the incentives system:

- All qualified investment projects benefit from the same three-year tax-exemption period. This exemption comes into effect from the first year of profit or three years after initial revenue earnings, whichever comes first.
- Firms must obtain a 'certificate of obligation satisfaction' every year to remain entitled to tax perks. This requirement could raise costs for firms, but means that exemptions from equipment import duties and export taxes are guaranteed, as are visas and work permits.
- There are no extra privileges granted to firms setting up in export-processing zones. Those investors already paying tax will be able to continue to benefit from the 9% profits tax already in place for another five years, so long as they fulfil the 'certificate of obligation satisfaction' requirement. However, any new project will be subject to the standard 20% profits tax rate once any tax-exemption period runs out.

Further incentive conditions specified by the Cambodian Development Council in the first half of 2004 included, under certain conditions, reductions on corporate tax for three to nine years, and zero import taxes for raw materials and equipment.

Taxation

The standard profit tax rate for companies that are registered in Cambodia is 20%; a 9% special rate (usually stated as the basic rate) can be granted to an investment enterprise by the Council for the Development of Cambodia (CDC). Oil, gas, timber, ore, gold and precious stone exploitation activities attract a 30% tax rate. VAT, which was introduced in 1999, is currently levied on large businesses and incorporated taxpayers at a uniform rate of 10%.

Investment Incentives

In 1994 the government created the CDC as a 'one-stop shop' for potential investors. The CDC is required to respond to all investment applications within 28 days. The main incentives available to investors are as follows:

- a corporate income tax rate of 9%, except for the exploration and exploitation of natural resources (including gas, gold, oil, precious stones and timber);
- a corporate tax exemption of up to eight years depending on the nature of the project and the priorities of the government;
- losses carried forward for up to five years;
- non-taxation on the distribution of dividends, profits or proceeds of investments, whether transferred abroad or distributed within the country;
- full import duty exemption on construction materials, means of production, equipment, intermediate goods, raw materials and spare parts used by an export project with a minimum of 80% of the production set apart for export and projects located in the designated special promotion zone; and
- exemption from export tax.

Land

To improve Cambodia's overall investment environment and boost FDI in the agro-industrial, a new Land Law was passed in 2001. In theory, this should have assisted the resolution of land-ownership disputes, end the widespread practice of land grabbing and allow foreigners to lease Cambodian land for the first time, although no positive impact had been seen by early 2008 with the practice of land concessions continuing to enrich corrupt officials. The law follows the same standards as neighbouring countries and will allow foreigners to lease up to 10,000 hectares of land for up to 99 years. In August 2008 a US\$543m agricultural land

lease deal with Kuwait was agreed in principle, while the government is continuing related discussions with Qatar and South Korea.

Company Organisation

There are various options for establishing a commercial entity through the Ministry of Commerce. The most common types of commercial entities are:

Limited Liability Companies: There are two types of limited liability companies: limited companies and sole proprietorship limited companies. A limited company must have a minimum of two and a maximum of 30 shareholders. The minimum issued and paid up capital is KHR20m at a par value per share of at least KHR20,000. Issued capital must be fully paid in cash or non-cash items before the company can be incorporated. A limited company cannot carry out finance, banking or insurance activities without separate licences. Either shareholders or outsiders can be appointed directors. A sole proprietorship limited company has only one shareholder and is subject to the same requirements as a limited company.

Anonymous Company: An anonymous company (*Societe Anonyme, SA*) is a legal entity with no limited liability status. An SA must have at least seven members. The minimum issued capital is KHR100m at a par value per share of at least KHR10,000. Some 25% of the issued capital must be paid in cash before the SA can be incorporated. Payment of issued capital by non-cash means must be fully paid on incorporation and can only be sold after two years of ownership. The remaining capital must be paid within three years.

Partnership and Sole Proprietorship: Individuals can set up an entity as a partnership or sole proprietorship. Both entities have unlimited liability status. A partnership has at least two members and at least one of the names of the members must be included as part of the entity's name, which must also reflect the unlimited liability status of the entity.

Representative Office: A representative office (RO) may be established by an eligible foreign investor to facilitate the sourcing of local goods and services and to collect information for its parent company. It is not considered a separate legal entity from its parent company. An RO is regarded as a cost centre and accordingly should derive no income from its activities. An RO is not subject to Cambodian tax laws.

Portfolio Investment

Cambodia currently has no capital markets. There is no stock or bond market and no means to purchase equity in a company except by agreement with the existing owners. Most companies are privately held. However, the government is drafting a capital market law and plans to open the country's first stock exchange late in 2009.

Additional Sources of Information

Ministry of Foreign Affairs and International Co-operation

3 Samdech Hun Sen Street
Phnom Penh
Tel: 855-23-214441/216122
Fax: 855-23-216144/216141
<http://www.mfaic.gov.kh>

Cambodia Customs and Excise Department

6-8 Norodom Boulevard
Phnom Penh
Tel/Fax: 855-23-214065
<http://www.customs.gov.kh>

Ministry of Commerce

20 A-B Norodom Boulevard
Phnom Penh
Tel: 855-23-216948
Fax: 855-23-217353
<http://www.moc.gov.kh>

Cambodian Investment Board

Government Palace
Sisowath Quay
Wat Phnom
Phnom Penh
Tel: 855-23-981154/981156
Fax: 855-23-428426/427597
www.cambodiainvestment.gov.kh

Ministry of Economy and Finance

Str. 92. Sagkat Wat Phnom
Khan Daun Penh
Phnom Penh
Tel/Fax: 855-23-723164
<http://www.mef.gov.kh>

National Bank of Cambodia

22-24 Norodom Boulevard
Phnom Penh
Tel: 855-23-722563/722 221
Fax: 855-23-426117
<http://www.nbc.org.kh>

CAMCONTROL

50Eo St 144
Phnom Penh
Tel : 855-23-722085/426166
Fax: 855-23-426166
<http://www.camcontrol.gov.kh>

Credit Information

D&B provides information relating to over 140m companies worldwide. Visit www.dnb.com for details. Additional information relevant to country risk can also be found in the following service:

International Risk & Payment Review: Provides timely and concise economic, political and commercial information and analysis on 132 countries. Available as a subscription-based internet service (www.dnbcountryrisk.com) and monthly update journal, the IRPR carries essential information on payment terms and delays. It also includes the unique D&B Country Risk Indicator to help monitor changing market conditions.

Glossary

Balance of payments	The sum of payments made to all other nations less the sum of external receipts.
Basis point	One one-hundredth of a percentage point.
CAD	Cash against documents: On payment, the buyer receives the documents that give access to the purchased goods.
CiA	Cash in advance: The buyer pays the seller before shipment is effected.
CIS	Commonwealth of Independent States (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Ukraine and Uzbekistan)
CLC	Confirmed letter of credit: A letter of credit in which payment is guaranteed by the opening bank in the buyer's country and by another bank.
CPI	Consumer price index
Current account balance	Part of the balance of payments that records a nation's exports and imports of goods and services, and income and transfer payments.
CWP	Claims waiting period: The time between when the covered risk materialises and the earliest time when indemnification of a claim can take place.
DSR	Debt service ratio: Annual interest and principal payments on a country's external debts as a percentage of exports of goods and services.
ECB	European Central Bank
ECGD	Export Credits Guarantee Department (UK)
EU	European Union
Eximbank	Export Import Bank (US)
FDI	Foreign direct investment: Investment in productive assets by a company incorporated in a foreign country.
Fitch	Fitch Ratings
FX	Foreign exchange
G7	Group of Seven industrial nations (Canada, France, Germany, Italy, Japan, UK and US)
G8	Group of Eight industrial nations (G7 plus Russia)
GDP	Gross domestic product: The value of goods and services produced within an economy.
GNP	Gross national product: GDP plus net income from abroad.
Government balance	The balance of government expenditure and receipts.

HIPC	Heavily Indebted Poor Countries initiative: A framework for creditors to provide debt relief to the poorest and most heavily indebted countries.
IMF	International Monetary Fund
Import cover	The amount of official FX reserves a country has in relation to the average monthly value of imported goods and services.
Inflation	The increase in prices over a given period.
IT	Information technology
LC	Letter of credit: A guarantee of payment to a seller from a buyer's bank. Payment is conditional on named documents being presented by specific dates.
Moody's	Moody's Investors Service
MP	Member of parliament
NATO	North Atlantic Treaty Organisation
NGO	Non-governmental organisation
Nominal effective exchange rate	The weighted average exchange rate of the local currency vis-à-vis a basket of foreign currencies.
OA	Open account: credit extended that is not supported by a note, mortgage or other formal written evidence of indebtedness.
OECD	Organisation for Economic Co-operation & Development
OPEC	Organisation of Petroleum Exporting Countries
Q1; Q2; Q3; Q4	First, second, third and fourth quarter
R&D	Research and development
Real effective exchange rate	The nominal effective exchange rate adjusted for inflation differentials with the country's trading partners.
Real GDP	GDP adjusted for inflation
S&P	Standard & Poor's
SD	Sight draft: A draft or bill that is payable on demand or on presentation.
STIPP	Short-Term Insurance Pilot Program (US): Provides short-term cover to buy US goods in countries where Eximbank is otherwise not open for medium-term financing in the public or private sector.
Terms of trade	The ratio of the index of export prices to the index of import prices. A rising ratio indicates improving terms of trade.
UN	United Nations
VAT	Value-added tax: A consumption tax levied at each stage of production based on the value added to the product at that stage.
WTO	World Trade Organisation

Country Risk Indicator Definition

D&B's Country Risk Indicator provides a comparative, cross-border assessment of the risk of doing business in a country. The indicator seeks to encapsulate the risk that country-wide factors pose to the predictability of export payments and investment returns over a time horizon of two years. The risk indicator comprises a composite index of four over-arching country risk categories:

<i>Political risk -</i>	internal and external security situation, policy competency and consistency, and other such factors that determine whether a country fosters an enabling business environment;
<i>Macroeconomic risk -</i>	the inflation rate, government balance, money supply growth and all such macroeconomic factors that determine whether a country is able to deliver sustainable economic growth and a commensurate expansion in business opportunities;
<i>External economic risk -</i>	the current account balance, capital flows, FX reserves, size of external debt and all such factors that determine whether a country can generate enough FX to meet its trade and foreign investment liabilities;
<i>Commercial risk -</i>	the sanctity of contract, judicial competence, regulatory transparency, degree of systemic corruption, and other such factors that determine whether the business environment facilitates the conduct of commercial transactions.

The DB risk indicator is divided into seven bands, ranging from DB1 through DB7. Each band is subdivided into quartiles (*a-d*), with an *a* designation representing slightly less risk than a *b* designation and so on. Only the DB7 indicator is not divided into quartiles.

Indicator Meaning Explanation

DB1	Lowest risk	Lowest degree of uncertainty associated with expected returns, such as export payments, and foreign debt and equity servicing.
DB2	Low risk	Low degree of uncertainty associated with expected returns. However, country-wide factors may result in higher volatility of returns at a future date.
DB3	Slight risk	Enough uncertainty over expected returns to warrant close monitoring of country risk. Customers should actively manage their risk exposures.
DB4	Moderate risk	Significant uncertainty over expected returns. Risk-averse customers are advised to protect against potential losses.
DB5	High risk	Considerable uncertainty associated with expected returns. Businesses are advised to limit their exposure and/or select high-return transactions only.
DB6	Very high risk	Expected returns subject to large degree of volatility. A very high expected return is required to compensate for the additional risk or the cost of hedging such risk.
DB7	Highest risk	Returns are almost impossible to predict with any accuracy. Business infrastructure has, in effect, broken down.