Impact of Asia's Financial Crisis on Cambodia and the Lao PDR

Studies of the impact of the East Asian financial crisis on Cambodia and the Lao PDR highlight the importance of macroeconomic management, particularly in the face of serious shocks.

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AS THE DEBATE on East Asia's crisis moves to the issue of how the region can regain its past growth momentum, the economies of Indonesia, Korea, Malaysia, and Thailand continue to dominate the headlines. The impact and implications of the Asian crisis have been dramatic and well publicized, yet the fate of the region's smaller economies has gone largely unreported. Cambodia and the Lao People's Democratic Republic (Lao PDR), for example, have been affected by the crisis and remain vulnerable. Although they were insulated from some of the initial adverse effects, other effects have been aggravated unnecessarily by extremely weak economic management and unsustainable policy responses.

Selected social indicators

Indicator (latest available year)	Cambodia	Lao PDR	East Asia and Pacific	Sub-Saharan Africa
Life expectancy at birth	54	53	69	52
Infant mortality rate (per 1,000 live births)	103	101	39	91
Under-five mortality rate (per 1,000 live births)	147	140	47	147
Maternal mortality rate (per 100,000 live births)	900	650	..	..
Illiteracy rate, all adults (percent)	38	43	17	41
Female illiteracy rate	51	56	24	53
Net primary enrollment rate (percent)				
Boys and girls	97	77	99	..
Girls	90	66	98	..
Access to safe water (percent of population)	13	39	84	45
Physicians (per 1,000 people)	0.0 [1]	0.2	1.4	..
Hospital beds (per 1,000 people)	2.0	2.6	2.1	1.2

Source: World Bank, 1999, *World Development Indicators* (Washington).
.. Indicates information not available.
[1] Less than 0.1.

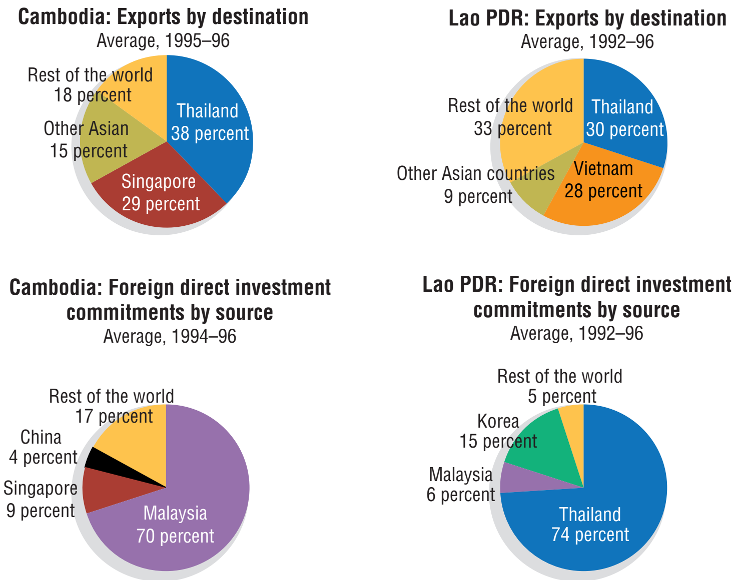
Economic reforms and growth

Cambodia and the Lao PDR are the poorest countries in East Asia, with estimated annual GNP per capita in 1998 of $280 and $330, respectively. Social indicators are poor (see table), and poverty rates are high, particularly in rural areas. Both economies have a small industrial base and depend heavily on subsistence agriculture, which contributes 43 percent of GDP in Cambodia and 52 percent of GDP in the Lao PDR.

Before the crisis swept through East Asia in 1997, Cambodia and the Lao PDR, like the region's larger economies, were registering commendable real growth rates. Both had made good progress in the transition toward a market economy. The Lao PDR's reforms had begun under the New Economic Mechanism in 1986, while Cambodia's reforms gathered momentum following the end of civil conflict and United Nations–sponsored elections in 1993.

In both countries, reforms supported macroeconomic stability, increased trade and investment flows, and a rebound in growth. Real growth in Cambodia averaged about 6 percent over 1993–96, and inflation, which had averaged 140 percent a year during 1990–92, was reduced to single digits during

Exports by destination and foreign direct investment commitments by source



Source: World Bank staff estimates based on government data.

1995–97. Per capita income is estimated to have doubled, from about $150 in 1991 to nearly $300 in 1997. Between 1992 and 1997, annual GDP growth in the Lao PDR averaged 7 percent, raising hopes that the country might graduate from the ranks of the least developed countries by 2020.

Growth and stability in Asia before the crisis supported the reform efforts of Cambodia and the Lao PDR and afforded them the opportunity to develop their economies. By the same token, however, both countries relied heavily on the region for export markets, large foreign savings, and trade tax receipts, and were therefore vulnerable to an economic downturn in the region (see chart).

Emerging weaknesses, slowing reforms

Although the regional financial crisis triggered adverse shocks to both economies, their vulnerability to such external shocks had actually been mounting in the period leading up to the crisis. The reform momentum in both countries had slowed considerably, and as a consequence, underlying weaknesses in their economies were not addressed.

Cambodia's structural reforms lost steam with the increase in political tensions during the first half of 1997 and decelerated considerably in the second half of 1997 because of continuing political uncertainties. Governance problems exacerbated weaknesses in revenue mobilization and public expenditure management; donors began to halt disbursements because of the political instability; and private investor confidence was weakening. The Lao PDR's reforms had also been flagging since 1997. Weak macroeconomic management was compounded by lengthy consensus building in the decision-making process, making it more difficult for the country's authorities to react quickly to the deteriorating macroeconomic situation.

Banking systems in both countries were undermined by inadequate regulatory and prudential frameworks and weak financial management. Nonperforming loans are a problem in the Lao PDR, while the excessive number of banks, some of which are weak, is a concern in Cambodia.

Declining investment flows

In the wake of the regional crisis, foreign direct investment commitments to the Lao PDR fell by 91 percent in 1997, and actual flows declined by 41 percent. Cambodia experienced an estimated 45 percent drop in investment flows in 1997, along with a decrease in new investment commitments of roughly 35 percent, compared with 1994–96. The decline of flows to Cambodia was caused not only by the external shock but also by the domestic political upheaval that culminated in the overthrow of First Prime Minister Prince Norodom Rannaridh in July 1997, which had a significant impact on Cambodia's economic performance.

The countries' currencies began to lose value. The Cambodian riel initially fell less precipitously than other Asian currencies because of the extensive dollarization of the Cambodian economy. The Lao kip, however, given its close link to the Thai baht, was particularly vulnerable to the exchange rate volatility that rocked the region. Between July 1997 and June 1998, the kip lost 70 percent of its value vis-à-vis the dollar. Inflation began to rise—much more in the Lao PDR than in Cambodia—and the social impact was significant (see box). In both countries, weakening confidence in the economy as a whole as well as in the currencies triggered an outflow of funds from the banking system.

Mitigating factors

Both Cambodia and the Lao PDR were insulated from the sharp credit crunches and rapid flight of portfolio investment observed elsewhere in the region because they were not well integrated into global financial markets and received virtually no volatile, shorter-term capital inflows.

The impact of the regional financial crisis and domestic political unrest on Cambodia's external balance was also tempered by the strong increase in 1997 in the country's garment exports, for which the primary markets were located outside the region, mainly in Europe and the United States. This increase allowed Cambodia to boost its reserves to 2.5 months of imports and offset a 14 percent reduction in tourism receipts that was due to security concerns in the midst of political unrest. Perhaps most important has been the extensive dollarization of Cambodia's economy—as much as 70–90 percent of all transactions are carried out in dollars, and commercial bank assets and liabilities are denominated almost exclusively in foreign currencies. This has helped limit the exchange rate impact of the external shock and inflationary pressures.

Social effects of the East Asian crisis

For countries as poor as Cambodia and the Lao PDR, even relatively small changes in social conditions and living standards are cause for concern. The degree to which households are being affected by the crisis is determined by their involvement in the cash economy and dependence on imported goods and inputs. Qualitative assessments in selected communities in Cambodia and the Lao PDR provide some preliminary insights into initial effects and coping strategies.

Cambodia

• Rural communities and poorer groups paid in riel have been hurt the most by inflation. Civil servants earning fixed incomes denominated in riel have also been affected. Workers paid in dollars have fared better.

• Drought and widespread illegal exports of rice to Thailand and Vietnam have led to severe food shortages in some areas. In addition, the economic downturn has restricted opportunities for people to supplement their incomes. There are reports of growing numbers of women and children turning to prostitution, raising the specter of an increase in already-high rates of HIV transmission and incidence of AIDS.

• Migration from rural to urban areas has increased, putting pressure on limited social and economic infrastructure and resources. Diseases linked to poor housing conditions, inadequate access to clean water, and malnutrition are widespread.

• Cambodian refugees being repatriated from Thailand face the formidable challenge of resettlement.

Lao PDR

• Triple-digit annual inflation and substantial price increases for basic commodities have reduced real incomes and purchasing power, forcing changes in consumption and saving patterns. Diets have been adjusted, spending on clothing has been reduced, and nonfarming households are growing more of their own food.

• The costs of school supplies and drugs have increased significantly, beyond the reach of many poor rural families.

• More affluent farmers have benefited from higher agricultural prices in Thai markets and a favorable baht-kip exchange rate. However, poorer farmers and those with inadequate access to markets have suffered significant real income erosion and declining living conditions.

• Traditional patterns of labor migration have shifted. The number of Chinese laborers who once migrated south into Oudomxay to work in the construction industry has decreased with the weakening of the kip against the yuan, opening up positions in the industry for Lao laborers. At the same time, Lao laborers in neighboring Thailand have been under pressure to return home, as competition from Thais, even for unskilled jobs, has increased.

The Lao PDR maintained robust growth of nearly 7 percent in 1997, largely because of favorable weather conditions that led to a strong performance by the agricultural sector. Growth slowed to 4 percent in 1998.

Inappropriate policy responses

Given the high degree of dollarization in the Cambodian economy and the limited effectiveness of monetary policy, the government has successfully used fiscal restraint to limit recourse to bank financing and keep inflationary pressures in check, and has maintained fiscal prudence since the crisis. However, the quality of fiscal adjustment has been poor and is unsustainable. In response to revenue shortfalls (owing to lower trade tax receipts, weak revenue mobilization, and the political disturbances that have disrupted economic activity and general administration) and overruns in defense and security outlays, Cambodia has relied excessively on expenditure cuts, specifically of civilian nonwage expenditures, including spending on health and education, to achieve fiscal balance and sustain macroeconomic stability. Recognizing that the quality of fiscal adjustment needs to be improved, Cambodia has begun to demobilize and reintegrate the military into society and adopted a value-added tax.

In contrast, in the Lao PDR, inappropriate monetary and fiscal policies have multiplied the negative effects of the crisis on domestic macroeconomic stability. A tightening of macroeconomic policy, particularly monetary policy, was needed to reverse or at least stem the loss of confidence in the currency and the economy. Instead, a focus on achieving food self-sufficiency led to extrabudgetary expenditures through rapid monetary expansion, which further eroded investor confidence and accelerated the flight out of the kip.

Fiscal policy became loose as revenues fell short of targeted levels, while capital expenditures increased, resulting in a fiscal deficit in 1996/97 that was more than 1.5 percent of GDP higher than planned. In addition, monetary control weakened as instruments of direct control were abandoned without effective use of other indirect instruments. Rapid monetary expansion has been fueling inflation, as the country finds itself trapped in a vicious circle of monetary expansion and accommodation, inflation, deepening loss of confidence, and flight out of and depreciation of the kip.

Weaknesses in the financial sector have both contributed to, and been aggravated by, the inappropriate policy stance. Negative real interest rates, high inflation, and expectations of devaluations have undermined confidence in the financial sector, keeping saving rates low and limiting monetary depth. In turn, the lack of monetary depth and other inefficiencies in the financial system (including the central bank's inability to enforce monetary discipline by public sector banks) contribute to macroeconomic instability.

By May 1999, the kip had lost more than 80 percent of its July 1997 value against the U.S. dollar and inflation had shot up to over 150 percent a year. The Lao PDR's continued macroeconomic instability stands in sharp contrast to the return to stability of most other countries in the region and underscores the vital role for strong macroeconomic management in the face of external shocks.

Economic management

While both countries are taking steps to address underlying structural issues in their economies, further efforts are needed if they are to return to the more rapid growth of the recent past. Most economies in the region are stabilizing and have intensified their reform and recovery efforts. With anticipated lower external investment resources for the region as a whole and shrinking regional export demand in the near future, Cambodia and the Lao PDR can ill afford to be left behind.

Even with the encouraging sense of renewed political stability in Cambodia and the revival of investor confidence and international support, underlying weaknesses in the country's economy need to be addressed. One key objective is to achieve sustainable fiscal balance by improving revenue mobilization in forestry and other sectors, strengthening tax and nontax administration, cutting back the numerous tax exemptions, and increasing accountability and transparency in economic management. Cambodia also needs to increase allocative and technical efficiency by reorienting expenditures toward health, education, and rural development.

Cambodia's banking sector is still in its infancy, and much more needs to be done to build a strong financial system to underpin market-based development, including providing a strong and transparent regulatory, supervisory, and prudential framework. Broad reforms are needed over the longer term to improve the economy's competitiveness, particularly given the extensive dollarization of the economy.

For the Lao PDR, regaining macroeconomic and financial stability is the most immediate priority. Decisive action is needed to tighten monetary and fiscal policy in order to stabilize the exchange rate and dampen inflationary pressures. Financial sector distress should be addressed in parallel with a broad sector restructuring program to improve the banks' ability to intermediate resources effectively. The Lao PDR will also need to address remaining structural constraints to growth—in particular, it will need to improve the climate for investment and business activity to restore external investment flows and boost exports.

Inevitably, the recovery of Cambodia and the Lao PDR will depend, to a large degree, on the recovery of the bigger economies in the region. Nevertheless, there is clearly considerable scope to mitigate the adverse impact of external threats by implementing appropriate domestic policies, strengthening the financial sector, and building the capacity to manage the economy and respond to external shocks.

Support from the international donor community will be crucial. Since the crisis, the bulk of donor support has gone to the larger Asian economies. More recently, however, donors have signaled their willingness to provide support to the region's smaller economies if they demonstrate their commitment to reform and sustainable growth.

As East Asia's wounded tigers recover and regain their competitive edge, the depth and speed of the reform efforts of the region's smaller economies will be that much more important. Strong institutional capacity, good governance, and sound economic management will be critical for these economies to benefit from the recovery, and it is in these areas that the governments of Cambodia and the Lao PDR and their development partners should be concentrating their efforts. F&D

This article is based on two unpublished papers prepared by the World Bank's Poverty Reduction and Economic Management Unit, East Asia and Pacific Region: "Effects of the Asian Crisis on Lao PDR" (February 1999) and "Effects of the Asian Crisis on Cambodia" (March 1999).

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