The Cambodia's Economy

Reforming Its Financial System toward Economic growth

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Abbreviations and Acronyms

ACLEDA: The Association of Cambodian Local Economic Development Agencies
ADB: Asian Development Bank
ASEAN: Association of South- East Asian Nations
BIS – Bank for international Settlements
BoJ – Bank of Japan
BSD – Bank Supervision Department, National Bank of Cambodia
CAISB – Cambodia Agriculture Industrial Specialized Bank
COA – uniform Charts of Accounts
FCB – First Commercial Bank
FTB – Foreign Trade Bank of Cambodia
GDP – Gross Domestic Product
IFS— Index of Fiscal Sustainability
IMF – International Monetary Fund
IT – Information Technology
KTB – Krung Thai Bank
MB – May Bank
MEF – Ministry of Economy and Finance
MFI – microfinance institution
MOC—Ministry of Commerce
NBC – National Bank of Cambodia
NGO – Nongovernmental Organization
NPLs – Non-Performing Loans
OFIs – other financial institutions
PCB – People's Bank of China
PHSB – Peng Heng S.M.E. Limited
PP – Phnom Penh city (Cambodia)
RDB – Rural Development Bank
RMB – Renminbi
SME – Small- and Medium-sized Enterprise
SOCB – State-Owned Commercial Bank
SOE – State-Owned Enterprise
TA – Technical Assistance
USD – US dollar

Ⅰ.Introduction

The kingdom of Cambodia locates in the center of South East Asia, sharing its border with Thailand on the west and Vietnam on the east. Unlike her neighbors whose population reaches to 70 millions each, Cambodia's population is relatively small with only 14 millions people are counted in 2003. Roughly 80% of the whole population is living in the rural areas, and putting their work force into the field of agriculture. With this fact, like other developing countries, Cambodia's economy is characterized as an agricultural oriented economy.

Cambodia has undergone several civil wars: a coup d'etat of Lon Nol's regime (1970~1975) ;the genocide Pol Pot regime (1975~1979) and the Vietnamese occupation (1980~1989). These upheavals resulted in the lack of human resource, social systems, infrastructure, and leads to the collapse of the whole economy.

Not different from other sectors of economy, the financial system that is considered as the main role for sustaining a country's economic growth which was also destroyed in the Pol Pot regime. During that period, the state-currency (Riel) system was abolished; local banks' operation was completely out of order; and a primitive barter economy was putting into practice, instead.

However, after the Paris Peace Accords in 1993 has been signed, Cambodia has ended up its isolation from the international community and has changed its social-planning economic system into the market-oriented economy one. Since that the government adopted the long-term vision and development strategy to make structural reforms in all sectors of economy including the financial system. More than this, legal and tax system were significantly improved, contributing to attract more foreign investment in Cambodia, mainly in garment industry.

In sum, this paper presents a brief on Cambodia's economy contained in the first section, an introduction to Cambodia's financial system and its recent reforms described in seconds and third section. Section 4 gives a review of literature theory of financial system toward economic growth, and finally I present my own empirical study on growth and financial development in Cambodia, and I draw a conclusion at the end.

Ⅱ.Overview on Cambodia's economy

1. Historical background of Cambodia's economy

In this section, I describe the historical background of Cambodia's economy by dividing into 2 timeframes: the first one is the collapse of socio-economic system since Sihanouk regime, and the second is the transition period from the socio-economic system to market based economy since the Paris Peace Accords in 1991.

1.1 The collapse of Socio-economic system

On March 18th, 1970, the head of State, Shihanouk, was removed out of power by a Lon Nol's coup d'etat. Monarchy system was officially dissolved and Cambodia turned to be a republic state under the name of "Khmer Republic". This turning point can be considered as the collapse of Cambodian socio-economic system.

At the meantime, the war was waged against the government lead by Shihanouk and North Vietnam, which resulted in a bad damage on economy. Consequently, economic activity was interrupted, including agriculture. Production and export were substantially reduced and created a shortage of rice, forcing Cambodia, who before was net-export of rice, into the net-import country of rice. By 1972, rice imports were needed for the first time since independence. The harvest that year was less than one third of normal levels.

The war ended in April 1975, with the National United Front's entry into Phnom Penh and the fall of Saigon. However, as Pol Pot held power, all existing culture and social and economic systems were destroyed for more than three years. Free economics activities were denied, and people were forced resettlement to the countryside to work in groups targeted for the rice production. It is estimated that more than one and half million Cambodian people were killed or died from starvation in that regime. By the time the Vietnamese forces ousted the Khmer Rouge Government in early 1979 and installed a communist government loyal to Hanoi, Cambodia's physical infrastructure was in ruins and its human capital base decimated.

1.2 Transition to Market-oriented economy

Up till 1980s, Cambodia had still been an agricultural based economy. Rice, rubber, timber and fishery and other agriculture products were the main products for exporting and sustaining the whole state's economy. In fact, it is estimated that over 80% of the labor force was involving in agricultural sector, whereas industrial sector was in a relatively small scale.

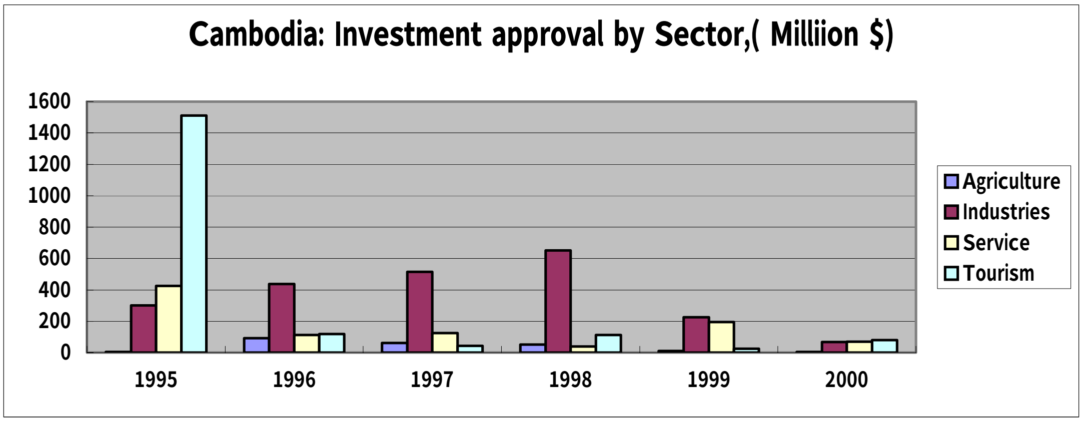
However, after the Paris Peace Accords in 1991, a long-waited peace came to Cambodia after a decade- long of war chaos. This peace contributed to a stability of politics in the country and a smooth transition from socio-economy into the market-oriented economy, simultaneously, with the strong support from the new established constitution, the Constitution of the Kingdom of Cambodia. As a result of this, it can be observed that there were a lot of structural reforms in these 10 years that one can segment into 5 timeframes as below:

1. The start of transition's period (1993~)
2. Economy based on foreign aid (1994~)
3. Strong foreign investment performance in garment industry (1995~)
4. Politic instability and the effect of Asian Currency Crisis (1997~1998)
5. ASEAN regional integration (1999~)

In 1993, as the starting point of transition period, UNTAC settled in Cambodia with the main object of keeping peace. By that time, large numbers of NGO were established in the aim of cutting poverty in the country. Economic condition in that period can be recognized as the economy depended on foreign aid.

In August 1994, Cambodia enacted its Investment Law and the Government established the Council for the Development of Cambodia (CDC) as 'one-stop shop' for approving foreign investment project. This law resulted in attracting more foreign investment companies, mainly from ASEAN's ethnic Chinese such as Malaysia, Singapore, Taiwan and mainland- China. Some also come from the USA, the United Kingdom, Australia and France. According to the World Bank, foreign investment in Cambodia has dramatically increased since 1994. It is estimated that approximately 10 folds increase in 1995 to around US$100 million per year. The level of stock of approved investment was much higher. Between August 1994 and September 1996, the Cambodian Investment Board, which approves incentives available to domestic and foreign investors as well as investment applications, approved 330 applications, with a registered capital of US$2.8 billion. Of these, 42 were from fully domestically owned firms, 124 were from foreign-owned firms and the remainders were joint ventures. It has been clearly known that most foreign investment has been concentrated in hotel construction, casinos, logging, and light industry particularly garment manufacturing was starting to lure large foreign investment flows.

(Figure 1)



Source: Ministry of Economy and Finance

With the market-oriented economy, Cambodia enjoyed its high level of economic growth until 1997, the year that 2 shocks conflict its economy: the first shock was the so-call Asian Financial Crisis, and the second one was a local politic disorders. By that time, most of international aid institutions immediately suspended their aid providing activity. A large number of foreign firms also stopped their economic production and at the same time foreign direct investment fund was dramatically decreased.

However, the economic condition was on track toward recovery as the result of the relentlessness in local politics pressure, and the historic joint with ASEAN regional economy in April 1999.

2. Macro-economic outlook

In this section, I focus attention on an overall macro-economic performance by observing the trend of economic growth rate, inflation rate, the exchange rate of Riel, trade performance, and finally the fiscal performance of Cambodian government in recent years.

Table1: Macro-economic Outlook

Indicator	Projection						
	1995	1996	1997	1998	1999	2000	2001
Main Indicator Estimates							
Inflation, Price Index (%)	7.7	7.1	8.6	17.3	4.2	-0.8	0.2
Nominal Ex-rate (Riel/$)	2526	2713	3452	3770	3770	3905	3895
Real Economic growth							
(2000) (%)	4.8	6.6	3.6	10.2	6.8	5.5	5.3
Balance Payment							
Current Account/GDP(%)	-12.3	-16.3	-12.2	-17.2	-14.3	-10.2	-10.5
Government Finance/GDP							
Budget revenue/GDP(%)	9	9.1	9.7	8.7	11.2	11.7	12
Budget expenditure/GDP	16.7	17.4	13.8	14.4	16.4	17.3	18.4
Tax Revenue	7.4	7.8	7.6	6.6	8.7	8.9	8.7

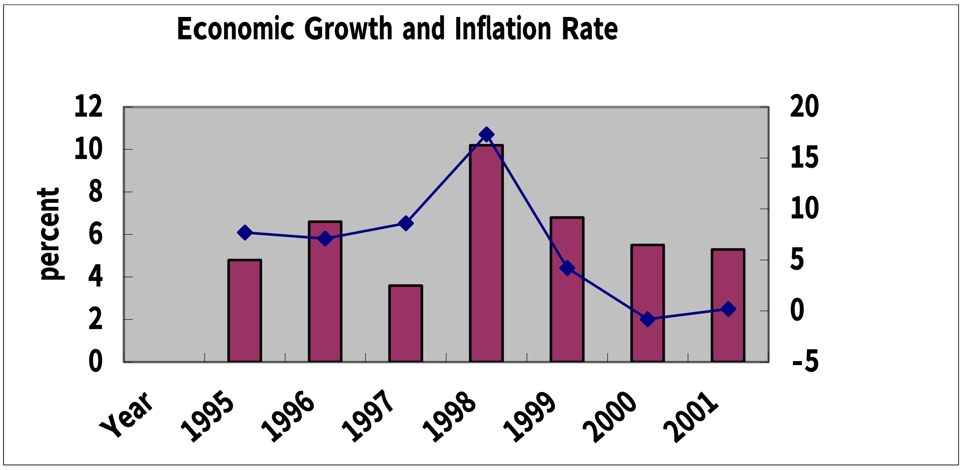
Source: IMF statistic data (2005)

Economic growth:

Despite its low level of development, Cambodia has succeeded a rapid economic recovery. Based on my calculation using the IMF's statistic data (2005), the real economic growth based on 2000's year price, was 7.7% in 1995, 7.1% in 1996, and 5.3% in 2001. It is estimated that the rise of productivity especially in rice, an increase of foreign investment in garment industry, and much amount of aid donated by international institutions are the main three factors that sustained this high growth.

With the rapid economic growth, inflation rate fell sharply from an average 140 percent in 1990 to 1992 to 7.7% in 1995, before rising again to 17.3% in 1998 (a year after the Asian Financial Crisis), but fell to 4.2%in 1999, and 0.2% in 2001.

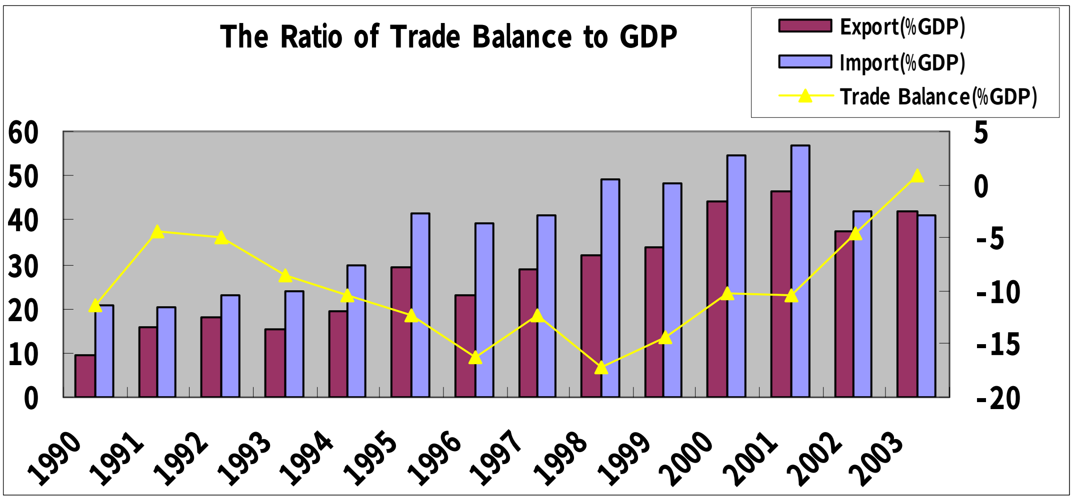
Figure 2: Real economic growth and inflation rate



Trade performance:

With the joint of regional trade ASEAN in 1999, the trade between Cambodia and its counterparts ASEAN countries was remarkably increased. According to IMF statistic (2005), the ratio of total export to GDP was 23%, grew to 28.7% in 1997, 32% in 1998, and 42% in 2001. Despite this, its import exceeds export, leading to the trade deficit. However, trade deficit have been decreasing as the trade surplus in garment sector continued to improve. However, the trade deficit in energy and non-garment manufacturing sectors increased slightly, owing to an expansion in local economic activity. In contrast, the service sector continues to increase significantly since 2001, thanks to the expansion in tourism.

Figure 3: Trade performance



Source: IMF statistic data (2005)

Exchange Rate Trends:

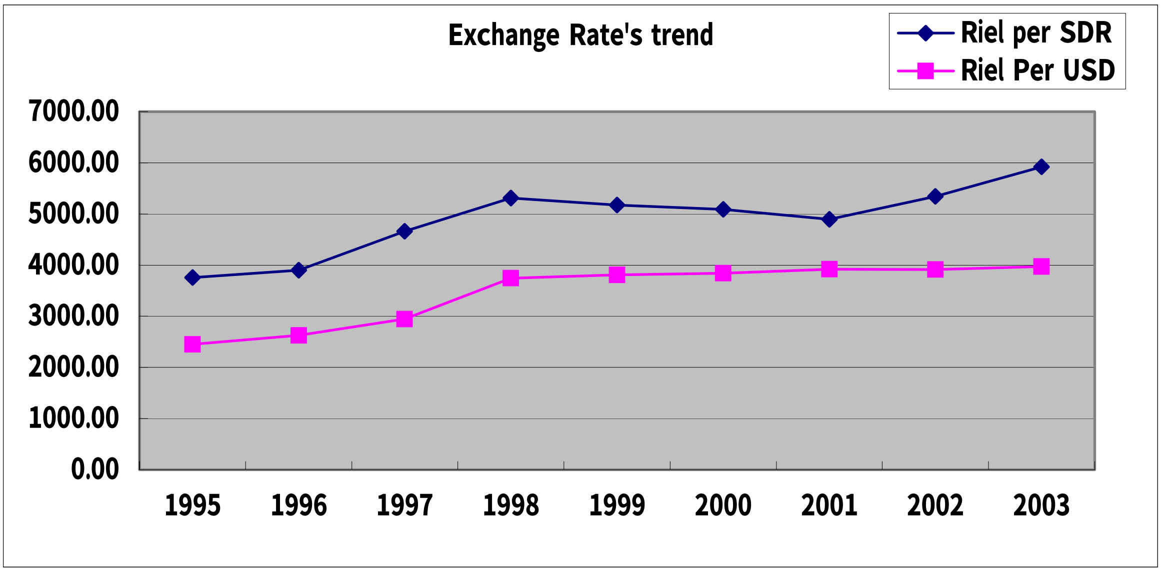
Riel, Cambodia's official currency was traded in the rate of 2700 Riel in a US dollar in 1993. The value of Riel depreciated smoothly to 2700 riel a dollar in1997, when a sudden fall of exchange rate of the Riel took place. The rate was 3460 riels a dollar in Dec 1997, and 4000 riel a dollar in the second quarter of 1998, and 3984 riel a dollar in 2003. This sharp and sudden depreciation have been estimated as the cause of：

① The local political chaos provoked in July 1997;

② The Asian currency crisis affected the whole region, including Cambodian economy;

③ And the rise of local price level can be considered as the factor of the fall in Riel exchange rate.

Figure 4: Exchange rate's trend



Source: IMF statistic (2005)

Figure 4 shows the trend of Riel per SDR[1] and USD from the year

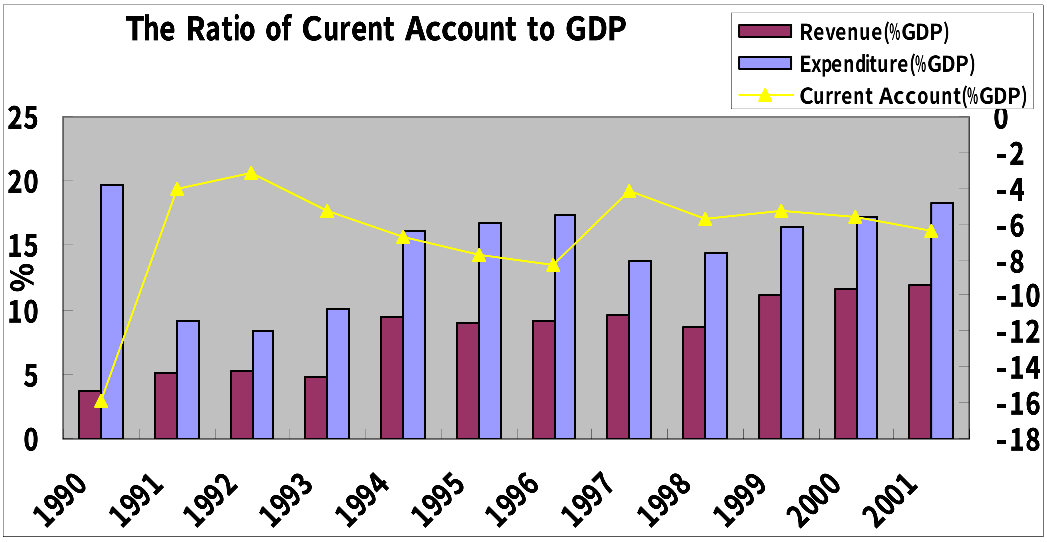
[1] SDR stands for Special Drawing Right, once was created by the IMF in 1969 to support the Bretton Woods fixed exchange rate system. However, today, the SDR has only limited use as a reserve asset, and its remain function is to serve as the unit of account of the IMF and some other international organizations. The SDR is defined as a basket of currencies, consisting of the euro, Japanese yen, pound sterling, and USD

1995 to 2003. Since 1993, the NBC pursued a flexible exchange rate policy, and relied on tight financial policies by keeping spread between the official and the market rates below 1 percent. Most of the time since late 1999, the NBC has further kept the spread at only at half of 1 percent, and it intends to eliminate the spread entirely.

The fiscal performance

In 1994, the government created a Budget Law, a single national budget, which in principle all state's revenue and expenditure are obliged to pass through the ministry of finance. In 1996 expenditure was cut due to the reduction in national defense and security spending to 5% of GDP and public service numbers by 10% in 1996 and again in 1997. According to official figures published by the MEF, Cambodia's budget revenue for 2001 reached $389 million, roughly 12% of GDP, and the budget expenditure amounted to $593 million (18.4% of GDP). In order to fill out the budget deficit, Cambodia needs a budget support loan provided by international aid which is estimated in the proportion of total expense as 57.6% percent in 2001, up from 56.4% in 2000, meaning that Cambodia has marginally increased its dependence on foreign aid.

Figure 5: Government's budget



Source: IMF statistic (2005)

According to the Budget Law of 2001, total tax revenue in the proportion of GDP was 8.7%, compared to 8.9% in 2000. In order to boost the budget revenue, the government introduced a number of new measures such as VAT on diesel, extra fees for visa, and stamp duties on cigarettes. However, tax revenue declines due to the weakness of implementing those measures

3. Assessment of the fiscal sustainability for Cambodia

In this section, I assess the fiscal sustainability for Cambodia in the recent years. The fiscal sustainability refers to the government's ability to maintain its current policy and satisfy its lifetime budget constraint without defaulting on its debt obligation. The study on the impact of fiscal policy whether it is sustainable or not, is regarded as vital on the macroeconomic issue. Obviously, an unsustainable fiscal policy is not able to continue to the infinite future and eventually ends up with a crisis. If an unsustainable fiscal policy ends up with a crisis, it may involve sharp contractions in the size of government, thus a large fall in aggregate demand and swings in financial markets. This would ultimately lead to defaults in government financial liabilities.

In order to approach assessing the level of fiscal sustainability, the following index of fiscal sustainability (IFS) is introduced and can be obtained as the ratio of total public debt to nominal GDP. If this indicator, IFS, has a negative sign, it implies that trend of the public debt to GDP is declining and hence sound fiscal sustainability.

Its dynamic change in IFS can be defined as follows:

$$IFS = \Delta D / D - \Delta Y / Y \qquad (1)$$

where $\Delta D / D$ is an annual change in the public debt and $\Delta Y / Y$ is the annual growth rate in nominal GDP.

However, the annual change of nominal GDP consists of the change of inflation rate $\Delta P / P$ and the annual change of real GDP, $\Delta y / y$

Hence, we can rewrite (1) as:

$$IFS = \Delta D / D - (\Delta P / P + \Delta y / y) \qquad (2)$$

Applying data from the year 1991 to 2001 into equation (2) above, I can obtain the level of indicator, IFS, as shown in table 2 below:

Table 2: Recent trend in the Fiscal Sustainability Indicator, IFS

Year	$\Delta D / D$	$\Delta P / P$	$\Delta y / y$	IFS
1991	0.99	0.60	0.11	0.28
1992	1.25	1.02	0.14	0.09
1993	-0.59	0.75	0.09	-1.43
1994	-0.91	-0.01	0.05	-0.96
1995	-0.38	0.08	0.08	-0.53
1996	-4.75	0.07	0.07	-4.89
1997	7.61	0.08	0.01	7.53
1998	-2.90	0.15	0.03	-3.08
1999	-1.36	0.04	0.07	-1.47
2000	-0.56	-0.01	0.06	-0.61
2001	-1.55	-0.01	0.05	-1.60

Source: IMF Statistic data (2005)

Table 2 shows that the indicator IFS has a declining trend from 0.28 in 1991 to –4.89 in 1996. By contrast, except in the year 1997, IFS remarkably increased to 7.53, which this can be predicted as a consequence of Asian Financial Crisis. IFS is estimated to have a declining trend again, to –1.6 in 2001. This reveals that Cambodia government would be able to maintain its sound fiscal sustainability.

Ⅲ. Cambodia's financial system

1. The current financial system of Cambodia

The Cambodia financial system consists of the National Bank of Cambodia, and commercial banks and micro-financial institutions. (Figure 7)

The National Bank of Cambodia, NBC, was re-established in 1980 after the fall of Pol Pot regime. It was renamed from the People's Bank of Cambodia in 1992 as an anonymous entity with the right of issuing regulation, circulars, and other instructions. According to the new central bank law, the NBC principally plays a role in determining the monetary policy aimed at maintaining price stability, controlling the money supply, publishing currency notes, and stabilizing the foreign exchange rate. In addition, the NBC is in charge of licensing, de-licensing and supervision of commercial banks and micro-financial institutions, as stated in the new central bank's law (2000), based on capital requirements and CAMELS[2] rating systems.

Central Bank in Cambodia typically resembles to other central banks elsewhere in developing world, especially, in its inadequate function in stabilizing the macroeconomic condition. In fact, it is estimated that NBC has no enough powerful measure in order to control its money supply due to the high degree of dollarization in its economy's platform. If we look back over 1990s, Cambodia started to dollarise, thanks to UNTAC who took over the administration during 1991-1993. This major nation-building operation involved the stationing of up to 22.000 UN military and civilian personnel throughout Cambodia, and it is estimated that the total cost of the two-year operation was closed to USD2 billion. This contributes to a large amount of cash dollars' inflow into market, and quickly turned Cambodia to a massive dollarized state.

According to Mario de Zamaroczy and Sophanha Sa (2002), empirically estimated that the true degree of dollarization in Cambodia has

[2] The acronym "CAMELS" refers to the six components of a bank's condition that are assessed: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. This Rating is assigned to evaluate a bank's financial condition and to monitor its compliance with laws and regulatory policies.

increased from 50 percent at the end-1994 to 70 percent at end-2001, and reached a 71 percent peak in November 2001. Comparing to other dollarized countries, Cambodia ranks fourth after Bolivia (84%), Lao PDR (75%), and Uruguay (72%).

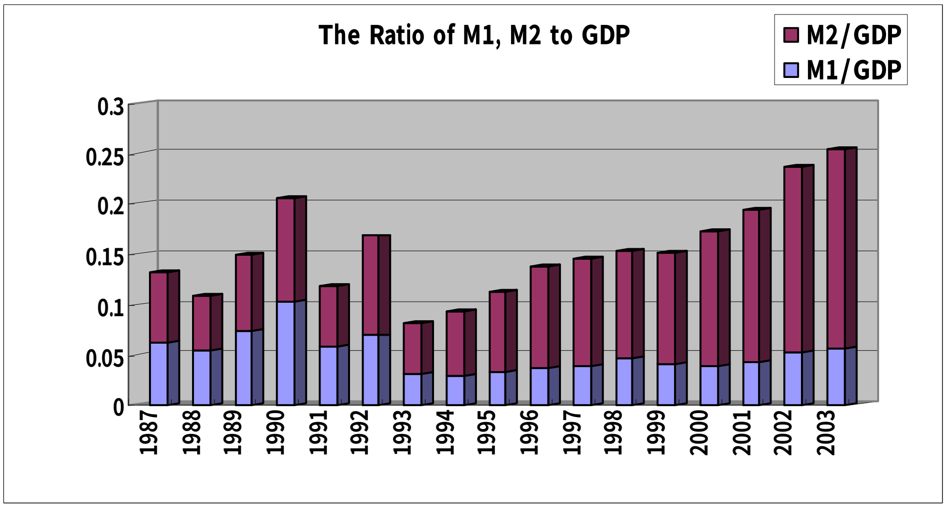
In theory, in case of highly dollarized economy, money supply is not determined by the monetary authorities but by the behavior of agents holding both foreign and domestic currency-denominated assets, including cash. In Cambodia, however, as financial intermediation is limited and conducted almost entirely in foreign currency, the NBC has no enough power to control its base money. The NBC's potential measures retains changes in reserve requirement, however, this regulatory instrument is unable to used frequently for the sake of financial stability. As another monetary instrument, a refinancing facility was introduced in 1994 that allows the lender to redeem the bill before maturity at a discount of 70 percent of face value. However, no commercial bank has adopted this facility.

Regarding to the interest rate policy, since the NBC does not refinance banks, it does not influence interest rates and therefore interest rate policy can not be used as an effective monetary measure.

High dollarization also implies losing flexibility in the exchange rate policy, as it obviates exchange rate adjustments in response to external shocks. Since most monetary and exchange rate instrument are not available to the NBC, the brunt of macroeconomic adjustment falls on fiscal policy.

However, high dollarization benefits a low inflation rate, and earns back the credibility of local currency. In contrast, although money supply M2 and M1 is growing upward annually (see Figure 6), most of them are based on foreign currency. With the very low liquidity in Riels circulated in the financial system, the NBC is facing difficulty in controlling its money supply, which is the main measure of the monetary policy for stimulating the economy performance.

Figure 6:



Source: IMF statistic (2005)

However, thanks to the transition-oriented economy, the financial system was remarkably reformed; financial liberalization has been introduced and foreign-fund commercial banks were permitted to operate in Cambodia. Since that number of commercial bank was significantly increased, to 30 banks in the early of 1999. Among those private banks, 5 of them were based on local fund where the rest were on foreign-fund.

Table3: Number of foreign banks by country

Country	Number of banks
France	1
Australia	1
Singapore	4
Thailand	9
Malaysia	4
Indonesia	1
Taiwan	1
Hong Kong	3
Korea	1
Total	25

Source: National Bank of Cambodia (2003), annual report

In order to obtain a license, commercial bank obligates to have a paid –up capital at least equal to the minimum requirement. The minimum capital requirement for commercial banks is 50 billion Riel, approximately equal to USD13 million (NBC, 2004).

In general, those commercial banks share some common characteristics. First, their total asset is very small in scale with weak management skills. This results in a high transaction cost, in response to the burden of high fixed cost. Second, insufficient information network provides an inefficient of economy. Third, services such as: depositing and financing are provided only in the short-term and is concentrated only in the city area, Phnom Penh. With the high transaction cost and high risk that banks apparently take, banks must increase their interest rates that finally lead to an inefficiency of fund investment.

Specialized banks are concentrated on their rural credits operating and loans to small and medium sized enterprises (SMEs). Specialized banks that are operating in Cambodia are not allowed to take deposits. Specialized banks are entities that can provide loans among the three basic operations, or only one component of each of the three basic operations of commercial banks. Before obtaining a license, specialized banks must have a paid-up capital at least equal to the minimum requirement. The minimum capital requirement for specialized banks is KHR 10 billion, set up by the NBC (NBC, 2004).

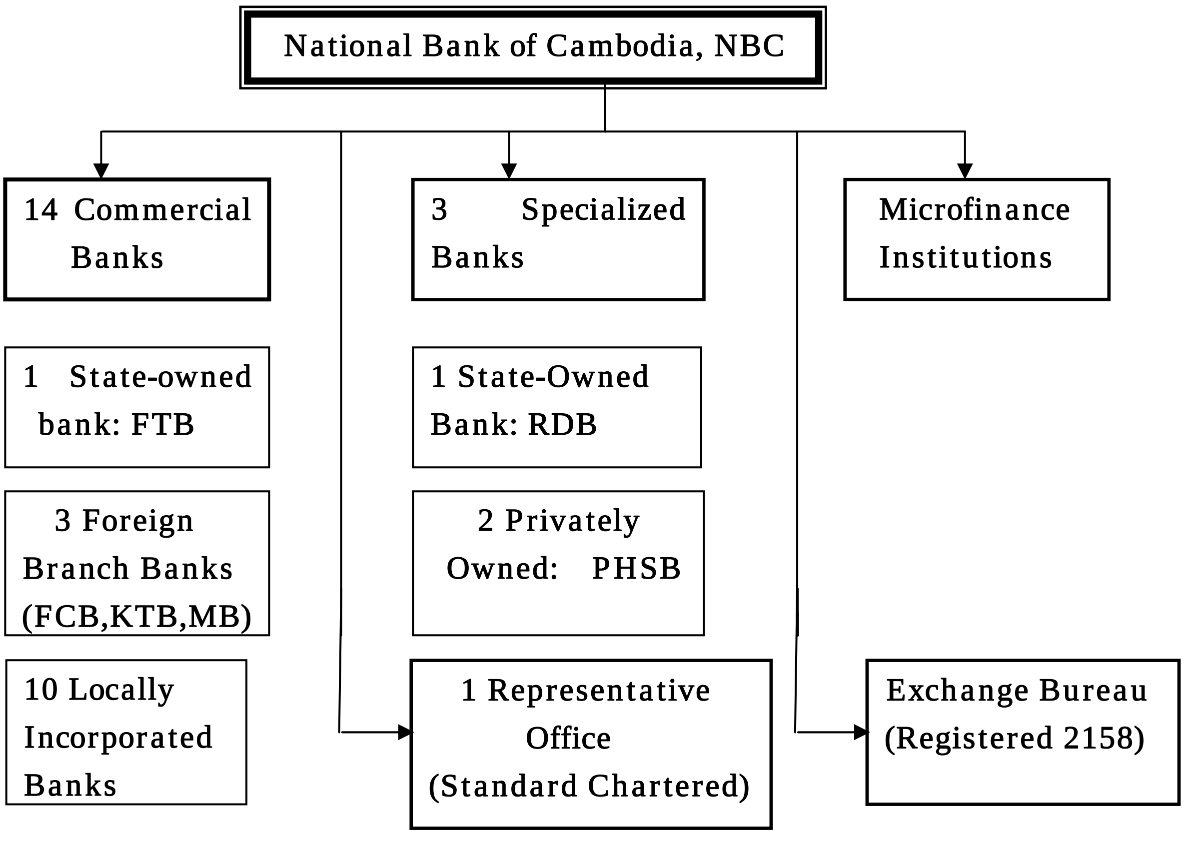
With a target of cutting poverty in Cambodia, the government points out that financial service is in need for developing its rural areas, home of 80% of the whole Cambodian population. In order to meet this target, Microfinance Institutions, a so-call Grameen-bank[3] system originally founded by Doctor Yunus of Bangladesh, were introduced by NGO in 1990s with their specification of providing loans to farmers and small businesses in the rural areas. Some receive funds from international organizations. However, they are allowed to take household savings in their operating

[3] Grameen Bank(GB) has reversed conventional banking practice by removing the need for collateral and created a banking system based on mutual trust, accountability, participation and creativity. GB provides credit to the poorest of the poor without any collateral. It serves as a catalyst in the overall development of socio-economic conditions of the poor who have been kept outside the banking orbit.

regions. Before obtaining the license, microfinance institutions must have a paid-up capital at least equal to the minimum requirement. The minimum capital requirement for microfinance institutions is KHR 250 million, set up by the NBC (NBC, 2004). Presently, it is estimated that approximately USD 20 millions are funded to 300,000 people in the rural areas what one believes that it can efficiently cut down the poverty in their community.

The biggest Microfinance institution in Cambodia was established in 1993 in the name of ACLEDA. This institution is sponsored by some foreign-aid organizations. ACLEDA is now operational with more than 130 professional staff members in 12 provincial branches with its domestic money transfer services rose from the equivalent of USD 28.0 million in 2002 to USD 68.5 million in 2003 to USD145.7 million (+113%) mostly in the rural areas.

Figure 7: Banking System in Cambodia (as of March 31, 2005)



Source: Bank Supervision Department, NBC

2. The Level of Financial Intermediation in Cambodian Banks

With the start of market economy's transition from 1993, not different from other sectors, financial sector also faced a lot of changes such as liberalizing its interest rate under the proposal of international institutions; liberalizing financial policy in order to provide license to foreign banks to freely operate their business in the kingdom. These prompt changes result in a weak in financial system as well as in legal system that subsequently lead to the banking crisis. NBC supervision of the banking system remains rudimentary and weak, and lacks uniform, and well-understood accounting standards. Some smaller commercial banks have a weak management base forced to fail in their business while some banks are said to spend more time laundering money than lending it. Non-performing Loans (NPLs) were substantial growing and some banks turned out to be unprofitable and insolvent. Finally, the whole banking system was in a worse condition and suffered a heavy loss. This phenomenon discourages banks to lend money to enterprises on one hand, and on the other hand enterprises pay high cost in financing their project.

Comparing to other neighboring countries, Cambodia's financial sector is in rudimentary stage where banks have not performed financial intermediation as widely as many other countries did. As it is shown in Table 4 below, the ratio of total deposit to GDP is still in a very low level. Part of the reason is that people lost their confidence in state's financial system after several civil wars in the last decades.

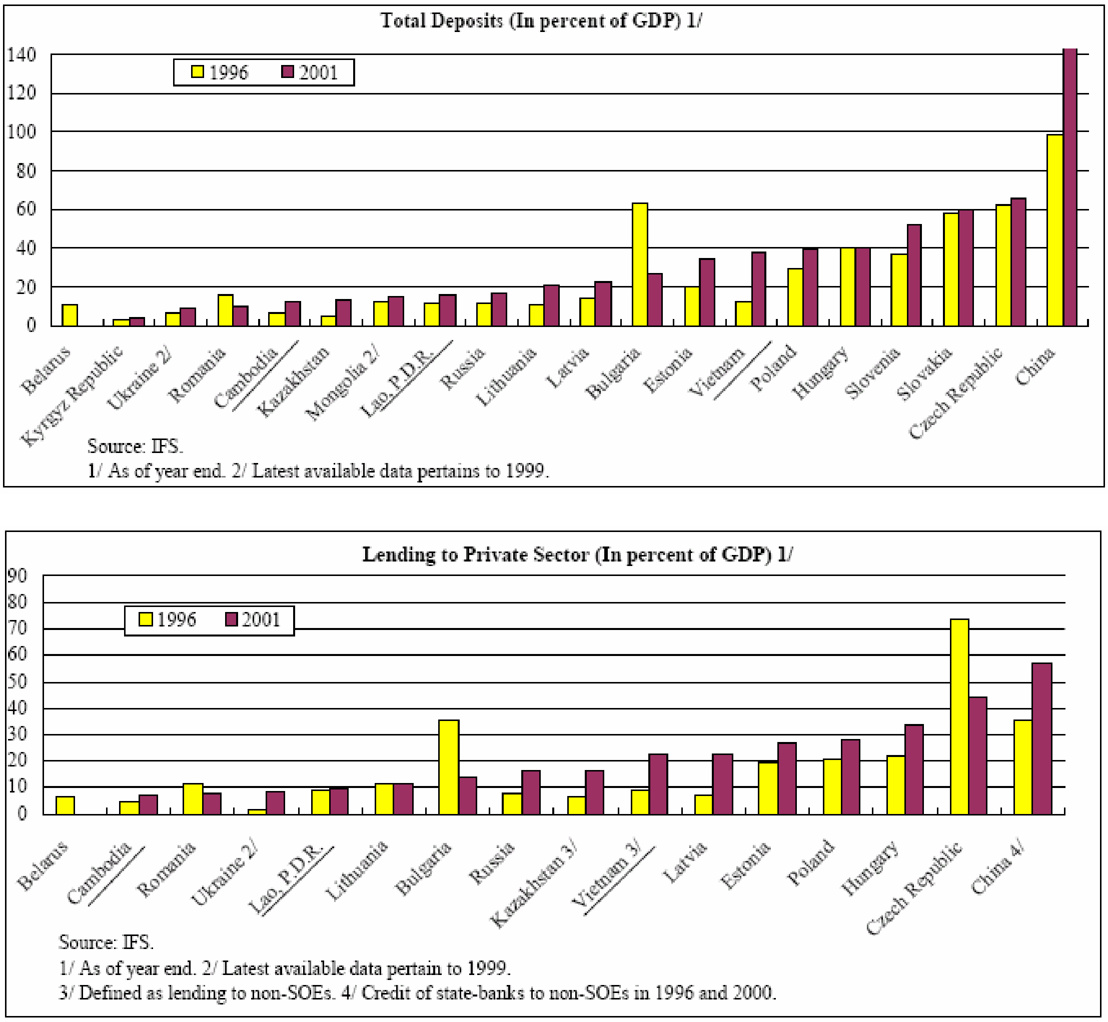
Table 4. Lower Mekong Countries and China: Selected Banking Indicators (as of end 2003)

(In percent of GDP)	Vietnam	Cambodia	Lao P.D.R.	China
Total deposits	56.0	14.4	17.2	182.8
Credit to the economy	51.8	8.0	11.1	165.5
Credit to SOEs	17.1	0	4.4	…
Credit to private sector	34.7	8.0	6.7	…
Non-performing loans	25.9	15.6	30.0	18.4

Source: IMF Statistics (2005)

Furthermore, as shown in the figure 8 below, the level of banks' credit to the private sectors and to the whole economy is also relatively small compared to other transition countries. Among those, China is out-performance in both categories: total deposit and lending to private sector.

Figure 8. Banks Performances in Selected Transition Economies



In this section, I analyze prudential ratios to evaluate the financial standing of the banks. Prudential ratios include the liquidity ratio, the solvency ratio (capital adequacy ratio), and the non-performing loan ratio of the banks.

The liquidity ratio can be calculated as liquid assets divided by weighted deposits. This ratio is used to evaluate the ability of banks to pay back depositors when they come to withdraw money. Banks had been required to keep this ratio at 100% at minimum, but since June 2002, banks were required to keep this ratio at 80%, until December 2004, when the ratio was amended to 50%. As shown in Table 5, the liquidity ratio of the banks is higher than the required minimum. Therefore, one can conclude that the Cambodian banking system has enough liquid assets to cover liquid liability (Figure 9).

The solvency ratio (capital adequacy ratio) equals net worth divided by risk-weighted assets. This ratio represents the adequacy of required capital of banks. Banks were required to keep their solvency ratio at 20% or more, but the rate was amended to 15% in December 2004. Since re-capitalization in 2000, Cambodian banks have had high solvency ratios (Table 5 and Figure 9).

The non-performing loans (NPLs) ratio represents the asset quality of banks and can be estimated by the amounts of non-performing loans divided by the total amounts of loans. Since banking supervision has been strengthening, the NPLs ratio has decreased from year to year. It dropped to 10.18% in March 2005 (Table 5 and Figure 9).

With the result below, it can be clearly shown that the financial standing of Cambodian banks remains strong in terms of their capital base, liquidity, and capital adequacy, but the NPLs ratio is still in a worse condition. It should also be recognized that high liquidity ratio often indicates the problem that banks are forced to keep very high liquid assets due to the absence of an inter-bank market whom being prevented from utilizing their investing funds in a more profitable way.

Table5: Prudential ratios

ITEMS	2000	2001	2002	2003	2004	2005
	Dec	Dec	Dec	Dec	Dec	Mar
Liquidity Ratio						
Target[1]	100%	100%	80%	80%	50%	50%
Actual[*]	**174%**	**182%**	**155%**	**140%**	**131%**	**126%**
Solvency Ratio						
Target[2]	20%	20%	20%	20%	15%	15%
Actual[**]	**218%**	**122%**	**155%**	**62%**	**34%**	**35%**
NPL Ratio* **	**14.84%**	**8.37%**	**12.37%**	**13.85%**	**10.33%**	**10.18%**

(*Source:* Bank Supervision Department, NBC)

1- The liquidity ratio was amended to 80% as of June 2002, and to 50% as of December 2004.

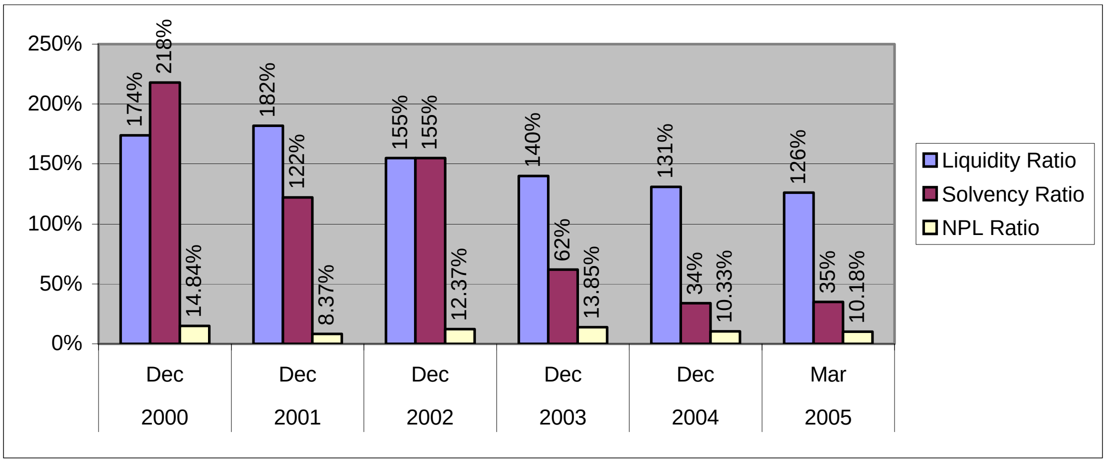
** Average liquidity ratio of all Banks.*

2- The solvency ratio (capital adequacy ratio) was amended to 15% on 29 December 2004

*** Average solvency ratio of all banks.*

**** Average NPLs ratio of all banks.*

Figure9: Prudential Ratios



Source: Bank Supervision Department, NBC

3. Critical issues in banking sector

As mentioned in the section above, the banking system in Cambodia remains rudimentary, weak, inefficient, and lacks uniform; once facing a situation of rebuilding rather than transforming a banking system. Its functionless of mobilizing saving portion to the economy's circle has hindered the development of financial investments and the country's economic growth.

Some observations point out that an uncertainties issue due to the lack of a proper collateral valuation system, the absence of a legal basis for secured transactions, and an inadequate public registration system could discourage banks to grant loans and finally contribute to poor quality asset. Having banks make an investigation on whether or not clients own a suitable collateral is time consuming and high cost spending.

Reliable information is significantly needed for banking business. Not surprisingly, banking sector in Cambodia remains short of capacity in collecting reliable information in order to make decision on their investing projects. The lack of information may provoke some problems in financial systems, such as adverse selection and moral hazards. These deter banks from providing excessive loans to the private sectors. Furthermore, there are no common accounting standards enforced in the private sector. As a result, financial statements of each enterprise are not reliable enough for banks to analyze the firms' future cash flow, and financial condition, which finally forces banks to lend their fund mainly based on collateral.

The third issue has been seen in banking sector is the deficiencies in supervision and regulations of the NBC. The NBC has introduced the basic framework and capacity for on-site and off-site surveillance, as well as a prompt corrective acting system. A series of new regulations have also been issued continuously. However few banks have found to be not in compliance with laws and regulations. Also, capacity building for banking supervision has been strengthened by seminars both at the NBC and abroad, along with on the job training. However, the flow in and out of staff members in the supervision department is relatively high.

The shortage of liquidity management resulting from underdeveloped financial market and lack of inter-bank market has contributed to an increase in bank operating costs and has impeded banking operations because most banks keep a high level of liquid assets, particularly cash on hand. Moreover, the NBC cannot provide liquidity service to commercial banks temporarily due to its ineligible negotiable instrument.

The shortage of managerial skills and human resource capacity takes a huge responsibility among other issues. As a matter of fact, annually, Cambodia employs many experienced foreign commercial bankers with an extremely high salary cost. However, most banks find difficulty in recruiting local qualified working-level staff members due to the damage of human resource during the decade-long civil wars in the past.

Finally, lack of legal and judiciary system is the biggest concern not even in the financial sector, but also in other sectors of economy. In the financial sector, it affects strongly on the part of credit culture, on an environment in which credit contracts are not honored and enforced, it impedes development of banking system. Simply, financial sector developments depend mostly on adequate laws that cover contracts, bankruptcy, and loan recovery and other financial activities.

4. Government's long-term vision and development strategy for financial sector

In 1999, in the recognition of an importance of financial sector development, the Royal Government of Cambodia adopted a long-term vision and development strategy called "Financial Sector Blueprint for 2001-2010" with technical assistance from the Asian Development Bank (ADB). ADB launched its comprehensive plan for developing this sector in December 2000 starting with the formulation of a long-term development strategy. In March 2001, the first draft of this Blueprint was issued, and was later approved by the government on 24th August 2004. This blueprint aims to enhance financial intermediation and raise public confidence over financial system by improving bank supervision, laying the foundation for the development of inter-bank and money markets, as well as the development of information infrastructure, and building the human resources capacity by upgrading training institutions in the financial sector.

The blueprint set out the reform into three phases over a 10-year period, with Phase I from 2001-2004, Phase II from 2005-2007, and Phase III from 2008-2010. "The first phase aims at laying the foundation for the banking system by establishing basic policy and an institutional framework. The second phase aims to enhance intermediation through competition. The third phase is willing to promote financial intermediation efficiency by facilitating the integration of the formal and informal financial sectors as well as the reorganization of the banking industry" (Financial Sector Blueprint for 2001-2010).

Until recently, Cambodia has almost completed its target of the first phase. The second phase, which aims at enhancing the intermediation through competition, has also now been started. According to the Financial Sector Blueprint for 2001-2010, the programs to be implemented during the second and third phases are as follows:

Phase II (2005-2007): Enhance intermediation through competition. One believes that competition leads to an increase in diversification of banking services as well as the expansion of services areas. This development goal in the second phase can be achieved through the following intermediate reform's agenda:

- Improving monetary policy instruments
- Improving the enforcement of prudential regulations
- Enhancing banking services through diversification
- Improving the efficiency of the payment system through investment in IT
- Promoting outreach to rural areas by encouraging the establishment of branches
- Strengthening the NBC organizational structure

Phase III (2008-2010): Level up the efficiency through Integration and Reorganization. This phase would be achieved throughout six areas of intermediate reform:

- Developing a market-based monetary policy framework

- Upgrading prudential regulations
- Facilitating bank reorganization though incentives and a reinforced supervision system
- Establishing an integrated on-line inter-bank system
- Strengthening outreach to rural areas through competition
- Enhancing central bank independence

5. Recent progress in financial sector reform

In general progress in banking sector reform was relatively modest. We can see some achievements after the banking restructuring of the first phase come to its goal, the liquidation of banks is remarkably improved. Public confidence in the banking system has regained since 16 non-viable banks were closed by either voluntary or compulsory liquidation. Since then, banks have increased their number of loan projects and the number of deposits has gradually moved upward but yet insufficient. The following goals have been achieved.

Laws and Regulations

Financial sector development totally depends on the adequacy of its related laws. Success in reforming of judiciary system and enforcement of key laws, such as contract laws, bankruptcy laws, corporation laws, and secured transaction laws, as well as laws on negotiable instruments and payment transactions, etc. are in necessity. The Ministry of Commerce (MOC) drafted a bankruptcy law and a secured transactions law with the technical assistance from IMF. The government is also putting effort on reforming the judiciary system in order to recover public and investors confidence in the financial system. The Law on Negotiable Instruments and Payment Transactions was already accepted by the Council of Ministers on April 4th, 2003 and submitted to the National Assembly for approval. This law will play a big role as an important instrument in strengthening the payment system by reducing payment system risk, providing a legal basis for inter-bank market instruments that will improve liquidity management, and promoting stability in the development of a sound financial system. In addition, the corporation law was also submitted to parliament. Furthermore, the Ministry of Justice and Ministry of Commerce have been jointly working to establish a commercial court.

Aimed at enforcing of laws and prudential regulations, ten Prakas (declaration) on prudential regulations were issued in the early of 2000, and six more were issued in 2001. Some Prakas and circulars have been subsequently issued in the aim of strengthening the banking supervision.

Strengthening Banking Supervision

In the term of supervision, it requires a suitable and adequate legal framework including provisions relating to authorization of banking organizations and their ongoing supervision, powers to address compliance with laws as well as safety and soundness concerns, and legal protection for supervisors. The NBC introduced a number of new regulations, in particular on capital adequacy, loan classification, provisioning, and strengthening the supervision capacity of the NBC, including the use of a resident advisor.

The NBC continues its efforts to strengthen the supervisory department capacity as an effective supervisory body. The professional staff of the Bank Supervision Department has improved its capacity through various workshops, seminars, and courses supported by ADB, World Banks, IMF, and Bundesbank. NBC also conducted in house training on all subjects related to central banking. More than this, the bank supervision department set up two offices to be responsible for banking supervision: on-site inspection and off-site inspection both cooperate well with each other.

On-site inspectors further study and analyze the irregularities raised by off-site supervision. They prepare program and strategies for on-site inspection, then conducting on-site inspection. On-site inspections started in 2003 using CAMELS methodologies. On the other hand, the off-site office is responsible for keeping documents and monitoring bank transaction. The off-site staff permanently examines and monitors the periodical financial statements of banks. Moreover, the off-site staff analyzes the annual audit reports of commercial banks using key financial measures and ratings according to CAEL[4] methodologies. The bank rating or evaluation provides a basis for judging the safety and soundness of a bank.

In the case that the inspectors find weaknesses at some banks or any banks fail to comply with the law and regulations, especially related to loan classification, those banks will be required to rectify those errors within a given period.

Privatization of State Owned Commercial Bank (SOCB)

The privatization of SOCB focuses on the Foreign Trade Bank of Cambodia (FTB). The FTB announced in January 2003 that it would be partially privatized and would seek a strategic international investor. Bank management and operations have been strengthened and improved by the Reform Commission to become a commercial bank with the aim of privatization in 2005.

Currently, the FTB is subject to the reform of its organization and operations to comply with law and regulations and to be competitive. The need to privatize the FTB is imperative. Privatization means that the FTB can operate entirely as a competitive commercial bank without influence from any government institutions. So far, the National Bank of Cambodia had received purchase requests from some potential buyers, but none of them have been accepted yet.

According to the NBC, the FTB can be privatized only if the potential buyer has a required capital, experience and skills in banking operation, a reasonable price given with a reasonable policy regarding to staff banker, and can merge with a local bank that is currently operating with a strong position and is compliant with all required laws and regulations.

In concern to the process of privatization, the National Bank of

[4] For Off-site supervisors, they use only CAEL methodologies, which include capital adequacy, asset quality, earning, and liquidity. It is difficult for off-site supervisors to investigate and evaluate the management and sensitivity to the market of banks, as most of the information is available only at the banks.

Cambodia has suggested that, firstly, a committee for privatization of the Foreign Trade Bank, involving the MEF and the NBC as shareholders, should be formed. The committee would be in charge of organizing the process of privatization of the FTB. Secondly, independent auditors to study and evaluate the value of the bank should be nominated to have a basis on which to set the price of the bank and put it on auction. Thirdly, the company that acquires the FTB must be subject to conditions set by laws and regulations of the NBC on banking and financial institutions.

Implementation of Uniform Charts of Accounts

Accounting and auditing systems have been developed based on international standards. Improving transparency in accounting, auditing, and disclosure standards will increase public and investor confidence in the banking sector and enhance intermediation.

According to the Law on Banking and Financial Institutions (1999, Article 45, p. 14), "a covered entity shall prepare, publish and if need be consolidate its accounts under the conditions prescribed by the supervisory authority." The Bank Supervision Department with support from the ADB and the IMF initiated the use of the Uniform Charts of Accounts (COA) for banking and financial institutions. To facilitate the implementation of the COA, many seminars were conducted to show how the COA is used, and issues related to it were discussed. The IMF mission and the IMF resident advisor to the NBC have provided a lot of support to the COA audit team in terms of training sessions, discussion on the issues, and accompanying the team during on-site inspections.

As of now, COA on-site inspections conducted on all banks are finished. As a result, the implementation of the COA has been completed, and all banks are compliant with the COA implementation.

In conclusion, banking restructuring during the first phase was successfully achieved by the efforts and commitment of the NBC as well as with support from international organization such as the IMF, the ADB, and the World Bank. However, the government and the National Assembly should put more effort into using important laws, such as a law on negotiable instruments and payment transactions, a bankruptcy law, and a secured transactions law, as soon as possible. Moreover, implementation of laws and regulations should be strictly enforced to improve public confidence in the banking system. A Deposit Insurance System should be introduced as soon as possible because it is an essential means to regain public confidence, but it should be designed properly to avoid moral hazards and adverse selection.

Despite some progress mentioned above, little effort has been made o establish a basic framework for monetary policy and building capacity mechanisms for the whole industry. The reserve requirement on deposits in both foreign and local currency is still 8 percent, as it was first set in 1993. Consequently, this idle reserve is enormous and increases commercial banks' operating costs. In addition, the guarantee deposit of 10 percent of total capital has not been phased out yet; rediscount and refinance facilities have not been implemented.

Ⅳ.Literature review on Financial Intermediation and Economic growth

Functions of Financial Intermediaries

A healthy and developed economy requires a good financial system that moves funds from savers to people with productive investment opportunities. Banks and financial institutions make financial markets work. They move funds from people who save to people who need money. They also have important effects on the performance of the economy as a whole. There are two routes for flows of funds through financial systems. The first route is direct finance, in which the funds flow from lenders and savers to borrowers and spenders through the financial market. The second route is indirect finance, involving a financial intermediary that borrows funds from lenders and savers and then uses these funds to make loans to borrowers and spenders. This is called financial intermediation. The financial intermediation have many important roles, such as reducing transaction costs, sharing risk, and dealing with information problems caused by asymmetric information in financial transaction (Mishkin, 2004).

Savers who want to invest their money require time and money. Moreover, they may have no means to collect and process information about investments. Financial intermediation help solve this problem. For example, a person wants to lend money to another person who needs money to start a small business, but also need to protect him/herself from default of payment. That person may need to hire a lawyer to write a loan contract, which can be expensive. However, financial intermediaries can hire one lawyer to write a contract that is usable for many customers, reducing the transaction cost. "Financial intermediaries can substantially reduce transaction costs because they have developed expertise in lowering them; because their large size allows them to take advantage of economies of scale, the reduction costs per dollar of transactions as the size (scale) of transactions increases" (Mishkin, 2004, p. 30).

Low transaction costs allow financial intermediaries to help reduce uncertainty and risk by diversifying risk. This is called risk sharing. If investors invest in individual assets, they may face high risk. However, financial intermediaries invest in many places, making the overall risk lower than for individual assets. "Low transaction costs allow financial intermediaries to do risk sharing at low cost, enabling them to earn a profit on the spread between the returns they earn on risky assets and the payments they make on the assets they have sold. This process of risk sharing is also sometimes referred to as asset transformation, because in a sense, risky assets are turned into safer assets for investors" (Mishkin, 2004, p. 32).

Financial intermediaries help to reduce asymmetric information problems in the financial market. For example, one party often does not have enough information on the other party to make a proper decision. This inequality is called asymmetric information. Savers are reluctant to invest in activities about which they have little reliable information. Lack of information creates two important problems in the financial system: adverse selection and moral hazard. Adverse selection refers to problems created by asymmetric information before transactions occur. According to Mishkin (2004), "Adverse selection in financial markets occurs when potential borrowers who are the most likely to produce an undesirable (adverse) outcome – the bad credit risks – are the one who most actively seek out a loan and are thus most likely to be selected. Because adverse selection makes it more likely that loans might be made to bad credit risks, lenders may decide not to make any loans even though there are good credits in the marketplace." Moral hazard refers to problems created by asymmetric information after transactions occurs. "Moral hazard in financial markets is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) from the lender's point of view, because they make it less likely that the loan will be paid back. Because moral hazard lowers are most probably that the loan will be repaid, lenders may decide that they would rather not make a loan" (Mishkin, 2004, p. 33).

The problem created by adverse selection and moral hazard is important impediments to well-functioning financial markets. Financial intermediaries can reduce these problems. The best tools to help solve adverse selection and moral hazard problems are financial intermediaries, especially banks, which have the ability to effectively collect reliable information at a low cost based on their expertise and scale, thus avoiding the free-rider problem by primarily making private loans without advantage being gained by other investors. It is especially difficult to collect reliable information in developing countries because of weak accounting and auditing standards. Consequently, the roles of banks are important in solving asymmetric information problems (Mishkin, 2004).

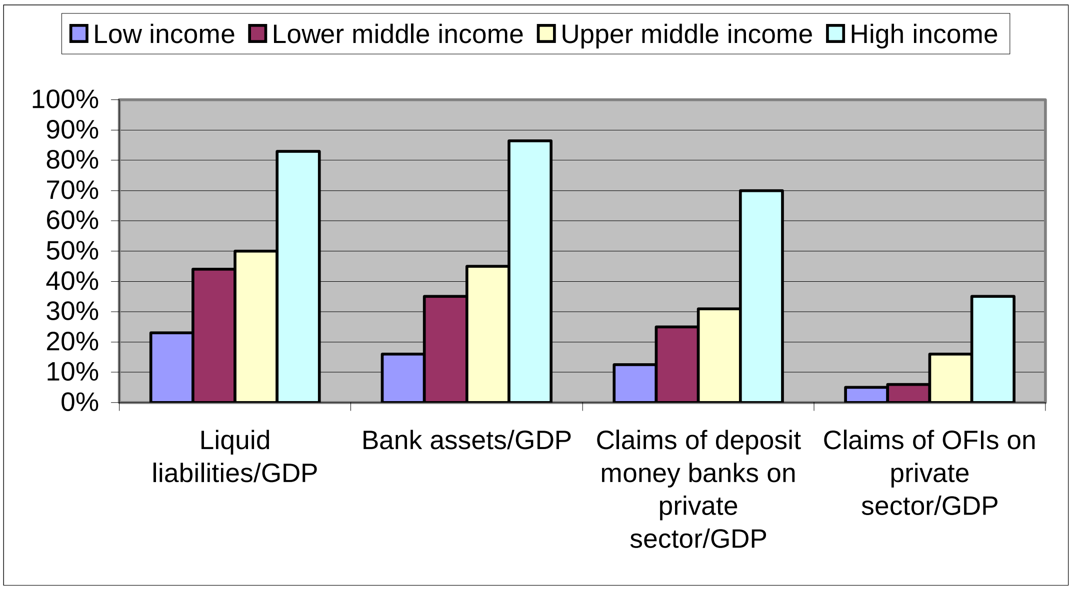
Empirics in the literature

Financial intermediaries play a vital role in economic development because they facilitate the allocation of resources from individual savers to investors who need money to expand their businesses. An economy is hard to develop if financial intermediation is very low. For example, "recent research has found that an important reason why many developing countries or ex-communist countries experience very low rates of growth is that financial systems are underdeveloped" (Mishkin, 2004, p. 187). Underdeveloped financial systems in developing countries cause slow economic growth because the financial systems in such countries face several difficulties, such as a poor legal system, weak accounting standards, inadequate government regulation, and government intervention through directed credit programs and the nationalization of banks. Moreover, in countries with weak accounting standards, financial statements of borrowers are not reliable. As a result, this may cause asymmetric information problems (Mishkin, 2004).

Many studies show that financial development has a positive relationship with economic growth. For instance, Raymond W. Goldsmith (1969) showed that "banks tend to become larger relative to national output as countries develop" (Goldsmith, as cited in Demirgüç-Kunt and Levine, 2001, p. 3). Recent research has focused on expanding the analysis of Goldsmith's goal: "the connection between financial development and economic growth." In particular, researchers showed that "firm-level, industry-level, and cross-country studies all suggest that the level of financial development exerts a large, positive impact on economic growth." Also the differences in legal systems in different countries influence financial development (Demirgüç-Kunt and Levine, 2001, p. 4).

Demirgüç-Kunt and Levine (2001) further provided empirical data showing the positive relationship between high levels of income and increases in financial intermediation based on the analysis of data from IMF's International Financial Statistics covering the period from 1960 to 1997 for 175 countries. Figure 10 shows that the liquid liabilities to GDP, bank assets to GDP, claims of deposit money banks on private sector to GDP, and claims of other financial institutions on private sector to GDP all rise when comparing richer with poorer groups of countries. These patterns are statistically significant. It means that financial intermediation increases as the countries become richer.

Figure 10 Financial intermediary development in the 1990s



(Source: Demirgüç-Kunt and Levine, 2001, p. 90)

Beck, Demirguc-Kunt and Levine (2000) also studied the relationship between financial structure and economic growth. Their focus is on the degree the financial system is market or banking oriented and what the relation is to economic growth. Two methodologies of these authors are interesting and worth to review here. The first is their cross-country approach that determines if economies grow faster in market or banking oriented systems. They find no clues that either market or banking oriented systems have more or less influence on economic growth. What comes forward is that the level of financial development and surroundings in which financial intermediaries and markets operate influence economic growth. The second methodology is a branch of industry approach to analyze whether different branches, which heavily depend on external finance, grow faster in market or bank based financial systems. They conclude that economies that heavily depend on external finance grow faster.

The final article in this overview is Fase (2001). This article searches for an answer on the question whether an increase in financial development can be associated with long-term economic growth in the Netherlands between 1900 and 2000. One conclusion of this analysis is that financial intermediaries, and thus the level of financial development, have a positive influence on economic growth in the Netherlands during the first decenniums of the 20th century. However, in the post-World war 2's period, the financial intermediation has less influence on economic growth. An important conclusion from this analysis is that before World War 2 financial intermediation plays an important role for economic growth, but disappears after this war. Fase assumes that this may reflect the growing maturity and internationalization of the Dutch economy since the world war.

Growth and Financial development

The aim of my analysis is to establish the relationship between financial development and economic growth empirically in the case of Cambodia. To measure financial development, I use the ratio of domestic credit to the private sector to GDP as a proxy. It corresponds to credit granted to the private sector by the central bank and commercial banks, as a fraction of GDP. The main advantage of this over other monetary aggregate is that because it excludes credit to the public sector, it represents more accurately the role of financial intermediaries in channeling funds to private market participants. Thus this is the definition of financial intermediation that should be more closely related to the level and efficiency of investment, and hence to economic growth.

The use of this proxy appears to be the most appropriate indicator of the level of financial intermediation that occurs through the banking system, it may be a weaker indicator of financial development broadly defined. In case of developing countries where most of financial development has occurred within the banking system, therefore, in these countries included Cambodia, this proxy is likely to be a better proxy for financial intermediation.

I also include some other explanatory variables such as: government consumption expenditure, foreign investment, and school enrollment ratio as a measure of human capital accumulation.
In Romer (1990), human capital is the key input to the research sector, which generates the new products or ideas that underlie technological progress.

Thus, countries with greater initial stocks of human capital experience a more rapid rate of introduction of new goods and thereby tend to grow faster. This variable is based on information from the UNDP's education indicators and I suppose that this proxy is positively related to country's economic growth.

For the variable of Government consumption expenditure, Baro (1989, 1990) found that it has a negative association with growth and investment. The argument was that the government consumption had no direct effect on private productivity, but lowered saving and growth through the distorting effects from taxation or government expenditure programs. This variable is measured by the ratio of real government consumption purchases to real GDP.

Many studies have regarded foreign investment as an engine for economic growth in most developing countries. In fact, foreign investment can be considered as the potential measure for providing a stable source of financing to meet capital needs. It also roles as an important channel of international transfer of technology from developed to developing host countries and are often the only source for developing human capital and finally contribute to the growth in host economies. With this logic, this variable is expected to have a positive sign with GDP growth.

Ⅴ. Empirical study on growth and financial development in Cambodia

Model specification and data

Following the contribution of Barro (1991), I will extend this by including the proxy for financial development into my empirical estimation. It includes as explanatory measures of human capital based on primary school enrollment ratio, the level of government expenditure, and the level of foreign investment in the same period. The basic specification for the model is therefore:

$$GDP(growth) = C + a_1.Credit + a_2.Gov + a_3.Enrollment + a_4 ForeignInv$$

where: *Credit* is the ratio of domestic credit to the private sector and GDP.
Gov : ratio of Government expenditure to GDP
Enrollment : Primary school enrollment ratio
ForeignInv : the ratio of foreign investment to GDP

My analysis was performed on annual data for Cambodia extending from 1993 to 2001. More detail description of the data and their source are provided in Appendix. And the estimations were carried out using ordinary least squares (OLS)

Empirical result and interpretation

In this section, I discuss and make an interpretation on the estimation results for this paper. The result of the regression on equation above is reported in table below:

Table 6: Financial development and growth in Cambodia from1993 to 2001

Variables	Parameter estimate	t-statistic
Constant	22.31	1.58
Credit	−2.244	−2.174**
Gov	0.39	0.939
Enrollment	−0.453	−1.20
ForeignInv	0.839	0.181
Sample		1993—2001

With the result in Table 6 above, I find that, interestingly, the explanatory variable of Credit is significantly negative to GDP growth. It does mean that from 1993 to 2001 Cambodia's financial intermediation has a negative correlation on economic growth. At first glance, this finding is very puzzling as it is controversial to what I expected in the last section.

There are several possible reasons for this result. First, I can explain as that the recent liberalization of financial market was often undertaken in the context of poor regulatory environments, resulting in very fragile financial systems. The negative effects of lack of regulation were compounded by widespread expectations that the financial system would be bailed out in the event of failure. In many case, this led to massive over-lending. Therefore, high degree of financial intermediation in the sample of Cambodia was often a sign of a fragile and overexposed financial system, rather than the one that was efficiently allocating credit.

Second, due to the banking system remains weak and clear policy to prevent capital flight have not been yet established, most of commercial banks are lending the deposit to investors outside the country in the aim of keeping profit and reducing risk. According to the figure compiled by the NBC, the amount of Cambodia's saving transiting through banking system is estimated to have reached about USD1350 million at the end of 2001, of which about 54 percent (USD730million) were continued to fly abroad, as the domestic credit declined.

The above considerations suggest that the negative relationship between financial development and long-run growth observed in the sample of Cambodia in the period of 1993 to 2001 come from the a negative effect on the efficiency of investment, rather than from effects on the volume of investment. Thus, the more financial intermediation could be associated with higher but less efficient investment.

Although my focus is on financial intermediation, it is worth noting some other interesting results that emerge on Table 6 above. First, I did not see any effect of Government expenditure and foreign investment over Cambodia's economic growth in the same period. Interestingly, foreign investment that I supposed to have a positive sign with growth becomes insignificant. This result could be interpreted that most foreign investment in Cambodia is based on labor extensive type and most of them are concentrating on short-term benefit business. As a matter of fact, this kind of foreign investment couldn't play a role as an important channel of transferring technology to contribute to the growth of host country.

Table 6 also indicates that the explanatory variable '*Enrollment*' which is proxying for the initial stock of human capital seems to have a negative correlation with growth. This estimation result can be described as the reason of lower quality of education in Cambodia that directly contributes to the lower quality of initial stock of human capital as a whole. It is often seen that most children in the rural area are quitting their school after the primary school due to the poverty and finally impossible to get rid of the trap of poverty because the lack of their education.

VI.Conclusion

Throughout this paper, I first presented the Cambodia's economy condition since the collapse of socio-economy to the market-oriented economy by describing its macro-economic condition, assessing government's fiscal sustainability, and mentioning on the condition of current financial system in these recent years. With the economic transformation, Cambodia government has adopted the long-term vision and development strategy to make structural reforms in all sectors of economy including the financial system in the aim of developing its economy. Finally, I worked on an empirical study in order to investigate the impact of financial development on economic growth in the case of Cambodia using a sample for the period 1993 to 2001. The empirical estimation results suggest that with the absence of proper financial regulation, more financial intermediation may be associated with lower efficiency of investment, which finally costs to the economic growth. It also illustrates that not only is important a large degree of financial intermediation, but the quality of this intermediation influenced to a large extent by economic policy, is also important.

According to this study, I would propose some policies such that strengthening the banking sector should be done in the most effective way to achieve the best result within a given timetable. I think it requires continuous monitoring of the compliance of banks with laws, regulations, and prudential regulations. I also strongly suggest that the government should avoid unnecessary intervention in the banking sector that may impede the financial development and may contribute to financial crisis. The government should make a proper judiciary and legal reforms in all sectors especially in financial sector to provide a favorable environment for sustainable investments for domestic and foreign investors. With these reforms, I strongly believe that the public confidence in the banking system would be increased and finally the financial intermediation can function as a potential engine for economic growth.

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