

MONEY DEMAND IN CAMBODIA

TIONG CHUI UNG

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ABSTRACT

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By

Tiong Chui Ung

This study attempts to empirically study the existence of long-run equilibrium money demand relationship as well as short-run dynamics in the context of Cambodia broad money (M2) by using ADF unit root test, Johansen cointegration test, Normalized regression model, error-correction model and Granger causality test. Thus, the relationship between real M2, real gross domestic product, deposit rate and exchange rate is examined on the sample period between 1995Q1 till 2007Q4. The empirical evidence demonstrates that there exist a stable long-run relationship between real M2 with its determinants. However, real M2 only cointegrated with real gross domestic product and exchange rate in the short-run. The CUSUM and CUSUMSQ tests show that parameters in real M2 demand is relatively stable. As a result, the stability that shows in real M2 indicates that real M2 is suitable to design monetary policy.

ABSTRAK

Permintaan Bekalan Wang di Cambodia

Oleh

Tiong Chui Ung

Kajian ini bertujuan untuk mengkaji kewujudan hubungan di antara pembolehubah di Cambodia pada jangka masa pendek dan panjang dengan menggunakan ujian kepegunan, ujian kopengamiran, ujian persamaan normalisasi, model pembetulan ralat dan ujian penyebab Granger. Dengan itu, hubungan antara bekalan wang M2, Keluaran Dalam Negara Kasar (KDNK), kadar deposit dan kadar pertukaran asing dapat ditentukan pada tempoh masa 1995Q1 hingga 2007Q4. Berdasarkan keputusan ujian kopengamiran, ia telah membuktikan bahawa hubungan antara bekalan wang M2, KDNK, kadar deposit dan kadar pertukaran asing memang wujud pada jangka masa panjang. Walau bagaimanapun, kajian ini hanya mengaitkan hubungan antara bekalan wang M2 dengan KDNK dan kadar pertukaran asing pada jangka masa pendek. Tambahan pula, 'CUSUM' dan 'CUSUMSQ' ujian membuktikan bahawa permintaan untuk bakalan wang M2 adalah stabil. Lantaran itu, kestabilan bekalan wang M2 menunjukkan bahawa bekalan wang M2 adalah sesuai digunakan untuk mereka dasar kewangan.

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CHAPTER 1

INTRODUCTION

1.0 Introduction

Studying the demand for money in Cambodia is significant as it is the foundation for macroeconomic analysis by which government can influence the performance of an economy. Therefore, money demand has been always of vital priority for both policy makers and economists due to the importance of money demand relationship to almost all theories of aggregate economics activity, particularly to the formulation of a successful monetary policy¹. Despite that, monetary policy seeks to maintain price stability to achieve sustainable stable output growth in the face of internal and external shocks from time to time in developed and developing economies.

Most fundamentally, the demand for money reflects how much wealth people desire to hold in liquid form. People's decision to hold money is affected by efficiency of monetary policy whereas foreign monetary developments are influenced by people's demand for money. The purpose of the money in the economy can be used as a medium of exchange, unit of account and a store of value. The medium of exchange and unit of account can be identified by small transactions which involving the non-

¹ Monetary policy is the decisions made by policymakers in the central bank that concerning the setting of money supply. At the Federal Reserve, monetary policy is made by Federal Open market Committee (FOMC) which discusses the condition of the economy and considers the changes in monetary policy.

durable goods and services such as foodstuff, haircut and so on whereas portfolio balance approach represent people hold money as a store of value.

Nevertheless, alternative monies have different characteristic because not all monies have equal medium of exchange, unit of account and stores of value. Monies tend to have good stores of value if monies can maintain their purchasing power in low inflation countries. Currencies provide good transactions if it is recognizable in large economies while serve best as unit of account with stable exchange values. In addition, formulation of monetary policy will lead to errors if repeated velocity shocks are likely lead to persistent deviations of growth in monetary aggregates from estimated values.

As a result, stable money demand function play a vital role in discovering the impact of monetary policy over time on the real output and the price level as well as assessing the welfare implication of such policy in a market driven economy. Through the stable money demand function, National Bank of Cambodia (NBC)² able to formulate, implement and monitor monetary and exchange policies. Moreover, stable money demand function will also allow NBC to understand the potential impact of the changes in one of the explanatory variable on money demand. However, tighter monetary policy is necessary if the depreciation of domestic currency raise the domestic currency value of foreign securities held by domestic residents. The

² NBC is establish in December 23, 1954 after Cambodia gain the independence from French Colony and after the Indochina Printing Institution is closed. The main function of NBC is to maintain price stability. The NBC printed its own national currency of Riel in order to completely terminate the monetary alliance with the Vietnamese and Laos currency.

currency depreciation may either reduce demand for money due to the substitution effect or increase the demand for money due to the wealth effect.

Hence, the depreciation of the Cambodia Riel will raise the Riel value of foreign assets. Those holding foreign assets may regard this situation as an increase in their wealth and thus demand more for Riel. Despite that, people will hold less domestic currency if they anticipate currency will depreciate and thus substitute foreign currency for domestic currency. If domestic currency further depreciated, the decline in domestic money holdings will cause economic slowdown and further deteriorate the economic.

1.1 Background of the Study

Cambodia is one of the world's poorest nation which located at Southeast Asia on the Gulf of Thailand. During the period of Khmer Republic (1970-1975), there exist some amount of United States (U.S.) dollar circulate in Cambodia, but Riel still remain as domestic transaction. The financial infrastructures³ in Cambodia have systematically destroy due to the shock that appear in that period and National Bank of Cambodia's headquarter has been boomed under Khmer Rouge period⁴. Therefore, the Democratic Kampuchea regime has established in April 1975 that led by Saloth Sar, also known as Pol Pot. In December 1977, Cambodia has breaking-off

³ The financial infrastructures include markets, trade, money and banking system.

⁴ Under leadership of Khmer Rouge, Cambodia undergoes brutal and radical revolution. Economic development strategy of Khmer Rouge is to build strong agricultural base that support by handicrafts and local small industries.

diplomatic relations between Democratic Kampuchea and Vietnam after two years riddled with growing severe border incidents. The commercial transaction is conducted in the form of barter by using rice and gold in 1979. Later, the Vietnamese dong also used as transaction. In 1980, NBC has been reestablished and the Riel has become legal currency.

Since the late 1980s, Cambodia has transformed from a centrally planned economy to the market economy, which is from civil war to peace and from single-party authoritarianism to multi-party democracy. The transition to market economy started when Cambodia borders open to trade and when economic and political relations with western countries resumed. Under the centrally planned economy, the U.S. dollar and Thai Baht have been restricted. However, the confidence using Riel as transactions still remain low. The transition of centrally planned economy to market economy is followed by the collapse of the dreadful experiments with total collectivization that is conduct by the Democratic Kampuchea in the late 1970s. During that period, Cambodia government has accepting the aid from western countries to rebuild Cambodian state and society in the consequence of the devastating Democratic Kampuchea regime.

In the 1980s, the war is conducted between Phnom Penh based regime and resistance based on the border with Thailand. Afterward, the war has transformed to peace when negotiations begin to gather steam from 1989. Therefore, the reform measures have introduced that consist of changes in land tenure policy and farm level structure of production, improvements in pricing, tax and marketing policies,

disengagement of the state from production through reduction of subsidies and privatization of state-owned enterprises. In 1990, Cambodia has transit from single-party authoritarianism to multi-party democracy. In that era, there exist new sources of international aid following the arrival of United Nations Transitional Authority in Cambodia (UNTAC), which fund up to 50 percent of central government's budget⁵. Thus, the U.S. dollar that flooded Cambodia economy has create new shock against the national currency due to the growing foreign currency deposits.

Throughout 1990, 90 percent of Cambodia's poor live in countryside and total poverty is widespread⁶. In 1991 till 1992, the growth of money supply (M2) cause sharp devaluation in Riel and three digit hyperinflation which created an additional shock for potential users of the Riel. Subsequently, Cambodia suffers from rapid loss of purchasing power of the Riel and fiscal performance is out of control, which resulted in monetization of fiscal deficit. As a result, extensive use of U.S. dollar is encouraged and dollarization becomes pervasive phenomenon in Cambodia. In 1994, officially welcomes foreign direct investment and Law of Investment that established has open and liberal foreign investment regime. The structural change has stimulated rapid growth in Cambodia economy and transforms Cambodia into small open economy. The main domestic activities for rural household depend on agriculture and related sub-sectors whereas the main industries are garments, tourism and construction. Garments sector started to expand rapidly in the mid 1990 and agricultural production that grew slowly in that period has representing slow rises in income. Inward investment is heavily oriented towards the urban areas. So, the

⁵ See for example, Hughes (2003).

⁶ See for example, Hughes (2003).

difference between strong rates of growth in urban areas and weak growth in rural areas has contributed to a high rate of rural-urban migration. The increase in migration to urban area has put pressure on limited social and economic infrastructure and resources.

During 1995, implementation of firm stabilization policies goes under difficult situation. However, the macroeconomic performance remains excellent. Cambodia's economy slowed dramatically in 1997 to 1998 due to the regional economic crisis, civil violence and political infighting. The foreign investment and tourism in Cambodia started to plummet dramatically and the main harvest hit by drought in 1998. Besides, food shortage indicating that hunger is not confined to countryside only, but also present in urban areas and the unemployment rate remain high. Nevertheless, the holding of foreign currency is unrestricted and Cambodia economy has already largely dollarized when Asian crisis erupted. In addition, Cambodia has established diplomatic with most countries, including U.S. and become the member of Association of Southeast Asian Nations (ASEAN) in 1998. In 2001, the Vision and Financial Sector Development Plan for 2001 till 2010 (FSDP 2001-2010) has adopted by Royal Government of Cambodia (RGC), which is long-term strategy for financial sector development in Cambodia. The FSDP 2001-2010 served to guide the efforts of RGC, stakeholders and development partners in defining policy and programs to support development of financial sector in Cambodia for achieving market-based financial system.

Since 2001 until 2004, Cambodia economy has driven largely by an expansion in garment sector by providing the biggest input into GDP growth. However, tourism sector slowed in 2002 to 2003 after several years of rapid growth due to the Severe Acute Respiratory Syndrome (SARS) and begin to increase rapidly in 2004. Cambodia currency, the Riel, is relatively stable over 2002 but depreciate slightly against U.S. dollar in 2003. Therefore, NBC intervenes in 2004 to maintain stability of the Riel. Despite of that, Cambodia economy is heavily dollarized, the dollar and Riel can be used interchangeable. In October 2004, Cambodia becomes the member of World Trade Organization (WTO). At that period, Cambodia has already become the member of World Bank⁷, International Monetary Fund and the Asian Development Bank (ADB). Meanwhile, in 2005, the WTO agreement on textiles and clothing has obliged Cambodia textiles producers to compete with China and India which has lower textiles prices. Nonetheless, the exploitable oil and natural gas has representing new revenue stream for government. The mining that consist of bauxite, gold, iron and gems has attracted investor interest, mostly in northeastern parts of the country.

In 2006, Cambodia has signed US-Cambodia Bilateral Trade and Investment Framework Agreement (TIFA). The Financial Sector Development Strategy for 2006 through 2015 has been developed based on broad and inclusive participatory approach with all stakeholders in the financial sector of Cambodia. This plan provides an update for FSDP 2001-2010 that take account in the rapidly changing conditions in the market and the changes in the concrete priorities of the country, which in turn

⁷ The World Bank coordinates much of Cambodia's aid plan and focusing on empowering the poorest people and working with government, private sector and civil society.

require better sequencing of the reform program. In 2007, several major central banks are obliged to conduct monetary easing and intervene in the markets to provide the needed liquidity due to sub-prime mortgage crisis and associated global credit crunch. However, the effect is minimal due to strong fundamentals in various economies. In addition, NBC has bought total amount of U.S. dollar 210.58 million in exchanges for 853.16 billion of Riel that contribute to substantial increase in country foreign exchange reserves (National Bank of Cambodia, 2007). At the same time, NBC sold U.S. dollar at 4,087 Riel per U.S. dollar, thereby injecting U.S. dollar 500,000 into the market and absorbing 2,043.5 million Riel from circulation (National Bank of Cambodia, 2007). The dollarization in Cambodia emerged due to the public confidence in Riel eroded rather than policy decisions. In spite of heavy dollarization, the tourism industry has continued to grow rapidly in Cambodia during that period.

It can be noted that economic development in Cambodia has experienced three distinct period of progress. In the first period, everything has to be start over in 1979. Cambodia is rebuilt and reached stable stage. However, the scarcities and legacies still remain shortage particularly in skilled manpower. The second period is from 1993 to 1997 when country economies attack by Asian Financial Crisis and internal conflict. Nonetheless, the third period started when Cambodia undergo the period of peace, stability and uninterrupted growth and progress from 1998 until 2007. There are strong interconnection between economic growth, poverty reduction, structural reforms, and improved governance. The reduction of poverty and increased investment in social sector are due to macroeconomic stability and rapid economic growth. Structural reforms in banking and financial sector have strengthened

macroeconomic policies and remove microeconomic distortion affecting key sectors of the economy.

Table 1: Chronology of the events in Cambodia, 1975 – 2007

| Date | Events |
|---------------|---|
| April 1975 | * The Khmer Rouge forces storm into Phnom Penh and capture the capital city. In addition, the Democratic Kampuchea regime is established that led by Saloth Sar, also known as Pol Pot. |
| December 1977 | * Cambodia has breaking-off diplomatic relations between Democratic Kampuchea and Vietnam after two years riddled with growing severe border incidents. |
| 1979 | * The commercial transaction is conducted in the form of barter by using rice and gold as the medium of exchange. However, Vietnamese dong also used as transaction. |
| 1980 | * National bank of Cambodia has been reestablished after boomed by Khmer Rouge and Riel has become legal currency. |
| Late 1980 | * Transformation of Cambodia economy from centrally planned economy to the market based economy. |
| 1989 | * The negotiation begins to gather steam when the war has transformed to peace. |
| 1990 | * Cambodia transit from single-party authoritarianism to multi-party democracy. There exist new sources of international aid, but the total poverty still remains widespread. Thus, U.S. dollar has flooded into Cambodia economy. |
| 1991-1992 | * Money supply (M2) caused sharp devaluation in Riel and there are three digit of hyperinflation. Cambodia suffers from rapid loss of purchasing power of Riel due to the extensive use of U.S. dollar is encouraged. |
| 1994 | * The foreign direct investment and Law of Investment that established has open and liberal foreign investment regime. Thus, garment sector started to expand rapidly and inward investment is heavily oriented towards urban areas. |
| 1995 | * The implementation of firm stabilization policies goes under difficulties but the macroeconomic performance remains excellent. |
| 1997-1998 | * Cambodia economy slowed dramatically due to the regional economic crisis, civil violence and political infighting. The foreign direct investment and tourism in Cambodia started to decline dramatically. However, Cambodia economy has largely dollarized in the period. |

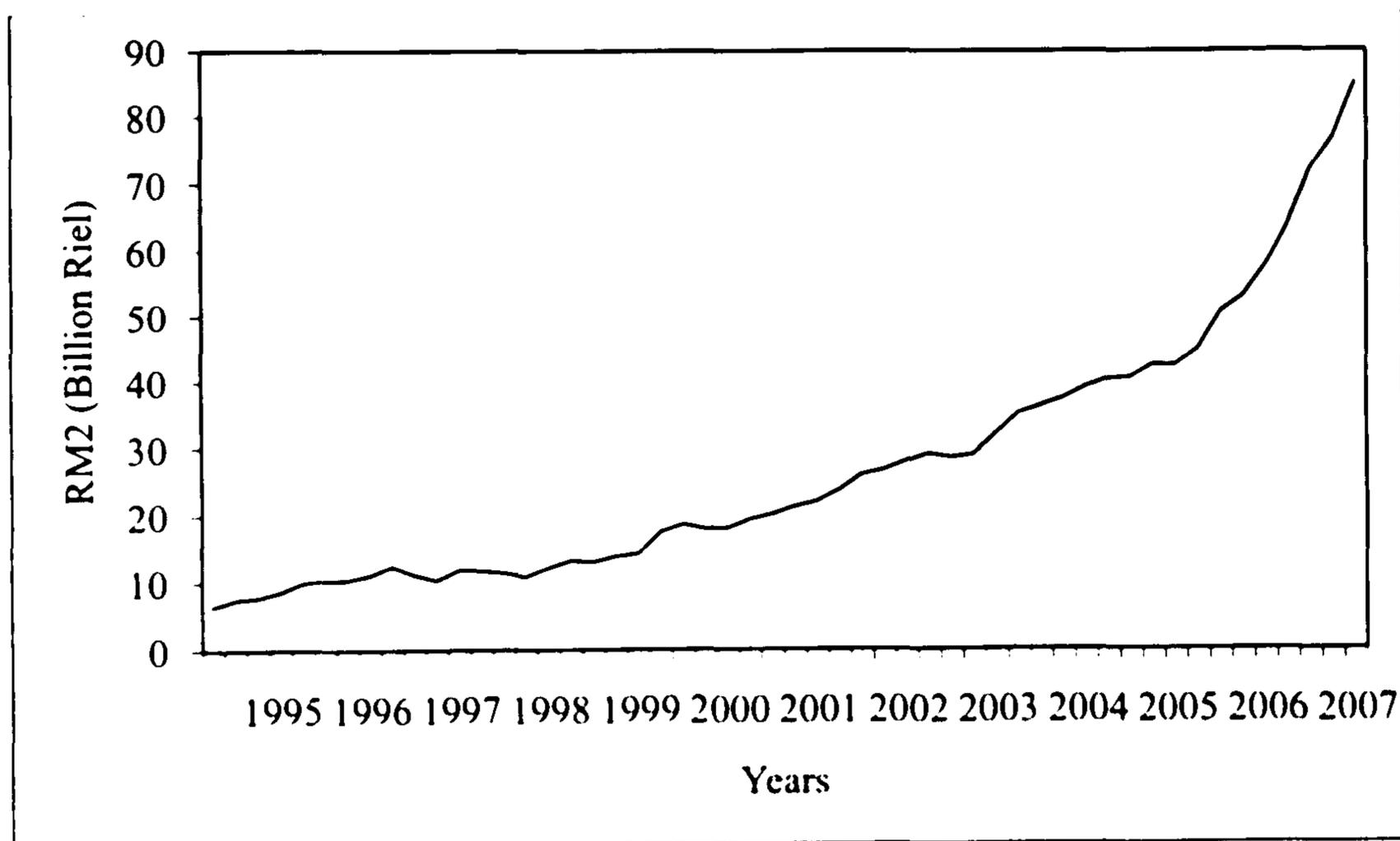
Table 1: Chronology of the events in Cambodia, 1975 – 2007 (Continued)

| Date | Events |
|-----------|---|
| 1998 | * Cambodia becomes the member of Association of Southeast Asian Nations (ASEAN). |
| 2001 | * Financial Sector Development Plan for 2001 till 2010 (FSDP 2001-2010) has adopted by Royal Government of Cambodia (RGC), which is long-term strategy for financial sector development in Cambodia. |
| 2002-2003 | * Tourism sector has slowed down due to the Severe Acute Respiratory Syndrome (SARS), but it recovered after that. However, garment sector continued to expand by providing biggest input into GDP growth. |
| 2006 | * Cambodia signed US-Cambodia Bilateral Trade and Investment Framework Agreement (TIFA). The Financial Sector Development Strategy for 2006 through 2015 has been developed based on broad and inclusive participatory approach with all stakeholders in the financial sector of Cambodia. This plan provides an update for FSDP 2001-2010. |
| 2007 | * Several major central banks are obliged to conduct monetary easing and intervene in the markets to provide the needed liquidity due to sub-prime mortgage crisis and associated global credit crunch. |

1.2 Macroeconomic Developments in Cambodia Money Demand

1.2.1 Demand for Broad Money (RM2)

Figure 1: Demand for RM2 in Cambodia



Source: The data was obtained from International Financial Statistics by International Monetary Fund.

The broad money (RM2) comprises a wider range of financial instruments which is equal with nominal M2 divided by CPI as measured in billion Riel. RM2 includes more assets in its measure of money compare to RM1. It consists of sum of the RM1, time and saving deposit in banking system.

Figure 1 exhibits the demand for broad money in Cambodia. As illustrated, the broad money in Cambodia not fluctuates severely and roughly have upward trend. However, RM2 shows some instability trend during 1997 and 1998. The Asian financial crisis that invades Cambodia economy in 1997 and 1998 has eroded demand

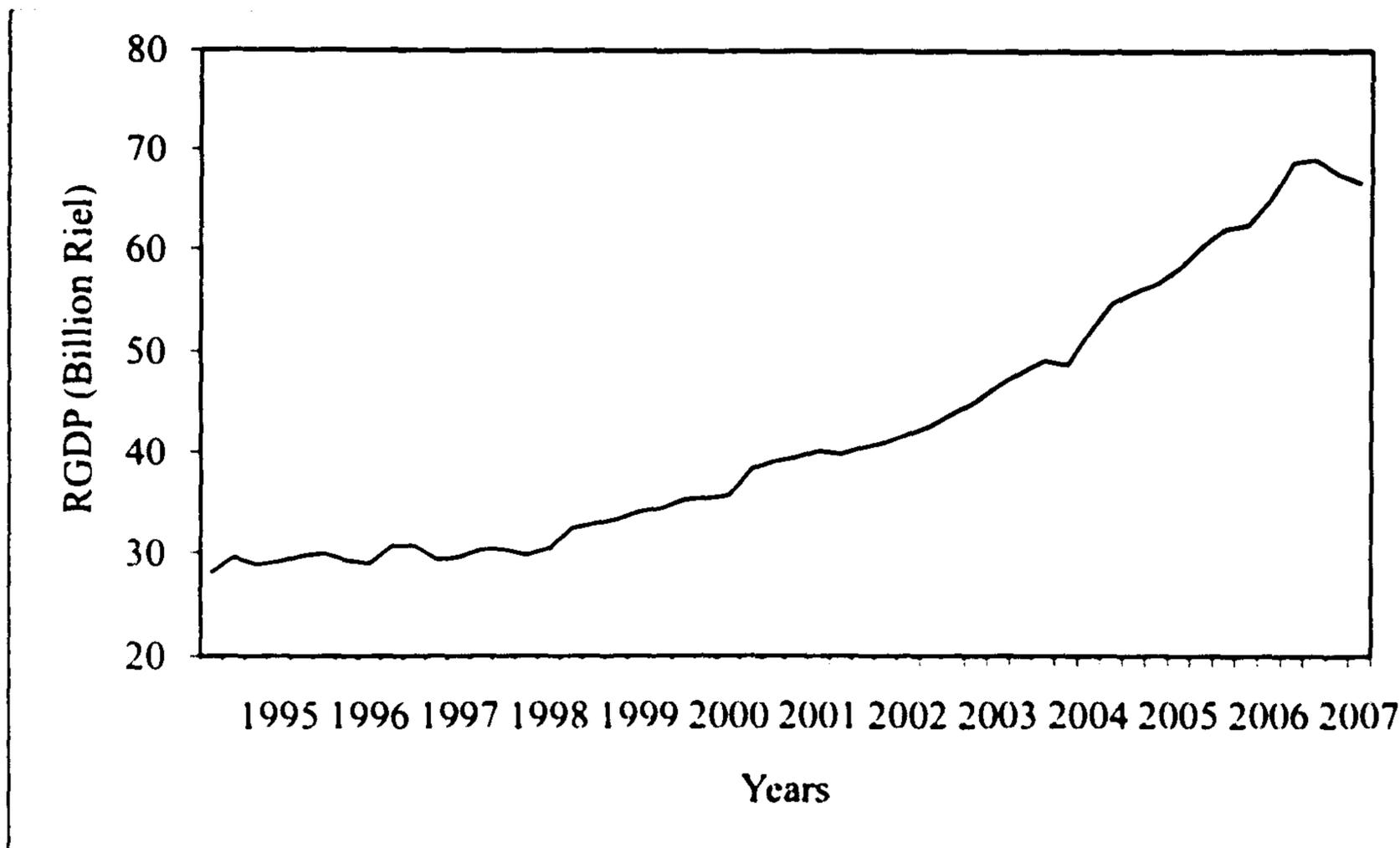
for broad money in Cambodia. Nevertheless, during 2002, RM2 has rise by 5.98 billion Riel, which is from 21.99 billion Riel in 2001 to 27.97 billion Riel in 2002. The increase in RM2 is caused by increase in foreign currency deposits of residents by 447 billion Riel and growth in currency outside banks by 182 billion Riel in M2 (National Bank of Cambodia, 2002).

Aside from that, in 2003, the RM2 has drop slightly from 29.02 billion Riel in quarter one to 28.51 billion Riel in quarter two. However, in 2004, foreign currency contributes to 769.50 billion Riel that caused the M2 to growth which at the same time drive the RM2 to grow. The foreign currency deposits have registered the largest increase since the mid 1990s. These development suggested that banking services has recovered remarkably during 2004, following period of concern and uncertainty stemming from general election in Cambodia and other unfavorable events which occurred in 2003 (National Bank of Cambodia, 2004).

In addition, RM2 continued to have increasing trend in 2005, but albeit at slower pace when compared to 2004. The aggregate money RM2 increased by 3.27 billion Riel, from 39.08 billion Riel in 2004 and reached 42.35 billion Riel in 2005. This is due to the increase in foreign currency component of broad money. Despite that, National Bank of Cambodia (2007) reported that broad money in Cambodia has expand at faster pace, rising from 57.57 billion Riel in 2006 to 84.96 billion Riel in 2007. The acceleration of RM2 growth in 2006 reflected the increase in RM2 in all quarter whereas 2007 has revealed an expansion in Narrow money (M1) and quasi money.

1.2.2 Real Gross Domestic Product (RGDP)⁸

Figure 2: Real Gross Domestic Product in Cambodia



Source: The data was obtained from International Financial Statistics by International Monetary Fund.

RGDP can be defined as the production of goods and services that valued at constant prices within a country by using 1995Q1 as the base year⁹. RGDP usually used to measure the total income and total expenditure on the economy. If the total expenditure keeps increasing, it means that the economy is producing larger output of goods and services or goods and services are sold at the higher prices.

⁸ Real GDP is better measure for economic well being than nominal GDP because real GDP measure economy production of goods and services that reflect economy ability to satisfy people's need and desires (Mankiw, 2007).

⁹ The prices in base year provide the basis for comparing the quantities in different year (Mankiw, 2007).

Part of the Cambodia economy depends on the performance of global economy. The major sector in Cambodia is occupied by agriculture sector. However, Cambodia economy has experience major shift from agriculture to industry base on larger contribution in promoting growth. The RGDP in Cambodia has increasing trend after Cambodia has open up the economy in 1994. From 1995Q1 to 1998Q3, the trend almost become flat and varies throughout the years. Nonetheless, in 1997 and 1998, Asian financial crisis have contribute an impact on Cambodia economy. Accordingly, macroeconomic performance quickly rebound from the relapse in 1997 till 1998 and has improved notably.

In spite of that, the incident of September 11 that attacks U.S. in 2001 has slightly slowed down the export of garment in Cambodia. Foreign direct investments fail to show remarkable growth due to low level of investment couple with flooding and drought in some places in Cambodia. Nevertheless, the number of foreign tourist arrives to Cambodia keep on rising in 2002 compared to 2001. In 2002, Cambodia economy has grown around 41.88 billion Riel compare with 40.14 billion Riel and 35.71 billion Riel in 2001 and 2000 respectively. The macroeconomic performance remains stable in the view of weak world economy.

Besides, the growth rate of the national economy in 2004 has increase by 11.08 percent favorable performance which increases from 46.74 billion Riel in 2003 to 51.92 billion Riel in 2004. The higher growth rate is due to recovery in tourism and garment sector that continue to play a vital role in economic expansion. These achievements provide impetus to the production activities that offset the slowdown in

agricultural performance that cause by drought in several major rice production areas within the country (National Bank of Cambodia, 2004).

Cambodia economy that receives 11.08 percent of growth rate during 2004 has increase slightly to 12.33 percent in 2005. The economic expansion has support by number of important sectors such as agricultural and services sectors that contribute to 4.50 percent and 6 percent respectively in 2005. Nonetheless, the largest export sector in Cambodia manufacturing industry remains positive but the growth rate has plummet around 5.30 percent (National Bank of Cambodia, 2006). In 2006, the growth rate has expanded by 11.40 percent which has contributed to 64.97 billion Riel.

Moreover, Cambodia RGDP in 2007 has reached 66.72 billion Riel which has growth of 2.70 percent at slower pace compare to 11.40 percent in 2006. The agriculture has expanded steadily due to good weather and the government's attention toward this important sector. Furthermore, industry has maintained a positive but smaller growth compared to 2006 due to increase competition in the garment sector, which requires improvement in production efficiency. The services sector has also expand with the value-added variable in the finance sector which grows by 22.20 percent.