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Cambodia: Rapid Growth in an Open, Post-Conflict Economy

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May 2014

Working Paper No. 2014/12

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Paper prepared for The World Economy, Trade Policy Review, 2014

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Abstract

This paper provides an analytical review of World Trade Organization, Trade Policy Review: Cambodia, the first such report undertaken for the country. The report highlights Cambodia's rapid economic growth after one of the world's worst cases of genocide in the second half of the twentieth century. This growth has been underpinned by open trade and investment policies, in the context of dynamic neighbourhood growth effects. The trade regime is mainly tariff-based, with modest inter-sectoral variations in rates. Cambodia has limited trade policy space. It is a signatory to the 10-nation ASEAN Free Trade Agreement, soon to become the ASEAN Economic Community. Moreover, given its long and porous borders with the much larger, dynamic economies of Thailand and Vietnam, any major cross border price differences will quickly result in informal trade with these economies, and nearby China. Most of the country's trade policy challenges are to do with 'behind the border' issues, a legacy of its generation of civil war and conflict. These include weak bureaucratic capacity, high levels of corruption, poor infrastructure, and limited human capital.

Key words: Cambodia, trade policy, ASEAN, globalization, weak institutions.

JEL Codes: F14, F63, O53

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(1) Introduction

The 2012 Trade Policy Review for Cambodia (WTO, 2012) is the first detailed study of this country's trade and commercial policy. Cambodia became a member of the WTO in October 2004, and was the first least developed country to join through the full accession process. The report draws attention to the key features of the country's development policy regimes and outcomes, since it rejoined the international community two decades ago following one of the worst cases of genocide in the second half of the twentieth century. These features have been shaped by the weak institutions and absence of trust that followed three decades of devastation as a result of civil and regional wars. The country was increasingly engulfed in the Vietnam War from the mid 1960s, followed by the barbaric Khmer Rouge (KR) rule and its 'ground zero' economic policies, the Vietnamese invasion and occupation of 1979, and subsequently its international isolation. Yet since Cambodia's peace settlement in 1991, and its first general elections in 1993, it has been one of the world's fastest growing economies, built on the pillars of sound macroeconomic policies, openness to trade and investment, large capital inflows, and a dynamic neighbourhood.

The TPR examines one major element of the evolving policy regime, namely trade and commercial policy. The report highlights both the deliberately open economic policies after the years of isolation, and some of the challenges of this openness, all in the context of the country's unusual policy settings, its weak institutions, its porous international boundaries, and the paucity of statistics. Our analytical review of the report is organized as follows. Section 2 examines the country's development context, particularly the legacies of severe conflict, and its geography, as a very small economy surrounded by much larger economies. In section 3 we summarize the key features of the report, and draw attention to elements of a research agenda for future reports. Section 4 investigates a range of 'trade plus' issues that are not directly covered in the report but which affect commercial policies and shape the potential benefits of the country's openness. In section 5 we summarize our main arguments.

(2) The Cambodian Development Context[1]

Cambodia became an independent nation state in 1953 following the end of French colonial rule. For most of the first 40 years of its independence it was conflict-ridden, initially as it was drawn into the Vietnam war, and then from 1975 when the KR forces took control of the country following the defeat of the United States and the reunification of Vietnam. The

[1] This section draws in part on Hill and Menon (2013). For general overviews of the economy, see also Guimbert (2010), Hughes and Un (eds, 2011), Naron (2011), and IMF (2012).

effects of KR rule were devastating: it is estimated that about one-quarter of the population perished owing to mass executions, malnutrition and disease, or fled the country. The KR also abolished most formal institutions of the state, including private property and money. Following its overthrow by Vietnamese forces in early 1979, the country then experienced a decade of intermittent civil war, as well as international isolation and sanctions. By 1991, with the signing of the Paris Peace Accords, it was one of the poorest countries in the world. Much of its physical infrastructure had been destroyed. Most of its educated community had either perished or fled. The country hardly possessed any of the key attributes of a modern state (Naron, 2011): the bureaucracy and the formal legal system were barely functioning, property rights were ill-defined, and there was little trust in the currency. The security situation remained tenuous, while unexploded ordnance was a serious problem, particularly along the border with Vietnam.

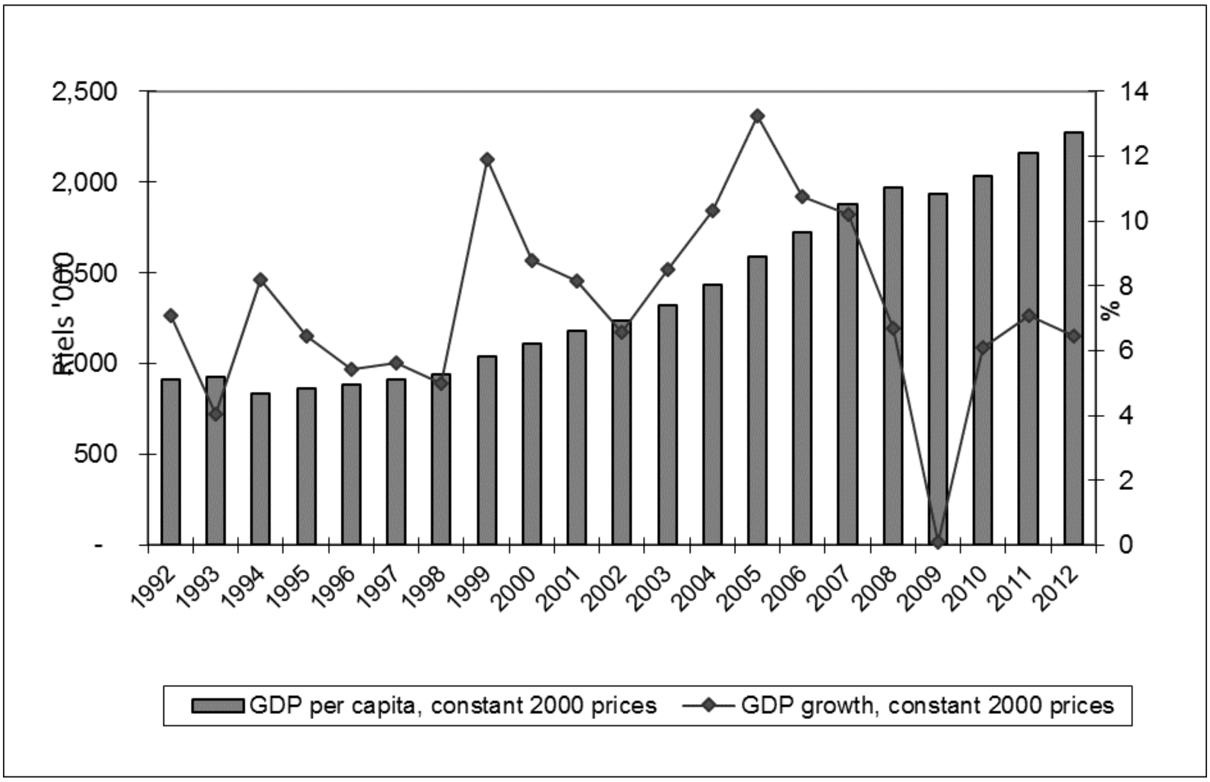
Since 1992, economic growth has been rapid, averaging about 7% per annum, faster than in almost any other post-conflict society, and resulting in a doubling of per capita income (Figure 1).[2] Growth was particularly fast over the period 1998-2007, following a recurrence of domestic conflict and prior to the 2008-09 recession. Not surprisingly, growth has also been volatile, owing to sporadic domestic political instability, to the country's narrow economic base, and to external economic shocks. Among the latter, the Asian financial crisis of 1997-98 had a limited impact on Cambodia, as the country was not then connected to regional capital markets, the principal source of the contagion, while the dominant rural economy was largely insulated from the real economy shocks. However, the country was more severely affected by the global economic recession of 2008-09. Although China, by now its major commercial partner, continued to grow strongly, the economy was now much more open, and globally connected. Economic growth slumped as a result of the sharp fall in the major garment export and tourism sectors, owing to the recession in the OECD countries, and also some major Southeast Asian neighbours. Short-term capital flows also contracted, leading to a collapse in the modern construction sector.

Rapid economic growth has resulted in equally rapid structural change. Although agriculture, dominated by rice, has grown strongly, its share of GDP has fallen sharply from about 55% in the early 1990s to one-third currently. About half of this decline is explained by the rise of manufacturing, the share of which has increased by 10 percentage points over the period. This transformation is consistent with the generalized structural change that occurs in the process of economic development. But in Cambodia's case there is a special

[2] Unless otherwise indicated, our data sources are the WTO (2012) report, the Asian Development Bank database, World Bank, World Development Indicators database, International Monetary Fund, World Economic Outlook database, and the UNCTAD trade statistics. All Cambodian data should be regarded as approximate.

factor at work. The export-oriented garments sector dominates manufacturing, generating more than half its output and almost 80% of the country's merchandise exports. This sector owed its existence initially to preferential market access arrangements that were provided to the country during its rehabilitation phase. This dynamism was maintained owing to the country's very open trade and investment policies, and generous fiscal support for the industry. The service sectors have also grown rapidly, particularly trade, transport, communications, and personal services. Apart from the general rise in incomes, the two key drivers of this services growth have been tourism, centred on the world famous Angkor Wat temple complex, and the booming capital city, Phnom Penh.

Figure 1: Economic Growth and GDP per Capita, 1992-2012



Source: International Monetary Fund, World Economic Outlook Database, April 2013

In spite of this rapid growth, economic activities remain narrowly based and externally dependent. The non-agricultural economy is dominated by tourism, garments and construction. Both tourism and garments are highly export-oriented, while much of the construction sector is financed by foreign capital. This openness is both inevitable and desirable, but it does pose particular development policy challenges to which we return in section 4.

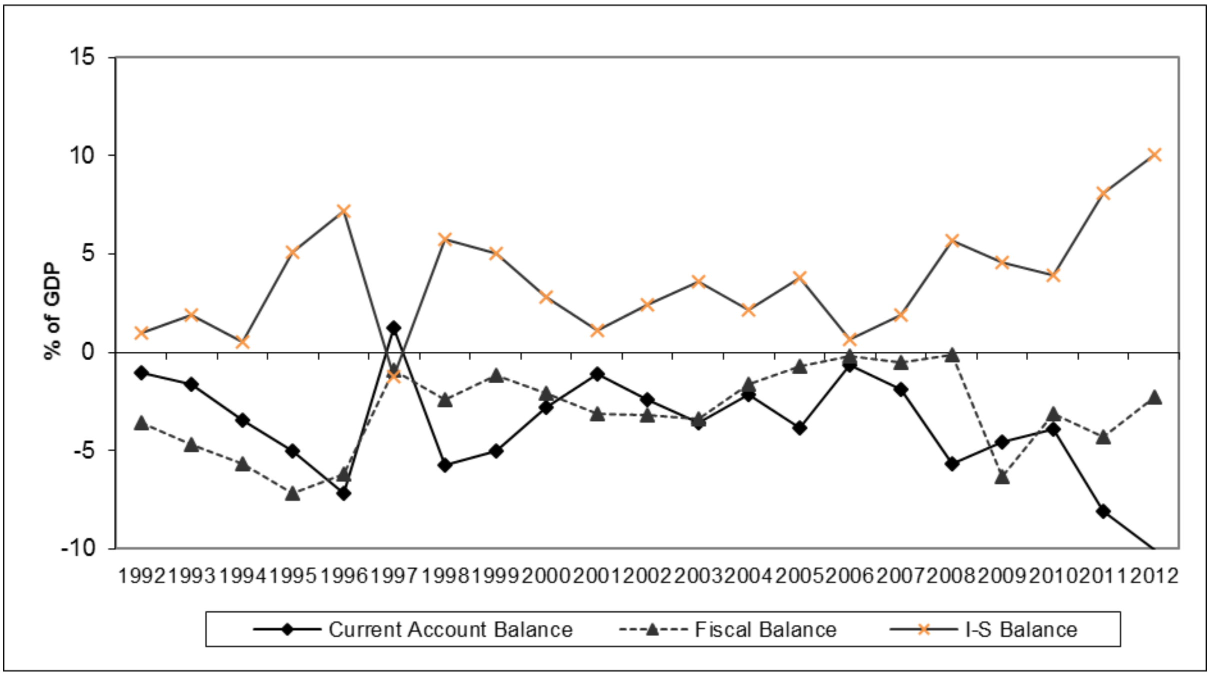
Table 1: The Composition of GDP by Sector

	1990		2000		2012	
	Riel bil	% of GDP	Riel bil	% of GDP	Riel bil	% of GDP
Agriculture	*333*	*55.6*	*5,065*	*35.9*	*18,999*	*33.6*
		0.0		*0.0*		
Industry	*67*	*11.2*	*3,078*	*21.8*	*12,959*	*22.9*
Mining	3	*0.5*	34	*0.2*	439	0.8
Manufacturing	31	*5.2*	2,255	*16.0*	8,563	15.1
Electricity, gas, and water	2	*0.4*	58	*0.4*	294	0.5
Construction	30	*5.0*	732	*5.2*	3,662	6.5
		0.0		*0.0*		
Services	*190*	*31.7*	*5,231*	*37.1*	*21,409*	*37.8*
Trade	56	*9.4*	2,033	*14.4*	7,722	13.6
Transport & communications	23	*3.8*	930	*6.6*	4,264	7.5
Finance	41	*6.8*	1,030	*7.3*	4,099	7.2
Public administration	28	*4.7*	377	*2.7*	858	1.5
Other services	42	*7.0*	861	*6.1*	4,466	7.9
		0.0		*0.0*		
Less: Imputed bank service charges		*0.0*	*155*	*1.1*	*661*	*1.2*
Taxes less subsidies on production and imports	*9*	*1.5*	*870*	*6.2*	*4,006*	*7.1*
		0.0		*0.0*		
Gross domestic product (in billion riels)	*599*	*100.0*	*14,089*	*100.0*	*56,617*	*100.0*

Sources: Downloaded from Asian Development Bank's Statistical Database System (SDBS);
Date of download: Fri Oct 25 12:43:21 PHT 2013

Also reflecting the country's history, Cambodia's macroeconomic policy framework is unusual. As a large aid recipient, it has been able to run very large fiscal and current account deficits that have been sustainable and non-inflationary because they have been financed by aid that is highly concessional in nature. Especially during the 1990s rehabilitation period, aid flows were equivalent to at least 5% of GDP and sometimes higher. The country was therefore able to run large fiscal deficits without running into serious debt problems (Figure 2). Tax collection procedures are also rudimentary, resulting in a high dependence on these aid flows for the provision of government services. Moreover, the government has adopted a very liberal stance towards foreign investment, and the resultant large capital inflows, combined with the aid flows, financed very large current account deficits, in several years in excess of 5% of GDP. Domestic savings, that were negligible in the wake of the country's protracted conflict, began to rise quickly, but investment rose more quickly still. Thus the large current account deficits reflect the fact that much of the country's investment continues to be financed externally.

Figure 2: Macroeconomic Balances, 1992-2012

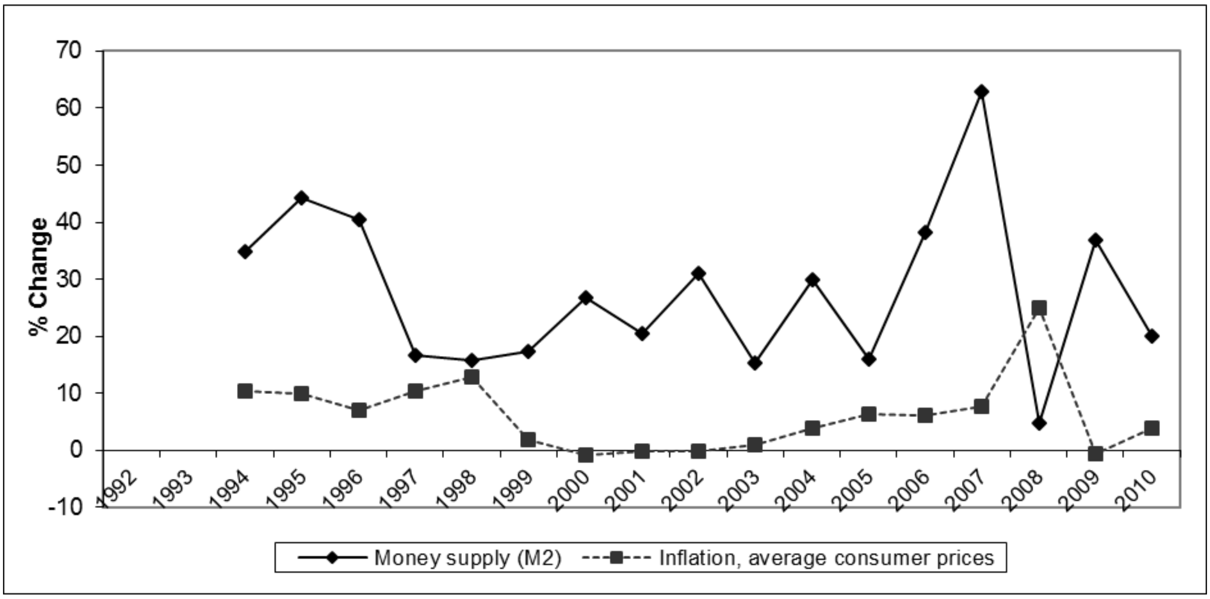


The monetary policy framework is also unusual, but reasonably effective. In the transition from plan and conflict to market and peace, the country briefly experienced an episode of hyperinflation. The immediate cause was the abrupt cessation of Soviet aid, then equivalent to about 15% of budget expenditure, in the late 1980s, and the government's resort to large-scale deficit financing to cover the shortfall. However, the 1991 peace settlement ushered in very large aid flows from western donors, and inflation fell quickly (Figure 3). It has been under control ever since, and mostly at single digit levels. There have been occasional spikes, such as in 1997-98 as a result of domestic conflict and the Asian financial crisis, and in 2007-08, as a result of rapidly rising food prices and then the government's program of fiscal stimulus in response to the economic slump in 2008. The moderately low inflation rates have been achieved in spite of substantially higher rates of monetary expansion (Figure 3), indicating both monetary restocking as household and business confidence in the financial sector has been restored, and a loose relationship between monetary and price movements. The high levels of dollarization established in the early 1990s have persisted, and as a result the nominal exchange rate has come to serve as the government's de facto nominal anchor for inflation. We return to this issue in section 4.

(3) Cambodian Trade and Commercial Policy

We now examine Cambodia's trade policy and external commercial relations. We draw mainly on the WTO (2012) report, supplemented by some additional contextual information that facilitates an understanding of these trade policies and patterns. Cambodia is a highly open economy, with few restrictions on trade and capital flows; labour flows are also relatively unregulated. This openness is a result of the policy framework established during the United Nations transitional rule. In turn, the Cambodian leadership has explicitly embraced open trade and investment policies. Figure 4 shows the trends and magnitudes of the key external transactions. Merchandise trade has risen dramatically since the early 1990s re-engagement with the global economy, in nominal US dollar terms by about 20-fold over just two decades, from equivalent to about one-third of GDP to almost one and half times its magnitude at the peak in 2006-07. Foreign investment flows have also been very large, equivalent to about 10% of GDP in most years. On these indicators, Cambodia is one of the most open economies in the Asia Pacific region.

Figure 3: Money and Inflation, 1992-2011



Sources: Inflation - International Monetary Fund, World Economic Outlook Database, April 2013;
M2 Growth - ADB Statistical Database System

These trade and investment statistics should of course be regarded as approximate. The country's statistical collection apparatus, like the civil service in general, is still very weak. International borders are very porous, resulting in large unrecorded trade flows, especially with its two large neighbours, Thailand and Vietnam. (Although the low formal trade barriers mean that smuggling as an evasion strategy is modest.) Prior to the 1990s, there was also substantial trade with the former Comecon bloc that was not recorded in the UN trade data system, and so to that extent the initial (ie, early 1990s) values were not as low as indicated in Figure 4. With regard to investment, the formal 'foreign' investment totals may be an understatement to the extent that there is substantial investment from the country's large international diaspora that enters as domestic investment. Moreover, as is commonly the case in post-conflict societies, much of the country's political and commercial elite hold dual passports, with Australia, France and the US home to the major Cambodian populations living abroad.

Figure 4: Indicators of Openness (Trade and Investment), 1992-2010

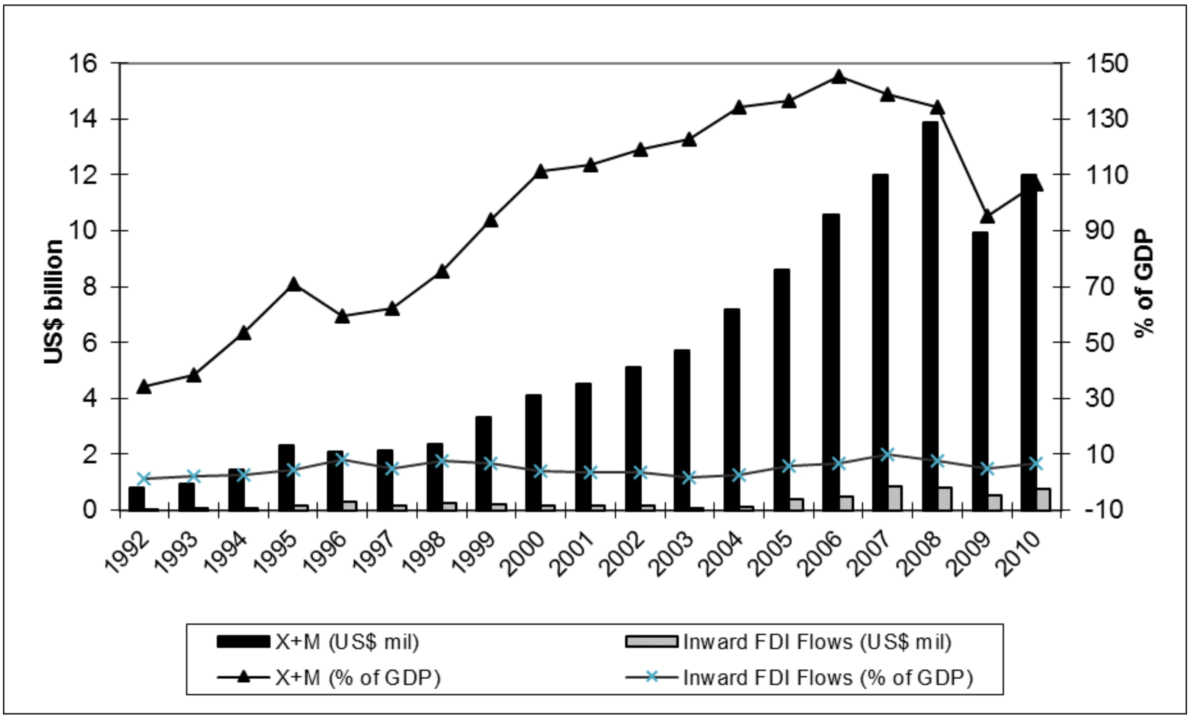
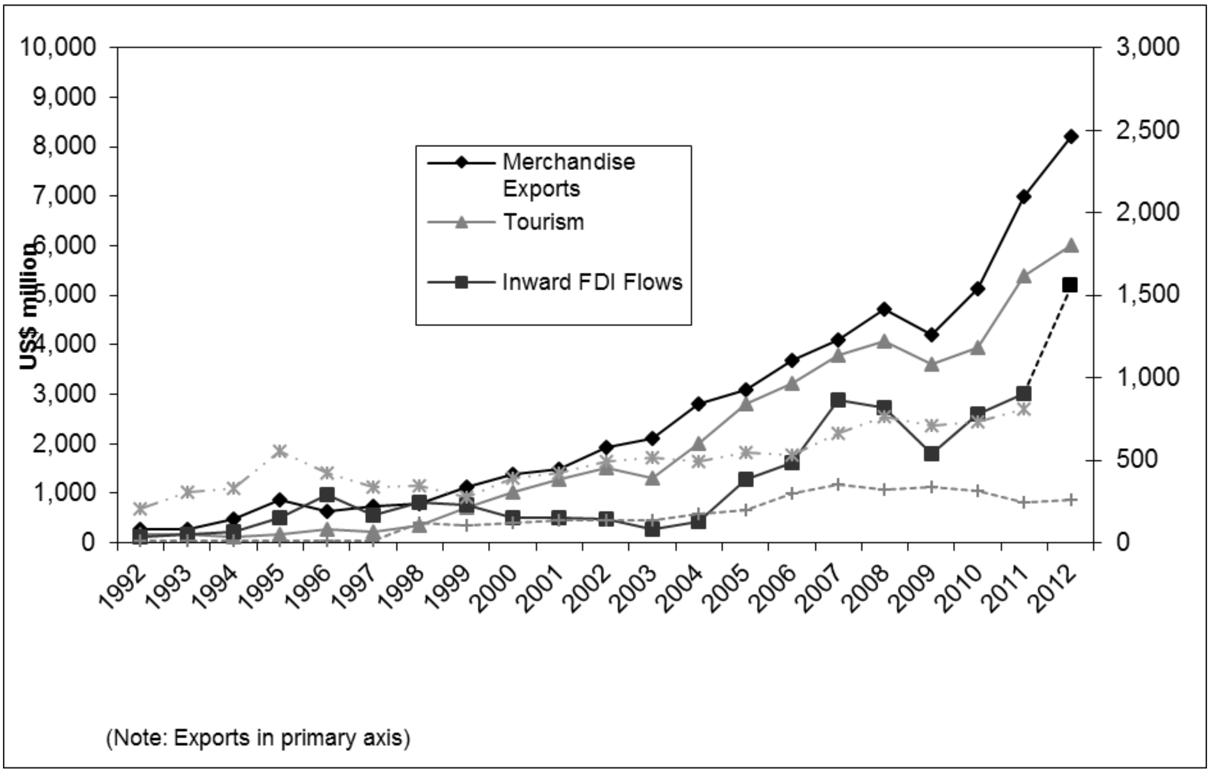


Figure 5 provides orders of magnitudes for some of the major flows in both the current and capital accounts of the balance of payments over the period 1992-2012. Merchandise exports, dominated by garments, are a major source of foreign exchange earnings. Apart from the dip during the 2008 slowdown, they have been rising rapidly throughout the period. Receipts from tourism are the next largest, and are unusually large relative to merchandise exports, in some years almost equal in value, and currently equivalent to about three-quarters of the value. Their rapid rise can be traced to the restoration of the security situation from the late 1990s, the opening up of the Angkor Wat temple complex, and the development of tourism support infrastructure such as hotels and air transport. In the years immediately after the peace accord, official development assistance (ODA) was by far the most important source of foreign exchange, in some years larger than the sum of all the other flows. After peaking in the mid 1990s, it began to increase again modestly from the late 1990s. However, since 2006 foreign investment (FDI) has generally exceeded ODA. Remittances have been smaller in value, but like ODA more stable than FDI. Notably, during the global economic recession of 2008-09, exports, tourism and FDI declined, while ODA and remittances were stable, an important factor in the difficult task of macroeconomic stabilization over this period.

Figure 5: Major Exchange Flows



Cambodia's trade patterns reflect the interplay of regional growth dynamics and preferential access to the OECD markets, particularly the US. At the time it emerged from international isolation, its major trading partners were almost exclusively in the East Asian region (Table 2). In 1995, Singapore and Thailand alone accounted for more than half of its exports, which were dominated by simple wood products. This pattern changed dramatically following the normalization of relations with the US, and with the granting of preferential market access for the country's garment exporters. Thus, just five years later garments were the major export item, and the US alone accounted for almost 60% of total exports. The dominance of garments and the key role of the US has continued since 2000, albeit with encouraging signs of early-stage product and market diversification. The country has also enjoyed preferential access to the EU market following the implementation of the 'Everything but Arms' initiative in 2001. By 2012, the US share of total exports was little more than half that of 2000. Hong Kong and other East Asian economies have become important export markets, while footwear has also become a significant export item. The rise of East Asia will continue, reflecting the prolonged recession in the OECD countries and East Asian dynamism. The import patterns and sources are as would be expected, with East Asia the dominant source of imports, and petroleum and textile products the major items.

Table 2: Major Imports and Exports, by Country and Commodity and Composition

	Top Exports (SITC, Rev.3)	% of Total	Top Destinations	% of Total
1995	[247] Wood in the rough or roughly squared	38.2	Thailand	42.9
	[248] Wood simply worked, and railway sleepers of wood	18.3	Singapore	11.3
	[231] Natural rubber & similar gums, in primary forms	13.9	Viet Nam	5.7
2000	[845] Articles of apparel, of textile fabrics, n.e.s.	30.0	United States	59.6
	[841] Men's clothing of textile fabrics, not knitted	17.2	Germany	6.6
	[842] Women's clothing, of textile fabrics	15.8	United Kingdom	6.4
2005	[845] Articles of apparel, of textile fabrics, n.e.s.	29.2	United States	56.3
	[844] Women's clothing, of textile, knitted or crocheted	16.9	Germany	9.2
	[842] Women's clothing, of textile fabrics	16.0	China, Hong Kong SAR	6.6
2012	[845] Articles of apparel, of textile fabrics, n.e.s.	27.7	United States	31.5
	[844] Women's clothing, of textile, knitted or crocheted	15.8	United Kingdom	8.5
	[851] Footwear	8.1	Germany	8.2
	Top Imports (SITC, Rev.3)	% of Total	Top Sources	% of Total
1995	[122] Tobacco, manufactured	11.8	Singapore	37.0
	[785] Motorcycles & cycles	11.5	Thailand	24.7
	[334] Petroleum oils or bituminous minerals > 70 % oil	8.5	Viet Nam	6.2
2000	[334] Petroleum oils or bituminous minerals > 70 % oil	16.5	Singapore	17.1
	[655] Knitted or crocheted fabrics, n.e.s.	8.3	Thailand	16.8
	[652] Cotton fabrics, woven	8.0	China, Hong Kong SAR	15.0
2005	[655] Knitted or crocheted fabrics, n.e.s.	14.0	Thailand	19.8
	[334] Petroleum oils or bituminous minerals > 70 % oil	10.2	China	14.5
	[652] Cotton fabrics, woven	7.5	China, Hong Kong SAR	14.1
2012	[334] Petroleum oils or bituminous minerals > 70 % oil	17.5	Thailand	26.8
	[655] Knitted or crocheted fabrics, n.e.s.	11.5	Viet Nam	20.2
	[652] Cotton fabrics, woven	3.2	China	19.9

Source: UNCTADStat

	Top Exports	% of Total	Top Destinations	% of Total
1995	[TOTAL] Total all products	100.0	World	100.0
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As noted above, Cambodia is heavily dependent on trade taxes, which in all forms contribute over half of the government's total tax revenue (Table 3). The three main forms of import levies, customs duties, excise duties and VAT, account for almost all of this revenue. The export and other trade levies are trivial, in the category of nuisance taxes that could be abolished as part of a general reform. The data also indicate that foregone customs duties are very large, and exceed the value of those actually collected. This heavy reliance on trade taxes and the large customs revenue foregone are as would be expected for a transitional, dualistic economy. Their relative importance as revenue sources is declining over time as the tax base is broadened. As we argue below, the major policy challenge is to extend the VAT as quickly as possible, so that there is equal treatment between imports and domestically produced goods and services. This will facilitate continued trade liberalization, including full implementation of the ASEAN free trade agreement, and ensure that the government's fiscal position is not jeopardized.

Table 3: Trade Taxes and Government Revenue, 2004-10
(Billion riels and % share)

	2004	2005	2006	2007	2008	2009	2010
Total tax revenue[a] (billion riels)	1,656.2	1,989.8	2,391.6	3,584.7	4,688.7	4,332.2	5,070.0
					of which (%)		
Customs duties (after exemption)	21.9	23.1	22.7	19.5	19.2	17.3	16.9
Excise duties on imports	15	16.3	14.9	14.7	16.5	13.7	14.6
Gasoline/diesel taxes	5.3	4	4.3	3.3	2.5	3.7	3.7
VAT on imports	24.4	24.3	24	20	20.3	21.4	19.8
Export taxes	1.2	0.9	1	0.6	0.5	0.3	0.4
Others (fees & penalties)	1.8	2	2.2	2	1.8	1.1	0.8
Total international trade taxes	69.5	70.6	69	60.1	60.7	57.5	56.3
Forgone customs duties (billion riels)							
Customs duties before exemption	911.6	1,171.90	1,321.30	1,628.00	2,206.50	1,739.70	2,006.30
Customs duties after exemption	362.8	459.2	541.9	698.6	899	751.5	858.7
Exemption / forgone	548.8	712.7	779.4	929.4	1,307.50	988.2	1,147.60
Exemption % of CD before exemption	60.2	60.8	59	57.1	59.3	56.8	57.2

aT TR comprises direct taxes, indirect taxes and international trade taxes.
Source: WTO, 2012, p. 34.

With regard to the country's trade policy regime, as noted the tariff is the country's main protective instrument, in that there are relatively few non-tariff barriers (NTB's). As part of its WTO accession, the number of tariff lines was reduced to four, set at zero, 7%, 15% and 35%. Over time, the rates have been compressed, and most products placed in the lower or intermediate categories. The standard deviation of rates in 2011 was a relatively modest 9.2%. However, there is some escalation in the structure according to the level of processing, with the top tariff rate of 35% applied to a range of semi-processed and consumer goods, such as processed food products, beverages and tobacco, footwear and motor vehicles (Table 4). With relatively thin domestic value added, this probably implies high effective rates of protection in these cases. Effective rates of protection are not computed in the TPR study, presumably because Cambodia does not yet have an input-output table. Over three-quarters of tariff lines fall within the two intermediate tariff rates, 7% and 15% (Figure 6), leaving just 14% of tariff lines duty free and 10% at the top rate. Thus 53% of tariff lines are either zero or subject to the minimum tariff, up from 44% in 2001. Cambodia has bound 100% of its tariff lines, while the average applied rate of duty is estimated at 11.7%.

Table 4: The Tariff Structure, 2003, 2005, 2011 (%)

		MFN applied			Final
		2003	2005	2011	bound[a]
1	Bound tariff lines (% of all tariff lines)	..	100	100	100
2	Simple average rate	17.3	15.1	11.7	20.1
	Agricultural products (HS01-24)	20.6	17.7	15.4	28.4
	Industrial products (HS25-97)	16.7	14.8	11.1	18.6
	WTO agricultural products	20.6	17.9	14.5	28.8
	WTO non-agricultural products	16.8	14.8	11.3	18.7
	Textiles	15.7	10.8	5.7	10.4
	Clothing	30.3	27.2	14.1	17.5
	ISIC 1 - Agriculture, hunting and fishing	11.9	10.8	10	23.2
	ISIC 2 - Mining	11.8	10.2	6.5	17.7
	ISIC 3 - Manufacturing	17.7	15.4	11.9	20
	First stage of processing	12.2	10.8	9.3	21.2
	Semi-processed products	10.9	8.3	6.2	13.6
	Fully processed products	21.1	18.5	14.5	22.6
3	Domestic tariff "peaks" (% of all tariff lines)[b]	0.2	0	0	0
4	International tariff "peaks" (% of all tariff lines)[c]	28.1	20.8	9.9	46.7
5	Overall standard deviation of tariff rates	13.6	11	9.2	11.6
6	Coefficient of variation of tariff rates	0.8	0.7	0.8	0.6
7	Duty-free tariff lines (% of all tariff lines)	4.3	5.9	13.7	1.1
8	Non-*ad valorem* tariffs (% of all tariff lines)	0	0	0	0
9	Nuisance applied rates (% of all tariff lines)[d]	0.1	0	0	0

.. Not available.

a Based on 2011 tariff schedule. Cambodia implemented its tariff reduction commitments for all but 21 tariff lines by 2007. Tariff reduction commitments are to be met for 20 tariff lines by 2013.

b Domestic tariff peaks are defined as those exceeding three times the overall simple average applied rate.

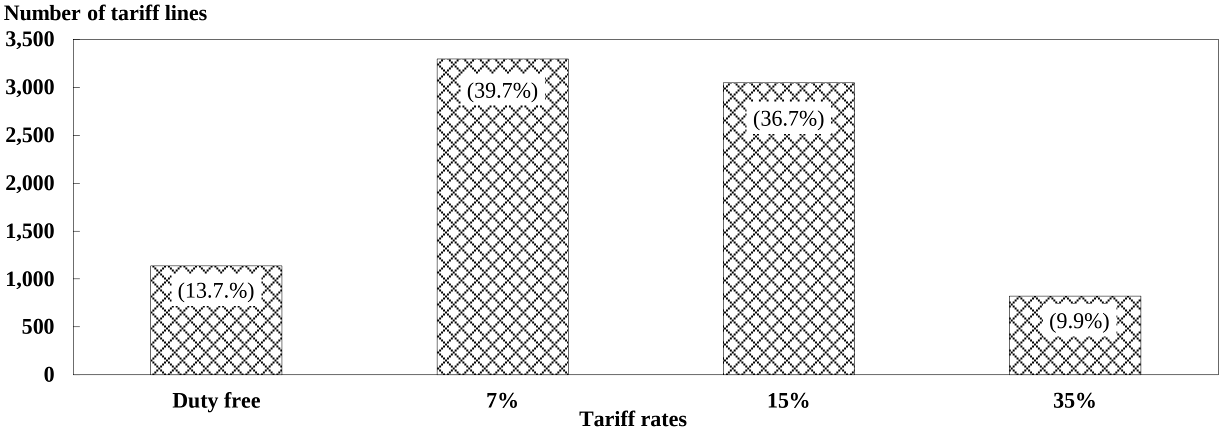
c International tariff peaks are defined as those exceeding 15%.

d Nuisance rates are those greater than zero, but less than or equal to 2%.

Note: The 2003 tariff is based on HS96 nomenclature, consisting of 6,809 tariff lines; the 2005 tariff is based on HS02 nomenclature, consisting of 10,689 tariff lines; and the 2011 tariff is based on HS07 nomenclature, consisting of 8,298 tariff lines.

Source: WTO, 2012, p. 36.

Figure 6: Distribution of MFN Tariff Rates, 2011



Note: **Percentages in brackets denote the share of total lines.**

Source: WTO, 2012, p. 36.

The regulatory regime has also been simplified. Import and export procedures have been streamlined. There are few import prohibitions. A small number of export taxes apply to encourage greater domestic processing. State trading companies are not major players. The government is also in the process of establishing the various technical standards required for certain industries, particularly in food industries. Special economic zones have proliferated, mainly to attract FDI. The export-oriented garment firms generally operate within these zones, and are able to import textiles on a duty-free basis. More recently, zones located on the Thai and Vietnamese border have been established to facilitate cross-border trade. In the Thai case the motive has been Cambodia's major labour-cost advantage, with its unskilled wages being one-quarter to one-third of those in Thailand. In the case of the Vietnamese border, the main motivation has been proximity to that country's superior international port and logistics facilities.

Cambodia's service sector is one of the most open in the Asia Pacific region, with the government recognizing the importance of the tourism industry, and also the large deficit in modern-sector skills. Sensibly also, Cambodia has adopted an 'open skies' civil aviation policy, enabling direct international flights to the nearby city of Siem Reap. The country has benefited from not having to support a national airline that might have sought preferential market access. This feature is a more general reflection of the political economy of protection in Cambodia, namely the general absence of powerful commercial vested interests. In the wake of the KR, there was virtually no established private wealth in existence. Foreign firms are also able to operate in the legal services, accounting, banking, telecommunications, and transport industries. Foreign retailers are restricted to large supermarket and department stores, while the hotel market is open for establishments ranked at three-star or above.

Aside from its WTO membership, Cambodia's major international commercial agreement is the ASEAN Free Trade Area, under which tariffs on ASEAN products were reduced to 0-5% over a 10-year period commencing on January 1, 2000. Cambodia has now agreed to eliminate tariffs on essentially all ASEAN products by 2015, except for 7% of the tariff lines where tariffs will be eliminated by 2017. For products covered by its Sensitive List, the maximum tariff will be set at 5% by 2018. Cambodia is also bound by the tariff reductions agreed to in ASEAN's preferential trade agreements with China (by 2015), India and Korea (by 2018), Japan (by 2026), and Australia and New Zealand (by 2024).

(4) Beyond Trade Policy: Managing Globalization

Cambodia's open economic policies over the past 20 years illustrate both the opportunities and challenges for small transition economies with weak institutions in managing globalization. Its experience demonstrates that the benefits of openness far exceed the costs. The opportunities created by openness have been evident especially in the rapid growth in garments and tourism exports. These two sectors now generate about 71% of the country's exports of goods and services. They are by far the most important sources of non-agricultural employment, providing jobs for about one-seventh of the workforce.[3] For a country that was until recently war-ravaged and internationally isolated, the growth of tourism has been remarkable. International tourism receipts are now estimated to be equivalent to about 15% of GDP, a share that is almost double that of neighbouring Thailand, long famed as a tourism destination (World Economic Forum, 2012). Cambodia was able to build on it natural advantage, as host to the famous Angkor Wat temple complex. It has been able to do so not only because of the restoration of peace but also because of its openness, in civil aviation, hotel and related facilities.

As noted garment exports grew rapidly initially owing to preferential market access in the US and EU, and under the general auspices of the Multi-Fibre Arrangement. However, over time, these preferential facilities have become increasingly unimportant, as the MFA was phased out in 2005 and the margins of preference in major export markets have shrunk. However, apart from the global recession of 2008-09, the export growth rates have been maintained in this more competitive environment.

[3] Garments employs about 370,000 workers and tourism about 620,000, out of a total workforce of approximately 7 million.

Importantly, two other, related developments have occurred that flow from open economic policies. First, Cambodia was able to use the period of temporary export support to establish a country reputation among international investors and buyers, in garments and other light manufactures. This has had two consequences. One is that, as noted, the early heavy reliance on the US market is declining, for example from 55% in 2007 to 35% in 2012. This diversification to European and Asian markets places the industry on a more secure footing, and insulates it against a sudden decline in US demand due to a renewed recession or the granting of preferential concessions to alternative garment suppliers to that market. Another result has been the export diversification into other labour-intensive manufactures. The most important of these has been footwear, the exports of which have increased rapidly, from $88 million in 2008 to $311 million in 2012. In its factor proportions and international production and sales networks, footwear has much in common with garments. However, footwear exports are subject to less international regulation, and therefore their growth is an unambiguous indicator of the country's rising competitiveness.

Second, being open to commerce has meant that the country has been able to take advantage of unforeseen opportunities, particularly in the international relocation of labour-intensive manufacturing for export. For example, multinational enterprises with Asian production networks have long adopted a 'China plus one' risk diversification strategy. More recently, these firms have also adopted a 'Thailand plus one' strategy, in response to the serious floods in 2011 that incapacitated that country's production and logistics networks for several months. Thailand is the major export-oriented hub for the automotive industry in Southeast Asia, and therefore several MNEs, particularly from Japan, sought to establish production facilities in neighbouring countries. Cambodia's open economy and business-friendly environment has been a preferred destination, particularly as the government established special economic zones on the Thai-Cambodian border. These developments serve as a reminder that openness creates commercial opportunities that are difficult to predict, since they are often driven by exogenous factors that cannot be modeled, nor incorporated into the planning paradigms of those who favour more emphasis on governments pursuing selective industrial policies. Moreover, in small economies like Cambodia, a few major industrial projects can make a significant difference, both in terms of direct labour market impacts and in garnering community support for the success of the strategy, hence underpinning its durability.

Nevertheless, this openness has to be managed, to ensure that it delivers sustainable and equitable growth. Ongoing reforms will be required in Cambodia, as international donor support declines, as the country faces intensified competition from its neighbours with the implementation of the ASEAN Economic Community in 2015, and as living standards rise so that a new generation of job entrants seeks more productive employment opportunities. These issues are beyond the immediate remit of TPR reports, but they are crucial in understanding the context of trade policy. In this section, we therefore draw attention to them, as a means also of illustrating the challenges associated with managing globalization in small economies with weak institutions.

Openness introduces greatly economic volatility. This was evident in the 2008-09 global economic recession, when Cambodia's growth rate declined by eight percentage points, one of the sharpest falls in the Asia-Pacific region. Demand for its two major exports, garments and tourism, declined, while the private capital flows that had been financing much of the country's construction boom evaporated. The country therefore needs to have policies that ensure macroeconomic resilience, factor market flexibility and social support to navigate through these crises. As it turned out, the effects of the recession were quite short-lived, and by 2010 the economy was growing strongly again. But recurring negative external shocks will inevitably be a feature of this small, open and potentially vulnerable economy.

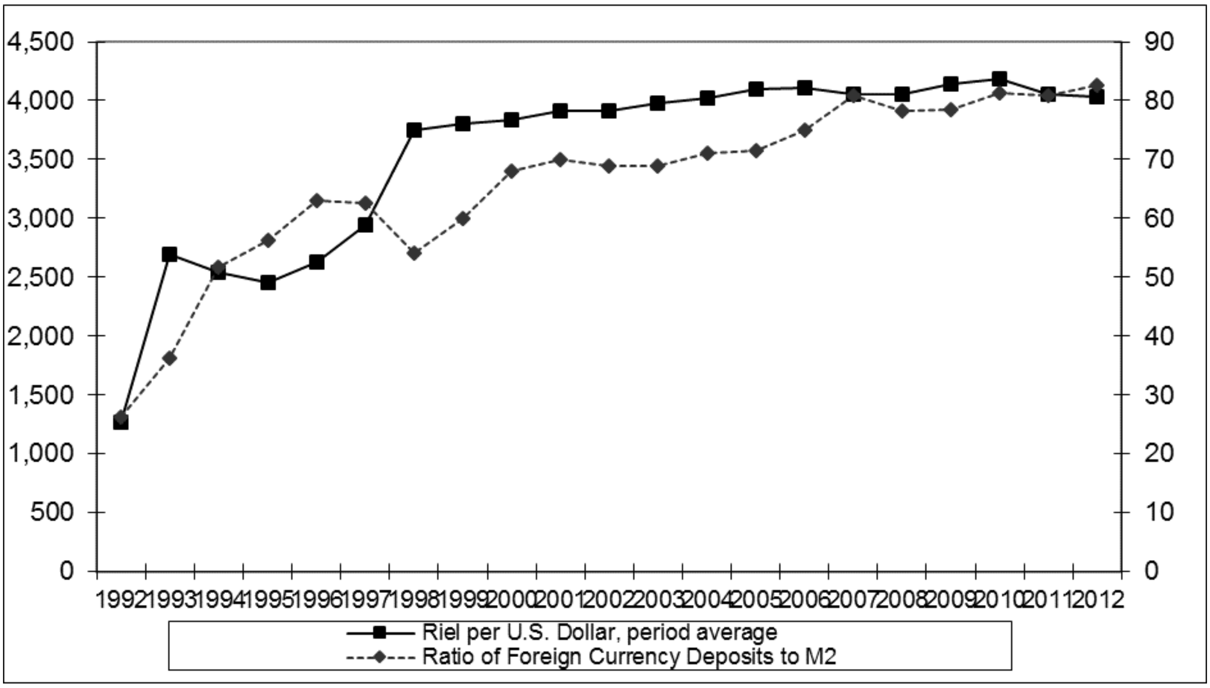
It is also needs to be noted that Cambodia has achieved export competitiveness in part through extremely low wages in the formal manufacturing sector. However, wages are now beginning to rise, owing to labour activism (aided in part by international NGO support) and the very rapid growth in demand. The export industries now have two decades of operating experience in Cambodia, but most production is confined to sewing and other simple processing activities. These are still internationally footloose activities without deep production roots in the country. Significant wage increases could endanger competitiveness unless labour productivity increases and ex-factory costs are reduced. Therefore continuous investments on the supply-side are needed, in improved education and more efficient infrastructure provision. Broad-based education investments are also required to enable the poor to participate in the expanding employment opportunities, and to help ameliorate the glaring inequalities that have emerged within the urban economy, and between it and the rural economy.

In turn, institutional development needs to accelerate, to support the development of an efficient market economy and to protect the interests of the poor and marginalized. Unsurprisingly for a country whose formal institutions were completely destroyed by conflict, and which has subsequently had only one prime minister in continuous rule for over one quarter of a century, political power is highly concentrated and patronage networks embedded in essentially one-party rule. Cambodia therefore ranks very poorly on most international comparisons of governance quality and corruption.

We now illustrate these challenges with reference to five specific policy issues. How these are managed will have a large bearing on whether the country can maintain its open commercial policies and its impressive development record.

<u>Exchange rate and monetary policy</u>: Reflecting its history and weak institutions, Cambodia is one of the most heavily dollarized economies in the world, apart from those that formally use the US currency or have adopted a hard peg to it. The monetary and financial systems were destroyed during the KR era, and over the next decade of civil war there was little confidence in the monetary system. As noted, there was also an episode of hyper-inflation in the transition from plan to market. The large UN presence and open economy from the early 1990s resulted in a very large inflow of foreign currency, principally US dollars. As Figure 7 indicates, dollarization, as measured by foreign currency deposits relative to broad money (M2), rose quickly to about 50%. It rose again to over 70% during the political instability of 1997-98, and has remained at this level ever since. Extended periods of low inflation and political calm have not yet had a discernible impact. In spite of official unease, and periodic drives to promote the use of the local currency, the Real, the government has reluctantly tolerated this high level of dollarization, as have neighbouring Laos and Vietnam.

Figure 7: The Exchange Rate and Dollarization, 1992-2012



With the nominal exchange rate exogenously determined, the ability of exchange rate policy to ease adjustments to such shocks is compromised. The real exchange rate changes required to move the economy toward equilibrium following a shock will require changes to wages, which may be slow to adjust and sticky downwards. Although it is unlikely that a small, open economy like Cambodia could pursue a totally independent monetary stance without capital controls, the issue is about the degree of discretionary power available to implement counter-cyclical monetary policy that dampens the effects of external shocks. Heavy dollarization removes almost all such discretionary power because capital inflows or outflows automatically change the money supply when a foreign currency can be used as a medium of exchange. The duration of crises are likely to be prolonged as a result, and their social costs magnified.

This is not the place to debate the pros and cons of the dollarization.[4] Arguably it has supported good macroeconomic management to the extent that it has effectively removed the scope for the government to engage in deficit financing through monetary expansion. In a country with very weak institutions, this must be counted as a major advantage. It does however mean that the government does not have an important macroeconomic policy tool at its disposal, namely monetary policy, and by extension exchange rate policy. For an open economy with a significant natural resource sector and in a region of floating exchange rates, the government therefore has limited capacity to manage large external shocks. For example, during 2008-09 the Thai Baht and the Vietnamese Dong depreciated significantly, and therefore these economies' competitiveness vis-à-vis Cambodia improved. The government also loses the revenue from seigniorage, although this is estimated to be small, in the range 0.1-0.5% of GDP.

The implication is that the adjustment to external shocks has to come from fiscal policy and the labour market. The government was able to undertake a modest fiscal stimulus in response to the economic recession of 2009, and Cambodia's labour market is quite flexible. If dollarization persists, as is likely at least in the short to medium term, these policy areas will need to be strengthened. There are also implications for trade policy. To the extent that there may be periods of exchange rate misalignment, as in 2008-09, pressures from the tradable goods and services sectors for compensating support may arise.

<u>Strengthening and broadening the fiscal base</u>: Cambodia's comprehensive tax policy and administration reforms over the last two decades have helped increase domestic revenue from 6.5% of GDP in 2003 to more than 10% in 2011. The introduction of a VAT has helped broaden the tax base, and three indirect taxes - the VAT, excise, and turnover taxes - have accounted for an average 60% of all collections over the past five years. While trade taxes accounted for about 40% of revenue in the late 1990s, their share has been falling gradually

as tariffs have come down and they now contribute only about 20% of tax revenues. Unlike the original ASEAN member countries, however, Cambodia has resisted multilateralizing its tariff preferences and in principle retains multiple rates associated with its various preferential trade agreements, increasing the administrative burden on customs and creating opportunities for rent-seeking.

In passing, the Cambodian trade reforms, and the government's high reliance on trade taxes as a source of revenue, especially in the 1990s, also highlight the challenge of implementing trade liberalization while building fiscal consolidation. The empirical evidence on the fiscal implications of trade liberalization is mixed, as was pointed out by Greenaway and Milner (1991) over two decades ago. In some cases trade liberalization has led to fiscal enhancement while in others it has led to fiscal depletion. It is not yet clear which conclusion applies to Cambodia. But as the country begins to graduate from ODA it is obvious that a much more vigorous tax effort will be required.

Recent developments on the revenue side include the updating of the medium term revenue mobilization policy and strategy (2013-2018), the introduction of various non-tax revenue sources and property taxes, and the strengthening and updating of the 'Asycuda' system facilitating an automated customs clearance process. While these programs and policies are steps in the right direction in improving the revenue mobilization effort, the binding constraints relate to issues of administration and governance, which continue to limit the collection of taxes. The presence of a large informal sector, consisting mainly of small and unregistered traders, further constrains the ability of the government to raise tax revenues. The share of total government revenue in GDP has remained relatively stagnant at about 10% since 2009, suggesting that the reform momentum has slowed. Therefore, and despite good progress historically, Cambodia's revenue share makes it the second lowest among Asian low-income countries, for which the average is 17% (IMF, 2012).

<u>Improved infrastructure and logistics</u>: While Cambodia is a very open economy, it is much less competitive with regard to 'behind-the-border' infrastructure and logistics services. Thus the benefits of low tariffs are nullified somewhat by high internal transport, utility and regulatory costs. For example, trade facilitation costs are estimated to be about 136% of those in the six major Southeast Asian economies, while the 'release time' for cargo is 24 days, as compared to the regional average of 16 days.[5] Costs in the country's major international port, Sihanoukville, are about double those of the port servicing neighbouring Ho Chi Minh City, Vietnam. For reasons of scale, speed and economy, export-oriented

[4] See Menon (2008) for a detailed discussion.

enterprises in the capital, Phnom Penh, prefer to trade through the Vietnamese port. This in turn requires two sets of customs procedures and, since the region's trucks are not licensed to operate across borders, the reloading from one set of trucking operations to another. Cambodia also has the most expensive power costs in Southeast Asia, with electricity charges in Phnom Penh being about double those of Kuala Lumpur and four times those of Ho Chi Minh City.[6] Owing to the unreliability of supplies, most firms resort to expensive private generating capacity.

Five factors complicate the development of high-quality logistics in Cambodia. First, there is the large historical backlog, as a result of the protracted conflict, which not only resulted in extensive destruction but also little new investment and maintenance for more than one-quarter of a century. Unexploded ordnance along the more remote regions of the border with Vietnam also complicates infrastructure development. Second, the country's unusual economic geography poses challenges. There are five principal centres of economic activity, in addition to several second-tier cities. These are the capital, Phnom Penh; the special economic zones along the east and west borders with Vietnam and Thailand respectively, with export-oriented activities more connected to these economies than with the rest of Cambodia; the port city of Sihanoukville; and the tourism complex centred on Siem Reap. The dispersed nature of these economic centres requires a larger road network than would otherwise be the case. Third, although the country is not land-locked, its major international sea connections are the ports of these two neighbouring economies. Therefore, to this extent, Cambodia is quasi land-locked, and cross border customs and transport procedures have to be improved for the smooth flow of goods. Sihanoukville is unlikely to have the trade volumes to justify investments in large-scale container shipping, although efficiency levels could be increased. Fourth, much of the major infrastructure provision is donor-driven, and it tends to lack nationally integrated coordination, for example in the connectivity between major highway routes and the much inferior secondary feeder road networks. There is also a lack of provision for maintenance work, especially in the road network. Finally, the capacity to manage logistics provision is still weak, reflecting the overall state of the bureaucracy. Large infrastructure projects are seen as one of the principal means of personal enrichment within the poorly paid bureaucracy, sections of which are perceived as available to the highest bidder.

<u>Social investments</u>: Cambodia's tragic historical legacy is nowhere more evident than in the case of education. Virtually the entire educated class perished or fled the country in the

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[5] Most of the data in this paragraph are sourced from CTIS (2013).

[6] See "The 21st Comparative Survey of Investment-Related Costs in 31 Major Cities and Regions in Asia and Oceania", JETRO, Tokyo, April 2011.

1970s. During the 1980s there was little investment in education and health owing to the ongoing conflict and the need to divert the government's meagre fiscal resources into defence and security. The country also has a very young population, with 60% aged 25 years or less. Since the early 1990s, education enrolments have increased quickly, with a target of universal primary education by 2015. However, the school dropout rates are still high, even for primary education, with only a little over half of pupils commencing grade 1 continuing through to grade 5. These dropout rates are of course highly correlated with socio-economic class and remoteness. In comparative maths and science tests, the country also ranks very low.

Table 5 shows summary education indicators over the period 1990-2010. Although the adult literacy rate has risen from 81.5% in 1990 (a figure that is probably overstated) to nearly 93% in 2009, increases in net enrolment rates have been minimal, and dropout rates remain high at 12%. In 2010, the typical Cambodian aged 15 years and above had only 4.5 years of primary schooling on average. Non-attendance and dropouts are typically determined by the development context that translates into household conditions, including poverty, the need to do household chores, or contribute to the generation of household income (World Bank 2012).

Table : Cambodian Education Indicators

	1990	1995	2000	2005	2010
Adult (15+) literacy rate (%). Total	81.5	-	-	92.0[a]	92.6[b]
Barro-Lee: Average years of primary schooling, age 15+, total	2.9	3.4	4.0	4.3	4.5
Net enrolment rate. Primary. Total	94.6	92.5	90.1	92.4	96.5
Drop-out rate. Primary. Total	20.3	10.8	14.1[c]	16.6[d]	12.0
Percentage of repeaters in primary. All grades. Total	9.8	7.6	6.2[e]	4.6	3.3

Notes: [a] data for 2006; [b] data for 2009; [c] data for 2001; [d] data for 2004; [e] data for 2001; [f] data for 2002
Source: World Bank, World Development Indicators, data downloaded 20 November 2013.

Apart from increasing retention rates in schools, there is a pressing need to improve the quality and relevance of skills of its workforce. Most enterprise surveys report skill shortages to be among the most serious constraint. In the 2007 Investment Climate Survey, 15.5% of the foreign firms surveyed reported skills as a major constraint to growth, while another 22% of the firms identified skills as a 'severe' or 'very severe' constraint to their businesses. In a more recent survey of 78 employers, 73% reported that university graduates did not have the right skills, and 62% noted that vocational training graduates did not have the right skills mix (World Bank, 2012). While the number of tertiary education establishments and vocational training programs and institutes has grown sharply, these findings point to the need to significantly improve quality. There is also a mismatch between the education suppliers, market demand and societal needs. The tertiary education system trains large numbers of low-cost commerce, management and related disciplines (about half the student enrolments in 2009), many of whom have little prospect of employment commensurate with their aspirations. By contrast, the system produces very few students in more expensive but much needed disciplines, such as agriculture and rural studies (2.3% of the tertiary total) and science and technology (0.1%). The technical and vocational education system is also underdeveloped, in spite of the high private returns from such education.

The education catch-up and reform agenda is therefore a very large one. It will become more pressing as regional and international competition intensifies, including from other low-wage suppliers in emerging Myanmar, South Asia and elsewhere. There will need to be greater public expenditure to achieve higher quality basic education at primary and at least lower secondary levels, with a particular focus on areas of disadvantage. For higher and technical education, the main challenge will be to make markets work more effectively, which will involve the establishment of effective accreditation mechanisms, curriculum support, and needs-based student financing. Cambodia's very open labour market can help overcome supply bottlenecks during this transitional period, although there is community resistance to the large presence of Chinese, Thai and Vietnamese workers, the most obvious sources of supply for middle-level technical and professional workers. Unusually for a low-income country, especially one located adjacent to the open Thai labour market with its much higher unskilled wage levels, Cambodia is probably a net labour importer.

<ins>Bureaucratic reform</ins>: As would be expected, most comparative surveys highlight Cambodia's weak formal institutional quality. It ranks 164th out of 182 jurisdictions in Transparency International's Corruption Perception Index. According to the World Governance Indicators, the country is placed in the 8th percentile in terms of control of corruption, but a good deal higher (36th percentile) with regard to regulatory quality. It performs somewhat better on the Heritage Foundation's Index of Economic Freedom (102 out of 179 jurisdictions), and the World Bank's Ease of Doing Business (102nd out of 179). Property rights, particularly land ownership, are a major problem, with implications for financial development, social trust and cohesion, and income distribution (Naron, 2011). Hard land titles exist only in the capital city and a small number of secondary urban centres.

This limited institutional capacity has major implications for the process of regional and global economic integration. The government struggles to negotiate and comply with complex international trade agreements, especially the ‘trade plus’ clauses such as intellectual property rights, government procurement, sanitary and photosanitary measures, and rules of origin. There is substantial informal cross-border trade that is largely unregulated. Customs regulations and procedures are opaque, resulting in a flourishing secondary industry of agents and ‘brokers’ who facilitate these transactions (CTIS, 2013). In an effort to overcome these problems, the government has established special economic zones, most privately owned, that provide an integrated package of infrastructure, logistics and regulatory compliance. This second-best measure has created a ‘dualistic’ economic structure that effectively discriminates against small-scale, start-up and rural enterprises that do not have the requisite resources to locate in the zones, or whose location is determined by input supplies. But the zones are arguably the most effective transitional response pending broader economy-wide reform.

(5) Conclusions

The first TPR on Cambodia demonstrates that the economy is comparatively open, formal trade barriers are relatively low, and they mainly take the form of tariffs. There is no attempt to estimate effective rates of protection in the report, but these also are likely to be generally low, apart from a few cases of tariff escalation. The Cambodian government has deliberately chosen this open-economy strategy, an outcome made easier by the absence of major commercial vested interests, such as state enterprises and large industrial conglomerates, lobbying for protection. From an extremely low and narrow base, exports have grown strongly, accompanied by some product and market diversification. The early heavy reliance on trade taxes in the budget is also declining, though it remains high. The country has been able to build effectively on preferential export market access, particularly for garments to the US, and it has now established a modest country reputation as an attractive location for footloose, labour-intensive activities. For example, it was able to capitalize on the opportunities created by MNE’s adopting a ‘Thailand plus one’ strategy, especially in the wake of that country’s massive supply side disruptions as a result of its 2011 floods and ongoing political disturbances. These impressive achievements are further consolidated by Cambodia’s membership of the dynamic Southeast Asian regional trade and investment arrangements, including the ambitious ‘seamless market’ to commence in late 2015 as part of the ASEAN Economic Community. The growing integration that flows from the expanding cross-border road networks as part of the six-nation Greater Mekong Sub-Region infrastructure programs is also a contributing factor.

Cambodia has grown rapidly because of good economic policies, combined with the return of peace, a conducive neighbourhood effect and large inflows of capital, both concessional finance in the 1990s, and increasingly private flows over the past decade. Development outcomes have been significantly better than could have been imagined at the outset of this period. It is arguably the fastest-growing post-conflict economy in recent history.

However, its experience also illustrates that a strategy of economic openness is a necessary but not sufficient pre-requisite for rapid, broad-based development. The major barriers to economic integration are now principally behind the border, including high logistics and infrastructure costs, opaque regulations, a weak legal system and high levels of corruption. Moreover, social outcomes have lagged economic growth and economic development is narrowly based. The glaring inequalities associated with the inflows of foreign capital and skills, and the concentrated domestic political patronage networks that benefit from this inflow, threaten to undermine social cohesion and may provoke a nationalist backlash. To ensure that the openness is broadly beneficial and durable, the impressive progress to date will need to be accompanied by a higher priority for social expenditures, extending the tax base to the very wealthy, a more inclusive political system, and institutional, legal and civil service reform.

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