CDRI – Cambodia's leading independent development policy research institute

Cambodia Outlook Brief

2014, № 01

Cambodia the Next Five Years - An Agenda for Reform and Competitiveness

> "There has never been a more important time for us all to work together for Cambodia's peace, stability, development, and future prosperity."
>
> *Samdech Akka Moha Sena Padei Techo HUN SEN*
> *Prime Minister, Kingdom of Cambodia*

Strong Foundations for Change

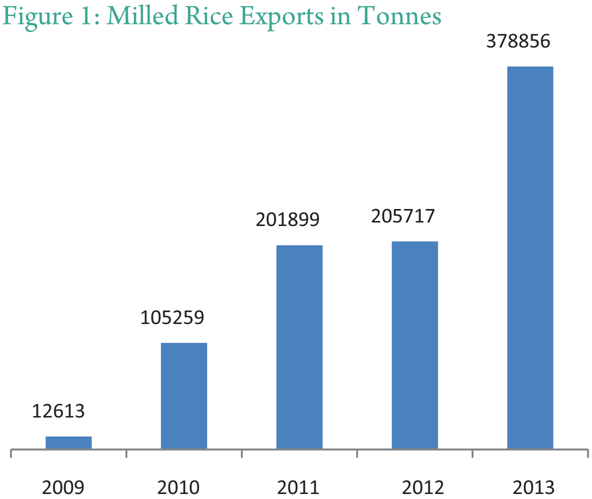
Cambodia is entering a new phase of growth as change is expected in the structure of its economy, the aspirations of its population and regional market conditions. Two major transitions are forecast in the next five years: integration into the ASEAN Economic Community (AEC) will open new markets for Cambodian products, but also lead to increased competition from regional producers; Cambodia's comparative advantages will shift from low-cost labour-intensive production as it graduates to lower middle-income country status.

Policy makers are in a good position to navigate this transitory period following two decades of strong GDP growth. In terms of high and consistent growth, the Cambodian economy is one of the success stories in the latter half of the 20th century – it averaged 7.8 percent annually in the period 1994-2011. Growth registered 7.6 percent in 2013, and is forecasted to remain at around 7 percent annually over the next five years.

This is a summary of the 2014 Cambodia Outlook Conference Session 1 panel discussion. Participants included H.E. Vongsey Vissoth, Secretary of State, Ministry of Economy and Finance; Dr Faisal Ahmed, Resident Representative, International Monetary Fund (IMF), Cambodia; Ms Lay Sokunthea, Chief Executive Officer, CSCS Cornerstone Co., Ltd; Dr Jayant Menon, Lead Economist (Trade and Regional Cooperation), Office of Regional Economic Integration, Asian Development Bank Manila. The session moderator was Mr Grant Knuckey, CEO, ANZ Royal.

Figures for 2013 show that Cambodia's remarkable trend of export-led growth continues. Total exports increased by 16.2 percent in 2013, the equivalent of USD6.99 billion, driven by strong performance in the economy's core sectors. Garment exports grew by 17.3 percent, footwear by 21.3 percent and tourism by 17.3 percent. Exports of milled rice increased by 84 percent, reaching nearly 379,000 tonnes, continuing a trend of strong growth in output since 2009 (Figure 1). Foreign Direct Investment (FDI) is estimated to reach USD1.22 billion in 2013, surpassing pre-global financial crisis levels though falling short of 2012's all-time high of USD1.41 billion.

Figure 1: Milled Rice Exports in Tonnes



Source: Ministry of Economy and Finance

A PRODUCT OF THE 2014 Cambodia Outlook Conference: A Partnership of CDRI and ANZ Royal.

Prudent macroeconomic policies have meant inflation has stayed low during the past two decades, averaging 5.5 percent from 1994-2011. In 2014 it is expected to fall further, to between 3 and 4 percent, in spite of high regional inflation and a spike in oil and food prices.

Other macroeconomic indicators also suggest a stable outlook: in 2013 the riel maintained stability against the dollar, bank deposits and loans grew, there was adequate liquidity in the market, and external debt declined slightly to just over 23 percent of GDP. Overall the budget deficit as a proportion of GDP is estimated at 6.8 percent and will be reduced to below 5.3 percent in 2014. The government aims to reduce this figure further to the pre-global financial crisis level of 3 percent in the medium-term. Encouragingly, there have also been strides in improving public revenue collection: in 2014 the government expects a year-on-year increase of 14.5 percent in tax payments.

Strong macroeconomic performance has translated into poverty reduction. Poverty incidence declined from 53 percent of the population in 2004 to 20 percent in 2013. If current trends continue, the Cambodian Millennium Development Goal to halve poverty between 2000 and 2015 will be met.

Policy makers must build on these solid foundations a diversified and competitive economy that can improve on past successes during Cambodia's next phase of growth.

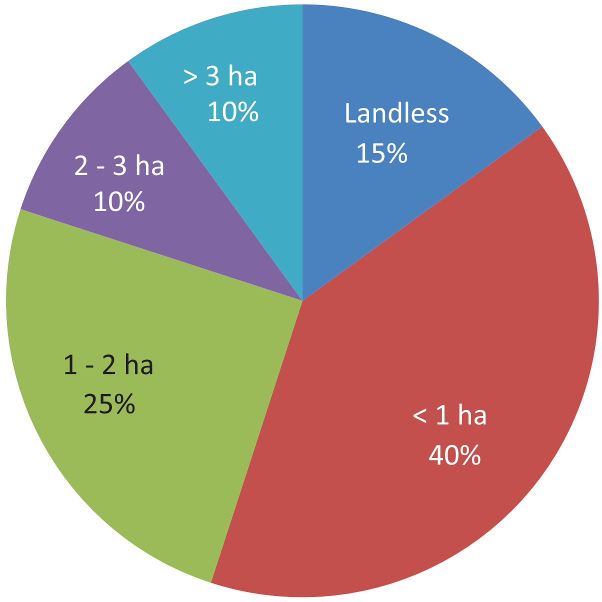
Inclusive Development a Priority

To maintain stability and growth during the coming period of social, economic and political transition will require polices that ensure high GDP growth is shared equitably across the population. Countries with low rates of poverty and inequality, and strong property rights supported by equitable, transparent institutions have fared better in cross-country comparisons of long-term economic growth. Governments also have obligations to their populations that necessitate working for a more just and equal society.

Despite major gains in poverty alleviation over the past two decades, Cambodia's poor remain vulnerable to even small fluctuations in income. In 2009, CDRI found that one in five was subsisting on a daily consumption of less than USD1.25; one in two was living on a daily consumption of less than USD2. Such households are vulnerable to shocks resulting from natural disasters, such as floods and drought, or costs stemming from healthcare services.

Asset inequality, particularly land inequality and the related problem of tenure insecurity, is a major cause of poverty. Currently 55 percent of all rural households are land poor (Figure 2); they either have no land or are limited to cultivating subsistence crops. These households are stuck in a cycle of poverty, and are unable to create a surplus to contribute to growth.

Figure 2: Ownership of Agricultural Land for Rural Households in 2011



Source: CSES 2011

The Prime Minister has pledged to build the capacity of land administration institutions to legally protect small-holders' property rights from expropriation and spur investment, highlighting this as the policy priority of the fifth legislature. In addition, efforts will continue to increase regulation of Economic Land Concessions (ELCs) and redistribute land where appropriate.

The extension of land titles that confer secure land ownership has widely been viewed as a precondition to economic diversification by promoting industrialisation. In Newly Industrial Countries (NICs), experience shows that households with hard titles are more likely to leave their land and migrate to urban centres to drive industry, an important requisite for economic transformation. Land titles also contribute to a process of market formalisation by providing a basis for the extension of formal credit and service infrastructure.

Crucial to including the rural majority in growth is the removal of all constraints to small-holder productivity – coordinated policy action will be required to achieve this. Key constraints include high production and trade costs, the prevalence of traditional farming practices, and lack of training infrastructure. Lack of health care provision and social safety nets compound these issues by diverting resources from productive activity: it is estimated that the problem of malnutrition could negatively affect GDP by up to 2.5 percent over the next five years.

Government must also include poor populations that do not own agricultural land in growth. In rural areas this means promoting employment opportunities in cassava and rubber plantations, developing fisheries and providing training for off-farm jobs. Increasingly, rapid urbanisation resultant from growth in industrial and service sectors is creating a class of urban workers. It is essential that policy addresses vulnerability in this population. The government must develop fair national wage policies that balance the need for competitive production costs with decent living standards for workers and establish a social safety-net system to protect vulnerable households from economic shocks.

Training and education have been prioritised by the government as crucial tools for inclusive development. Technical skills need to be extended so that the underemployed rural workforce have the skills necessary to drive industrialisation and diversification. This will require the scaling-up of Technical and Vocational Education and Training (TVET) schemes and their extension into peripheral areas. Training is also important for those that remain in agriculture so that new farming practice can drive up productivity.

Strategic Macroeconomic Management

Macroeconomic management will play a crucial role in the next five years as the political economy becomes more complex and presents new challenges to policy makers. There are strong signs of change in the macro-financial environment already: the credit-GDP ratio has increased rapidly, from between 6 and 9 percent of GDP in the years 2000-2005 to just below 40 percent in 2013, according to IMF figures. Rapid growth in credit has taken place in a crowded, unregulated, dollarized market, potentially leading to the production of risk.

It is important that mechanisms are in place to effectively monitor and regulate credit providers. Policy makers need to strike a careful balance: diminishing macro-financial risks, but also providing a fertile framework for the growth of credit, and its extension across the economy, particularly to Small and Medium Sized Enterprises (SMEs) and small-holder rice farmers. This requires a holistic approach that sees credit in the context of a wider process of formalisation of financial markets.

Currently the majority of Cambodia's industries have not embraced formal financial processes, such as business registration, independent auditing and tax payments. This is particularly true of SMEs, which account for the vast majority of Cambodian companies. The informal structure of business constitutes a major source of uncertainty in the market, limits the extension of credit from many formal sector lenders, and ultimately constrains investment.

Formalisation of financial practice will also build on recent gains in tax collection and create fiscal space to fund much needed improvements in social service provision, and provide resources to see the economy through possible external shocks. It is important that institutional mechanisms are put in place to optimise efficient usage of these funds. Such measures include developing the institutional capacity to detect imminent economic risks, respond appropriately to emergencies, and to mobilise funds effectively for social reforms.

Fiscal policy will also be important in rebalancing the economy to benefit from greater regional integration and to promote new industries as Cambodia's comparative advantage shifts from low-cost labour. Currently, investment laws are geared towards attracting Foreign Direct Investment (FDI): they must be amended to incentivise SMEs to join the formal economy. At the same time, fiscal policy should coordinate FDI to benefit SMEs by encouraging the development of secondary industries for manufacturing industries, such as automobile production.

Physical Infrastructure for Trade and Investment

The government and development partners have made huge strides in both the upgrading of the country's transport infrastructure, and corresponding regulatory reforms to facilitate the passage of trade. However, the current state of hard infrastructure constrains ambitions to move up the value chain in agriculture and industry, and pile high transaction costs on producers. With impending realisation of the ASEAN Economic Community, removal of these barriers will reduce production costs, allow producers to be competitive in regional markets and encourage FDI.

Low capacity physical infrastructure – and the corresponding delays and high costs – limits investment in all sectors, but particularly the unconnected hinterlands where poverty is highest. Increasing the capacity of physical infrastructure and connectivity will be crucial to enabling the government to reach ambitious export targets, diversify into new products and nurture value chains in a variety of sectors.

A striking example of physical barriers to export ambitions is the case of milled rice. The government aims to export 1 million tonnes a year by 2015 to become the world's third largest exporter. At present, however, there are not enough mills in Cambodia to process paddy at the quantity or quality required. Moreover, mills currently operating cannot compete regionally because of high production costs, including electricity and transport. Even if mills could produce 1 million tonnes of milled rice per year current infrastructure – ports, haulage capacity – is not sufficient to move this volume.

A priority issue highlighted by policy makers and business leaders to increase competiveness is improving electricity provision. Cambodia's power deficit has led to reliance on expensive, unreliable imports with varying service quality across the country. This adds high costs to producers. Rice mill operators, for example, frequently resort to expensive fuel generators because of uncertain energy provision, adding significant costs to production.

The government has pledged to significantly upgrade energy infrastructure to become a net exporter of power by 2020 as part of the ADB's Greater Mekong Sub-region economic corridor programme. This will require the construction of dams after the completion of thorough social and environment impact assessments. In tandem, government and development partners must meet targets for power line extension across the country. Cooperation between government, policy makers and the engagement of private sector partners are crucial ingredients in achieving these aims.

In parallel with physical infrastructure, building logistical capacity to efficiently export products is important to drive down costs and better connect Cambodia's producers to regional markets, particularly rural producers. Government must promote multi-modal logistics systems across road, rail and shipping, which are deeply integrated into rural areas and within regional logistics networks.

Cooperation and Capacity Building Key

The key to ensuring Cambodia's growth and prosperity over the coming years is building institutional capacity to implement policy frameworks and the rule of law across society. There are four frameworks that map out the policy reforms necessary to realise Cambodia's vision of future development: the Rectangular Strategy Phase III (RSIII); the National Strategic Development Plan (NSDP); Industrial Development Policy (IDP); and the Cambodia Vision 2030 (CV2030). Capacity must be developed to ensure that they are implemented.

A key problem is 'informal' fees charged by officials, which lead to high transaction costs and uncertainty from the top to the bottom of the market, and constrain trade and divert resources away from investment. A study by CDRI, for example, found that informal fees in rice exports added costs of USD10 per ton. This costs hinders the competiveness of Cambodian rice and limits the capital available for rice producers to invest in production. Hence, government must strengthen bureaucracies associated with cross-border trade to ensure increases in rice production and exports over the next five years.

The effective identification, development and implementation of policy require cooperation and coordination across ministries, policies and stakeholders. There must be engagement with the private sector so that mechanisms to facilitate trade and investment reflect their needs. This engagement must include business leaders from large companies, but also representatives of SMEs and rice producers, and research institutes. Mechanisms must be strengthened to promote inter-ministry cooperation, and the effective harnessing of private sector resources through Public-Private Partnerships (PPPs).

To develop an effective bureaucracy it will be necessary to work within existing frameworks. This will, for instance, involve building the capacity of local authorities through decentralisation and deconcentration reforms, enhancing the abilities of the judiciary through training schemes for officials, as well as the revision of civil service pay scales across the board. Building an effective bureaucracy will also require the development of new bespoke institutions that are built on the principles of transparency and good governance, such as cadastral commissions and arbitration councils, which eliminate uncertainties for investors.

CDRI – Cambodia's leading independent development policy research institute

☞ 56 Street 315, Tuol Kork ✉ PO Box 622, Phnom Penh, Cambodia
☏ (855 23) 881 384/881 701/881 916/883 603 🖷 (855 23) 880 734
E-mail: cdri@cdri.org.kh, Website: www.cdri.org.kh