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ASEAN Economic Community (AEC) 2015 and Regional Integration: What does it really mean for Cambodia?

“A competitive and dynamic economy is essential if Cambodia is to seize opportunities offered by AEC membership.”

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Cambodia and the AEC

In 2015 Cambodia will join other Southeast Asian nations to form the ASEAN Economic Community (AEC) single market. This economic union marks the culmination of over a decade of increasing economic interaction between Cambodia and other regional economies through the ASEAN framework. With the establishment of the AEC, the nations of ASEAN take a further step towards eliminating barriers to the free movement of goods, services, capital and labour across the region.

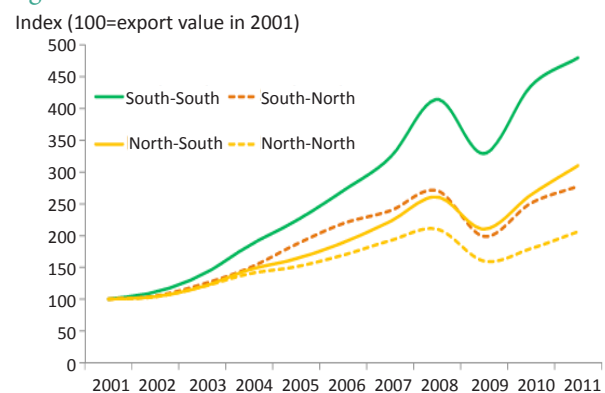
The AEC signals an intent by Cambodia and partner economies to enhance ASEAN’s position as one of the globe’s foremost trading blocs. It represents a trend of developing alliances between economies of the “global south” and mirrors the changing profile of the global economy, principally the shift of poles of growth to newly

industrialised economies. Today, the majority of the world’s trade takes place between economies of the “global south”; this trend looks set to define the global economic landscape of the future (Figure 1).

The benefits of AEC membership for Cambodia are many. The country will gain from increased and diversified trade and investment from AEC nations, from integration into regional networks of production, and from free movement of labour across the region. Through affiliation with a powerful trading bloc, the country will also be able to develop favourable economic relationships with key global economic powers. Already ASEAN has forged free trade partnerships with key Asian economies; the AEC provides opportunities to further such forms of interaction.

This is a summary of the 2014 Cambodia Outlook Conference Session 3 panel discussion. Participants included Mr Enrique Aldaz-Caroll, Senior Economist, The World Bank, Cambodia; H.E. Tekreth Kamrang, Secretary of State, Ministry of Commerce; Dr Suthad Setboonsarng, President, NawachiOne Foundation, Bangkok, Former Senior Thai/ASEAN Trade/Economic Official; Mr Hing Vutha, Research Fellow, Economy, Trade and Regional Cooperation Programme, CDRI; Mr David Vichet Van, Deputy Secretary General, Alliance of Rice Producers & Exporters of Cambodia. The session moderator was H.E. Dr Sok Siphana, Chair, CDRI Board of Directors, Adviser to the Royal Government of Cambodia.

Figure 1: Global Trade Flows



Source: Dr Enrique Aldaz-Caroll, Cambodia Outlook Conference 27/03/14, citing ITC trade map figures

It is predicted that the changes engendered by the AEC will significantly strengthen Cambodia's economy. Exports are expected to rise by 5.3 percentage points, investment by 24.8 percentage points and real GDP by 4.4 percentage points.

The Cambodian government has worked hard to implement the reforms required to take full advantage of AEC membership, and as signposted in the Road Map to AEC 2015. The government and development partners have upgraded railways and roads, and implemented reforms to eliminate physical and regulatory barriers between Cambodia and other ASEAN nations.

According to the Road Map, Cambodia has implemented more than 70 percent of the reforms required for AEC membership, ranking third in the region behind Singapore and Malaysia.

Challenges remain that policy makers must overcome to ensure Cambodia reaps the benefits of integration into the AEC: to develop modern infrastructure that effectively connects Cambodia to the region; to diversify the export base to appeal to ASEAN consumers; and to encourage exporters to utilise the AEC formal trade mechanisms.

Cambodia as Economic Node

The vision that AEC leaders promote is of a deeply integrated and connected ASEAN. Urban centres will be linked by road, rail, shipping and air-travel; in turn, hinterlands will be connected to urban nodes via a modern transport system that provides a cost-effective and predictable service.

Connecting Cambodia to regional markets through a modern transport system will benefit producers by reducing transaction costs and increase the competitiveness of the country's products in a single market. Export costs in 2012 were 40 percent higher in Cambodia than in Vietnam, according to the World Bank, rendering Cambodian products comparatively more expensive than regional alternatives. If government were able to drive down costs to the level of Vietnam, the Bank predicts a threefold increase in output of medium sized enterprise.

Better links to its neighbours will enable the Cambodian economy to join regional Just In-time Production (JIP) networks. JIP is a feature of the ASEAN economy that enables manufactured goods to be produced quickly and at minimum cost. A core feature of this production model is a high-level of connectivity and coordination in the supply chain: speed and predictability across all supply chain actors are crucial to the smooth functioning of the system. Integration into JIP networks will create demand for a diverse range of products and industrial processes, and spur diversification of Cambodia's production base. In

the medium term, the skills garnered through integration into JIP networks will encourage higher-value industry to migrate to Cambodia as market conditions change across the region.

Facilitating the efficient movement of goods will mean that Cambodia can gain from increasing through-trade. The close proximity of ASEAN to the global growth poles of East Asia means there are opportunities to generate capital from trade moving across the region: in the past five years trade has increased by 12 percent annually.

Cambodia's strategically important position between the regional hubs of Ho Chi Minh City and Bangkok means that it is well placed to benefit from increasing through-trade. These benefits include increasing revenue, competition and efficiency in logistics services, and increased demand for related support services, such as accountancy and law.

If Cambodia is to become a key node in the AEC, policy makers must take a three-pronged approach to overcoming capacity limitations in transport infrastructure.

First, there must be continued efforts to upgrade hard infrastructure. The government and development partners have made strides here, specifically in upgrading roads, railways and ports. In particular, the ADB's Southern economic corridor has provided the policy frameworks and funding to better link Cambodia to Vietnam and Thailand.

Second, hard infrastructure must be complemented by the development of modern, global standard logistical services. The World Bank's Logistics Performance Index (LPI) 2012 ranked Cambodia at 101 among 155 countries, compared with Vietnam (53) and Thailand (38). This low logistical capacity hurts producers from the top to the bottom of the market by adding costs to exports and creating uncertainty in service provision.

A key issue is integration of logistical services, at the local, national and regional levels. Currently logistics at the local level is informally structured, unpredictable in terms of time and cost, and not well linked to cross-border logistics networks. At the border containers must be removed and placed on different vehicles, costing an estimated extra 100USD per container.

To increase efficiency of logistical systems, government must put in place measures to ensure that local-level transport systems, particularly in remote areas, are well integrated into national logistics networks. Mechanisms should also be developed that increase awareness about international transit agreements to improve cross-border cooperation. Government must also promote competition in trucking, port and air freight to drive

up service standards and give producers the choice of services.

Third, a lack of institutional capacity to transparently and efficiently implement customs procedures adds transaction costs and causes delays. The government has made efforts to streamline customs procedures as part of the Road Map to AEC 2015, but a lack of institutional capacity to implement policies at borders results in informal fees adding costs to Cambodian products. It is crucial, therefore, that government incentivise officials against levying “informal” fees.

Diversification of Skills and Products

As members of the AEC, Cambodian producers have a potential market of 600 million consumers. It is the task of policy makers to ensure that this potential turns into growth by encouraging diversified exports that satisfy the demands of this market.

At present Cambodia imports value-added consumer products from other ASEAN economies and exports agricultural products and raw materials. If this trend is not altered AEC membership will result in an increase in the trade deficit. Government must lay the foundations for a diversified economy, built by an appropriately skilled workforce, representative of business needs, and responsive to changes in external market conditions.

A driver of diversification in many economies is Small and Medium-sized Enterprise (SME), widely credited with contributing to China’s economic transformation. To harness the power of Cambodia’s SMEs, policy makers must address the lack of skills, technology, capital and marketing capacity in the sector. Currently, Cambodia’s SMEs cannot compete with producers in neighbouring countries; an influx of cheaper imported products might threaten their development.

Government can increase productivity of SMEs by formalising business practices. Standardising financial statements and balance sheets to enable proper audits will enable increases in lending from banks, encourage investment, and provide a foundation to link with larger companies as part of regional production chains.

It is important that regulation is complemented with support services that promote strategies to enter production networks, expand into new markets, and enhance technical and managerial capital.

Increases in intra-ASEAN Foreign Direct Investment (FDI) are expected as a result of AEC membership; formal monitoring processes and increases in productivity will give confidence to foreign investors and contribute to an increase in FDI to SMEs. However, a potential increase in

FDI presents new sources of risk: as demonstrated in the 2009 economic crisis, when external conditions change foot-loose foreign investors take flight. It is important that government enhance supervision so that FDI liabilities are known, and shocks can be managed.

Producing products for the AEC market will require new skills, posing labour policy challenges. Cambodia’s workforce is not yet primed to capitalise on AEC membership; most workers are unskilled or inappropriately skilled.

The AEC free movement of labour presents an opportunity to move into new industry by plugging the skills shortage in Cambodia’s labour market. It is important that these skills are transferred to the Cambodian workforce in the medium term.

In the longer term, attracting future FDI will require a pool of highly-skilled Cambodian workers, but currently there is weak capacity in the core subjects of science, technology, engineering and mathematics (STEM subjects). This must be addressed if Cambodia is going to move into products that require high technical competencies.

A key issue that will determine the success of diversification into new industries is the ability of government to link private sector needs, changing external conditions and education policy. Many small and medium-sized businesses currently lack information about external market conditions and how these might change with the AEC.

In addition, there is a disconnect between the current and future needs of business and the supply of appropriately skilled labour. There must be better mechanisms to communicate current market information and predicted future changes to business, and to feed this market information into training schemes.

Barriers to AEC Uptake

At present there is a feeling of uncertainty in the private sector about what the AEC will mean for them. It is important for government to convey that the adoption of the AEC 2015 represents not a seismic shift in intra-ASEAN economic relations, but the continuation and formalisation of a trend of increasing economic assimilation, which has been occurring over the past decade.

Cambodian producers already are party to several tariff-reducing agreements across the region, most notably the ASEAN+5 Free Trade Area (FTA), which have contributed to a sustained reduction in tariffs across ASEAN over the past decade.

The issue that is currently facing policy makers is how to encourage exporters to embrace FTA and use these

agreements as the primary framework of intra-regional trade. As is the case with FTAs in existence, the benefits of AEC membership will only be realised if government is successful in widening and promoting a culture that accepts the use of formal trade mechanisms across the economy.

A useful barometer of the challenges facing AEC implementation is the constraints to ASEAN+5, as both agreements promote trade through tariff-reducing frameworks.

At present only 47 percent of Cambodian trade flows through the ASEAN+5 framework, despite the lower tariff regimes offered. The reason for this is that the savings margins for producers between using ASEAN+5 and other trade routes – for example the Cambodia Lao Myanmar Vietnam (CLMV) most favoured nation framework – are minimal.

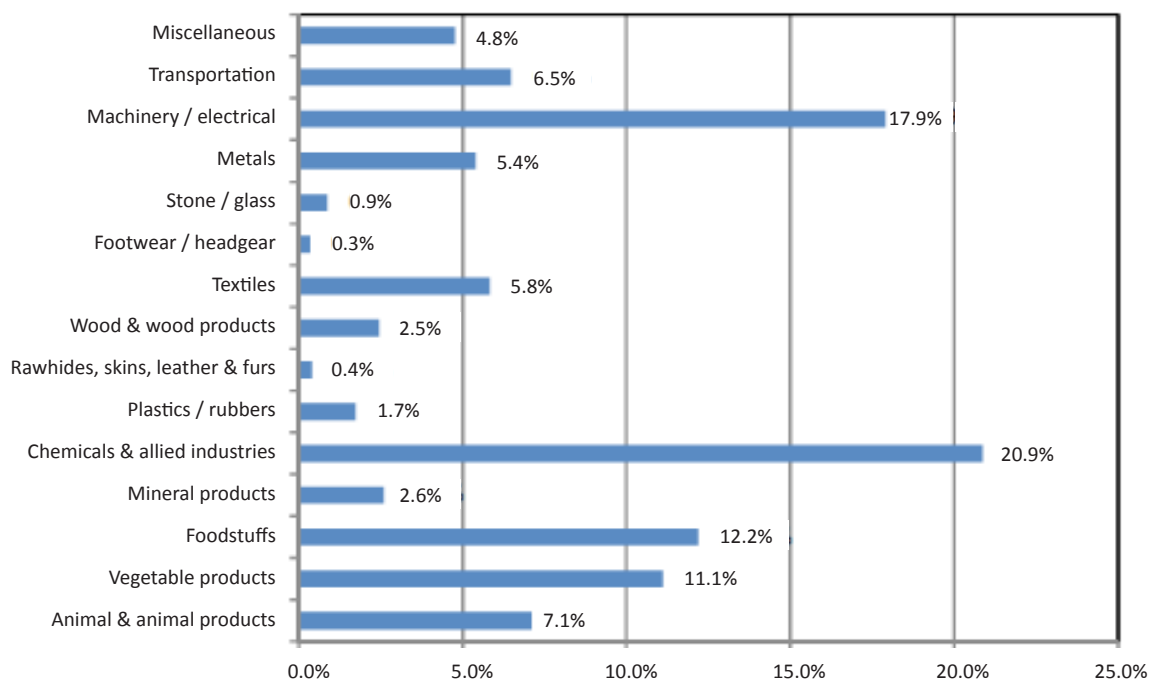
Lower tariff rates are negated by the costs and complexity associated with complying with ASEAN+5 criteria; these barriers to accessing free trade frameworks are called Non Tariff Measures (NTMs).

The most significant NTM discouraging usage of ASEAN+5 framework from a Cambodian producer's perspective is the requirement to obtain an export licence. Out of a database of 49 countries that enforce NTMs, only Cambodia and Sri Lanka require exporters to acquire an export license.

NTMs are not only a problem in Cambodia. As figure 2 shows, the associated fees affect a wide range of products across ASEAN and can increase costs by up to 21 percent in some cases. This region-wide issue constitutes a major obstacle to free trade.

For Cambodia and other countries in the region to benefit from the AEC single market, NTMs must be eliminated and access criteria to the AEC streamlined so that exporters are not discouraged from using the framework as a vehicle for trade. Policy makers in Cambodia should address this problem at a national and regional level: policies should concentrate on removing Cambodia specific NTMs, but also encourage other ASEAN states to streamline processes for traders accessing the AEC.

Figure 2: NTMs in ASEAN



Source: Dr Enrique Aldaz-Caroll, Cambodia Outlook Conference 27/03/14, citing ASEAN NTM database

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