DEVELOPMENT PARTNERS' BACKGROUND PAPER ON
MITIGATING THE ADVERSE IMPACT OF THE ECONOMIC CRISIS

for the
14TH MEETING OF
THE GOVERNMENT-DEVELOPMENT PARTNER COORDINATION COMMITTEE (GDCC)

Phnom Penh, April 28, 2009

1. This is truly a global crisis. It may have started in the advanced economies but the fallout of the crisis is now being felt by countries at all stages of economic development around the world. Cambodia is not immune. As the impact of the crisis filters through the Cambodian economy, vulnerable because of its narrow sources of growth, Cambodians already living in poverty face new hardships while the vulnerable are at risk of spiralling down into poverty. It is important to recognise that how the Royal Government of Cambodia and its development partners respond to this crisis will set the direction for Cambodia's developmental trajectory and the well-being of Cambodians for the next decade and more. Without action now, hard-won gains in the fight against poverty over the past ten years will be quickly eroded and progress towards the Millennium Development Goals (MDGs) will go off-track. The sheer depth and breadth of the global crisis means it is no longer "business as usual".

2. The crisis does, however, provide an opportunity to tackle some of the fundamental pressing issues that have been identified over recent years, and development partners commend the Government for prioritising the response to the crisis as the main agenda item for the 14th Government-Development Partner Coordination Committee (GDCC) on April 28, 2009.

3. We support Prime Minister Hun Sen's call made first at the Cambodia Economic Forum in February and then at the Cambodia Outlook Conference in March for close collaboration by Government and development partners to manage our way through this crisis "*to ensure that the remarkable development and poverty reduction achievements of Cambodia over the past two decades are not lost, and to further strengthen Cambodia's key sectors for future growth and development*".[1] As the Prime Minister went on to detail, greater communication, coordination and cooperation across Government and between Government and development partners are essential for coping with this crisis. We also strongly encourage the Government's efforts to engage with its other partners, the private sector, to assess the situation and design an effective solution, as well as civil society, to benefit from their experience on the ground in delivering services.

4. Development partners look forward to the GDCC dialogue resulting in agreed priorities and next steps for joint action by Government and development partners to ensure that the response to the crisis in Cambodia is effective. To inform the GDCC dialogue and identification of priorities for action, the aim of this background paper is to outline recent developments, concerns and questions on how to mitigate the adverse impact of the economic crisis.

Impact of the crisis

5. Cambodia is particularly vulnerable to the crisis mainly because its sources of growth remain relatively few. Cambodia's economy is already feeling direct hits to three of its growth engines with reduced demand for garment exports, a slowdown in construction and reduced levels of foreign tourist arrivals and spending. In addition to the rapid slowdown in export, foreign direct investment and remittances are also declining. The immediate result is rising unemployment (for example, there are reports of 50,000 laid-off garment workers,[2] out of a total of 352,000, and anticipated large job cuts in the construction sector). Added to this is the

[1] Prime Minister Hun Sen (2009) *Opening Address at the 2009 Cambodia's Outlook Conference on "Cambodia and the Global Economic Crisis: Impact, Policy Responses and Action"*. (March 12, 2009)
[2] Source: Ministry of Commerce (February, 2009).

challenge for the labour market to absorb the 5% (circa. 250,000 young people) annual growth in the labour force. Second round effects from the economic crisis are also likely to come, including through the stress on domestic banking sector, a decline in availability of credit for domestic borrowers (which will include small and medium sized enterprise owners, farmers and so forth), the negative effect of last year's high inflation and the recent appreciation of the dollar on tourism and the competitiveness of garment exports, and reduced consumption as a result of lower income. Other secondary impacts include decreased remittances from laid-off workers, especially from garment workers who send a large proportion of income to home rural villages and from migrant workers abroad, and increased pressure from laid-off workers and returning migrants on family farms and urban areas. These effects will intensify in the coming months and the negative shock to economic activity in Cambodia will be significant.

6. Experience across developing countries is that levels and quality of education and health commonly deteriorate during economic crises. The Government's recent anthropometric survey showed the significant progress made in reducing chronic malnutrition, as measured by stunting (shortness), which declined from 43.2% in 2005 to 39.5% in 2008 due to considerable improvement in the health and nutrition status of children younger than 1 year old (from 21.9% in 2005 to 14.5% in 2008). However other indicators of malnutrition that respond more rapidly to decreasing food intake (i.e. underweight and wasting, which are indicators of acute malnutrition) have stagnated. Some population groups and areas have recorded particularly significant increases in acute malnutrition: wasting among poor urban children increased from 9.6% in 2005 to 15.9% in 2008, exceeding the threshold of 15% wasting rate taken to define a 'humanitarian emergency' and calling for emergency response in urban areas.

7. These observations of worsening child nutrition and health from late 2008 primarily reflect the impact of food prices increases earlier in 2008. Indeed, it is estimated that more than two-thirds of Cambodian households are worse off after the increase in food prices. The anthropometric survey also found that, to cope with higher prices, two out of three households in both rural and urban areas reported relying on less expensive or less preferred food at least one time in the month prior to the survey; many other households reported purchasing food on credit, reducing food eaten in a day, and restricting consumption by adults so that small children can eat. Another coping strategy, used by two out of five households, is to reduce expenditure on health care.

8. When work opportunities are scarce and families have little or no access to credit, they may have to pull children out from school.[3] With approximately 40% of Cambodian school children already not completing primary school, the risk of even lower completion rates in face of the crisis is therefore a serious concern.

9. There is also a gender dimension to the impact. The crisis will impact on women's and men's employment opportunities, with garment workers (80-85% of the labour force in the textile and clothing industry are women[4]) being laid-off and construction workers (predominately male) also at risk of losing their jobs. An effective policy response should take into account that women's loss of income has special effects on the well-being of their families, including impacting on the care the women are able to provide to their children (critically important as women are commonly the principal carers) and on the additional income remitted to rural farming households.

10. All of this also puts a strain on informal coping mechanisms, with a risk of a consequent rise in levels of child labour, domestic violence, drug addiction, crime, human trafficking and strain on social harmony. Left unchecked the impact of the crisis will result in a deterioration of recent achievements of the Cambodia MDGs and, moreover, on the indicators of the National Strategic Development Plan as well. In particular, the national poverty level, which has been falling rapidly in the past few years – putting the first Cambodia MDG to eradicate extreme hunger and poverty within reach – could very well increase in 2009 as a result of the economic slowdown.

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[3] Mendoza, R.U. (2009). *Aggregate shocks, poor households and children: transmission channels and policy responses.* Social Policy Working Paper (February 2009.) UNICEF.

[4] Cambodia Institute of Development Study (CIDS) (2009). *Impact of the Global Financial and Economic Crisis on Cambodia: A Rapid Assessment*. (February 5, 2009.) ILO.

11. This highlights the importance of service-providing ministries, such as Education and Health, putting in place rapid tracking mechanisms and developing appropriate responses. While real-time monitoring of the effects of an unfolding crisis is difficult, the Ministry of Health and the Ministry of Education, Youth and Sports both have in place good management information systems. These should be able to provide data on, for example, the effects of the crisis on changes in enrolment, completion and survival rates, with only a short lag between data collection and calculation of indicators.

a/ What are the Government plans to monitor changing levels of risks and vulnerabilities in the coming months, notably in the economic sectors/regions/social groups estimated to be more vulnerable and more at risk? How can development partners support this?

Policy response

12. Development partners commend the Government for the start made in responding to the impact of the crisis, including: (i) the loosening of monetary policy; (ii) proactive discussions with the private sector on support to stressed industries such as the garments sector, tourism and support to agri-business, and (iii) the initial expenditure policy response (such as reprioritization of agriculture and infrastructure projects, and creation of a fund to finance the training of laid-off workers).

13. The severe, broad-reaching and deep nature of the impact of the crisis, however, requires a similarly broad and deep policy response. The Government has an important opportunity now to:

- address structural constraints that are holding back more sustainable and broader growth of the economy, with a focus on improving competitiveness and increasing diversification of sources of growth – for example, by ensuring progress in facilitating trade and improving the business environment, and by creating, as a matter of urgency, a viable social safety net system;
- push forward reforms that enable better implementation of the law, regulations and expenditure programs, such as the ongoing public financial management and public administration reforms, and improve governance and accountability. Strengthened transparency and accountability in the management of Cambodia's public finances and natural resources is of key importance in order to present Cambodia as a safe opportunity for all serious investors.

14. Moreover, the Government response will be effective if it is integrated and comprehensive, covering central and service-providing line ministries, and accompanied with a communication strategy not only for the people of Cambodia, but also for its investors – existing and potential, domestic and foreign.

15. In particular development partners are responding to the Prime Minister's call to work with Government to fast track growth-promoting expenditures that involve local labour and services (such as infrastructure investment and public works programs), inputs to production by smallholder farmers, food security and other key development programs to mitigate the impact of the crisis on the vulnerable. A focus should be on key bottlenecks for implementation, from Government and from development partners. The stimulus spending must take into account the gender dimension of the impact of the crisis, complementing the spending on male labour dominated construction and infrastructure sectors with a focus on meeting the needs of the large numbers of women affected by the economic slowdown. The policy response must also take into account the effects on sustainable development and address measures to improve Cambodia's capacity to adapt to the effects of climate change.

b/ What are Government's next steps in identifying and monitoring priority projects and programs for implementation? What could be the role of the technical working groups in identifying and monitoring these priority projects and programs?

16. Globally, aid budgets are under pressure because of debt problems and weak fiscal positions of advanced economies.[5] In Cambodia, the importance of official development assistance is set to rise as the economy contracts and foreign direct investment slows. It is thus critical that development partners deliver on their commitments, so ensuring budgeted social spending and enabling effective and efficient public expenditure and

[5] Te Velde, D.W. (2008). *The global financial crisis and developing countries.* Background Note. (October 2008). ODI.

service delivery. **Development partners take this opportunity to reaffirm their indicative financing for 2009 and 2010, as reported at the Cambodia Development Cooperation Forum (CDCF) in December 2008.**

17. To enable the Government to monitor aid flows, aggregate reports of development partners' actual disbursements on a quarterly basis could be a useful indicator.

c/ Development partners welcome Government's thoughts on this proposal.

18. Development partners also look to the Government to do its part to ensure that sufficient fiscal space is created to allow for additional spending to help cushion the downturn. In this context, while the overall budget deficit could be allowed to rise to around 4¾ percent of GDP in 2009, development partners strongly urge the Government to avoid backsliding in tax administration efforts at risk of eroding an already-low revenue base. Most of the additional stimulus should come from higher spending, as this would provide more effective support to growth than would weaker revenue collection. The focus should be on pro-poor social outlays and safety nets and high-quality infrastructure projects that would strengthen competitiveness, facilitate broader private sector growth and promote sustainable development.

19. The approach to responding to the economic crisis must also aim to improve aid effectiveness, and not undermine progress in this area. The implementation of aid effectiveness priorities identified by technical working groups in quarter one of 2009 will serve to bolster a successful response to the crisis, as these priorities are focused on working towards better coordination and alignment of Government resources, including development partner assistance, to national priorities and systems

i) Garment sector

20. The downturn in the garment sector is the most immediate and visible effect of the global economic crisis in Cambodia. The domestic industry's difficulties have been compounded by a deterioration of competitiveness (because of last year's high inflation and more recently as the dollar appreciated) and Cambodia's own challenges in the industry. Many of the factors driving the difficult situation (seasonally adjusted, exports in the first two months of 2009 14% below 2008 average, the sharp reduction in overtime payments, and a net impact of 50,000 layoffs since the middle of 2008) are outside Cambodia's control and expectations should be realistic. But the garment sector is vital for Cambodia and has been a hallmark of its development over the past decade.

21. Development partners would like to support the intensive dialogue between the Government and the private sector in this area. Some tax-related measures have been adopted and a fund for the retraining of laid-off workers has been created. Development partners would appreciate an update on two other critical issues raised by the industry – which have benefits for other parts of the economy as well:

d/ What priority steps can be taken to simplify trade, make it cheaper and more reliable? Development partners welcome the measurable progress made through the implementation, for instance, of the ASYCUDA system. How fast can it be expanded? What are agencies other than customs doing to implement the risk management strategy? Can the issuance of certificates of origins be quickly automated? Can fees be rationalized?

e/ What is the progress in the dialogue on industry relations? What are the solutions to better implement the Labor Law (e.g. provisions relating to the most representative unions), respecting workers' rights and recognizing the importance of a predictable working environment for the businesses? Can funding be mobilized for upgrading skills of workers <u>before</u> they are laid-off, using the downtime in the industry at the moment?

22. While appreciating the special nature of this industry, development partners would like to note the importance of developing a response for other hard-hit sectors – tourism and construction in particular, all in a way that promotes the diversification of the economy in the medium term.

23. Development partners stand ready to support progress in the areas of trade facilitation and labor. Focus should also be on increasing productivity, competitiveness and building physical infrastructure to attract other

light manufacturing investment. Significant programs are already in place and can respond to the directions set by the Government. For example, a National Garment Training Institute is under preparation, promoted by GMAC and MoLVT and should be accelerated.

24. Development partners take this opportunity to re-affirm their strong commitment to working in partnership with Government in the agriculture sector at this critical time of responding to the impact of the economic crisis.

ii) Social safety net

25. Many Cambodian households are increasingly vulnerable to poverty as a result of the global price and financial crises that have unfolded over the last 18 months. Long-standing risks for poor and food-insecure people were exacerbated by the escalating prices of food and other essential commodities in 2007/8: while some farming households were able to benefit from these higher prices, most farming households are subsistence producers, many of whom will have suffered a net negative impact from price increases. Structural changes to the rural economy also mean that households are less able to withstand these shocks than in the past: the number of landless and land-poor households is much higher now, and access to common property resources (a traditional safety net) is significantly reduced. Reinforcing safety nets is therefore important to mitigate effects of the economic crisis and to complement the Government's longer-term growth-oriented development.

26. Development partners welcome the progress that has been made since the December 2008 Cambodia Development Cooperation Forum (CDCF) agreement by Government and development partners to establish an interim working group for social safety nets under the Food Security and Nutrition Technical Working Group. This interim working group has made good progress in reviewing current safety net programs (the scoping and mapping exercise) and is in the process of developing options for a coordinated social safety net system to underpin Cambodia's future growth, to be discussed at a National Forum in June. This process will also attempt to identify safety net interventions that can be feasibly scaled up or introduced to mitigate the immediate crisis, and to locate these short-term actions within a long-term process of system development. We also recognize the ongoing work to expand the Government's poverty identification program (ID Poor) into a further five provinces. Scale up will need to be sequenced according to the most affected provinces.

27. Development partners confirm their commitment to working in partnership with the Government to support the development of an appropriate and affordable safety net system. Acknowledging that this process is well under way but will take some time, we confirm our commitment to support scaling up existing social safety nets which could be rapidly expanded and strengthened to address priority sectors, social groups and / or geographical areas, focusing on the most vulnerable. Examples of such support include health service fee exemptions backed by health equity funds; basic education scholarship programs for poor students; school feeding; food- and cash- for work and public sector pensions. Development partners also commit to approach this short-term response within a Government-led process to develop a more comprehensive social safety net system that is better able to respond to household- and economy-wide crises in the future: we are ready to engage in discussions and possible expansion of currently successful initiatives piloting social safety net measures such as cash-for-work or conditional cash transfer (CCT) programs (which have proved effective and cost-efficient in other countries but have not yet been tested in Cambodia).

28. Development partners have some questions on the next steps in the Government and development partner response to the crisis, and social safety nets:

- ***f/ Government's social safety net system development and the need for immediate actions: Given that the current Government initiative to establish a more comprehensive national social safety net system will require time for conceptualisation, design and implementation (NB. a Government social safety net strategy is to be finalised by the tentative date of December 2009), <u>does the Government have a short-term strategy to immediately establish new social safety nets (or strengthen and expand existing ones)</u> to address the immediate needs of the poor and vulnerable?***
- ***g/ Development partner (DP) funded social safety nets & new vulnerabilities: Among the existing DP funded social safety net projects, where (i.e. in which sectors, social groups or regions) does***

Government believe at this stage that there are major gaps that need to be addressed immediately to assist those most affected by the global economic crisis? Which type of DP funded social safety nets (existing or under review) does Government believe could best provide short-term relief/immediate response to those most seriously affected by the global economic crisis?

29. Development partners take this opportunity to re-affirm their strong commitment to working in partnership with Government on social safety nets at this critical time of responding to the impact of the economic crisis.

iii) Agriculture

30. Agriculture is an important driver in the economy (around 30% of GDP) and is less likely to be affected by the economic slowdown because the sector is dominated by small-scale subsistence farming that is not tightly integrated into international markets.

31. The impact of the global economic crisis on the other key sectors of the Cambodian economy highlights the importance of the agriculture sector as a short-term buffer. Addressing constraints to higher productivity in the sector will be critical for agriculture to fulfil its role in supporting continued growth and poverty reduction. Specifically, the Rectangular Strategy Phase II and the Strategy for Agriculture and Water identify the need for: (i) increasing knowledge at the farm level, including use of improved seed and fertilizer inputs as appropriate; (ii) strengthening the role of farmer associations to reduce the costs faced by smallholders in engaging input and output markets; (iii) attracting increased investment and financing into the agro-processing sector – in particular rice milling – to link farmers to value-added domestic and foreign markets. In parallel, there is significant scope to both expand irrigation, but just as importantly, to strengthen the management of existing irrigated areas.

32. The Government's Strategy for Agriculture and Water has already mapped out a blueprint for increasing agricultural production in Cambodia. There is now an urgent need to fast track investments in activities that will have quick impacts on productivity and food security, and generate rural employment.

33. In the short term, the main option to support agriculture production is to increase yields for the next wet season by facilitating access to quality seeds and fertilizers. Cambodian farmers currently have the lowest rates of utilization of improved seed and fertilizer in the East Asia region.

h/ What can Government do in the immediate term to boost agricultural productivity for the coming wet season?

34. Cambodia agriculture can be seen as the major mid-term growth option if proactive measures are taken at different levels of the value chain. Cambodia faces several important challenges in achieving increased productivity and diversification. These challenges include institutional weaknesses and poor coordination; insecure land tenure; weak agriculture research and extension; inadequate vocational training; inappropriate legal framework for the registration of farmers' associations, poor road and irrigation infrastructure; and a lack of affordable credit and public investments in agriculture.

35. To increase the impact of important on-going and/or future investments, the Government should support the options designed to increase local added value. Contract farming is often presented as the best way to develop an agriculture sector that is more reactive and connected to market.

i/ What investment is the Government planning under the different options of contract farming? Does the Government intend to assess the different types of investment regarding their impacts on added value and poverty reduction?

36. Development partners take this opportunity to re-affirm their strong commitment to working in partnership with Government in the agriculture sector at this critical time of responding to the impact of the economic crisis.

iv) Foreign direct investment

37. Development partners appreciate that access to foreign direct investment (FDI) has been both a success and a necessity to achieve rapid growth over the past decade. It is equally important to stress the role of quality in FDI, so that it brings to Cambodia the know-how and sustainability that the country needs. However, it is important to recognize that global FDI flows have dried up and are unlikely to start flowing again before 2010. In fact, outflows (or disinvestment) have been experienced by a number of countries. At the same time, it is likely that some entrepreneurs in Cambodia would still be able to start new ventures, hence the need to promote domestic as much as foreign investment. Development partners would like to discuss three complementary priorities:

- ***j/ How is the Government planning to help existing foreign investors so that they do not leave? What is the status of the aftercare program at the Cambodia Investment Board? What is the advice of the Cambodia Investment Board to the rest of the Government in terms of avoiding disinvestment? How will Special Economic Zones contribute to this objective? Can support to investors be more actively targeted?***
- ***k/ How is the Government planning to facilitate the entry of new domestic businesses? Can the process of creating a business be further simplified? What can be done to facilitate access to finance for these entrepreneurs?***
- ***l/ Finally, how is the Government planning to position the Cambodia market as attractive for the rebound in the global economy? As is correctly identified in the Rectangular Strategy, and covered in a number of the Joint Monitoring Indicators, issues include the need for more effective ways to resolve disputes (e.g. through alternative dispute resolution); progress in legal reforms; drastic simplification in regulatory requirements (licenses, inspections, etc.) and anti-corruption reforms. What are Government's expected achievements for 2009 in these areas?***

38. Development partners take this opportunity to re-affirm their strong commitment to working in partnership with Government in the promotion of FDI at this critical time of responding to the impact of the economic crisis.