

Exclusive Summary

CAMBODIA

Sustaining Growth in a Challenging Environment

Discussion Draft

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Executive Summary

1. Many countries succeed in generating high economic growth at some point in their history, but only a very few manage to sustain rapid growth for an extended period. Only such a prolonged period of rapid growth can have a significant impact on income per capita, and such an impact often brings with it many other important changes to people's lives.
2. Cambodia has been one of the countries in this select group. It has more than doubled its income per capita over the past decade. This doubling has been accompanied by the trappings of a profound structural transformation: integration into the global economy; a shift of jobs from agriculture to manufacturing; a demographic transition; and migration from rural to urban areas. Translating into jobs and better services, these outcomes have led to a significant reduction in poverty, as well as improvements in health and education.
3. Even so, the next episode in this story is very uncertain. The achievements of the past decade are very fragile and leave many Cambodians poor and with few assets. The base for this economic growth appears narrow. And the winds that once served Cambodia well—global trade and investment flows—seem to have lost their strength, at least temporarily.
4. What will it take for Cambodia to continue on this trajectory, to become a middle income country in a decade or so, and lift more of its people out of poverty? This report aims to contribute to policymakers' and citizens' thinking about growth in Cambodia in three ways: (i) it reviews the experience of the past decade and draws the Cambodia-specific lessons of this period; (ii) it sketches the major potential sources of growth with the aim of assessing the barriers to growth; and (iii) it outlines policy options for addressing these barriers.
5. The analysis has three main messages. First, the economic growth of the past decade is a remarkable achievement, but it is unlikely to be sustainable in its current form. That said, the experience has established that growth in some sectors can be stimulated by good policies and governance arrangements. Second, Cambodia has a potential to sustain growth if it increases competitiveness and diversifies. This requires a focused growth strategy. Finally, Cambodia has three important opportunities: harnessing regional integration; managing natural resources in a sustainable way; and investing in its future (through agriculture, infrastructure, education, and higher savings).
6. This analysis builds on recent developments in thinking about growth, in particular the report of the 2008 Report of the Growth Commission. The approach used here is to undertake some detective work on what works and does not work in the Cambodian context, to propose a diagnostic on the key constraints on growth, and to pinpoint the actions that hold most promise for sustaining growth. It readily acknowledges that much remains unknown about the process of growth and development; and thus takes the view that experimentation, monitoring, and evaluation will be key components of a successful strategy.

Understanding a Decade of Rapid Growth

7. **Four features of this decade of rapid growth are of particular significance** (Chapter 1). First, growth has been driven by *an open economy and a stable macroeconomic environment*. These

macroeconomic features are visible in the rapid increases in exports and Foreign Direct Investment (FDI) and the relative stability of inflation and the exchange rate. Second, stable macroeconomic management has been achieved with very few policy instruments. Indeed, the economy is largely dollarized, leaving fiscal policy as the main instrument in the policy mix. Third, growth has been narrowly based. The four leading sectors have been garments, tourism, construction, and agriculture. Very little diversification has occurred beyond them: garment products account for 88 percent of all exports. Fourth, the levels of *domestic savings and investment are low*, though increasing. While this was to be expected given the initial conditions of Cambodia in the 1990s, it differs from other experiences of rapid growth, in particular in East Asia. Related to this is the recent and very rapid development of the financial sector, from a very low base, mobilizing well-needed financing but also creating significant risks.

8. **How did this happen?** The dynamic behind this rapid progress can be understood along three dimensions. (Chapter 2). They are not mutually exclusive and each provides useful insights for the future (Table 1):

- Cambodia has benefited from its recent history and its favorable geography. The past decade has seen the end of the multi-decade conflict and the establishment of political stability, the rapid growth of global trade, and a demographic transition. Geographically, it is a coastal country in dynamic South East Asia. In this "history and geography" view, the achievements that underlie Cambodia's sustained growth are its political and macroeconomic stability, and the policies that have allowed it to become integrated within the region. These factors have enabled it to establish a track record of change, including its accession to the World Trade Organization and the approval of a number of significant economic laws. On the other hand, this dimension of the story highlights how vulnerable Cambodia is to the recent global economic turmoil.
- Cambodia has helped to fuel growth by drawing on some of its assets (forestry, fisheries, land, Angkor Wat site), but at the cost of a reduction in the level or quality of these assets. A related issue is the low – albeit increasing – level of savings and some misallocation of savings. Evidence for this view can be found in environmental concerns (e.g. on the Angkor Wat site), the disproportionately high returns on some classes of assets (e.g. real estate and land), the increase in inequality, and the short horizon of many investments. This dimension suggests a style of growth that is unsustainable and highlights the importance of sustainable management of assets.
- Cambodia has achieved rapid growth in an environment of poor governance through sector-specific or product-specific arrangements. These are best illustrated by the garments sector. The U.S.-Cambodia Trade Agreement negotiated in 1999 linked progressive increases in quotas to improvements in labor standards, monitored by a "third party" (the International Labour Organization program known as Better Factories Cambodia, or BFC). This has given Cambodia's overall industry an international reputation for being able to meet these standards. The Garment Manufacturers Association of Cambodia (GMAC) has liaised closely with government counterparts, particularly in the Ministry of Commerce, to continually address constraints on sustained growth in the sector (part of this happened because 6NIAC chaired one of the working groups of the Government-Private Sector Forum). The BFC arrangements and sectoral collective action and dialogue were crucial in sustaining growth even after the original quota scheme was phased out. Indeed, the absence of development in many other sectors can be explained by the absence of such arrangements. A major question for Cambodia is therefore how to replicate similar arrangements in other sectors.

Table 1: Understanding A Decade of Rapid Growth

Dimensions		Evidence	Lessons Learned
1. History and geography	Benefits from history (post-conflict, global growth, demographic transition) and geography (East Asia)	Timing of growth and increase in trade and FDI Demographic trends (dependency ratio)	Role of political and macro stability Role of openness and international commitments
2. Unsustainable use of assets	Growth fueled by onetime use of natural resources	High consumption, low savings, rising inequality High returns on some classes of assets Unsustainable management of natural resources	Need for sustainable management of natural resources Need to further increase domestic and/or foreign savings
3. Sector-specific governance	Growth through narrowly focused solutions to generally bad governance	Garment success (extended quotas, monitoring by Better Factories Cambodia, capacity of business association and close relationship with government) Limited diversification Role of Government-Private Sector Forum	Role of third-party monitor (labor standards in garments), external drivers, and signals Active role of government in creating good sectoral business environment

Cf. Chapter 2

9. **This period of rapid growth profoundly transformed the economy** (Chapter 3). Poverty incidence was reduced from an estimated 45-50 percent in 1993-94 to 30 percent in 2007. Many other social indicators confirm the improvements in the welfare of the Cambodian people. Key drivers of these achievements were the labor market changes and the demographic transition. In the labor market, a major development was the creation of jobs outside of agriculture, in industry and services: as these sectors have higher labor productivity than agriculture, this reallocation of labor had a significant impact on growth. Demographic trends reveal two baby booms, in the early 1980s and 1990s, followed by a demographic transition in the 1990s: the reduction of the dependency ratio over the past decade (fewer non-working age Cambodians for each working-age Cambodian) contributed 1 to 2 percentage points of per capita growth per annum.

10. **Three conclusions emerge from this review.** First, the current growth dynamic is unlikely to be *self-sustaining*, because (i) the economic base is relatively narrow and diversification has made no progress; (ii) a significant proportion of past growth was driven by events, such as the demographic transition and the establishment of political stability, which were either one-offs or in which the major gains have already been made; (iii) some natural assets, such as forestry resources, have been used in an unsustainable way; and (iv) governance arrangements are sector-based. The global financial turmoil of late 2008, to which Cambodia is not directly exposed given its weak financial sector, will significantly weaken the existing drivers of growth. Second, some important *conditions for afresh wind* have been established: the importance of macroeconomic stability has been institutionalized; the garment sector has demonstrated that adequate governance arrangements (and an adequate investment climate) can deliver growth; the usefulness of an independent third-party monitor (BFC/ILO) has been proven; the efficiency of partnerships between public and private sector (the Government-Private Sector Forum) has been tested; and the role (and limits) of industrial policy have also been proven. Third, Cambodia's *demographics* played a major role in its sustained growth; but a sustained flow of new jobs is required to absorb the 250,000 or so young Cambodians entering the labor market each year, many with high expectations prompted by the recent growth.

Scoping Cambodia's Growth Potential

11. In this context of highly commendable but fragile achievements, and sharp global slowdown, from which quarters will Cambodia new wind blow? Reviewing Cambodia's growth potential and options for diversification, the analysis highlights four potential sources of growth (Chapter 4 and 5).

12. First, Cambodia should make the most of its relatively abundant land, natural assets, and inexpensive labor. A growth strategy should be built on, rather than run counter to, these comparative advantages. Unfortunately, at the moment, distortions are pushing up the price of land, and lack of planning for areas away from major population centers reduces these areas' potential as a source of growth. The recent sharp appreciation of the Cambodian riel (due to inflation in a context of a stable Cambodian riel against the US dollar) has also increased the cost of labor (a problem compounded by poor industrial relations, leading to a high incidence of strikes). It is important to correct these distortions to enable Cambodia to make the most of its comparative advantages. If this can be achieved, it should continue to perform well in agriculture, tourism, and light manufacturing. Cambodia should in parallel upgrade its endowment — in particular through education, health, and infrastructure — to enable a transition to a new set of comparative advantages in the medium term.

13. Agriculture will continue to be important, but needs to be complemented by development in other sectors. Experience in Cambodia and other countries has shown the central role of agriculture-led growth, in particular in reducing poverty (since more than 9 out of 10 of the poor live in rural areas). Cambodia has the potential to significantly increase yields in rice production and consolidate food security, and this could provide a sizeable growth dividend in the short term. But experience has also shown that agriculture is unlikely to grow beyond 5 percent or so per annum, hence contributing less than 2 percentage points of growth per annum. Manufacturing will remain very important in absorbing new workers. The fact that urbanization has proceeded slowly, while value added per worker in agriculture is similar to other countries at the same level of development, suggests that Cambodia is not taking full advantage of the agglomeration effects around urban centers. These should not be ignored, as they will contribute greatly to growth.

14. Second, Cambodia needs to build on its existing capabilities and develop new ones as a step towards diversifying its economy. Cambodia currently has very few of the capabilities needed to move to new products. Recent cross-country research has shown that certain transitions from exporting one product to exporting another, are more typical than others, indicating that the capability- to export product A can often be related to the capability to export product B. It is no surprise, given the absence of diversification over the past decade, that there are very few products “similar in capabilities” to those that Cambodia now exports. This leaves Cambodia with few options for diversification. One obvious option would be to develop new products in the garment sector; but other products that Cambodia is already — although marginally — exporting (such as fish and wood products) could also be given priority.

15. Third, diversification should also be a matter of new markets, not only new products. From that point of view, Cambodia has underperformed in relation to its regional market (only 13 percent of its trade is intra-regional, against an average of 49 percent). Much more could be done to integrate further into the East Asia region.

16. Fourth, sustainable management of natural resources, particularly minerals and energy, represents another growth opportunity. Although the extent of its reserves remains unclear, Cambodia could develop a significant extractive industry in oil, gas, and mining over the next decade. To ensure Cambodia reaps the growth dividends of this sector, there needs to be a significant upgrade of the sector's management which, at the moment, is ineffective and opaque.

The three priorities in this area are (i) to clarify the legislative, regulatory, and institutional framework to increase accountability; (ii) to build the staffing to implement the framework, recognizing that the capacity- required develops in tandem with the sector itself over time; and (iii) to manage expectations in relation to subsidies of petroleum and mining products or downstream industries.

17. If these changes are achieved, these opportunities should help Cambodia to sustain growth of around 6 or 7 percent per annum in the medium term, although the short-term outlook is less encouraging given the global environment. It is not possible – and unlikely to be desirable – to pinpoint through such analytical work which product or which market will emerge: a fresh wind may come, but policymakers and entrepreneurs will have to "feel it". A sustained growth rate of 6 to 7 percent per annum would be consistent with: (i) international experience based on the quality of some drivers of growth (such as education and financial sector development); and (ii) continued investments in human and physical capital.

Identifying the Constraints

18. To realize this potential, it is important to clarify the constraints on growth (Chapter 6). In a low-income, low-governance country such as Cambodia, it would be easy to make a case that everything is a constraint. However, not only would this be at odds with the experience of rapid growth over the past decade, it would also contribute little to a growth strategy. The methodology for identifying and prioritizing constraints consists of enquiring into why entrepreneurs do not invest more for new capacity or new products, or to improve productivity. The answer could be either that the returns of the potential investments are too low or that the cost of financing them is too high.

19. There is little evidence of finance being a constraint at the aggregate level. Overall, the financial sector is very liquid (e.g. the loans-to-deposits ratio is 64 percent), it has developed rapidly in response to the increasing demand of the past few years, and real interest rates have recently become negative. Over the longer term, real interest rates and the rate of investment in durable equipment have been moving in parallel, suggesting that investment is constrained by demand rather than supply. Two exceptions stand out. First, large investments are difficult to undertake: only a link with a foreign investor makes them possible. Second, access to finance in agriculture remains insufficient and a constraint on farmers' ability to improve productivity. In addition, there is evidence that a large part of the available financing comes from foreign savings (cf. for example the fact that growth and the current account have parallel trends), highlighting the potential adverse impact of tighter conditions in international financial markets.

20. Hence the question is why entrepreneurs cannot identify projects with higher returns. Two hypotheses are possible: either there are simply too few of these high-return projects (because of excessive costs of inputs or coordination issues), or entrepreneurs doubt that they can capture sufficient returns themselves (because of the risks in the environment or because of official or unofficial taxation). It is likely that the issue is not primarily the cost of inputs, but one of coordination and appropriation of returns. Indeed, a striking feature of the Cambodian economy is the productivity of the top performers (in a few cases on par with more advanced countries), with a wide dispersion of performance across firms – in most sectors, firms on average work at 60 percent or less of the productivity of the top performer.

21. Coordination is a major issue. Production, especially of new products, requires the coordination of a large number of actors along the value chain and the establishment of a large number of rules or regulations for various transactions. This is in particular important for "self-discovery", i.e. finding out what "Cambodia is good at". Evidence of the difficulties in achieving this coordination includes: O the lack of diversification into new products over the past decade;

(ii) the simplicity of the value chains of most products made in Cambodia (for instance, the vast majority of garment firms are “cut-make-trim”, the simplest part of the value chain), and (iii) the fact that most agricultural products are exported as raw commodities (e.g. paddy rice, unshelled cashew- nuts, unprocessed rubber). This highlights deep issues in coordinating more complex value chains. In the past, this has happened in Cambodia mainly through dedicated governance mechanisms (e.g. in garments).

22. Appropriation issues are pervasive, at the macro and micro levels. Macroeconomic instability is only a recent concern and should be promptly addressed (other types of instability costs, such as crime or security, are now much less of a concern than they were 10 years ago). Entrepreneurs are unable to appropriate the returns of their investments due to two types of microeconomic issues: (i) disputes (both commercial and labor) have become a major concern given the lack of an effective court system; and (ii) corruption remains widespread, in its many forms. The level of tax itself — as opposed to its administration — is not viewed as a major constraint. It should be noted that, in relation to both issues, many firms have found mitigating strategies (such as pre-paying sales to avoid any dispute; moving toward collective bargaining agreement to reduce the incidence of labor disputes; keeping businesses informal; etc.), but many other firms simply have not been set up because of these appropriation issues, partly explaining the lack of diversification over the past decade.

23. In relation to input costs, the high costs of electricity and logistics appear to be major constraints. Their importance is evident in (i) the willingness of firms to produce 36 percent of their electricity from expensive generators; (ii) the lack of investment in electricity-intensive sectors (the garment industry is rather light in that regard); (iii) the efforts by garment firms to reduce the costs of transport and customs (over the past four years, the costs of shipping goods through customs went down for garment firms, but up for rice producers); and (iv) the high inventories that firms maintain (41 days on the main input, against less than 30 in most countries). Logistics services are constrained by poor trade facilitation and complex cross-border processes. Limited rural road coverage constrains Cambodia's agriculture potential in particular. The cost of labor remains low, but, as noted above, the recent sharp appreciation of the Cambodian riel in real terms is weakening this comparative advantage: unaddressed, it will weaken the performance of the garment sector and prevent further diversification.

A New Wind?

24. The Royal Government of Cambodia has a development strategy, the National Strategic Development Plan, which elaborates on the goals and policy priorities laid out in its political platform (the Rectangular Strategy, the second phase of which was presented by the newly re-elected Government in September 2008). These strategy documents focus on the key elements of a growth strategy. The foregoing analysis contributes to further understanding the drivers of growth in Cambodia, past and future, with a view to fine-tuning or prioritizing actions to sustain rapid growth.

25. With this background, what actions in today's context could feasibly contribute to extending the recent period of rapid growth? This report focuses on three instruments: macroeconomic policy and financial sector development; fiscal policy; and regulatory, trade, and industrial policy (Box 1 provides an illustrative list of potential “quick wins”). To get a fresh wind, three key tactics could be prioritized (Chapter 7-9).

26. The first priority is to deepen Cambodia's integration, in particular in the East Asia region. The slowdown of global trade gives this objective an added sense of urgency. Obviously, progress in trade facilitation (at the border and behind the border) is important. There are opportunities to make trade within the Greater Mekong Subregion much easier,

making Cambodia the bridge between Ho Chi Minh and Bangkok, two of the largest cities in South East Asia. But this first priority should focus more deeply on inserting Cambodia's firms into global supply chains: Thai, Chinese, and possibly Vietnamese firms should increasingly be looking at Cambodia as a place to locate their factories. Cambodia could use ASEAN as a vehicle for new initiatives in this area. Three types of action could be considered:

- Cambodia needs to address financial sector risks (e.g. by tightening bank entry criteria and by renewing efforts to monitor non-performing loans) and to manage the policy mix (by containing inflationary pressures while supporting growth). At the same time, it is important to manage the exchange rate more actively as Cambodia, being essentially dollarized, is quickly losing its comparative advantage of low costs due to inflation and the appreciation of the dollar. It is important to address this soon, as large revenues from extractive industries would exacerbate the problem in the future.
- Trade and investment can be further facilitated, most likely with a focus on agri-business. This could be accomplished by creating a dedicated unit to service agri-business investors and by creating an independent monitor of sanitary and phyto-sanitary standards (on the model of BFC for labor standards). Doubling rice yields requires a coordinated approach in order to create the knowledge and incentives for farmers to apply the appropriate combination of seeds and fertilizers. Making the existing tax incentives more active could also generate a significant return.
- Finally, the diagnostic of constraints on growth stresses the importance of coordination issues, especially the need to integrate Cambodia into more complex value chains. As well as the investor servicing unit and the standards monitor (previous point), consideration could be given to support for business associations, more proactive management of Special Economic Zones, and increased access to financial products (including through a well-functioning credit bureau). An important platform for identifying and addressing issues of common concern is the Government-Private Sector Forum (this would require the Forum to prepare more research and analysis). In addition, a number of business associations — such as associations for the hotel and garment industries — could be supported in identifying common issues hurting productivity and in proposing options for diversifying within the sectors (in particular, they would have a role in addressing vocational training issues). Indeed, the government and the private sector need to work hand in hand to prioritize key constraints and opportunities. The role of such coordination in agriculture is particularly important and can take the form of contract farming, farmers' associations or cooperatives, and self-help groups, etc. Such creative solutions to providing public goods will be a critical factor for Cambodia's success in sustaining growth.

27. Second, management of natural resources must be sustainable. Cambodia can build upon both good experience (e.g. development of community forestry and fishery) and bad experience (e.g. illegal logging). The possible development of extractive industries provides both an opportunity and a series of major challenges. Priorities in this area include the following:

Box 1: Quick Wins

Create investment servicing office, with professional staff, dedicated to agri-business and consolidating existing fragmented responsibilities

Create third-party standards monitoring organization, modeled on the Better Factory Cambodia experience

Accelerate trade facilitation reform to offset sharp appreciation of the Cambodian riel in real terms

Deepen role of Government-Private Sector Forum, by providing it with research capacity, to develop its role in identifying constraints on growth

Implement property and capital gain taxes and review tax holiday systems to orient tax incentives more toward productivity and diversification

- A more decisive effort to manage existing resources should be initiated, including the demarcation of forests, community forestry and fisheries, and management of state land. In tourism, coordination should also be improved.
- In the area of extractive industries, the legal and fiscal regime for both petroleum and mining should be clarified urgently. The RGC should build its capacity to manage the sector, including through training, computerization, and development of a good cadastre, etc. If and when the revenue base turns out to be large, external monitoring mechanisms comparable to BFC would be useful in reinforcing accountability in the sector (in particular, for revenue collection, the Extractive Industry Transparency Initiative provides a process and label to strengthen accountability and to signal Cambodia's commitment to transparency).
- More broadly, further experimentation with external mechanisms addressing governance constraints in a sector-specific way should be encouraged.

28. Third, in the medium term, Cambodia should upgrade its endowment to move to the next stages of development. While it is not desirable to work against its current comparative advantages, Cambodia should continue to develop its infrastructure and human capacity, and mobilize more savings to prepare for future episodes of growth:

- Priorities are the upgrading of rural roads, agriculture public goods (research and extension), and human capital (continuing to stress primary- education to expand the base). In all cases, however, higher spending will not be sufficient: the quality of spending (including addressing institutional issues and electricity pricing, the maintenance of roads, and the quality of teaching) will matter more than the level of expenditures. The limited fiscal space also calls for a strong effort at prioritizing expenditures based on good cost-benefit analyses (e.g. there is evidence that the returns on improvements in rural infrastructure in terms of rice yields vary greatly across regions).
- Mobilizing domestic savings is likely to become increasingly important, including to finance infrastructure and education. Expanding the fiscal space, especially through developing the revenue base, will be important in this regard.
- To manage this medium-term agenda, a number of public sector reforms will take on an increasing importance.

29. Finally, the report identifies three challenging areas for further analysis (Chapter 10). Although these areas would not generate an immediate growth dividend, they deserve closer analysis so that they can be fully integrated into the growth strategy. *Urban development* needs to be better managed given the growth potential of cities and the risk of mismanagement (such as congestion, poor services, etc, which would reduce incentives to invest and increase costs for existing firms). Depending on its nature, rapid growth could fuel *inequality*, which indeed has increased significantly over the past four years: a rapid increase in inequality is not only politically and socially undesirable, it also tends to be inimical to sustained rapid growth. Finally, the *environment* is an asset for Cambodia, but rapid growth — and global developments such as climate change—are putting it under stress.

30. Cambodia has made strong progress with a long episode of rapid growth. The conditions for a new episode of growth, however, remain highly uncertain. The country has the potential for further growth and the foregoing analysis has sketched what this potential could look like. But it will take resolute actions to achieve this potential. What needs to be done cannot be fully known in advance and the diagnostic of constraints on growth should be an ongoing process of testing new policies, scaling up the successful ones, and learning from failures. This process will require committed leadership and focused attention on growth constraints and opportunities. If such a

process is achieved, it is indeed possible for Cambodia to push its development toward new levels, contributing to a number of important welfare and social outcomes.