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# Cambodia Outlook Brief\*

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## Towards an Enabling Environment for Business Investment and Trade: Institutional and Policy Software

“Cambodia is an easy place to do business... challenges remain, but the trend is clear: Cambodia is heading in the right direction.”

*Stephen Higgins*  
CEO, ANZ Royal Bank

### Software for Sustainable Growth<sup>1</sup>

With the economic recovery well underway, attention is now turning to optimising Cambodia's medium and long-term growth trajectories. The central issue is transforming the seeds of recovery into sustainable and equitable socioeconomic development. The future profile of Cambodia's trade and investment will be a key factor in this transition.

Trade and investment policy interventions fall into two broad spheres. The first is developing hardware – transport links and other physical infrastructure; the second is constructing policy, regulatory and institutional space for trade and investment to develop.

As hardware development and other comparative advantages boost trade and investment, Cambodia's policy makers are presented with opportunities to maximise gains with appropriate software.

Appropriate regulatory and policy frameworks implemented by transparent institutions are a

key component in facilitating increased trade and investment. They are also tools that determine how trade and investment will shape the country in the future. Appropriate software can contribute to outcomes that are sustainable and equitable.

### Coordinating Trade Policy

Trade has been a driving force in Cambodia's socioeconomic transition. The government has developed and implemented policy frameworks that have transformed the country from virtually a closed economy to one of the most open in the region over the last two decades. As Figure 1 shows, this trend is expected to continue, with the World Bank predicting exports and imports to rise steadily over the next few years.

Accessions to the WTO (2004) and ASEAN (1999) have been critical to opening market access for Cambodian goods and services, as has increased sub-regional cooperation as part of the GMS. In particular, the implementation of a WTO-related agenda has greatly contributed to a trade-friendly environment. Some 70 legal reforms were identified in 2004 as a result of accession. Nearly two thirds of those have been completed.

Looking to the future, the government has focused on diversifying its export product base. Shifting away from traditional export markets such as garments and into areas such as agriculture has the potential to ensure long-term growth that yields high poverty reduction

<sup>1</sup> This is a summary of the 2011 Cambodia Outlook Conference presentations by Mr Stephen Higgins, CEO, ANZ Royal Bank; Mr Stephane Guimbert, Senior Country Economist, The World Bank; H.E. Pan Sorasak, Secretary of State, Ministry of Commerce, Royal Government of Cambodia.

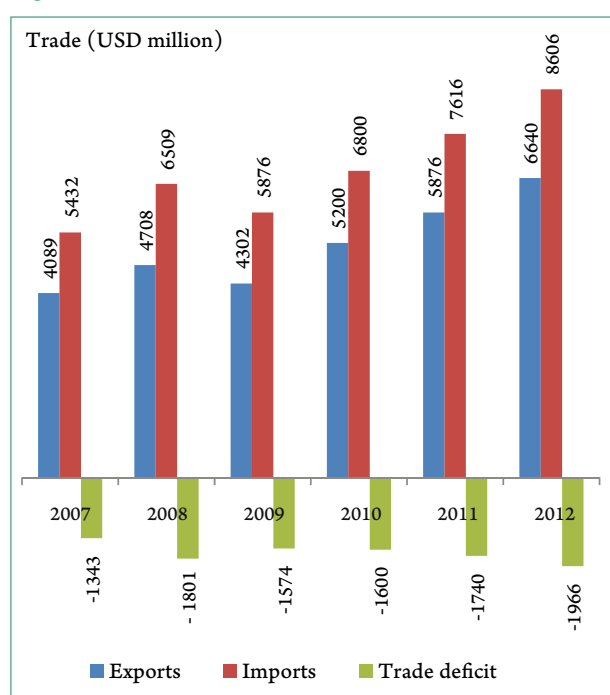
impacts. Trade policy has a huge part to play in moving Cambodia into new export products and services, new geographical markets, and up the value chain.

The government's diversification strategy coordinates policy-making resources to achieve maximum policy impact. The idea is to mobilize the financial and technical resources of government and development partners to strategically remove binding constraints to developing new export sectors.

The Sector Wide Approach (SWAp) forms the overarching framework for the government's push to 'mainstream' trade policy, and seeks to mobilise resources around common goals. Currently, projects under this framework – supported by the World Bank, AusAid, Danida, JICA and many more – are structured around three core pillars relating to export product diversification: policy and legal reform, export sector development, and institutional capacity building.

But while significant steps have been made to coordinate between development partners and government, major challenges remain. Foremost is the difficulty in coordinating the varied agendas underlying development assistance. Interests of development partners frequently run counter to the need for coordinated interventions. At present, optimal resource mobilisation and allocation is being constrained by this institutional deficiency.

Figure 1: Cambodia's Trade Profile



Source: World Bank (2010-2012 estimated)

## Targeted, Dynamic Trade Policy

It is important that policy represents the changing economic realities of the emerging export sectors. Institutional mechanisms have been developed that connect trade policy to the context specific aspects of Cambodia. The Government-Private Sector Forum (G-PSF) held twice yearly is central to dialogue between government and the private sector at the national level. The government is extending this dialogue to the provincial level with support from various development partners.

Steps are also being taken to strengthen the capacity of chambers of commerce and product associations to better serve their sectors and lobby on behalf of business.

Although lines of communication are improving, effectively engaging private sector stakeholders is proving to be a challenge. Entrepreneurs tend to think short-term gains, while diversification is a long-term strategy. Policy needs to be developed to create incentives that enable private sector to support diversification. Regionally there are many examples of successful government interventions in this regard (e.g. Japan and South Korea). Investing in research that learns these lessons and applies them to Cambodia could provide valuable policy insights.

To ensure trade policy represents the vulnerable, research into the potential effects of policy, and the monitoring and evaluation of outcomes, is critical. To this end, the 2007 Diagnostic Trade Integration Strategy (DTIS) helped identify 19 export potential sectors with positive impacts on poverty-reduction. The government must increase capacity in the network of Cambodian research institutions, enabling in-depth analysis of the relationship between export sector development and sustainable human development.

A product of increased research and consultation, the Promotion of Paddy Production and Rice Export Policy Paper issued by the prime minister in July 2010 is the first effort to formulate a deliberate response to the needs of an individual export sector. At the same time, it works within the overarching SWAp framework, and has a poverty reduction focus. This could be used as a model for similar sector-specific policies focusing on other sectors.

## Building Institutional Capacity for Trade

An intended outcome of the SWAp is building the capacity of national institutions to effectively implement trade policy. This is particularly important because the government is responsible for coordinating the SWAp. Capacity building will have the potential to greatly enhance the outcomes of the programme.

A key aim is to enable better coordination within government. One way SWAp contributes to this is by connecting ministries' priorities through alignment with the three pillars. For example, line ministries and other stakeholders generate "bottom-up" proposals for funding which relate to the three pillars.

There have been a number of targeted initiatives to increase the capacity of institutions to deal with the demands of growing and diversifying trade. For example, a UNDP TRADE project focused on building the capacity of selected key departments in the Ministry of Commerce. Through the Enhanced Integrated Framework Tier 1 project, selected key departments of line ministries that are key players in trade have been targeted for capacity building and improvements in service provision (e.g. MAFF, MIME, CDC and RSA).

The fact that the Cambodian government has taken the lead on the SWAp has meant that its institutional capacity has been tested to the limit, and across many ministries and agencies. Effective inter-ministerial coordination has proven difficult. Moreover, coordinating resources at the level of the overall Trade SWAp is proving still to be more challenging. A key issue is streamlining bureaucracies, effectively managing duplication, and simplifying monitoring and reporting requirements.

Assuming a lead role in trade policy increases ownership and will be beneficial to Cambodia in the long-run. However, it is clear that Cambodia does not have the institutional capacity to effectively implement these policy frameworks at the present time. The government recognises that it is on a steep learning curve and envisages a time-horizon of 5 to 10 years to develop global standard institutions.

A key issue is coordinating and formulating realistic solutions to the problem of institutional capacity. In practice, there are uneven expectations about the pace and nature of capacity building. This is even the case within the organisational structures of development partners. In-country teams typically understand the 5 to 10 year time-frame – headquarters often do not and have unrealistic expectations. This dichotomy undermines the process of formulating and implementing appropriate, coordinated policy. This expectation "gap" must be reduced – for policy to be successful it must match the reality of institutional capacity.

### Building Capacity for Private Investment

Investor-friendly policy and regulatory frameworks, coupled with significant comparative advantages, have warmed the private sector to Cambodia. There is a

growing confidence in the future of the Cambodian economy in the private sector. For example, this year ANZ bank expects growth of about 7 percent, and in the next three or four years somewhere in the region of 8-10 percent, which is a more optimistic outlook than that of the IMF. Correspondingly, the World Bank expects FDI to grow rapidly this year, reaching USD971 million by 2012 (Figure 2).

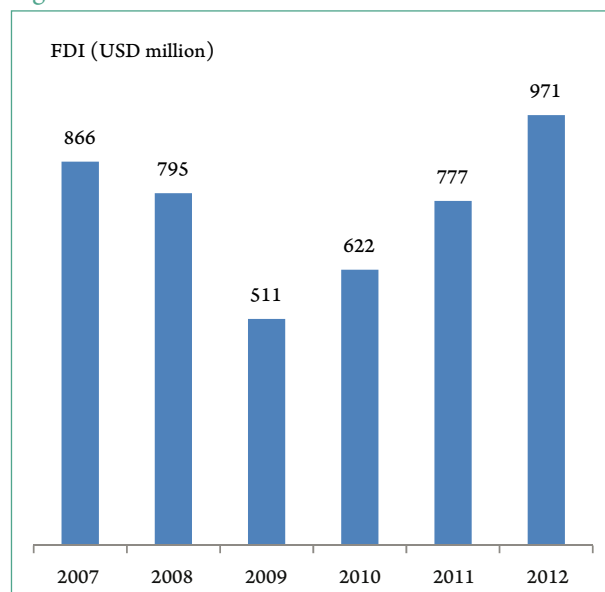
The Special Economic Zone (SEZ) is an example of how successful Cambodia's current policy and regulatory frameworks would be in attracting increased private investment if institutional constraints were adequately addressed. SEZ laws are broadly similar to Cambodia's laws in terms of policy, but they have dedicated staff to implement them and deal with issues as they arise, making implementation faster and more predictable than in other places.

The volume of investments that has been seen in the SEZ is testament to the fact that this transparent process of implementation is highly valued by investors. The challenge is to learn lessons from what has worked in the SEZ and, crucially, how such lessons extrapolate to the Cambodian economy in general.

So far, there has been some great progress in the capability of institutional frameworks to facilitate investment. Cambodia has some excellent institutions that have done much to bring investment into the country; notable examples include the National Bank of Cambodia, the Council for the Development of Cambodia and the Ministry of Finance.

External commitments to institutions such as the WTO and ASEAN have driven up the quality of Cambodia's institutions. Membership requirements have acted as signaling devices, alerting government to key constraints to investment. This has helped the

Figure 2: FDI in Cambodia



Source: World Bank (2010-2012 estimated)



government internally to coordinate ministries and adopt pro-business policies.

There are still shortcomings that need to be addressed despite these encouraging signs. A major issue is corruption, which though being tackled is still rife in key institutions such as the judiciary.

Institutions will face implementing complex policy and enforcing complex laws with increasing frequency as the economy diversifies and volumes of investment increase. Deficient institutional frameworks that are unable to implement policy in a transparent and predictable manner will greatly constrain future investment. This is especially true in areas where returns are long-term, such as in agriculture.

The investment climate could be improved by constructing new institutional frameworks that deal with specific issues in a transparent process. Examples of these are arbitration councils for settling industrial disputes, or cadastral commissions for settling land disputes. Particularly promising are arbitration councils, which already are widely perceived as credible. Once the framework is fully developed, it will provide a vehicle to resolve commercial disputes in a transparent and efficient manner – which is greatly beneficial to business.

New institutional frameworks targeting particular areas of policy implementation have numerous benefits. Creating institutions independent of the judiciary means that investment is not constrained by its lack of capacity. It also means that the judiciary is not overwhelmed by the number and complexity of cases. Moreover, it will improve the investment climate for Cambodia, reducing risks and uncertainties, especially among foreign investors.

Another challenge is reducing uncertainties resulting from inadequate information. This is particularly relevant for infrastructure development and the labour market. For example, a constraint to increased investment is the price of electricity; while it is clear that electricity provision is increasing, it is not clear how this will affect the future cost of electricity. In order to invest, business needs to know what electricity prices will look like in 5-10 years. The same is true with regards to the structure of the labour market. Again, such information is crucial for encouraging longer-term investments.

Stability is valued above all else by long-term investors. Political and macroeconomic stability is one of the key strengths of Cambodia. To maintain this advantage, there are a few issues that should be addressed. There is the potential impact from social unrest resulting from food price inflation, and how this would affect the economy. A growing concern is the evictions of urban communities, which have been much reported in the national and international media, and by international organisations. Such coverage could adversely affect future investment in Cambodia.

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