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CAMBODIA OUTLOOK CONFERENCE 2014: THE NEXT FIVE YEARS – REFORM AND COMPETIVENESS IN AN INTEGRATED REGION

The 8th annual Cambodia Outlook Conference, a partnership of CDRI and ANZ Royal, was held in Phnom Penh on 27 February 2014. Leaders from government, the private sector, development partners, the research community and NGOs came together to discuss the theme *Cambodia: The Next Five Years – Reform and Competiveness in an Integrated Region.* In his opening address, Prime Minister Hun Sen congratulated CDRI and ANZ Royal for their long and fruitful partnership and highlighted the important role of the conference in informing government on areas where policy action is necessary. This paper highlights the major policy issues raised by participants during the conference sessions.

H.E. Dr Sok Siphana, Chair of CDRI Board of Directors, presenting his welcoming remarks at the opening ceremony of the 2014 Cambodia Outlook Conference presided by Prime Minister Hun Sen, Phnom Penh, February 2014

Introduction

The 2014 Outlook Conference agenda affirmed a renewed focus on the part of government to diversify and increase the competiveness of the Cambodian economy to represent the dual realities of impending lower-middle-income status and the realisation of the ASEAN Economic Community (AEC) in 2015.

Following two decades of high GDP growth, the economy has become increasingly complex. New sources of growth will have to be cultivated as per capita GDP rises, and a cornerstone of past growth – low-cost labour – disappears. In addition, Cambodia's inclusion in the AEC will bring change to its relationship with other regional economies; this will also require a programme of economic restructuring if benefits from increased intraregional trade and investment are to be captured.

Prepared by Benjamin C.R. Flower with Kim Sour, Roth Vathana and Sum Sreymom, researchers at CDRI, this article is based on the presentations at the 2014 Cambodia Outlook Conference and draws on the Cambodia Outlook Brief Series available online at www.cdri.org.kh. Recommended full citation: Flower, Benjamin C.R., with Kim Sour, Roth Vathana and Sum Sreymom (2014), *"Cambodia Outlook Conference 2014: The Next Five Years – Reform and Competiveness in an Integrated Region",* Cambodia Development Review, 18(1):1-7.

In This Issue

The coming period of transition has implications for both economic policy and for important social and political dimensions. There is recognition from government that with industrialisation, urbanisation and rising per capita GDP, the aspirations of the population are changing in terms of the standard of living and expectations from the political system. Meeting these aspirations is key to success during the next phase of growth. This was reflected in the Outlook Conference agenda, which asserted the government's commitment to follow a path of economic reforms through an overarching framework of inclusive development.

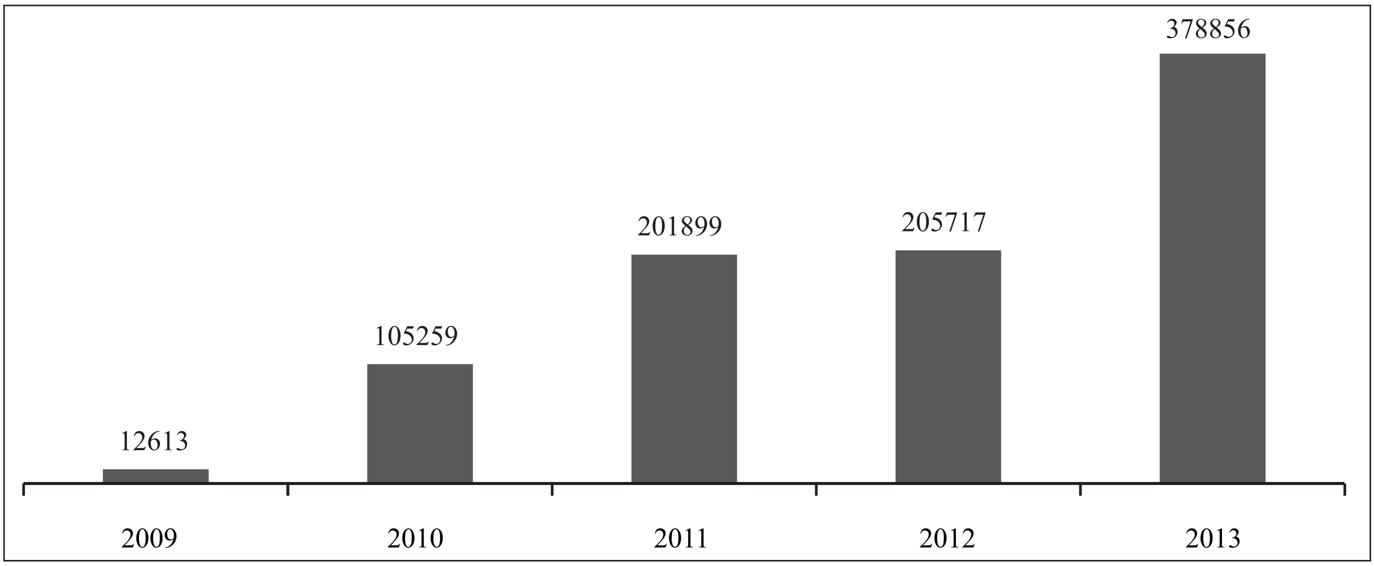
This article presents the main policy priorities highlighted at the conference. The first section details the government's aim to translate high growth into inclusive growth, underling the current issue of secure land ownership. The second section presents human resource development to drive diversification and competiveness by enabling Cambodia's population to contribute more productively to the economy. The third provides an overview of constraints in the business environment, focusing on SME development, and the fourth section focuses on Cambodia's transport infrastructure as a constraint to economic development.

Laying Foundations for Strong and Inclusive Growth

Cambodia enters the next phase of growth from a base of consistently strong GDP growth, which averaged 7.8 percent annually in the period 1994-2011, registered 7.6 percent in 2013, and is forecast to remain at around 7 percent over the next five years. 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 54 percent reaching 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 the all-time high of USD1.41 billion in 2012.

Despite high growth, inflation averaged 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 as a proportion of GDP declined slightly from 26 percent in 2012 to 23 percent in 2013. Overall, the budget deficit as a proportion of GDP is estimated at 6.8 percent, and will fall to below 5.3 percent in 2014. The government aims to reduce the deficit 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

Figure 1: Milled Rice Exports (tonnes)



Source: Ministry of Economy and Finance

the government expects a year-on-year increase of 14.5 percent in tax payments.

Also on a positive note, using standard poverty indicators, there have been major gains in poverty reduction: between 2004 and 2013, the poverty incidence declined from 53 percent of the population to 20 percent and, if current trends continue, Cambodia is on track to meet its Millennium Development Goal to halve poverty between the years 2000 and 2015. Even so, in 2009 CDRI found that one in five Cambodians were subsisting on a daily consumption of less than USD1.25 and, even now, many Cambodians exist only just above the poverty line: financial shocks from natural disasters (floods, storms and droughts) or illness could quickly push them below the poverty line again.

Asset inequality, particularly land inequality and the related problem of tenure insecurity, is a major cause of poverty. Around 55 percent of all rural households are land-poor; they either have no land or are limited to cultivating subsistence crops because they have insufficient land to produce surplus. These households are stuck in a cycle of poverty, and unable to create a surplus to contribute to growth. The Prime Minister has pledged to build the capacity of land administration institutions to legally protect smallholders' property rights from expropriation and to 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, where appropriate, redistribute land to the land-poor through social land concessions (SLCs).

Government must also include poor populations that do not own agricultural land in plans for growth. In rural areas this means promoting employment opportunities in cassava and rubber plantations, developing fisheries and providing training for off-farm jobs. Rapid urbanisation resultant of growth in industry and services 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 create a strong social safety-net system that protects vulnerable households from economic shocks.

Human Resource Development

Education and training policy will play a key role in diversifying and increasing the competiveness of the economy. Widening access to good quality education and training services is a core tenet of inclusive development.

Creating a global standard education system capable of pushing Cambodia through the next phase of development is a task that will require improvements at primary, secondary and tertiary levels. There are three core areas that policy will have to address: increasing access to secondary and tertiary education across the country, increasing the quality of education at all levels, and closing the gap between skills needed to drive the economy and skills that the education system provides.

While there have been great gains in access to primary education, access to secondary and tertiary education remains an issue that government must attend to. Overall enrolment at lower secondary level declined from 55 percent in 2011-12 to 53 percent in 2012–13, and in higher secondary level from 30.6 percent to 27 percent in the same period. In general, enrolment rates are lower in rural areas than in urban areas (Figure 2).

In response, the government is committed to improving enrolment figures by building more schools, particularly in rural and remote areas, increasing incentives for teachers to locate in peripheral areas and encouraging pupils to participate in secondary education.

There is a pronounced rural-urban divide in access to tertiary education. There are few higher education institutions (HEIs) or technical and vocational education and training (TVET) programmes located outside of urban centres; many rural households cannot afford the time and expenses associated with accessing education and training services, and/or are unaware of their benefits. This contributes to underemployment in rural areas and inefficiency in the national labour market, because excess agricultural workers do not gain the skills necessary to contribute to other sectors of the economy.

The quality of education provision is a problem at primary, secondary and tertiary levels, including TVET. A focus on enrolment statistics has often masked structural problems in Cambodia's education system. A core problem is that both primary and lower secondary schools have low completion rates, particularly in rural areas (Figure 2).

Low quality teaching and teaching facilities are features of Cambodia's education system at public primary and secondary institutions, especially in rural areas where resources are most scarce. There is a pronounced rural-urban divide with regard to teaching materials: rural pupils have less access to IT equipment, which limits their training in skills necessary for employment in a modern economy. In addition, teachers in rural schools earn low wages – approximately USD100 per month – and often have to work additional jobs or supplement their income through corrupt activities, including selling exam questions to pupils. The practice of purchasing exam questions is widespread; it has led to quality issues in education provision because hard work and academic excellence can be substituted with bribes, and has put poorer students – unable to afford informal costs – at a disadvantage because they do not have the financial resources necessary to achieve top grades.

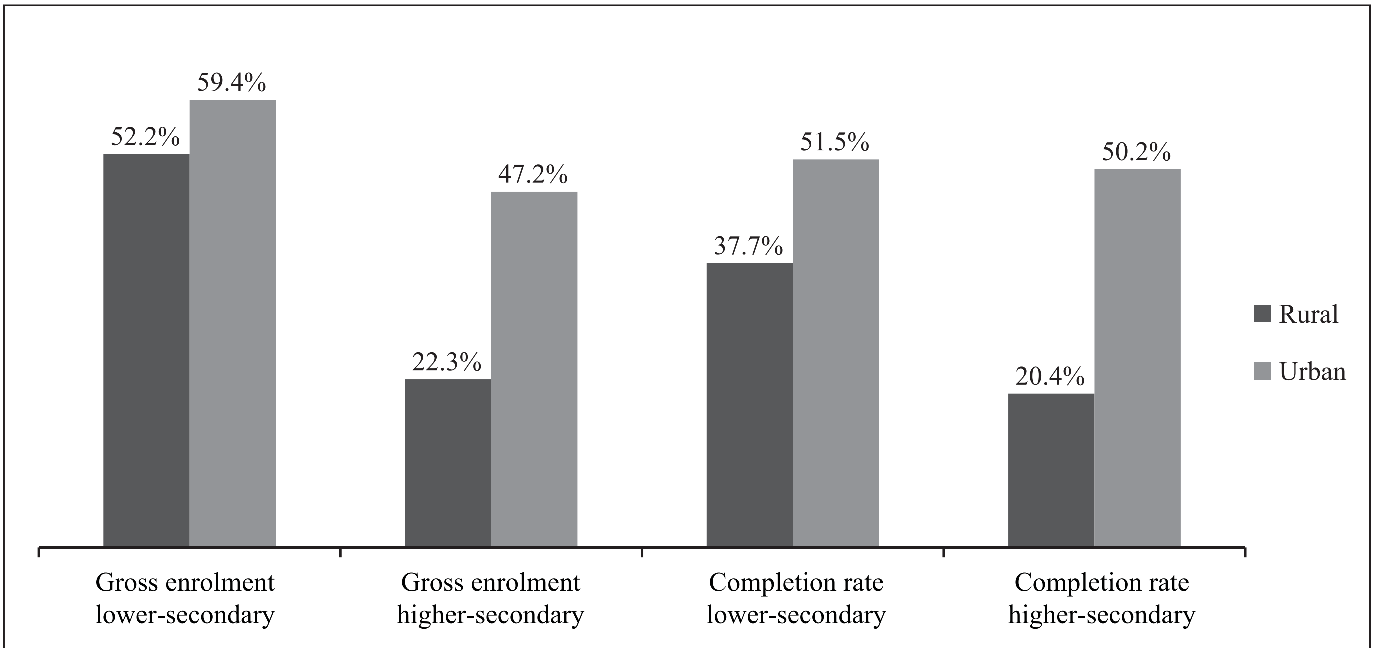
The key to improving primary and secondary education in Cambodia is increasing public funding, prioritising rural areas. This includes funding for better facilities and equipment, providing better salaries for teachers, providing better training for teachers in core subjects like mathematics, and making sure that children are adequately nourished so they are able to maintain concentration during class. There must also be efforts to cultivate a culture of education by engaging parents in their children's education and starting schooling at a young age by increasing the number of pre-schools, training pre-school teachers and improving pre-school enrolment rates.

HEIs in Cambodia also suffer from low quality teaching and facilities. An underlying issue is that higher education is private sector led and poorly regulated, often prioritising profit over quality. Without quality controls, effective monitoring and standardised certification, HEIs often provide poor training and worthless qualifications. Low quality teaching and poor regulation of HEIs also negatively affect TVET: poorly trained staff are recruited from HEIs to teach TVET courses, resulting in quality issues that impede progress in technical subjects that are necessary to drive Cambodia's economic future.

It is important to engage the private sector to fund state-of-the-art, global standard science facilities at key HEIs, which would benefit companies requiring highly skilled workers. Global-standard facilities would also attract high-calibre academics to Cambodian HEIs – crucial for creating a culture of research excellence and feeding into high-quality teaching.

For education and training to translate into a diversified and competitive economy, it is crucial that curricula provide the labour force with the

Figure 2: Rural-Urban Divide in Secondary Education, 2013



Note: gross enrolment refers to percentage of the school-aged population enrolled in schooling
Source: Ministry of Education, Youth and Sport

skills that employers require. At present, however, Cambodia's labour market does not have employees with the skills needed for current or predicted economic conditions.

A major issue is the oversupply of inappropriately-skilled graduate workers, and a corresponding shortage of semi-skilled workers. CDRI projected that in 2012 the labour market would demand around 16,000 graduates, but higher education institutions produced around 29,000; it is estimated the figures will be 22,000 versus 70,000 in 2014.

Policymakers must ensure that Cambodia's education system closes the gap between the expectations of young Cambodians entering the job market and the jobs that are available to them. This means refocusing from encouraging students to study for white collar jobs, of which there are relatively few, and reducing supply-side constraints to skill development that will boost the hospitality and tourism sectors, as well as the garments and manufacturing industries.

A core issue is to encourage more prospective students to enrol in TVET, rather than in white-collar graduate programmes. There is a stigma attached to TVET because of its association with manual labour; the image of TVET needs to change if it is to draw talented students away from white-collar courses.

The curricula of TVET schemes must represent the needs of employers if workers are to be appropriately skilled. In the manufacturing and service sectors a common complaint from employers is a lack of emphasis on soft-skill development, which limits needed improvements in workplace attitude, problem solving and creative thinking. Building effective mechanisms that ensure private sector needs are represented in TVET curricula is important to maintain dynamism as Cambodia diversifies into new industries and moves up the value chain.

Strengthening the Business Environment

The realisation of the AEC will mean that Cambodian producers have a potential market of 600 million consumers. It is the task of policymakers to ensure that this potential turns into growth by fomenting an environment that encourages diversified exports that respond to market demand. Promoting new, high value-added industries will become increasingly important as Cambodia graduates to lower-middle-income country status and its comparative advantage shifts from low-cost labour.

A driver of diversification and a major pillar of the market are small and medium-sized enterprises (SMEs), widely credited for China's economic transformation. The realisation of the AEC may result in stunted development of Cambodia's SME sector as a result of an influx of cheap imported manufactured products. Government must increase the productivity of SMEs, which are largely unregulated, by formalising business practices, including standardising financial statements and balance sheets, to enable proper audits. This will enable lending from banks, encourage investment, and provide a foundation to link with larger companies as part of regional production chains. Formalisation of financial practices will also make it easier for government to collect taxes from SMEs and so create fiscal space to fund much needed improvements in social service provision, and provide resources to see the economy through possible external shocks.

Current investment laws are geared towards attracting 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 sector manufacturing industries, such as automobile assembly. It is important that regulation is complemented with support services that promote strategies for SMEs to enter production networks, expand into new markets, and enhance technical and managerial capital.

With the expansion of entrepreneurial activity and the formalisation of business practices there will be an increased demand for formal sector credit. There are strong signs of change in the macrofinancial 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, dollarised market, which may lead to the increased risk of a macrofinancial shock.

It is important that mechanisms are in place to effectively monitor and regulate credit providers. Policymakers need to strike a careful balance: diminishing macrofinancial risks, but also providing a fertile framework for the growth of credit and its extension across the economy, particularly to SMEs.

Increases in intra-ASEAN FDI are expected with AEC realisation; formal monitoring processes and increases in productivity will give confidence to foreign investors and contribute to increase FDI to SMEs. However, a potential increase in FDI presents new sources of risk: as demonstrated in the 2009 global economic crisis, when external conditions change, footloose foreign investors take flight. It is important that government enhances supervision so that FDI liabilities are known, and shocks can be managed.

Formalisation of investment practices should be complemented by formalisation of prevalent routes of trade; this is a particularly urgent issue given impending AEC realisation in 2015. Producers will only see benefits from the AEC if government is successful in widening and promoting a culture of using formal trade mechanisms across the economy.

A useful barometer of the challenges facing AEC implementation are the constraints on the ASEAN-5 Free Trade Agreement, as mechanisms 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. 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 the ASEAN-5 framework from a Cambodian producer's perspective is the requirement to obtain an export licence. NTMs are not only a problem in Cambodia, but also affect a wide range of products across ASEAN. 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. In addition, government must provide more help to the private sector (especially SMEs) so they can understand what the AEC will mean for them – how they can benefit and what the risks are. Many businesses are unsure of the implications of the AEC and have so far received only limited information from government. The AEC can offer substantial benefits to Cambodia, but only if Cambodians understand and are able use the system effectively.

Increasing Connectivity

Increasing the capacity of hard and soft infrastructure connectivity will be crucial to enabling the government to reach ambitious export targets, diversify into new products and move up the value chain.

A striking example of barriers to export ambitions is found in 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. If Cambodia's mills could produce 1 million tonnes of milled rice per year, current infrastructure – ports, haulage capacity – would not be sufficient to move this volume. In addition, if current conditions persisted, Cambodian milled rice would be more expensive than regional alternatives because of transport costs that are 40 percent higher in Cambodia than in Vietnam, according to the World Bank. It is clear that to meet targets for rice exports, significant improvements in transport capacity are needed.

Better links between Cambodia and its neighbours will enable the economy to join regional "Just-in-time" (JIP) production (JIP) networks. JIP is a trait 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 important East Asian economies of China, Japan, South Korea and Taiwan provides opportunities to generate capital from trade moving across the region: in the past five years, trade has increased by 12 percent per year. Cambodia's strategically important position between the regional hubs of Ho Chi Minh City and Bangkok mean 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, policymakers must take a three-pronged approach to overcome capacity limitations in transport infrastructure. First, there must be continued efforts to upgrade hard infrastructure. The government and development partners have made strides in upgrading hard transport infrastructure, including roads, railways and ports. In particular, the development of the Southern Economic Corridor, supported by the Asian Development Bank (ADB) has provided the policy frameworks and funding to better link Cambodia to Vietnam and Thailand.

Second, hard infrastructure must be complemented with the development of modern, global standard logistics 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 logistics 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 logistics services at the local, national and regional levels. Currently logistics at the local level are informal, 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, at an estimated extra cost of USD100 a container.

To improve logistical efficiency, government must put in place measures that integrate local-level transport systems, particularly in remote areas, into national logistics networks. Mechanisms should also be developed that improve information 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 a choice of services.

Third, a lack of institutional capacity to implement customs procedures transparently and efficiently adds to 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 should find ways to discourage the levying of informal fees.

Cooperation and Institutional Capacity Building Key for the Future

The thread that links economic diversification, increased competiveness and inclusive development is institutional capacity. The key to Cambodia's growth and prosperity over the coming years is building institutional capacity to implement policies and laws predictably, efficiently, transparently and equitably at all levels.

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 that promote interministry cooperation, and the effective harnessing of private sector resources through Public-Private Partnerships (PPPs).

Developing an effective bureaucracy will require working within existing frameworks, such as building the capacity of local authorities through decentralisation and deconcentration reforms, building the capacity of the judiciary through training schemes for officials, as well as the revision of civil service pay scales across the board to lessen the need for officials to charge informal fees. 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 reduce uncertainties for investors. It is crucial that access to these institutions is widened to include all sections of society, and that contracts are enforced and disputes resolved according to the letter of the law, and not according to the connections or power-base of the stakeholders.