



Cambodia Outlook Brief*

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Cambodia's Economic Outlook for 2013: Possibilities and Policy Priorities for Sustainable and Inclusive Growth¹

“ We are now at a critical point in Cambodia's socio-economic development as we build on our past successes and move steadily towards graduation from least developed country status to lower middle income country by 2015-16.”

*Samdech Akka Moha Sena Padei Techo HUN SEN
Prime Minister, Kingdom of Cambodia*

The Global Economy in 2013: Implications for Cambodia

The global economy appears to have regained some momentum and a degree of stability. The risk of extreme financial events occurring in advanced economies is declining, manufacturing is showing signs of recovery, and the threat of European sovereign default has subsided. Despite these encouraging signs, a robust recovery is still a long way off and the general outlook is gloomy: low growth seems set to remain a stubborn trait of advanced economies.

Across Asia, economies are enjoying high and stabilising growth rates. The notable exception is Japan, where drastic structural reforms are needed to jump-start its economy from perpetual stall. External demand is regaining some stability on an aggregate level, while increasing capital inflows from bonds and financial market transactions reflect renewed confidence in growth potential. But there is no room for complacency: policy makers must be vigilant against asset bubbles, inflation risks and spillovers from the on-going downturn in Europe.

Emerging markets in Asia, led by China, have become the key driver of global growth, offering new opportunities to policy makers in the region. Most notable are those afforded by the ascendancy of China as an economic and geopolitical superpower.

China's regional presence has increased dramatically in recent years: it is now at the heart of production networks, effectively linking the different components of regional manufacturing processes, facilitating the supply of goods to global markets, and providing a core source of FDI. So integrated are Asian economies, the Greater Mekong Sub-Region (GMS) countries in particular, that even slight changes in China's GDP growth have major implications for national economies.

If China's economy continues to grow and its society becomes more affluent, large markets will emerge for a variety of GMS products. Already, there has been strong growth in domestic demand for durable goods and agricultural products as the Chinese population's consumption patterns change. Sustained and diversified industrial development means Chinese industry will require vast quantities of raw materials, minerals and energy. The GMS is well placed – geographically, economically and politically – to satiate this demand.

As Chinese labour costs rise, industry will migrate to sites of lower-cost production. With low labour costs and a high level of assimilation into regional production networks, the GMS is well poised to take the mantle of global manufacturing hub.

For Cambodian policy makers, the challenge will be to restructure the economy to realise the opportunities

¹ This is a summary of the 2013 Cambodia Outlook Conference presentations by H.E. Dr Hang Chuon Naron, Secretary of State, Ministry of Economy and Finance, Permanent Vice Chairman, Supreme National Economic Council; Mr Faisal Ahmad, IMF Representative, IMF, Cambodia; Dr Srinivasa Madhur, Director of Research, CDRI; and Mr Mike Smith, Chief Executive Officer, Australia and New Zealand Banking Group Limited (ANZ).

offered by a growing China. Used effectively, policy tools can take advantage of changing patterns of intra-regional capital flows to increase employment, raise labour productivity, transfer technology, move production up the value chain, and, ultimately, enable sustained high GDP growth.

Strong and Diversifying: Cambodia's Economic Growth

Cambodia's growth, recently revised to 7.7 percent, remained strong in 2012. Gains were made across the board, with all three core sectors posting strong results: agriculture 4.3 percent, industry 9.2 percent and services (which includes tourism and construction) 8.1 percent. There are nascent signs of diversification within these sectors to producing higher value-added products and into new sectors such as mining and oil.

This trend of high and diversifying growth is attributable to a number of factors. Key among them are deepening regional integration, promulgation of effective national and sectoral policy frameworks, and favourable changes in external trade conditions.

Agriculture has benefitted from the EU's tariff-eliminating "Everything but Arms" trade initiative, and the government's drive to commercialise rubber and rice production. As a result, rice exports reached 180,000 tonnes in 2011 and 207,168 tonnes in 2012, more than 80 percent of which was exported to the EU. Rubber exports increased by 30 percent, from 46,168 tonnes in 2011 to 60,032 tonnes in 2012. The overall value of rubber exports, however, decreased by 10.6 percent in 2012 due to falling global rubber prices, vindicating the government's strong focus on diversification.

There is encouraging evidence that some agricultural diversification is occurring. For example,

fishery lot reforms resulted in 6.7 percent growth in output in 2012.

The manufacturing industry, specifically garments and footwear, remained the dominant contributor to export earnings. Exports of clothing, shoes and other textile products, which account for more than 90 percent of all exports, have increased by an average of 18.1 percent annually between 2000 and 2012, excluding the 14.3 percent decline amid the 2009 crisis. In 2012 garment exports to the EU increased from 23 percent to 30 percent of total, also resultant of the "Everything but Arms" trade initiative.

Growth in the service sector was buoyed in 2012 by high numbers of tourist arrivals, which achieved a year-on-year increase of 24.4 percent, reaching a total of over 3.5 million visitors. Tourism directly employs 350,000 people and supplements the incomes of many more. It brought about USD2 billion into Cambodia's economy in 2012. There are signs that tourism is diversifying to include beach and eco tourism, with the development of Cambodia's Islands opening up new opportunities in the sector and drawing more high-end tourists to the Kingdom. Construction also continued its resurgence following sharp contraction during the financial crisis, with indications of a strong performance in 2012, though concrete figures are not yet available.

Sectoral growth has been built on the solid foundations laid by sound macroeconomic management. Despite high growth, inflation in 2012 was contained at 2.7 percent decreasing from the hike of 19.5 percent in 2008; the inflation rate forecast for 2013 is 3 percent. Other key indicators also suggest healthy macroeconomic conditions for 2012 and a stable outlook for 2013: the exchange rate held steady, the budget surplus ran at 1.9 percent of GDP, the current account deficit narrowed, the overall balance of payments ran a surplus, and

Table 1: Key Macroeconomic Indicators

(% of GDP, if not indicated otherwise)	2009	2010	2011	2012p
GDP nominal (in \$ m)	10400	11634	12937	14231
Real GDP (% growth)	0.1	6.0	7.1	7.3
- Agriculture (share)	33.5	33.9	34.6	36.8
- Industry (share)	21.7	21.9	22.1	21.9
- Services (share)	38.8	38.3	37.5	35.9
GDP per capita (\$)	753	830	911	990
Inflation (%)	-0.6	4.0	5.5	2.9
National savings (% of GDP)	21.1	24.7	24.4	23.7
Domestic revenue	11.9	13.2	13.2	13.7
Budget expenditure	20.5	21.3	20.7	19.0
Overall deficit	-6.4	-8.7	-7.3	-5.3
Investment expenditure	9.1	10.3	9.3	7.3
Domestic investment	13.4	14.1	13.7	13.3
Private investment	16.6	18.2	16.8	16.7

Source: Dr Hang Chuon Naron, Cambodia Outlook Conference

international reserves rose to USD3.4 billion (Table 1). This stability resulted in increased FDI, which is back to pre-crisis levels, and enabled the government to withdraw its stimulus package.

Revenue collection is making huge strides for the better as the government seeks to increase resources for health, education and infrastructure. Tax revenue is expected to increase from 10.9 percent of GDP in 2011 to 11.4 percent of GDP in 2012. Revenue collection by the General Department of Taxation is estimated to increase by 27 percent to KHR2501 billion (USD625 m) in 2012.

Cambodia's banking sector is becoming increasingly sophisticated: 32 commercial banks, 7 specialised banks and 34 licensed microfinance institutions were operating by 2012-end. Deposits increased by 26.2 percent from USD4.9 billion in 2011 to USD6.2 billion in 2012 and credit to the private sector in 2012 increased by 35.4 percent to USD5.9 billion from a year earlier. Microfinance deposits also increased more than two fold to USD273.9 million in 2012, while the total loan portfolio grew by 37.9 percent to USD885.8 million.

Fast but not Inclusive Growth

Cambodia's progress in improving inclusive development indicators has lagged behind its impressive economic performance. Recent research suggests that Cambodia is moderately pro-poor on consumption (income) indicators but is making slow progress on ensuring inclusiveness in non-consumption (non-income) dimensions, especially education and healthcare.

In education there has been mixed progress. Primary education has significantly improved, but secondary and tertiary education remains problematic. The first issue is access: many, especially poor families, cannot afford the costs of secondary school and university. Second, higher education institutions (HEIs) are poorly regulated and many provide low-quality teaching and worthless qualifications, often at high costs to households. Third, the current structure of Cambodia's tertiary education does not provide the labour force with the skills necessary to find employment. For example, the sector is weighted towards providing white-collar qualifications, such as IT and

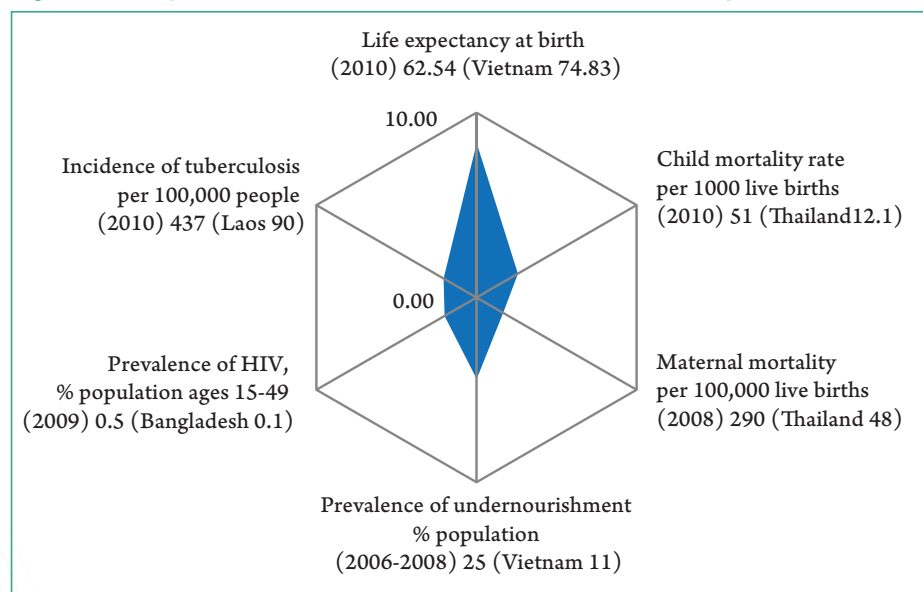
business management, despite there being far more jobs in manufacturing.

Cambodia's healthcare system, which fails to adequately cover poor households, is a constraint to inclusive social and economic development. Countries with good social service provision commonly experience higher labour productivity and higher growth because a healthy population diverts less money from entrepreneurial activities to healthcare. This same dynamic holds true for poorer households, which typically have limited resources to cope with extra expenses arising from healthcare needs. Cambodia still lags behind other countries in the region in many aspects of healthcare (Figure 1).

A particularly contentious issue regarding social and economic inclusion is land management and tenure security, especially where smallholders have come into conflict with Economic Land Concessions (ELCs). There have been many well publicised land conflicts of this nature. Government recognises the need for policy that balances the economic need for ELCs in the transition to commercial scale farming, while at the same time protecting the assets of smallholders in a way that fosters socially inclusive development.

Recently, the government ordered reviews into the ELC allocation process – many ELCs were found to be in violation of the terms of contract and were cancelled. Government must ensure that ELCs are socially and environmentally sustainable, especially for communities affected by their activities. The ruling about conducting thorough Environmental Impact Assessments (EIA) and monitoring and evaluation (M&E) plans has to be strictly applied before ELC projects are licensed.

Figure 1: Comparison of Cambodia's Health Indicators with Comparator Countries'



Source: Dr Srinivasa Madhur, Cambodia Outlook Conference

The national land titling programme also aims to increase household tenure security across the country. At the prime minister's behest, the programme has been expanded to speed up the issuance of land titles to rural smallholders, thereby increasing their tenure security. These efforts need to be sustained if universal tenure security – a foundation of inclusive growth – is to be achieved.

Failure to respond to underlying issues of socioeconomic inclusion risks jeopardising the hard-won gains Cambodia has made over the last two decades. There is a consensus that persistent high inequality in income and especially opportunities imperils sustainable growth. Worse, inequality can undo social cohesion and potentially ignite unrest. Thus, while enjoying the fruits of high growth, Cambodia has to be ever vigilant of the level of social inequality to ensure that growth prosperity is equitably distributed to all segments of society.

Moving towards Middle-Income Status

The structure of Cambodia's economy is changing as it moves towards middle-income status. Looming is the so-called "middle-income country trap", a precedent that suggests economic development stalls as rising per capita GDP diminishes the effect of comparative advantages that fuelled past high growth. If not countered now, this effect could spell the end of Cambodia's remarkable growth surge.

Policy makers recognise that Cambodia's comparative advantage will change as its economy develops. At present, a major advantage that has attracted investment and made exports competitive is low-cost labour, but this advantage will be lost as per capita GDP grows. It is essential, therefore, that the labour force is appropriately skilled to diversify economic activity into more complex, more value-added industrial, agricultural and service industries.

The government has been promoting Technical Vocational Education and Training (TVET) programmes to up-skill the labour force. It is now imperative that such programmes be expanded, both to prepare for the ASEAN Economic Community in 2015 and to avoid the middle-income trap. This requires an institutional mechanism that brings together government, higher education institutions and the private sector to develop curriculums that are dynamic and flexible to keep up with rapidly changing economic conditions.

Strong government efforts are also needed to strengthen the financial sector to encourage entrepreneurialism and diversification. Like other countries at a similar stage of development, Cambodian banks tend to provide credit to big companies but not to small or medium-sized enterprises (SMEs). Credit needs to be extended to these future drivers of growth, but must be well regulated to reduce risk. Credit extension should form part of a broader strategy to formalise the economy, which will increase both investment and revenue collection. In the longer-term, de-dollarising the economy is crucial to deepen the financial system and further develop the financial sector.

Policy makers must also act to take advantage of China's position as a key driver of global economic growth. Regional trade and investment is increasingly providing new opportunities for growth in traditional sectors as well as in new areas such as mining, hydropower, cash crops and oil. To seize the opportunities offered by a growing China, Cambodia will have to develop the needed hard and soft infrastructure, and, against the current global background of green and inclusive growth, it will be expected to do so in an environmentally and socially responsible manner.

A strong ASEAN will increase Cambodia's negotiating power and enable the economy to benefit from favourable trade agreements with China and other emerging Asian economies. Cambodia, as Chair of ASEAN in 2012, encouraged member states to integrate the requisite reforms to promote inclusion into the ASEAN Economic Community 2015. There is a danger, however, that Cambodia's policy space may be reduced by commitments to ASEAN. This is an important issue for Cambodia, which is lagging behind its neighbours in a number of areas and where decisive policy action is needed.

It is also crucial that policy frameworks are receptive to the increasing intra-regional flows of foreign investment. A prerequisite to this is improvement in the country's business environment. The biggest constraint to creating a climate conducive to setting up and running a business is corruption, especially when it comes to conflict resolution and contract enforcement. Long-term, diversified foreign investment demands an institutional environment that promotes strong property rights and even distribution of market information. The capacity of existing institutions can be re-oriented to satisfy this need.

CDRI – Cambodia's leading independent development policy research institute

📍 56 Street 315, Tuol Kork ✉ PO Box 622, Phnom Penh, Cambodia

☎ (855 23) 881 384/881 701/881 916/883 603 📠 (855 23) 880 734

E-mail: cdri@cdri.org.kh, Website: www.cdri.org.kh