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DRIVING HIGH GROWTH AND SUSTAINABLE DEVELOPMENT FOR CAMBODIA: PERSPECTIVES AND POLICY PRIORITIES FROM THE 2011 CAMBODIA OUTLOOK CONFERENCE[1]

The 5th annual Cambodia Outlook Conference, took place on 16 March 2011 in Phnom Penh. Senior representatives of government, the private sector, development partners, the research community and civil society came together to discuss the theme *Driving High Growth and Sustainable Development for Cambodia – Opportunities and Challenges*. In his keynote opening address, Prime Minister Hun Sen congratulated CDRI and ANZ Royal Bank, partners in the Outlook Conference, "on their initiative in hosting this important annual conference" and welcomed the theme as "both timely and relevant". This paper provides an overview of the key points from the conference, including Cambodia's institutional and regulatory environment, labour force profile and infrastructure development, focusing on major policy priorities and perspectives identified by speakers and participants. Presentations from the outlook conference are accessible on CDRI's website at www.cdri.org.kh.

Prime Minister Hun Sen presenting the keynote opening address at the 2011 Cambodia Outlook Conference, 16 March 2011

With growth set to increase from 5.9 percent in 2010 to 6-7 percent this year, Cambodia continues its robust recovery from the global economic crisis. Its traditional growth sectors – and those hardest hit in the downturn – are staging a remarkable resurgence and underpin current growth. The strongest performer has been industry, which posted 13.5 percent growth in 2010, compared to -9.5 percent in 2009. Garment production is soon expected to reach pre-crisis levels, creating over 55,000 jobs – almost recovering the amount lost in the crisis. While the statistics are encouraging, the economy's structure remains a concern: dependent on garments and tourism, it remains vulnerable to external shocks. Over-reliance on external demand for a narrow product base can have devastating consequences if demand slows or terms of trade change – a lesson

1 This article, by Benjamin C. R. Flower, CDRI research intern, is based on the presentations made at the 2011 Cambodia Outlook Conference.

In This Issue

Cambodia learnt to its cost in the recent crash. To mitigate such risks and build strong foundations for the future, it must seize this opportunity to diversify its economy between sectors, within sectors, up the value-added chain and into new markets.

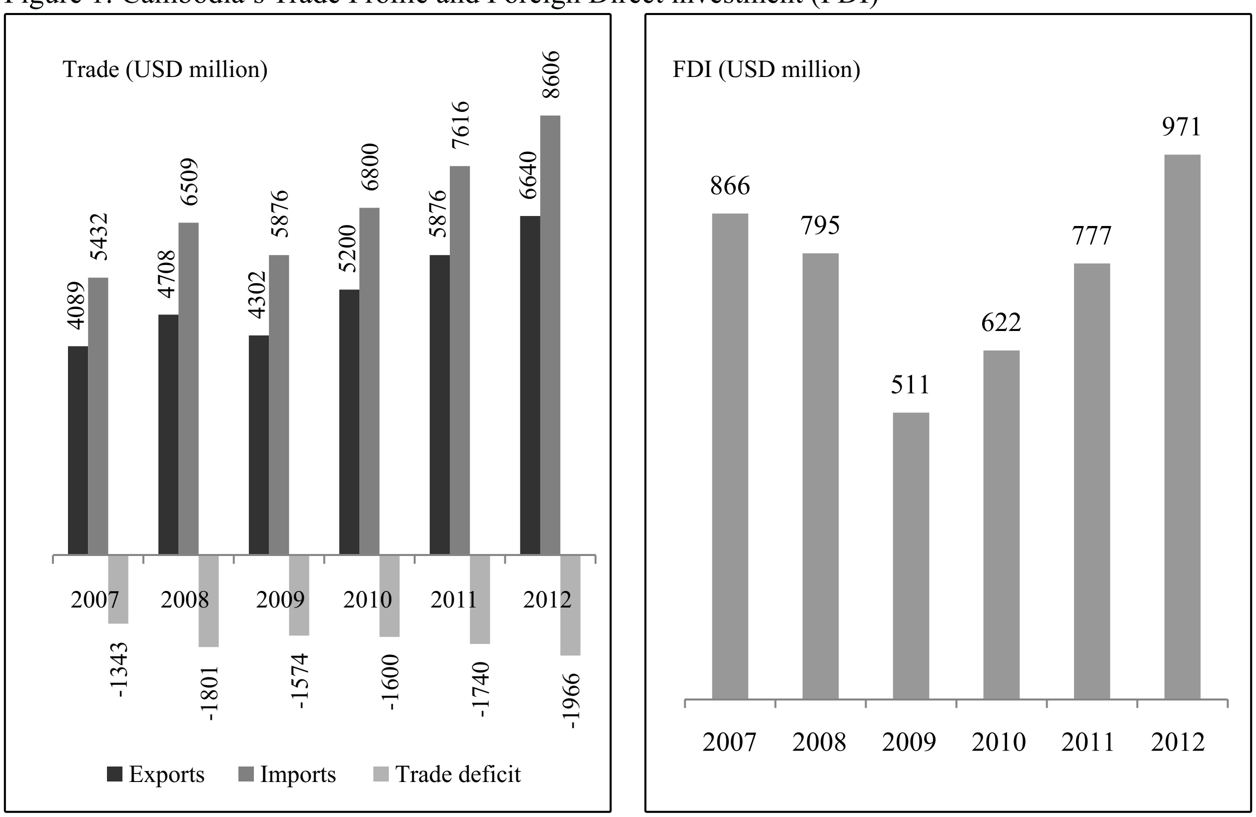
Building on past achievements and identifying appropriate policies for the future, the 2011 Outlook Conference focused on three key areas where government action is needed to ensure high, sustainable and equitable growth. These areas include: first, policy that strengthens the institutional and regulatory environment for trade and investment, encouraging equitable, diversified growth in new export sectors; second, policy that positions Cambodia's human capital to drive and benefit from a diversified economy; and, third, policy that develops the physical infrastructure necessary to support its desired development trajectory.

Constructing an Enabling Institutional and Regulatory Environment

Trade and investment are expected to increase in the medium term (Figure 1). Appropriate policy implemented by transparent institutions will strengthen this growth and ensure it is sustainable and equitable. An enabling institutional, policy and regulatory environment has a huge part to play in moving Cambodia into new export products and services, new geographical markets, and up the value chain. Moreover, enabling emergent sectors such as agriculture to benefit from increased trade and investment has the potential to pay high dividends in poverty reduction; targeted policy can help optimise such outcomes.

Trade policy constitutes a core component of the government's diversification strategy. The overarching Sector Wide Approach (SWAp) framework seeks to 'mainstream' trade policy, coordinating government and development partner resources in order to achieve maximum policy impact. The framework targets the binding constraints to diversification, both sector-specific and systemic. Regarding the latter, there has been a concerted push to build the capacity of institutions to adequately implement trade policy. For example, a UNDP TRADE project focused on building the capacity of and coordination between selected departments in the Ministry of Commerce. Innovative, sector-specific policy frameworks have also been deployed: the Promotion of Paddy

Figure 1: Cambodia's Trade Profile and Foreign Direct investment (FDI)



Source: Presentations from the 2011 Outlook Conference.

Production and Rice Export policy 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, while working within the overarching SWAp framework.

Policy can only be effective if constraints have been correctly identified and if policy represents Cambodia's diverse socioeconomic and demographic profile. The Government-Private Sector Forum facilitates dialogue between government and the private sector at the national level to ensure that trade policy represents the changing economic realities of Cambodia. But effectively engaging private sector stakeholders is proving to be a challenge: entrepreneurs tend to think short-term, while diversification is a long-term strategy. To align these positions, the government should give incentives to the private sector to think more long-term and aid diversification. There must also be in-depth policy research and analysis to enable trade policy to represent the needs of the most vulnerable in society. To this end, the 2007 Diagnostic Trade Integration Strategy helped identify 19 export sectors with the potential to effect significant reduction in poverty. The government must increase the policy research capacity in Cambodia's network of research institutions to deepen understanding of the relationship between export sector development and sustainable human development. Research resources also need to be mobilised to monitor and evaluate policy outcomes, which can also contribute to equitable growth by making sure policies are appropriately implemented and their aims fully realised.

The key issue in regard to Cambodia's investment climate is institutional capacity. 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. While Cambodia and the SEZ share very similar laws and regulatory frameworks, there are faster and more predictable implementation procedures in the SEZ. The increasing volume of investments 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 from what works in the SEZ and extrapolate this to the Cambodian economy in general.

A weak judiciary is a major institutional constraint to investment, particularly in sectors where dividends are long-term (e.g. agriculture). As the economy expands and diversifies, the implications of its limitations will become more acute. A pragmatic response is to build the capacity of conflict resolution mechanisms distinct from the judiciary, for example arbitration councils for settling industrial disputes, or cadastral commissions for settling land conflicts. Creating institutions independent from the judiciary means that investment is not constrained by its lack of capacity and that the judiciary is not overwhelmed by the number and complexity of cases. Moreover, transparent specialist institutions have the potential to reduce uneven distributions of market information, increase efficiency and reduce risks and uncertainties for investors.

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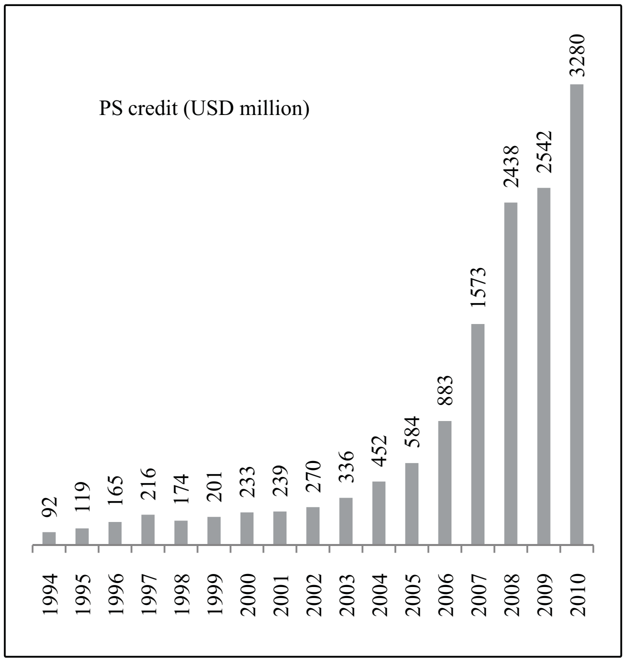
Stability is the overriding factor in determining a country's long-term economic health, and is a crucial precondition for investment. Cambodia's macroeconomic policy has been shrewd: the climate remains stable and conducive to investment, inflation has remained very low, foreign exchange reserves had increased to USD2.7 billion by the end of 2010 and public debt is manageable. Due to this stability, foreign direct investment (FDI), though not back to pre-downturn levels, still managed an increase of USD42 million from 2010-11. So far a proactive response from the National Bank of Cambodia – appreciating the riel and increasing reserves of foreign currency – has kept inflation at bay. But as rates rise regionally and pressures stemming from growth, capital inflows and increased public spending grow, the onus is on government to keep inflation manageable through appropriate policy. Another potential destabilising factor is credit supply to the private sector, which expanded by 30 percent between 2009 and 2010

Figure 2: Private Sector Credit Expansion



Source: Presentations from the 2011 Outlook Conference.

(Figure 2), and which requires regulation to mitigate risks and control inflationary tendencies. Sources of political instability such as land grabbing, urban redevelopment and rising food prices should also be addressed.

Labour Force Development

Cambodia has a young, mobile and dynamic population. With appropriate policy, this "demographic windfall" has the potential to be a huge asset in driving and diversifying growth. Traditionally, low cost labour has been an important factor in attracting foreign investment, particularly to the manufacturing sector. This investment has provided thousands of jobs as well as a firm foot-hold on the industrial ladder. Consolidating these gains and realising a diversified economy will require a concerted policy push on the part of government. Key is the government's ability to provide the labour force with the skills necessary to drive diversification, as well as strengthen traditional sectors such as tourism and garments.

A prerequisite to diversified growth is increased labour productivity in the agricultural sector. Presently the per capita contribution per unit of GDP growth is unevenly distributed between sectors: a worker in agriculture is proportionally much less productive than one in industry (the most productive) or in the service sector. The government has correspondingly focused on increasing labour productivity in agriculture, disseminating new skills, technology and training to the rural labour force. The National Budget has provided significant support to provincial agricultural training centres to provide training programmes in cultivation methodology, fertiliser production, post-harvest storage, multi-cropping and basic entrepreneurship. Increasing labour productivity in the sector will have the effect of driving agricultural output, but also of releasing excess agricultural labour into the more productive industrial and service sectors.

At present the Cambodian labour force lacks the skills necessary to diversify within the industrial and service sectors. It is essential that the standard of higher education in general is improved and that access to it is broadened to address this "skills gap". Many higher education institutions (HEIs) in Cambodia fall short of international standards in core areas such as research, governance and teaching. Compounding limitations in institutional capacity are lack of teaching and research materials, such as books, up-to-date ICT, laboratories etc. There are also huge disparities in rates of enrolment between rural and urban populations, which are heavily weighted in favour of the urban elite. In response, the 2009-2013 Strategic Development Plan Update has targeted both the capacity and reach of HEIs, broadening access through scholarship programmes and facilitating higher standards of teaching and research through capacity building programmes. Appropriate regulation also has an important part to play: codes of conduct, standards and systems of accreditation will give incentives for HEIs to improve and offer more information to employers and potential students about the content and quality of their degrees.

Another core issue regarding labour market efficiency is the mismatch between labour market skills that the private sector requires and skills that HEIs provide. This is particularly the case with specific vocational and occupational skills required for certain types of industry. Technical, Vocational and Educational Training (TVET) is the government's overarching labour-policy framework to provide Cambodia's labour market the skills that are desired by employers. Initiatives include the reform agenda of the National Training

Board (NTB), the establishment of the National Employment Agency (NEA) and the ADB funded Strengthening Technical and Vocational Education and Training programme (STVET). There are significant challenges to TVET: foremost is society's perception that TVET courses are for workers and not professionals. Policy needs to focus on changing these perceptions through appropriate regulation and accreditation.

Developing Physical Infrastructure

There have been numerous developments in transport and electricity infrastructure in the country over the last decade. These are largely a result of increased regional cooperation through ADB-GMS sponsored initiatives; by the end of 2008, there were a total of nine projects supported by USD418 million of ADB funding. ADB-GMS initiatives have been instrumental in developing the Southern Economic Corridor (SEC), upgrading physical infrastructure linking Cambodia to Thailand, Vietnam and Laos. Cambodia is currently rehabilitating its ailing railway network, with support from the ADB and private sector investment. This USD148 million project will connect the country to Thailand and Vietnam, forming a key section of the Singapore – Kunming rail link. Road and rail infrastructure will enable Cambodia to better integrate into regional supply chains, moving up the value-added ladder and accessing new markets.

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Logistical capacity at present is a binding constraint to the rapidly developing infrastructure from realising its potential. Issues such as outdated vehicles and customs procedure add time, and by extension, cost to Cambodia's exports. This is a particular hindrance to the development of SMEs, which need affordable, dynamic and reliable access to global markets that modern logistical infrastructure provides. Streamlining customs procedures, implementing clear rules and regulations, and developing infrastructure to clear goods before they get to borders (for example inland clearing depots), would enhance the country's competiveness in global markets. The limited capacity of its out-dated cross-border transport sector also negates the competitiveness of its exports. Low vehicle standards and underinvestment have resulted in high costs per kilogramme, unpredictable transit times and uncertainties over the safety of freight. Regulation is required to foster greater competition in this sector, giving operators incentives to drive up standards.

Manufacturing output has increased and consumption patterns have changed with economic growth. This has driven significant increases in the demand for electricity. Very high growth in consumption of electricity – 19 percent in Cambodia as a whole and as high as 25 percent in Phnom Penh – will mean that a significantly upgraded capacity is needed to keep up with future demand. In order to fill this demand and secure future power needs, the government has identified three crucial points where policy will be focused. First, given that 42 percent of Cambodia's power is imported, there is need to pursue policy, regulatory and institutional frameworks – as well as upgrading physical infrastructure – to secure cheap and reliable imported power in the short-term.

Second, there needs to be active investment in hydropower to release the vast potential reserves of electricity locked in the country's waterways. Its medium to long-term strategy is developing the infrastructure to tap into these significant natural endowments. The potential of hydropower is huge – estimated at around 10,000 MW. However, at present only 3 percent of electricity comes from indigenously sourced hydropower. A massive increase in capacity is planned for the future, and in the long-term Cambodia hopes to derive revenue from exporting this power to its GMS neighbours.

Third, electricity supplies need to be extended outside population hubs and into rural Cambodia. This will improve standards of living and drive up agricultural productivity. The government has set some ambitious targets in addressing the issue of rural electrification: by 2030 it is hoped that 70 percent of rural households will have access to reliable electricity, with 100 percent of villages acquiring electricity services by 2020. To achieve this, the government needs to increase the length of transmission lines to more than 2,100 km by 2020, and plans to spend USD500 million towards realising this in the next five years alone (Figure 3).

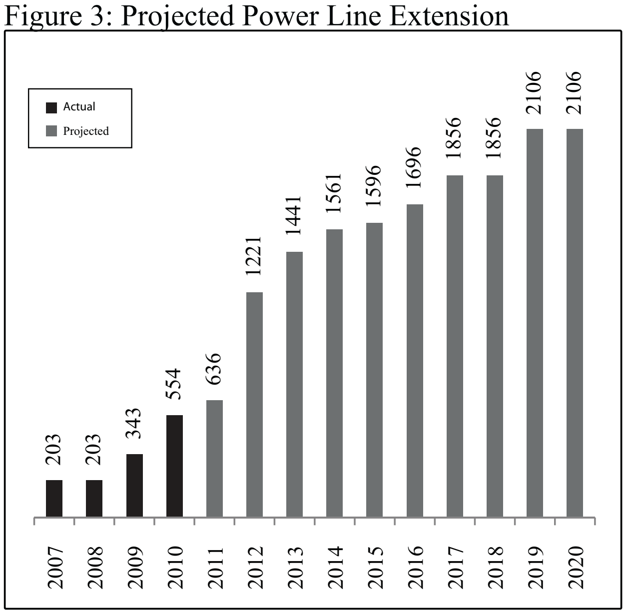
There are cross-cutting themes that the government is also addressing as part of a holistic energy policy framework. Foremost is taking measures to ensure that future energy supplies and sources are not only economically sustainable, but also environmentally and socially sustainable. The government will seek to encourage as well the efficient use of energy and to minimise the detrimental environmental affects resulting from energy consumption. To these ends, there needs to be increased research on the socioeconomic and environmental impacts of energy supply, consumption and policy effectiveness; the findings should be fed back to government and integrated into future policy.

Prospects and Priorities

Cambodia's economy has recovered remarkably well from the shock of the financial crisis: growth is strong and is expected to remain strong in the next few years. But there is now a pressing need to prepare for the medium to long-term, to build on strong foundations, to diversify the economy and position the country for high, sustainable and equitable growth. The government has a clear idea of the challenges it faces in this endeavour, and is intent on meeting them, removing constraints through targeted and coordinated policy. Impeding these policies from realising their intended outcomes is a lack of institutional capacity – a constraint that was highlighted on numerous occasions in the 2011 Outlook Conference. The government's focus on drafting laws, regulation and developing innovative policy frameworks has opened up the country and catalysed a period of growth and prosperity unparalleled in Cambodia's recent history. However, to make sure these gains are consolidated and transparent, effective institutions built on the principles of good governance must implement policies that are designed to promote diversified, equitable and sustainable growth. Whether regulating credit markets or effectively implementing TVET programmes, institutional capacity is important in ensuring that government's policies are implemented, enforced and monitored.

Strengthening Cambodia's institutions requires long-term capacity building and coordination between government and development partners around set objectives. Typically, however, it is hindered by a disparity between the expectations of development partners and the reality of institutional capacity. Development partners generally expect quick results, but in reality the systemic deficiencies in Cambodian institutions will take time to address; institutional capacity is not just a socioeconomic problem, it also has important cultural and political aspects, which by their nature cannot be changed overnight. To be effective, expectation and reality must be reconciled in appropriate policy interventions. The government sees capacity building as realistically taking between 5-10 years to achieve global standard institutions, and this is the timeframe development partners should also work within, developing and coordinating policy responses accordingly.

Figure 3: Projected Power Line Extension



Source: Presentations from the 2011 Outlook Conference.

Reference

Presentations from the 2011 Outlook Conference available at http://www.cdri.org.kh