Moving Up Value Chains for Industrialisation, Digitisation, Growth and Development

The Industrial Development Policy 2015-25 sets vision for Cambodia to transform and modernise its industrial structure from labour-intensive industry to skill-driven and technology-driven industry by 2025. Integrating into and moving up global value chains are crucial to achieving this ambitious goal.

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What are global value chains?
The global value chain (GVC) refers to the sequence of steps in which intermediate inputs such as parts and components are produced in one country and then exported to other countries for further production and/or assembly to produce final goods. For example, the production of Apple iPhone4 involves a series of complex tasks performed in various countries: design from the United States, software from India, a silicon chip from Singapore and metals mined in Bolivia. Other major countries that supply iPhone parts and components include South Korea, Japan, Germany and France. All components are shipped to China for assembly into final products and then exported to the United States for global marketing and distribution. GVCs are often coordinated by multinational corporations (MNCs), with trade of inputs and outputs taking place within their networks of affiliates, contractual partners and arm’s-length suppliers. In a world of lowering trade barriers, falling transport costs and accelerating digital innovation, the fragmentation of production in GVCs provides MNCs access to low-cost, more differentiated and better quality inputs; all contribute to improved efficiency and competitiveness.

Why is moving up value chains so important for Cambodia?
Justification for Cambodia to move up value chains is twofold. First, GVCs have emerged as a new development paradigm on the back of cheaper transport costs, lower trade barriers and greater digitisation. Most countries are increasingly competing to integrate their firms in and move them up value chains because GVCs can be a catalyst for productivity improvement, export growth and employment generation. Integration and upgrading in GVCs can also contribute to private sector development through increases in foreign direct investment, access to new networks and global markets, technology and knowledge transfer, and improved competencies in such key aspects as corporate management practices and quality and standards compliance. The economic development of newly industrialising countries in East Asia is attributable to their successful integration and upgrading in GVCs.

Second, Cambodia’s economic structure has changed tremendously. The economy has rapidly industrialised largely due to the successful integration of domestic firms into GVCs. Cambodia
is most actively involved in the apparel and footwear value chain and increasingly involved in electronics, automotive components and vehicle assembly. In the first stage of industrialisation, Cambodia specialised in labour-intensive and low-cost/low-value activities. But now that the country has reached lower-middle-income status, it is necessary to switch to higher value-added activities to achieve the next stage of industrialisation. The Industrial Development Policy (IDP) 2015-25 clearly recognises this structural issue and sets out a bold vision to transform and modernise the industrial structure from labour-intensive to technology-driven and knowledge-based modern industry by 2025. The GVC-oriented development strategy is even more appropriate given that increasing numbers of MNCs are looking to relocate certain segments of value chains in emerging economies such as Cambodia.

**Major policy recommendations**

Moving to higher value activities in GVCs can be achieved through four main channels: products, processes, functional areas and inter-chain interactions. **Product upgrading** happens when firms can move into more sophisticated product lines. **Process upgrading** refers to turning inputs into outputs more efficiently by introducing superior technology or reorganising the production system. **Functional upgrading** occurs when firms acquire new functions in the chain, such as moving from production to design or marketing. **Chain upgrading** refers to entry into new industry.

Upgrading strategy differs across sectors and might require different mixes of government policies, institutions, corporate strategies, technologies and skills. Even more challenging is that upgrading depends not only on the host country’s policies but also the governance of GVCs – the strategic corporate decisions that government cannot influence. Despite this, there are certain policy spaces that can be more conducive to moving up value chains. Based on the experiences of countries that have successfully integrated and upgraded in GVCs, this brief proposes the following policy recommendations:

**#1: Create a conducive business and investment climate.** Since MNCs are the leading actors in GVCs, it is extremely important for Cambodia to create a business climate that attracts them. Despite significant improvements in areas such as macroeconomic management, access to finance and information technology, and trade facilitation, Cambodia’s investment climate remains less favourable than in most other countries in ASEAN, ranking low in business and economic assessments. To be the location of choice for MNCs will involve, among other things, improving the ease of doing business and creating the right incentives. Priorities to remedy investment climate weaknesses include:

- Improving institutional efficiency;
- Streamlining customs procedures;
- Strengthening commercial and contract regimes;
- Improving labour market efficiency, especially availability and quality of skills and coordination among education institutions, firms and government;
- Strengthening business facilitation to support both foreign affiliates and local firms.
- Identifying supply and value chains in which it would be beneficial for Cambodia to participate.
- Attracting MNCs involved in those identified GVCs to invest in Cambodia

**#2: Improve transport and logistics infrastructure.** The availability and quality of transport and logistics infrastructure that connects a wide range of sites within the country, within the region and with the rest of the world are crucial to the smooth operation of value chains. Latest evidence from cross-country analysis suggests a strong and positive correlation between logistics performance, which takes into account customs efficiency, quality of infrastructure, quality of logistics services and several other indicators, and GVC integration.

Key recommendations arising from the 2016 Outlook Conference on the theme “Getting Things Moving – Regional and National Infrastructure and Logistics for Connectivity, Growth and Development” include:

- Finalising and implementing the Master Plan for Transport and Logistics;
- Promoting healthier competition in national transport and logistics industry;
- Developing human capital specifically for transport and logistics industry;
- Aligning Cambodia’s infrastructure development with China’s Belt and Road Initiative (BRI). The BRI and its complementary mechanisms
such as the Asian Infrastructure Investment Bank (AIIB) and the Silk Road Fund are new sources of much-needed infrastructure financing in Cambodia. A number of large-scale infrastructure projects such as Sihanoukville Special Economic Zone, the construction of a highway from Phnom Penh to Sihanoukville, Phnom Penh Autonomous Port, and the railway linking Sihanoukville Autonomous Port to Phnom Penh are the main projects under the BRI initiative. In this context, it will be very important for Cambodia to determine how, in addition to existing multilateral and bilateral partnerships, the AIIB and the Silk Road Fund can support major infrastructure and connectivity projects.

#3: Streamline custom procedures and border management. For smooth, efficient and low-cost cross-border transactions, more attention must be paid to supportive soft infrastructure through:

- Reducing and abolishing repetitive and non-transparent procedures;
- Simplifying documentation and procedures;
- Eliminating informal payments;
- Sharing information more widely through trade information centres;
- Strengthening the implementation of the Cross-Border Transport Facilitation Agreement (CBTA) and Single Window mechanism.

#4: Further develop special economic zones (SEZs) and industrial parks. International experiences suggest that well-functioning SEZs are key to GVC integration and upgrading. Key actions for SEZ development include:

- Strengthening administrative capacity and institutional framework for managing SEZ operations;
- Developing industrial zones in provinces, including agribusiness zones, to boost rural production capabilities;
- Promoting the development of industrial corridors, especially coastal economic corridors, national roads linking domestic economic poles, and highways connecting neighbouring ASEAN countries.
- Providing superior trade facilitation services, creating more flexible employment relationships, and ensuring ready access to both low and high-skilled labour.

- Developing technology parks to attract high-tech MNCs and their production.

#5: Strengthen local firms’ capacities and enhance linkages of local supply chains with GVCs. Lack of supply capacity, especially production technology, formality, corporate governance, product quality and regulatory compliance, among local firms could prevent their successful upgrading in value chains. Policy priorities should focus on:

- Strengthening business facilitation and upgrading production technology;
- Improving access to finance;
- Enabling SME participation in GVCs;
- Improving certification and standards;
- Building entrepreneurial capacity to enable firms to deal better with large enterprises and foreign investors;
- Promoting the development of industrial and SME clusters.

#6: Produce quality human capital and high class vocational training centres. Cambodia struggles to build high quality and effective human resources to meet the immediate and long-term needs of industrialisation and development. Some of the striking challenges include the quality and educational attainment of the labour force, the mismatch between skill supply and demand, and the lack of technological knowledge and skills. Without strong interventions to develop human capital, there is a high possibility of the economy becoming caught in a “low-skill, low-wage” trap. In contrast, if the country can align education policy and institutional reforms with industrial policy, it could create a competitive labour force with sufficient skills that would enable Cambodia to move up value chains and pursue catch-up industrialisation. Key policy priorities include:

- Creating a conducive ecosystem for human capital and skills development. There should be a clear vision and direction for the role of education in the economy; strong links to industrial development strategy; and regular and genuine collaboration among government ministries, training institutions and industry.
- Changing public perception and improving the image of vocational and technical education. As vocational training is still accorded lower status than other forms of education, rebranding vocational education to change
its image is an integral part of promotion and transformation efforts. This can be supported by a comprehensive marketing campaign.

- Building strong links with industry through mutual needs and benefits, i.e. participation of industry representatives in curriculum development, provision of industry-specific training and apprenticeship schemes, and joint research and development facilities.
- Enhancing the quality of vocational and technical education. This can be done through the adoption of proven practices and models such as the German dual training system, a strong focus on science, technology, engineering and mathematics (STEM) as well as on soft skills, upgrading the capacity of teachers, and investment in modern campus infrastructure.
- Ensuring that training curricula and standards meet the future skills requirements of sustainable manufacturing in Industry 4.0 (the fourth stage of industrialisation) where digitisation is already making value chains more efficient. This requires strong national STI capabilities.

#7: Develop science, technology and innovation (STI) capacity. Industrial upgrading cannot be achieved without promoting technological upgrading and innovative capacity. Although the country aspires to transform its industrial structure to skill- and technology-driven industry, the values of science and technology are yet to be mainstreamed in Cambodia’s social environment. It is therefore extremely important that the country both develops STI policy and aligns it with IDP 2015-25. Some progress has been made with the establishment in 2014 of the National Science and Technology Council (NSTC) and the adoption of the National Science and Technology Master Plan 2014-20. Even so, the following priority actions should be expedited:

- Build institutional capacity of NSTC and promote strong links between STI policy and that of other sectors including education and industry.
- Create an entrepreneurial and innovation ecosystem conducive to the generation of new ideas and inventions by eliminating systemic failures and promoting interactive learning;
- Develop STI human resources and invest in research and development
- Improve the technological absorptive capacity of firms and other actors in the innovation system to increase their ability to benefit from knowledge flows.

#8: Promote Cambodia as a prototyping and piloting hub for ASEAN/Asia.

- Build an active marketing campaign for Cambodia that is ideal for piloting new concepts: low-touch regulations, open capital market jurisdiction, young demographics; connectivity at the heart of Asia/ASEAN.
- Attract start-up FDI to develop new value chains and ecosystems.

Key success factors for upgrading in GVCs

Successful upgrading along value chains requires strong policy coherence, clear vision and direction, efficient regulatory framework and institutions, and an unprecedented level of coordination and cooperation among ministries and between governments, private organisations, industry associations, development partners and education institutions. Economic, political and social stability, a robust commercial regime and favourable business climate, and cooperative ecosystems conducive to start-ups, technology and innovation are also important preconditions for all types of upgrading in value chains. Beyond this, government has three important roles in upgrading GVCs – facilitation, financial support and regulatory action.