



Leveraging Regional Cooperation for Economic Growth in Cambodia¹

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Introduction

No country can sustain high growth without actively engaging in regional and global cooperation frameworks. Regional cooperation affects growth in several ways; it allows a country to exploit its comparative advantages, which enhances resource allocation efficiency and facilitates foreign technology and knowledge acquisition thus raising productivity, and attracts more investment, stimulating competition and improving competitiveness. Cambodia has undergone dramatic economic transformation over the last decades, from a regime effectively controlled by the state to one that is outward-oriented. Now that its economy has become more liberal and interdependent, the challenge is how to make regional cooperation work for growth. This policy brief attempts to answer two important questions: (1) Why is regional cooperation vital for Cambodia's growth path? (2) What is the right policy mix for Cambodia to maximise the benefits from regional cooperation?

Why is Regional Cooperation Vital for Cambodia's Growth Path?

Regional cooperation is important as Cambodia embarks on the path to long-term growth for three key reasons: (i) the international economic landscape is changing so rapidly that policy requires constant adjustment to meet emerging challenges; (ii) economic integration has played a significant role in the past growth process; and (iii) Cambodia is at the heart of various regional cooperation frameworks.

A Changing International Economic Landscape

International economic governance has undergone significant changes over the last decade, particularly proliferation of regional trading arrangements (RTAs) and the emergence of global supply chains (GSCs). While multilateral trading underpinned by World Trade Organisation (WTO) rules remains a central pillar of the international trading system, RTAs have proliferated creating the "spaghetti bowl" syndrome. As of January 2013, the WTO had received 546 notifications of RTAs; of these, 354 were in force, covering over 50 percent of world trade. East Asia is even more

dynamic in multi-layered RTAs. As of March 2013, countries in the region were engaged in 143 bilateral, sub-regional, regional or global free trade agreements (FTAs) and were negotiating a further 84 FTAs², forming an "Asian noodle bowl". ASEAN has been central to and a catalyst of Asia's regional endeavours. Apart from commitments to build the ASEAN Economic Community (AEC) by 2015, ASEAN has made significant commercial policy commitments with its partners in Asia, initially in the form of ASEAN+1, later ASEAN+3, and more recently ASEAN+6. At the 2012 East Asia Summit, leaders of 16 Asia-Pacific countries launched the ASEAN Regional Comprehensive Economic Partnership to reconcile existing regional trade architectures. It will cement ASEAN's central role in the emerging regional economic architecture and seek to harmonise the "noodle bowl" of differences between the various ASEAN FTAs.

Global supply chains—the breaking up of production processes into vertically separated stages carried out in different countries—have become much more prevalent. The relocation of production has been spurred by (1) rapid advancement in production technology, which has enabled industry to slice the value chain into smaller, portable components; (2) technological innovations in communication and transportation, which have both shrunk physical distance and allowed the establishment of services links that combine various fragments of the production process in a timely and cost-effective way; and (3) policy reforms in both home and host countries, which have significantly reduced barriers to trade and investment (Athukorala and Nasir 2012).

Why does the rapidly changing international economic landscape have important implications for Cambodia's growth prospects? Its first significance lies in the experience of successful exporting countries in the 1990s. There is a strong conviction among development economists that countries that have had sustained growth pursue a more open and export-oriented economic policy. Most successful countries have benefited greatly from global integration, using trade and investment as a central element of growth. Apart from maintaining political and

¹ Prepared by Hing Vutha, Research Fellow, Cambodia Development Resource Institute (CDRI), which coordinates the DRF Research Interest Group on "Cambodia and its Region", this policy brief draws upon the insights highlighted in Hing Vutha (2013), *Leveraging Trade for Economic Growth in Cambodia*, Working Paper Series No.81 (Phnom Penh: Cambodia Development Resource Institute).

² ADB Asia Regional Integration Office, <http://aric.adb.org/ftatrends.php> (accessed March 2013).

macroeconomic stability, Cambodia has benefited greatly from increased trade and participation in various regional and sub-regional integration frameworks. Regional cooperation can also promote physical connectivity and bring greater access to new markets, resources and investments that in turn accelerate productivity, employment generation and economic growth.

The second argument relates to the necessity of using multiple frameworks for export diversification, export growth and competitiveness. It is extremely important for Cambodia to align with the dynamic regional integration efforts to promote economic diversification and resilience. The prospect of an integrated Asian production network and market, extending from southern China through the GMS countries to the rest of Southeast Asia, offers vast opportunities for investment and trade, private sector development and growth and prosperity (Hing *et al.* 2013). Cambodia has not been part of the intra-regional dynamics of production sharing, but a new shift in the phenomenon of Asia's global supply chains promises to inspire a new era of opportunity for emerging economies. Because of rising costs, a considerable number of firms are moving production away from China and relocating in low-cost countries to exploit comparative advantages of low labour costs, increasing intra-regional dependence and third-country market access. This trend is evident in the investment of two Japanese firms—Minebea, a global leader in micro-motors, and Sumitomo Electric, a leading producer of wiring harnesses—to set up modern production facilities in Cambodia to serve global markets. Since global supply chains rely on open trading systems, trade and industrial policy will play a crucial role in determining the rate of off-shoring in Cambodia.

Successful Economic and Trade Policy Reform

Cambodia has successfully transformed from a centrally planned to a market-driven economy. It abandoned an economic regime where the state strictly controlled the price and quantity of goods produced, imported and exported, and adopted an outward-looking trading strategy. Cambodia has benefited from its liberalised trade and investment policy in a number of ways, including linking its economy more firmly to regional and global markets and increasing trade, investment and competitiveness. Most of the growth has been driven by just four sectors: garments and footwear, tourism, construction and agriculture. The boom in the garment sector is a clear example of how outward-looking trade policy under regional and global trading systems affects growth. The tourism sector owes its rapid growth to key policies such as the Open Sky Policy introduced in late 1997 and regional policy cooperation in the form of the GMS Tourism Strategy, which aims to create a sub-regional tourism sector as a major engine for development, and the ASEAN Tourism Strategic Plan.

Cambodia's economy has become more open and integrated, a necessary precondition for sustained growth

because it fosters investment, technology and knowledge and raises productivity. The country is now actively involved in the Greater Mekong Sub-region (GMS), the Ayeyawady-Chao Phraya-Mekong Economic Cooperation Strategy (ACMECS), the Association of Southeast Asian Nations (ASEAN) and several ASEAN-initiated schemes, including the ASEAN Free Trade Area (FTA), ASEAN-China FTA, ASEAN-Korea FTA, ASEAN-Japan FTA and broader ASEAN+3 initiatives. These strategies have laid a sound basis for determining further policy reforms and deepening integration with regional and global economies.

Some critics, based on *ex-ante* analysis, argue that the country should have delayed participation in regional blocs until it was better prepared in terms of economic conditions and capacity, but using an *ex-post* approach they may well argue to the contrary. Not only is Cambodia part of the dynamic trends of sub-regionalism, regionalism and globalism, but its membership in multi-layer trade cooperation frameworks provides useful and learning-by-doing experiences in international trade and domestic reform. Perhaps most importantly, the country is gaining a friendly and cooperative foreign policy and positive image in regional and global arenas. The consensus from most analysts is that ASEAN integration is a building block, rather than a stumbling block, to a deeper and more complicated economic partnership for trade development, industrialisation and sustained economic growth.

Cambodia's Economic and Strategic Location

Cambodia is at the heart of the GMS, ASEAN, ASEAN+3 and several other regional frameworks. Its strategic location is a major asset. The country is a beneficiary of Greater Mekong Sub-region and ASEAN infrastructure and “connectivity”—major roads, railways, bridges, waterways and ports. Alongside hard infrastructure development, there is further progress in soft infrastructure: regulatory reform and capacity building of government agencies and officials responsible for the movement of goods and people across borders. The prospect of an integrated Asian production network and market, extending all the way from southern China, through the GMS countries to the rest of Southeast Asia, provides Cambodia with vast opportunities for growth, prosperity, private sector development, and poverty reduction. This takes on greater importance with the increasing pace of GMS, ASEAN and East Asian connectivity and integration.

Policy Priorities to Maximise the Benefits from Regional Cooperation

This policy brief takes the view that while regional cooperation is a necessary condition for growth, it is not sufficient. Following are policy priorities to maximise the benefits of regional cooperation for economic growth.

Maintain sound macroeconomic management

Securing a stable and resilient macroeconomic environment

will continue to be critical to underpinning successful outcomes from trade promotion policies. Policy priorities for sound macroeconomic management include containing inflation under 5 percent, maintaining exchange rate stability, building external sector resilience, improving revenue collection, and strengthening financial sector services.

Improve investment climate

A climate conducive to investment combines a number of factors, such as degree of macroeconomic certainty; quality and accessibility of infrastructure; extent of government regulations; nature of taxation; access to and cost of financing for firms; access to, cost, and quality of factors of production; degree to which the government enables fair competition for firms; governance and corruption; and security. Immediate policy priorities to remedy investment climate weaknesses include improving infrastructure, streamlining customs procedures, enhancing logistics efficiency and investing in human development and capability. Deepening implementation of Special Economic Zones (SEZ) will also be conducive to investment. That can be done through significantly superior infrastructure, timely and efficient administrative collaboration, flexible employment relationships, and ready access to low- and high-skilled labour.

Invest in human capabilities

Cambodia's labour market is characterised by the dominance of a low-educated workforce, skill mismatch and skill gaps. Learning from the experience of successful exporting countries, Cambodia must invest heavily in skill upgrading and human development and capability. Education policies should stress universal primary education and improving the quality of learning at primary and secondary levels. Technical and vocational education and training should scale up and focus on skills that are urgently needed by the market. Tertiary enrolment should focus on science, technology, engineering and mathematics (STEM) education. Priority policy options include improving school infrastructure especially in rural areas, increasing the supply of technical and vocational training to match demand for skilled labour, improving the quality of teaching and the governance of tertiary education, and institutionalising research and development capacities in higher education institutions.

Synchronise regional cooperation frameworks

The immediate challenge for Cambodia is to ensure that regional cooperation is well coordinated, reached and taken advantage of by the private sector. The country needs to improve its institutional arrangements, which have hampered effective integration in the past. Coordination and communication among government agencies need to be clear and efficient. Capacity building has to be provided to those who have a role in these cooperation frameworks. Central to this will be ensuring the coordination and synchronisation

of GMS-ASEAN-East Asian development cooperation and regional integration to include a focus on sustained growth and bridging the development gap, with associated regional investment in long-term institutional capacity development. While regional cooperation could open up markets that would benefit local producers, especially SMEs in Cambodia, the problem so far has been producers' lack of access to information on trade agreements and how these could be of benefit to them. Despite the existence of effective national government-private sector mechanisms in Cambodia, private sector awareness and engagement in ASEAN and AEC processes is generally weak. Knowledge of the implications of the AEC and its potential benefits is low or uneven. This indicates the need to develop a greater understanding about regional cooperation frameworks among private sector actors and motivate them to engage in regional cooperation processes.

Address trade policy constraints:

- a) *Improve logistics efficiency:* Cambodia is among the countries with the least efficient logistics services in the region. Poor logistics performance stems from a host of factors including insufficient and poor quality infrastructure, low efficiency and effectiveness of the clearance process by customs and border control agencies, and low competence and quality of logistics services. Policy interventions can range from improved trade-related hardware infrastructure to better border management through the reform and modernisation of customs procedures, wider information sharing, greater competition in trucking, port and airfreight services, and ready access to information about international transit agreements.
- b) *Simplify customs procedures:* Customs formalities including paperwork, clearance, regulations and fees are among the top three impediments to exports (World Bank 2009; ADB 2012). Inefficient import and export processes directly affect trade costs, total factor productivity and competitiveness. Cambodia requires comprehensive reforms to ease major constraints perceived by the private sector, in particular standardisation and simplification of customs and trade documents, coordination among various agencies for trade and transport facilitation, and access to information on export procedures, regulations and fees.
- c) *Improve export market information services:* The private sector's lack of knowledge about export procedures and export markets constrains firms from fully harnessing opportunities arising from regional and global economic integration (WTO 2011). Given the role of trade promotion organisations in overcoming information asymmetries, strengthening the function of the Trade Promotion Department (TPD) as part of the export promotion strategy is sensible. A short-term priority measure should focus on providing support and

information needed by exporting firms, particularly in the areas of product and market development and market information services. Development partners' support and cooperation can be useful in the initial stages of reform as these partnerships can promote best practice and effective organisations. But such support should be temporary and followed by sufficient domestic resources, either full government funding or a combination of government financing and service charges. Another important element in strengthening the TPD is ensuring quality staffing through on-going capacity building and recruitment of talented staff with business experience. Policy measures should also focus on building domestic (government, private sector, and investor) and overseas trade networks (foreign governments, international buyers and investors) and improving information systems.

- d) *Improve standards compliance:* Cambodia has encountered great challenges in complying with importing countries' technical standards. Monitoring and enforcement of standards compliance suffers from serious flaws including weak legal and regulatory frameworks, poor coordination and duplication of functions among various agencies, absence of systematic laboratory testing to support inspection due to limited human and financial resources, lack of systematic inspection and monitoring, and a certification system that is not backed by testing (FAO 2010). Comprehensive reforms are needed to resolve all major problems in the standards management system. Pragmatic measures should focus on strengthening institutional frameworks especially in relation to mandates and coordination, building technical and managerial capacity, and establishing Cambodia Assessment Bodies (CABs) that are recognised by international accreditation agencies.

Conclusion

As global experiences indicate, no country can sustain high growth without integrating into the world economy. And that should be the way forward for Cambodia's trade and growth

strategy. Regional cooperation, albeit a necessary condition for Cambodia's growth trajectory, it is not sufficient. Integration into larger economic regions can strengthen a smart growth strategy, but cannot ensure its success. Other elements that loosen binding constraints to growth need to be in place including sound macroeconomic management, a business and investment-friendly climate, competent institutions, thoughtful investment in human capabilities and infrastructure facilities, and effective trade policy.

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About DRF: The Development Research Forum (DRF) of Cambodia was established following the All-Partners Forum organised by the International Development Research Centre (IDRC) in September 2007. The DRF vision is of a high capacity, professional and vibrant Cambodian development research community. Its goal is to support and strengthen the capacity of the Cambodian development research community. The DRF partnership involves the Cambodia Development Resource Institute (CDRI), Cambodian Economic Association (CEA), Learning Institute (LI), National Institute of Public Health (NIPH), Royal University of Agriculture (RUA), Royal University of Phnom Penh (RUPP), Supreme National Economic Council (SNEC) and the International Development Research Institute (IDRC).

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