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# **ASEAN 2030: Growing Together for Economic Prosperity - the Challenges**

## **Cambodia Background Paper**



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*Responsibility for ideas, facts and opinions presented in this research paper rests solely with the authors. Their opinions and interpretations do not necessarily reflect the views of the Cambodia Development Resource Institute.*

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## FOREWORD

In late 2011 the Cambodia Development Resource Institute (CDRI) was commissioned by the Asian Development Bank Institute (ADBI) to produce a Cambodia country background paper for the *ASEAN 2030: Growing Together for Economic Prosperity—The Challenges* study. The study, conducted in collaboration with the ASEAN Secretariat and the ADB's South-East Asia Department, was part of a wider study on the transformation brought about by the emergence of the Association of South-East Asian Nations (ASEAN), China and India as major global economic players. The highlights of this study, under the title *ASEAN 2030: Towards a Borderless Economic Community*, were published by the ADBI in 2012 to coincide with the 2012 ASEAN Summit in Cambodia. They are accessible at [www.adbi.org](http://www.adbi.org).

After several revisions, the final draft of the CDRI Cambodia paper was submitted to the ADBI in July 2013. It was also over this period fed into the consultation processes between the Cambodian government, its development partners and the research community, in the drafting of the government's broad development policy statement for 2014-18, the Rectangular Strategy Phase III, which provides the policy framework for Cambodia's 2014-18 National Strategic Development Plan.

This paper was a collaborative effort within CDRI involving researchers in the Economy, Trade and Regional Cooperation programme—Hing Vutha, Khieng Sothy, Lun Pide, Saing Chan Hang and CDRI's executive director, Larry Strange. Since its submission to the ADBI, it has been further revised and updated to reflect more recent statistical and analytical material from the Cambodian government and development agencies such as the World Bank, for publication in CDRI's working papers series. It should be read in conjunction with another recent CDRI research publication, *Cambodia's Development Dynamics: Past Performance and Emerging Priorities*, which analyses many facets of Cambodia's development over the last two decades, including some useful comparisons with other developing economies, and identifies development priorities, strategies and policy options for the future. Published in September 2013, this is accessible via CDRI's website at [www.cdri.org.kh](http://www.cdri.org.kh).

CDRI wishes to express its appreciation to the ADBI for the opportunity to be involved in this important project.





# 1 INTRODUCTION

## 1.1. Overview and Key Messages

Despite its characterisation in international development literature as a “post-conflict, aid-dependent, least developed country”, Cambodia has over the past two decades experienced sustained peace and stability, high levels of growth and remarkable socio-economic development. This paper analyses Cambodia’s current economic and development conditions, defines a positive scenario for the country in 2030 and identifies the factors that will determine whether this scenario can be achieved. It includes a SWOT analysis summarising the strengths, weaknesses, opportunities and threats that Cambodia will face, along with an analysis of the major challenges in achieving its aspirations and some priority policy options that should be considered in meeting those challenges. At the outset, the paper deals briefly with Cambodia’s unique context, the legacy of civil war, the Khmer Rouge regime and genocide of the 1970s and the consequent loss of human resource potential and destruction of infrastructure and state institutions. This legacy remains fundamental to understanding the socio-economic challenges and underscores the significance of Cambodia’s development achievements in the past two decades.

The key messages in the paper’s analysis are:

- (1) In spite of its unique historical legacy, Cambodia over the past two decades has achieved remarkable levels of peace and stability, economic growth and socio-economic development, with steady but uneven poverty reduction, based on strong performance in agriculture, garment manufacturing, tourism and construction, high levels of international development assistance, steadily increasing foreign investment and significant progress towards regional and sub-regional economic integration.
- (2) Cambodia is on the threshold of graduation from a low income country to lower middle income country, with annual GDP growth projections of around 7 percent meaning this will be achieved by 2015-16; it is at a development and policy crossroads if growth and development outcomes are to be sustained.
- (3) Cambodia’s major aspirations towards 2030 include graduation from low income or least developed country status; strong, stable macroeconomic conditions; a more business-friendly environment for private sector development and domestic and foreign investment; a significant reduction in aid dependency; economic diversification; a less dollarised economy; and significant progress on key socio-economic indicators: poverty reduction, inclusiveness, education, health, hard and soft infrastructure.
- (4) If Cambodia is to achieve these aspirations, six clear policy priority areas will need to be addressed: human capital development with focus on skills, education and health; economic diversification; poverty reduction; improved natural resource management and environmental protection; the strengthening of governance and institutions; enhanced macroeconomic management.
- (5) Cambodia’s strategic location and the very real benefits of regional integration and “connectivity” should be reflected in a continued and deepening commitment to sub-regional and regional integration and connectivity in the Greater Mekong Sub-region,

ASEAN and east Asia, and to an open, competitive, investment-friendly and globally oriented economy.

## **1.2. Cambodia's Unique Historical Context: Rebuilding from Year Zero**

In April 1975, after five years of civil war, the extreme communist Khmer Rouge army entered Phnom Penh, taking control of Cambodia and turning the clock back to “Year Zero”. During the Khmer Rouge regime, from April 1975 to January 1979, between 1.5 and 2 million Cambodians—including almost an entire generation of educated Cambodians—perished from repression and execution, forced labour, hunger and disease. Along with the human cost went wholesale destruction of infrastructure, productive agricultural activity and the private sector.

In January 1979, Vietnamese and Cambodian forces liberated most of Cambodia from the Khmer Rouge, but significant pockets of resistance survived until as late as the second half of the 1990s. As a result of Cold War geo-politics, an international embargo of the Vietnamese-backed regime throughout the 1980s brought further suffering, hardship, poverty and hunger to the Cambodian people (Mysliwiec 1988), although the efforts of the new regime and humanitarian efforts by some international NGOs and the Soviet bloc and Scandinavian nations helped stabilise the country and enabled some rehabilitation of infrastructure and basic agricultural activity.

In the early 1990s, after protracted peace negotiations, a United Nations Transitional Authority in Cambodia (UNTAC) was established to supervise Cambodia's transition back to “normality”, with an international peacekeeping force, the drafting of a new constitution, the first national elections under this constitution and large-scale international development assistance. During the 1990s the rudiments of a market economy were established with the reintroduction of private property, the privatisation of state-owned companies and the de-collectivisation of agriculture. Following further political conflict in 1997-98, the national election of 1998 finally ushered in a protracted period of peace, stability and development, and the return of significant numbers of the Cambodian diaspora from Europe, North America and Australia.

An understanding of this historical context is critical in assessing the remarkable progress Cambodia has made in a relatively short time in achieving sustained peace and stability, high levels of economic growth, socio-economic development and poverty reduction and integration into the global and regional economies.

## THE ECONOMY OF CAMBODIA TODAY

### 2.1. Economic Transition and Policy Priorities in Brief

The economy of Cambodia has undergone profound transformation, which can be broadly classified into three major phases. The first phase (1989-93) involved a gradual economic system change. Policy reforms (1) ended the state's interference in economic production and privatised state-owned enterprises; (2) allowed private ownership of agricultural land and unrestricted private crop sales; and (3) re-established the national bank and transformed banking into a two-tiered system. These policy reforms were aided by peace brought about by the Paris Agreement in 1991, and by political stability resulting from establishment of the coalition government in 1993.

The second phase (1994–99) involved economic rehabilitation and reconstruction. Economic policies focused on (1) developing the productive base; (2) developing a strong private sector; (3) Foreign Direct Investment (FDI); and (4) reintegrating Cambodia into regional and global economies. The trade regime gradually became more outward-looking and liberal through abolition of trade restrictions, along with more aggressive promotion of exports through bilateral, regional and global trade arrangements.

The third phase began in 2000. Policy focuses on (1) creating a favourable macroeconomic and financial environment; (2) promoting active participation, especially of the private sector, in sub-regional, regional and global economic cooperation; (3) fostering economic and trade diversification and competitiveness; and (4) attracting investment through a more conducive climate. During this period, comprehensive reform programmes have been undertaken aimed at creating a transparent and predictable legal framework for business, facilitating trade and maintaining efficient and competitive investment incentives. The current economic policy both gives Cambodia a bigger role in regional and global production and helps to improve its economic structure.

### 2.2. Overview of the Cambodian Economy

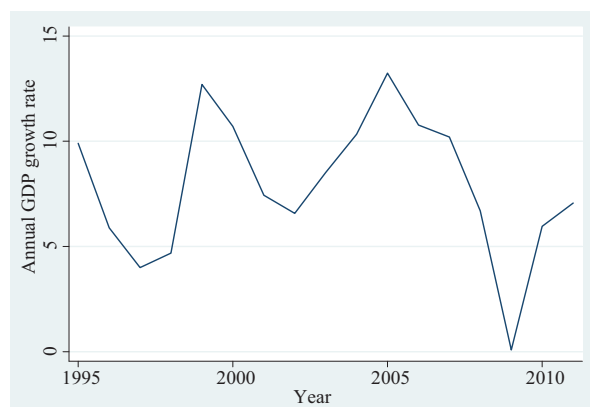
One notable feature of the Cambodian economy is its high level of dollarisation. Measured as the ratio of foreign currency deposits to broad money, dollarisation is 80 per cent (Duma 2010). Significant inflows of aid, FDI, tourism receipts and the growth of the garment export sector, which transacts exclusively in dollars, have all contributed to dollarisation (*ibid*). With dollarisation limiting the effectiveness of monetary policy, fiscal policy has been used to address inflationary pressures. The government managed to keep inflation below 5 per cent between 1997 and 2007 (World Bank 2009a), while maintaining a credible fiscal position. However, given the potential costs and risks associated with dollarisation—loss of seigniorage, liquidity risk and balance sheet risks—in the long run, Cambodia would be better off if it were de-dollarised. Benefits are likely to accrue only if de-dollarisation occurs as a natural process, in response to other reforms and increased confidence in the economy and its institutions; any attempt to enforce de-dollarisation before that could prove counterproductive.

The policy shift to a market-driven and liberal model has boosted economic growth and increased incomes. Between 1995 and 2012, economic growth averaged 7.9 per cent per year (Figure 1); per capita income increased from USD248 to USD878 during the same period. High growth has rapidly altered the economic structure (Figure 2). Agriculture's share of GDP

dropped from 44.4 per cent to 26.3 per cent; industry’s share increased from 13.5 per cent to 28.4 per cent; and the services sector grew steadily, from 35.3 per cent to 38.2 percent of GDP during the same period.

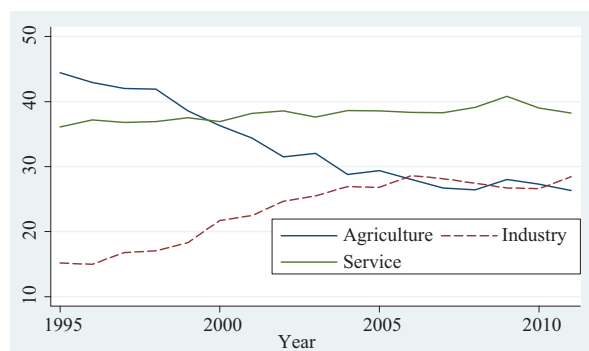
Most of the growth has been driven by a rapid expansion in garment exports, tourism, real estate and agriculture. Such narrowly based economic growth is highly vulnerable to external shocks and is unlikely to be sustainable in the long run. The global financial crisis dealt a huge blow to the economy, bringing growth down to 0.5 per cent. This demonstrated, more acutely than ever, the necessity of diversification.

Figure 1. GDP Growth Rate, 1995-2011



Source: National Institute of Statistics & Ministry of Economy and Finance

Figure 2. Composition of GDP, 1995-2011



Source: National Institute of Statistics & Ministry of Economy and Finance

Sustained growth has led to a dramatic decline in poverty, the national poverty headcount dropping from 39.0 per cent in 1994 to 22.9 per cent in 2009 (Table 1). A recent report by the Ministry of Planning (2012) noted that the poverty rate in 2011 was around 19.8 per cent i.e. Cambodia’s Millennium Development Goal 1 is highly likely to be met by 2015. In recent years, Cambodian poverty rates declined even more steeply. Urban and rural poverty rates both decreased, although poverty remains higher in rural areas. Income disparities increased during the rapid economic growth, the Gini coefficient rising from 0.35 in 1994 to 0.43 in 2007 (Table 1). However, inequality decreased to 0.34 in 2009 and 0.31 in 2011.

Table 1. Poverty and Inequality in Cambodia (1993-2009)

	Poverty headcount					Gini coefficient				
	( per cent below national poverty line)					(0= perfect equality, 1 = perfect inequality)				
	1994	2004	2007	2009	2011	1994	2004	2007	2009	2011
Rural	43.1	39.1	34.7	24.6	20.7	0.27	0.33	0.36	-	-
Other urban	36.6	25.8	21.9	19.3	-	0.44	0.43	0.47	-	-
Phnom Penh	11.4	4.6	0.8	12.8	-	0.39	0.37	0.34	-	-
Cambodia	39.0	34.8	30.1	22.9	19.8	0.35	0.39	0.43	0.34	0.31

Source: World Bank 2006, 2007 & 2009b; MOP (2012)

The employment structure has shifted notably. In 1995, agriculture employed 81.4 percent of the total labour force; by 2011, its share had declined to 59 percent.<sup>1</sup> Meanwhile, industry’s share increased from 2.9 percent to 15.5 percent, while services’ share rose from 15.7 percent to 25.5 percent.

<sup>1</sup> Estimation using Cambodia Socio-Economic Survey 2011

About 61 percent of 6.8 million employed Cambodians (aged 15 years or older) had some education at primary school level; 23 percent had completed primary education; 13.7 percent had lower secondary education; 1.5 percent had secondary or diploma education; and only 1.1 percent had tertiary education. Compounding this lack of formal education is a lack of technical skills and expertise, leading to a mismatch between labour supply and demand.

The revealed comparative advantage (RCA) index suggests that Cambodia is good at labour-intensive industry but moderate in a few agricultural products, such as live animals, rubber, wood products, rice and maize.<sup>2</sup>

The Cambodian economy has become greatly dependent on international trade. The trade dependence index<sup>3</sup> increased from 34 percent in 1994 to 152 percent in 2011. During the same period, foreign trade grew at an annual average rate of 19.0 percent; while exports of goods increased at an annual rate of 20.5 percent, reaching USD5.276 billion in 2011. The export structure is highly concentrated, the export product concentration index being 36.4 percent in 2009. Textiles, apparel and footwear accounted for 84 percent of total exports, while other exports include wood products, rubber, rice, cassava and live animals. Exports are also highly concentrated in a few markets, chiefly the US, EU and Hong Kong.

Imports increased at an annual rate of 17.5 percent from 1994, reaching USD6.879 billion in 2011. The import product concentration index was 19 percent, while import source concentration index was 36.62 percent in 2009. The biggest imports were textiles and apparel, accounting for 28 percent of total imports. China is Cambodia's largest source of imports, accounting for 21.1 percent of total imports, followed by Thailand, Hong Kong, Vietnam and Taiwan.

Total investment in 2010 was estimated at USD2721.4 million or 24.1 percent of GDP. Of this amount, 28.6 percent was public investment, largely funded by official development assistance (ODA). Private investment was 16.4 percent of GDP, of which 70 percent was domestic. FDI inflow grew from almost nothing in the late 1980s to an annual average of USD163 million between 1993 and 2004 and USD604 million in the second half of the 2000s. FDI stock between 1993 and 2010 reached USD5.58 billion, accounting for 34 percent of total private investment, or an annual average of 5.4 percent of GDP.

Cambodia is struggling to rehabilitate and build the physical and economic infrastructure for future growth and development. Insufficient and poor quality infrastructure is perceived as a major obstacle for business in the country (WEF 2011). Infrastructure development in Cambodia has lagged behind that of its ASEAN neighbours. Cambodia is ranked second from the bottom among ASEAN countries in the World Bank's logistic performance index. The Global Competitiveness Report 2011 (*ibid.*) ranked Cambodia's overall infrastructure at 114, with a score of 2.70—quite low compared with the average score of 4.35 for ASEAN.<sup>4</sup> Road transport remains embryonic and inefficient; the railway system is in bad shape. While the efficiency of ports has improved, the cost of shipping remains high. Power is costly, insufficient and to some extent unreliable, while telecommunications coverage remains limited.

<sup>2</sup> The RCA indices of apparel and footwear stand at 49 and 6.2, respectively, an index higher than one indicating a comparative advantage. RCA indices of rice (2.6), rubber (1.2) and wood products (1.6) are also competitive (International Trade Centre 2011).

<sup>3</sup> This index (also often called the openness index) is a measure of the importance of international trade in the overall economy. It can give an indication of the degree to which an economy is open to trade. The index is the value of total trade (imports plus exports) as a percentage of GDP.

<sup>4</sup> Laos and Myanmar are excluded due to data unavailability. The score range is 1 to 7. One means 'worst' and 7 means 'best'.



### 3 SWOT ANALYSIS

In facing its development challenges towards 2030, Cambodia has particular strengths, weaknesses, opportunities and threats. Its strengths include sustained peace, political stability and security since the late 1990s; high growth rates over the past 15 years due to structural transformation from a planned to an open market economy and the strong performance of sectors such as agriculture, garment manufacturing, tourism and construction; effective macroeconomic management, particularly in response to crises, including a rapid recovery from the 2008-09 global financial crisis (GFC) and regional economic downturn; strong government-private sector consultation and responsiveness and an entrepreneurial private sector; its location in the GMS-ASEAN-East Asia region with the benefits of regional economic integration and “connectivity”; a relative abundance of natural resources; a steady inflow of foreign direct investment, particularly from Asia; an adaptable and open export-oriented economy; and a young, growing population and middle class.

Its weaknesses include significant human resource capacity constraints and the low education/skills level of the workforce, with uneven quality and retention rates in primary and secondary education, particularly for girls, and inadequate vocational education and training responsive to labour market needs; pronounced dependency on foreign aid and uneven aid effectiveness; a complex “hybrid democracy” with weak institutions and a poorly paid civil service; a high degree of dollarisation; a low degree of economic diversification and high vulnerability to shocks; increasing income inequality with the associated potential for social disharmony, and an urban-rural divide; underdeveloped economic infrastructure; diffuse corruption across sectors; highly concentrated land ownership and community conflict over land management and the administration of economic land concessions; and the lack of a mature and effective civil society.

Opportunities include Cambodia’s privileged ASEAN status as a CLMV country; sustained development prospects as part of the GMS and the benefits of sub-regional and regional economic integration in ASEAN and East Asia; strong Chinese investment and earmarked infrastructure development projects, and increasing investment from Japan, South Korea and Vietnam, particularly in agri-business and light industry; the prospects of serving huge neighbouring Asian markets, especially China, and enlargement of export markets due to realisation of an ASEAN Economic Community. There are also opportunities for further expansion of tourism based on increasing incomes in neighbouring countries and, in the longer term, potential revenues from oil and gas deposits.

Threats include the prospect of political instability in neighbouring countries, with potential cross-border consequences, and regional tensions generated by unresolved maritime disputes, particularly in the South China Sea, and their impact on regional cooperation and integration; slow growth in Cambodia’s major export markets after the global financial crisis; the potential indirect impact of any significant slowing of China’s growth and development; the impact of climate change, environmental degradation and increased frequency and intensity of natural disasters, especially floods, on rural livelihoods and agricultural development; and rising inequality and constraints on absorption of the youth population into the labour market; competition from stronger and emerging economies in ASEAN post-AEC 2015.

These strengths, weaknesses, opportunities and threats are summarised in the table below.

<p><b>Strengths</b></p> <ol style="list-style-type: none"> <li>1. Sustained peace, political stability and security</li> <li>2. High growth record over past 15 years due to structural transformation from planned to open market economy</li> <li>3. Effective macroeconomic management in response to crises</li> <li>4. Strong government-private sector consultation and responsiveness</li> <li>5. Location in GMS-ASEAN-East Asia and the benefits of regional integration and cooperation in achieving an east Asian production network and market</li> <li>6. Relative abundance of natural resources</li> <li>7. Steady inflow of foreign direct investment</li> <li>8. Adaptable and open export-oriented economy</li> <li>9. Young, growing population and middle class</li> <li>10. Policy and legal framework to promote women in political and social spheres</li> </ol>	<p><b>Weaknesses</b></p> <ol style="list-style-type: none"> <li>1. Human resource capacity constraints, low education/skill level of the workforce and uneven health outcomes for women and children</li> <li>2. Pronounced dependency on foreign aid and uneven aid effectiveness</li> <li>3. Complex “hybrid democracy” and weak democratic institutions</li> <li>4. High degree of dollarisation</li> <li>5. Low degree of economic diversification and high vulnerability to shocks</li> <li>6. Increasing income inequality and associated potential for social disharmony</li> <li>7. Underdeveloped economic infrastructure</li> <li>8. Diffuse corruption across sectors</li> <li>9. Highly concentrated land ownership and poor land and other natural resource management, with associated community conflict</li> <li>10. Lack of mature civil society, including predominance of men in governance and decision making</li> </ol>
<p><b>Opportunities</b></p> <ol style="list-style-type: none"> <li>1. Privileged ASEAN status as a CLMV country</li> <li>2. Sustained development prospects as part of GMS and benefits of sub-regional and regional economic integration in ASEAN and east Asia</li> <li>3. Strong Chinese investment and earmarked infrastructure development projects and increasing investment from Japan, South Korea and Vietnam</li> <li>4. Possibility of serving huge neighbouring Asian markets, especially China, enlargement of export markets due to AEC realisation</li> <li>5. Development opportunities for tourism based on increasing incomes in neighbouring countries</li> <li>6. Potential revenues from oil and gas exploitation</li> </ol>	<p><b>Threats</b></p> <ol style="list-style-type: none"> <li>1. Prospect of political instability in neighbouring countries, with potential cross-border consequences; regional tensions on maritime issues and major watercourse usage</li> <li>2. Slow growth in Cambodia’s major export markets due to double dip recession after the global financial crisis</li> <li>3. Indirect impact of any significant slowing of China’s growth and development</li> <li>4. Impact of climate change, environmental degradation and increased frequency and intensity of natural disasters, especially floods, on rural livelihoods and agricultural development</li> <li>5. Rising inequality and constraints on absorption of youth population into the labour market</li> <li>6. Competition from stronger and emerging economies in ASEAN post-AEC 2015</li> </ol>

## ASEAN AND ASIAN CONTEXT

Cambodia is a small but strategically important country at the heart of the Greater Mekong Sub-region (GMS). It is a member of ASEAN, ASEAN + 3, the East Asia Summit and several other sub-regional and regional integration frameworks. Its location in an increasingly integrated GMS, in ASEAN and in proximity to China is a major asset. The prospect of an integrated production network and market, extending from China, through the GMS countries to the rest of south-east Asia, provides Cambodia with opportunities for trade, growth, prosperity, private sector development and poverty reduction.

Cambodia's trade with China, South Korea and Vietnam has increased significantly in the last few years. The government's rice production and export promotion policy reflects the high potential of agricultural production and the need to attract investment in the production of rice and other high-demand export crops such as cassava, soy beans and rubber, and in broader agribusiness and food processing.

Cambodia is currently rehabilitating and modernising the rail system linking Phnom Penh to its borders with Thailand and Vietnam. Along with such hard infrastructure, progress is being made in strengthening "soft" infrastructure—the regulatory reform and capacity building of government agencies and officials responsible for the smooth, transparent and cost-effective movement of goods and people across borders. This takes on greater importance with the increasing pace of GMS, ASEAN and east Asian connectivity and integration.

The government has a strong policy commitment to membership of ASEAN, an ASEAN Economic Community (AEC) by 2015 and associated regional institutional arrangements. This commitment looks beyond the achievement of AEC 2015 to utilising more effectively the ASEAN-China/Japan/South Korea FTAs, as well as the longer term potential for an East Asian Free Trade Area and/or the Regional Comprehensive Economic Partnership as vehicles to narrow the development gap in the region and promote regional competitiveness, invigorate domestic demand and boost intra-regional trade.

According to the July 2010 status report by the Ministry of Commerce, Cambodia has achieved compliance with 70 percent of the key deliverables under the AEC, partly due to its accession to the WTO in 2004 and the openness of the economy, placing it third among ASEAN member countries in AEC compliance. However, unresolved issues remain in relation to the free flow of goods and people across borders, both formally, because of time consuming and duplicative administrative transactions and a lack of computerised systems, and informally, through rent seeking and corrupt practices.

Despite effective national government-private sector consultative mechanisms, private sector awareness and engagement in GMS, ASEAN and AEC processes are generally weak. Knowledge of the implications of the AEC and its potential benefits is low or uneven, and, unlike other ASEAN countries, Cambodia has yet to undertake a detailed analysis of its competitiveness by sector, to identify opportunities under the AEC.

Cambodia's deepening relationship with China is fundamental to its future prospects. There is now constant two-way traffic between Cambodian and Chinese government leaders and officials on trade and investment issues, development cooperation and military and security cooperation. At the same time, the Cambodian government continues to balance its deepening



economic and strategic relationship with China with its relationships with other major players in the south-east Asian region—Japan, South Korea, the United States and Australia.

Over the past decade there has been a significant expansion in bilateral trade between Cambodia and China. However, Cambodia's negative trade balance within China continues to widen at an average annual growth rate of 34 percent. Despite this imbalance, bilateral trade has made a significant contribution to poverty reduction through rising export shares of labour-intensive agricultural products, particularly rubber, and textiles and garments, and rising import shares of pro-poor consumer goods (Ouch *et al.* 2011). There is strong potential for increasing Cambodia's export to China of other agricultural products—rice, cassava, maize and soy beans—as agricultural productivity and diversification improve.

Tourism from China to Cambodia has increased dramatically, nearly 334,000 Chinese tourist arrivals being recorded in 2012, an increase of 35 percent from 2011, and behind only arrivals from South Korea and Vietnam (MoT 2012). This trend is likely to continue as sub-regional and regional infrastructure, transport and connectivity improve.

Official Chinese investment approvals in Cambodia have increased dramatically, from USD83.1 million in 2004 to USD260 million in 2012.<sup>5</sup> However, the realisation of these approvals remains uneven. Investment is focused on garments, agriculture, energy (hydro power), tourism and mining. Chinese investors have responded positively to Cambodia's low labour costs, political stability, investment incentives and growing domestic market. Chinese investment in the garment sector has contributed to poverty reduction in Cambodia by providing employment opportunities and income generation for the rural poor, particularly young women (Ouch *et al.* 2011).

In 2010, China became the largest source of development assistance to Cambodia. Planned disbursements registered with the Council for the Development of Cambodia (CDC) reached approximately USD138 million, with a further commitment of about USD211 million for 2011 (CDC 2011b). This assistance is primarily focused on infrastructure—the repair or construction of major roads, bridges, irrigation and hydro-power generation schemes. While the impact of Chinese ODA has been contested by civil society and the media, particularly in relation to its lack of conditionality, and the dominance of construction contract opportunities by Chinese companies and Chinese labour, real benefits flow to local communities from specific projects. Improved roads, bridges and irrigation schemes expand opportunities for crop diversification and provide access to markets, public health and education services.

Ultimately, and certainly by 2030, it would be in Cambodia's interests to have moved beyond the ASEAN Economic Community and to have become part of an east Asia-wide free trade and economic community, which could help narrow or bridge the development gap in east Asia through a coordinated approach to economic and regional development cooperation and integration. This could be transformational for the smaller GMS members of ASEAN—Cambodia, Laos and Myanmar.

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<sup>5</sup> Chinese investment approvals hit a record high of USD4415 million in 2008, USD1192 million in 2011 and USD890 million in 2009.

## THE 2030 VISION FOR THE CAMBODIAN ECONOMY

Prior to the GFC, Cambodia grew at a remarkable pace. Although the crisis affected growth in 2008 and 2009, recovery was well underway by late 2010. Cambodia has grown at a rate which suggests that the economy could regain its pre-crisis momentum. By 2030, Cambodia is expected to have (1) become a lower middle income country; (2) continued to maintain macroeconomic stability; (3) provided a more friendly business environment; (4) become less aid-dependent; (5) attained a more diversified economy; (6) become less dollarised; and (7) attained sustainable socio-economic development with equitable distribution of wealth and substantial reduction in poverty.

(1) **Lower middle income country:** Using data from IMF (2012) to project Cambodia's per capita GDP growth, we find that Cambodia is expected to have graduated from LDC status and have become a lower middle income country by 2018 in a low growth scenario (5 percent), by 2016 with medium growth (7 percent) and by 2015 with high growth (9 percent). In 2030, it will still be a lower middle income country under all three scenarios (Table 2).

Table 2. Growth Projections under Low, Medium and High Growth Scenarios

Projections	2010 (base)	2030 (5%)	Growth (times)	2030 (7%)	Growth (times)	2030 (9%)	Growth (times)
GDP billion USD	11.3	29.9	2.7	43.6	3.9	63.1	5.6
Population, millions (1% annual growth)	15.0	18.2	1.2	18.2	1.2	18.2	1.2
Per capita GDP, USD	752.7	1636.7	2.2	2387.1	3.2	3457.2	4.6

Source: IMF-WEO (2012) and CDRI's projections

Our analyses of Cambodia's SWOT, historical growth path and current economic stance convince us that Cambodia could achieve average annual growth of around 8.5 percent during the next two decades, making GDP expand by around 5.2 times and per capita GDP by approximately 4.2 times between 2010 and 2030 (Table 3).

Table 3. Cambodia in 2030, on Optimistic Scenario

	2010 (base)	2030 (8.5%)	Growth (times)
GDP billion USD	11.3	58.1	5.2
Population million (1% annual growth)	15.0	18.2	1.2
Per capita GDP USD	752.7	3182.6	4.2

Source: IMF-WEO (2012) and authors' perspectives

(2) **Stable macroeconomic conditions:** Fundamentally, macroeconomic stability depends on sound fiscal and monetary policies, along with a developed and stable financial sector. In a dollarised economy in which monetary policy is extremely weak, fiscal stimulus is a more practical means of dealing with macro shocks (WB 2009b: 78). However, the government's budget deficits, spanning decades, limit fiscal space and undermine the effectiveness of countercyclical measures.

Nonetheless, continued efforts to broaden the tax base and government budget discipline will narrow the budget deficit; this narrowing could be more accelerated if revenue from oil and

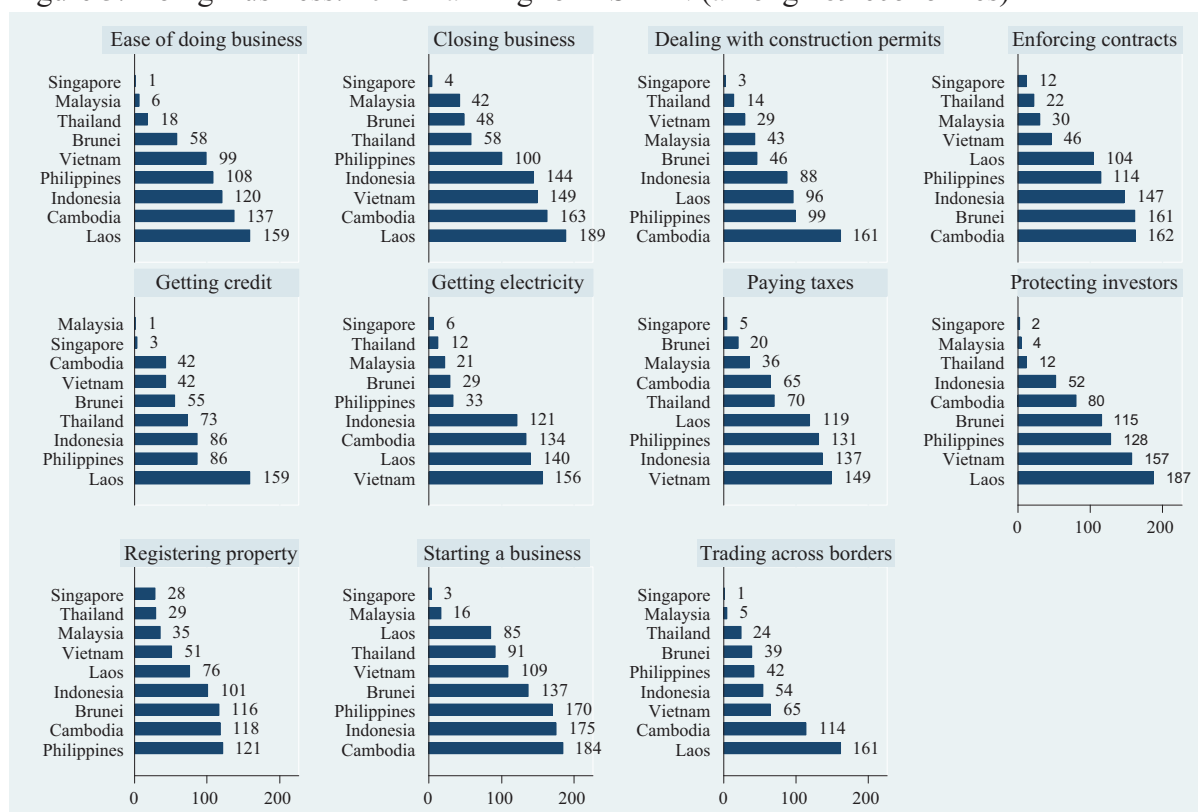
gas materialises in a few years. Disciplined spending will continue to be critical, as too much spending may result in inflationary pressures.

Restoring the credibility of monetary policy of the National Bank of Cambodia is also important to macroeconomic stability. A sound and developed financial sector is also important. Cambodia's financial sector remains underdeveloped, but recent efforts by the NBC and development partners to modernise the sector have been underway through the adoption of blueprints for financial sector development and strengthening of controls to deal with potential high liquidity, credit risks and bank governance.

**(3) A more business-friendly environment:** With the exception of Laos, Cambodia lags behind the rest of ASEAN in ease of doing business in 2013. As shown in Figure 3, Cambodia performs fairly well in providing an enabling environment for obtaining credit, paying taxes and protecting investors, but poorly in terms of starting and closing a business, dealing with construction permits, enforcing contracts, obtaining electricity, registering property and trading across borders. These bottlenecks must be addressed.

There is some sign of improvement, attributable to progress in the above indicators. There was a surge in foreign fixed asset investment approvals, from around USD160 million in 2000 to USD1.372 billion in 2012 (CDC 2013) reflecting improvements in Cambodia's business environment during the last decade.

Figure 3. Doing Business: 2013 Ranking for ASEAN (among 189 economies)

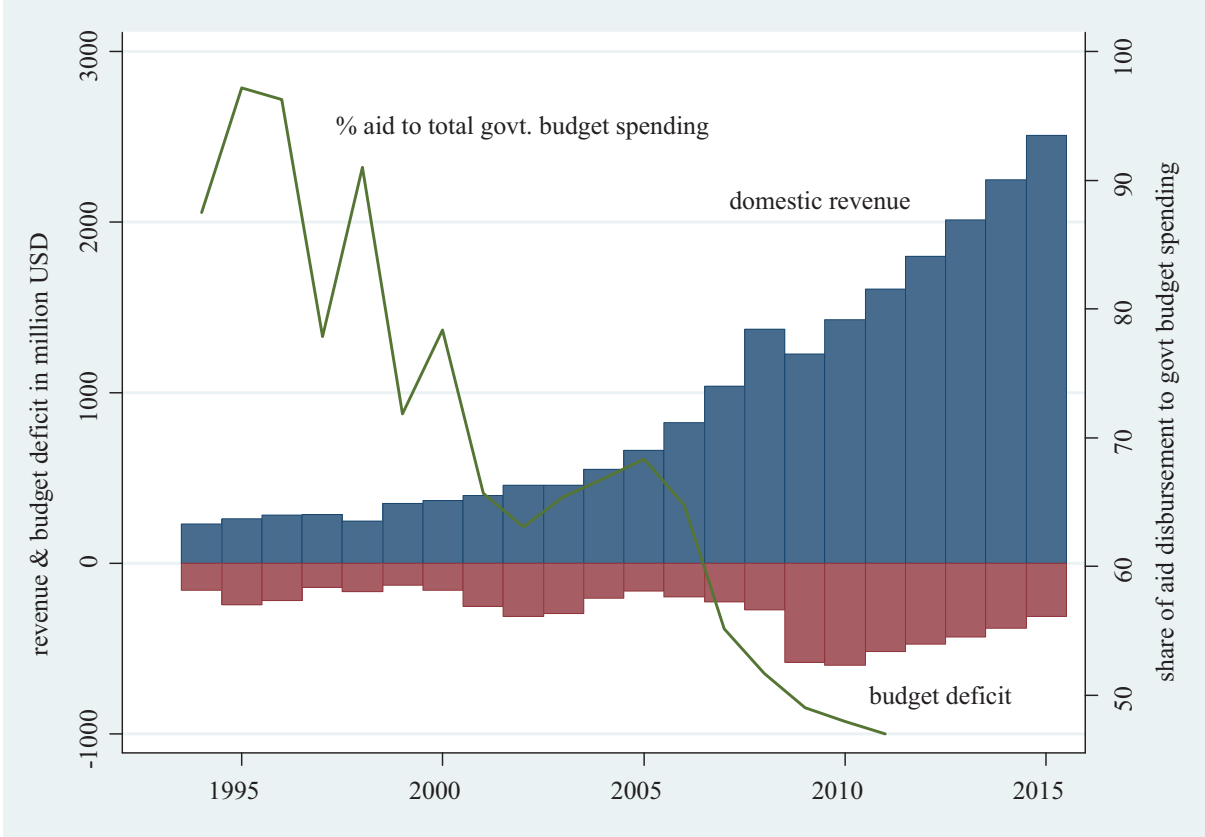


Source: World Bank (2013)

**(4) Less aid-dependent:** Cambodia is widely perceived to be aid-dependent. Total aid, including disbursements to NGOs, amounted to around USD12.108 billion between 1992 and 2011. In 1992 aid disbursements amounted to only USD250 million, mainly in the form of natural disaster and civil war relief. By 2011, disbursements had grown to USD1.235

billion, covering sectors such as governance, agriculture, environment, education, health care, energy and transport (CDC, 2007, 2008, 2010 & 2011a). Over time, aid dependency should dissipate as tax revenues grow in tandem with the economy. As shown in Figure 4, domestic revenue grew markedly between 1993 and 2011; this growth is projected to continue to 2015 and beyond. During the same period, the share of aid disbursements in total budget spending declined significantly. Cambodia has multiple offshore blocks of oil and gas reserves, and these are expected to generate significant revenues in a few years. This all suggest that Cambodia has gradually shifted away from aid dependency.

Figure 4. Government Revenue and Share of Aid in Budget Spending



Source: Authors' calculation using data from CDC & MEF 2011

(5) **More diversified economy:** The key drivers of the Cambodian economy have been extremely narrow, concentrated in garments, tourism, construction and agriculture. Although these sectors will continue to drive growth over the next four years, the government is already taking measures to diversify the economic base. In 2006, the government, in collaboration with the UNDP, produced a Diagnostic Trade Integration Strategy, which identifies 19 products and services with varying degree of export potential.<sup>6</sup> It was meant to diversify Cambodia’s export base and export markets. A trade sector-wide approach was subsequently introduced to help coordinate and manage Aid for Trade for Cambodia.

In the wake of the GFC, more initiatives have been taken to mitigate Cambodia’s vulnerability to external shocks. For instance, the introduction in mid-2010 of a policy to promote paddy rice production and export of milled rice is expected to expand the rice sector. Capital accumulation is also critically important for diversifying Cambodia’s narrow economic base. Anticipated revenue from offshore oil and gas may facilitate the growth of sectors that are not skill-

<sup>6</sup> For a list of the 19 product and service export potentials and action matrix see UNDP 2007: 4 & 36-60.

intensive, given that the majority of Cambodian labour has low education. This could be made feasible through selective intervention by the government and its development partners, using the 19-product list to place high priority on products with high human development impact and high export potential.

(6) **A less dollarised economy:** Dollarisation in Cambodia can be traced back to the presence of UN peacekeeping forces and UNTAC in the early 1990s, which spent around USD2 billion in 1993. Subsequently, significant FDI and ODA inflows made the dollar more dominant and legal tender. Government efforts to de-dollarise the economy have been slow and inadequate. Some of the measures taken include the use of Cambodian currency for the payment of public salaries, taxes and utility bills. Banning the use of the dollar has never been attempted, given Laos' negative experience with this approach in 2007. Menon (2008), Duma (2010) and Huot and Khan (2010) concede that de-dollarisation will have to be a long-term process.

(7) **Sustainable socio-economic development:** Further reduction in poverty and inequality will require a significant increase in public investment. One of Cambodia's Millennium Development Goals is to reduce the proportion of people whose income is below the national poverty line to 19.5 percent by 2015, while the proportion below the food poverty line should be down to 10 percent. The poverty rate is expected to be reduced more significantly by 2030.<sup>7</sup>

MEF (2011) reveals that the share of public spending in total spending by key ministries, including Health, Education, Agriculture, Rural Development and Public Works and Transport, grew gradually between 2010 and 2012; this trend is expected to continue until 2015. According to the 2014 draft budget approved by the government in October 2013, the funding allocated for the Ministry of Education, Youth and Sport increased remarkably by 20 percent to USD335 million for 2014, up from USD280 million in 2013 (*Cambodia Daily*, Education to Receive 20% Boost in 2014 Budget, 29 October 2013).

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<sup>7</sup> As of writing, gender disaggregated data on poverty rates are not available.

## KEY CHALLENGES

### 6.1. Human Resource Development

Cambodia's education indicators reveal that the country's literacy rate is quite high compared with other low income countries (78 percent in 2010 for both sexes aged 15 and above, but higher for males than for females). However, despite the increase in enrolment rates over the past few decades, Cambodia's Human Development Index is one of the lowest in the ASEAN region, due partly to high repetition and dropout rates in primary school (male students have higher repetition but lower dropout rates than females) and poor access to and quality of education (UNDP 2010; Lall & Sakellariou 2010). Cambodia's inefficient educational system increases the public and private costs of education, thus reducing the social and private returns to schooling.

Many concerns have been raised about the need to improve labour skills and human capital, the quality of higher education and job seekers' lack of interest in the private sector (Kim & Tong 2011; UNDP 2009; World Bank 2010). Other issues that have been raised by the private sector include job security, lack of information on job markets, lack of quality trainers and the mismatch between university graduates' skills and job requirements, particularly in engineering, mechanics, construction, ICT and tourism.

To address these challenges, the government has again identified education as a priority of the Rectangular Strategy Phase III (2014-18). The MoEYS in the new term has already committed to reforming the sector by focusing on policy areas such as ensuring equitable access to education, improving the quality and efficiency of education, and institutional and capacity development for educational staff. The government also plans to increase the current budget allocation for education and vocational training to about 21.4 percent by 2015; according to the approved budget, education expenditure will increase by 20 percent to USD 335 million in 2014 (*Cambodia Daily*, Education to Receive 20% Boost in 2014 Budget, 29 October 2013).

### 6.2. Sustainable Growth Based on Agricultural Development and Economic Diversification

Cambodia has been an agrarian economy and even today is still viewed as having a comparative advantage in agriculture due to its cheap labour force and vast arable lands. However, the sector's full potential has not been realised because of low agricultural productivity and lack of diversification. Productivity has been greatly constrained by insufficient public investment in technology and rural infrastructure, such as paved roads and irrigation systems. Investments in rural infrastructure, agricultural research and extension, improved access to markets and rural credit and stronger institutions will be needed to address these gaps. In the longer term, the main vision for the sector is not only to achieve food security and improve the nutritional status of citizens but also to generate a surplus and spill-over effects to assist the growth of other sectors.

Cambodia is also unlikely to sustain growth in the long term if it continues to rely on the current drivers of growth. Garment manufacturing is concentrated in the lower end of the value chain, while tourism is concentrated in a few sites such as in Siem Reap and Sihanoukville. Agricultural exports are mostly in the form of primary products such as paddy rice, unprocessed cassava or rubber. To achieve sustainable long-run growth, Cambodia needs to broaden and



diversify its economic base. Diversification in light manufacturing such as agro-processing industry will be important to add value to Cambodia's agricultural products. However, the biggest challenge lies in improving competitiveness compared to neighbouring countries. Investments in technology and infrastructure are essential to enhancing productivity. Both the government and private sector have a role in this effort.

### **6.3. Poverty Reduction**

Poverty remains a serious concern, despite recent declines in the poverty headcount. The GFC may have led to an increase in poverty, given the reduction in income due to unemployment in garments, construction and tourism (Jalilian & Reyes 2010). This may have pushed many people back into poverty, or at least widened the poverty gap.<sup>8</sup> The World Bank estimates that the crisis could increase the poverty headcount by 1 to 4 percentage points from the 2007 level; if so, it would take two to six years for poverty to return to the 2007 level, assuming that the economy grows at an average of 7 percent per year.

Since poverty remains predominantly rural, with most of the poor engaged in agriculture, promoting agricultural growth will make a significant contribution to poverty alleviation. Although the sector grew at an average of about 5 percent (2011), a rate comparable to that of other south-east Asian countries, the sector's value added is much lower because of low productivity and poor crop diversity. Hence, achieving broad-based agricultural growth is fundamental to poverty eradication. Employment in other sectors is also crucial to absorb surplus labour from agriculture as the latter becomes more developed and productive. However, the low level of education of the rural workforce makes it difficult for them to shift to other sectors that require more skills.

Equally important, eradicating poverty will require improvements in access to social services such as health care and education, as well as appropriate social safety nets that can help poor households deal with temporary income shocks. Moreover, the rural credit gap, which is estimated to be between USD60 and USD70 million annually, also needs to be addressed (Hang 2009). Lack of access to credit prevents poor farmers from investing in land and labour.

### **6.4. Natural Resource Management**

Cambodia has abundant natural resources. Offshore oil and gas represent major sources of future revenue. The country is also blessed with minerals such as coal, bauxite gemstones and gold, the exploration and extraction of which are on the rise. Licences have been granted to many foreign firms, mainly in the eastern part of the country, where mining resources abound. Recovery from the GFC, coupled with the rise of China as an economic powerhouse, will likely increase the demand for such resources as industrial inputs.

Land, water and marine resources are all vital to people's livelihoods in Cambodia. Until recently, the country has been unable to exploit land fully due to a lack of technology, but the adoption of improved technology should turn this around. For common resources like water, effective management will be critical, and coordination among local communities will have to be addressed. A growing population has already put pressure on the sustainable use of common resources, requiring closer collaboration among the communities involved. Ecological knowledge among the people who use the resource must be improved so that overexploitation can be minimised.

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<sup>8</sup> Details of how women are affected by this gap are unavailable; new data will be required.

State institutions and human resource capabilities will have to be strengthened. Governance of the oil and gas sectors, for example, requires high technical expertise across different areas. Institutional arrangements need to be well developed to minimise rent-seeking and ensure effectiveness and transparency. Laws and regulations to govern the sector need to be established. Equally important, sound macroeconomic and fiscal policies need to be designed to oversee and manage the macroeconomic impact of revenue collection and expenditure. Fiscal policy needs to define how the benefits can be broadly distributed, as well as targeted to vulnerable groups. Revenues could be invested in infrastructure to improve productivity in agriculture and manufacturing.

### **6.5. Regional Integration and Connectivity**

Cambodia has benefited greatly from increased trade and participation in various regional and sub-regional integration frameworks. The challenge is to fully exploit the benefits offered by these initiatives. Data on international trade indicate that the country has not fully reaped the benefits of regional integration. Cambodia's intra-regional trade volume is meagre compared with other countries in the region, given its status as a latecomer and its narrowly based economy with low competitiveness. Although much effort has been put into trade facilitation, the main challenge is to diversify exports and build the basic infrastructure needed to support this. Cambodia 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 for those who have a role in these cooperation frameworks.

Different levels of development between the ASEAN 6 and the CLMV have made integration difficult. In Cambodia's case, the ASEAN FTAs have created pressure to increase revenues from non-tariff duties over the next few years. While the AFTA could open up markets that would benefit local producers, especially SMEs, the problem so far has been their lack of access to information on these trade agreements and how they could benefit from them. The proposed ASEAN + 6 Regional Comprehensive Economic Partnership, including its commitment to regional cooperation to bridge or narrow the development divide within ASEAN, also holds potential economic and development benefits for Cambodia.

Regional integration could pose security threats and create social problems among member countries, especially those that share borders. An increase in illegal migration and incidents of human and drug trafficking in the last decade have created many problems for both origin and destination countries.

### **6.6. Policy and Institutional Reform and Strengthening**

Cambodia's tragic history has left the country in a disadvantageous position; it has had to rebuild its institutions almost entirely from scratch. A number of institutional reforms have been initiated and implemented. These include public financial and administration reforms, decentralisation and deconcentration (D&D) and legal and judicial reform.

The civil service reform has made a significant contribution to state institutions. Thus far, the reform package has led to improvements in personnel management and the establishment of regulatory frameworks. Achievements have also been noted within D&D. Despite recent progress, remaining challenges include poor coordination and accountability among public agencies and shortages of human and financial resources. Reform of the armed forces is evinced



by the declining ratios of defence and security to GDP and the national budget. Judicial reform has been underway since 2002. Progress includes promulgation of the criminal and civil codes and the establishment of a model court. However, the justice system in Cambodia is still poorly regarded. Low salary is partly to blame, although weak law enforcement has also contributed to corruption. Judicial reform is also constrained by the shortage of qualified legal personnel, as well as insufficient resources for capacity building.

The quality of institutions in Cambodia is also captured in various indicators. Cambodia's country policy and institutional assessment score<sup>9</sup>, published by the World Bank (2011), reveals a marginal improvement from 3.2 in 2007 to 3.6 in 2011. This composite score combines four other indicators: economic management, structural policies, policies for social inclusion/equity and public sector management and institutions. Cambodia scored lowest in transparency, accountability and corruption in the public sector (2.0), followed by quality of public administration (2.5).

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<sup>9</sup> The score ranges from 1 (low performance) to 6 (high performance)

## POLICY PRIORITIES AND OPTIONS

If Cambodia is to achieve its socio-economic development aspirations by 2030 and meet the development challenges outlined above, six clear policy priority areas should be addressed, as highlighted above and summarised in the table below: human capital development; economic diversification; poverty reduction; improved natural resource management and environmental protection; the strengthening of governance and institutions; and enhanced macroeconomic management. The government's three key policy and planning documents—the Rectangular Strategy, the National Strategic Development Plan and the Cambodia Vision 2030 Statement—should be aligned to focus on these policy imperatives.

- 1. Human capital development:** Further reforms and public investment in all levels of education—primary, secondary and tertiary—along with improved health care, especially for rural women and girls, and investment in the skills, capacity and salaries of the civil service, will all be fundamental to achieving socio-economic development aspirations as Cambodia graduates from low to lower middle income status. This will require an integrated approach to improving education, including the achievement of universal primary and secondary education with higher retention rates and improved teacher salaries and conditions; improved governance of both public and private higher education and more effective standards certification for private tertiary institutions; an increase in decentralised vocational education and training in response to key industry labour needs through a balance of investment in public TVET, incentives for the promotion of enterprise-based training and an increased use of public-private partnerships to deliver TVET, where possible linked to well-managed special economic zones; and the institutionalisation of research and development in higher education.
- 2. Economic diversification:** The diversification of the economy, which is already underway, should be promoted through public and private investment in agricultural productivity, agribusiness and export promotion with supportive rural infrastructure development, market access and cross-border trade facilitation policies. Manufacturing should be diversified from garments to light industrial, including electronics, motor vehicle assembly and food processing, through trade and investment promotion, improved management of special economic zones, access to credit, more accessible and less expensive energy and investment incentives for sectors with comparative advantage. Public-private partnerships should be utilised to address major labour market skill gaps through both generic and sector-specific vocational education and training. The GMS and ASEAN, and their associated FTAs, along with the potential benefits of a broader ASEAN + 6 Regional Comprehensive Economic Partnership, should be better utilised to enhance manufacturing exports.
- 3. Poverty reduction:** Further poverty reduction will require a policy focus on more inclusive growth, significantly increased public investment in rural infrastructure, energy generation and distribution, especially to rural and remote areas, higher quality education and health care, political and economic participation, particularly for rural women and girls, and the implementation of appropriate social protection measures, including emergency safety nets (cash and food) to counter temporary economic shocks and natural disasters.
- 4. Natural resource management and environmental protection:** More effective and transparent natural resource management policy and implementation will be critical to further poverty reduction, economic diversification and social stability, particularly in

relation to land management. This can be achieved through the direct involvement of local communities in the management of natural resources with other stakeholders; a review of land management policy and practice to ensure that economic land concessions are being awarded transparently and used for productive purposes with positive benefits for local communities and that social land concessions are well administered in the interest of poverty reduction and providing livelihoods for the landless or land poor; ensuring that water resource management policy, including the impact of hydropower development, supports agricultural development and productivity and rural livelihoods, and includes climate change adaptation strategies; and improved forests and fisheries administration.

- 5. Strengthening of governance and institutions:** Sustainable inclusive growth and stronger socio-economic development will need to be based on a significant strengthening of responsible governance and of the rule of law and public institutions, delivering more transparency and certainty for citizens, the private sector and investors. Government anti-corruption strategies and agencies will need to be strengthened and to demonstrate their effectiveness and objectivity, with genuine regulation to minimise rent-seeking and improve the effectiveness of public and private institutions. Democratic development (decentralisation and deconcentration) will need to be deepened and better resourced, with a focus on clarifying the roles and responsibilities of national and sub-national government and the central role of district administrations as one-window service deliverers to local communities. Increased taxation revenue should be allocated to increasing the remuneration and capacity building of a more professional and efficient civil service.
- 6. Macroeconomic management:** The maintenance of Cambodia's recent sound macroeconomic policy and management will be essential to continued sustainable growth and development. Increased revenues will be needed through better tax administration and compliance, a widening of the tax base and expansion of the registration of informal businesses. Inflation should be constrained to below 5 percent per annum, and the government's current policy of strengthening the local currency deepened to gradually eliminate dollarisation. Should significant income be generated through the exploitation of offshore oil and natural gas, consideration should be given to the establishment of a well-managed sovereign wealth fund to ensure that these resources support national development priorities, particularly hard and soft infrastructure, health and education, poverty reduction and social inclusion.

These major policy priorities should be underpinned by a continued and deepening commitment to sub-regional and regional integration and connectivity, in the Greater Mekong Sub-region, ASEAN and East Asia, and to an open, competitive, investment-friendly and globally oriented economy.

Cambodia's Challenges						
Challenges		Policy Options				
1	<b>Develop Human Capital</b>	Use an integrated approach to improve the overall quality of education; significantly increase public investment in education and health	Improve school infrastructure of rural areas to achieve universal secondary education	Increase supply of technical and vocational schools to match demand for skilled labour through public investment and public-private partnerships	Improve teachers' quality and governance system of tertiary education	Institutionalise research and development activities in higher education institutions
2	<b>Diversify the Economy</b>	Create an incentive scheme to boost investment in agricultural technology and infrastructure	Introduce fiscal incentives and training programmes to expand light manufacturing	Use trade facilitation schemes under GMS and ASEAN networks to enhance manufactured exports	Introduce incentives in industries with comparative advantage identified by sectoral diagnostic studies*	
3	<b>Reduce Poverty</b>	Expand public investment in rural infrastructure	Increase investment in power generation	Improve access to health care and education for the poor	Introduce emergency safety nets (cash, food) to counter temporary income shocks	
4	<b>Improve Environmental Protection and Natural Resource Management</b>	Encourage local communities to manage natural resources with other stakeholders; review land policy and the role of economic land concessions	Cautiously invest natural resource revenues (oil, gas, etc.) to develop hard and soft infrastructure	Increase investment in technology and research and development to mitigate the environmental impact of using natural resources	Bolster capacity building in public institutions managing natural resources	Employ best international practices in managing use of resources from Mekong River and Tonle Sap Lake
5	<b>Strengthen Governance and Institutions</b>	Implement existing reforms to decentralise and improve public administration and legal and judicial systems	Introduce regulation to minimise rent-seeking and maximise effectiveness of public institutions	Implement agreed measures to ensure transparency of public institutions	Increase remuneration of civil servants to curb corruption	Implement strategy to increase capacity of local government agencies in public administration and other areas
6	<b>Enhance Macroeconomic Management</b>	Widen the tax base and register informal businesses to improve tax administration and increase revenues	Establish a sovereign wealth fund and carefully monitor its management to finance priority development projects and attract private investment	Ensure monetary policy tools are effective to contain inflation within its target	Introduce administrative measures and use monetary tools to restore market confidence in the riel and gradually eliminate dollarisation	

\*United Nations Development Program (2007)

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