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Leveraging Trade for Economic Growth in Cambodia

HING Vutha

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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.

CDRI
☞ 56, Street 315, Tuol Kork, Phnom Penh, Cambodia
✉ PO Box 622, Phnom Penh, Cambodia
☎ (855 23) 881 384/881 701/881 916/883 603
🖷 (855 23) 880 734
E-mail: cdri@cdri.org.kh
Website: www.cdri.org.kh

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ABSTRACT

This paper attempts to answer three important questions: (1) Why does trade matter? (2) Why is trade vital for Cambodia's growth? (3) What policy priorities for Cambodia will make trade work for economic growth?

First, trade matters because it increases growth. Openness to trade affects growth by: allowing a country to exploit its comparative advantages and thereby enhance the efficiency of resource allocation; facilitating acquisition of foreign technology and knowledge and thus raising productivity; and attracting more investment, stimulating competition and improving efficiency and competitiveness. Although academic debate has failed to reach a consensus due to problems such as weak theoretical foundations, measurement of openness, reverse causation and diverse methodologies, most economists now agree that an outward-oriented trade policy promises economic benefits. This is why almost all governments in both developed and developing countries have designed trade policy as a key element of their growth and development strategies.

Second, trade is important for Cambodia's growth strategy for at least three reasons. One, Cambodia has transformed its trade sector into an engine of economic growth over the last two decades, and that provides the momentum for further liberalisation and development of trade for future growth. Two, regional economic integration has moved toward regional free trade zones as the way to boost trade and promote prosperity. Given the country's strategic location in the fast growing East Asian region, these dynamic regional cooperation and integration processes represent huge opportunities for export growth, diversification, competitiveness and growth. Three, most analysts agree that much remains to be done in Cambodia's trade sector development. Despite significant progress, the trade sector remains weak and vulnerable. In addition to being at the low end of the value chain and lacking diversification, Cambodian exports are constrained by cumbersome customs procedures, infrastructure bottlenecks, poor logistics and trade facilitation and lack of capacity to meet technical standards.

Third, the key to enhancing the role of trade in Cambodia's growth is to remove obstacles. Policy priorities include, among others, investing in trade-related infrastructure; improving logistics; upgrading customs procedures; strengthening regional cooperation and connectivity; stepping up export market information services; and improving standard management systems. These measures should come together with complementary policies including macroeconomic stability and financial sector development; improvement in the investment and business climate; investment in general infrastructure, education and health; technology and knowledge transfer. It is also recommended that further trade policy liberalisation and reforms gain political support from the leadership, receive momentum and impetus from key stakeholders and be supported by effective and responsive institutions.

1

INTRODUCTION

> "Ideas with regard to trade policy and economic development are among those that have changed radically. Then and now, it was recognised that trade policy was central to the overall design of policies for economic development … it is now widely accepted that growth prospects for developing countries are greatly enhanced through an outer-oriented trade regime." —Krueger (1997: 1)

> "Trade is an opportunity, not a guarantee. While trade reforms can help accelerate integration in the world economy and strengthen an effective growth strategy, they cannot ensure its success. Other elements that address binding constraints to growth are needed, possibly including sound macroeconomic management, trade-related infrastructure and institutions, and economy-wide investments in human capital and infrastructure." —World Bank (2005: 131)

Over the last half century, international economic governance has changed dramatically, most notably in policy paradigms, increased agreement on the positive trade-growth nexus and global interconnectivity. First, there was a shift in trade policy from a protectionist and inward-looking regime, which was popular among developing countries during the 1950s, 1960s and 1970s, to an outward-oriented and liberal regime. The adoption of a more liberal policy model was inspired by the idea that openness to trade improves resource allocation; attracts more investment; facilitates acquisition of foreign technology and knowledge and thus raises productivity; stimulates competition and improves efficiency and competitiveness. It was also inspired by developments including the apparent failure of protectionist policy[1] and the successful experiences of rapidly growing countries,[2] especially in East Asia, that aggressively implemented outward-oriented strategies. Nowadays, almost all governments in both developed and developing countries have designed trade policy as a key element of their growth and development strategies.

Second, academic research on trade policy and economic growth has tended overwhelmingly to support an open and outward-oriented trade policy. Although academic debates have failed to reach a consensus due to problems such as weak theoretical foundations, measurement of openness, reverse causation and diverse methodologies, most economists now agree that an outward-oriented and liberal trade policy promises economic benefits. A voluminous literature also claims that openness affects growth in a number of ways by: allowing a country to exploit its comparative advantages and thereby enhance the efficiency of resource allocation; facilitating acquisition of foreign technology and knowledge and thus raising productivity; and attracting more investment, stimulating competition and improving efficiency and competitiveness (see literature review). It is now widely accepted that trade is a necessary condition for growth, although it is not sufficient. No country has ever been able to sustain long-term growth without expanding trade.

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1 A wealth of literature draws a similar conclusion that the import substitution strategy has not only failed to promote development, but may have actually created additional barriers to industrialisation.

2 There are now many examples of developing countries that have been able to develop competitive export industries and have been rewarded with remarkable economic growth: the Republic of Korea and Chinese Taipei in the 1960s; south-east Asian countries such as Thailand, Malaysia and Singapore in the 1970s; China in the 1980s; and Central and South American countries such as Chile in the 1990s (International Trade Centre 2011).

Third and perhaps most important for trade policy design is that the world has become more integrated and interdependent. This can be explained by a number of factors, including improved transport and communication technologies, liberalisation of international trade and the increasing role of transnational corporations brought about by foreign direct investment (FDI). The interconnected world is accompanied by a greater significance of international trade rules and regulations as well as the proliferation of regional trade architectures to promote trade and growth. In most countries, this means that trade will become even more dynamic and that economic development will depend greatly on trade sector development.

These recent developments in international economic governance provide justification for Cambodia to develop further its trade sector to promote economic growth—the major focus of this paper. The question arising from this is: why is trade vital for Cambodia's growth? It is important for at least three reasons. First, Cambodia has transformed its trade sector into an engine of economic growth over the last two decades. The sector was developed through a radical change of regime from control by the state to a liberal and outward-oriented regime by means of unilateral liberalisation and gradual integration into regional and global economies. Trade policy included reforms to attract FDI, improve the business and investment climate and build trade-related infrastructure and institutions. Trade played a significant role in past growth, and its enormous contribution provides the momentum for further liberalisation and development of trade for future growth.

Second, regional economic integration has deepened, moving toward a broader regional free trade zone as the way to boost trade and promote prosperity. The Greater Mekong Sub-region is increasingly integrated; ASEAN's integration aims at achieving the ASEAN Economic Community (AEC) by 2015 and a central role in the East Asian regional cooperation. Given Cambodia's strategic location in the GMS, in the fast-growing East Asian region and in proximity to China—the world's second largest economic power and largest market for agricultural products, these dynamic regional processes represent huge opportunities for Cambodia to enhance exports, diversification and competitiveness. The country's success in raising its trade competitiveness and moving up the value chain is likely to depend on its ability to reap the full benefits from regional cooperation.

Thirdly, most analysts agree that much remains to be done in Cambodia's trade sector development. Despite significant progress, the sector remains weak and vulnerable. Exports are highly concentrated on a few products and markets, and intra-regional trade has been very low. Exports remain constrained by cumbersome customs procedures, infrastructure bottlenecks, poor logistics and trade facilitation and lack of capacity to meet technical standards. The potential adverse effect would be to slow growth. So the medium-term challenge is to develop the trade sector further in line with the changing regional and global economic landscape. The policy priorities to achieve this are elaborated in the main text, but, in a nutshell, this paper takes the view that Cambodia's economic growth will most likely be sustained if it manages to promote trade and competitiveness along with macroeconomic stability, accessible infrastructure, capable human capital and effective institutions.

Section 2 provides answers to the question of why trade matters, by reviewing major trade theories and then discussing the empirical evidence. Section 3 responds to the question "Why is trade policy vital for Cambodia's growth?" Section 4 elaborates on policy to promote trade as an engine of growth. Section 5 concludes.

2

WHY DOES TRADE MATTER? THEORETICAL ARGUMENTS AND EMPIRICAL EVIDENCE

The importance of trade policy in growth is supported by both theory and empirical evidence. Trade theories argue that trade is welfare-enhancing through static and dynamic gains. Static gains refer to the more effective use of resources according to the law of comparative advantage (technological difference according to a Ricardian model and factor endowment difference according to a H-O model). Dynamic gains refer to benefits resulting from productivity growth, acquisition of knowledge and technology, investment flow and capital accumulation and increasing competition. In "new" growth theory, these all are externalities through which trade improves long-run growth performance. Empirically, there is increasing research that supports liberal trade policies as more growth-enhancing.

2.1. Openness Improves Efficiency

Openness to trade helps countries utilise their resources better. While classical trade theories base their explanation of efficiency gains on specialisation according to comparative advantage, new trade theory borrows ideas from industrial organisation economics to focus on economies of scale as the explanatory factor. According to classical trade theories, trade allows a country to specialise in the production of goods that it can produce relatively more efficiently for export and import goods that can be produced relatively less efficiently. Resources are shifted toward a more efficient structure of production, leading to better resource allocation. Comparative advantage is assumed to be derived from either exogenous technological differences (the classical Ricardian model) or different factor endowment (the Heckscher-Ohlin model). This reallocation of resources generates efficiency gains that increase aggregate national income.

A new trade theory, developed in the 1980s as a consequence of dissatisfaction with traditional theories that could not explain trade patterns of countries with similar factor endowment (by the 1980s trade was largely between countries with similar resources exporting similar goods), focuses on increasing return to scale, relaxing the constant to scale assumption in traditional trade theories. This model, known as the static model of monopolistic competition and economies of scale (Krugman 1979), contends that the gains from international trade come through two channels. First, there is increasing competition as more varieties become available. Second, increased competition lowers the equilibrium price because the larger market allows firms to realise economies of scale.

2.2. Openness Attracts More Investment

Debates on the relationship between trade and investment have focused on whether the two substitute for each other or are complementary. Despite the lack of consensus, there is an increasing view that international trade has a strong positive relationship with investment. Trade allows increased specialisation and thus stimulates investments that seek to exploit cost and location advantages of the host country. The typical example of such investment is labour-seeking FDI. As wages rise in the home country, multinational corporations (MNCs) locate the labour-intensive segments of their production in a host country that has relatively abundant and inexpensive labour. Openness to trade is also attractive to investments that seek a platform or gateway to export products or services. Motives for export-oriented FDI are not only market access granted to the host country but also incentives offered to foreign investors. Incentives

may go beyond the financial (e.g., tax holiday and subsidies) to include a conducive liberal investment regime and an enabling environment for investment and the private sector.

A wealth of literature provides empirical evidence supporting a positive link between trade openness and FDI. Most literature that examines the link between trade policies, FDI and growth argues that openness to trade has induced investment inflows. Harrison and Revenga (1995), for example, found that trade reforms have been accompanied by significant increases in investment inflows. Attempting to investigate the links between trade policy and economic growth in 57 countries between 1970 and 1989, Wacziarg (1998) concluded that trade openness affects growth mainly by raising the ratio of investment to GDP; this seems to be the most important channel by far (63 percent of the total effect). Lee (1995), Baldwin and Seghezza (1996), Frankel and Romer (1996) and Krueger (1997) have also shown that trade fosters growth through its favourable effects on investment and capital stock.

Investment literature, on the other hand, raises the question of whether trade openness is important in influencing investment decisions. Much of this literature uses variables that are grouped in two categories—economic conditions and host country policies—as explanatory variables for FDI flows. Economic conditions include market size, growth prospects, labour cost, human capital, physical infrastructure and macroeconomic fundamentals like inflation, tax regime and external debt. Host country policies include the promotion of private ownership, efficient financial markets, trade policies, regional trade agreements, FDI policies, perception of country risk, legal framework and quality of bureaucracy. Many writers agree that trade policy and openness are among the important economic variables in FDI flows (Edwards 1990; Lankes and Venables 1996; Tadesse and Ryan 2004; Campos and Kinoshita 2003, Garibaldi *et al.* 2001). For example, Edwards (1990) concludes that, in addition to large internal markets and higher domestic investment ratios, openness is positively associated with FDI flows. Lankes and Venables (1996) observe a shift from investment projects to serve local markets to those serving export markets. Tadesse and Ryan (2004) draw a similar conclusion that, while factors traditionally listed as FDI determinants are important, a mix of the host's market maturity and its role as an export platform to third party markets also affect both the amount of FDI that it receives and its FDI-bilateral trade interaction with the FDI source.

2.3. Openness Fosters Technology and Knowledge Transfer

There is general agreement in economic theory and empirical literature that openness has positive effects on knowledge and technology transfer. Open economies tend to absorb greater knowledge and adopt new techniques, machinery and production processes more than less open economies. The major channels through which openness fosters technology transfer are trade and FDI.

Trade can contribute to international technology diffusion through many channels. It lends local firms access to technologically advanced imported capital goods and intermediate products and creates opportunities for reverse engineering of products developed abroad. Trade also creates incentives to adopt and improve technologies for exporting opportunities. Foreign buyers may impose higher quality standards and at the same time provide information on how to meet them. There is evidence of technology diffusion transmitted through trade. Coe and Helpman (1995) argued that technology spillovers from developed to developing countries are substantial and that trade is an important channel of spillover. More specifically, the benefits to developing countries of developed country R&D are strongly correlated with the developing countries' openness to international trade. Grossman and Helpman (1991) found that participation in the world market seems to accelerate greatly a country's acquisition of

foreign knowledge and technology. Wacziarg (1998) found trade openness affects growth and technology transmission, explaining 22.5 percent of the overall positive effect. Keller (2004) and Miroudot *et al.* (2009) concluded that foreign technology—embodied in imported inputs and capital goods—is the dominant source of domestic productivity growth.

Although there is anecdotal evidence claiming learning about foreign technology through exporting experience, some interesting empirical studies are worth highlighting. Blalock and Gertler (2004), for example, found strong evidence that Indonesian manufacturing firms experienced a jump in productivity of 3-5 percent following the initiation of exporting. Lileeva and Trefler (2007) showed that less productive Canadian plants, which were induced by tariff cuts to start exporting, increased their labour productivity, engaged in more product innovation and had high adoption rates of advanced manufacturing technologies. A causal link from exporting to productivity was also supported by Van Biesebroeck (2005) for nine African countries and by Aw *et al.* (2009) for the Taiwanese electronics industry. Harrison and Rodríguez-Clare (2010) summed up the broad empirical literature in asserting that although studies suggest mixed evidence on learning through exporting, it is probably safe to conclude the following: (1) the most productive firms are likely to become exporters; (2) while there is selection into exporting, there is also learning through exporting; and (3) learning from exporting is most likely to occur in technologically backward countries and among less productive firms.

FDI is generally perceived as the best channel for technology transfer, not only across national boundaries but also between firms – in particular, between foreign and domestic companies. According to economic theory, technology spillovers from FDI may arise through various mechanisms. The most common mode of transfer is directly from MNCs to their subsidiaries in host countries. The diffused knowledge and technology can include technologically advanced equipment and technical information, know-how, management style and production processes. Another mode of technology spillover from FDI can occur between firms that are vertically integrated with the MNC (inter-industry spillovers). MNCs may transfer technology to firms that are potential suppliers of intermediate goods (backward linkage) or buyers of their own products (forward linkage). The presence of MNCs may also lead local firms to copy technology and update their production methods. Finally, technology diffusion may arise from labour turnover. Workers employed by multinational companies acquire knowledge of its superior technology and transfer important information to local firms by switching employers or starting their own firms.

Despite the lack of consensus on empirical evidence due partly to significant variations in host countries' economic conditions, technology absorptive capacity, private sector dynamics and quality of institutions, some influential literature claims significant evidence of technology transfer from MNCs to local firms. Some early studies—for example, by Findlay (1978) and Caves (1974) on the Australian manufacturing sector, Globerman (1979) on Canadian manufacturing industry and Blomström and Persson (1983) on Mexican manufacturing—conclude that MNCs have contributed to diffusion of technology that reduces productivity gaps between foreign and local firms. Some recent case studies produced similar results. Aitken and Harrison (1997) showed significant technology transfer to the affiliates and some positive spillovers to domestic firms in Venezuela located close to the affiliates. Blalock and Gertler (2001) examined welfare gains of FDI through technology transfer of Indonesian manufacturing establishments and found strong evidence of productivity gains among local firms upstream from foreign entrants. Similar findings are also demonstrated in Javorcik (2004) for the case of Lithuania and in Liu (2002) for the case of China. There is also evidence of technology spillovers through labour mobility. Fosfuri *et al. (2002)* present models of technology spillovers through

labour turnover and some evidence of spillover through labour mobility. Bloom (1992) found substantial technological transfer in South Korea when production managers left multinationals to join local firms.

2.4. Openness Enhances Productivity

Theoretical and empirical literature widely agrees that openness has a strong positive correlation with productivity. There are at least three broad ways in which openness to trade contributes to productivity. The first channel is supported by the "x-efficiency" argument stipulating that openness induces greater foreign competition, which in turn forces firms to increase efficiency by better allocating resources across sectors and adopting more efficient technology. This leads to a decrease in x-inefficiency and reduces costs of production. Openness to trade may also permit firms to achieve economies of scale and hence lower average cost. Openness may influence productivity through diffusion of knowledge and technology. As elaborated in an earlier section, openness has a strong positive effect on technology transfer through trade and FDI. The third channel is improved access to final and intermediate imported goods and services. Openness to trade offers a wider choice of technologically advanced imported goods and high quality imported intermediate inputs at lower prices.

The empirical evidence is far from conclusive, but in most cases trade liberalisation is associated with rising average productivity of domestic firms. In an earlier study, Krueger and Tuncer (1982) found that periods of greater liberality in Turkey were periods of faster growth in total factor productivity. This finding was confirmed by the World Bank's (1987) finding that total factor productivity increased much faster in strongly outward-oriented economies than in strongly inward-oriented economies. In an influential cross-country study on R&D spillovers based on data for 77 developing countries, Coe *et al.* (1995) concluded that by trading with an industrial country that has a large "stock of knowledge", a developing country can boost its productivity by importing a larger variety of intermediate products and capital equipment embodying foreign knowledge, and by acquiring useful information that would otherwise be costly to obtain. Developing countries that are relatively open to imports enjoy further productivity. Using firm-level data to examine the effect of liberalisation via NAFTA on firm productivity, Iacovone (2009) found that, on average, a 10 percent reduction in tariffs led to a productivity growth of 4-8 percent. Similar results are found in Edwards (1998), Alcala and Ciccone (2004), Keller (2004) and Iacovone (2009). Keller (2004) concluded that for most countries, foreign sources of technology account for 90 percent or more of domestic productivity growth.

Cross-country evidence of positive effects of openness on productivity is supported and complemented by several case studies. In Thailand, for example, trade liberalisation increased total factor productivity through domestic and international competitive pressure, wider choice of intermediate goods, expansion of output and R&D expenditure (Urata and Yokota 1994). Productivity growth was found to have tripled after the reform in Côte d'Ivoire (Harrison 1994), whereas the productivity of producers of import-competing goods improved on average 3 percent to 10 percent more than the productivity of plants in the non-traded-goods sectors due to liberalised trade in Chile (Pavcnik 2002). Trade liberalisation was also shown to improve productivity in South Korea (Kim 2000) and in India (Goldberg *et al.* 2009). Evidence of productivity growth due to improved access to imported intermediate goods can be found in Amiti and Konings (2007) for Indonesia, Halpern *et al.* (2009) for Hungary, and Miroudot *et al.* (2009) for OECD countries.

2.5. Openness Stimulates Growth

Modern empirical work on trade policy and growth can be classified into two broad and distinct categories: cross-country studies that investigate experiences of a group of countries with trade policy reform and country case studies that examine specific country trade policy reform. The earlier investigations on particular episodes of inward-looking and outward-looking policy pioneered by Krueger (1978) and followed by World Bank (1987) and Papageorgiou et al. (1991) reached the same conclusion that outward-oriented economies have been broadly superior to inward-oriented ones in achieving rapid industrialisation, total factor productivity growth and sustained economic growth. The finding was later confirmed by several influential cross-country studies such as those by Grossman and Helpman (1991), Papageorgiou et al. (1991), Dollar (1992), Sachs and Warner (1995), Ben-David (1996), Herrison (1996), Greenaway et al. (1998), Wacziarg (1998), Edwards (1998), Frankel and Romer (1999), and Srinivasan and Bhagwati (2001).

The cross-country evidence is of successful experiences of East Asian countries having pursued a more liberal and outward-looking trade strategy to promote economic growth and development. Most literature on East Asian growth—e.g. Krueger (1990 & 1993), Hughes (1992), World Bank (1993), World Bank (2005) — reaches two fundamental conclusions. The first and perhaps most important is that openness to trade has been a central element of successful growth strategies. Liberalisation has led to rapid expansion of investment and exports, permitted more rapid acquisition of knowledge and access to best-practice technology, made high rates of productivity growth possible and subsequently ensured efficient allocation of resources. The second conclusion is that East Asian countries also adopted other policies conducive to growth, i.e. the pursuit of macroeconomic stability, stable and secure financial systems, economy-wide investments in physical and human capital, flexible and efficient labour markets and quality government institutions effective in providing public services and managing the economy. These policies permit further gains to be realised from the trade strategy and induce further growth.

The empirical studies that support a positive relationship between openness and growth are not without criticisms, notably from Rodriguez and Rodrik (2001). They picked frequently cited studies that are influential in policy and academic circles, e.g. Dollar (1992), Sachs and Warner (1995), Edward (1998), and Wacziarg and Welch (2003), and observed that their measurements of openness are flawed and their econometrics weak. Using authors' original database for their estimation, they argued that the case for a positive relationship between the two had been stated too strongly and the relationship was not robust. Although Rodriguez and Rodrik are not convinced by empirical evidence on openness and growth, they themselves state that they have seen no credible evidence – at least for the post-1945 period – suggesting that trade restrictions are systematically associated with higher growth rates.

Notwithstanding criticisms, almost all economists agree on two fundamental statements. First is that while trade protection is not good for economic growth, liberal trade is more appropriate in achieving this goal. Second is that trade openness by itself is not sufficient for growth. Studies show that trade policy is most likely to be associated with positive outcomes when it is conducted in a favourable economic environment, with macroeconomic stability, flexible and capable human capital and strong domestic institutions. Lack of these foundations can undermine the growth effects of trade.

3

WHY IS TRADE VITAL FOR CAMBODIA'S GROWTH?

Cambodia has transformed its trade sector into a driving force of economic growth. Past successes in trade will be a base for moving forward. Trade lays a foundation, a precondition for a higher stage of industrialisation. At present, Cambodia's manufacturing is largely labour-intensive and low-skilled, using low technology. But it has a strong comparative advantage and firm competitiveness. It is a sizeable source of formal employment as the country shifts away from an agrarian economic structure.[3] The government's rice policy reflects the high potential of agricultural production and the need to promote and attract investment in rice and other high demand export crops such as cassava, soy beans and rubber, and in broader agribusiness and food processing. Having become a major source of growth, the trade sector puts pressure on the government for regulatory and administrative reforms to address the perceived bottlenecks to trade development viz. issues of the business environment, trade facilitation, logistics services and trade-related hard and soft infrastructure. Finally, trade growth builds trust among public institutions and the private sector in working together and proves to policy makers the significance of trade in future economic growth. Since Cambodia is now striving to upgrade its industrial structure and improving competitiveness through a more diversified and resilient economy, past successful is a necessary, though not sufficient, condition for it to kick off another stage of industrialisation and growth.

The subsequent subsections offer detailed explanations why trade policy matters for Cambodia's growth. Arguments centre on three themes: (1) trade policy is important because its historical development, especially the transition in policy, was relevant; (2) it is important because trade has played a significant role in past growth; and (3) it is important because the landscape of international trade has changed so rapidly that every country needs to adjust.

3.1. The Relevance of Historical Development

Cambodia has undergone significant change in its trading system over the last three decades, from a regime controlled by the state to a modern trade regime based on a liberal policy paradigm. This transition has produced major changes in favour of international trade, investment and the private sector and also in building solid economic foundations, i.e. macroeconomic stability, economic openness and a business and investment climate of growth potential.

3.1.1. Successful Trade Policy Transition

The country's trade policy transition went through three major phases: transitional, economic reintegration and post-WTO. The first phase of policy change in the 1980s and early 1990s shifted from a regime in which the state strictly controlled the price and quantity of goods produced, imported and exported to a modern trade system that favoured the private sector and foreign investment in international trade. The transition was supported by extensive economic reform programmes aimed at creating a more open market-driven economy with outward-looking development. Pressing measures included the abolition of the state monopoly on

[3] In 1995, agriculture employed 81.4 per cent of total labour force; by 2007, its share had declined to 55.9 per cent. Industry's employment share increased from 2.9 per cent in 1995 to 15.4 per cent in 2007; services' share nearly doubled from 15.7 per cent to 28.7 per cent during the same period. This change in employment structure is largely due to the boom in garment and footwear manufacturing brought about by trade policy liberalisation.

foreign trade, the promulgation of foreign investment laws that enable private companies to engage in foreign trade, abolition of price controls, privatisation of state enterprises and other state properties and elimination of quantitative restrictions. The policy reform process was boosted by peace brought about by the Paris Agreement in 1991 and by political stability as a result of the establishment of a coalition government in 1993.

The second phase of trade policy reform started in 1994 under the slogan of reintegrating into regional and global economies. Participation and partnership in sub-regional, regional and global trade arrangements have been an integral objective in trade development and national development strategy. The ultimate goal was a more liberal trade and investment policy as a means to promote economic growth and poverty reduction. Measures included the adoption of a law on investment in 1994; a "trade relations" campaign with major trading partners;[4] joining regional trading blocs (i.e. ASEAN and ASEAN plus FTAs) and the multilateral trading system. The major outcomes were increasing recognition and engagement in multi-level economic and trade cooperation frameworks.

In the third phase of Cambodia's trade policy transition, which started in 2004, the economy experienced high growth and rapid expansion of trade, investment and private enterprise. Trade policy focused on (1) enhancing participation in sub-regional, regional and global economic cooperation; (2) fostering export diversification; and (3) facilitating and encouraging investment for export. Most government reform programmes and development partners' assistance concentrated on putting in place a transparent and predictable legal framework, and addressing trade facilitation issues and improving the investment climate. Measures included passing the laws and regulations required as a result of WTO accession; the adoption of a Twelve-Point Action Plan[5] to enhance trade facilitation and the investment climate; amendment of the investment law and promulgation of laws on special economic zones; and the adoption of Trade SWAp[6] as part of trade-related institutional strengthening to consolidate ownership of Aid for Trade, strengthen development partners' trade-related

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[4] Cambodia established normal trade relations with the United States in October 1996 and reached a three-year bilateral trade agreement on textiles and apparel in January 1999. Cambodia also signed bilateral agreements on trade in textile products with the European Union in 1999, and a few years later was granted GSP status under the Everything But Arms programme. The country also made a tremendous effort to obtain GSP tariff exemption from Australia, Canada, South Korea, Japan, New Zealand and the UK. These efforts gained Cambodia preferential market access and the catalyst for rapid expansion of garment exports

[5] The twelve points were: (1) establish a full-time, cross-agency change management team by 1 July 2004; (2) review and re-engineer the entire trade facilitation process to remove overlaps and unnecessary approvals and reduce both cost and time. A performance monitoring system will be put in place, with baseline measures to start in July 2004; (3) implement a single administrative document by 1 December 2004 to facilitate automated customs processing; (4) introduce an overall risk management strategy to consolidate and rationalise all inspection requirements; (5) carry out a strategic review of the role of CamControl to make better use of the institution's knowledge base and also optimise use of information and resources from other agencies; (6) automate streamlined trade facilitation, including a single-window process in the Sihanoukville port, by December 2005; (7) the government to introduce a WTO-compatible and publicly announced flat fee for services, defined by a service-level agreement; (8) remove the requirement to incorporate with the Commercial Register; (9) remove the requirement to send a notification to the Ministry of Labour to start hiring employees; (10) automatically register a company for VAT using the same form as for company registration and associate the tax identification number with the registration number; (11) implement a national award for good corporate citizenship and governance; (12) ensure that the private sector participates in the monitoring and evaluation of reforms, through the Private Sector Forum.

[6] The Trade SWAp framework was adopted by the government in 2007 after the Diagnostic Trade Integration. It is structured based on three pillars: reforms and interrelated issues for trade development; products and services export development; and capacity building for trade development. More details can be found at http://www.moc.gov.kh/tradeswap/.

technical assistance and move forward integration into the global economy. There is general agreement that the economic transition and policy reforms were timely and were the major driving force in the impressive growth of the past decades. This experience provided stimulus for further policy reforms and at the same time built confidence among public institutions and the private sector in managing reform.

3.1.2. Favourable Economic Conditions Achieved during the Previous Reform

Favourable Macroeconomic and Financial Environment

Macroeconomic and financial sector stability was handled with great care during the transition period, and Cambodia has done exceptionally well. Inflation has been strictly managed at below 5 percent, the exchange rate of the riel against the US dollar was stable, and fiscal credibility is strengthening. Since 2004, the government has been implementing the Public Financial Management Reform Programme with a view to building a public financial management system. Notable outcomes include improved and strengthened revenue policy, forecasting, management and tax collection (total revenues collected as a percent of GDP increased from 11.4 percent in 2006, to 12.1 percent in 2007 and 13.3 percent in 2008) and improved budget implementation and efficiency (budgetary control is more simplified and effective, disbursements and payments are smoother and timely, and recording is more transparent and accurate) (RGC 2008).

Since the early 1990s, the financial sector has undergone substantial changes, including structural reforms and financial service opening. Structural reforms were initiated in 1989 through a government decree to establish a two-tier banking system by separating the function of commercial banks from the National Bank. Foreign banks have been authorised since 1991 and encouraged through prudent liberalisation and the opening of an appropriate competitive environment between local and foreign banks. The Law on Banking and Financial Institutions was adopted in 1999 to govern all financial operations. This law and subsequent regulations guaranteed foreign banks rights and obligations equal to local banks, while it provides no restriction on foreign ownership of banks. Financial service openness is also stimulated by the financial sector development strategy 2006-2015. With the principal objective to support a sound market-based financial system, resource mobilisation, effective financial resource allocation and broad-based sustainable economic growth, this plan encompasses several aspects of the financial system, one of which is financial services openness in order to create a more balanced financial structure, increase the depth of the financial sector and promote competition.

Significant progress has been made in transforming financial institutions into a market-based, private sector-dominated sector. Banking has grown rapidly, the total number of banks increasing from 19 in 2005 to 30 in 2008. As of 2008, the banking sector consisted of 20 private local banks, three foreign banks and one state-owned bank. Branches increased even more rapidly from 49 in 2004 to 105 in 2008 (Hing 2009). Bank outlets flourished throughout the main towns and provinces, and banking services were introduced and offered to consumers in more convenient and competitive packages. In 2008, total loans grew four times from 200, reaching USD 2,401 million or 34 per cent of GDP; total deposits rose to USD 2534.9 million from USD 958.6 million in 2005 (*ibid.*). Although deposits and loan services are concentrated in a small group of banks, none of these had dominant power in the market and therefore competition was fairly healthy. The ratio of broad money (M2) to GDP and ratio of bank assets to GDP increased at an average rate of 36 per cent and 46 per cent, respectively, during 2005-08. As of 2008, broad money accounted for 41 per cent of GDP, rising from 22.8 percent in 2005, while bank assets represented 58 per cent of GDP, an increase from 25 per cent in

2005. Loans and deposits also expanded, at an average rate of 53 per cent and 35 per cent, respectively, during 2005-08 (*ibid*).

There was also significant improvement in openness in the financial sector. Restrictions against foreign participation and discrimination in both banking and insurance were extremely low (Saing 2008[7]). The improvement reflects the changes in the existing rules and the introduction of several new outward-oriented regulations and practices of free market economy (*ibid*). A favourable environment for financial service liberalisation is extremely important for growth in Cambodia because the more open the financial system, the more robust and efficient it will be. Most literature[8] agrees that trade liberalisation of financial services can help countries build more robust financial systems. Liberalisation affects financial development by: (1) facilitating capital inflows, (2) spurring domestic financial institutions to improve quality, innovation and efficiency, (3) increasing competition, (4) introducing international practices and upgrading standards of accounting and auditing and (5) intensifying pressure on government to improve legal, regulatory and supervisory systems (World Bank 2008; Francois & Schuknecht 1999; Mattoo *et al.* 2001; Levine 1996; King & Levine 1993).

Improved Business and Investment Climate

After receiving some negative perceptions from investors and private enterprises, the government has paid greater attention to improving the investment climate. For example, the government made significant efforts to pass regulations identified in the programme of legal reforms resulting from WTO accession. More than half of the 73 laws and regulations are already promulgated and the remaining ones are at various stages of development.

In June 2004, the Special Inter-Ministerial Task Force on Trade Facilitation and Investment Climate was established to address the most urgent impediments to trade and investment through its Twelve-Point Action Plan. A customs reform and modernisation programme was implemented aimed at creating a modern customs administration with fast, straightforward and reliable services. Some of the significant achievements of this reform include: (1) introduction of a single administrative document in 2006; (2) development of a risk management strategy for the clearance of imported and exported goods; (3) passage of the new customs law in 2007; (4) the computerisation of customs clearance through ASYCUDA (Automated SYstem for CUstoms DAta) in 2009 at five border checkpoints and expansion to the remaining 17 international border checkpoints in 2011; (5) the elimination of pre-shipment inspection in 2009; and (6) continued implementation of customs valuation transaction. The government in 2004 adopted a Ten-Point Action Plan also known as the "Blue Book on Best Practices in Investment Promotion and Facilitation" to guide improvements in the investment climate and to deal with a range of investment impediments and public-business sector dialogue. The

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7 Saing borrows the framework designed by McGuire and Schuele (2000) and uses the Trade Restrictiveness Index (TRI) to estimate the openness or restriction of an economy's trading regime for finance services. Similar to McGuire and Schuele (2000), indicators used for calculating TRI for banking services are licensing of banks, forms of commercial presence, foreign equity participation permitted, restrictions on certain types of services by foreign banks, joint venture arrangements, permanent movement of foreign executives, raising and lending funds by foreign banks and other restrictions; indicators for insurance services include licensing of insurance companies, forms of commercial presence, foreign equity participation permitted, restrictions on certain types of services by foreigners, joint venture arrangements, cross border supply by insurance companies, limitation on foreign suppliers, scope of raising funds by domestic and foreign investors and the number of insurance outlets.

8 See, for example, Bhattacharaya (1993), Bhattacharaya *et al.* 1997), McFadden (1994), Levine (1996), Barajas *et al.* (2000), Clarke *et al.* (2000), Demirguc-Kunt and Huizinga (2000), Kono *et al.* (1998), Nicholl (1997), and Armendariz (1997).

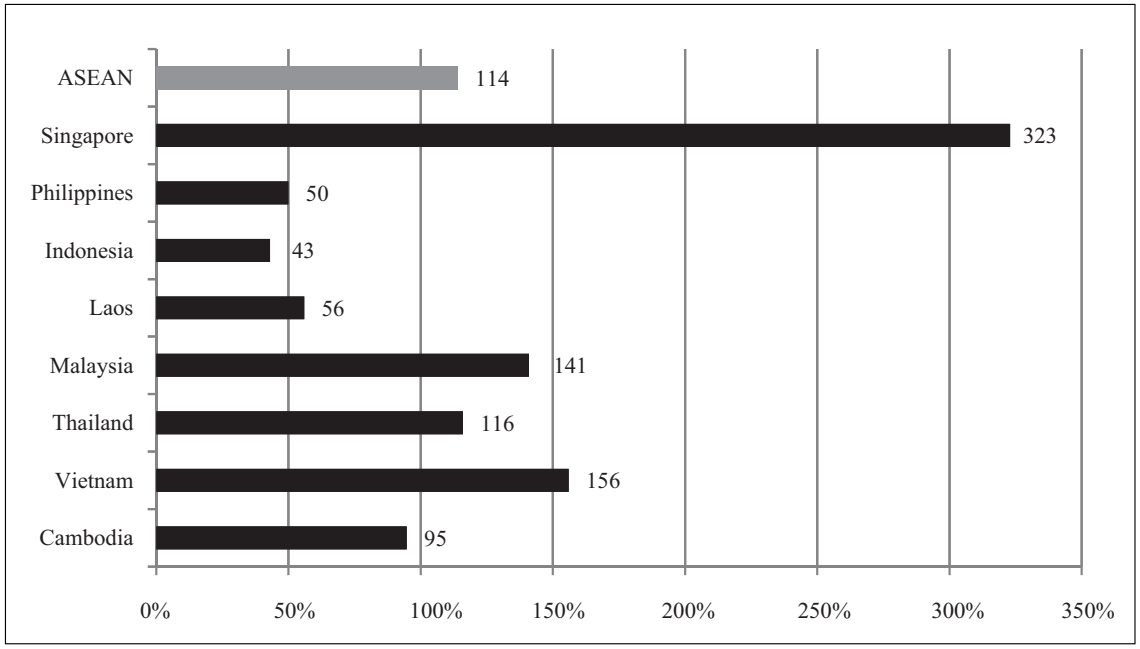
Government-Private Sector Forum was established in 1999 for identifying and overcoming policy constraints on private sector development; it is widely regarded as an effective platform to address business concerns. The government adopted the Sub-Decree on the Establishment and Management of Special Economic Zones in December 2005 to attract industrial and export-oriented investments.

Although some measures have made relatively slow progress, the overall trade and investment climate has notably improved. The World Bank's Doing Business data show that the average total time to export was reduced from 43 days in 2006 to 22 days in 2011 and from 53 days to 26 days for imports. With the introduction of ASYCUDA, more than 90 percent of import declarations are cleared within 24 hours (from the filing of the declaration to the release of goods) (WTO 2011). A firm-level survey also suggested an improved perception of the investment climate, especially in legal reforms and access to finance and trade. Although a lot still needs to be done to create a more conducive business and investment climate, the positive outcomes highlighted above should be applauded. They create necessary conditions for greater investment and the further development of trade and the private sector.

A More Open Economy and Active Participation in Multi-Layer Trade Arrangements

Cambodia's policy reforms were directed towards a more open and market-driven economy. The country's openness index[9] in 2011 stood at 95 percent, slightly below the ASEAN average but well above the indices of Laos, the Philippines, Indonesia and Myanmar. The degree to which Cambodia's economy depends on trade has increased gradually since the mid-1990s, when the openness index was 44 percent (Figure 1). Global experience suggests that a high level of openness is a necessary precondition for sustained growth because it fosters investment, technology and knowledge and raises productivity.

Figure 1. Trade Dependence Index of ASEAN Members



Source: Author's calculations with trade data from Trade Map (at http://www.trademap.org/) and GDP data from World Development Indicators

[9] This is also often called trade dependence index; it is calculated as the total value of trade as a percentage of GDP.

The trade regime has become less and less restrictive through gradual tariff reduction and elimination of non-tariff measures deemed unlawful under regional and global trade rules. Tariffs were restructured in 2001 into four bands: 0, 7, 15 and 35 percent, with around 8300 total tariff lines based on HS 2007 nomenclature. There was a notable reduction in the average rate and a significant decline in the number of tariff lines in the highest band. The simple average applied tariff fell from 17.3 percent in 2003 to 15.1 percent in 2005 and 11.7 percent in 2011. Around 54 percent of tariff lines are duty free or subject to the minimum 7 percent rate, up from 46 percent in 2005; and tariff lines in highest band fell from 2225 items or 21 percent to 820 items or 10 percent (Tables 1, 2 and 3).

Table 1. Cambodian Tariff Structure by Type of Product

	MFN Applied Tariff Rate		
	2003	**2005**	**2011**
Total tariff lines	6808	10689	8298
Simple average rate (%)	17.3	15.1	11.7
Agricultural products (HS01-24)	20.6	17.7	15.4
Non-agricultural products (HS25-97)	16.7	14.8	11.1
Overall standard deviation of tariff rates	13.6	11	9.2
Duty-free tariff lines (% of all tariff lines)	4.3	5.9	13.7
Non-*ad valorem* tariffs (% of all tariff lines)	0	0	0

Source: WTO's Tariff Analysis Online Facility at http://tariffdata.wto.org/

Table 2. Cambodian Tariff Structure by Rate

	2003		**2005**		**2011**	
Duty range	No. of tariff lines	% of tariff lines	No. of tariff lines	% of tariff lines	No. of tariff lines	% of tariff lines
All items	6808	100	10689	100	8298	100
Duty Free	290	4	631	6	1136	14
7 percent	2738	40	4228	40	3295	40
15 percent	1856	27	3605	34	3047	37
35 percent	1567	23	2225	21	820	10

Source: WTO's Tariff Analysis Online Facility at http://tariffdata.wto.org/

Table 3. Cambodian MFN Applied Tariffs, 2010

		Average	**Range**
		(%)	**(%)**
Total	**8298**	**11.7**	**0-35**
HS 01-24	1271	15.4	0-35
HS 05-97	7027	11.1	0-35
By WTO definition			
Agricultural products	**1145**	**14.5**	**0-35**
Animals and products thereof	125	26.7	0-35
Dairy products	35	23.2	7-35
Fruit, vegetables and plants	295	13.5	0-35
Coffee and tea	40	26.2	7-35
Cereals and preparations	152	12.2	0-35
Oils seeds, fats, oil and their products	181	7.3	0-35

Sugars and confectionary	28	7.0	7
Beverages, spirits and tobacco	104	19.0	7-35
Cotton	5	0.0	0
Other agricultural products, n.e.s.	180	11.4	0-35
Non-agricultural products	**7153**	**11.3**	**0-35**
Fish and fishery products	206	19.3	0-35
Minerals and metals	1263	8.2	0-35
Chemicals and photographic supplies	1213	7.7	0-35
Wood, pulp, paper and furniture	381	9.4	0-35
Textiles	696	5.7	0-35
Clothing	253	14.1	7-15
Leather, rubber, footwear and travel goods	269	14.5	0-35
Non-electric machinery	1188	13.0	0-35
Electric machinery	557	16.5	0-35
Transport equipment	413	16.6	0-35
Non-agricultural products, n.e.s.	680	15.2	0-35
Petroleum	34	12.1	0-35
By stage of processing			
First stage of processing	884	9.3	0-35
Semi-processed products	2165	6.2	0-35
Fully processed products	5249	14.5	0-35

Source: WTO (2011)

Cambodia's import regime also provides import duty concessions and exemptions for: temporary imports for re-export, goods in transit, personal items of Cambodians having resided abroad, imports by diplomatic missions and items for humanitarian or religious purposes. Duty exemptions are also offered to export investment projects approved by the Council for the Development of Cambodia on production equipment, construction materials, raw materials and intermediate goods and accessories. As of 2010, about half of imports entered Cambodia duty and tax exempt with forgone revenue equalling nearly 60 percent of the customs duties[10] collected (WTO 2011).

Cambodia eliminated several non-tariff measures such as quantitative restrictions and import bans as part of its accession to the WTO. As in most countries, import prohibitions and export restrictions are still in place. These are justified under international trade laws rather than used to protect domestic producers. Import prohibition is governed by Sub-decree 209 for purposes such as: protection of national security; protection of national treasures of artistic, historic or archaeological value; conservation of national resources; and protection of human, animal or plant life or health. Export restrictions use export taxes, prohibitions, and licensing requirements to achieve diverse policy objectives including environmental protection or conservation of cultural and natural resources, and promotion of downstream processing industries.

Cambodia is linked to bilateral economic partnerships as well as to sub-regional, regional and global bodies. It established normal trade relations with the United States in October 1996 and reached a three-year bilateral trade agreement on textiles and apparel in January 1999.[11] The

[10] Revenue from customs duties before exemption in 2010 was 2006.3 billion Riels.

[11] The agreement was extended until 31 December 2004. It set an export quota for garments from Cambodia to the US in exchange for the commitment to improve working conditions consistently with international labour standards.

country also signed bilateral trade agreements on textile products with the European Union in 1999 and a few years later was granted GSP status under the Everything But Arms programme. It also made great efforts to obtain GSP status with Australia, Canada, South Korea, Japan, New Zealand and UK. Cambodia has been active in regional programmes such as the Ayeyawady-Chao Phraya Mekong Economic Cooperation Strategy, ASEAN and several ASEAN-initiated schemes, including the ASEAN Free Trade Area, the ASEAN-China FTA, the ASEAN-South Korea FTA, the ASEAN-Japan FTA and broader ASEAN + 3 initiatives.

Why is Cambodia's participation in these regional cooperation frameworks necessary and important for its growth? Regional cooperation offers a number of benefits. First, the country is a beneficiary of Greater Mekong Sub-region and ASEAN infrastructure and "connectivity" – major roads, railways, bridges, waterways and ports. Along with such hard infrastructure, 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. This takes on greater importance with the increasing pace of GMS, ASEAN and East Asian connectivity and integration.

Second, through these trade arrangements, Cambodia's economy became more open, with significant improvements in economic conditions and the business environment. Under the ASEAN Free Trade Area, for example, it committed to a gradual reduction in almost all tariff rates to 0–5 percent on goods from other ASEAN members by 2010. It also agreed to eliminate tariffs for essentially all products by 2015. As of 2001, about 46 percent of tariff lines were put under the so-called Inclusion List (IL) for gradual tariff reduction, while 52 percent were put under the Temporary Exclusion List (TEL). Five years later, about 75 percent of tariff lines were under the IL, while 23 percent were under the TEL. About 19 percent of tariff lines in the IL in 2006 had rates between 0 and 5 percent, up from 7.64 percent in 2003. Under the ASEAN-China FTA, Cambodia has to eliminate tariffs by 1 January 2015, and the ASEAN-Korea Comprehensive Economic Partnership tariff rate has to be reduced to 0-5 per cent for at least 50 per cent of tariff lines under the Normal Track by the same date.

As part of WTO accession, the government, with support from development partners, implemented regulatory and legal reforms in trade governance and strengthened trade facilitation (customs reform) and the institutional building framework in compliance with WTO rules and regulations. The review of Cambodia's trade policy conducted by the WTO highlights significant progress. A customs reform and modernisation programme was implemented aimed at creating a modern customs administration with fast, straightforward and reliable services. Major elements of the reform programme included strengthening the legal framework, restructuring tariffs, modernisation and streamlining of customs procedures, expansion of international relations, effective enforcement, automated systems and procedures, measures to strengthen the Customs and Excise Department and better services.

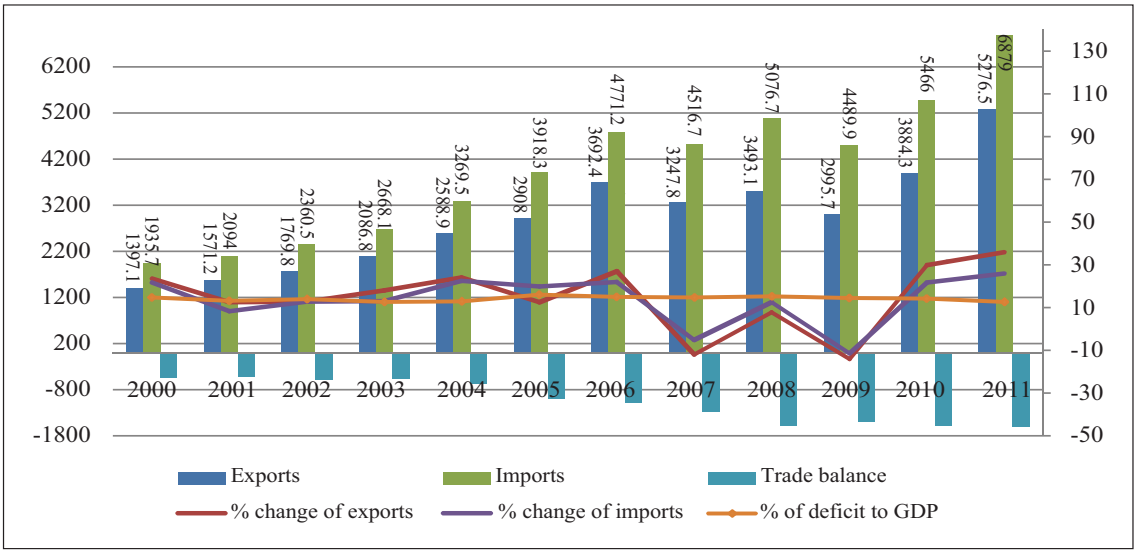
Third, like many least developed countries (LDCs), Cambodia has benefited significantly from trade-related technical assistance, viz. initiatives for ASEAN integration designed to narrow and eventually bridge the development gap among ASEAN members, and Aid for Trade programmes of WTO and development partners that mobilise resources to address trade constraints. Although some critics, based on *ex-ante* analysis, argue that the country should have begun participating in regional blocs later, when it was better prepared in terms of economic conditions and capacity, they may have a contrary view when using an *ex-post* approach. 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.

3.1.4. Increased Trade and Competitiveness

Economic transition and deeper economic integration have brought about wider market access for Cambodian exports and greater interaction among private sector—all a tribute to the rapid expansion in trade in the past two decades. Since the mid-1990s, there has been a rapid revival in the trade sector, making it the key driver of economic growth. Total trade in 2011 reached USD12.16 billion, a huge leap from USD3.33 billion in 2000 at an average annual growth rate of 14 percent (Figure 2).

Figure 2. Cambodia's Exports, Imports and Trade Balance, 2000-11



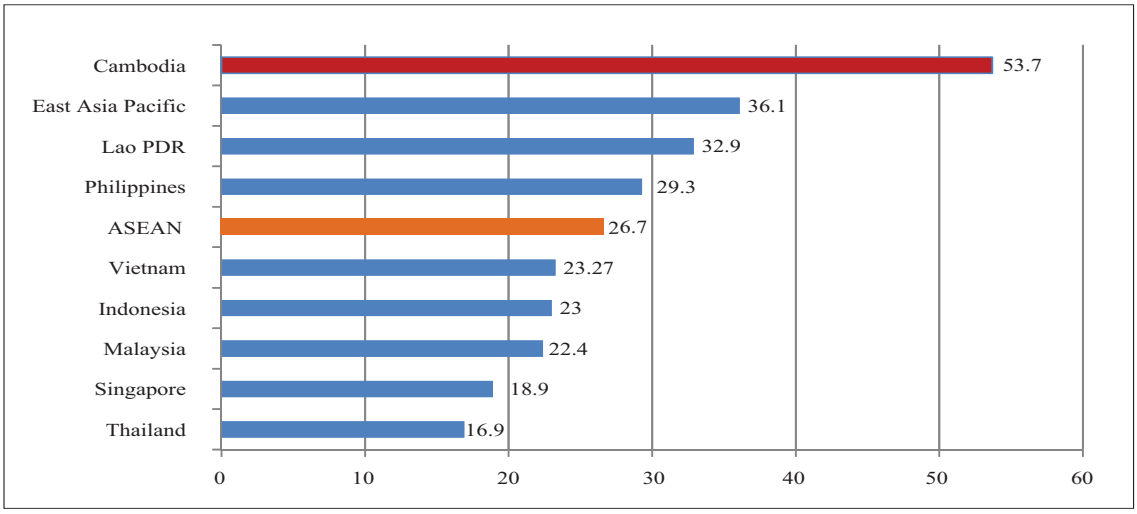
Source: Author's calculation with data from ADB's economic and financial indicators

During 1994-2011, exports grew on average 20.4 percent a year, from USD490 million in 1994 to USD5276 million in 2011. The USA is the largest market for Cambodia's exports, taking 31.4 percent of the total. Other major export markets are Hong Kong (17.9 percent), Singapore (6.6 percent), United Kingdom (5.8 percent), Canada (6.7 per cent), Germany (4.8 percent) and Thailand (2.8 percent). Among country blocs, NAFTA is the biggest market at 37.8 percent, the EU is the second largest (22.7 percent), followed by ASEAN (12.4 percent) (Figures 3 and 4). Cambodia's export structure is regarded as highly concentrated in a few markets. The export market concentration index[12] is the highest in the region at 53.7 percent,[13] twice as high as the average of ASEAN nations. This makes it more vulnerable to external shocks. The recent economic crisis, which hit Cambodia's exports hard, has proven how vulnerable such a narrow export base is and demonstrates the need for export market diversification.

[12] This indicator reflects the Herfindahl-Hirschmann index measure of the degree of export market concentration of a country.

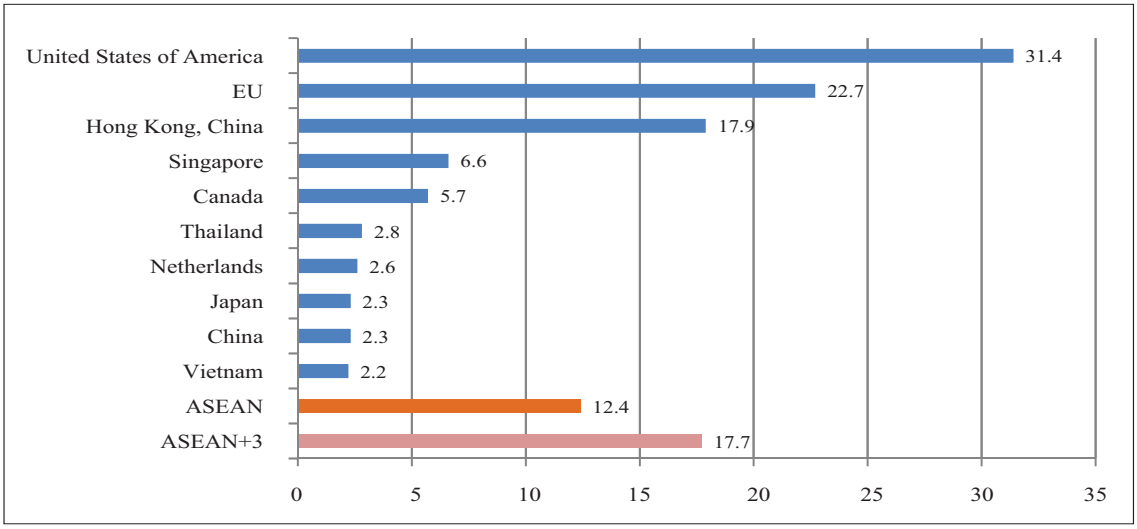
[13] The latest data available are in 2009 from the World Trade Indicators accessed on 4 December 2012 at http://info.worldbank.org/etools/wti/3a.asp?pillarID=5&indList=66&indList=118&indList=152&indList=161&indList=190&regionID=&periodID=16

Figure 3. Market Destination Concentration Index



Source: the World Bank's World Development Indicator

Figure 4. Cambodia's Top 10 Export Markets



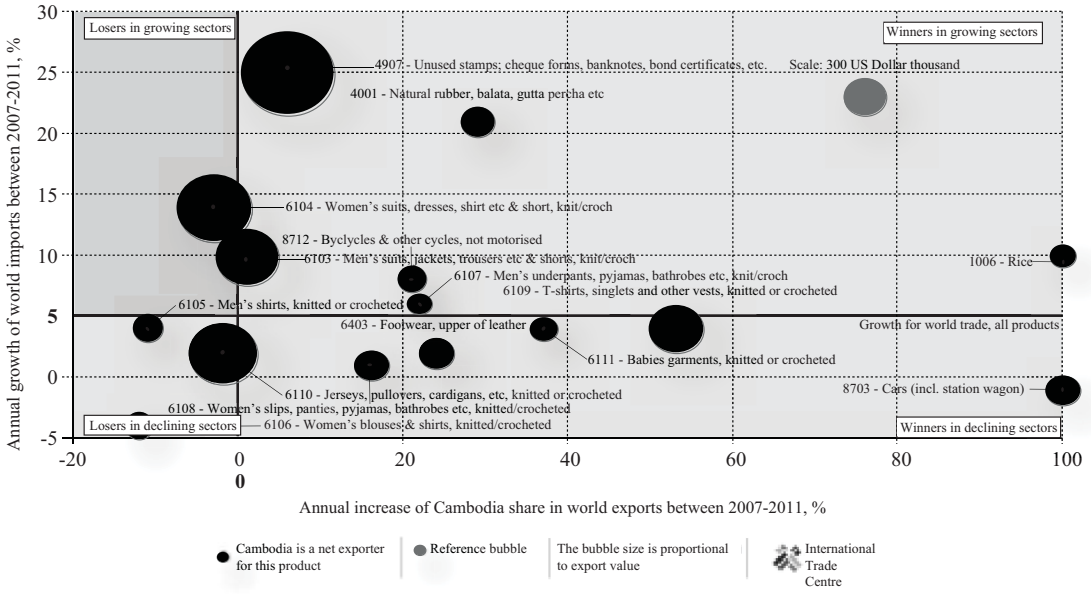
Source: International Trade Centre's Trade Map

Cambodia's exports are dominated by a small group of products. The top 15 exports at HS 4 digit level represent 90 percent of total exports and fall within a few broad product classification categories, namely: apparel (HS 61-62), paper (HS 49), rubber (HS 40), footwear (HS 62), vehicles (HS 87) and cereal (HS 10). Such an export pattern is regarded as one of high concentration as shown by a high export diversification index of 0.87, the highest in the region.[14] Figure 5 maps the status of these 15 products, which are positioned horizontally according to their annual growth rate as Cambodian exports and vertically according to their growth rate in world imports. Products with positive growth in both value and world imports are classified as "winners in growing sectors". Those with positive growth in value but negative growth in world imports are classified as "winners in declining sectors". Those with negative growth in

[14] The indicator is drawn from World Integrated Trade Solution interactive database, accessed on 5 December 2012 at http://wits.worldbank.org/wits/. Export diversification index, which measure of the degree of export product concentration of a country, in 2011 was 0.54 for ASEAN, 0.68 for Laos, 0.65 for Myanmar, 0.48 for Vietnam, 0.35 for Thailand, 0.43 for Indonesia, 0.35 for Malaysia and 0.33 for Singapore.

value but positive growth in world imports are classified as "losers in growing sectors". Those with negative growth in both value and world imports are classified as "losers in declining sectors". While a few products like women's blouses and shirts, men's shirts and jerseys and pullovers are decreasing in value between 2007 and 2011 amidst declining world demand, the other export products have had sharp growth. More than half of them grew amidst rising world demand while the others grew significantly but within falling world imports.

Figure 5. Growth of National Supply and International Demand for Cambodia's Exports



Source: International Trade Centre's Trade Map

Cambodia's revealed comparative advantage (RCA) index, which is measured by a product's share in the country's exports in relation to its share in the world trade, suggests that Cambodia has very strong competitive edge in labour-intensive manufactured products such as apparel and footwear but less so in agricultural goods (Table 4). Manufacturing represents nearly two-thirds of total exports and about 2 percent of world exports. Although the demand for clothes and footwear in major export markets has slowed, their production will continue to increase in the foreseeable future and their competitiveness might remain firm. At least two trends lead to this prediction. First, considerable new apparel and footwear manufacturing projects have been invested in Cambodia in recent years. These investments are attracted by the generous investment incentives such as tax holidays and exemptions. The increase is also attributed to the relocation of firms from countries such as Vietnam, Thailand and China which are no longer cost-competitive due to rising costs of labour. The second explanatory factor relates to cost competitiveness. Not only has the cost of labour in Cambodia remained significantly lower than in many major clothes and footwear exporting countries, but exports are also duty-free and quota-free in major markets such as the US, EU and Canada. This appears to be a big cost advantage that sufficiently offsets the country's higher logistics and trade facilitation costs.

Table 4. Cambodia's Revealed Comparative Advantage Index

HS Code	Description	Export value 2011 (USD million)	Share in total exports (%)	Growth 2007-2011 (%)	RCA 2007	RCA 2011
61	Articles of apparel, accessories, knit	3843.3	57.3	9	45.8	46.7
64	Footwear, gaiters and the like, parts	267.1	4.0	37	11.5	18.2
62	Articles of apparel, accessories, not knit or crochet	139.5	2.1	-2	16.4	15.7
10	Cereals	107.9	1.6	123	0.5	4.4
25	Salt, sulphur, earth, stone, plaster, lime and cement	0.7	0.01	-54	0.2	3.5
65	Headgear and parts thereof	9.7	0.1	17	2.3	3.3
63	Other made textile articles, sets, worn clothing etc	17.6	0.3	9	1.5	2.0
76	Aluminium and articles thereof	5.4	0.1	37	0.1	1.6
01	Live animals	0.4	0.01	41	0.2	1.4
97	Works of art, collector pieces and antiques	2.4	0.04	38	0.6	1.4
17	Sugars and sugar confectionery	12.6	0.2	434	0.0	1.3
40	Rubber and articles thereof	192.2	2.9	48	0.3	1.2
07	Edible vegetables and certain roots and tubers	2.5	0.04	23	0.1	1.1

Source: RCA is derived from WITS at http://wits.worldbank.org; export values are derived from Trade Map

Although Cambodia is well endowed with agricultural land, forestry and water resources with high potential for primary production, it has yet to become competitive enough in agricultural trade (exports of agricultural goods are just 4.9 percent of total exports). However, a positive trend may also be projected since the RCA index suggests prospects for certain agricultural products. A number of agricultural products that did not have comparative advantage in the past four years appear more competitive now and increasingly contribute to total exports. Cereals are the most successful product in terms not only of rapid increase in export values but also of stronger competitiveness evident in a significant improvement in the RCA index. Other products that made impressive progress in comparative advantage are sugar and sugar confectionery, live animals, rubber and edible vegetables and roots.

3.2. Role of Trade in Past Growth

Despite the absence of empirical evidence, it is hard to deny the important role trade policy has played in boosting and sustaining economic growth in the last two decades.[15] The government's policy reforms have transformed a virtually closed economy into one of the most open in the region. More liberal trade and investment policies in the context of deeper integration into regional and global economies are widely perceived as a means for Cambodia to strengthen peace and stability and to increase trade, investment and competitiveness. Following the setback of the 1998 constitutional, political and military crisis, and the subsequent achievement of an uneasy political stability, international recognition of the Cambodian government was re-established soon after; in 1999, the country became a member of ASEAN and five years later a member of the WTO. Democratic institutions were rebuilt, and ambitious sub-national governance reforms of decentralisation and deconcentration were implemented. Despite the absence of research on the extent to which trade policy has contributed to peace and stability

[15] Cambodia's real growth over 1994-2011 averaged around 8 percent.

in Cambodia, it is widely accepted that the private sector, investors and development partners have played roles in pressuring the government to maintain political stability.

After decades of conflict, Cambodia is short of capital. The government has recognised this shortcoming and regards private investment as a major source of development and economic growth. To attract investment, the government has modernised its investment regime through the adoption of the law on investment,[16] removal of restrictions on private investment and improving the investment climate. The outcome has been impressive. FDI increased from almost nothing in the late 1980s to an annual average of USD203 million or 36 per cent of annual average private investment during 1994-99 and USD604 million in the second half of the 2000s. FDI stock in 2010 reached USD5.58 billion, accounting for 34 percent of total private investment. It is widely argued that trade policy has contributed to this huge inflow of FDI. While some FDI is resource-seeking, the majority of investment projects are driven by export opportunities and by a more dynamic domestic economy—tourism, construction, finance and trading services.

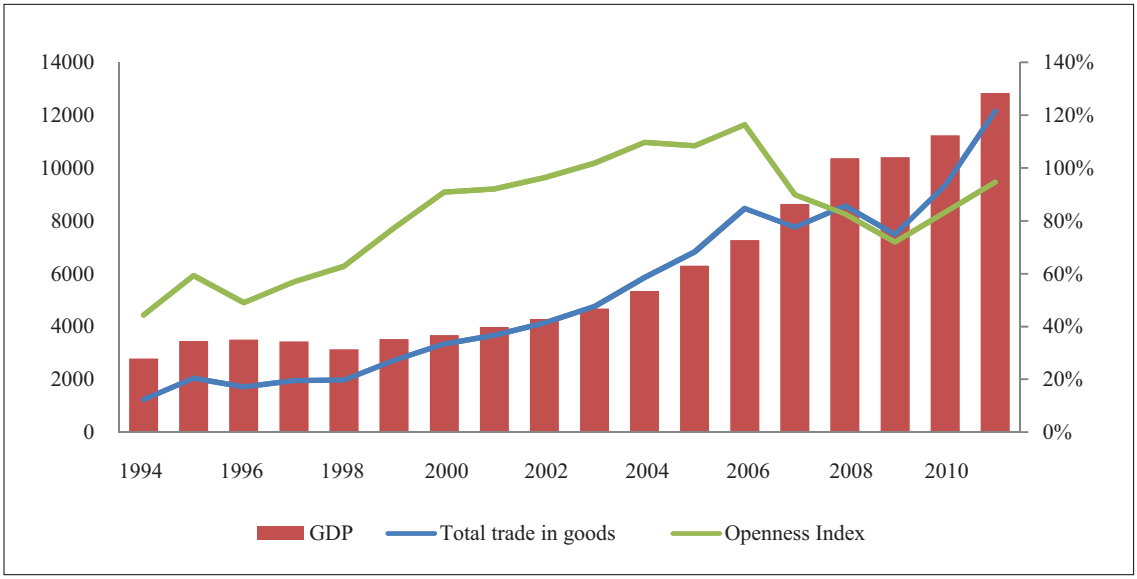
Growth over the past decade has been driven mostly by four sectors: garments and footwear, tourism, construction and agriculture. Garments and footwear have become a major source of employment and foreign exchange and the backbone of Cambodia's economy. The sector is the leading exporter, making up 12 percent of the 2010 GDP. Its exports went from almost zero in 1994 to USD4.54 billion in 2010, equivalent to 86 percent of the total. Cambodia is one of the fastest growing tourist destinations in south-East Asia. Tourist arrivals grew at an annual average rate of 21 percent during 1994-2012, from 0.18 million in 1994 to about 3.56 million in 2012.[17] Construction was 6.2 percent of the 2010 GDP and grew at an average of 11 percent per annum during the 2000s. The sector has closely followed real estate development, most construction projects having been in commercial and residential real estate. Agriculture accounted for 33.2 percent of the 2010 GDP and grew at 5.1 percent during 2001-10. Growth in this sector is driven by crops (mainly rice) and, to a lesser extent, livestock and fisheries. At 53 percent of 2010 agricultural production and 14.5 percent of GDP, crops grew at an average of 7.2 percent during 2001-10. Fisheries are the second largest source of agricultural production at 25 percent, followed by livestock and poultry, 16 percent. Fisheries grew at an average rate of 3.2 percent and livestock and poultry 5 percent during the same period.

Figure 6 shows the trends in the economy's openness, trade volume and GDP over two decades. Although this cannot prove a relationship between trade policy, trade performance and economic growth, the figure suggests a positive correlation. Since the mid-1990s, the volume of trade has risen significantly along with the increased openness of the economy. The more open the economy is to international trade, the greater will trade values contribute to the overall economy.

[16] The law on investment was adopted in 1994. It offered generous incentives to Cambodian and foreign firms: a corporate tax rate of 9 per cent, tax holidays, unrestricted repatriation of profits and import duty exemption. The law also created the Cambodian Investment Board under the Council for Development of Cambodia as a "one stop" organisation responsible for approving foreign investment applications.

[17] Ministry of Tourism, accessed in March 2013 at http://www.tourismcambodia.org/images/mot/statistic_reports/tourism_statistics_annual_report_2012.pdf

Figure 6. Cambodia's openness, trade and growth, 1994-2011



Source: Author's calculation with data from ADB's economic and financial indicators

An example on how trade policy affects growth is the boom in the garment sector, which was largely explained by the outward-looking trade policy. Cambodia was given preferential market access by the USA and EU through bilateral textile trade agreements from mid-1990 until the end of WTO's Multi-Fibre Agreement in 2004 and later through their GSP programmes. About 65 percent of garment and footwear exports went to the US market and 20 percent to the EU. The rapid growth of tourism, on the other hand, has been due to Cambodia's natural and cultural endowments, political stability and policies such as the Open Sky Policy, introduced in late 1997, and regional cooperation on tourism viz. the GMS tourism sector strategy and the ASEAN Tourism Strategic Plan. Trade liberalisation of financial services, especially under the GATS framework, has played a role in strengthening Cambodia's financial system (Hing 2009). Not only have the depth and outreach of the financial system increased, but competition and efficiency have also improved significantly. More than contributing directly to output and employment, a more robust and efficient financial system can provide essential infrastructure for the entire economy.

3.3. A Changing Trade Landscape

International trade has gone through significant changes over the past decade, particularly rapid expansion in trade volume, proliferation of regional trading arrangements (RTAs) and the emergence of global supply chains (GSC). The world has become more interconnected. World trade volume has been expanding more rapidly than real world outputs during the past decade. According to WTO statistics 2012,[18] world merchandise trade has grown by 3.7 per cent annually since 2005 while GDP has risen by 2.3 per cent. Driven by improvements in transport and communications, liberalisation of international trade and the increasing role of transnational corporations brought about by liberalisation and FDI, growth has been accompanied by the rising importance of trade among developing countries.[19] The rise in South-South trade has become the driving force behind global trade in the 2000s. China has become the world's largest

[18] Accessed in March 2013 at http://www.wto.org/english/res_e/statis_e/its2012_e/its2012_e.pdf

[19] UNCTAD's Development and Globalization: Facts and Figures, accessed in Match 2013 at http://dgff.unctad.org/chapter1/1.html

exporter and will be the world's largest economy in PPP terms in the near future. The growth of China significantly changes the trade landscape for other developing countries. China and other large, rapidly growing nations create major opportunities for diversification (WB 2011:1).

While the multilateral trading system underpinned by WTO rules remains a central pillar of international trade, RTAs have become increasingly common, 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. Broad-based RTAs aimed at high standard liberalisation and regulatory cooperation are emerging, such as the Trans-Pacific Partnership, which might turn into an APEC-wide agreement, and a possible Trans-Atlantic agreement proposed for 2014 (UNCTAD 2012). Most RTAs have become deeper and more comprehensive, expanding their scope beyond the subjects covered by WTO agreements to include investment, competition and government procurement to create a duty-free and barrier-free trading environment (*ibid*). 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 FTAs and were negotiating 84 FTAs,[20] 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 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. Last year in the 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. The growth of FTAs in Asia is a result of economic and political factors including the need to improve international competitiveness, exploitation of scale economies, dissatisfaction with the slow progress of global trade talks, defensive responses to regional trading blocs elsewhere (EU, NAFTA), fear of exclusion and political and national security concerns (Kawai 2008, Zhang & Shen 2011).

Global supply chains—the breaking up of production processes into vertically separated stages carried out in different countries[21]—have become much more prevalent. They began in electronics and garments in the late 1960s before spreading to other industries such as sports footwear, automobiles, televisions and radios, sewing machines, office equipment, power and machine tools, cameras, watches and printing and publishing, among others (Athukorala and Menon 2010). The most important and mutually reinforcing factors underlying GSC are comparative advantage and increasing returns (*ibid.*). Transnational corporations in advanced economies move their final assembly overseas to be physically closer to final users and/or to take advantage of inexpensive labour. The relocation of production has been spurred by (1) rapid advancement in production technology, which has enabled the industry to slice the value chain into smaller, portable components; (2) technological innovation in communication and transportation, which has not only shrunk physical distance, but also allows 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 (*ibid.*). World network trade increased from USD988 billion (about 44 percent of total manufacturing exports) in 1990-91 to USD4557 billion (51 percent) in 2009-10, accounting for over 60 percent of the total increment in world manufacturing

[20] ADB's Asia Regional Integration Office, accessed in March 2013 at http://aric.adb.org/ftatrends.php

[21] This definition is adopted from Athukorala and Menon (2010). Several terms have been used interchangeably to describe this phenomenon. They include global production sharing, global production network and global value chains.

exports during this period (Athukorala and Nasir 2012). The share of developing countries in total world network trade increased from 18.5 percent to 47.3 percent between 1990-91 and 2009-10, but it is heavily concentrated in Asia (*ibid*).[22]

Why does the rapidly changing international trade landscape have important implications for Cambodia's export and 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 trade 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 macroeconomic stability, the country 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 regional markets, resources and investments, all contributing to accelerating productivity, employment generation and economic growth.

The second argument relates to the necessity of using multiple frameworks for export diversification, export growth and competitiveness. Although the WTO Doha negotiations are stalemated, the multilateral trading system remains central for Cambodia. It is also extremely important for the country 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 south-East Asia, offers vast opportunities for investment and trade, private sector development and growth and prosperity (Strange *et al*., forthcoming). In achieving its aspirations for regional and sub-regional integration, Cambodia must coordinate ASEAN-GMS integration initiatives in a more strategic manner and adopt more realistic timeframes for implementing complex reforms and long-term institutional capacity building. These initiatives include the GMS Cross Border Transport Agreement and synchronicity of the Master Plan on ASEAN Connectivity with GMS connectivity initiatives and processes, and a greater awareness of and engagement in AEC mechanisms and opportunities. Moreover, Cambodia, along with other ASEAN LDCs, needs the GMS, ASEAN and ASEAN + 3 partnerships to deliver on the ASEAN charter commitment "to alleviate poverty and narrow the development gap within ASEAN through mutual assistance and cooperation" (*ibid.*).

The third argument is that Cambodia has not been part of dynamic regional production sharing. There is an emerging GSC-related phenomenon in Asia in which considerable numbers of firms are moving their production out of China due to rising costs and relocating in LDCs to exploit the host countries' low labour costs, increasing intra-regional dependence and market access to third countries. This is evident in the recent investment of two Japanese firms—Minebea, the global leader in micro-motors, and Sumitomo Electric, a leading producer of wiring harnesses—to set up state-of-the-art production facilities in Cambodia to serve global markets. Given GSCs' reliance on open trading systems, trade policy plays a crucial role in determining the rate of offshoring. Driven by the experience of the most dynamic developing countries that integrate well into GSC and become exporters of parts and components, the Cambodian government is seeking to follow a similar path through policy interventions particularly in the areas of improving the business and investment climate, opening up special economic zones and addressing the skills shortage and skills mismatch in its labour force, apart from its liberal

[22] In 2009-10, developing Asia accounted for 26.5 percent of total world network exports (77 percent of total developing country network exports), China alone accounting for 17.3 percent (57 percent of the developing country total).

trade and investment policies. The government is also developing an industrial policy. In his keynote address to the Fourth Cambodia Economic Forum in 2011,[23] Prime Minister Hun Sen said: "There is no doubt that there is an urgent need for Cambodia to modernise its economy; in practical terms this means promoting the development of the industrial sector. Modernising the economy by promoting industrial development is an appropriate and necessary solution for achieving sustainable growth of the Cambodian economy and will take it to a higher stage of development." Notable progress in the take-off stage has raised Cambodia to a level that has the conditions, policy settings and experience to harness the opportunities arising from international trade policy. The challenges are how to exploit the benefits fully and leverage trade for economic growth.

[23] The fourth CEF was held in Phnom Penh, on 16-17 February 2011 titled "Cambodian Economy in Post-Crisis Environment: Industrial Policy—Options Towards a Sustainable Development". It was organised by the Supreme National Economic Council with the support of the United Nations Development Programme, Asian Development Bank and the World Bank. More details can be found at http://www.un.org.kh/undp/4th-cambodia-economic-forum/4th-cambodia-economic-forum.

4

WHAT ARE POLICY PRIORITIES TO PROMOTE TRADE FOR GROWTH?

Global experience suggests that trade policy has been a key to growth and development. No country has ever been able to sustain long-term growth without integrating into the world economy. But while trade is a necessary condition for growth, it is not sufficient. To sustain growth over a long period, a host of factors apart from export promotion and industrial policy need to come together: macroeconomic stability and financial sector development; investment in infrastructure, education and health; technology and knowledge transfer; and effective government (World Bank 2008).

Below are policy priorities for Cambodia to promote exports, enhance diversification and upgrade its industrial base to sustain economic growth. These recommendations are based on a balance of the country's current socio-economic and policy contexts, taking into account the experiences of successful exporting countries. The proposed policies are broadly categorised into two groups. The first comprises measures that aim to remove distortions and reduce transaction costs (known as "permissive policies"). Typically, these involve maintaining macroeconomic stability, improving the business and investment climate, removing high rates of domestic protection, especially through special import regimes (e.g. duty/tax exemption, special economic zones) and reducing high transaction costs for exporters. The second refers to measures that intend to overcome structural market deficiencies ("positive policies"). They can be subdivided into functional and selective interventions. Functional interventions are aimed at remedying market failures without influencing resource allocation between specific activities. Examples include improvement in physical infrastructure, human capital or provision of information and technical support to exporters. Selective interventions aim at influencing resource allocation or remedying market failures for specific activities through specific subsidies or protection, credit direction, creation of specific skills or technology or attracting specific investors. Functional interventions are more market friendly and less controversial than selective interventions.

4.1. Policies to Remove Distortions and Reduce Transaction Costs

1. **Maintain sound macroeconomic management.** Over the past two decades, Cambodia has done exceptionally well at maintaining macroeconomic stability: fiscal credibility has been maintained, the financial system is stable and secure, the exchange rate is stable, and inflation is low. A stable and resilient macroeconomy will continue to be important to successful outcomes from trade promotion. Policies for sound macroeconomic management for Cambodia include maintaining inflation under 5 percent, maintaining external sector and exchange rate stability, improving collection of revenue and deepening the financial sector. The financial sector is young, so the country should pay greater attention to building a robust and efficient financial system. One option would be to liberalise financial services in conjunction with improving supervisory capacity and the regulatory framework. Financial regulatory reforms need to set in place pro-market financial institutions, pro-competition regulatory frameworks and macroeconomic and monetary stability prior to opening up financial sectors. Financial services liberalisation helps to accelerate reforms, encourage a more transparent regulatory and supervisory framework, increase the incentive for better macroeconomic policies and regulations

and enhance the credibility of rules. It is expected that trade liberalisation of financial services would strengthen Cambodia's financial system.

2. **Improve the investment climate.** This is an effective complementary strategy in fostering export performance and sustaining growth. The investment climate combines factors such as macroeconomic certainty; quality and accessibility of infrastructure; extent of government regulation; taxation; access to and cost of financing; access to, cost and quality of factors of production; degree to which the government creates a level playing field; governance and corruption; and security (Asian Development Bank & World Bank 2007). Despite significant improvements in areas such as macroeconomic management, access to finance and information technology and trade facilitation, the Cambodian investment climate remains less conducive than in most countries in the region, as evidenced by its low ranking in business and economic assessments. In the 2012-13 Global Competitiveness Report, the country ranked 85th out of 144 countries as a result of poor infrastructure, higher education, auditing and reporting standards, irregular payments and bribes and transparency of government policy making. This finding confirms Cambodia's 2009 investment climate report (World Bank 2009a), which contends that corruption, anti-competitive practice, economic and regulatory policy uncertainty, expensive and unreliable electricity, poor skills and education, the legal system and customs and trade regulations are perceived by investors as important constraints on investment and business. Improving the investment climate is synonymous with removing or reducing these perceived constraints. Some of the policies to do this should be upgrading infrastructure, streamlining customs procedures, enhancing logistics and investing in human capital. While such improvements are already in the priority agenda of the government, also needed are: strong recognition of the issue by concerned institutions and stakeholders; sufficient human and financial resources; political support to tackle sensitive issues; and a stronger and more harmonious public-private partnership.

3. **Improve customs procedure.** Issues related to import and export are among the areas that the government has made the greatest effort to tackle. This is clear from the measures that have been implemented, namely the Twelve-Point Action Plan for Trade Facilitation, the government-private sector forum and the single administrative document and computerisation of customs clearance through ASYCUDA. As a result, trade facilitation has improved significantly. However, the outcomes vary across sectors. The garment sector was reported to benefit from significant progress, reflecting the active role of its industry association and recognition by government of its role in the economy (World Bank 2009b).

   Compared to other countries in the region, the gap in trade facilitation performance has been significant. While in Thailand it takes 14 days, in Malaysia 11 days and in Singapore five days to comply with all procedures required to export, the same process takes 22 days in Cambodia.[24] Similar evidence was reported in World Bank (2009b) suggesting that the top one-third of performers (in terms of total factor productivity) have documentation problems: the cost of shipping remains high; the cost of an import licence is also high due to significant informal payments; and the cost of exports is worsened by delays and informal payments to obtain VAT rebates. This is confirmed by exporters' opinions reported in ADB (2012) that customs formalities including

[24] The World Bank Doing Business 2013 accessed on 03 January 2012 at http://www.doingbusiness.org/rankings

paperwork and clearance are among top three impediments. Specifically, certificates of origin presently require five to seven days, but are issued almost immediately in Thailand. Inefficiency in import and export processes directly affect trade costs,[25] total factor productivity[26] and competitiveness. Addressing this issue will be critical in fostering export growth and competitiveness. To improve customs procedures, there is a need for comprehensive reforms that address major constraints perceived by the private sector, especially in documentation, coordination among trade-facilitation agencies and access to information on export procedures, regulations and fees.

The initial implementation of ASYCUDA was widely perceived as reducing import and export time. The system needs to be fully implemented in the remaining customs inspection points. Alongside ASYCUDA is needed a single electronic administrative document that would allow traders to submit required documentation to the government through one electronic gateway and to do so only once, instead of multiple times to different agencies. There are different ways to manage a single window, and the debate remains inconclusive on which model is most effective. However, there is an increasing tendency toward a public-private partnership joint venture such as Singapore's TradeNet, Hong Kong's (SARC) DTTN, South Korea's "e- Trade", Senegal's ORBUS, Tunisia's TradeNet (World Bank 2009b). The government has opted for 100 percent public ownership of the single window. At this moment, it is premature to propose a change of ownership model. Instead, there should be a credible internal monitoring mechanism and external independent assessment.

Coordination and the quality of interface between trade-facilitation agencies remain issues that need greater attention. The most common practice to improve coordination is to agree on a governance framework for agency cooperation, especially in delegating authorities and powers. Frequently, customs takes the lead in coordinating smaller agencies. Lack of information and transparency remain a concern. World Bank (2009b) reported that only 10-20 percent of firms have good information about export requirements, processes, times and costs. Increasing access to information should be a priority, and it can be done through multiple channels. One way is by providing widely available booklets. A handbook on export procedures was developed in 2009 with financial support from the World Bank Group, and it is highly valued by the private sector. This has two implications: first, information in the handbook needs to be updated on a regular basis; second, it generates demand for other booklets for instance on technical barriers to trade, sanitary and phytosanitary (SPS) measures and trade logistics. Developing a credible website that contains comprehensive trade information will also raise awareness and the transparency of custom procedures. Significant progress made so far in several areas of facilitation has been accompanied by willingness to reform and strong leadership. This momentum should be maintained and supplemented by a strong political commitment to achieve trade facilitation targets.

4. **Improve logistics efficiency.** Cambodia is among the countries with the least efficient logistics services. The World Bank's logistics performance index 2012[27] ranked the country at 101 among 155 countries. Although the ranking has improved from 129

[25] According to the World Bank Doing Business 2013, the cost to export from Cambodia is USD755 per container as compared to USD610 in Vietnam, USD585 in Thailand and USD435 in Malaysia.

[26] WB (2009b) reports that firms that significantly use customs lose 3.78 percentage points of productivity due to problems there. Cutting 50 percent of delays would increase productivity by 1.15 percent.

[27] It was accessed on 03 January 2012 at http://lpisurvey.worldbank.org/.

in 2010, the quality and efficiency of logistics remain significantly below regional standards.[28] Poor logistics performance largely stems from insufficient supply and poor quality of infrastructure; low efficiency of the clearance process (speed, simplicity and predictability) by border control agencies; and low competence and quality of logistics services. Cambodia's infrastructure has lagged behind most countries in the region. Road transport remains embryonic and inefficient; the railway system is in bad shape, with little traffic demand. While the efficiency of ports has improved, the cost of shipping remains high. Poor infrastructure is compounded by the lack of competitive transport due to restrictions on foreign-owned trucking companies and the lack of firms engaged in cross-border shipments (ADB 2012). The time-cost survey on transporting "normal" goods from Bangkok to Phnom Penh and from Phnom Penh to Ho Chi Minh City reported in ADB (2012) reveals that logistics costs in Cambodia are double those of Thailand and Vietnam. The average logistics cost for the Cambodian section is $0.20 per tonne-km from Bangkok to Phnom Penh, compared with $0.09 in the Thai section and $0.19 per tonne-km from Phnom Penh to Ho Chi Minh City compared with $0.10 in the Vietnamese section (*ibid.*). Such low performance justifies policy intervention to improve logistics. The underlying idea is to reduce the costs of trade-related transport and logistics and increase their timeliness and reliability. This can be achieved through upgrades in trade-related hard infrastructure including roads, railways and seaports and their management; reforming and modernising customs and wider information sharing and dissemination; greater competition in trucking, port and air freight; and improved access to information about international transit agreements.

5. **Strengthen regional cooperation and connectivity.** Cambodia is at the heart of the GMS, ASEAN, ASEAN+3 and several other regional frameworks. The prospects of an integrated Asian production network and market and huge East Asian market for exports offer vast opportunities for trade growth, private sector development and prosperity. The country has not yet fully harnessed opportunities from regional integration; this is evident in low intra-regional trade and weak awareness and engagement in ASEAN and AEC processes by the private sector (Strange, *et al.* forthcoming, Chan & Strange 2012). The immediate challenge is to ensure that regional cooperation is reached and taken advantage of by the trade sector so that exports become more diversified. Cambodia must deepen regional cooperation and partnership while ensuring the coordination and synchronisation of development cooperation and regional integration processes to achieve development objectives. In a recent speech to a national and ASEAN audience,[29] Cambodia's prime minister emphasised:

    - The medium-term challenge for ASEAN is to sustain growth in the post-crisis environment by promoting domestic sources of growth and diversifying regional cooperation. This requires more effective regional economic integration, by utilising the ASEAN-China/Japan/South Korea FTAs, as well as the longer term potential for an East Asian Free Trade Area and/or the Comprehensive Economic partnership in East Asia, while avoiding overlapping efforts and resources.

    - The Cambodian government has been careful to keep its options open in relation to the broader regional architecture. It would be in Cambodia's interests to move beyond the ASEAN Economic Community and to become part of an East Asia-wide free trade

[28] Singapore is ranked 1, Japan 8, Republic of Korea 21, China 26, Malaysia 29, Thailand 38 and Vietnam 53. Only Laos at 109 and Myanmar at 129 are below Cambodia.

[29] Hun Sen Address to Opening of 2010 Asialink Conversations-Cambodia, Phnom Penh, 4 September 2010

and economic community, which could help narrow or bridge the development gap through a coordinated approach to economic and regional development cooperation and integration. Central to this will be 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 in Cambodia, Laos and Myanmar. This could be transformational for the economically and strategically important small GMS members of ASEAN.

6. **Deepen implementation of special economic zones (SEZs).** In an attempt to emulate the successes of some East Asian economies, Cambodia has established rules on SEZs and approved the number of them. The idea is to provide a "one-stop service" for investment approvals and customs procedures along with fiscal incentives, a better standard of regulatory administration and better infrastructure. Although SEZs were introduced almost a decade ago, they have not been as successful as hoped in attracting investors. There are currently approved 21 SEZs, with total investment capital in excess of USD1 billion.[30] Only eight of these are now operational,31 while others are at various stages of development and some remain undeveloped. There is almost no assessment that explains why SEZs have made such slow progress. Cambodia is well positioned to implement SEZs as a central component of its investment and export strategy. Learning from successful experiences elsewhere, these SEZs will need to offer investors something significantly different from what is available in the rest of the economy. Apart from superior infrastructure and fiscal incentives, SEZs should offer a sound business and investment environment, broader industry clusters that provide backward and forward manufacturing and service linkages and cost and flexibility of employment matters. More specifically, they have to attain high quality and efficient administration of taxes and regulations; overcome bureaucratic and administrative hurdles; offer tailored solution to investors' problems; create more flexible employment relationships; and ensure easy access to labour (both low skilled and high skilled). Because the SEZ strategy involves comprehensive institutional and regulatory reforms, the zones' success requires strong leadership and political oversight from the government. That will include a commitment to streamline cumbersome and complicated regulatory processes, to manage the pervasive corruption, to ensure the efficient delivery of services and to provide regulatory oversight. Finally, the strategy needs to be accompanied by an effective investment promotion agency that actively seeks to attract FDI.

4.2. Policies to Overcome Structural Market Deficiencies

7. **Invest in human capital.** Cambodia's education and human capital lag behind most countries in the region, creating a major constraint on socio-economic development. The country has one of the highest illiteracy rates in the world (78.3 percent in 2010), and its Human Development Index is one of the lowest in ASEAN. The current labour market is characterised by a poorly educated workforce and emerging skills mismatches and skills gaps. Of the 6.8 million Cambodians (aged 15 years or older) employed in 2008, 61 percent had education below completion of primary school; 23 percent had completed primary education; 13.7 per cent had lower secondary education; 1.5 per cent had secondary or diploma education; only 1.1 per cent had tertiary education. A survey by

[30] http://www.investincambodia.com/economic_zones/sezs.htm accessed on 14 February 2013

[31] They are Sihanoukville, Phnom Penh, Manhattan, Tai Seng Bavet, Poipet, Goldfame Pak Shun, Koh Kong and the recently opened Sihanoukville Port.

the Cambodian Federation of Employers and Business Associations identified workers' skills as "difficult to find" (World Bank 2010). Employers reported soft (analytical and work attitude) skills as the most critical kills missing in most workers, especially among out-of-school youth (*ibid*). Some of the hard-to-find hard skills (specific technical abilities) identified were ITC, foreign languages, sewing, plumbing, carpentry and blacksmithing. The same report stated that "the lack of soft skills is a major challenge, but poor technical skills that do not match employers' needs also represent an obstacle to productivity growth—in particular for the unskilled". The shortage of educated and skilled labour has slowed the shift from a predominantly agrarian society toward a more diversified economy. Building on the lessons of successful exporting countries, Cambodia should invest heavily in human capital development. Education policies should stress universal primary education and improvement in quality at primary and secondary levels. Tertiary education should focus on the acquisition and mastery of technology and vocationally and technologically sophisticated disciplines. Priority policies to achieve these objectives include improving school infrastructure, especially in rural areas to achieve universal secondary education; increasing the number of technical and vocational schools to match the demand for skilled labour; improving teachers' quality and the governance of tertiary education; and institutionalising research and development in higher education institutions.

8. **Improve export market information services.** Cambodia's private sector has low or uneven understanding of the implications of trade agreements and their potential benefits (Chan and Strange 2012) and lacks adequate knowledge of export procedures and export markets (WTO 2011). Information asymmetry is primarily due to the high cost of obtaining information, limited human and financial resources, lack of networks of trade support institutions and government failure to provide needed information. As in most developing countries, the trade promotion department of the Ministry of Commerce, which is tasked to provide information services on trade promotion and overseas markets, has not done well enough on its mandate (Rah & You 2011). This is largely due to limited human and financial resources, lack of clear strategies, weak overseas networks, little ability in market research (e.g. sectoral export market analysis, global market environment and trends, importer and exporter contact database) and insufficient promotion websites (*ibid*). The role of trade promotion organisations is increasingly recognised in overcoming information asymmetry and there is firm empirical evidence that trade promotion organisations have a strong and statistically significant impact on exports (Lederman *et al.* 2006). It will be critical to strengthen the functions of the Trade Promotion Department (TPD) as part of export promotion.

   A short-term priority should be providing support and information needed by exporting firms, especially product and market development and market information services. This recommendation is justified by the fact that the TPD has such a broad mandate: from exhibition management and product development to market development and providing trade information services that existing financial resources and cannot provide adequately. That requires a mixture of political support and strong leadership, adequate funding and capable staff. Since successful reforms in Cambodia usually benefit from strong political support, the TPD should firmly commit to transforming itself into an important institution in trade development. Funding needs immediate policy attention. Donor financing can be useful initially in the reform process as it can promote best practices and effective organisation, but such support should be temporary and followed

by sufficient domestic resources from either government or a combination of government financing and charging for services.

Ensuring quality staffing is another important element in strengthening the TPD. This can be achieved through ongoing capacity building, recruitment of talented staff with business experience and proper salary. Policy should also focus on building domestic trade networks (government, private sector and investors) and overseas networks (foreign government, international buyers and investors), improving information systems and enhancing cooperation and coordination with other ministries and institutions. The effectiveness and efficiency of trade promotion should be evaluated periodically. This requires a system to monitor and evaluate performance and assess customer satisfaction. A medium-term policy should consider changing the TPD into an independent entity. Trade promotion organisations that operate directly under ministries are often poorly positioned to deal with the main issues affecting external trade and competitiveness. Moreover, most successful trade promotion organisations are autonomous, and such a model fosters the confidence and mutual trust required to develop a supportive relationship with the business community. The TPD may also consider combining FDI promotion with trade promotion and try to promote a brand like JETRO in Japan, KOTRA in the Republic of Korea and MATRADE in Malaysia.

9. **Improve standard management system.** Like most LDCs, Cambodia encounters great challenges in complying with importing countries' technical standards. Its standard management system suffers from serious weaknesses. These include a weak legal and regulatory framework, problems of coordination and duplication of functions, absence of systematic laboratory testing to support inspection, lack of systematic inspection and monitoring and a certificate system that is not backed by testing (FAO 2010). This appears as a major constraint on harnessing opportunities for export diversification (most of the products identified as high export potential in the Diagnostic Trade Integration Study 2007 are SPS sensitive). While comprehensive reforms are needed in the standard management system, pragmatic measures should focus on strengthening the institutional framework, especially in relation to mandates and coordination; building technical and managerial capacity; and establishing assessment bodies accredited by internationally recognised bodies. Apart from clearly identifying roles and responsibilities of institutions involved in SPS management, and putting in place mechanisms of coordination, there should be a strengthening of working arrangements for inspection, monitoring and testing. There should be a coordinated staff capacity building programme across all areas of SPS management, from food safety and control to inspection, monitoring and testing. Such a programme requires both support from the government and technical assistance from development partners and agencies. The creation of conformity assessment bodies is justified by the fact that there is no internationally recognised process or systems conformity assessment body in Cambodia, and as a result all agricultural products have the conformity assessment undertaken by the importer or buyer (ADB 2008). It is therefore important to provide flexibility to exporters to gain their own certification and standards conformity requirements.

5

CONCLUSION

This paper concludes with two fundamental statements. First, trade is a necessary though not sufficient condition for economic growth and development. If designed and managed properly, it can foster investment, technology and knowledge transfer; improve efficiency and raise productivity; and stimulate economic growth. Most countries, particularly rapidly growing economies, develop their trade sector by adopting outward-oriented trade policy along with other policies conducive to growth, i.e. maintaining macroeconomic stability, developing an efficient financial system, investing in infrastructure, building trade-related institutions, investing in human capital and ensuring a labour market that works efficiently. Trade will be even more vital in a context in which it is governed by more integrated and borderless regional trade architectures and by rules-based and least restrictive global trading rules.

Second, Cambodia's experience in developing its trade is impressive. The country not only managed its economic transition successfully but also transformed trade into a driving force of economic growth through liberalising trade and investment and opening up to regional and global cooperation. Now, trade is the backbone of the economy and has reached a level that needs greater policy attention and focus to sharpen competitiveness and move up value chains. The challenge is how to leverage trade for economic growth in the changing domestic and international economic environment. Despite remarkable progress, Cambodia's trade sector remains constrained by regulatory, institutional and infrastructure and service bottlenecks. The key to enhancing the role of trade in the country's growth is to remove these obstacles. Policy priorities include investing in trade-related infrastructure, improving logistics efficiency, improving customs procedures, strengthening regional cooperation and connectivity, improving export market information services and improving standard management systems. These measures should come together with a number of complementary policies including macroeconomic stability and financial sector development, improvements in the investment and business climate, investment in general infrastructure, education and health and technology and knowledge transfer. There will also be a need to strengthen sub-regional and regional economic integration as a complement to the global trading system and to exploit the benefits of economic cooperation. Experience also suggests that trade policy is most likely to be associated with positive outcomes when it is conducted with effective institutions and strong commitment from the leadership. Therefore trade policy liberalisation and reforms need to gain political support from the leadership, receive momentum and impetus from stakeholders and be supported by effective and responsive institutions.

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