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FOREWORD

Gathering highly committed intellectuals and professionals, Cambodian Economic Association has become a place to independently debate, discuss and understand the socio-economic development issues of Cambodia.

For more than one year now, CEA has been the representative of the independent voice of Cambodia within the Federation of ASEAN Economic Associations (FAEA) and has actively defended the interests of the country.

Today, CEA continues to pursue its objectives and to develop its activities in order to promote and strengthen economic research.

Along with all the members of the Cambodian Economic Association, we are very proud to present this first issue of the Cambodian Economic Review.

This review has been created in the image of the CEA: independence and impartiality of thinking, diversity of skills and research domains and proposition of methods to develop Cambodia.

To understand socio-economic issues is the first step we must take to promote future prosperity for all Cambodians. We are pleased to know that you will join us for this first step.

Happy reading.

Economically yours,

Sok Hach
President of CEA

CORRUPTION

IN DEVELOPING COUNTRIES:

A VICIOUS CIRCLE OF POVERTY¹

Sok, Klara *

INTRODUCTION

Corruption does not only concern developing countries. Corruption is indeed a worldwide issue. However, least developed countries are particularly affected. As expounded in this paper, corruption may become the governing norm of the administration of these countries. The reality of corruption is all the more pronounced in that the needs of economic development and the scarcity of productive resources are high.

Specific socio-economic and cultural contexts of developing countries may call into question the very relevance of treating corruption as a problem. The political environment in some developing countries automatically leads public economy stakeholders to corrupt practices. In some developing countries, in order to accomplish their work, civil servants have no choice but to play the game of corruption. In these countries, efficient corruption practices have greatly replaced slow and bureaucratic legal practices.

However, the establishment of such corrupt systems must be fought. Corrupt practices deter citizens from equitably getting the overall benefits of economic development to the advantage of only a very small number of powerful people. Hidden transactions of public finances impede optimal budget allocation. A generally corrupt environment discourages foreign investments. Corruption does feed poverty.

The fight against corruption is thus a great challenge. The first step is to diagnose the phenomenon. It is most important to understand the socio-

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¹ This article is based on an academic paper the author prepared during a masters degree programme in Organizational Sociology at the Institute of Political Sciences of Paris.

economic, political and cultural causes and effects of corruption. The portrait of corruption as an expanding system must be drawn.

This paper thus focuses on the causes of the expansion of this phenomenon in developing countries. More specifically, the following question is raised: *To what extent do the particular contexts of developing countries feed this endemic phenomenon?* In order to answer this question, effects of corruption will be brought up as well, insofar as they participate in the expansion of the phenomenon and breed a spiral of corruption.

What is corruption?

Corruption is generally defined as “the abuse of public office for private gain”².

Corruption has multiple facets. There are various types of corruption, affecting different types of organizations³. Corruption often leads to financial remuneration. However, corrupt individuals may also seek non-financial compensation. In some complex cases, corruption is a way to get non-material compensation, such as access to a political party, or to an exclusive sphere of influence. In all cases, corruption implies an *exchange* between at least two parties.

Most definitions of corruption include only one of the exchange’s stakeholders: the corrupt party. Nonetheless, any exchange implies at least two parties. In any case of corruption, there must be a corrupt party and also a corrupting party.

From a micro-economic perspective, the costs that are assumed by the corrupting party can be considered as any other investment. However, the corrupt party breaks the contract he/she had with the general community by cheating and abusing power and prerogatives. From a sociological perspective, both corrupt and corrupting parties are considered as co-actors in the exchange. From a legal perspective, if caught, both parties are judged guilty.

² OECD, http://www.oecdobserver.org/news/fullstory.php/aid/233/What_is_corruption.html

³ Corruption is a very complex issue and affects all sectors of the economy; this paper will, however, focus on corruption in the public sector. Large parts of developing countries’ economies still rely on international aid and foreign investments. The main part of foreign aid is managed by public administrations, while foreign direct investments levels are very sensitive to political stability.

Corruption may also be defined from the unique perspective of the corrupting party. Interestingly, in a first stage⁴, French sociologist Jean-Gustave Padioleau defined corruption, as “the use of favors to make a politician or a civil servant act inconsistently to its duties”.

American economist Robert Klitgaard enriches the definition with a more contextual aspect. He models the phenomenon of corruption as follows:

$$C = M + D - A$$

With C as corruption in a particular situation, in which a person has monopoly power (M), with a discretionary decision-making (D) capacity, and is not accountable (A).

For instance, a person has monopoly power over certain goods and services, with the discretion to decide who will get these goods or services. This person is not really accountable to anyone. Such a context favors corruption practices. Risks of sanction are very small. This definition is based on a real analysis of the environment, detecting favorable conditions for corruption. Such an analysis especially fits the context of developing countries where accountability is very low due to institutional weaknesses.

This leads to the question of conditions, underlying causes and reasons⁵ why corruption expands to such a level in developing countries. *To what extent do the particular contexts of developing countries feed this endemic phenomenon?*

⁴ In this 1975 article, Jean-Gustave Padioleau specifies that this definition is temporary, and continuously expounds a series of varied, more complex definitions from different perspectives. The definition here has been chosen for heuristic reasons, and its active dimension. In this simple definition, Jean-Gustave Padioleau presents corruption more as the action of corrupting, rather than the phenomenon. Additionally, the French sociologist also vividly distinguished what he called “la corruption-troc” (barter corruption) to what he called “la corruption-échange social” (social exchange corruption). For more details about this distinction, refer to this article, compiled in L’Etat au concret, Paris - France, Presses Universitaires de France, Coll. « Sociologies », 1982, pp. 173-204.

⁵ The rational aspect of the word “reasons” is very important here. As expounded later in this paper, one can attribute rationality to the corruption stakeholders.

HISTORICAL AND SOCIOLOGICAL PERSPECTIVE

Learning Democracy

From an historical perspective, one can refer to a post-colonialism or post-war context specific to developing countries. As S.M. Ghazanfar and Karen S. May expounded in their article published in *Third World* review in Fall 2000, corruption may have been favored by the rapid establishment of governments and public administrations. As a result, public administration suffered from institutional weaknesses, while civil servants carried out only a very low level of education. The country was still learning to live in a recently established and often imported democracy model. Civil servants had been facing numerous and pressing demands from the general population due to the context of transition to modernity. The old administrative capacity had been overthrown. Citizens had to queue to have their cases treated. At the same time, flows of cash suddenly came into the country along with international aid and international staff. In such a context, low-paid civil servants may have been tempted to accept immediate speed-up fees. In the longer run, as the risk of sanction and accountability was very low, the whole administrative system got corrupt.

Corruption and democracy sound, in an apparent contradiction, closely linked together. British historian Edward Gibbon even described corruption as “the most infallible symptom of constitutional liberty”. It is difficult to completely agree on his statement. However, one can learn from it and consider it as food for thought. It reflects on possible causes of corruption. In Western countries, democracy had a long path to becoming an effective political system. It is the fruit of the learning process of several centuries. Democracy is based on the solid and progressive construction of institutional foundations.

Democracy’s main force is its intrinsic liberty. This is also one of its main weaknesses. Democratic administrative systems do leave free room for maneuver to their stakeholders. The other face of democratic freedom is the *vacuum* of strict control of the system, based on coercive sanctions. However, democracy is based on the confidence that citizens have in the political system. Success of democracy thus depends on good governance and wise public management. In this way, as democracy is a fragile and dynamic balance based on confidence, corruption may build its nest in the room of freedom or *vacuum* of control intrinsic to democracy.

Cultural Specifics

The cultural specifics of some developing countries put corruption into perspective. The very notion of corruption may be questioned as well. In some cases, the line between corrupt acts and cultural behavior might be difficult to draw. For instance, from a Western point of view, familial solidarity and clannish behavior might be understood as nepotism, while in some societies, such behavior might be merely cultural components.

Specifics of Bureaucratic Systems

Additionally, developing countries are still at their first steps in terms of establishing modern bureaucratic models of neutrality. Max Weber described bureaucracy through its rational, legal authority and legitimacy. The German sociologist also highlighted the importance of neutrality of the bureaucratic system versus political power. In modern societies, administrative authority and political power are clearly separated in order to deter administrative exercise from populist aspirations. In such systems, neutral, administrative authority must be *independent* of political power, particularly when related to recruitment and to civil servants' careers.

In developing countries, the line is not so clear. Civil servants working in public agencies are often very implicated in political life. They sometimes need to be members of the same party as the ruling power. Administrative career logic within public agencies may be very closely linked to the internal rules of the ruling party. In this case, the ruling party finances may partly come from corruption fees that public agents accumulate during their terms of office.

In order to professionally grow within such public agencies, civil servants must contribute to the ruling party. The public agency is monopolized by a unique party which entirely controls the civil servants' careers. Such political party thus controls a very strong interdependent system.

Considering the high amount of financial contributions asked by the party, and the very low level of their pay, it might be difficult for civil servants to get the money legally. In such a system, corruption affects all levels of public administration. A real system of "informal fees" can be observed. In order to perform their work, civil servants may be forced to corrupt colleagues and thus breed the system.

This economic logic of “informal fees” may be instructive as to how corruption can replace the legal system itself. In such a system, corruption may become the exclusive way to “get things done”. In this way, corruption substitutes itself for the *norm of behavior* of civil servants. Corrupt systems can engender real parallel administrative channels. Formalized corrupting fees correspond to all administrative and regulatory levels. Beyond this organizational logic, this principle of illegal functioning is not only tolerated but also fed by the system. Corruption has been integrated by stakeholders as their *pragmatic norm of action*.

The rapid establishment of imported democracy and of bureaucratic administrative systems in specific historical, cultural and socio-economic contexts may partly explain *why* corruption feels so comfortable in developing countries. However, in order to complete one’s understanding of *how* this phenomenon does last and expand, micro and macro-economic analyses and modeling must be brought up as well.

CORRUPTION: A FREE MARKET IN A WEAK LEGAL SYSTEM CONTEXT

Corruption market: micro-economic construction

From a micro-economic perspective, the corruption market is a place where individuals exchange illegitimate public goods and services for bribes and other compensations. From the corrupt party perspective, the corruption level would thus result from the coordination of aggregate demand and supply of bribes. From the corrupting party perspective, the corruption level would result from the coordination of aggregate demand and supply of illegitimate public goods and services. Such coordination can exist and last in a context of low risks of sanctions and accountability. The reality of all this is unfortunately particularly blatant due to the lack of effective legal systems.

Corrupt individuals -demanders of bribes or suppliers of illegitimate public goods or services- may accept, or look for, this type of illegal remuneration. They can accept this bribe for illegitimate public goods and services because they have monopoly power with the discretion to make decisions and no accountability to society and citizens. The lack of effective

legal systems is interestingly put into perspective by Robert Klitgaard's formulation, $C=M+D-A$ ⁶.

Information asymmetry and opacity: an environment favoring corruption

The above described situation reflects an information asymmetry between the representative and its constituents, the citizens. The opacity of public administrations is indeed closely linked to the opportunities for corruption. This opacity corresponds to the indirect protection of representatives from potential sanctions by the citizenry.

According to the asymmetric information and moral hazard theory, the individuals who are best informed of the actions of other individuals have an important advantage over the others. A better informed individual's actions are indeed not easily identifiable by the other individuals. Better informed people thus have some room of maneuver and to act freely without any need of accountability. The more asymmetric the information, the wider is the room for corruption. In other terms, the less transparent the exchanges of public goods and services are, the more numerous are the opportunities for the representative to be corrupted by a third party, to the detriment of the citizenry.

This analysis confirms and illustrates Robert Klitgaard's formulation as well ($C=M+D-A$). All things being equal, the bigger is A –accountability-, the smaller gets C –corruption. A is a negative function of information asymmetry and a positive function of public administration transparency.

Such situations of asymmetric information do exist worldwide and in developed countries as well. However, this reality is particularly true in developing countries. Asymmetric information is reinforced by a low level of education, particularly in the civic and political fields. This “ignorance” factor increases the structural information asymmetry and opacity, and thus indirectly facilitates corruption.

High levels of regulations multiplies the opportunities for corruption

The very high level of laws and regulations is another factor reinforcing the lack of transparency of developing countries' administrations. There are,

⁶ Corruption (C) equals to monopoly (M) plus discretion minus accountability (A).

indeed, at least as many opportunities for corruption as stages of regulations, especially when they are not clearly defined. The amount of different signatures necessary to obtain a license *equals* the number of opportunities for civil servants to accept or to refuse their signatures.

If rules are complicated or unclear, the use of a “facilitator” can be tempting. If paperwork and administrative requirements are time-consuming and if there is a possibility to short-cut all this, a rational individual will consider short-cutting the process. His or her decision to short-cut the process will depend on the risks and cost of this alternative. In developing countries the risk of being caught are very low, so a rational individual would likely short-cut the procedures and offer bribes to speed up the whole process.

Referring to the information asymmetry model, citizens who do not pay bribes are bypassed in the queue for services. Corrupt practices are by definition hidden. Not informed of the trick, honest citizens are thus unable to conduct any legal actions either against the offending public agency or against the corrupting individual.

From a market perspective, maximizing the rationalities of corrupting and corrupt individuals draws the aggregation of supply and demand of bribes. In a very constraining bureaucratic context, the number of bribes is likely to be high. This would also increase competition among bribery suppliers. Following this rationale, the amount of bribes –or price of illegitimate public goods or services– should automatically increase. Corruption motivates itself. This can partly explain how this phenomenon can last and expand. In such context, corrupt civil servants and representatives may find it in their interest to maintain the administrative constraints. Administrative constraints are the sources of their rent.

Corruption from a macro-economic perspective

From a macro-economic perspective, corruption can negatively affect all legitimate sectors of the economy⁷. If foreign investors have a choice of investing in a country perceived as heavily infected by corruption or to choose a

⁷ For a penetrating analysis and modeling of the impact of corruption on all sectors of the economy in developing countries, please refer to: OWOYE, Oluwole and Ibrahim Bendardaf, « The Macroeconomic Analysis of the Effects of Corruption on Economic Growth of Developing Economies », in *Rivista Internazionale di Scienze Economiche e Commerciali*, Vol. 43, number 1, 1996, pp.191-211

healthier country, they would rather set up their businesses in the country perceived as healthier.

Growth is the increase of national production. National production (Y) is a positive function of capital stock (K), and of labor (L):

$$Y=f(K^+, L^+)$$

Capital stock (K):

$$K=K_{.1}+I-D$$

With: $K_{.1}$ the stock of existing capital or cumulated invested capital in an anterior period

I the investment in capital

D the depreciation of this investment

The depreciation of an investment project subject to corruption will be higher than normally expected. For instance, a government invested USD 100 million in a road construction project. Life expectancy of this road was evaluated at 20 years, provided there would be normal maintenance. If corrupt acts have parasitized the project, its life expectancy may be shortened.

In order to hide the losses due to corrupt practices, corrupt individuals may have, for instance, decreased the actual quality and quantity requirements of materials necessary for the construction of a particular road. This would have decreased the actual cost of the road thereby allowing the corrupt partners to pocket the difference and thus get richer, while the road quality and life expectancy would be decreased from expectations at the launch of the project. This road, instead of lasting 20 years, would last, for instance, only 2 years. Depreciation (D) is thus a positive function (d) of corruption (C):

$$D=d(C^+)$$

Moreover, the main part of developing countries' investment comes from abroad. Investment comes under foreign direct investments (FDI), or funded by the international aid, under grants and loans. The more corrupt the economy is perceived to be, the less the foreign investors are keen to invest in the country⁸.

⁸ During several interviews with top business people, conducted by the *Economic Institute of Cambodia (EIC)* on behalf of the *World Economic Forum's Executive Opinion Survey 2005*,

International aid follows the same logic. Investment (I) is thus a negative function (i) of corruption (C):

$$I=i(C^-)$$

k is a function composed by d and i:

$$k=d \circ i$$

All other things being equal, the capital stock (K) is thus a negative function of corruption:

$$K=k(C^-)$$

Labor (L)

The better educated a population, the more productive it is, in terms of added value. Labor productivity (L) is thus a positive function (h) of education (E):

$$L = h (E^+)$$

Furthermore, education, as a public service, is a negative function (e) of corruption. Corruption lowers state revenue and thus decreases public expenditures, especially in the social sectors, like education:

$$E = e (C^-)$$

l is a function composed by h and e:

$$l = h \circ e$$

Thus:

$$L= l (C^-)$$

National Production (Y):

$$Y= f (K^+, L^+)$$

And:

$$\begin{cases} L=l(C^-) \\ K=k(C^-) \end{cases}$$

corruption appeared as one of the most problematic factors. “Corruption really diminishes one’s willingness to invest. It is one of the biggest, if not *the* biggest, challenge that we face.”

g is a function composed by k and l :

$$g = k \circ l$$

Thus:

$Y = g(C^-)$

Growth, as an increment of national production (Y), is thus a negative function of corruption. In other terms, corruption does not favor national growth, but weakens the positive effects of the factors of production (K and L). Corruption thus feeds poverty.

Poverty of a nation also favors corruption. For instance, low wages of civil servants make them behave as rent seekers. Poverty increases the probability of corrupt practices. Poverty also attracts international aid, which, as a sad paradox, finances the corruption of public administration.

This is the vicious circle of corruption which feeds on itself. Economic stakeholders are in the corruption “trap”⁹.

CONCLUSION

The specific environments of developing countries favor the *culture of corruption*. The lack of effective legal systems contributes to a real “culture of impunity”, as Robert Klitgaard calls it. The specific context of developing countries is not the cause of corruption. Corruption exists in all societies in all parts of the world and at all levels of development. However, the socio-economic and political consequences of developing countries *catalyze* the “malignant tumors of decomposition”¹⁰ described by French sociologist Jean-Gustave Padioleau.

Developing countries are still undergoing a socio-economic and political transition. They still are in the process of learning Western imported “modernity”. This transition is perceived as necessary by both local and

⁹ ROSE-ACKERMAN, Susan, in notably her recent article: « The Challenge of Poor Governance and Corruption », in Copenhagen Consensus Challenge Paper, 2004

¹⁰ The un-translated expression used by the French sociologist is “*tumeurs malignes de décomposition*“, translated here by the author for this paper. See: PADIOLEAU, Jean-Gustave, « De la Corruption dans les oligarchies pluralistes », in L’Etat au concret, Paris - France, Presses Universitaires de France, Coll. « Sociologies », 1982, pp. 173-204

international stakeholders. Developing countries must play the game of global economy and compete with international players.

Furthermore, corruption follows an exponential logic that affects social, economic, and political fields. Neither financial nor institutional resources can effectively contain the phenomenon of corruption unless systemic and serious administrative reforms are implemented. In a *status quo* situation, the risk is to see amplified and combined effects of stakeholders networking, power abuse, and institutional weakness.

However, corruption is not inevitable. Effective actions to fight corruption will not be brought up as they are beyond the scope of this paper. In any event, this would hardly be feasible, since the contexts of developing countries are varied and numerous. It would be presumptuous to set up precise recommendations without considering and understanding the specificities of each country. To achieve such an objective, a far reaching field study would have to be undertaken. However it is possible to draw some conclusions as to what must be adapted to each particular context. It is also important to note that any change must be organized through systemic reform.

Such lines would be:

- First priority should be institutional reforms and reinforcement. This must be a *sine qua non* condition to the access to international aid. Such reforms' performance shall be evaluated by both reformers and donors with the common set-up of comprehensive objectives.

- This should accompany a substantial increase of civil servant wages. Such an increase should first be financed by a loan from international aid, for instance. Increase of state revenue should allow the country to repay the loan through the automatic transfer from corruption to formal fees. Such an increase should go along with a capacity building program for all levels of administrative workers. A competence evaluation system should be set up and designed by the local public administrators with the technical assistance of donors.

- The computerization of the tax system should increase tax revenue through automatic accountability.

- Legal system simplification and reinforcement as well as the establishment of a credible court of law should provide a proper environment for both the public and private sector.

- The allocation of public goods and services should systematically go through a proper public bidding process. This should allow state revenue to be allocated to social sectors through the decrease of externalization costs.

- The establishment of an advisory board, composed by experts from local and international civil society, top business people, and civil servants shall assist the government to draw major strategic lines. The government shall keep executive power while benefiting from synergic competences and experiences of such advisory board members.

The six recommendations mentioned above may be considered as six, strategic, virtuous priorities, whose detailed actions have to be defined according to the specificities of each country. Effectiveness of such actions shall depend on the ability of the stakeholders to *work together*. The success of the fight against corruption shall greatly depend on the stakeholders' capacity to concretely admit the benefits of mutual synergy and collaboration.

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GOVERNANCE AND ECONOMIC PERFORMANCE: CREDIBILITY, POLITICAL WILL, AND REFORM

Ear, Sophal *

“[The Royal Government of Cambodia is] conscious that good governance is a sine qua non condition for promoting social and economic development and sustainable social equity.”¹

—Prime Minister Hun Sen (2001a; 2001b)²

—Senior Minister Keat Chhon (2001)

INTRODUCTION

This paper examines how well words have turned into action when it comes to governance in the context of Cambodia’s economy. It reviews a wide-ranging series of achievements in the last decade, many of which the Royal Government should indeed be very proud of. It also examines shortcomings and offers a framework through which to evaluate the likelihood of success.

The paper contains five sections, including this Introduction. Section II begins with an evaluation of economic performance and governance together as policy, practice, and outcomes—success transitioning to a market economy, in containing inflation and keeping exchange rates stable. Success has been more limited in strengthening judicial independence, decentralization, and empowering the National Audit Authority. Based on outcomes, Cambodia has

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¹ The origin of the phrase “governance is a *sine qua non*” can be traced at least as far back as the “Public Administration and Development Report of the Secretary-General” to the United Nations Economic and Social Council, 8 March 1996. Available:

<http://www.un.org/documents/ecosoc/docs/1996/e1996-7.htm>

² The phrase “The RGC is conscious that good governance is a *sine qua non* for promoting social and economic development and sustainable social equity” was first used on 29 January 2001 and would be used again in his closing address at the 2nd National Conference on the Implementation of the Government’s Political Platform for Social Development and Poverty Reduction on 14 March 2001 (as excerpted in *Cambodia New Vision*, 2001).

also seen a number of disappointing trends in the last decade, chief among them has been the failure to achieve significant poverty reduction despite massive aid, and concurrently the increase in infant and child mortality and inequality among other indicators. Finally, again judging from outcomes alone, Cambodia has not yet passed an Anti-Corruption Law since the issue first came to fore in 1994, nor has it enjoyed success in contracts transparency and concessions policy (albeit a draft law is under discussion).

While there are always foreseen and unforeseen extenuating circumstances, such as elections, bird flu, Severe Acute Respiratory Syndrome (which resulted in 10% drop in tourism), the anti-Thai riots, the events of 5-6 July 1997 (which saw a plunge in FDI), the results speak for themselves. These are, ultimately, failures of development due to poor governance. Economist William Easterly has said that “Development is too important to be left to the politicians.” Unfortunately, development is more often than not subservient to patronage politics in Cambodia. Although every country is unique in character, history and culture, its quality of governance can be measured with albeit imperfect subjective instruments (like polls of experts, surveys of firms, etc.) that can in turn be compared to other countries. How Cambodia performs relative to other countries across one element of governance or another offers important insights into its political economy. The World Bank aggregated database (Kaufmann et al., 2003) of six dimensions of governance composed of: (1) voice and accountability; (2) political stability; (3) government effectiveness; (4) regulatory quality; (5) rule of law, and (6) control of corruption reveals that in 2002, when compared with similar income countries in the region, Cambodia performed relatively better in the first four dimensions of governance, while it did relatively worse in the rule of law and control of corruption. As we shall see in this paper, these particular weaknesses of governance will appear and re-appear.

Section III is about the political reality of reform given the experience of the last decade. It discusses trends in donor and government strategies, touching upon the Royal Government’s “Rectangular Strategy for Growth, Employment, Equity and Efficiency” (RGC, 2004b).³ It provides as a framework of reference a

³ The Rectangular Strategy is so-named because during the 2nd Mandate of the National Assembly (1999-2003), the RGC outlined the “Triangle Strategy” which aimed to achieve three main objectives: (1) Ensure and maintain the peace, stability and the security for the nation and its people; (2) Integrate Cambodia into international community and normalize Cambodia’s relationships with international development and finance institutions; and (3) Promote sustainable socio-economic development through the intensive implementation of reforms in key areas including demobilization,

Rectangular Reality in which political willingness is juxtaposed against policy environment. It goes on to describe the “natural experiment” of 1998 following the “events of 5-6 July 1997” in which Official Development Assistance (ODA) decreased significantly and the Royal Government subsequently committed to “break away from the past.” It posits as evidence the possibility that reforms can be achieved in the presence of credible budget constraints (risking a balance of payments crisis), but that such conditions are unlikely to arise again in the near future, and where this change contradicts political reality, the intervention will eventually falter.

Section IV discusses possible solutions and prospects by examining performance-based allocations, contrasting two recent cases of corruption underscoring the importance of credibility. Cambodia has rationally engaged alternative donors to provide financial resources which will dilute the strength of Consultative Group donor coordinated reductions in aid (the first instance of which happened in at the 2004 CG, but minimally). Sadly, while dislodging the current low governance equilibrium is unlikely from a political economy perspective, it may be the burden of debt repayments in the near future that will trigger effective reforms. By that time, Cambodia may join the ranks of dozens of heavily indebted poor countries. The Conclusion, Section V, summarizes the paper’s main findings and offers three lessons learned.

A DECADE OF GOVERNANCE AND ECONOMIC PERFORMANCE

*Qualified Successes*⁴

*“Governance is the manner in which power is exercised in the management of a country’s economic and social resources for development. Good governance ... is synonymous with sound development management.”*⁵

–World Bank (1992: 1) and Asian Development Bank (1997)

public administration reform, judiciary and legal strengthening as well as economic and financial reforms.

⁴ I use the word “qualified” here to circumscribe or limit the word “success”. Of course, credit should be given where credit is due.

⁵ In fact, this phrase dates back to *Webster’s New Universal Unabridged Dictionary*, London: Dorset & Baber, 1979. This reference is thanks to Ahrens (2001: 16). One may wonder what is “power”? Among 16 possible noun variations, the American Heritage® Dictionary of the English Language, Fourth Edition, defines “power” as: “(1) The ability or capacity to perform or act effectively. (2) A specific capacity, faculty, or aptitude. Often used in the plural: her powers of concentration. (3) Strength or force exerted or capable of being exerted; might. See Synonyms at strength. (4) The ability or official capacity to exercise control; authority. (5) A person, group, or nation having great influence or control over others: the western powers. (6) The might of a nation, political

“There is no need to plead the case of good governance. We are all converts.”⁶

—Deputy Prime Minister Sok An (2003)

If nothing else, the last decade has also shown that there is no need to plead the case for macroeconomic stability or the merits of the market economy. Members of the Royal Government are all converts.

On 14 October 1994, a *Sarachor* or Circular No. 63 (RGC, 1994), pursuant to directive No. 536 dated October 19, 1993 of the Cabinet of the then First and Second Prime Ministers, signed by then Minister of Commerce Var Huot, announced the “adoption of the market economy”:

1. All the prices of goods shall be determined by mutual agreement between buyers and sellers.
2. The State shall allow free competition between traders. In order to foster competition, the State shall encourage the participation of all traders.
3. The state shall guarantee to the traders freedom to move goods.

The Heritage Foundation (2005) rates Cambodia as “Mostly Free” in terms of economic freedom with an overall score of 2.89 (ranked 63 just above Mexico), and the country ranks higher than Thailand (71), Vietnam (137), and Laos (150) out of 161 countries. While items 1 and 2 were faithfully implemented, it is now abundantly apparent that item 3 leaves much to be desired. Illegal checkpoints have made the freedom to move goods very costly, despite occasional pronouncements by senior officials announcing their dismantlement.

Furthermore, while most State-Owned Enterprises have been privatized, the process cannot be said to have been transparent. To be sure, while the Government of Canada (2004) lauds Cambodia’s economy as having a “Liberal investment climate with many incentives” we also know from recent empirical evidence that unofficial payments⁷ amount to 5.2% of surveyed firms’ gross

organization, or similar group. (7) Forcefulness; effectiveness: a novel of unusual power.” Available: <http://dictionary.reference.com/search?q=power>

⁶ H.E. Sok An was at the time Senior Minister, Minister in charge of the Office of the Council of Ministers, and Chairman of the Council for Administrative Reform when he spoke on “Administrative Reform” at the “Interim Consultative Group Meeting” on 28 January 2003.

⁷ This is the preferred phraseology of the authorities, while it is more commonly known as a bribe tax. While the World Bank (2004a) faithfully replaces all instances of “bribe tax” with “unofficial

revenues (World Bank, 2004d), more than twice that of Bangladesh, Transparency International's bottom performer on the Corruption Perception Index 2004 (which does not include Cambodia due to a lack of data).⁸ An estimate for corruption was proffered at \$120 million (World Bank, 2004d) and between \$300-500 million by Calavan et al. (2004) for USAID which was a descriptive study of corruption in Cambodia. The Global Corruption Report 2005 by Transparency International inaugurates Cambodia's first Country Corruption Report.

Box 1: Low Inflation and Stable Exchange Rates

“Cambodia has achieved some modest economic successes, recently meeting its overall targets for revenue, expenditures and domestic financing while maintaining low inflation and a stable exchange rate.” (USAID, Undated)

“At the same time prudent monetary policy contributed to continued expansion of net foreign assets, a stable exchange rate and a low inflation rate of 0.5 percent.” (World Bank, 2004c)

“The authorities have achieved progress in economic growth and kept inflation low despite the adverse impact of the floods in 2000... Prudent monetary and exchange rate policies will continue to be needed, supported by the avoidance of domestic financing of the budget.” (IMF, 2001)

“Inflation has remained low and economic growth has been sustained despite a weakening in the external environment.” (IMF, 2002)

“Performance under the PRGF arrangement was broadly satisfactory, as inflation remained low and sustained economic growth was maintained despite adverse weather conditions.” (IMF, 2003)

“Inflation will be subdued given the central bank's recent history of responsible monetary management.” (ADB, 2002)

Notwithstanding this, specific macroeconomic outcomes have been nothing short of remarkable. Both inflation and exchange rate instability were very serious problems during this early 1990s period.⁹ The riel depreciated against the US dollar from an average of 418 riel to the dollar in 1990 to circa 2500 between 1994 and 1997 to 4000 in 2004 and has been stable for the last several years. Box 1 gives recent examples of donor praise for Cambodia's low inflation and/or exchange rate stability.

payments” the find-and-replace function missed (perhaps intentionally) one instance in “Annex III: Methodology: Productivity and Investment Climate Survey” on page 110.

⁸ Bangladesh is tied with Haiti in last place at 145 out of 145. Available:

<http://www.transparency.org/cpi/2004/cpi2004.en.html#cpi2004>

⁹ While Consumer Price Index (CPI) figures are not available prior to 1996, what is available is GDP Deflator (1990: 146%; 1991: 107%; 1992: 75%; 1993: 107%). From 1994-2002 the GDP Deflator averaged 6.45%.

While macroeconomic stability was achieved, rapid economic growth was not. Real GDP growth has been respectable, albeit modest, at circa 5% in the last decade.¹⁰ Growth in 2005 is projected to plunge to between 1.9 and 2.4% according to the IMF and the World Bank, respectively, due to the end of garment export quotas. Based on the country's comparative advantage, agriculture is Cambodia's best hope for long-term growth—but this has unfortunately not been the case.

Finally, another success for Cambodia was its accession to the World Trade Organization in 2004. It should be noted that joining WTO came at a great price in terms of both generic drugs and agricultural sector concessions according to Oxfam (2003), the details of which will not be detailed here. Debating the pros and cons of joining is moot at this point. Cambodia is now a member, and dozens of laws await passage.

WTO membership is widely seen as a possible straightjacket for further and deeper reform. For example, making laws publicly available has not been a forte of Cambodia. While ignorance of the law does not permit one to violate it, the basis of this principle presumes that the law is at least made known to the public. The Government has published for some years now an Official Gazette, but following the 2003 elections, publication was reported to have ceased for nearly a year due to lack of funding. As a member of the WTO, Cambodia is required to place all laws on the Internet.¹¹ Furthermore, the creation of commercial courts has been precipitated by WTO membership. The Royal Government recognized their importance as long as a decade ago,¹² but was unable or unwilling to move forward. Of course, while challenges remain with the rule of law and impunity, it is hoped that other WTO members will not take lightly to this attitude, and will encourage the letter of the law to be respected.

¹⁰ Its composition however was too narrow, because of its focus on garments and tourism. Employment in garments is significant, at a quarter of million jobs were created (plus or minus the retrenchment now observed in the aftermath of the end of garment quotas, see related paper by Keo Chamroeun in the same issue of the CER) from essentially zero in the mid-1990s. However, the 250,000 youth entering the labor market each year represent the entire garment industry.

¹¹ The Ministry of Commerce maintains a partial listing that has not been updated since 26 December 2002 (when checked on 25 March 2005). The absence of a database-powered indexing system makes difficult finding specific laws. Available: http://www.moc.gov.kh/laws_regulation/default.htm.

¹² See Articles 54, 55, and 57 of RGC (1995).

Partial Successes, Partial Failures

“[There] is a saying that ‘Rome was not built in a day’. Nor can we build Cambodia in a day. We are a very young state. However, my government is truly committed to the vision of a Cambodia [with] fundamental principles of democracy such as rule of law. We are also equally committed to implementing judicial reform where there is complete judicial independence ...”

—Deputy Prime Minister Sok An (2002)

While some economic successes in macroeconomic stability and market orientation were truly remarkable in the last decade, progress in key governance reform was more limited. One of these areas was judicial independence. The Law on the Organization and Functioning of the Supreme Council of the Magistracy (LOFSCM) was enacted in 1994. The Law should have strengthened the independence of the Judiciary from the Executive and the Legislative branches of government to ensure separation of powers, but the Council’s membership includes a member of the Executive,¹³ despite apparent contradiction with Articles 79 and 120 of the Constitution (RGC, 1999a):

Article 79:

The National Assembly mandate shall be incompatible with the holding of any active public function and of any membership in other institutions provided for in the Constitution, except when the assembly members (s) is (are) required to serve in the Royal Government.

¹³ The Minister of Justice is a member of Supreme Council of the Magistracy (SCM). Other members are known to be active in partisan politics, while his Majesty the King officially chairs the SCM and is the guarantor of its independence according to Article 132- New (Previously Article 113). According to the Article 7 of the Constitution, “The King of Cambodia shall reign but shall not govern.” Amnesty International (2002) states: “On 7 December 1999, then Minister of Justice Uk Vithun suspended from duty the President of the Phnom Penh Municipal Court and its Chief Prosecutor, because of the allegations made against them of corruption. According to the Constitution, only the Supreme Council of Magistracy has the power to act in disciplinary proceedings against judges and prosecutors, although the Minister of Justice is a member of the Supreme Council of Magistracy, which in itself raises serious questions about the independence of this body from the government. Article 12 of the 1994 Law on the Organization and Functioning of the Supreme Council of Magistracy excludes the Minister of Justice from meetings of the Disciplinary Council, which should be convened to consider cases of disciplinary actions against judges and prosecutors. The suspension of court officials by the Minister of Justice contravened Cambodian law, because the Minister is not authorised to act in such matters.”

In this circumstance, the said assembly member (s) shall retain the usual assembly membership but shall not hold any position in the Permanent Standing Committee and in other assembly commissions.

Article 120- New (Previously Article 101):

The functions of members of the Royal Government shall be incompatible with professional activities in trade or industry and with the holding of any position in the public service.

Secretary-General Kofi Annan has said: “The United Nations exists, not as a static memorial to the aspirations of an earlier age, but as a work in progress — imperfect, as all human endeavours must be, but capable of adaptation and improvement” (2002: 6). The same should be said of the Cambodia’s relationship with its Constitution.¹⁴ Angkor, like Rome, was built over a period of centuries. A decade has passed since the LOFSCM was enacted and the first meeting of the Supreme Council of the Magistracy took place in December 1997. Since the end of 1999 it has met regularly. All can recognize, however, that much more progress is needed.

Finally, both decentralization and the creation of the National Audit Authority (NAA) can be cited as partial successes in governance. Their shortcomings had to do mainly with lack of empowerment. Decentralization was an outgrowth of the United Nations’ Cambodian Resettlement and Reintegration (CARERE) program. This program was set up in 1992 to assist returnees from the Thai border camps, later becoming the Cambodia Area Rehabilitation and Regeneration Project (CARERE2) and finally succeeded by Seila, which the Royal Government has adopted as its own. The NAA was created in 2001 with support from the Asian Development Bank following an extensive study of governance for sustainable development in Cambodia which called for (1) strengthening public accountability institutions; (2) building partnership between government and non-government sectors; and (3) building capacity for local governance.

Both decentralization and the NAA merit a longer exposition than this paper can provide. The Royal Government took a major step forward with the

¹⁴ Margaret Slocombe summed it up another way: “The main problem with politics in Cambodia is having a Lexus Constitution when what is really needed is a secondhand Toyota.” *Phnom Penh Post*, Issue 13/27, December 31, 2004 - January 13, 2005. Slocombe is the author of *The People's Republic of Kampuchea 1979-89: The Revolution After Pol Pot*.

Commune Elections of 2002. Fiscal decentralization and empowerment of commune councils are still desperately needed. Observers may see the difference in expectations and outcomes as a conflict of visions where, according to a scholar and practitioner of development administration intimated, “The goals of the government and the international community are not aligned on this. The international community repeats their good governance mantra, but the government, if you are listening carefully, is talking about peace, stability, and *control* (emphasis added)” (Informant, 2004). With respect to the NAA, three years after its creation, then Asian Development Bank Country Director for Cambodia, Urooj Malik, pointedly remarked that the NAA “needs to be strengthened, it needs to be empowered.”¹⁵

Areas Needing Improvement

“As for being matter-of-fact, I have deliberately spared you any flights of rhetoric. This hall [the UN General Assembly] has heard enough high-sounding declarations to last us for some decades to come. We all know what the problems are, and we all know what we have promised to achieve. What is needed now is not more declarations or promises, but action to fulfill the promises already made.”

—Kofi Annan (2005: 6)

Based purely on outcomes or “results”, it might be said that Cambodians also “know what the problems are” and what actions are needed. Several documents make this clear. The Socio-Economic Development Plan: 2001-2005 (RGC, 2002a) launched on 29 July 2002 coincided with the launch of the National Poverty Reduction Strategy: 2003-2005 on 20 December 2002 (RGC, 2002b). The NPRS committed Cambodia to the Millennium Development Goals (MDGs) by 2015, in particular (1) halving the proportion of people under the US\$ 1 poverty line; (2) halving the number of people suffering from hunger; (3) achieving primary education for all, and reducing by two-thirds from the 1990 level the child mortality rate. Although Cambodia is at an initial stage, it is seriously off track in meeting the MDGs in several areas.

¹⁵ As quoted in Cochrane (2004).

Poverty Reduction and Infrastructure

“To get rich is glorious.”

— Deng Xiaoping

In spite of more than five billion dollars (an average of about 13% of GDP annually) of external financial assistance being received between 1993 and 2003, there has been a negligible impact on national poverty reduction.¹⁶ Moreover, Cambodia now lags behind Laos in infrastructure (see Table 1) and according to the same report, a larger proportion of people (78% as opposed to 73%), now live on less than \$2-a-day in Cambodia than in Laos (Asian Development Bank et al., 2005: 39).

Table 1: Infrastructure in Laos and Cambodia

	Clean Water	Toilets*	Electricity	Internet	Paved Roads
Cambodia	44	22	17	0.2	4
Laos	58	30	41	0.3	15

* Includes latrines

(% population, except for paved roads which are % of total roads)

Source: Asian Development Bank et al. (2005).

Indeed, there may have even been an increase. In a regional update published last year, World Bank (2004e) estimates of \$1-a-day poverty in Cambodia, Vietnam, and Laos (1990-2004) show that only Cambodia observed a steady increase in poverty since 1996, from 36.7% to 45% in 2004 (see Table 2). By contrast, poverty has been halved since 1990, in Laos and Vietnam.

Among the possible explanations are: (1) problems in measurement; (2) a lag effect between poverty reduction programs and actual poverty reduction; (3) ineffective programs themselves either due to donors or the Royal Government or both. Increasing discrepancy in income distribution would suggest this third alternative. Aside from anecdotal evidence (landlessness of between 12-15%, inexplicably numerous luxury vehicles in the streets of Phnom Penh, palatial villa construction, etc.), the only measurement of inequality is of an official Gini index (ranked by per capita expenditure) of 40.39 in 1997, based on the

¹⁶ National poverty (urban and rural), which is based on a caloric formula and stands at circa 55 cents per person per day has remained at circa 36% using data from both 1997 and 1999.

Cambodia Socio-Economic Survey that year.¹⁷ Changes in the Gini index *since* 1997 could help prove the hypothesis that growth has been inequitable and should help to explain the dynamics, indeed, the puzzle of poverty increase to date.¹⁸

Rising Inequality

“In the past ten years of openness we’ve gone from ox-carts to Mercedes.”¹⁹

—Secretary of State Sok Siphana

Fortunately, estimates do exist of the Gini index for Cambodia, Vietnam, and Laos, permitting international comparison. Estimates of which suggest that inequality has increased in Cambodia, from 41.4 in 1998 to 48.1 in 2004. As can be seen below in Table 2, among the three countries, only Cambodia exhibits a steady and disturbing increase in inequality since 1998.

Table 2: Estimates of \$1-a-day Poverty and Inequality

	CAMBODIA		VIETNAM		LAOS	
	Headcount Index (%)	Gini Index (%)	Headcount Index (%)	Gini Index (%)	Headcount Index (%)	Gini Index (%)
1990	48.3	41.6	50.8	35.0	53.0	32.7
1996	36.7	41.6	23.6	36.3	41.3	36.5
1998	39.4	41.4	16.4	35.4	39.6	36.5
1999	41.5	42.3	16.9	35.4	36.7	36.5
2000	43.4	43.9	15.2	35.9	35.1	36.5
2001	43.0	44.6	14.6	36.8	31.3	36.5
2002	45.5	46.2	13.6	37.5	29.9	36.5
2003	45.5	47.4	10.9	37.5	29.3	36.5
2004	45.0	48.1	9.5	37.5	27.0	36.5

Source: Adapted from Appendix Table 8 in World Bank (2004e).

¹⁷ The Gini index is the Gini coefficient expressed in percentage form, and is equal to the Gini coefficient multiplied by 100. A Gini coefficient is an index between 1 (most inequitable outcome possible) and 0 (most equitable outcome possible).

¹⁸ It should be noted that the transition from central planning to market economy also produces inequality, but increasing poverty, infant and child mortality in the presence of moderate real GDP growth is unusual.

¹⁹ H.E. Sok Siphana is a Secretary of State in the Ministry of Commerce and Cambodia’s focal point on accession into the World Trade Organization. His remark was in the context of why Cambodia is ready to join the WTO and is quoted from “You can say that again! 2003 Quotable quotes” *Phnom Penh Post*, Issue 12/26, December 19, 2003 - January 1, 2004.

Infant and Child Mortality

“The link between good governance and economic development has long been established.”

—Senior Minister Keat Chhon (1999)

Finally, since projections are inherently based on assumptions that can sometimes be problematic, further evidence of slippage can be observed with respect to both infant and child mortality rates in Table 3. In 1990, eight infants out of 100 died at birth. By 2001, that number had increased to nearly 10. While 11.5% of children who were under five years of age died, by 2001 that figure had increased to 13.8%, making Cambodia the country with the highest child mortality in the region.

Table 3: Cambodia: Mortality Rate per 1,000 Live Births for Infants and Under-5

	1990	1992	1995	1997	2000	2001
Mortality rate, infant	80	83.2	88	90.8	95	97
Mortality rate, under-5	115	..	120	..	135	138

Source: World Bank (2003).

A handful of other countries have seen similar or even larger increases in mortality rates for infants and children under five. Botswana for instance saw its infant mortality rate go from 50 in 1995, to 74 in 2000, and 80 in 2002, and its under-5 infant mortality go from 66, to 101, to 110 in 1995, 2000, and 2002, respectively. The increase can be attributed to the HIV/AIDS pandemic, not poor governance and corruption. Landlocked Botswana has enjoyed four decades of civilian leadership and has been one of the most dynamic economies in Africa since gaining independence in 1966.

POLITICAL REALITY

“The pace of poverty reduction has been disappointing.”²⁰

—Urooj Malik, Asian Development Bank

²⁰ As quoted in Woodd (2004b). Mr. Malik was at the time the Country Director and Resident Representative for the Asian Development Bank office in Cambodia.

“We are of clear view that we are accountable not just to our people but also to taxpayers of donor countries. From this perspective governance has been and continues to be the top item of our development agenda.”

—Senior Minister Keat Chhon (2004) to Asian Development Bank

Success has many fathers but failure is an orphan!

One is left with little doubt that a failure of either governance or development or both played a major role in the infant and child mortality outcomes observed and the absence of poverty reduction. Certainly, while the Royal Government must ultimately take responsibility for its own development, donors are not faultless for the failure of their interventions, nearly half of which have been in the area of Technical Cooperation. To be sure, reaching for consultants is a natural response to a difficult governance environment, but at 40-50% (IMF, 2004) for the last decade, it has redefined notions of aid. The Royal Government, to its credit, wishes to focus aid on infrastructure, and does not wish to borrow for technical assistance. An emerging complaint from the few in government who dare to speak-up has been the “mountain of reports” and the “cut-and-paste” consultants who offer nothing new in terms of high-level policy advice but whose English is “beautiful”.²¹

Infrastructure is one sector of focus for the Royal Government for donor resources, but the outcomes, when compared to Laos, suggest underinvestment. Indeed in the aforementioned report by Asian Development Bank et al. (2005: 169) the authors argue that expenditure on infrastructure “appears to have been less than optimal in recent years” and that “This may have undermined economic growth and poverty reduction, and even long-run fiscal solvency.” In addition, only eight percent of Official Development Assistance went to agriculture and forestry in the last decade (World Bank, 2004a: 24) in a country where 80% of the population is rural.²²

While the results have indeed been disappointing, two examples may help to elucidate the discrepancy between policy and practice. Many examples come to mind, but two shortcomings stand out in particular. At the 2002 CG, the

²¹ Kate (2004) was quoting Secretary of State for the Ministry of Commerce, Sok Siphana.

²² According to OECD (2004), in 2001-02, eight percent of ODA going to agriculture happens to be the regional average for Asia as well. Are the cut-and-paste consultants to blame? Let us hope it is merely coincidence. Regardless, donors should be more attuned to Cambodia’s specific development needs.

Benchmark for Public Financial Management called for the government to increase transparency in its contracts with the private sector. The IMF, on behalf of Development Partners, stated bluntly:

Performance has been most disappointing in regard to public-private contracts. Indeed, few if any reforms have been introduced that effectively improve [their] transparency ... Nor have the government's own regulations been systematically enforced; thus, review and approval by the Ministry of Economy of Finance of unsolicited bids continues to be circumvented more often than not. Most concession contracts still have never been subjected to public scrutiny, the financial terms of most contracts never having been disclosed to the public. Nor have the operations of concessionnaires been assessed by an impartial and independent audit company of international renown. Moreover, new contracts, or extensions of existing ones, continue to be negotiated rather than decided through competitive bidding. Finally the opaqueness surrounding the process of granting land concessions is an especially troubling indicator of lack of progress in this area.²³

At the time, the only glimmer of hope with respect to contracts was mention of “a positive response to a draft concessions law that would substantially improve the transparency of contracts, including unsolicited bids that would be negotiated bilaterally” (Ibid).

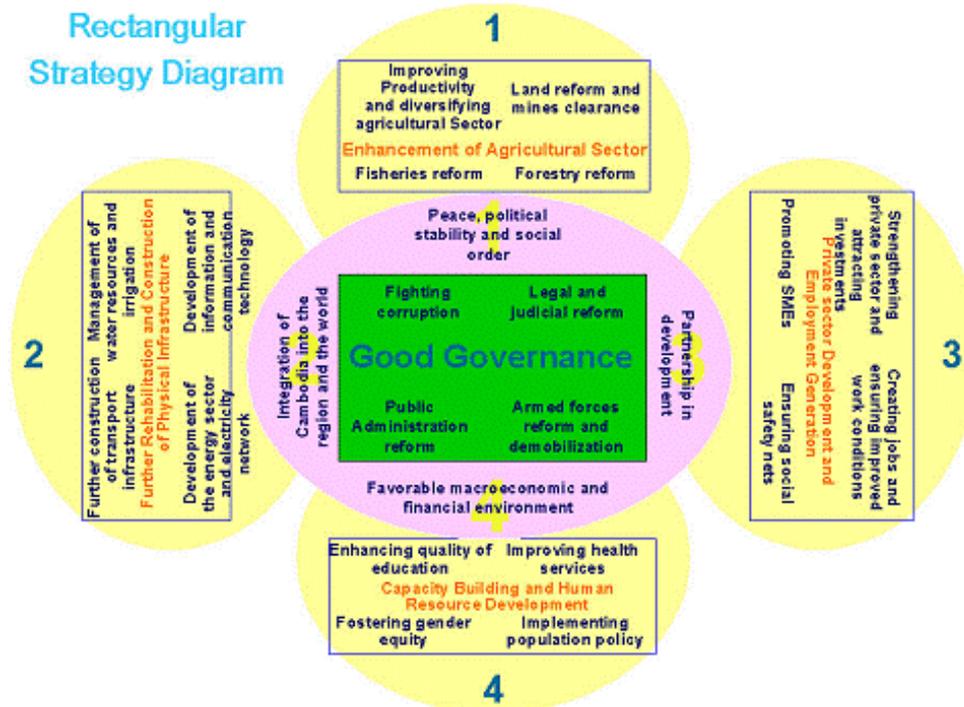
Another example of an apparent inability or unwillingness on the part of the Royal Government to confront governance problems deals with the decade-long wait for an Anti-Corruption Law, work on which began in 1994. Just prior to the 2003 National Elections, promises were made to deliver the Law. Yet to date, the National Assembly has yet to pass any law, although a draft is said to be under serious consideration. Unfortunately, the draft is known to fall short of the UN Convention against Corruption which provides a comprehensive set of standards and measures to promote international cooperation and domestic efforts in the fight to prevent corruption. The Convention is the result of a three-year effort by 129 countries to take global action against corruption and was signed in Merida, Mexico on 9 December 2003. While Cambodia has willed itself into ASEAN, WTO, and has announced its desire to join the UN Security Council, will it join 129 other countries in supporting the fight against corruption?

²³ Hagemann (2004).

Meanwhile, the first cabinet meeting of the Third Legislature on 16 July 2004 saw the launch of the “Rectangular Strategy” for Growth, Employment, Equity and Efficiency, which distilled key elements from a mélange of the MDGs, SEDPII, NPRS, and “various policies, strategies, plans and other important reform programs” (RGC, 2004). Its full breadth and series of interlocking circles and rectangles (see Graphic 1) cannot be done justice in this paper. Praised as an important Government led initiative, it nonetheless offers few indicators and benchmarks against which to judge performance. It was ultimately used as the basis of the Royal Government’s background document for the Consultative Group Meeting.

The World Bank’s background document (2004a: i) “argues that it will take more than the policies set out in the Rectangular Strategy to transform governance in Cambodia so that it is supportive of and not destructive to the development process.” Indeed, policy pronouncements, legal instruments, and even resources alone while necessary are not sufficient to ensure success. What is needed is political willingness. The Joint Monitoring Indicators and Benchmarks for 2005 adopted by donors and the Royal Government are based on the Rectangular Strategy. But let us be realistic. For them to succeed, it will require political will.

Graphic 1: Rectangular Strategy for Growth, Employment, Equity and Efficiency



Source: RGC (2004)

This suggests that the policy environment, based on the Rectangular Strategy, is supportive and that a degree of ownership is evident. Why then have outcomes not been as encouraging? Could the resources be lacking or are the targets too lofty? Or is it a question of political will? The following diagram is a stylized representation of how the selected successes and shortcomings discussed thus far may be classified along a political willingness and policy environment continuum. It is by no means comprehensive and should merely be taken as indicative. For example, while judicial independence is a stated goal of the Royal Government, the legal basis of the Supreme Council of the Magistracy, as discussed earlier, conflicts with the principle of separation of powers. As has been pointed out by Sok An, the principle is enshrined in the Constitution (Articles 128 to 134). Article 130- New (Previously Article 111) specifically states that “Judicial power shall not be granted to the legislative or executive branches.”²⁴

How can this be reconciled? He explained in 2002: “*My government is now in the process of further activating these principles and look[s] forward to donor support to further strengthen the Council and its secretariat, and hope[s] that the Council will ensure the credibility of the judiciary.*”²⁵ The speech underscores a truism of the Royal Government: “*We realize that as a developing nation we do not have the necessary financial nor technical requirements to travel this long road by ourselves. This is why the government gives every support and cooperation to donor agencies to help us with this task. We are very open in our policies in accepting donor assistance and donor interventions and at all times strive to create an environment that is friendly to donor interventions.*”²⁶ Certainly, “*acceptance of donor assistance and donor interventions*” indicates a willingness to receive technical assistance and aid, but it does not imply political willingness within a policy framework. Indeed, as Dapice (1995: 15) has underscored for Myanmar, “*economic reform is not simply setting an interest rate or exchange rate. It is establishing a shared vision of where the policies should lead and creating credibility and confidence that most movements will be in the right directions.*”

²⁴ RGC (1999a).

²⁵ Sok An (2002).

²⁶ Ibid.

THE RECTANGULAR REALITY: GOVERNANCE AND ECONOMIC PERFORMANCE

Political Willingness

		No Will	Will
Policy Environment	No Policy	<ul style="list-style-type: none"> • Judicial Independence (in practice and as proscribed in LOFSCM despite Constitution) • Anti-Corruption Law (that would adhere to UN Convention against Corruption) 	<ul style="list-style-type: none"> • Anti-Corruption Law (short of UN Convention against Corruption) • Infrastructure Borrowing (as opposed to Technical Assistance)
	Policy	<ul style="list-style-type: none"> • Poverty Reduction • Promoting Equity • Reduce Infant and Child Mortality • Min. Econ. & Finance Review of Contracts • National Audit Authority (not empowered) • Enforce Forestry Law 	<ul style="list-style-type: none"> • Market Economy • Exchange Rate Stability • Inflation Control • WTO Membership • Decentralization • Growth & Employment (however narrowly based)

Criteria for Political Will (Government): Outcomes, Results, and Practices

The National Strategic Development Plan 2006-2010 is now being formed. The Circular announcing its formulation (RGC, 2005a: 1-2) states, among other points, that the NSDP will:

- Be responsive to the political commitments articulated in the Political Platform and the Rectangular Strategy ... of the Royal Government of Cambodia in the Third Legislature of the National Assembly;
- Be a realistic strategic plan providing contextually appropriate, feasible, and achievable targets and programmes by taking the environmental, economic and social sustainability into account;
- Be a national strategic plan that incorporates the vision and the priority action plans of the Royal Government and which is consistent with the financial and other resource potentials of the nation;
- Be a national strategic plan that will have been formulated through an improved linkage between planning and budgeting processes;
- Be a document that will have been elaborated in a government led and owned process and with a broad participation of all stakeholders.

Given prior experience, the words “realistic”, “government led and owned”, and “feasible” are particularly encouraging. And while strategizing and planning is important for reaching goals, and shows a degree of willingness and acceptance by the Royal Government, even ownership, it is equally important to follow-through on the allocation and commitment of sufficient resources to attain objectives. With a results based approach, economic performance speaks for itself. Recent experience, when judged against economic performance, as illustrated above, indicates that failures of governance persisted, save for the aftermath of the events of 5-6 July 1997.

Budgetary Crisis-Induced Reform: The Natural Experiment of 1997-8

“Since the removal of the anarchic elements, which by its nature was violent, and its immediate aftermath, Cambodia has sprung back quickly to normalcy. Rule of law, as well as law and order, has been fully restored, and security prevails in the country except in remote pockets on external borders where the rebels are active.”

—Senior Minister Keat Chhon (1997: 76)

After the July 1997 events, the freezing of donor funds and the pull-out of the IMF over governance problems (civil administrative reforms and forestry management), the Royal Government was faced, for the first time, with a hard budget constraint. Whereas before, donor resources were fungible, the curtailment of aid had immediate consequences on budgetary expenditures. According to the United Nations (2000), total donor disbursement decreased from \$520 million in 1996 to \$375 million in 1997, moreover:

This reduction was directly related to the suspension of aid by some donors, notably the United States and Germany (subsequently restored). Other countries took up a wait-and-see attitude - in most cases maintained throughout the national elections in mid-1998 - resulting in long delays in the implementation of many development programs and projects.²⁷

Senior Minister Keat Chhon expressed dismay at the IMF-World Bank Annual Meetings held in Hong Kong that year:

We are somewhat surprised and saddened that, since these events [of July 1997] ... important external partners have ... begun to slow down

²⁷ United Nations (2000: 99).

*their support for the rehabilitation and development programs in the country, which are designed to serve the people at large. Development cooperation has to be a long-term commitment and should not be affected by misconceived perception of temporary events of a political nature...*²⁸

During this period of hardship, real belt-tightening took place. In 1998, an advisor to the Ministry of Economy and Finance warned that “In the first six months of 1997, we went through nine months of budgeted expenditure. And with no budget support from the World Bank or IMF, the national bank printed money. I’m afraid if the political situation is not resolved by the end of this year [1998], [the value of the riel] will be a big, big problem.”²⁹

A more colorful unnamed Southeast Asian diplomat astutely commented at the time:

*Aid is the key to sustain them and get them going. Right now [October 1998] the government coffers are empty. For three months the military and police have not been paid. This is why crime is up. A businessman told me that an army colonel came to see him, begging for \$200 so his men could eat. The Chinese business community is frightened of kidnapping which are getting down to the small fry a bakery manager kidnapped for \$1000 ransom ... The situation is serious and getting worse. Even investments in entertainment [sic] a cowboy country, cheap wine, women, gambling are suffering.*³⁰

In the austerity of 1998, a fiscal crisis emerged. Its antidote: actionable reform. Reform through crisis is nothing new in much of the developing world (Grindle and Thomas, 1991), but this was the first time since 1994 that a budgetary crisis had left the Royal Government without any choice but to undertake serious reforms. Box 2 describes the discourse between the RGC and the IMF in the run-up to resumption of lending by the Fund.

²⁸ Keat Chhon (1997: 76).

²⁹ As quoted in quoted Echardt (1998).

³⁰ Ibid.

Box 2: Cambodia and the IMF, Determined to Break With the Past in 1999

The Article IV Consultations completed on 17 March 1999, following the IMF's return to Cambodia, provided Executive Board Directors an opportunity to lash out at the Royal Government's performance. According to an IMF Public Information Notice:

Directors expressed disappointment that, in 1998, economic growth halted, the riel depreciated, inflation increased considerably, and there was little tangible progress in addressing key structural reforms. Of particular concern was the continued poor fiscal performance, characterized by extensive ad hoc tax exemptions, overspending on the military budget, and sizeable central bank financing of the government.

Against this background, Directors welcomed the authorities' recently announced commitment to break away from the past record of poor governance and weak economic policies and performance. They urged the authorities to fully carry out this commitment. Directors emphasized in particular that it was critical to increase transparency and accountability, adhere to the rule of law, take decisive actions against corruption and illegal logging, and improve fiscal management. Firm implementation of these reforms, together with prudent macroeconomic policies, would help lay the foundation for sustainable growth over the medium term.

Specifically, on 29 September 1999 a Letter of Intent and Memorandum of Economic and Financial Policies for 1999-2000 was signed by H.E. Keat Chhon and H.E. Chea Chanto (Governor of the National Bank of Cambodia) to the Managing Director of IMF. It stated that "The new government, formed in November 1998, is determined to break with the past. It has announced measures and taken actions against illegal logging and corruption and to strengthen fiscal management. It intends to reinforce these actions and also resume other structural reforms."

Source: *IMF (1999) and RGC (1999b).*

In October 1999, the RGC embarked on an IMF-supported program which ended in 2003. Domestic revenue which had been 8.1 percent of GDP in 1998 jumped to 10.2 percent of GDP in 1999, a staggering 2.1 percentage points or 26 percent increase, thanks in large part to the introduction of a 10 percent Value Added Tax. From 1999 to 2000, domestic revenue grew by only 0.2 percentage points. With the passage of a Forestry Law, the Royal Government announced a ban on logging in January 2002, and a ban on log transport in May 2002, as a means of compelling logging concessionaires to produce sustainable forest management plans (none has yet been produced). Critics charge that these bans are policies that have been violated.³¹ In December 2004, the transport ban was officially lifted.

Through 2002, the Royal Government's requests at annual Consultative Group meetings met or exceeded expectations, despite some donors' sometimes noisy complaints at these meetings that the Royal Government had failed to meet expectations by way of one reform or another. One should keep in mind that commitments differ from actual disbursements (not unlike the credibility of

³¹ Does a policy make a sound if it falls in the forest and no one is there to hear it?

Cambodia's annual Budget Laws). And almost always disbursements were far below commitments because the donor simply had double counted or miscounted or renege (but not because of poor performance by the RGC, at least it was never said publicly). This is a source of anxiety each year on the part of the RGC since the discrepancy announced at each CG is sometimes exploited by critics as evidence of corruption.

OPTIONS AND PROSPECTS: CREDIBILITY, CORRUPTION, AND COORDINATION

*“Fighting corruption, fighting corruption, fighting corruption ... This is Cambodia's problem. If you do not move, no one will cry over Cambodia ... If you do not become a credible competitor, it will be because of Cambodians, not because of the international community.”*³²

—President James D. Wolfensohn, World Bank

This paper has presented a wide variety and various degrees of successes and shortcomings in the last decade. What are the options and prospects?

A coordinated approach involving a secular decrease in aid would imply increasingly hard budget constraints for the Royal Government. In turn, this would give the right incentive and send the appropriate signal to the Royal Government to improve domestic revenue performance further well beyond current levels which, by international standards, remain inadequate and insufficient for fiscal sustainability without external assistance.³³

This has largely been attempted by the introduction of Performance-Based Allocations (PBAs) using Country Policy and Institutional Assessment (CPIA) scores. Both the PBAs and CPIAs represent a step forward. This year, the World Bank will disclose CPIA scores. Prior to 2005, it was not permitted to disclose scores publicly, even though doing so could have provided an incentive for decision makers to improve performance. In the case of Cambodia, Wolfensohn did reveal “We have reduced our lending to Cambodia – as a response to the poor performance on governance indicators – but we have not

³² As quoted in Reuters “Corruption is Cambodia's main problem” 11 February 2005.

³³ This paper has not addressed the equally important expenditure side, which to date shows few signs of progress. The World Bank has engaged in expenditure tracking for the education and health sectors. Anecdotal evidence in other areas, like Social Protection, suggests that leakage of a non-trivial amount takes place, see Chan and Ear (2004).

reduced our commitment, nor our efforts to push for the kinds of reforms that are needed to bring about a better life for all Cambodians.”³⁴

What is unstated but should be considered is that the impact of reduced lending can be negated by recourse to alternative financing through bilateral means,³⁵ which Cambodia quickly developed in the post-1997 period. This is akin to portfolio (in this case lender) diversification. The more lenders Cambodia has, the less power Cambodia’s lender of last resort (the IFIs) will exert over it. To be sure, this was only a natural response to a painful lesson learned. This increases the importance of donor coordination, but also reduces its effectiveness since Cambodia can calibrate any reduction in aid with additional resources from elsewhere to compensate. While the goal of ODA is to develop countries, it admittedly also allows governments to forestall reform. This is compounded by a lack of coordination among donors.³⁶

Corruption Case Studies: WFP, World Bank, and Credibility

It is also important to keep in mind that to be effective, threats must be credible. If corruption in lending is unacceptable, its discovery and tacit revelation will have little impact on the status quo.³⁷ As such, donors must engage in an honest and public discourse about expectations concerning the performance of the Royal Government. The formalities of Joint Monitoring Indicators and Benchmarks at annual Consultative Group Meetings have been a welcomed addition, but further transparency and accountability is urged among donors, especially in publicly reporting governance related problems. Two recent cases are instructive from a credibility standpoint.

³⁴ As quoted in World Bank (2005).

³⁵ China and Pakistan are but two countries that have made multimillion dollar loans to Cambodia announced in 2004, \$30 million and \$10 million, respectively, but these did not show-up in the pledging sessions of the December 2004 Consultative Group meeting. Marks (2000) reports that in February 1999 following an official visit to Beijing by the Prime Minister of Cambodia, the country obtained \$18.3 million in foreign assistance guarantees and \$200 million in no-interest loans for infrastructure projects which China acknowledges is one of the highest aid amounts they provide to any country in the world.

³⁶ Think for instance of a non-cooperative Nash equilibrium game in which the players, international donors, move independently of one another even while, to use Easterly’s phrase, they have a “cartel of good intentions”.

³⁷ The classic example is Dr. Strangelove’s doomsday machine from the movie of that same name. Why would the Soviets keep secret doomsday machine if its purpose was deterrence against an American nuclear attack? It would not make sense. If anything, its existence should be well-publicized.

Case 1: The World Food Programme and Food-for-Work

The case of corruption in the World Food Programme's Food-For-Work (FFW) scheme is particularly interesting. The approach was at first very public, with a front-page article in the *Phnom Penh Post* (Woodd, 2004c) and an interview with the then WFP Representative in Cambodia (Woodd, 2004a). It included prior consultation with Cambodia's largest donor and assurances of support by that donor as leverage on the RGC. At the time, that Representative put her foot down, "If [the government] did not accept anything then we would have to seriously look at our future in Cambodia."³⁸ The alleged fraud was initially pegged at \$2 million. The RGC quickly accepted the terms, taking responsibility and agreeing to repay in principle, following its own investigation.

Unfortunately, the \$2 million figure was then disavowed by WFP which made clear to the RGC that the amount in question was negotiable. A year to the day, on 28 February 2005, the RGC agreed to pay only \$900,000.³⁹ WFP had suspended FFW for the duration, but continued all other activities in order not to hurt the "hungry poor".⁴⁰ The agreement came coincidentally after WFP announced it would distribute 1,500 metric tons of rice to drought affected populations. There was no apparent rallying around WFP by other donors, and no press releases were found either on WFP's global website⁴¹ or its local one⁴² concerning this matter through mid-March 2005. One would hope that the lesson learned from this will be the importance of credibility in issuing ultimatums, and implementing more rigorous monitoring systems.

Case 2: The World Bank and Demobilization

In contrast, the case of the World Bank saw somewhat better results even though its initial approach was more muted.⁴³ The Bank initially took a very low-

³⁸ As quoted in McKenny (2005).

³⁹ This was complicated by the now dismissed WFP staff's own complicity in the corruption, which has been used as a foil for criticism of the Royal Government.

⁴⁰ As quoted in Cochrane (2005). With less than half the initial amount claimed repaid, the penalty for corruption appears to have gone on sale.

⁴¹ Click on "Press Releases" at http://www.wfp.org/country_brief/indexcountry.asp?country=116.

⁴² See <http://www.un.org.kh/wfp>.

⁴³ Prior to 1996, when the "c-word" corruption was seen as off-limits and political, the Bank's approach to corruption was ridiculed as the three-monkeys policy: see no evil, hear no evil, speak no evil. Unfortunately, the recent news that a number of Bank projects in Cambodia may have accountability problems was reportedly greeted without any comment whatsoever from the local

key approach for two years with respect to the declaration of misprocurement in a demobilization project with the Royal Government. Seeing no progress, it was then reported by media that a letter was sent by the World Bank's Vice President for East Asia and the Pacific which allegedly threatened that if reimbursement did not take place by 15 February 2005, its entire portfolio of more than a dozen Bank-funded development projects would be suspended. This quickly produced results: the immediate repayment of \$2.8 million.

At impromptu press conference on 21 January 2005, the Prime Minister suggested to reporters that the World Bank had brought into the tender process the private firms responsible for the corruption. Keat Chhon was more conciliatory when earlier interviewed by the Associated Press. He said "It is regretful for me that such a problem has occurred. This was because there were loopholes in the implementation ... We must work to build good governance, so others stop suspecting that corruption was committed."⁴⁴ To be sure, the World Bank's large size, its role as lender of last resort, and its stature as co-chair of annual Consultative Group meetings gave it more leverage than WFP, but the case also suggests that the World Bank's threat to suspend its entire portfolio was credible while WFP's threat to examine its future in Cambodia lacked credibility.⁴⁵

Final Squeeze: Debt Service

Finally, another factor that may help to produce results: Cambodia's debt servicing payments in 2005 are not known. In May 2004, the media reported that Cambodia would pay an estimated at \$4-5 million or the equivalent of about two percent of total government spending according to Kay (2004)⁴⁶ for concessional loans incurred after 1993. The IMF reports on its website that Cambodia is due to pay 6.52 million Special Drawing Rights (SDRs)⁴⁷ to the

Bank office other than a press release and a referral to the Institutional Integrity department at Bank headquarters.

⁴⁴ As quoted by the Associated Press in "Cambodia Says It Will Repay Aid Funds" 19 January 2005.

⁴⁵ Richardson (2005) quotes a Bank staff member as having said in July 2002: "As long as 60 percent of the money gets where it's supposed to go, that's good enough for me." On this basis, she argues that such staff members should have been made to pay 40% of the \$2.8 million.

⁴⁶ Debt sustainability analysis indicates that it is difficult to determine the exact amount of Cambodia's external debt, as the authorities are conducting negotiations with the Russian Federation and the United States on the rescheduling of its pre-1993 financial obligations.

⁴⁷ An SDR is an artificial currency unit that was created by the International Monetary Fund in 1969. It is a basket of currencies that include the Euro, the £ sterling, the Japanese yen and the United

Fund in 2005. This alone is twice as much as the May 2004 earlier estimate, and does not include any other lenders.

In any case, debt service payments may serve as a similar budgetary constraint that could encourage reform. Cambodia's total national debt picture is unclear because negotiations with the United States to whom Cambodia may owe \$500 million and Russia (\$1.6 billion) have not yet been completed. At issue is the discounting of the debt and the exchange rate to be used. Debt sustainability analysis undertaken by the IMF suggests that "the fiscal burden of the debt is heavy (given the low revenue to GDP ratios), with debt service amounting to more than 15-20 percent of revenue over the next ten years."⁴⁸ Moreover, according to the World Bank (2004b: 13), by 2008, after rescheduling of its pre-1993 obligations,⁴⁹ Cambodia's external debt is estimated to be about 48.9 percent of GDP, and debt service will equal 2.6 percent of exports of goods and services. While this is not large in relative terms, given Cambodia's low revenue to GDP ratios, the Bank reiterated the concern that the "fiscal burden of the debt is heavy". It would be a pity for the people of Cambodia if only the burden of debt repayments could lead to reforms and more importantly a fundamental transformation of its low governance equilibrium.

CONCLUSIONS AND LESSONS LEARNED

This paper has explored three gradients of development outcomes in the last decade by looking at governance and economic performance together. Policies for which there is political will, like foreign exchange stability and control of inflation, have the best chance of succeeding. Policies that negatively impact patronage politics, like equity and contracts transparency, have shown the least likelihood of success given Cambodia's political economy. Three lessons learned are apparent.

States dollar. Using 1 SDR = 1.52577 exchange rate of 22 March 2005, 6.52 million SDRs are worth about US\$10 million.

⁴⁸ Hang Chuon Naron (2003: 10).

⁴⁹ In *The Elusive Quest for Growth*, William Easterly (2001) rightly argues that a major test of good governance rests on whether, after receiving debt relief, a Government increases borrowing and returns to its original overburdened and unsustainable debt levels. In the case of Cambodia, this period of uncertainty in its debt outlook should give the authorities pause over how much more (or less) to borrow.

First, the politically-induced “natural experiment” of 1997-98 suggests external pressure to force reform, while initially successful at increasing domestic revenue collection, have floundered. Forestry policies adopted by the Royal Government in 2002 at the behest of donors are in a state of flux. Policy and political commitment were not concomitant. Furthermore, the recurrence of a fiscal crisis in the short to medium term is unlikely. The feasible set of options is small given external conditions. Among the factors that should be considered are Cambodia’s accession to WTO, preferences in the Royal Government’s borrowing (away from technical assistance and towards infrastructure, which is encouraging⁵⁰), and debt service payments. Membership in the WTO requires changes in the country’s legal and policy framework and their implementation may need to be credible. Finally, the burden of debt service payments will likely send increasingly strong signals about the need for effective reform.

A second lesson is that donors should examine policies in light of political reality, since a decade of governance and development has now taken place to permit a careful evaluation. It is clear that the Royal Government has fully adapted the language of development and governance, but in its practice, development is still subservient to political considerations. Poor development outcomes make this evident. Since the Royal Government’s posture is one of openness to donor interventions and to receiving aid, this should not be confused with political willingness to undertake necessary reforms. Donor interventions steeped in technical solutions to specific problems seldom take this reality into account.

A third and final lesson learned is that the three Cs; corruption, credibility, and coordination, are clearly linked. To fight corruption, as was shown in the two case studies presented, requires credible threats. In the longer run, the credibility of donor support in the face of governance failures requires that donors coordinate their actions to send a clear message and provide the right incentives for change. While Performance-Based Allocations are a step forward, their efficacy is limited when the borrower can access alternative sources of financing to compensate for reductions in CG-coordinated ODA. Paradoxically, this should underscore the importance of donor coordination to

⁵⁰ Asian Development Bank et al. (2005: iii) does warn: “[Q]uestions and concerns have often been raised about the impact of infrastructure development on the environment and local communities, about waste through corruption in public spending and private contracts, and about the appropriate roles of the public and private sectors in infrastructure financing, ownership and management” and concedes that “While infrastructure can be a force for good, we also have to make sure it is done well.”

provide an effective financing mechanism, despite the implication that the impact of such coordination will, inevitably, be diminished. While the scope for reform is narrow, it is not set in stone. Where there is credibility and political will, there is a way.

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CAMBODIA'S AGRICULTURE: IS IT A SLEEPING SECTOR OR A SLEEPING TIGER?

Srey, Chanty *

AGRICULTURE AND LAND USE AND MANAGEMENT

When one talks about agricultural development, land and water are important but limited resources. Competition for these resources is therefore a major threat to the capacity of the agricultural sector in producing food and in contributing to economic development. Land, in Cambodia, is used for different purposes, namely, agriculture, settlement and industry. Since this paper is focused on agriculture, the land use under agricultural production will be quickly examined.

Although forest cover has been degraded, more than half of Cambodia's territory is still under forest. In 2003, some 58.60% of Cambodia was still under forest cover¹, which had declined from some 73% in the 1970s, and 62% in the early 1990s. Non-woodland takes 7,514,778 ha (41.4%), which includes 2,601,715 hectares classified under evergreen shrub-land (3%), bamboo (0.2%), dry shrub-land (6.4%), inundated shrub-land (2%), barren land (0.1%), and other undefined land (0.01%), and agriculture land (23.4%). In real terms, land under agricultural production accounts for about 4.0 million ha out of which paddy rice takes up to 2.7 million ha. It should be also noted that 2.5% of Cambodia land is infested with land mines.

Under the current regime, excluding forest management (briefly reviewed above), land use in Cambodia falls under two main systems: (i) the private household land use system, and (ii) the land concession system. The private household land use system is the traditional way of using land in Cambodia. Small, medium and large-scale farmers/agricultural producers can be grouped under this system. Large-scale agricultural producers are those who cultivate more than a hundred hectares of land.

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¹ Department of Forestry and Wildlife. 2003. Forest Assessment Report (Cambodia).

In order to draw foreign direct investment and develop country's economy, the economic land concession system was introduced. It is a new mode of land management in Cambodia which was brought into being only in the last decade. The economic land concessions have been granted by and/or through the Ministry of Agriculture, Forestry and Fisheries (MAFF). The economic land concessionaires are both private and semi-state-owned enterprises.

Economic land concessions have been considered as a way of maximizing the productive use of vacant land, generating rural employment to alleviate poverty and promoting economic development. However, their expected benefits have never materialized. These concessions have not yet been able to generate any favorable results. Even worse, they have caused problems and conflicts within their local communities.

By 2000, while concessionaires held about 1.0 million hectares of undeveloped land, some 15.8% of the Cambodian population was landless². While a legal framework was lacking, land grabs and conflicts were rising. And poverty among the rural population who depend on agriculture was appalling. The poverty rate was as high as 56% in rural Cambodia³.

As a consequence, the RGC called for land reform⁴. The Ministry of Land Management Urban Planning and Construction (MLMUPC) was established and in August 2001 the new Land Law was promulgated, which forms a legal foundation for land management. The Land Law contains provisions that define: (i) ownership and use rights; and (ii) land administration and management systems and regimes. Interestingly, the Land Law legalizes not only private ownership of land but also collective ownership. This favors and recognizes the traditional practice and system of land use and management of the minority communities that consist of less than 5% of the total Cambodian population.

The Land Law also clearly defines the size of economic land concessions, which allows the RGC to recover large tracts of land from both active and idle concessions. The social land concession program is meant to distribute land for residency and agriculture to the landless and land-poor households. This should

² National Institute of Statistics. 1999. Cambodia Socio-Economic Survey (Both Rounds).

³ National Institute of Statistics. 1999. Cambodia Socio- Economic Survey (Both Rounds).

⁴ Land reform was implemented once in 1989 after the collapse of the Khmer Rouge, when each person in a household was given 1,500-2,000 sq. m. depending on availability of land in

contribute to reducing rural poverty. Currently, the land titling program is being implemented, the social land concessions program is a pilot project, economic land concessions are under review, a relevant legal framework is being formulated, and state land management and recovery and relevant legal papers are under discussion and preparation. Meanwhile, land grabs and conflicts continue.

AGRICULTURE AND WATER

Cambodia's climate is hot and humid with an abundance of water resources. However, its agriculture production is still weather dependent and thus remains vulnerable to natural and climatic shocks (e.g. flood and drought). Annual average rainfall gauged in the last nine years is less than 3,000 mm. Temperature is, on average, below 30°C, while day length is about 10 hours/day. Except for its seasonal nature, this climatic condition is favorable for the production of most tropical agricultural crops as well as trees, livestock and fish.

Cambodia has a huge potential of water resources for home and agricultural consumption and other uses that are derived from: (i) rain and surface runoff, the Mekong, the Great Lake and river system (500 billion cubic meters/year); and (ii) groundwater sources (17.6 billion cubic meters/year). The ministry has estimated that irrigation potential could be up to 1,667,300 ha. Unfortunately this potential is far from reach⁵. Agricultural outputs in Cambodia are strongly affected by fluctuations in climatic conditions due to limited capabilities in water resources management. In the dry season, vast agricultural land areas are left bare and unproductive because of lack of water.

By 2001 only some 23% of agricultural land in Cambodia was under irrigation. Between 2001 and 2004 some 315 irrigation schemes have been reportedly rehabilitated which could irrigate 153,149 hectares of paddy land including 89,383 ha and 63,766 ha for wet season and dry season rice production, respectively⁶. This means that another 7.2% more area could be

his/her locality. Note also that during the Khmer Rouge land was confiscated by the state and all ownership certificates or land title documents were all but reduced to ashes.

⁵ Ministry of Water Resources and Meteorology. Aug. 2001. Water Resources Planning.

⁶ Ministry of Water Resources and Meteorology. Aug. 2004. Strategic Plan on Water Resources Management and Development 2004-2008.

placed under irrigation. Therefore total irrigated areas could conceivably amount to 30.2% of the agricultural land.

In the rainy season, about 11 percent of harvested paddy area received supplementary irrigation. In the dry season, about 12 percent of harvested paddy land benefits from irrigation. This consists mainly of irrigated lowlands with full irrigation and flood recession rice with partial irrigation. Perennial and annual crops are largely grown under rain-fed conditions. Potential availability of Cambodian water resources is under-exploited for agricultural development.

AGRICULTURE SECTOR PERFORMANCE

As one of the developing and poorest countries in the world, Cambodia relies largely on its agricultural sector. This sector has a significant share in the Gross Domestic Product (GDP) and employs about 75 percent of the labor force. In 2002 this sector accounted for more than 30 percent in the GDP which had declined from about 45 percent in 1993. In terms of value, it generated above 5.0 trillion riels in 2002. The agricultural GDP constantly increased during 1993 – 2001 from 4.0 trillion riels to more than 5.3 trillion riels, but slightly declined in 2002. Daily per capita income of the agricultural population is only 1,440 riels (US\$0.36) which is below the poverty line of 2,000 riels (US\$0.5). The agricultural population is, therefore, among the poorest.

Table 1: Cambodia's agriculture facts

Indicator	Year 2002
Agricultural crops, excluding rice and rubber, US\$ mil	222.4
Paddy rice, US\$ mil	322.7
Rubber, US\$ mil	51.0
Livestock, US\$ mil	215.6
Fisheries, US\$ mil	437.6
Forestry and logging, US\$ mil	88.6
Employment by agriculture sector, mil	4.5
Number of women employed by agriculture sector, mil	2.6
Agriculture landholding per household, ha	1.5
Landlessness rate, %	12-15
Agriculture GDP per farm worker, US\$/year	278.9
Daily per capita income of agricultural population, US\$	0.36
Irrigated area, %	32.0
Agriculture share in GDP, %	33.5
Agriculture GDP, US\$ mil	1,337.8
Agriculture export, US\$ mil	214.9
Agriculture expenditure, US\$ mil	13.1

Although, the removal of farm subsidies by the developed nations which are members of the WTO, may somehow give Cambodian farmers a hope, the challenges still lie ahead. Meanwhile, Cambodian farmers have to produce to attain food security for their families and if they want to sell any surplus they have to compete with farmers in other developing countries who are probably more efficient and more productive.

In the long-run, when the economy advances, the industrial and service sector outputs will perhaps exceed that of the agriculture sector. But in order that that could happen, the agricultural sector has to be well prepared. The fact is the agriculture sector is always the engine for growth at the early stages of, and a good precursor to, economic development at least for the developing world. Advancement in the agricultural sector could help to prepare other sectors of the economy. For example, once the agriculture sector is developed its outputs could be used in industry and service sectors. Also, well-trained agricultural laborers could be employed in other sectors of the economy, assuming they have adaptable skills and retraining programs are available.

Agricultural productivity is relatively low and its growth low or in decline, way below its potential. This is despite its importance for the economy and rural poverty reduction. Its year-to-year growth kept declining between 1993 and 2002. Its growth in 2002 was extremely disappointing – it had a recession. Its output was down by about 3%. According to the estimate of the RGC, the agricultural sector grew by 9.2% in 2003. This growth is highly significant compared to the previous ten years of growth. The annual sector growth in the last ten years averaged only 2.4%; and it generated some 4.8 trillion riels per annum.

Understanding the sector as a whole is not helpful since it comprises many sub-sectors. This implies that the contribution of the various sub-sectors to the total growth of the sector is more important than the growth of the sector per se. Moreover, the fluctuation in the sector's growth could be attributed to the performance of a single or all sub-sectors combined. Therefore, understanding the behavior, characteristics and performance of each sub-sector is perhaps more crucial from a strategic and development point of view. The

agricultural sector of Cambodia consists of four main sub-sectors. In the sections that follow each of the sub-sectors will be briefly reviewed.

CROPS SECTOR

Crop production, including rubber, is the major sub-sector of agriculture in Cambodia. Its importance in the sector reflects preferences and traditional practices of Cambodian farmers. The most staple food crop of Cambodians is rice.

The crop production sector accounts for more than 40% of agricultural GDP. The production fluctuates from year to year. It trended upward during 1993-2000, and seemed to head downward during 2001-2002. In 2000 constant prices, crop production generated on average 2.1 trillion riels per annum. Gross Value Added (GVA) of all crops seemed to grow very slowly during the last 10 years except for rubber and other crops. The growth flattened out during 1999-2001 and declined during 2001-2002. The decline in the growth of crop production during 2001-2002 coincided with the period when Cambodia was hit hard by drought and flood.

For crop production, paddy rice is dominant. It accounted for more than 50% of crop production GVA in the last 10 years. In fact, the share of paddy rice in the sub-sector had declined over time. The share of paddy rice in the agricultural GDP may remain stable or decline as long as world market prices for rice continue to decline.⁷ Effective distribution networks could facilitate the flow of rice to deficit regions of the nation. This would allow farmers to have fewer food security concerns. According to the Ministry of Economy and Finance's latest assessment, the share of paddy rice in the agricultural crop sub-sector in 2003 accounted for only 43% of value-added.

It is obvious that the Cambodian farming system is focused mainly on growing rice but with very limited irrigation. Rice takes most of the cultivated areas and investment. According to MAFF 2003 statistics, rice cultivated areas amounted to more than 2.0 million ha, while other crops, excluding rubber, were planted on

⁷ During the past five years, world market prices for rice have substantially decreased from \$1,200 to less than \$300 per ton. Major problem for agricultural commodities is the inelastic nature of their demands. While technologies advance, agricultural productivities move up and thus prices of agricultural commodities are pushed downward.

less than 0.5 million ha. Rice cultivated areas in the last 20 years has increased very rapidly and investment in the sector is huge.

Although, advancement in the rice sector has helped Cambodia achieve food security, it is not able to ensure better nutrition and to contribute to economic development and poverty reduction.

While rice takes the largest cultivated and harvested area (80%), its yield remains low (2.1 t/ha) compared with that of neighboring Thailand and Vietnam. Its output and market value determine its ability to meaningfully contribute to economic development and poverty alleviation effort in Cambodia. In economic terms, its per-unit-area gross value added is lower than that of many other cash crops such as soy beans, sugar cane, yellow maize, vegetables and tobacco. This suggests that investing further in rice production will not be fruitful.

If poverty is to be reduced in the rural, agrarian-based population, and potential agricultural growth and economic development are to be achieved, one of the strategies in the agricultural sector could be to diversify away from paddy rice production. Agricultural planning should be more flexible and more aware of world market dynamics.

Table 2: Crop production situation and GVA, 2003

	Cultivated	Harvested	Yield,	GVA/ha,
Maize	80,215	67,213	2.8	178.5
Cassava	14,239	13,590	10.5	147.2
Mung bean	29,431	27,108	0.6	221.3
Peanuts	11,913	11,271	0.8	177.4
Soybeans	31,997	28,687	0.9	348.6
Sugar cane	7,854	7,727	21.9	388.2
Sesame	20,158	17,444	0.5	229.3
Yellow Maize	55,147	46,235	3.4	255.7
Tobacco	8,554	8,540	0.5	387.0
Sweet Potatoes	7,225	7,055	3.7	
Vegetables	35,311	34,569	5.3	4,873.8
Jute	203	198	1.2	
Rice	2,240,917	1,980,295	2.1	231.8
% Rice	88.1%	88.0%		
Non-rice	302,247.0	269637.0	3.5	

Source: Agri-Business Institute Cambodia (ABiC) and Supreme National Economic Council (SNEC), 2004

Assuming that just only enough land is allocated for rice production to meet food security purpose for some 13.5 million Cambodians, a large area of land used for paddy rice production could be released for high value cash crops such as soy beans, yellow maize, sesame, sugar cane and vegetables. If such a strategy is pursued, at least 673,000 ha of paddy land could be redirected into high value cash crops with some investment in land alteration.

Like rice, productivity of all other crops remains low in Cambodia compared with that of the neighboring countries such as Thailand and Vietnam. The yields of these non-rice crops are low because their production is mostly under rain fed conditions.

Table 3: Possible land area to be released from rice

Description	Unit	Quantity
Paddy rice yield	kg/ha	2,100
Post-harvest loss and seed reserves for production	%	17
Paddy rice converted to milled rice	%	62
Milled rice available for consumption	kg/ha	1,302
Food requirement	kg/person	151
Number of persons supported on per hectare basis	person/ha	8.6
Total Cambodian population	Million	13.5
Total harvested area under rice needed	Ha	1,567,742
Total rice area harvested in 2003	Ha	2,240,917
Total land area harvested under rice to be released for other crops/agricultural diversification	Ha	673,175

The dependence of crop production on weather conditions make it very vulnerable. Overall the growth of this sector is very slow and highly variable. In the period 2001-2002 the global growth of this sector was negative, reflecting the impact of flooding. Under rain-fed conditions, crop production is precarious. All crops reported in MAFF statistics in the last ten years experienced negative growth. Many of them were affected by drought and flood rather than fluctuations in market prices and demand.

LIVESTOCK SECTOR

Livestock production, albeit small in scale, is one of the important traditional sectors of Cambodia. Raising livestock, especially cattle, buffaloes, ducks and chickens, are very common among Cambodian farmers for traction power and as a means of saving. Livestock production contributed nearly 20% to the agricultural GDP between 1993 and 2002. It retained a constant share over the period, and generated, 779,000 million riels in 2000 constant prices. Similar to the crop sector, the livestock sector had very slow growth and experienced decline and stagnation for a number of years. In the period of 1993-1994 and 1999-2000, the sector growth was very much negative. Highest year-by-year growth was 11.6% (2000-2001), and lowest year-by-year growth was -9.4% (1999-2000). However, potential for this sector's growth is large.

According to the MEF, livestock production achieved 28% growth in 2003. But, the avian flu outbreak has raged across Asia, especially Hong Kong, China, Taiwan, Singapore, Thailand, Vietnam and will strongly affect the development of Cambodia's livestock sector. The poultry industry has been badly affected by the epidemic. Many small and medium size poultry producers and collateral businesses have been pushed nearly out of the industry. Large-scale poultry industries are struggling to survive.

One of the major constraints that hamper livestock sector development, specifically large ruminant production, from achieving its potential growth is the dearth of modern animal production and processing techniques and high-yielding breeds as well as veterinary services. Another constraint facing the livestock sector in Cambodia is the lack of water during the dry season. Despite these difficulties, Cambodia has been able to export live cattle to Thailand, Vietnam and Malaysia – rarely are processed animal products exported. An estimate shows that Cambodian live cattle exports in 2002 were at least in the range of 80,000-150,000 head⁸.

The flow of cattle from Cambodia to international/regional markets truly reflects Cambodia's comparative advantage and competitiveness in production of large ruminants. Cambodia still has natural grassland in abundance for livestock production. Following very traditional ways of livestock rearing, Cambodia's animal products could be labeled organic should an accredited

⁸ McNaughton, A. Upubl. data, Mar. 2004. Animal Production System (in Cambodia).

national organic certification system exist for this purpose, which could achieve a premium of 20-50% higher.

FISHERIES AND FORESTRY SECTOR

Fisheries and forestry sectors are among the hot spots that have caused a lot of concerns in terms of poor governance and human rights abuse. The sectors have been among the important sources of livelihoods for the rural populace of Cambodia⁹. They provide a lot of subsistence employment for farm households as well as the landless and unskilled population. Both sectors have been mismanaged and over-exploited. They are overstretched by the dearth of an appropriate legal framework, poor sector management, illegal and uncontrollable exploitation, and overpopulation.

During 1993-2001, year-by-year growth of the fisheries sector seemed robust, except for 1998-1999. It grew between 3.9% and 8.2%. The sector plunged in 1998-1999 (-1.6%), and grew marginally in 2001-2002 (1.3%). Over the period 1993-2002, the fisheries sector's GDP averaged some 1,436.3 billion riels per annum. Its average growth rate over the ten year periods was 3.4%.

The growth of the fisheries sector comes generally from natural fisheries, i.e. inland freshwater and marine, which might have reached the peak of nature's productive capacity. Aquaculture has also contributed to the fisheries sector's growth. It has seen tremendous growth in the last two decades. Although it has expanded dramatically from zero in 1980 to about 38,000 tons in 2000, its total share is still microscopic.

The fisheries sector has been managed as commercial concessions. This was introduced during the French colonial era and has been done through an annual bidding system. However small-scale family or subsistence fishing has been allowed for the rural population. While commercial fishing is banned during June-September for fish to lay eggs and hatch, the latter is allowed year-round.

⁹ Agri-Business Institute Cambodia (ABiC). Unpubl. data, Mar. 2004. Poverty and Social Impact Assessment of Planned Social Land Concession Program in Cambodia. Chan, S. and Acharya, S. Dec. 2002. Facing the Challenge of Rural Livelihoods: A Perspective from Nine Villages in Cambodia (pp. 52-53, pp. 109-112). Ahmed, M. et al. 1998. Socio-Economic Assessment of Freshwater Capture Fisheries of Cambodia (pp. 44).

The management and exploitation of commercial fishing lots and their domains and boundaries have been a controversial issue. Local fishing dependent communities have been poorly treated by the concessionaires and deprived of their traditional livelihoods. In 2000, with concerns over the fisheries management and local fishery-reliant communities' plight and pervasive poverty, the RGC initiated the fisheries reform program, which would: (i) reduce commercial fishing lots' areas in favor of local communities; and (ii) legally authorize local communities to set up and manage their own fisheries communities while traditional small-scale family fishing activities are allowed to continue. Until now, the commercial fishing lots' areas have been reduced by more than 56%, which has released a large chunk of fishing areas to the local communities.

Among the agriculture sub-sectors, the performance of the forestry sector has been a disappointment. Eight years out of ten (1993-2002) the forestry sector experienced the worse negative growth rate. The impressive performance was observed only during 1993-1994 and 1996-1997. During these two observed periods the sector grew at 95.7% and 52.3%, respectively. Annually, it generated 540.5 billion riels between 1993 and 2002.

Table 4: Agriculture sub-sector growth (constant 2000 prices)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Crops	2.6%	11.3%	3.1%	-1.5%	8.6%	15.1%	3.0%	0.5%	-5.8%
Livestock & Poultry	-3.1%	8.2%	1.5%	-0.5%	6.3%	-1.2%	-9.4%	11.6%	1.2%
Fisheries	4.1%	8.2%	4.6%	5.6%	3.9%	-1.6%	5.9%	6.8%	1.3%
Forestry & Logging	95.7%	-26.7%	-15.7%	52.3%	1.8%	-13.8%	-25.6%	-18.9%	-9.3%

Source: *Ministry of Planning, 2003*

Similar to fisheries sector management, the concession system was introduced for the exploitation of forest products as a model of sustainable forest resources management. Forest concession is a new form of forest management externally introduced to Cambodia. In addition to forest concession areas, there is another form of forest management in Cambodia, which is applied to, but not limited to, national parks, protected landscape, wildlife sanctuaries and biodiversity protected areas¹⁰. The concession system seems to have created

¹⁰ Cambodia was the very first country in South-East Asia that took the initiative and effort to establish a national park in 1925. By that time 10,800 hectares of forest surrounding Angkor

a lot of problems since its introduction. Its ability to provide a model for sustainable management of Cambodia's forests is questionable.

With unspeakable frustration at the performance of the forest concessions and the forest sector *per se*, the RGC is committed to this sector's reform, which should (i) ensure the best sustainable forest management practices, and (ii) allow for community forestry. To ensure the former and as part of improved forest concession management, the concessionaires have been required to prepare social and environmental impact assessment reports (SEIA), five year management plans, and annual cutting plans, which would have to be submitted for reviews, appraisals, and approvals. Through this process, the forest concession areas have been reduced from 4.2 million ha in 2002 to 2.4 million ha in late 2004¹¹.

For the latter approach, a sub-decree on Community Forestry was materialized and pilot programs of community forests have been implemented. At least two community forests are officially recognized by the Forest Administration. According the latest estimate by GTZ (2002), some 80,000 ha, which were degraded and/or poorly stocked forest, were under community forestry¹². The success of the community forest pilot programs will provide the RGC with a new tool for forest management in Cambodia.

AGRICULTURAL SECTOR INVESTMENT

Government Investment

The significance of the role of agriculture in economic development and poverty alleviation cannot be underestimated in contemporary Cambodia. Agriculture, among other sectors, is the central focus of the RGC's development

temple complex was declared a protected landscape/area. In 1969 the country established an additional six national parks and wildlife sanctuaries covering around 2.2 million hectares or about 12 percent of the country's total land area. In 1993, after the first general elections, His Majesty King Norodom Sihanouk issued a Royal Decree or Preah Reach Kret designating 23 areas covering 3.3 million hectares protected. In 2002 a few more, specifically wildlife sanctuaries were created under a new RGC's sub-decree. Currently, more than 20% of Cambodia's territory is put under protected areas.

¹¹ Agri-Business Institute Cambodia (ABiC). Unpubl. data, Oct. 2004. Land Allocation for Social and Economic Development: Possible Regional Priorities. Srey, C. Unpubl. data, Mar. 2002. Review of Agriculture and Environmental Issues in Cambodia. McKenney, B. and Tola, P. Jul. 2004 (pp. 85).

¹² World Bank. Unpubl. data, Oct. 2004. Cambodia Rural Sector Strategy Note: Towards a Rural Sector Strategy (pp. 24).

strategies, policies and plans such as the National Program for Rehabilitation and Reconstruction of Cambodia, the Socio-Economic Development Plan, and the National Poverty Reduction Strategy. In its latest strategy – Rectangular Strategy for Growth, Employment, Equity and Efficiency – the RGC renews its focus on the agricultural sector as a means for economic development and the fight against poverty. All applicable papers are well versed in the development of the sector. But, visions, goals, objectives and strategic measures cannot be achieved unless resources are adequate.

Table 5: Budgetary expenditures by ministry/sector 1992 – 2002
(in billions of riels)

Ministry	1995	2000	2002
Council of Ministers	38.1	85.0	82.4
National Defense	301.7	308.6	264.6
Interior	191.7	142.2	173.7
Agriculture	36.8	23.4	39.6
Water Resources and Metrology	...	6.2	11.9
(In percent of total budgetary expenditure)			
National Defense	25.1	20.0	13.8
Interior	15.9	9.2	9.0
Agriculture	3.1	1.5	2.1

Source: Ministry of Economy and Finance, 2004.

* Commitment basis.

In the last eight years the RGC's goals and expenditures for the agricultural sector went into opposite directions. The spending for the sector was only 1.5% of the total spending during 1995 and 2002. In 2002 the budget for the sector was slightly increased to 2.1% of the total budget, regardless of its significant share in the GDP and roles in rural employment and poverty reduction. In monetary terms, the spending on agriculture was only 39.6 billion riels. But if expenditure on water resources and meteorology is added, the agriculture sector related spending in 2002 amounted to 51.5 billion riels. This amount is much lower than that of spending by the Council of Ministers, National Defense and Ministry of Interior. In the period of 1995-2002, the average spending on the sector, including water resources, was only 36.0 billion

riels per annum, while real, budgetary needs for the sector could amount to more than 400.0 billion riels.

During 2004-2007, the budget allocated for the agriculture sector is again the smallest among the priority sectors. The allocation for this sector is one third or less than the education and health sector. Of all the sectors, defense and security has received and continues to receive the highest amount of the budget. The agriculture sector's budget will be increased from 69.91 billion riels in 2002 to 146.66 billion riels in 2007. This allocation is less than 1% of the GDP. Compared with the defense and security sector, the agriculture sector received 481.82% less in 2002 of the allocated budget. Until 2007, even after the allocation is increased, the agricultural sector continues to receive significantly less than the defense and security sector by 239.27%. The budget allocated to the defense and security sector continues to increase and to take the largest share in the national budget. Overall, the agricultural sector is seriously underinvested by the public sector.

Donors' Investment

The RGC's lack of spending on development activities has been compensated by more than 40% by overseas development assistance, including donors and the NGO sector. Donor agencies have committed and disbursed roughly US\$500 million every year since 1993. Between 1993 and 2009, some US\$883.23 million¹³ is earmarked for agriculture-related projects. On average, donors' investment in agriculture is US\$52 million per year, which is slightly higher than the RGC's spending for the sector *per se*.

For the period 1997-2009 and 2004-2009, the donor community has financed 54 and is planning 21 agriculture related programs, respectively. The total amount of funding for the ongoing projects is US\$82.1 million. Of this amount 42 % has been allocated for and spent on programs that have nationwide impact such as policy formulation, research, institutional strengthening and capacity building.

¹³ Srey, C. Unpubl. data, Nov. 2004. Agriculture Sector in Cambodia: A Brief Analysis.

NGO Investment

After being forced out of the country on the triumphant arrival of the Khmer Rouge (KR) in 1975 a few International NGOs (INGOs) restarted their operations in the early 1980s when the KR was already ousted. With the arrival of the United Nations Transitional Authority tasked to organize Cambodia's first general elections in 1993, many international NGOs began to move into the country and local NGOs (LNGOs) started to mushroom. These organizations have become an important channel of humanitarian, social and economic development aid.

During 1998-2002, the NGO sector invested and disbursed US\$398.742 million (Table 6). On average, they disbursed US\$79.75 million per year during this period. Although the investment and disbursement by the NGO sector seems impressive, the investment share for agriculture development is extremely small (4.3%) compared with other sectors. During this period the spending by the NGO sector on agriculture averaged roughly US\$0.53 million¹⁴.

Table 6: NGOs' disbursement by sector and year, in Million US\$ (1998-2002)

Sector	Total	Average	In percent of total
Agriculture, forestry and fisheries	15,8	5,3	4.0
Area/rural development	83,4	27,8	20.9
Communications	0.18	0.06	0.04
Health development	143.3	47.8	35.9
Human resources development/education	48.5	1.6	12.2
Natural resources and environment	1.0	0.3	0.3
Social development	67.0	22.3	16.8
Transport	.03	0.01	0.01
Human rights	12.9	4.3	3.2
De-mining	18.8	6.3	4.7
Media	1.1	.4	0.3
Development administration and others	6.8	2.3	1.7
Total	398.7	132.9	100.0

Source: Agri-Business Institute Cambodia, 2004

¹⁴ Srey, C. Unpubl. data, Nov. 2004. Agriculture Sector in Cambodia: A Brief Analysis.

Private Sector's Investment

The investment in the agricultural sector by the public sector (RGC, donor agencies, and NGOs) is extremely small. Given its ability to mobilize revenue, the RGC is not capable of attaining its pro-poor economic development as fast as it may have wished. Unless the private sector is engaged, economic development will stagnate.

The RGC has done its best to attract private investments but has been less than successful. Direct foreign investment is limited and declining. In addition, very few private sector investment projects have been found in the agricultural sector. In 2002, for example, only 83 of 910 private sector investment projects were in agri-business related activities and only 8 out of the 83 had been actually operational by 2003, with total fixed assets of US\$80 million¹⁵.

CONCLUSIONS AND RECOMMENDATIONS

Cambodian agriculture has performed very poorly. It has not been able to achieve its potential. Its growth averages just 2.4% in the past ten years. In 2002 it generated only 5.3 trillion riels. About 75% of the Cambodian population lives on agriculture. But each gets only 1,440 riels (US\$0.36) per day, which falls slightly (14%) below the national poverty line of 2,000 Riels (US\$0.5). This suggests that Cambodian farmers are likely to be very poor. The agricultural population of rural Cambodia will be able to move out of poverty only if the agriculture sector's productivity can be doubled or tripled; otherwise further employments must be generated quickly in non-agricultural sectors. Meanwhile, the sector is challenged by Cambodia's WTO membership.

Agriculture's productivity could be doubled and/or tripled to its potential, which would allow its economic growth to catch up with the population growth. But such a potential has not been achieved. The sector has been dependent almost entirely on monoculture, most often single cropping of rice, which has

seen the decline in prices and is faced with harsh competition with technologically and resourcefully advanced rice producers in Thailand and Vietnam. Although the main focus is on rice, very limited or no attention is given to post-harvest handling and marketing.

The weather dependent nature of Cambodia's agriculture makes it vulnerable to natural hazards. As a result, Cambodia's agricultural produce is seasonal and fluctuating.

Although water is important for the sector and is believed to be abundant in the country, water management, use and control is unfortunately regrettable. With limited capabilities in water management and control, vast tracts of land are left idle during the dry season. Rice has the largest irrigated area but it consists of only 30% of the total rice cultivated area.

While the overwhelming majority of Cambodians depend on agriculture, some 15% of them (or about 0.41 million households) is landless. A lot of land is still available and remains idle, but is concentrated in the hands of a handful of powerful and rich people as well as land concessionaire speculators.

The livestock sector remains stagnant with the potential of large, ruminant production left unexploited. A dearth of veterinary services and appropriate research contributes to the stagnating and slow development of this sector.

The natural fisheries sector has performed nearly to its maximum productive capacity. Further growth of this sector is not likely due to more threats from volatile natural conditions, loss of freshwater and coastal mangroves and changing water conditions due to upstream damming on the Mekong and tributaries and irrigation. Also there is improper management of commercial fishing concessions/lots and over-fishing. Any growth in this sector will possibly be derived from aquaculture.

The forest sector has failed to deliver. The forest resource base has been degraded and has become extremely fragile because of inappropriate and irresponsible management of forest concessionaires and illegal extraction of timber. Local communities depending on non-timber forest products are deprived of their livelihoods and live in appalling conditions.

¹⁵ Ministry of Planning. 2003. Statistical Yearbook.

The agriculture sector could be viewed as an important sector for the nation's economy in terms of its share in the GDP and rural poverty alleviation.

The RGC's policies on and strategies for agricultural sector development and poverty alleviation are well known. However, it has been under-invested. The trend is likely to continue in the next four years. In order to boost its development and to enable it to help in reducing rural poverty, the following measures should be considered: (i) triple the budget allocation and spending for the sector; (ii) promote diversification into high value agricultural products; (iii) rehabilitate and construct small and medium scale irrigation schemes; (iv) accelerate land reform and de-mining programs; (v) accelerate fisheries and forestry reform programs; (vi) improve agri-services, particularly, agricultural extension, veterinary services, agricultural marketing and agricultural credits; (vii) promote and facilitate farmers' organizations; and (viii) promote private sector investments in agro-industries and integration of small farmers into the value chain through fair contract farming.

THE GARMENT INDUSTRY IN CAMBODIA: CURRENT & LONG TERM PROSPECTS

Keo, Chamroeun* *and* Seng, Savuth**

GENERAL BACKGROUND

Since the mid 1980s, Cambodia has extended formal recognition to the private sector. Steps have been undertaken to promote an economy increasingly reliant on market forces. Then in the early 1990s, Cambodia achieved some peace for the first time in two decades of conflicts and international embargo. But due to post war population growth, the development challenge was immense. At this critical stage, the Cambodian government converted its economic system virtually from the centrally planned economy to a market economy. At the same time, the international community officially recognized the elected government.

As a result of these changes, tremendous foreign aid and foreign direct investment flew into the country to help rehabilitation and reconstruction. Normalization returned and capital and business readily circulated and operated across the country. For example, Cambodia's accumulated foreign direct investment (FDI) increased significantly between 1995 and 1999, reaching about USD 1.2¹ billion by the end of 1999. Garment factories and hotels represent about half of that. However, this momentum seemed to halt in 2000. The FDI was closely tied to Cambodia's ability to obtain a share of the protected U.S and EU garment and textile markets². See the selected main economic indicators in table below.

Main economic indicators at a glance: GDP per capita experienced a range from 252 to 306 USD over a period of 1995 to 2003. The export of goods as percentage share of GDP steadily increased over the years. At the same time,

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¹ CAMBODIA ECONOMIC WATCH, EIC, Issue 1, 2nd Edition, October 2004 p18

² Cambodia seizing the Global opportunity: Investment Climate and Reform Strategy, WB group, August 2004, p3

however, the import of goods as percentage share of GDP remarkably increased because raw materials are not internally available, thus negative trade balance. In addition, population grew over these years, raising concerns regarding job opportunities for those who are ready to enter the job market. There are about 200,000-250,000³ Cambodians who enter the job market each year. The garment sector absorbed most of these newly arrived laborers, particularly young girls from the rural communities. If this sector is no longer a source of employment and/or lay off their existing employees, then the employment situation in Cambodia will get much worse.

Table1: Main Economic Indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003
GDP per Capita (US\$)	302	298	280	252	276	280	283	298	306
Export of Goods (% GDP)	30.3	21.5	25.2	28.2	30.0	38.2	41.7	41.2	47.6
Import of Goods (% GDP)	33.0	34.9	34.0	41.7	43.3	48.7	53.3	54.7	59.5
Population (million)	11.1	11.5	11.8	12.1	12.5	12.8	13.1	13.4	13.8
Labor force (% population)	41.2	41.4	41.6	41.9	42.2	42.5	43.0	43.4	43.9

Source: extracted from EIC, compiled from government and international organization primary data

DEVELOPMENT OF GARMENT INDUSTRY

The rapid growth in the garment industry in Cambodia can be explained by internal and external factors:

Internal Factors

It appears that Cambodia has several things to attract foreign investments to the garment sector. First of all, Cambodia has cheap labor because rural people dominate the population of this country, and every year, at least 200,000-250,000 people seek new jobs. Most of these new labor forces are unskilled labor and young unmarried girls from the rural communities. Secondly, the investment incentives provided by the government to foreign investors are attractive. Thirdly, Cambodia has more favorable trading terms with the world's most lucrative markets.

³ Cambodia seizing the Global opportunity: Investment Climate and Reform Strategy, WB group, August 2004, p3

External factors

The most significant reason that contributed to the rapid growth in the garment industry in Cambodia was a reestablishment of a special relationship between the U.S and Cambodia. On January 2, 1992 the U.S. lifted the embargo on trade with Cambodia. A few years later, normal trade relations (NTR) were established between the U.S. and Cambodia in October 1996 upon signing a comprehensive Agreement on Trade Relations and Intellectual Property Rights Protection.

Cambodia was then designated as a Least Developed Beneficiary Developing Country under the U.S Generalized System of Preferences (GSP) program on May 30, 1997⁴. The Generalized System of Preferences allows limited exports of certain goods and commodities to enter the U.S. duty-free from most countries in the Global South. The U.S GSP program provides a petition process under which an organization can petition the U.S. government to investigate ("review") a country's treatment of workers to determine whether or not GSP benefits should be suspended for lack of progress in respecting worker rights⁵.

After a review process, Cambodia was accepted and signed with the U.S a three-year bilateral textile agreement on January 20, 1999 that set export limitations on 12 categories of textile and apparel products. The conditions were: first, overall trade normalization and second, a unique agreement on textile trade and labor policy reform. This agreement was to create new employment opportunities and improve living standards and working conditions for workers. Based on the requirements in the agreement, the International Labor Organization was invited to help implement an external program to monitor working conditions in the textile and apparel sector, based on internationally recognized core labor standards and with respect to Cambodian labor law.

After the agreement was implemented, the Royal Government of Cambodia implemented positive changes in its labor law and the working conditions of garment workers improved. Then the representatives of the Government of the United States of America and the Royal Government of

⁴ Internet, Country Commercial Guide FY2002: Ministry of Commerce, Cambodia

⁵ Internet, Worker Rights and U.S Trade Policy (<http://www.usleap.org/trade/tradetempnew.htm>)

Cambodia met in Phnom Penh on December 3 and 4, 2001. During these and subsequent consultations, they agreed to extend the bilateral Trade Agreement for another three-year period until December 31, 2004⁶. The question is what will happen when this vital agreement expires? This question will be further elaborated in the following section. Then, what is about the EU? Follow the explanation below to understand the EU agreement with the Cambodian government.

EC-Cambodia Trade in Textiles Agreement⁷

Besides having a textile agreement with U.S government, Cambodia has also signed a trade in textiles agreement with EC as well. This agreement entered into force on 1 July 1999 and expired at the end of 2002 and formalized the principle of unlimited access to the EU's Single Market for all Cambodian textile products. Close administrative co-operation between the European Commission and Cambodia's Ministry of Commerce has helped eliminate the fraudulent exploitation of this advantage by third countries.

The privilege of unlimited access has been supplemented by a liberalization of the conditions of access to the EU's GSP scheme, which grants an exemption from customs duties to Cambodian exports entering the EU market. A first measure of liberalization is the indefinite granting, since 1 September 1999, of the benefit of "regional cumulating" to Cambodia whereby unfinished textile products imported by Cambodia from another ASEAN country are considered of Cambodian origin, allowing Cambodia to more easily satisfy the GSP Rules of Origin.

Finally, an additional measure of liberalization is the renewal of a temporary exemption of the strict application of GSP Preferential Rules of Origin for intermediate textile products coming from a number of developing countries including Cambodia. This derogation is effective for limited volumes until the end of 2004, after which the normal rules will apply.

Factories and owners

Information regarding the number of garment factories in Cambodia differs from one source to another. Nonetheless, the figure is about 200

⁶ Internet, Trade Compliance Center: Cambodia Bilateral Textile Agreement

⁷ Internet, European Commission's Delegation to the Kingdom of Cambodia, and EC-Cambodia Trade in Textiles Agreement.

factories. Foreigners own most factories from Hong Kong, Taiwan, China, Singapore, South Korea, The U.S, as well as some Cambodians⁸ Most of these companies have their head offices in their native countries. All decisions regarding financing, sales, marketing, and purchasing are made overseas. It would be very useful for future studies to analyze the total garment profit picture; how much remain in Cambodia, and how much the profits are when those factories are owned by Cambodians?

Employment

In terms of job creation, the garment sector plays a vital role in employing low skill labor and young, unmarried girls who come from rural communities. According to the National Institute of Statistics, about 64⁹ percent of workers in the manufacturing sector are employed by the garment sector. Now, the number of garment workers in Cambodia is around 230,000 – 240,000 including those who have already lost their jobs (8,800¹⁰ workers) when the two garment factories closed down in early November 2004.

New concerns are as follows. Seventy of the 290¹¹ garment factories registered in Cambodia in 1996 have since closed after the end of the quota system, leaving 47,670¹² garment workers nationwide unemployed. However, Mr. Huot Chanty, Director of the Labor Inspection Department at the Ministry of Labor said he could not provide the official estimate of jobs lost on the same date.

Based on current trends, it appears that the garment sector is no longer a source of jobs anymore from year 2005 onward. In the worst case scenario, those 230,000-240,000 workers would gradually lose their jobs year by year if effective action from the Cambodian government and other related stakeholders is not taken.

⁸ Cambodia seizing the Global opportunity: Investment Climate and Reform Strategy, WB group, August 2004, p37

⁹ Cambodia Development Resource Institute, Volume 5 issue 3, July-September 2001

¹⁰ Cambodia Daily, Volume 30 issue 40, Wednesday, November 10, 2004

¹¹ H.E Cham Prasidh, Minister of Commerce, said Sunday and released in Cambodia Daily on 14 March 2005

¹² Mr. Chuon Mon Thul, President of the Cambodian Union Federation said Sunday “They are jobless because of no quota and no buyers and Strikes are not cause” released in Cambodia Daily on 14 March 2005

Contribution of garment industry in economic development

It is obvious that the garment sector plays a key role in the economic development of the country in different ways. Constant growth in the garment industry would help to attract foreign direct investment though this trend seems not sustainable. Of the total FDI in Cambodia, the garment sector took half. Moreover, this sector created more job opportunities for young Cambodian girls. In terms of exports, the garment sector took the bulk, 76% of the total country's exports.

The table 2 shows that the majority of garment products are sold in U.S. markets. It represents about 73% of total garment products. While the European Union markets absorbed about 23% and the remaining of 4% is sold in other markets. It is also projected that in year 2005 the growth will be negative.

Table 2: Markets of Garment Products

Garment	2001	2002	2003	2004p	2005p
Million Dozen					
US	22.2	25.8	28.4	34.0	32.3
EU	6.8	7.5	9.0	13.0	13.7
Others	0.4	0.6	1.5	2.4	2.6
Total	29.4	33.9	38.9	49.4	48.5
% increase	31.0	15.3	14.7	27.1	-1.9
Million US\$					
US	829	954	1,121	1,295	1,190
EU	309	356	407	561	589
Others	18	28	79	145	156
Total	1,156	1,338	1,607	2,001	1,935
% increase	17.2	15.8	20.1	24.5	-3.3

Source: Ministry of Commerce for 2001-2003, EIC Estimates for 2004-2005, based on the first 8 months trends in 2004 and export opinions

By and large, the garment industry is really the key engine for development of the Cambodian economy now. However, this will not be true in

the future particularly after the year 2005. This is because the prospects for the garment industry in Cambodia are bleak. In the worse case scenario if garment sector fails, economic and social problems may rise simultaneously.

LONG-TERM PROSPECTS

Different people with different interests and expertise may disagree about the prospects; nonetheless, the facts as presented below may provide better understanding in this regard. The expectation of growth in this sector seems uncertain in the long-term. Cambodia's garment industry is solely oriented for exports. In the past several years, this sector grew very fast and it has had great impact on economic and social developments in the country. However, this trend will be reversed after the U.S quota system expired on December 31, 2004.

This means that Cambodian garment products must compete in world markets. So the basic questions are, "Is it possible for Cambodia at this stage to fulfill the standard requirements from the world markets?" Within a competitive world "Is Cambodia ready and qualified enough to fight now?" The answers to these questions are very obscure because the sustainability of the garment industry depends on the commitments and capability of Cambodian government and its people. The long-term prospects of the garment industry in Cambodia depend on future developments.

First, the internal factor

The analysis of the prospects of garment industry in Cambodia centers on internal factors rather than the external ones. Based on the results of interviews with key informants and reviews of the literature there were many problems discovered and they pointed out that if Cambodia effectively solves those problems within a specific timeframe, then Cambodia can compete in the world marketplace. Problems discovered were corruption, crime and disorder, anti-competitive or informal practices, regulatory policy uncertainty, legal system and conflict resolution problems, customs and trade regulations, tax administration, tax rates, macroeconomic instability, and business licensing, operation permits (these extracted from WB study), and the capabilities of both government officials and its citizens.

To eliminate these obstacles requires effective government reform. However, the question is: can reform work within such a specific timeframe? It appears that the government and international financial institutes have put their thoughts and efforts into this critical issue. Nevertheless, who knows whether it will work or not? The following is a quote concerning findings about the abovementioned obstacles.

“The rampant corruption has paralyzed private business and is hampering economic growth in Cambodia. Four-fifths of 800 companies surveyed across Cambodia acknowledged the necessity of paying bribes in order to do business. The unofficial payments cost the firms an average of 5.2 percent of total sales revenue, more than twice the amount in Bangladesh, Pakistan and China”¹³.

Besides this, Cambodia’s labor force has increased every year since the mid-1990s. According to figures in the 1998 census, it is estimated that 230,000 young people per year will enter labor market during early 2000s. However, the number of jobs yearly created for supporting the labor force will not exceed 30,000 per year especially if the quota to the US-Cambodia Textile and Garment Agreement ends. If so, the amount of new the jobs will be even lower. This raises the concern that youth unemployment will have a massive social implication¹⁴.

Second, the external factors

It is important to look at things from different angles. Focusing on the external factors such as the US market and its quota system, the EU market and its GSP schemes, the roles and potential benefits of WTO regarding the garment sector and other competitors (i.e. Vietnam, China, India, ...etc) is important. Each of these items will be discussed one by one in more detail in the following sections.

The U.S quota system

The Multi-Fiber Agreement (MFA) implemented in 1975, assigns quotas as a means to limit textile imports to America, but with the establishment of the World Trade Organization (WTO) in 1995, the MFA became the Agreement on

¹³ United Press International, World Bank slams Cambodia’s corruption, August 12, 2004 (washingtontimes.com/upi-breaking/20040812-043359-1069r.htm)

¹⁴ Long term prospects of the Cambodian Economy, A quantitative Assessment of the WTO Membership, EIC, January-March 2004, p1

Textiles and Clothing (ATC), a binding commitment for all WTO member countries to phase out all garment quotas by 2005. When a country has joined the WTO, any bilateral textile agreement becomes invalid, along with labor or other “non-trade” provisions. Mainly because of this reason, the quota system that the U.S government offered the Royal Government of Cambodia had to expire on December 31, 2004. What it really means is that any bilateral textile agreement becomes invalid, not only the US quota system but also agreements with the EU and Canada.

The renewal of this quota system from the U.S and others is not possible because it is against the WTO agreement on the trade and clothing provision. The quota system is attractive to foreign investors because it offers a clear market destination and profitable business. For example, in 2000 the selling price of garment products under the quota system is 4.55 USD per unit and 2.90¹⁵ USD per unit for garment products not under the quota system. It is clearly shown that about 73% of Cambodian's garment products were sold in the U.S and this indicates that Cambodia depends almost solely on U.S markets.

It is critical to understand that even though the quota system has expired, it does not mean that Cambodian garment product is not allowed to export into the US markets anymore. This means that from 2005, Cambodian garment products can be exported to U.S markets but with competition. The question is "Will the factory owners continue to invest more in Cambodia after year 2005?" The answer to this question depends partly on the capability of government to curtail those internal problems. It is extremely hard for the Cambodian government to maintain the level of interest of the factory owners, most of whom are foreigners, after the quota system expires.

The EU market and its GSP schemes

Besides the U.S markets, Cambodian garment products depend on the EU markets as well, though it is a smaller portion compared to the U.S markets. About 23 percent of Cambodian garment products are sold to the EU. The question is whether Cambodia is able to maintain this market shares or not? The point is that the bilateral textile agreement between the EU and Royal Government of Cambodia also expired at the same time as the U.S quota

¹⁵Total Quantity of Cloths and Revenue from United States in 2000-2001 (US\$)

system. The same questions are raised and the same principles are applied all over the world because of the WTO policy.

It is important to be aware that garment products are not only made in Cambodia. Many countries all over the world, particularly many countries in the region are making the same products as Cambodia such as Vietnam, China, India, Pakistan, Bangladesh, and so on. There is a need to understand these countries and it is most important to understand the garment industries of these countries as they have a longer history in the garment industry, while Cambodia is new. Cambodia now resides in a great and competitive region¹⁶ and world, and without analyzing its surrounding environment, it will live and stand on very difficult ground. The potential implications of these countries on the Cambodian garment industry are explained below.

In this section, the focus is on Vietnam because this country has closer linkages. It appears that Vietnam is a critical competitor to the Cambodian garment industry. Vietnam has the climate for investment and better governance. Its labor force is more productive and cheaper. If Vietnam becomes a full member of WTO in the near future, then they can attract even more foreign investors to their country.

The end of the quota system not only affects the Cambodian garment industry but also many other countries all over the world. Many of those countries that used to get favorable treatment must now compete within the world garment markets. This means that garment products in the world are getting more competitive. The same is true for Cambodia, since the majority of factory owners and/or investors in Cambodia are foreigners and many of them have the same industry in their native countries.

World Trade Organization (WTO)

Now what is about WTO? How does WTO relate? What Cambodia benefits from being a member of WTO? There are some important things that we need to understand about the WTO. First, it is clear that the WTO cannot

¹⁶ Internet: World Economic Forum Releases its competitiveness score, Result of the 2003-2004 Overall Competitiveness Rankings for Asian Countries follow: Competitiveness ranking in 2002-2003, Taiwan 6 and 5, Singapore 7 and 6, Japan 16 and 11, South Korea 25 and 18, Hong Kong 22 and 24, Malaysia 30 and 29, Thailand 37 and 32, China 38 and 44, Vietnam 63 and 60, and Indonesia 69 and 72. Note that a country scoring low is highly competitive (http://www.business-in-asia.com/country_ranking.html).

help solve all problems of the garment industry in Cambodia. They cannot ask the buyers to continue buying Cambodian garment products, cannot stop the factory owners from closing down their factories and move to other countries, and cannot help find markets for Cambodia unless Cambodia sells its products competitively in the world market.

Second, it is good for Cambodia to be a member of WTO because then Cambodia can have the right to export its products to the markets of those countries that are members of the WTO, and not just limited to garment products, if they agree to buy other Cambodian products. For example, this means simply that you have the right to sell your chickens in the market because you bought a place and paid the market fee (being a member of WTO), but it does not mean that your chickens will be easily sold to buyers unless you have selling skills, promotion skills, good quality chickens, and so on. Otherwise, your chickens will stay in the shop forever. Finally, other important roles of the WTO are to ensure institutional reform and to set up a climate conducive to investment.

Options for Diversification

It is very clear from the above discussion that Cambodia needs to diversify its economy. Cambodia diversifies into other sectors such as the agricultural sector and small and medium enterprises rather than overwhelmingly depend on the garment sector. The World Bank has urged the Cambodian government to focus on improving sluggish productivity, diversifying the country's narrow economic base beyond the garment sector and improving water, electricity and transport services. So there are opportunities for Cambodia to improve and develop its own economy. The question is how and when will this happen?

The views of key informants

The director¹⁷ of the Economic Institute of Cambodia said that the long-term prospects of the garment industry in Cambodia are not clear. However, he said that the garment industry is no longer the main source of growth for the Cambodian economy. He added that there is no problem in 2005, but beyond 2005, the number of garment workers will gradually decline if government does

¹⁷ Interviewed by ADI-CCC group on November 10, 2004 at EIC office

not take corrective action to deal with the current problems. He estimated that about 10,000 workers would lose their jobs in 2005. Between 2006 and 2007, another 30,000 workers would lose their jobs and in 2010 another 50,000 jobs more would be gone. He pointed out the government needs to tackle corruption in providing support to the garment industry to make it more competitive.

The program manager¹⁸ of the IFC said there is no clear answer to the question about the prospects of the garment industry in Cambodia. There are several factors. However, the immediate and even long-term outlook needs not be that bleak.

He acknowledged that workers would lose their jobs with the end of the favorable US quotas. However, the prospects point to various scenarios. The first scenario is that there will be a slow decline but no mass exits. The second scenario is that the reform process under way will enable the garment industry to be competitive even without the favorable US quotas. This would allow the industry to maintain current production and job levels but with no further growth. The third scenario necessitates that reform will take place. This involves maintaining the strategy of linking labor and trade, strengthening the supply chain, and backward linkages. This would also involve the consolidation of smaller enterprises into larger ones. He added that Cambodia needs to diversify its industry and SME is indeed an important area of focus.

CONCLUSIONS

Garment industry in Cambodia grew very fast in a short time. At the same time, it contributed significantly to economic development, creation of employment, and poverty reduction. However, this positive trend now faces critical challenges because the global policy and market environments are changing particularly with the end of the quota system.

How will Cambodia itself tackle this problem? We are likely to be more pessimistic of the garment industry in Cambodia but in our opinion we still have some opportunities too. First, ILO monitors indicate that working conditions in the garment sector have improved over the year. Even though the labor standard is still much lower than international standards, Cambodia's level of labor standards and practices is among highest in Asia as compared to Bangladesh,

¹⁸ Interviewed by ADI-CCC group on November 11, 2004 at IFC office

Thailand, China and Vietnam. Our Benchmark in the labor standard is 3.5,¹⁹ low compared to those countries. Second, the rights of workers to organize unions are perceived as relatively well protected. Thus, it may encourage some companies in U.S and EU countries to continue to order and buy garment products. Third, the Ministry of Commerce²⁰ may plan to cancel two document requirements, the Commercial Invoice and the Certificate of Processing. These two document requirements may possibly hinder not only the Garment Manufacturer Association in producing clothes but also hurt job possibilities of garment workers.

Beyond the garment sector in terms of export promotion, Cambodia also has organic and handicraft products. Recently, EU countries strongly encouraged other countries to produce organic agricultural products to export to their countries. Thus, Cambodian farmers should consider this option. So far, Confirel²¹ starts industrial and commercial stages, expecting to be in a leading position in local and export markets in the palm product industry. There are about 10 items of palm products which are exported to the EU and Japan. These products are highly rated by consumers in those countries. Lastly, Cambodia has traditional handicrafts without any competition. The products produced from the Angkor symbol (i.e. Apsara, Temple and so on) cannot be pirated by anyone but can be produced only by a Khmer Artisan.

Finally, policy makers, decision makers, research institutes, NGOs, and other stakeholders should discuss these issues and then take action to achieve results.

¹⁹ FIAS 2004 issued by Economic Review, Volume 1 No 6, October-December 2004, EIC

²⁰ Samdech Hun Sen, Prime Minister, ordered Ministry of Commerce to cancel two documentation requirements: The Commercial Invoice and the Certificate of Processing, Cambodia Daily on March 16, 2005

²¹ Conservation of a natural heritage Originality of a local product New chance of development Following artisan way of manufacture Initiative around a tree Right remuneration of all the actors Employment and training for farmers Link for multi sector exchanges

IS DOLLARIZATION GOOD FOR CAMBODIA?

Dr. Kang, Kiwon¹

INTRODUCTION

Cambodia, one of richest countries in 1960's, has now become one of poorest countries in Asia. During the period of turbulence over 30 years prior to 1998, multiple millions of Cambodians were killed by wars, diseases and starvation. Six years have passed since the coalition cabinet was formed in 1998. Now Cambodians have the opportunity to obtain their political security and prepare their economic prosperity once again.

For the sake of the development of the Cambodian economy, the Cambodian government should utilize all forms of economic policies such as monetary, fiscal, international trade policies and so on. But these policies are not fully available to Cambodia because of the dollarization phenomenon. Thus, the question is whether Cambodia should turn into a country using its own currency or should adopt the dollar as her own currency. It is the purpose of this paper to provide the Cambodian government with an answer to this question.

This paper will discuss the share of the dollar used in the circulation, costs and benefits of dollarization, de-dollarization methods, and finally, conclusion. The costs of dollarization include, seigniorage loss, loss of monetary policy, loss of foreign trade policies, and distortion of income distribution. In contrast, the benefits of dollarization include suppressing inflation and reducing the risk of national default in a period of foreign currency crisis.

THE SHARE OF THE DOLLAR USED IN CIRCULATION

The use of the dollar by foreigners in Cambodia started around 1988 under the tacit approval of Cambodian government.² Many foreigners came to

¹ Dr Kang, Kiwon wrote this paper when he worked for Cambodian government as an economic advisor for the Prime Minister from December 20th 2004 to February 20th 2005. The author is thankful for the help and kindness of members in the office especially H. E. Yim Nolla and H. E. Touch Seang Tana.

Cambodia and use of the dollar increased especially since 1993 when the elections took place under the auspices of the United Nations. In addition to the foreigners, Cambodians started to use dollars as a means of saving.

In 1992 the share of the net foreign assets in the sum of the net foreign assets and the domestic credits was a mere 8%. But the share jumped to 25% in 1993, 50% in 1994, soared to 74% in 2000, and reached to 77% in 2003. Now, in terms of the amount of transactions, the dollar, a foreign currency, has become a major currency in Cambodia while the riel, Cambodia's legal tender, has degraded to a supplementary currency that is mostly used in rural areas and among middle and lower class people of Cambodia.

How much is the dollar used as a currency in Cambodia? What is the share of foreign currencies in M2? If the share were assumed to be equal to the share of the net foreign assets in the sum of the net foreign assets and domestic credits, the answer of the above questions becomes simple.³ In 1992, the net foreign assets, or foreign currencies in circulation in the total currency (M2 was 124 million dollars) were only 10 million dollars, 8% of M2. But in 2003 the amount of foreign currencies increased up to 642 million dollars, 77% of M2.

This raises several questions. Is there any difficulty caused by the fact that the share of foreign currencies in the total currency is so high? Does the domination of the country's legal tender by a foreign currency in Cambodia cause problems for the Cambodian government? Should the government of Cambodia ban the use of the dollar as a currency in her territory? The answer to these questions may be obtained after costs and benefits of dollarization in Cambodia are weighed.

² These foreigners were mainly officers of international organizations and members of various kinds of non-government organizations, according to H. E. Touch Seang Tana, the secretary of state in the Prime Minister Office of Cambodia.

³ In general, due to the lack of data, the share of foreign currencies in M2 is assumed to be equal to the rate of the foreign currency deposit to M2. (This rate was 69.3% in 2002.) However, this rate is an underestimate because the amount of foreign currencies in circulation is excluded. In this context the rate is assumed to equal the share of the net foreign assets in the sum of the net foreign assets and domestic credits. (This share is 79.9% in 2002 and 77% in 2003). See "Dollarization of Cambodia," http://www.moc.gov.kh/intergrated_framework/-component_report_b3.htm.

COSTS AND BENEFITS OF DOLLARIZATION⁴

Costs

Seigniorage Loss

To use another currency as well as one's own necessarily means the loss of some part of seigniorage. In other words, by using a foreign currency, a country cannot print its own money in full scale and at the same time cannot escape restrictions in the execution of monetary, finance and fiscal policies as well as the execution of foreign economic policies through controlling exchange rates and the foreign exchange market. So, whenever a country allows the use of a foreign currency as its own, the country must accept the huge losses in its economic and social independence.

Seigniorage Loss 1

The direct loss from renouncing some portion of seigniorage is equal to the amount of the loss of being unable to print currency due to the allowance of a foreign currency to circulate, minus the expense required to print that quantity of money. For example, if the Cambodian government prints a 1,000 riel bill with a cost of 1 riel, then the seigniorage loss being unable to print that bill would be 999 riels.⁵ The seigniorage, as a privilege of all social and economical sovereignties, directly provides any country that has its own currency with social savings as large as the amount printed in its own currency. Any capitalist country can take advantage of this social savings for its own economic development.

Currently in Cambodia, people use the dollar for 70% or more of the total currency (M2) instead of using the riel.⁶ Strangely enough, by losing the opportunity of forming its own social savings, Cambodia helps the U.S.A. (as well as Thailand and Vietnam) to accumulate American (Thai and Vietnamese) social savings. How much does Cambodia lose in social savings? If the share of

⁴ See Jayant Menon (1998).

⁵ In this context, it is assumed that there is no printing cost that is known to be under 0.1% of the nominated value. See "Dollarization" <<http://wfhummel.cnchost.com/dollarization.html>>

⁶ Cambodians use the dollar as their currency all over the country along with baht near the Thai border and the dong at the Vietnamese border.

the foreign currency in M2 in 2004 was unchanged from 2003, or 76.9%, then the seigniorage loss reached up to US \$ 681.8 million at the end of 2004.⁷

Seigniorage Loss 2

There is another kind of loss caused by giving up seigniorage. Whenever any economy grows, the volume of circulating currency also grows. In this case, the government can print money without inflation as long as the amount of money supplied is no more than the amount required by the economic growth. However the dollarization phenomenon in Cambodia restricts the amount of money it may print. For example, if the Cambodian economy grows by 6 % annually,⁸ the volume of currency required also grows accordingly.⁹ If Cambodia were not a dollarized economy, US \$ 53.2 million could be printed by the Cambodian government without inflation in 2005.¹⁰ Since the share of the usage of riel in the circulation is only 23%, the government may only print US \$ 12.2 million. So, the seigniorage of printing the remaining money, or US \$ 41 million, passes into the other country's hand.¹¹

Seigniorage Loss 3

If the dollar was not allowed to be used in Cambodia, the total amount of dollars circulated in Cambodia would be concentrated in the bank of Cambodia. Then the central bank of Cambodia could utilize the amount of foreign currency in lending, buying US treasurer bills, and holding all kinds of interest-bearing bonds. Nowadays, the interest rates on the financial markets are 15% to 18% per year.¹² However, it is also assumed in this paper that the central bank of Cambodia could at least collect 3% interest per year from the total amount of foreign currency. Thus, the amount of the forgone interest revenue due to dollarization is over US \$ 20.4 million (= US \$ 681.8 million at 0.03 percent) in 2004.

⁷ The estimated amount of M2 at the end of 2004 is around 886.3 million dollars. It is assumed that the share of foreign currency in M2 is equal to the share of net foreign assets in the sum of net foreign assets and domestic credits.

⁸ Since 2000, the growth rate of GDP has reached around 5 to 7%.

⁹ Generally, the velocity of circulation of money is reduced in accordance with economic growth. However it is assumed in this paper that the velocity remains unchanged.

¹⁰ Since the estimated amount of circulation at the end of 2004 was 886.3 million dollars, 6% of the amount is 53.2 million dollars.

¹¹ It is assumed that the share of the usage of riel in 2005 is also equal to that in 2003.

¹² According to bankers in Phnom Penh, the interest rates have usually risen up to 5% per month in the black markets.

In short, the lump sum loss from giving up seigniorage was US \$ 681.8 million at the end of 2004. Under the assumption of a 6% economic growth rate, the Cambodian government will lose US \$ 41 million in riel that it could have printed without inflation in 2005. Under the assumption of a 3% interest rate, US \$ 20.4 million would be lost in interest revenue.¹³

Loss of monetary policies

Due to dollarization, the Cambodian government cannot pursue monetary policies freely. The most important duty of a central bank is to supply money and control the quantity of money in circulation by use of monetary policies. Through such policies, the central bank could endeavor to stabilize price levels and the level of interest rates as well as stimulate economic development. However, in Cambodia where the outward and the inward flows of foreign currencies are free and the dollar is freely circulated, the increase and the decrease of the money supply are almost equal to the inflow and the outflow of foreign currencies. In this situation, the central bank of Cambodia can do nothing to control the supply of money. In addition, the open market operation is not a proper means for the Cambodian central bank to control money supply, since the money market itself is not well developed. Changing the reserve requirement rate by the central bank is also no longer useful because the money is supplied by foreigners through trade not through banks.

Under the heavy sacrifices incurred by dollarization, Cambodians enjoy price level stability today. How does this happen? Under a policy of allowing free trade, all the central bank of Cambodia can do is to stand by and watch the dollarization phenomenon. How can the price levels be stable without any control of currency? Generally speaking, in a dollarized economy the outflow of foreign currencies leads to deflation due to the lack of currency and the inflow of foreign currencies induces inflation because of the increase of currency. But this story is true only for a country where imports or exports are restricted. In Cambodia where the inflow and the outflow of commodities are free and the rate of industrialization is very low, whenever foreign currencies flow in, importation of commodities increases accordingly. So, the price of commodities should not rise. In this case, under the stability of price levels, the Cambodia economy expands (economic expansion). On the other hand, whenever the

¹³ In case of Argentina, the seigniorage loss was US \$ 15 billion, 4% of her GDP in 1999 and annually 1 billion US dollars, or 0.3% of her GDP. See Andrew Berg, Eduardo Borensztein,

inflow of foreign currencies decreases, people accordingly import fewer commodities. The price of commodities should not go down. In this case, under the stability of price levels, the Cambodia economy shrinks (economic contraction). By allowing the use of the dollar as a Cambodia currency, the central bank of Cambodia may guarantee the stability of price levels without doing anything. However, the Cambodian people must pay the huge costs of dollarization.

The costs of the stability of price levels are huge. The bases of price stability are free trade and dollarization in Cambodia that prohibit the Cambodian government from supporting domestic industries with monetary policies. Under the price level stability as mentioned above, the expansion and the contraction of the economy depend totally on the scale of the importation of foreign currencies. This may be a reason why the expansion of the Cambodian economy has always accompanied the increase of accumulated foreign debt. In this case, the Cambodian government cannot solve its unemployment and poverty problems even during an economic expansion.

The Loss of Foreign Trade Policies

Because of dollarization, the Cambodian government cannot protect its economy from outside shocks through the control of exchange rates and the foreign exchange market. For example, if Cambodia were not dollarized, then there would be an exchange rate between the dollar and the riel. If the government of Cambodia kept the exchange rate at \$1 = 4000 riels when the real exchange rate was \$1 = 3000 riels, then exports would increase while imports decreased. Currently most goods are imported with their prices expressed in dollars and are also sold in dollars in the Cambodian markets. All the export goods are produced with costs expressed in dollars and sold on the foreign markets with a dollar basis. Under the situation that more than 70% of all transactions use the dollar, is there any exchange rate in Cambodia? If there is an exchange rate between Cambodian money and the dollar, the rate would necessarily be \$1 = \$1 since the dollar is also one of Cambodia's currencies.

Then, what is the exchange rate between the dollar and riel? This rate has meaning within the territory where riel is circulated. In such a dollarized

“Full Dollarization, the Pros and Cons,” <http://www.imf.org/external/pubs/ft/issues/-issues24/index.htm>.

country like Cambodia, the exchange rate between the dollar and riel loses most of its original meaning.

In spite of such circumstances, one may insist that, during 1997 when the foreign currency crisis took place, Cambodia enjoyed stability of foreign exchange markets because of dollarization. This is a natural result in cases where there is no meaningful exchange market. During the foreign currency crisis in 1997, international speculative funds attacked Asian money markets with huge amounts of money. Indonesia, Thailand and S. Korea were victims. But in Cambodia, the fund managers could not even find a foreign exchange market to attack. How could they have attacked such a market that did not exist and/or that did not have even a meaning as a foreign exchange market?

The exchange rate system is the gate between an economy and foreign countries. It controls and mitigates many kinds of international shocks to the country. In Cambodia where there is no such gate due to dollarization, all kinds of economic shocks directly impact the Cambodian economy. Therefore, whenever the equilibrium is broken among key factors like wages, interest rates, profits, and so on, caused by occasional big or small international shocks, it takes a long time for a new equilibrium to be reached. In the meantime, the Cambodian economy suffers from the losses of unemployment, instability, and inefficiency.

Worsening Distortion of Income Distribution

In Cambodia there are large income differences between people who receive their pay in dollars and people who earn their salary in riels. Only a small number of people form the high income bracket and receive their pay in dollars. All others receive their income in riels. These constitute the middle and lower classes.¹⁴ In such a situation, if the exchange rate changes from \$1= 4,000 riels to \$1 = 5,000 riels, what would be the result for income distribution? If the income distribution is evaluated by riel terms, the income of the people earning riels does not change, but the income of the people receiving dollars increases. According to the evaluation by dollar terms, the income earned on a dollar basis does not change, but an income earned on a riel basis does decrease.

¹⁴ According to the 1999 survey, the proportion of the population below the poverty line was 36% of the total population of Cambodia. See Statistical Yearbook 2003, pp. 184, National Institute of Statistics, Ministry of Planning, Kingdom of Cambodia.

On the other hand, the Cambodian economy is developing through foreign relations such as imports, exports, tourism, foreign investments, loan projects, NGO activities, and so on. Since the dollar is mostly used in activities related to foreign countries, people who earn their incomes in dollars can easily access the benefits from economic development. But people who earn their incomes in riels have difficulty obtaining the benefits of economic development. In sum dollarization drives income disparities from bad to worse in Cambodia.

Benefits

Stabilizing Price levels

Since 1993, the balance of public finance has recorded a deficit of more than US \$ 100 million. The Cambodian government has had to make up the deficit by foreign borrowings.¹⁵ If Cambodia were not a dollarized country, then the government could easily choose to print money in order to solve the deficit problem instead of collecting more tax revenues or incurring all the difficulties of obtaining foreign loans. This is the reason why inflation may easily take place in Cambodia without dollarization. In contrast, because of the current dollarization of the Cambodian economy, inflation is held in check.

However Cambodia should know that there is no way to escape from inflation when the value of the dollar itself drops and also, in the event of an emergency, there is no way for Cambodian government to escape the emergency by printing money.

Reducing the Risk of National Default

During the period of the Asia foreign currency crisis starting 1997, the Cambodian economy managed to weather the crisis without serious damage in contrast to Indonesia, Thailand, and S. Korea, even though the riel was dramatically devaluated against the dollar.¹⁶ What made Cambodia economically stable? Was it the dollarization phenomenon?

Whenever there is a shortage in the required international reserve fund, the amount of dollars used in circulation may play the role of international

¹⁵ For 12 years from 1992 to 2003, the average deficit of public finance recorded US \$ 115 million.

¹⁶ The riel was devaluated 27.2% against the dollar. GDP in dollar terms recorded a negative annual growth rate of -13.5% in 1997.

reserve money. But in general, the amount of dollars in circulation does not serve as international reserve money. Only in the face of foreign currency crisis does it play that role. So, dollarization provides Cambodia with the benefit of reducing the risk of national default under a foreign currency crisis.

Summary

At the end of 2004, the lump sum loss of seigniorage reached US \$ 681.8 million and the annual loss US \$ 61.4 million. Added to this loss, the losses from depriving the Cambodian government of monetary, fiscal and foreign trade policies seems to outweigh the benefits obtained from stabilizing price levels and reducing the risk of national default. Moreover, considering the dollarization effect on income distribution, one may clearly reach the conclusion that the Cambodian government should act to reverse dollarization as soon as possible.¹⁷

METHODS OF DE-DOLLARIZATION

Once the Cambodian government reaches the conclusion that the costs of dollarization are far greater than the benefits, the next question to be answered is how to prohibit people from using dollars in Cambodia. First, after providing a certain grace period, the Cambodian government could prohibit by law the use of the dollar as a currency. 84% of the total population use riel as their own currency, and so this economic measure by the government could be executed without any difficulties.

If the use of the dollar is prohibited, some may worry that a lot of foreign currencies would flee Cambodia. How could this prohibition produce such an adverse phenomenon when free entry and free exit of foreign currencies are fully guaranteed and exchanges from riel to dollar and vice versa are also free? If there were flight of capital, then it might be a kind of illegal capital that needed to hide for a while. But the capital, illegal or not, eventually will return to Cambodia as long as the owners of the capital have businesses in Cambodia. Other worriers may object that de-dollarization will entail a great deal of effort, including printing money, formation of a financial and monetary committee,

¹⁷ The IMF executive board assessment in 2004 concluded that de-dollarization would be a benefit to Cambodia. See IMF Concludes 2004 Article IV Consultation with Cambodia, Executive Board Assessment, Public Information Notice (PIN) No. 04/108 September 27, 2004.

setting up a financial system, a great burden of exchanging moneys, and so on. But all these trivial problems could be solved by Cambodian government officials with a little effort.

Second, there are further measures that may reduce the costs and increase the benefits of de-dollarization in Cambodia. These measures are good for eliminating the shock of the prohibition of the use of dollars but require time to work. The following is an example for these measures.

① All organizations directly related to the government must use riel exclusively.

② All the salaries given to Cambodians people should be paid in riels. Anyone who wants to use dollars for paying salaries to his or her employees must report his or her plan of using dollars to the tax office concerned.

③ The National Bank of Cambodia should carefully regulate the supply riels. The currency management conducted by The National Bank of Cambodia should always be very conservative since the public confidence in the riel is very low.

④ The interest rate for deposits in riel must be higher than interest rates for dollar deposits in order to promote the riel as a means to store wealth.

⑤ The rate differences between buying and selling dollars should be widened as follows.

a) The National Bank of Cambodia sets everyday rates: Ex.) Buying dollar rate: \$1 = 3900 riels, Selling dollar rate: \$1 = 4000 riels.

b) Private Banks: Ex.) Buying dollar rate: \$1 = 3850 riels, Selling dollar rate: \$1 = 4050 riels.

c) Official approved exchange booths on the streets: Ex.) Buying dollar rate: \$1 = 3800 riels, Selling dollar rate: \$1 = 4100 riels.

d) Private exchange rates recommended by the National Bank of Cambodia: Ex.) Buying dollar rate: \$1 = 3600 riels, Selling dollar rate: \$1 = 4200 riels.

⑥ Taxes should be paid in riels. If they are paid in dollars, then the buying rate will be applied as \$1 = 3600 riels.

⑦ The National Bank of Cambodia should provide an honorable and valuable award to anyone who devises a reasonable and plausible idea for de-dollarization in Cambodia.

Both methods are applicable. But making a law to prohibit the use of the dollar gives the Cambodian government the bonus of confidence in the process of executing the de-dollarization policy because people would immediately confirm the firm will of the Cambodian government.

CONCLUSION

Cambodia was an experimental place between the systems of communism and capitalism during the long period of 28 years from 1970 to 1998. During the period of Vietnamese rule in the 1980's, Cambodians used gold as a means of value saving. But the means was changed from gold to dollars in 1990's. The share of the dollar in the circulating currencies of Cambodia has been continuously growing since 1992 and is now estimated to have reached more than 70% of the total currency. To employ dollars as a currency was a good method for securing economic stability in Cambodia when the political situation was unstable. However, the stability of price levels given by dollarization has required Cambodia to tacitly sacrifice her economic independence. Now that Cambodia has achieved political stability, the Cambodian government has recognized its loss of seigniorage. It is the time for the Cambodian government to consider the costs and benefits of dollarization.

Political stability is a basis for economic development. After the 2003 election, a new era of reconciliation and a wonderful opportunity for economic development has just opened for Cambodians. Given this golden chance, the government should implement a variety of economic policies. The central bank of Cambodia should have the ability to supply its own currency in full scale. Based on this money, private banks in Cambodia could create domestic credits. The government should also have the ability to use the credits for nurturing industries, controlling the foreign exchange market through the open market operation, and have a command of fiscal policy for the construction of large scale agricultural infrastructure. Unfortunately, all these policies are not currently available to Cambodia because of dollarization.

Here, the Cambodian government should make a choice: maintaining economic stability at the price of losing economic policies and economic

independence versus the implementation of a variety of economic policies at the cost, more or less, of weakening economic stability. This choice fully depends on the determination of Cambodia's political leaders and on the people's expectation of the political situation hereafter. However, the results of the decision, for good or ill, will finally rests with the people of Cambodia.

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FDI AND TRADE IN CAMBODIA: SUBSTITUTES OR COMPLEMENTS?

Neak, Samsen¹

INTRODUCTION

Foreign Direct Investment (FDI) and international trade have been widely studied for a long time, yet they have been disjointed. In 1957, Robert Mundell showed a perfect substitution relationship between FDI and trade in his well known article “factor mobility and commodity trade.” Following Mundell’s work, there were a significant number of scholars attempting to observe the relationship between FDI and trade. However, the majority of them point out contradictory predictions to Mundell’s claim.

Since Cambodia adopted a fully free market economy in 1993, the country has established pro-foreign investor policies through promulgation of investment laws, establishment of a special promotion zone (SPZ), conducting yearly private sector-government forums, encouragement in forming business associations, signing bilateral trade and investment promotion agreements with partner countries, and so on. At the same time, export and import activities have expanded rapidly. However, interactions between FDI inflow and trade will be called into question. Hence, this study aims to examine empirically the link between inward FDI and trade (export and import) in commodities from the investigation of host Cambodia. In other words, does inward FDI increase or decrease Cambodia’s commodity trade?

To address the above objective, the gravity model of bilateral trade is employed to test the relationship. This type of model is widely seen in many empirical analyses. The author also will develop a theoretical framework to support the regression equation. Furthermore, TSP software package is used in running this regression.

This paper is divided into five sections. Section two reviews the existing theory of the relationship between FDI and trade. Section three discusses

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previous empirical findings. Section four gives evidence of effects of FDI on trade. Section five draws conclusions.

LITERATURE REVIEW ON THE RELATIONSHIP BETWEEN FDI AND TRADE

Theories Predict Substitution Relationship

To analyze the relationship between FDI and trade, many scholars base their analyses on the traditional but powerful framework of the Heckcher-Ohlin model (H-O). This practice was pioneered by Robert Mundell in 1957 when he claimed capital movements are a perfect substitute for commodity trade. He noted that if there are trade impediments (tariffs or other barriers), many different factors in each will determine relative prices between countries. Thus, the mobility factor will lead to reduction in price differences and finally to eliminate trade. His assertion was backed by Markusen and Maskus (2001) whose study used a different approach.² Their conclusion is that overseas production would substitute for trade if countries (home and host) are quite similar, and if trade costs are moderate to high as well as if countries grow in total income.

Theories Predict Complementary Relationship

There are two main groups which used two different approaches to explain FDI and trade complementary relationships. One group used the H-O model. Schmitz and Helmlinger (1970), Purvis (1972), Markusen (1997), and Baldwin & Ottaviano (2001) are among the leading theorists. They concluded that there was a complementary relationship after relaxing the assumption of identical production functions and assuming identical labor and capital but differing in technology or endowing with only labor within H-O framework. Another group used firm behavior approach: Markusen (1983), Helpman (1984), Markusen, Venables, Konan and Zhang (1996). This approach, confirmed that complementarity occurs mostly under vertical integration strategies of the multinationals. Despite the two explanations, they reached the same conclusion: FDI complements trade.

² Their study used industrial to trade approach. This approach lays on the question of mode of entry: transnational corporation serves foreign market by exports or by setting up production?

Theories Predict Either a Substitution Relationship or a Complementary Relationship

There are some scholars who suggest that FDI can either complement or substitute for trade. For example, Kojima (1973, 1978, 1982, 1985), from a macro-economic approach, concluded that FDI creates trade if it moves from comparative disadvantaged industries in the home country to comparative advantages in the host country. However, if they move from comparatively advantageous industries in the home country to comparatively advantageous industry in host country, they will destroy trade. Similar to Kojima, Snider (1979) asserted, from the facts in the real world that factor mobility and trade partially substitute due to institutional or natural restrictions of factors of productions of land, labor and capital. Furthermore, although factor movement eliminates trade it simultaneously creates new fields of trade. Capital flows to recipient countries result in increasing real incomes, which creates new demand in terms of bigger volume and greater composition of goods and services.

From the above-mentioned theoretical summary, whether FDI and trade are substitutes or complements depend upon four main reasons: (1) the strategies of transnational corporations, (2) the policies of the host and home countries, (3) the stage of development and factor endowments of host country, and (4) type of sector. The first the main reason; from the behavior of transnational corporations, if corporations expand production operation in a host country in order to gain better access to that host country market, that FDI will decrease trade (horizontal FDI). On the other hand, if the corporations invest in a host country in order to gain cost advantages, that FDI will increase trade (vertical FDI). The second main reason; whether FDI trade has positive or negative relationships relies on export promotion or import substitution policies of sending and recipient countries. The third main reason; less important but a relevant condition, is the development stage and factor endowment. Operations of decreased trade corporations are often found in developed and/ or high income or big market size economies whereas increased trade FDI operates in developing countries with a natural resource endowment or a labor abundance. Last, the sectors of FDI that have taken place also determine the FDI trade relationships. FDI involved in primary and secondary sectors is likely to create trade while the presence of FDI in the service sector displaces trade.

REVIEW OF PREVIOUS EMPIRICAL FINDINGS ON THE RELATIONSHIP BETWEEN FDI AND TRADE

Outward Foreign Direct Investment and Home Country Exports

Lipsey and Weiss (1981) studied relationships between the U.S. and foreign affiliate activities in a market and exports to that market by the U.S. and foreign firms. Using cross-sectional data for the U.S. and the other 13 major exporting countries in 14 industries of the manufacturing sector, they found both complementarity and substitutability. The U.S. affiliates' activities were positively associated with exports from U.S. but negatively associated with exports from rival countries. It is the same finding in the case of foreign affiliates and their exports.

Three years later, in 1984 Lipsey and Weiss conducted another empirical study to examine more specifically the effect of foreign production on exports of parent firms by using unpublished data obtained from the U.S. Department of Commerce. They found that foreign production by a firm did not substitute for exports by that firm to the area in which the production had taken place. Instead, the higher the production of a firm in one country, the more exports from that parent firm to the host country. The strongest positive relationship applied not only between foreign production and intermediate goods for further processing but also between foreign production and finished goods.

Complementary evidence was also asserted by Blomström, Lipsey and Kulchicky (1988) who examined the effect of foreign production on home country exports, based on Swedish and U.S. data. Using cross-section firm-level data (1978 for Sweden and 1982 for United States), they found that foreign direct investment complements export sales. Nonetheless, the result suggested that overseas production has no effect on the home country exports at all for the case of Sweden, but has some effects for the case of the U.S.

Another positive finding was obtained from an analysis by Pfaffermayr (1995) who empirically investigated Austrian FDI outward flows to recipient countries and the exports of Austrian manufacturing to those markets. Using a time-series cross-section of seven industries dataset over a period of 13 years, the study found no evidence to support substitution relationships.

More recently, Fors and Kokko (2001) studied outward FDI effects on home country exports by analyzing the structural changes in home country production. Using firm-level data for 30 Swedish MNCs for the period 1986-

1994, they found large structural changes in the Swedish MNCs after those firms expanded their overseas production operations. Moreover, there was no evidence to show that overseas production reduced exports from Sweden. The reason is that the decrease of the export of finished goods was replaced by an increase in exporting intermediate goods.

Another recent study of outward FDI and home country exports was examined by Head and Ries (2001). Using panel data of 932 Japanese manufacturing firms over 25 years, they found a net complementary effect. In other words, firms that supply intermediate inputs to overseas affiliates can increase their exports. In contrast, firms that do not export intermediate inputs to supply overseas production facilities cannot increase their exports. Instead, overseas affiliates eliminate exports from parent firms. Thus, outward FDI stimulates exports through exporting of intermediate inputs only; it does not raise the export of finished goods.

Another more recent analysis for the Swedish case was conducted by Swedenborg in 2001. Using Swedish firm data for the period of 1965-1994, she found a net complementary relationship between parent company exports and foreign production sales. More specifically, she found that there was a weak negative effect on exports of nonaffiliated firms. However, this negative impact was offset by a strong positive effect on exports to manufacturing affiliates.

However, Svensson's empirical analysis (1996) on the Swedish case came up with different results. The study, using Swedish firm level data for the period of 1974-1990, found a net negative effect of foreign production on parent firm exports. The impact, however, is mixed. Overseas production substitutes for exports of finished goods but complements parent exports of intermediate goods. Moreover, the strong substitution effect was found particularly in third markets because exports by parent countries are replaced by exports of overseas production.

A recent empirical study done by Gopinath, Pick and Vasavada (1999) of outward FDI and exports from home countries also found substitution relationships. It examined the effect of foreign sales of foreign based U.S. firms in the U.S processed food industry on exports from U.S. by using panel data for the period of 1982-1994 across ten high income countries. The reason that FDI substitutes for export is due to the host country protection policies in favor of foreign investors to establish import substitution industries.

Inward Foreign Direct Investment and Host Country Trade

Helleiner (1973) is probably among the pioneering writers who investigated FDI trade relationships empirically although he did not explicitly mention complementarity or substitutability. He only claimed there was a close link between international trade and foreign direct investment by observing trade activities and operations of multinational firms of manufactured goods in less-developed and developed countries.

Clearer empirical evidence was provided by Naya and Ramstetter (1992) who examined trade and FDI in the Asia-Pacific countries. Despite their strict definition of complementarity and substitutability, they still found complementary relationships.³

One more empirical study in East Asia was elaborated by Lin (1995) who examined the effect of inward and outward FDI between Taiwan and four ASEAN countries, Indonesia, Malaysia, the Philippines and Thailand. Using time series data for a period of 1986-1992 across these four partner countries, the study found that outward FDI from Taiwan had a significant positive effect on both exports to and imports from those four host countries, but inward FDI to Taiwan found no positive effect on neither exports to nor imports from those four host countries.

Another contribution to positive evidence of an FDI effect on trade was made by Chen (1997). Using a cross-section of trade between provinces of China and 101 trading partners during 1987, 1989, 1991 and 1993, he found positive correlations for all four years.

More recent investigation in East Asian countries was done by Fukao, Ishido, Ito, and Yoshiike in 2002. They studied FDI and vertical intra-industry trade in East Asia. Using bilateral intra-industry trade of Japan and her 43 major trading partners for the period from 1988 to 2000 in the electrical machinery industry, they found FDI played a significant role in the rapid increase of vertical intra-industry trade.

³ They defined FDI complements to trade if increases in capital stock results in increases in the volume of trade through stimulation of import consumption and export production. FDI substitutes for trade if increasing capital stock results in increasing volume of trade through stimulation of import production and export consumption.

ECONOMETRIC ANALYSIS

Definition of “substitutability” and “complementarity”

It is necessary to define clearly what is meant by substitution and complementary relationships as most of the theoretical and empirical studies have done. Hence, through regression analysis, the concept of “substitutability” and “complementarity” between FDI and commodity trade will follow a quantitative sense that has been used extensively in doing empirical studies. FDI and goods trade are complements if increasing in the level of FDI stock leads to increasing in the volume of trade. On the other hand, FDI and goods trade are substitutes if increasing in the level of FDI stock leads to decreasing in the volume of trade.

The Gravity Model in Analyzing FDI-trade Relationship

The Conceptual Framework, Model and Variable Specification

Many applications of the gravity model have been used to investigate factors affecting trade. However, in this study, the author is trying to add one more independent variable, FDI, to see how this factor impacts on trade. The inclusion of the FDI variable in the gravity model was found in Frankel (1993) and Chen (1997).

The general concept of the gravity model of bilateral trade is that trade between countries is affected by their economic sizes, income levels, transaction and communication costs (distance, adjacency, cultural similarities) and a set of facilitating or restrictive factors (Frankel, 1993, Rivera-Batiz & Oliva, 2003).⁴

GDP, per capita GDP and distance between countries are used to be proxies for economic size, income level and transaction costs respectively. Facilitating or restrictive factors are proxied by adjacent, regional bloc, preferential and trade arrangements. Therefore, the regression equation of FDI-trade relationship is:

$$\begin{aligned} \log(BT_{cj}) = & \alpha + \beta_1 \log(GDP_c * GDP_j) + \beta_2 \log(PCGDP_c * PCGDP_j) \\ & + \beta_3 \log(DISTANCE_{cj}) + \beta_4 \log(FDI_{cj}) + \beta_5 (ADJACENT_{cj}) + \beta_6 (ASEAN_j) \\ & + \beta_7 (PREFERENCE_{cj}) + \beta_8 (BTAGREEMENT_{cj}) + u_{cj} \end{aligned}$$

⁴ Due to US dollarization of the Cambodian economy since early 1990s, the exchange rate, which is a major influential variable on trade, was not examined in this regression model.

BT_{cj} = Total trade between Cambodia and country j. In other words, the sum of exports from Cambodia to country j and imports to Cambodia from country j

GDP_c, GDP_j = Gross Domestic Product of Cambodia and country j

$PCGDP_c, PCGDP_j$ = Per capita Gross Domestic Product of Cambodia and country j

$DIST_{cj}$ = Distance from Cambodia to country j

FDI_{cj} = Accumulated FDI stock invested by country j in Cambodia

$ADJACENT_{cj}$ = Dummy variable for country j sharing a border with Cambodia

$ASEAN_j$ = Dummy variable for country j if it is a member of ASEAN

$PREFERENCE_{cj}$ = Dummy variable for a preferential arrangement between Cambodia and country j

$BTAGREEMENT_{cj}$ = Dummy variable for a bilateral trade agreement between Cambodia and country j

U_{ij} = stochastic disturbance

$\alpha, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7, \text{ and } \beta_8$ = regression parameters

Explanation of each variable and its specification, sources of data and expected result are presented in table 1 in the appendix. Table 2 indicates all countries that have trade agreements and preferential arrangements with Cambodia. A list of 29 trading partners with names of capital cities is shown in table 3 in appendix.

Sample Size and Data

Due to unavailability of product level and industry level datasets, the author used aggregate country level data from 1994 to 2002 for 29 trading partners. The partners consist of both developed and developing countries around the world (Table 3 in appendix).

Total volume of bilateral trade, exports and import are calculated in millions of USD at current rates. Data for the period of 1994-2002 was retrieved from the Direction of Trade Statistics CD-ROM 2003 published by the International Monetary Fund.

Gross Domestic Product is in Billions of USD at 1995 rates. We obtained this data from the World Development Indicator CD-ROM 2003. However, this time-series data is until 2001 only. We supplement the data set for 2002 by using the World Bank statistical database.

Per capita Gross Domestic Product is in USD at 1995 rates. Data is retrieved from the World Development Indicator CD-ROM 2003 for the period of 1994-2001. For 2002, the author divided real GDP in 2002 by population in 2002 for each country in our sample.

Data on distance is in hours by sea retrieved from the Great Circle Distance between Cities webpage. It is calculated between the capital city of Cambodia, Phnom Penh, and the capital cities of 29 trading partners.

Foreign Direct Investment is in millions of USD. It is inward investment stock from investing countries to Cambodia. The full set of data was obtained from the Foreign Direct Investment Database of the World Investment Directory on line which is accessible at the United Nations Conference on Trade and Development web site. Using investment stock rather than investment flows is commonly found in empirical studies of the FDI-trade relationship. However, there are two disadvantages of using book values of investment stock in nominal terms. One disadvantage is that data is always recorded in registered capital when investment projects have been approved. They can not be interpreted as stock of capital in an economic sense because some investment projects have not been carried out. Another problem is that the investment stock is affected by the exchange rate and the inflation rate.

ADJACENT are countries next to Cambodia; they are Laos, Thailand and Vietnam. Laos has not invested any capital in Cambodia so the researcher excludes it in his sample

ASEAN is the Association South East Asian Nations. Besides Cambodia, the other members are Brunei, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. However, the source countries that have invested in Cambodia are only Indonesia, Malaysia, the Philippines,

Singapore, Thailand and Vietnam. Hence, Brunei, Laos and Myanmar are not included in this study.

Regression Results and Interpretation

Using ordinary least squares (OLS) panel regression analysis. The regression results reported in table 4 in appendix are interpreted as follows:

- (i) The coefficient on the log of GDP is around 1.028. This means that when GDPs of Cambodia and her trading partner rise one per cent, the trade volume between Cambodia and her trading partners will also increase 1.028 per cent;
- (ii) The coefficient for log of PCGDP is negative which is contrasted the expectation. However, it is statistically insignificant;
- (iii) The coefficient on the log of distance is -2.09. It means that when distance between Cambodia and her trading partners is higher by one per cent, the trade between them falls by about 2.09 per cent;
- (iv) Another coefficient which is the central attempts to this analysis is 0.17. It is slightly positive correlation between FDI and trade. It can be interpreted that rising in FDI from host countries by one per cent will result in increasing in trade 0.17 per cent between Cambodia and those host countries;
- (v) ADJACENT and PREFERENCE that are statistically significant at 1% level have positive signs. Therefore, Cambodia tends to have substantial trade with neighboring countries and with preferential arrangement countries than other countries; and
- (vi) It is surprising that bilateral agreements and being a member of ASEAN do not play positive roles in increasing trade between Cambodia and those partners. They are statistically insignificant.

CONCLUSION

In this paper the author, using aggregate country level data, tries to investigate empirically how inward FDI to Cambodia affects the country trade. He found FDI has a positive impact on trade. It implies that increasing the level

of FDI inflows from source countries to Cambodia will lead to increasing volume of trade between Cambodia and those source countries.

Another conclusion is derived from the gravity model equation in section four. It has some major implications. Firstly, the major home countries investing in Cambodia are developing countries from Asia. This investment creates more imports and exports between pairs and at the same time stimulates exports to lucrative markets of developed countries. Thus, it reflects South-South FDI flows with mixed trade flows of South-North and South-South model. Secondly, preferential arrangements with U.S and EU have played a central role in massive flows of FDI and a boom of exports. Thirdly, being a member of ASEAN and signing bilateral agreements to promote trade and investment have so far not played any significant roles in boosting trade. Lastly, size of the economies and distance are also major factors affecting trade.

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