TRADE POLICY CHALLENGES IN A SMALL, OPEN, FRAGILE, POSTCONFLICT ECONOMY: CAMBODIA

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Contents

Abstract

This paper analyzes the World Trade Organization's (WTO) *Trade Policy Review: Cambodia,* the first completed for the country. The report highlights Cambodia's rapid economic growth after one of the world's worst genocides in the 20th century. This growth has been underpinned by open trade and investment policies in the context of dynamic neighborhood growth effects. The trade regime is mainly tariff-based, with modest inter-sectoral variations in rates. Cambodia has limited trade policy space. It is a signatory to the 10-nation ASEAN Free Trade Agreement, soon to become the ASEAN Economic Community. Moreover, given its long and porous borders with the much larger, dynamic economies of Thailand and Viet Nam, any major cross-border price differences will quickly result in informal trade with these economies, and the People's Republic of China nearby. Most of the country's trade policy challenges are "behind-the-border" issues, a legacy of a generation of civil war and conflict. These include weak bureaucratic capacity, high levels of corruption, poor infrastructure, and limited human capital.

Keywords: Cambodia, trade policy, ASEAN, globalization, weak institutions.

JEL Codes: F14, F63, O53

1. Introduction

The 2012 *Trade Policy Review* (TPR) for Cambodia (WTO 2012) is the first detailed study of Cambodia's trade and commercial policy. Cambodia became a member of the WTO in October 2004, and was the first 'least developed country' to join through the full accession process. The TPR discusses key features of the country's development policy regimes and their outcomes since Cambodia rejoined the international community 2 decades ago—following one of the worst cases of genocide in the 20th century. After 30 years of devastation caused by regional and civil wars, weak institutions and an absence of trust have shaped these policy features.

Cambodia was increasingly engulfed by the Viet Nam War from the mid-1960s, followed by the barbaric Khmer Rouge (KR) rule and its 'Year Zero' economic policies. Viet Nam invaded and occupied the country in 1979, followed by international isolation. Yet, since the 1991 peace settlement and first general elections in 1993, Cambodia has been one of the world's fastest growing economies—built on the pillars of sound macroeconomic policies, openness to trade and investment, large capital inflows, and a dynamic Southeast Asian neighborhood.

The TPR examines one critical element of Cambodia's evolving policy regime—trade and commercial policy. The report highlights both the deliberately open economic policies after years of isolation and some of the challenges this openness presents, all in the context of the country's unusual policy settings, weak institutions, porous borders, and a paucity of data. Our analytical review of the TPR is organized as follows. Section 2 examines the country's development context, particularly the legacies of severe conflict and its geography as a very small economy surrounded by much larger economies. In section 3 we summarize the key features of the report, drawing attention to the research agenda for future reports. Section 4 investigates a range of 'trade plus' issues—not directly covered in the report, but which affect commercial policies and shape the potential benefits of the country's openness. Section 5 summarizes our main arguments.

2. The Cambodian Development Context[1]

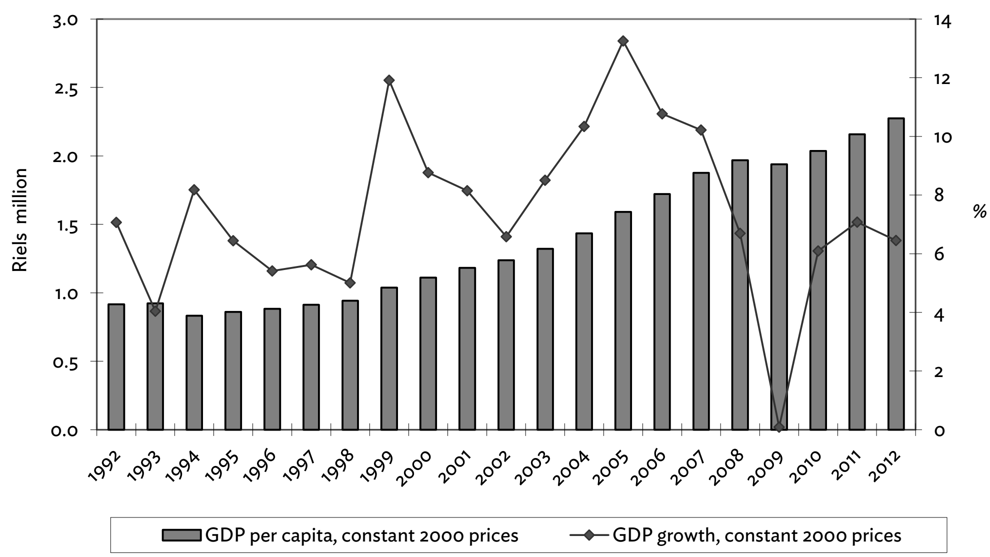
Cambodia became independent in 1953 following the end of French colonial rule. Its first 40 years of independence was mostly conflict-ridden, initially drawn into the Viet Nam war, and then from 1975 when the KR took control following the defeat of the United States (US) and Viet Nam's reunification. The effects of KR rule were devastating. It is estimated that about one-quarter of the population perished from mass executions, malnutrition and disease. Many also fled the country. The KR abolished most formal state institutions, including private property and money. The early 1979 Viet Nam, invasion, which ousted the KR, was followed by a decade of intermittent civil war, international isolation, and sanctions. By 1991, with the signing of the Paris Peace Accords, it had become one of the poorest countries in the world. Much of its physical infrastructure had been destroyed. Most of its educated community had either perished or fled.

1 This section draws in part on Hill and Menon (2013). For general overviews of the economy, see also Guimbert (2010), Hughes and Un (eds, 2011), Naron (2011), and IMF (2012).

There were hardly any of the key attributes of a modern state (Naron 2011). The bureaucracy and formal legal system were barely functioning, property rights were ill-defined, and there was little trust in the currency. Security remained tenuous, while unexploded ordnance peppered the countryside, particularly along the border with Vietnam.

Nonetheless, since 1992 economic growth has been rapid. Averaging about 7% per annum, it has been faster than almost any other postconflict society. Per capita income has roughly doubled (Figure 1).[2] Growth was particularly rapid in 1998-2007, wedged between a recurrence of domestic conflict in the mid-1990s and the onset of the 2008/09 recession. Not surprisingly, growth has also been quite volatile, reacting to sporadic domestic political instability, the country's narrow economic base, and to external economic shocks. Among the latter, the 1997/98 Asian financial crisis had only a limited impact on Cambodia. The country remained outside regional capital markets—the principal source of contagion—while the dominant rural economy was largely insulated from shocks to the real economy. However, the country was severely affected by the 2008/09 global recession. Although the economy of the People's Republic of China (PRC)—by now Cambodia's chief commercial partner—continued to expand

Figure 1. Economic Growth and GDP per Capita, 1992-2012



GDP = gross domestic product.

Source: International Monetary Fund, *World Economic Outlook Database, April 2013*, accessed 25 October 2013.

[2] Unless otherwise indicated, our data sources are the WTO (2012) report, the Asian Development Bank database, World Bank, World Development Indicators database, International Monetary Fund, World Economic Outlook database, and the UNCTAD trade statistics. All Cambodian data should be regarded as approximate.

strongly, the economy had grown much more open and globally connected. With the recession in Organisation for Economic Co-operation and Development (OECD) countries and in some major Southeast Asian neighbors, Cambodia's economic growth slumped as garment exports and tourism fell sharply, short-term capital flows also contracted, leading to a collapse in the modern construction sector.

Rapid economic growth brought equally rapid structural change (Table 1). Although rice-dominated agriculture continues to grow strongly, its GDP share has fallen sharply, from about 55% in the early 1990s to some 33% today. About half of this decline was taken over by manufacturing, whose GDP share has risen by 10 percentage points over the period. This transformation is consistent with the generalized structural change that occurs during the

Table 1. The Composition of Gross Domestic Product by Sector

	1990		2000		2012	
	Riel billion	% of GDP	Riel billion	% of GDP	Riel billion	% of GDP
Agriculture	**333**	**55.6**	**5,065**	**35.9**	**18,999**	**33.6**
Industry	**67**	**11.2**	**3,078**	**21.8**	**12,959**	**22.9**
Mining	3	0.5	34	0.2	439	0.8
Manufacturing	31	5.2	2,255	16.0	8,563	15.1
Electricity, gas, and water	2	0.4	58	0.4	294	0.5
Construction	30	5.0	732	5.2	3,662	6.5
Services	**190**	**31.7**	**5,231**	**37.1**	**21,409**	**37.8**
Trade	56	9.4	2,033	14.4	7,722	13.6
Transport & communications	23	3.8	930	6.6	4,264	7.5
Finance	41	6.8	1,030	7.3	4,099	7.2
Public administration	28	4.7	377	2.7	858	1.5
Other services	42	7.0	861	6.1	4,466	7.9
Less: Imputed bank service charges		0.0	155	1.1	661	1.2
Taxes less subsidies on production and imports	**9**	**1.5**	**870**	**6.2**	**4,006**	**7.1**
Gross domestic product (in billion riels)	**599**	**100.0**	**14,089**	**100.0**	**56,617**	**100.0**

GDP=Gross Domestic Product.

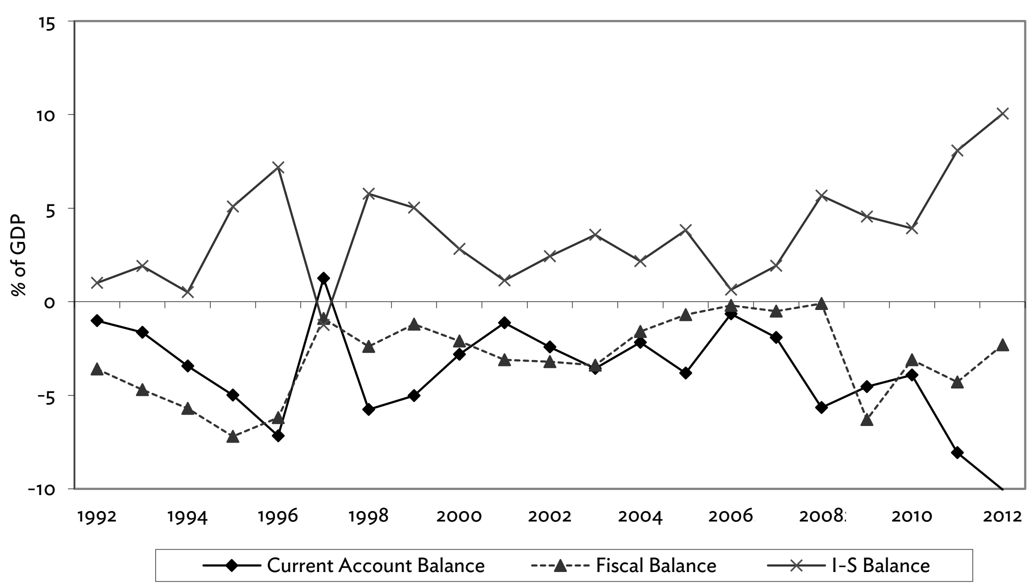
Source: ADB Statistical Database System, accessed 25 October 2013.

economic development process. But in Cambodia's case, one particular factor was at work. Exported garments dominates manufacturing, generating more than half its output and almost 80% of Cambodia's merchandise exports. Initially, the sector owed its existence to preferential market access arrangements provided during rehabilitation. This dynamism continued with the country's very open trade and investment policies, and generous fiscal support for the industry. Services have also grown rapidly, particularly in trade, transport, communications, and personal services. Apart from the general rise in income, the two key drivers of services growth have been tourism, centered around the world famous Angkor Wat temple complex, and the booming capital city, Phnom Penh.

Despite this rapid growth, the economy remains narrowly based and externally dependent. The non-agricultural economy is dominated by tourism, garments and construction. Both tourism and garments are highly export-oriented, while much of the construction sector is financed by foreign capital. While this openness is both inevitable and desirable, it poses particular development policy challenges (see section 4).

Reflecting its history, Cambodia's macroeconomic policy framework is unusual. As a large aid recipient, it has been able to run very large fiscal and current account deficits. Yet they have been sustainable and non-inflationary because they have been financed by highly concessional aid. Especially during the 1990s rehabilitation period, aid flows were equivalent to 5% of GDP, sometimes higher. The country was therefore able to run large fiscal deficits without running into serious debt problems (Figure 2). Tax collection procedures remain rudimentary, resulting

Figure 2. Macroeconomic Balances, 1992-2012 (% of gross domestic product)

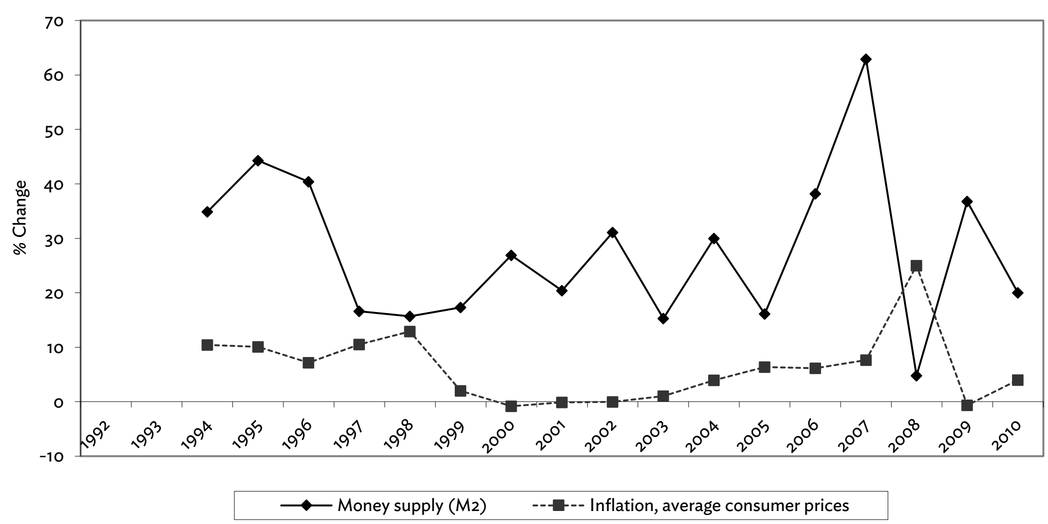


Source: International Monetary Fund, *World Economic Outlook Database, April 2013,* and ADB Statistical Database System, accessed 25 October 2013.

in a high dependence on aid flows to provide government services. Moreover, the government has been liberal toward foreign investment, with the resultant large capital inflows combining with aid inflows to finance very large current account deficits—several years in excess of 5% of GDP. Domestic savings, negligible in the wake of the country's protracted conflicts, began to rise quickly. But investment rose more quickly still. Thus, the large current account deficits merely reflect the fact that much of the country's investment continues to be financed externally.

Cambodia's monetary policy framework is also unusual, but reasonably effective. In the transition from plan and conflict to market and peace, the country briefly experienced hyperinflation. The immediate cause was the abrupt cessation of former-Soviet aid, in the late 1980s equivalent to about 15% of budget expenditure. The government resorted to large-scale deficit financing to cover the shortfall. However, the 1991 peace settlement ushered in large aid flows from western donors and inflation fell quickly (Figure 3). It has been under control ever since, mostly at single digit levels. There have been occasional spikes, such as in 1997/98 as a result of domestic conflict and the Asian financial crisis. Another occurred in 2007/08, first as a result of rapidly rising food prices and then the government's fiscal stimulus program in response to the 2008 economic slump. The moderately low inflation rates have held despite substantially higher rates of monetary expansion (Figure 3). This indicates both monetary restocking, as household and business confidence in the financial sector was restored, and the loose relationship between monetary and price movements. Also, high levels of dollarization—established in the early 1990s—persist, so the nominal exchange rate has come to serve as the government's de facto nominal anchor for inflation (see section 4 for further discussion).

Figure 3. Money and Inflation, 1992-2011 (% change)



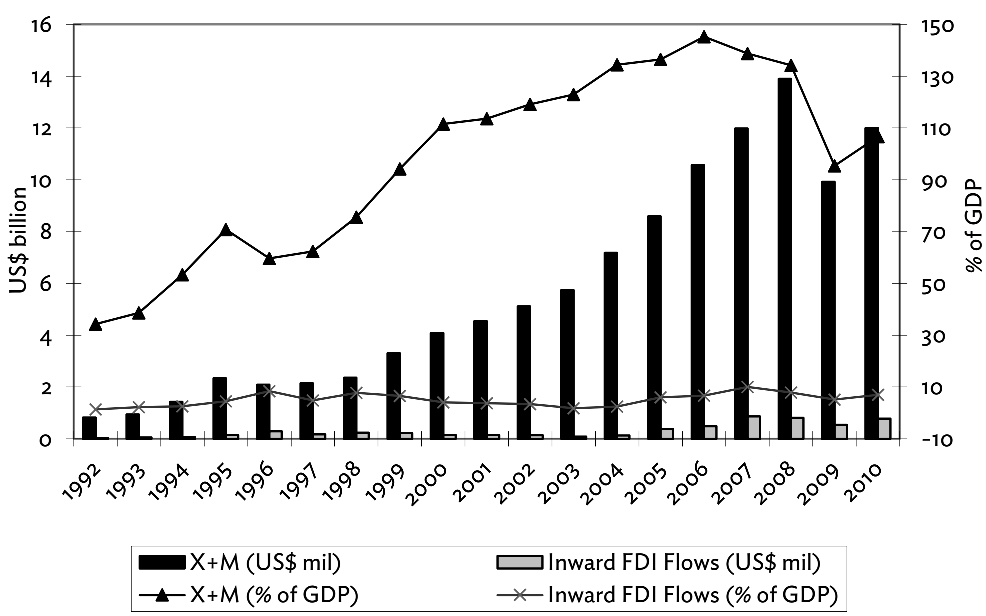
Sources: International Monetary Fund, *World Economic Outlook Database, April 2013,* and ADB Statistical Database System, accessed 25 October 2013.

3. Cambodian Trade and Commercial Policy

We now examine Cambodia's trade policy and external commercial relations, drawing mainly from the WTO (2012) report, but placed in context to better understand these trade policies and patterns. Cambodia is a highly open economy, with few restrictions on trade and capital flows; labor flows are also relatively unregulated. This openness is a result of the policy framework established during United Nations transitional rule. In turn, the Cambodian leadership has explicitly embraced open trade and investment policies. The trends and magnitudes of key external transactions can be charted (Figure 4). Merchandise trade has risen dramatically since the early 1990s, when Cambodia re-engaged with the global economy. In just over 2 decades, it rose by about 20-fold in nominal US dollar terms—from the equivalent of about 33% of GDP to nearly 150% at its 2006/07 peak. Foreign investment flows have been huge, equivalent to about 10% of GDP in most years. On these indicators, Cambodia is one of the most open economies in the Asia Pacific region.

However, trade and investment data is only approximate. The country's statistical collection apparatus, like the civil service in general, remains very weak. Cambodia's borders are porous, leading to large unrecorded trade flows, especially with its two large neighbors, Thailand and Viet Nam (although low formal trade barriers means that smuggling as an evasion strategy is modest). Prior to the 1990s, there was also substantial trade with the former Comecon bloc,

Figure 4. Indicators of Openness (Trade and Investment), 1992-2010



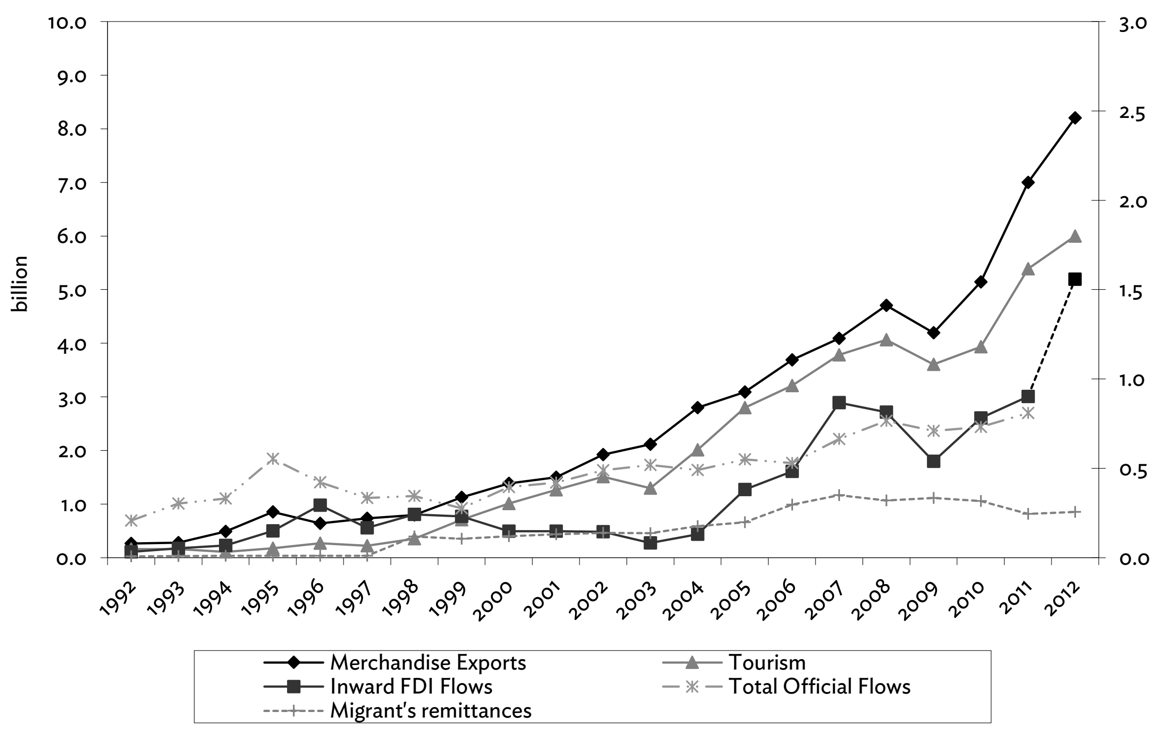
X = exports; M = imports; FDI = foreign direct investment; GDP = gross domestic product.

Source: UNCTAD, *UNCTADStat Database,* accessed 26 October 2013.

unrecorded in the UN trade data system. So to that extent values in the early 1990s were not as low as indicated in Figure 4. For investment, formal 'foreign' investment totals may be understated as there is substantial investment from the country's large international diaspora that enters as domestic investment. Moreover, common in postconflict societies, much of the country's political and commercial elite hold dual passports. Australia, France, and the US are home to large Cambodian populations.

The major flows in both current and capital accounts of the balance of payments from 1992 to 2012 tell an interesting story (Figure 5). Merchandise exports, dominated by garments, are a major source of foreign exchange earnings. Apart from the dip during the 2008 slowdown, they rose rapidly throughout the period. Tourism receipts are the next largest, unusually large relative to merchandise exports. In some years they were almost equal in value, but currently equal about 75% of receipts from merchandise exports. Tourism's rapid rise can be traced to the restoration of security from the late 1990s, opening the Angkor Wat temple complex, and the development of tourism support infrastructure such as hotels and air transport. In the years immediately after the peace accord, official development assistance (ODA) was by far the most important source

Figure 5. Sources of Major Foreign Exchange Inflows, 1992-2012 ($ billion)



Note: Exports in primary axis
FDI = foreign direct investment.

Source: UNCTAD, UNCTADStat Database, accessed 26 October 2013 of foreign exchange, in some years larger than the sum of all the other flows. After peaking in the mid-1990s, it began to modestly increase again from the late 1990s. However, since 2006, foreign direct investment (FDI) has generally exceeded ODA. Remittances have been smaller in value, but like ODA more stable than FDI. Notably, during the 2008/09 global recession, exports, tourism and FDI declined, while ODA and remittances remained stable, an important factor in the difficult task of macroeconomic stabilization during the period.

Cambodia's trade patterns reflect the interplay of regional growth dynamics and its preferential access to OECD markets, particularly the US. At the time it emerged from international isolation, major trading partners were almost exclusively in the East Asian region (Table 2). In 1995, Singapore and Thailand alone accounted for more than half of Cambodia's exports, which were dominated by simple wood products. This pattern changed dramatically following the normalization of relations with the US, and with the granting of preferential market access for the country's garment exporters. Thus, just 5 years later, garments had become the major export item, with the US alone accounting for almost 60% of total exports. The dominance of garments and the key role of the US has continued since 2000, albeit with encouraging signs of early-stage product and market diversification. The country has also enjoyed preferential access to the European Union (EU) following the implementation of the 2001 'Everything but Arms' initiative. By 2012, the US share of total exports was little more than half that of 2000. Hong Kong, China and other East Asian economies have become important export markets, while footwear has now become a significant export item as well. Given the prolonged recovery in OECD countries, coupled with East Asia's dynamism, trade patterns will continue to shift. Import patterns and sources are changing as expected, with East Asia the dominant source of imports, and petroleum and textile products the major items imported.

As noted, Cambodia is heavily dependent on trade taxes, which contribute over half the government's total tax revenue (Table 3). The three main forms—import levies, customs duties, excise duties and VAT—account for almost all of this revenue. Export and other trade levies are trivial, and lie in the category of nuisance taxes that could be abolished as part of general tax reform. The data also indicate that foregone customs duties are very large, exceeding the value of those actually collected. This heavy reliance on trade taxes and the large customs revenue foregone are expected in a transitional, dualistic economy. But their relative importance as revenue sources is declining over time as the tax base broadens. As argued below, the major policy challenge is to extend VAT as quickly as possible so there is equal treatment between imports and domestically produced goods and services. This will facilitate further trade liberalization, including full implementation of the ASEAN free trade agreement, while ensuring the government's fiscal position is not jeopardized.

As to the country's trade policy regime, tariffs, as noted, are the country's main protective tool, in that there are relatively few non-tariff barriers (NTB's). As part of its WTO accession, the number of tariff lines was reduced to four—set at zero, 7%, 15% and 35%. Over time, rates have been compressed with most products placed in the lower or intermediate categories. The standard deviation of rates in 2011 was a relatively modest 9.2%. However, there is some escalation in the structure according to level of processing, with the top tariff rate of 35% applied to a range

Table 2. Major Imports and Exports, by Economy and Commodity and Composition

	Top Exports (SITC, Rev.3)	% of Total	Top Destinations	% of Total
1995	[247] Wood in the rough or roughly squared	38.2	Thailand	42.9
	[248] Wood simply worked, and railway sleepers of wood	18.3	Singapore	11.3
	[231] Natural rubber & similar gums, in primary forms	13.9	Viet Nam	5.7
2000	[845] Articles of apparel, of textile fabrics, n.e.s.	30.0	United States	59.6
	[841] Men's clothing of textile fabrics, not knitted	17.2	Germany	6.6
	[842] Women's clothing, of textile fabrics	15.8	United Kingdom	6.4
2005	[845] Articles of apparel, of textile fabrics, n.e.s.	29.2	United States	56.3
	[844] Women's clothing, of textile, knitted or crocheted	16.9	Germany	9.2
	[842] Women's clothing, of textile fabrics	16.0	Hong Kong, China	6.6
2012	[845] Articles of apparel, of textile fabrics, n.e.s.	27.7	United States	31.5
	[844] Women's clothing, of textile, knitted or crocheted	15.8	United Kingdom	8.5
	[851] Footwear	8.1	Germany	8.2

	Top Imports (SITC, Rev.3)	% of Total	Top Sources	% of Total
1995	[122] Tobacco, manufactured	11.8	Singapore	37.0
	[785] Motorcycles & cycles	11.5	Thailand	24.7
	[334] Petroleum oils or bituminous minerals > 70 % oil	8.5	Viet Nam	6.2
2000	[334] Petroleum oils or bituminous minerals > 70 % oil	16.5	Singapore	17.1
	[655] Knitted or crocheted fabrics, n.e.s.	8.3	Thailand	16.8
	[652] Cotton fabrics, woven	8.0	Hong Kong, China	15.0
2005	[655] Knitted or crocheted fabrics, n.e.s.	14.0	Thailand	19.8
	[334] Petroleum oils or bituminous minerals > 70 % oil	10.2	People's Republic of China	14.5
	[652] Cotton fabrics, woven	7.5	Hong Kong, China	14.1
2012	[334] Petroleum oils or bituminous minerals > 70 % oil	17.5	Thailand	26.8
	[655] Knitted or crocheted fabrics, n.e.s.	11.5	Viet Nam	20.2
	[652] Cotton fabrics, woven	3.2	People's Republic of China	19.9

SITC = Standard International Trade Classification; n.e.s. = Not elsewhere specified.

Source: UNCTAD, *UNCTADStat Database*, accessed 26 October 2013.

Table 3. Trade Taxes and Government Revenue, 2004-2010

	2004	2005	2006	2007	2008	2009	2010
Total tax revenue (riels billion)	**1,656.2**	**1,989.8**	**2,391.6**	**3,584.7**	**4,688.7**	**4,332.2**	**5,070.0**
				of which (%)			
Customs duties (after exemption)	21.9	23.1	22.7	19.5	19.2	17.3	16.9
Excise duties on imports	15	16.3	14.9	14.7	16.5	13.7	14.6
Gasoline/diesel taxes	5.3	4	4.3	3.3	2.5	3.7	3.7
VAT on imports	24.4	24.3	24	20	20.3	21.4	19.8
Export taxes	1.2	0.9	1	0.6	0.5	0.3	0.4
Others (fees & penalties)	1.8	2	2.2	2	1.8	1.1	0.8
Total international trade taxes	69.5	70.6	69	60.1	60.7	57.5	56.3
Forgone customs duties (riels billion)							
Customs duties before exemption	911.6	1,171.90	1,321.30	1,628.00	2,206.50	1,739.70	2,006.30
Customs duties after exemption	362.8	459.2	541.9	698.6	899	751.5	858.7
Exemption / forgone	548.8	712.7	779.4	929.4	1,307.50	988.2	1,147.60
Exemption % of customs duties before exemption	60.2	60.8	59	57.1	59.3	56.8	57.2

Note: Total tax revenue comprises direct taxes, indirect taxes, and international trade taxes.

Source: World Trade Organization (2012), p. 34.

of semi-processed and consumer goods—such as processed food products, beverages and tobacco, footwear and motor vehicles (Table 4). With relatively thin domestic value added, this implies high effective rates of protection in these areas. Effective rates of protection are not computed in the TPR study, presumably because Cambodia does not yet have an input-output table. Over three-quarters of tariff lines fall within the two intermediate tariff rates, 7% and 15% (Figure 6), leaving just 14% of tariff lines duty free and 10% at the top rate. Thus 53% are either zero or subject to the minimum tariff, up from 44% in 2001. Cambodia has bound 100% of its tariff lines, while the average applied rate of duty is estimated at 11.7%.

The regulatory regime has also been simplified. Import and export procedures have been streamlined. There are few import prohibitions. A small number of export taxes apply to encourage greater domestic processing. State trading companies are not major players. The

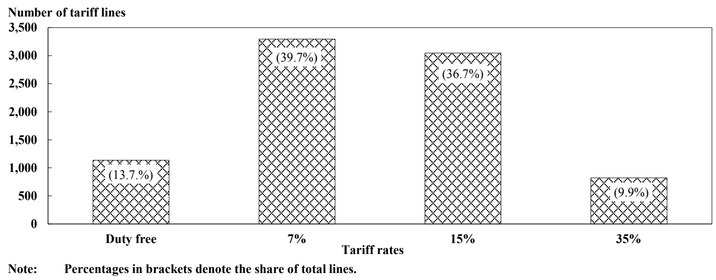
Table 4. Tariff Structure, 2003, 2005, 2011 (%)

		MFN applied			Final
		2003	**2005**	**2011**	**bound[a]**
1	Bound tariff lines (% of all tariff lines)	..	100	100	100
2	Simple average rate	17.3	15.1	11.7	20.1
	Agricultural products (HS01-24)	20.6	17.7	15.4	28.4
	Industrial products (HS25-97)	16.7	14.8	11.1	18.6
	WTO agricultural products	20.6	17.9	14.5	28.8
	WTO non-agricultural products	16.8	14.8	11.3	18.7
	Textiles	15.7	10.8	5.7	10.4
	Clothing	30.3	27.2	14.1	17.5
	ISIC 1 - Agriculture, hunting and fishing	11.9	10.8	10	23.2
	ISIC 2 - Mining	11.8	10.2	6.5	17.7
	ISIC 3 - Manufacturing	17.7	15.4	11.9	20
	First stage of processing	12.2	10.8	9.3	21.2
	Semi-processed products	10.9	8.3	6.2	13.6
	Fully processed products	21.1	18.5	14.5	22.6
3	Domestic tariff "peaks" (% of all tariff lines)[b]	0.2	0	0	0
4	International tariff "peaks" (% of all tariff lines)[c]	28.1	20.8	9.9	46.7
5	Overall standard deviation of tariff rates	13.6	11	9.2	11.6
6	Coefficient of variation of tariff rates	0.8	0.7	0.8	0.6
7	Duty-free tariff lines (% of all tariff lines)	4.3	5.9	13.7	1.1
8	Non-ad valorem tariffs (% of all tariff lines)	0	0	0	0
9	Nuisance applied rates (% of all tariff lines)[d]	0.1	0	0	0

WTO = World Trade Organization; MFN = most favored nation; ISIC = International Standard Industrial Classification.
Notes:
.. Not available.
[a] Based on 2011 tariff schedule. Cambodia implemented its tariff reduction commitments for all but 21 tariff lines by 2007. Tariff reduction commitments met for 20 tariff lines by 2013.
[b] Domestic tariff peaks are defined as those exceeding three times the overall simple average applied rate.
[c] International tariff peaks are defined as those exceeding 15%.
[d] Nuisance rates are those greater than zero, but less than or equal to 2%.

government is also in the process of establishing various technical standards required for certain industries, particularly food. Special economic zones have proliferated, mainly to attract FDI. Export-oriented garment firms generally operate within these zones and are able to import textiles duty-free. More recently, zones located on the Thai and Vietnamese borders have been established to facilitate cross-border trade. On the Thai border, the motive has been Cambodia's major labor-cost advantage, with unskilled wages one-quarter to one-third of those in Thailand

Figure 6. Distribution of MFN Tariff Rates, 2011



MFN = most favored nation.

Source: World Trade Organization (2012), p. 36.

itself. On the Vietnamese border, the main motivation has been proximity to Viet Nam's superior international ports and logistics.

Cambodia's service sector is one of the most open in Asia and the Pacific. The government recognizes the importance of the tourism industry, and also wants to fill the large deficit in modern-sector skills. Cambodia has also sensibly adopted an 'open skies' civil aviation policy, enabling direct international flights to the nearby city of Siem Reap. The country has benefited from not having to support a national airline that might have sought preferential market access. This is a general reflection of the political economy of protection in Cambodia: the general absence of powerful, vested commercial interests. In the KR's wake, there was virtually no established private wealth left. Foreign firms are also able to operate in legal services, accounting, banking, telecommunications, and transport industries. Foreign retailers are restricted to large supermarkets and department stores, while the hotel market is open for those ranked three-stars or above.

Aside from its WTO membership, Cambodia's major international commercial agreement is the ASEAN Free Trade Area, under which tariffs on ASEAN products were reduced to 0%–5% over a 10-year period, starting 1 January 2000. Cambodia has now agreed to eliminate tariffs on essentially all ASEAN products by 2015, except for 7% of tariff lines, which will be eliminated by 2017. For products covered by its Sensitive List, the maximum tariff will be set at 5% by 2018. Cambodia is also bound by the tariff reductions agreed upon in ASEAN's preferential trade agreements with the PRC (by 2015), India and the Republic of Korea (2018), Japan (2026), and Australia and New Zealand (2024).

4. Beyond Trade Policy: Managing Globalization

For managing globalization, Cambodia's open economic policies over the past 20 years illustrate both the opportunities and challenges for small transition economies with weak institutions. Its experience demonstrates that the benefits of openness far exceed the costs. Opportunities created through openness are most evident in the rapid growth in garments and tourism exports, which together now generate 71% of the country's exports of goods and services. They are by far the most important sources of non-agricultural employment, providing jobs for about one-seventh of the workforce.[3] For a country that was until recently war-ravaged and internationally isolated, the growth of tourism has been remarkable. International tourism receipts are now estimated to be equivalent to about 15% of GDP, a share almost double that of neighboring Thailand, long famed as a global tourism destination (World Economic Forum 2012). Cambodia was able to build on its natural advantage—the famous Angkor Wat temple complex. It has been able to do so not only because of the restoration of peace, but also because of its openness, in civil aviation, hotels and related facilities.

As noted, garment exports initially grew rapidly due to preferential market access to the US and EU; and under the general auspices of the Multi-Fibre Arrangement (MFA). However, over time, these preferential facilities have become far less important, as the MFA was phased out in 2005 and the margins of preference in major export markets have shrunk. However, apart from the 2008/09 global recession, export growth rates were maintained despite the more competitive environment.

Importantly, two other related developments flowed out of setting open economic policies. First, Cambodia used the period of temporary export support to establish its reputation among international investors and buyers in garments and other light manufactures. This had two consequences. One, as noted, is that the early heavy reliance on the US market is declining—from 55% in 2007 to 35% in 2012. Diversifying into European and Asian markets gives the industry a more secure footing, allowing a cushion against any sudden decline in US demand due to renewed recession or the granting of preferential concessions to alternative garment suppliers elsewhere. Another advantage has been diversification into other labor-intensive export manufactures. The most important of these has been footwear, which has increased rapidly from $88 million in 2008 to $311 million in 2012. Footwear has much in common with garments in its factor proportions and international production and sales networks. And with footwear exports subject to less international regulation, its growth is an unambiguous indicator of Cambodia's rising competitiveness.

The second development flowing out of openness has been Cambodia's ability to grasp unforeseen opportunities; particularly as labor-intensive export manufacturing relocates internationally. For example, multinational firms with Asian production networks have long adopted a "PRC plus one" risk diversification strategy. More recently, firms have also adopted a "Thailand plus one" strategy, both in response to the serious floods in late 2011—that incapacitated production and logistics networks for several months—and continued political instability. Thailand is the major export hub for Southeast Asia's automotive industry. Thus, several multinationals, particularly from Japan, have sought to establish production facilities in neighboring countries. Cambodia's open economy and business-friendly environment makes it attractive, particularly

[3] Garments employs about 370,000 workers and tourism about 620,000, out of a total workforce of approximately 7 million.

the government-established special economic zones on the Thai-Cambodian border. These developments serve as a reminder that openness creates commercial opportunities that are difficult to predict, as they are often driven by exogenous factors that cannot be modeled nor incorporated into governments' selective industrial policy planning. Moreover, in small economies like Cambodia, a few major industrial projects can make a significant difference, both in terms of direct labor market impact and in garnering community support for the success of the strategy, hence underpinning its durability.

Nevertheless, openness has to be managed to ensure it delivers sustainable and equitable growth. Ongoing reforms will be required in Cambodia as (i) international donor support declines, (ii) the country faces intensified competition from its neighbors with the ASEAN Economic Community gradually implemented, and (iii) living standards rise with a new generation of job entrants seeking more productive employment opportunities. These issues are beyond the immediate remit of TPR reports, but they are crucial in understanding the context of trade policy. We draw attention to them as a means of illustrating the challenges associated with managing globalization in small economies with weak institutions.

Openness also introduces economic volatility. This was evident during the 2008/09 global recession, when Cambodia's growth rate declined by eight percentage points, one of the sharpest falls in Asia and the Pacific. Demand for garments and tourism declined markedly, while private capital flows financing much of the country's construction boom evaporated. The country thus needs policies that ensure macroeconomic resilience, factor market flexibility and social support to navigate through crises. As it turned out, the recession effects were quite short-lived, and by 2010 the economy was back growing strongly. But recurring negative external shocks will inevitably be a feature of this small, open and potentially vulnerable economy.

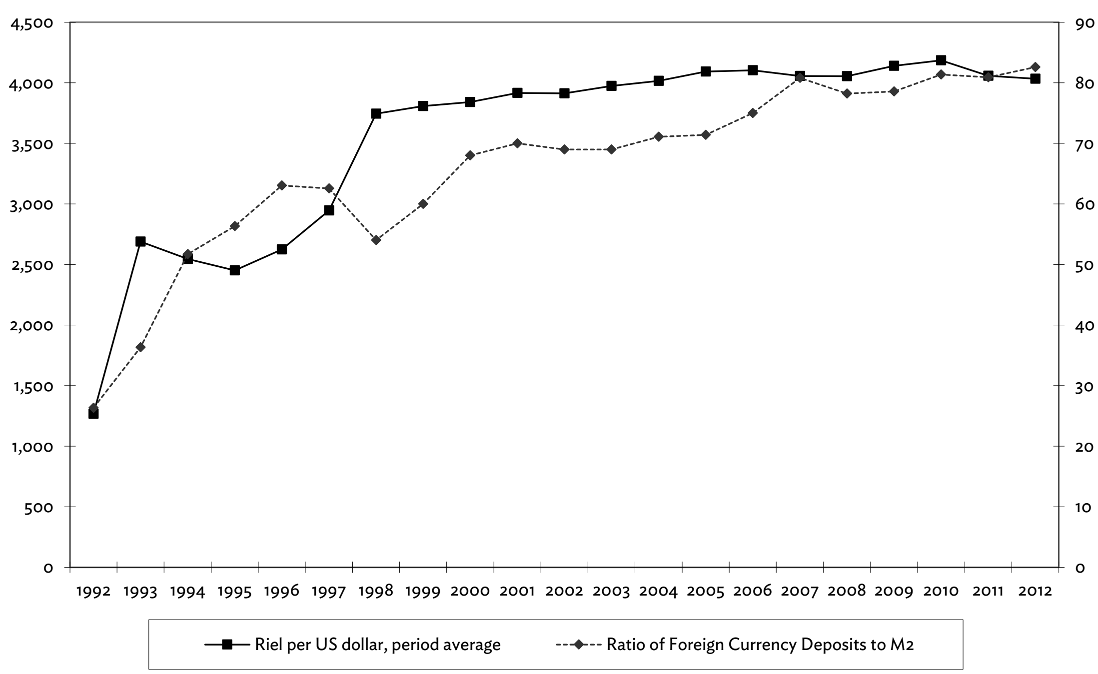
It also must be said that Cambodia achieved export competitiveness in part through extremely low wages in manufacturing. However, wages are beginning to rise, due to labor activism (aided in part by international NGO support) and the very rapid growth in demand. Export industries now have 2 decades of operating experience in Cambodia, but most production remains confined to sewing and other simple processing. These are very mobile industries internationally without deep production roots in the country. Significant wage increases could endanger competitiveness unless labor productivity increases and ex-factory costs reduced. Therefore, continuous supply-side investments are needed to improve education and create more efficient infrastructure. Broad-based education investments are also required to enable the poor to participate in expanding employment opportunities, and help ameliorate the glaring inequalities that have emerged within the urban economy, and between the urban and rural economy.

In turn, institutional development must accelerate to both support development of an efficient market economy and to protect the interests of the poor and marginalized. Not surprising for a country whose formal institutions were completely destroyed by conflict—and subsequently led by only one prime minister over a one quarter of a century—political power is highly concentrated and patronage networks embedded in essentially one-party rule. Cambodia therefore ranks very poorly on most international comparisons of governance quality and corruption.

We now illustrate these challenges as they pertain to five specific policy issues. How these are managed will have much bearing on whether the country can maintain its open commercial policies and its impressive development record.

(i) *Exchange rate and monetary policy:* Given its recent history and weak institutions, Cambodia is one of the most dollarized economies in the world—other than those formally using the US currency or having adopted a hard peg. The KR destroyed Cambodia's monetary and financial systems. And over the following decade of civil war, there was little confidence in the monetary system. As noted, there was also an episode of hyperinflation during the transition from a planned to market economy. The large UN presence and open economy from the early 1990s resulted in a very large inflow of foreign currency, principally US dollars. Dollarization, as measured by foreign currency deposits relative to broad money (M2), rose quickly to about 50% (Figure 7). It rose to over 70% during the political instability of 1997/98, and has stayed there ever since. Extended periods of low inflation and political calm have yet to have a discernible impact. In spite of official unease, and periodic drives to promote the use of the riel, the government reluctantly tolerates the high level of dollarization, as does neighboring Lao People's Democratic Republic and Viet Nam.

Figure 7. Exchange Rate and Dollarization, 1992-2012



M2 = money supply.

Source: International Monetary Fund (IMF), *International Financial Statistics* and Beresford, et al (2004) for 1990-1997 data; Menon (2008) for 1998-2006 data; IMF Staff Reports for Article IV Consultation for 2007-2011 data.

With the nominal exchange rate determined exogenously, exchange rate policy is limited in dealing with external shocks. Finding real exchange rate equilibrium following a shock thus requires changes to wages, which may be slow to adjust and hard to adjust downward, if required. Although it is unlikely a small, open economy like Cambodia could pursue a totally independent monetary stance without capital controls, the issue is about how much discretionary power exists to use counter-cyclical monetary policy to dampen the effects of external shocks. Heavy dollarization removes almost all discretionary power, because capital inflows or outflows automatically adjust money supply when a foreign currency is used as a medium of exchange. Prolonged crises will likely result, with their social costs magnified.

This is not the place to debate the pros and cons of dollarization.[4] One can argue it has supported good macroeconomic management in that it effectively removes the scope for the government to use monetary expansion for deficit financing. In a country with very weak institutions, this must be counted as a major advantage. However, it also means the government loses an important macroeconomic policy tool, namely monetary policy, and by extension exchange rate policy. For an open economy with significant natural resources in a region of floating exchange rates, the government is limited in what it can do to manage large external shocks. For example, during the 2008/09 global recession, the Thai baht and the Vietnamese dong significantly depreciated, improving economic competitiveness vis-à-vis Cambodia. Also, the government loses revenue from seigniorage, even if small—in the range 0.1-0.5% of GDP.

The implication is that adjustments to external shocks must come from fiscal policy and the labor market. In Cambodia's favor, the government had space for modest fiscal stimulus in response to the 2009 economic recession, and the labor market remains quite flexible. However, if dollarization persists, as is likely at least in the short to medium term, these policy areas will need to be strengthened. There are also implications for trade policy. Pressures from the tradable goods and services sectors for compensating support may arise during periods of exchange rate misalignment.

(ii) *Strengthening and broadening the fiscal base:* Cambodia's comprehensive tax policy and administrative reforms over the past 2 decades have helped boost domestic revenue from 6.5% of GDP in 2003 to over 10% in 2011. The introduction of VAT has helped broaden the tax base, and three indirect taxes—VAT, excise, and turnover taxes—have accounted for an average 60% of all collections over the past 5 years. While trade taxes accounted for some 40% of revenue in the late 1990s, their share has been falling gradually as tariffs have fallen. They now contribute only about 20% of tax revenues. Unlike the original ASEAN member countries, however, Cambodia has resisted multilateralizing tariff preferences and in principle retains multiple rates associated with its various preferential trade agreements. This increases the administrative burden on customs and creates opportunities for rent-seeking.

[4] See Menon (2008) for a detailed discussion.

In passing, Cambodian trade reforms, and heavy government reliance on trade taxes as a revenue source (especially in the 1990s) also highlight the challenge of further liberalizing trade while undertaking fiscal consolidation. Empirical evidence on the fiscal implications of trade liberalization is mixed, as was pointed out over two decades ago (Greenaway and Milner, 1991). In some cases trade liberalization led to fiscal enhancement, while in others it led to fiscal depletion. It remains unclear which conclusion applies to Cambodia. But as the country begins to graduate out of ODA, it is obvious that a much more vigorous tax effort will be required.

Recent revenue developments include updating the medium-term revenue mobilization policy and strategy (2013-2018), the introduction of various non-tax revenue sources and property taxes, and the strengthening and updating of the 'Asycuda' system, which facilitates an automated customs clearance process. While these programs and policies are steps in the right direction, administration and governance issues continue as binding constraints, limiting tax collection. The large informal sector, consisting mainly of small and unregistered traders, further constrains the government's ability of raise tax revenues. Since 2009, the share of total government revenue to GDP has remained relatively stagnant around 10%, suggesting that reform momentum may have slowed. Despite good progress historically, Cambodia's revenue share is second lowest among Asia's low-income countries, which average 17% (IMF, 2012).

(iii) *Improved infrastructure and logistics:* While Cambodia is a very open economy, it is much less competitive on "behind-the-border" infrastructure and logistics services. The benefits of low tariffs are somewhat nullified by high internal transport, utility and regulatory costs. For example, trade facilitation costs are estimated to be about 136% of those in the six major Southeast Asian economies, while the 'release time' for cargo is 24 days, compared with the regional average of 16 days.[5] Costs in the country's major international port, Sihanoukville, are about double those in neighboring Ho Chi Minh City, Viet Nam. So most export-oriented firms in Phnom Penh prefer to trade through Viet Nam for reasons of scale, speed and economy. This leaves two sets of customs procedures and—as the region's trucks are not licensed to operate across borders—forces carriers to reload from one set of trucks to another. Cambodia also has the most expensive power in Southeast Asia, with electricity charges in Phnom Penh about double those in Kuala Lumpur and four times those in Ho Chi Minh City.[6] Also, given unreliable power supply, most firms resort to expensive private generators.

Five factors complicate the development of high-quality logistics. First, there is a large historical backlog. Twenty-five years of protracted conflict both caused extensive destruction and withheld new investment and maintenance. Also, unexploded ordnance in more remote regions of Viet Nam/Cambodian border complicates infrastructure development. Second,

[5] Most of the data in this paragraph are sourced from CTIS (2013).

[6] See "The 21st Comparative Survey of Investment-Related Costs in 31 Major Cities and Regions in Asia and Oceania", JETRO, Tokyo, April 2011.

the country's five widely dispersed centers of economic activity, plus several second-tier cities, requires a larger road network than would otherwise be the case.[7] Third, although not land-locked, Cambodia's major international sea connections are through ports in neighboring Thailand and Viet Nam. Cross-border customs and transport procedures must improve for the smooth flow of goods. Unless trade volumes rise significantly in Sihanoukville, it is hard to justify investing in large-scale container shipping—although efficiency levels could be increased. Fourth, much major infrastructure is donor-driven, without any nationally integrated coordination, for example, between major highway routes and the much inferior secondary feeder roads. Maintenance, especially in the road network, also suffers. Finally, the capacity to manage logistics provision remains weak, reflecting the overall state of the poorly paid bureaucracy. Large infrastructure projects are seen as a way to personal enrichment, with sections of the bureaucracy perceived as available to the highest bidder.

(iv) *Social investments:* Cambodia's tragic historical legacy is nowhere more evident than in education. Virtually the entire educated class perished or fled the country in the 1970s. During the 1980s there was little investment in education and health because of the ongoing conflict and need to divert meager fiscal resources into defense and security. The country also has a very young population, with 60% aged 25 years or less. Since the early 1990s, education enrolment has increased quickly, given the target of universal primary education by 2015. However, school dropout rates remain high, even for primary education, with only slightly over half those entering grade 1 making it through grade 5. Of course, dropout rates are highly correlated with socioeconomic class and remoteness. In comparative math and science tests, the country also ranks very low (Table 5).

Although adult literacy has risen from 81.5% in 1990 (a figure probably overstated) to nearly 93% in 2009, increases in net enrolment rates have been minimal, and dropout rates remain high at 12%. In 2010, the typical Cambodian aged 15 years and above averaged only 4.5 years of primary schooling. As noted, non-attendance and dropouts are typically determined by the development context of household conditions, including poverty, the need to do household chores or contribute to household income (World Bank 2012).

Apart from increasing school retention rates, there is a pressing need to improve the quality and skill relevance of courses. Most enterprise surveys report skill shortages among the most serious constraints. In a 2007 Investment Climate Survey, 15.5% of foreign firms surveyed reported skills as a major constraint to growth, while another 22% identified skills as a "severe" or "very severe" constraint to their business. In a more recent survey of 78 employers, 73% reported that university graduates did not have the right skills, and 62% noted that vocational training graduates did not have the right skill mix (World Bank, 2012). While the number of tertiary education establishments and vocational training programs

[7] The five centers include (i) the capital Phnom Penh; special economic zones along the (ii) eastern border with Viet Nam and (iii) the western Thai border—with export-oriented activities more connected to these economies than to the rest of Cambodia; (iv) the port city of Sihanoukville; and (v) the tourism complex centered in Siem Reap.

and institutes has grown sharply, the results point to the need to significantly improve quality. There is also a mismatch between education suppliers, market demand, and societal needs. The tertiary education system trains large numbers of low-cost commerce, management and related disciplines (about half the student enrolment in 2009), many with little prospect of employment commensurate with their aspirations. By contrast, the system produces very few students in the more costly but much needed disciplines such as agriculture and rural studies (2.3% of the tertiary total) and science and technology (0.1%). Technical and vocational education is also underdeveloped, despite the high private returns this type of education offers.

The education catch-up and reform agenda is thus a very large one. It will become more pressing as regional and international competition intensifies, particularly from other low-wage suppliers in, say, emerging Myanmar, South Asia and elsewhere. There needs to be greater public expenditure to achieve higher quality basic education at the primary and at least lower secondary levels, with particular focus on areas of disadvantage. For higher and technical education, the main challenge is to make markets work more effectively. This involves establishing effective accreditation mechanisms, curriculum support, and needs-based student financing. Cambodia's very open labor market can help overcome supply bottlenecks during this transition period, although there is community resistance to the large numbers of workers from the PRC, Thailand, and Viet Nam—the most obvious sources of supply for middle-level technical and professional work. Unusual for a low-income country—especially one adjacent to an open Thai labor market with much higher unskilled wage levels—Cambodia probably remains a net labor importer.

(v) *Bureaucratic reform:* As would be expected, most comparative surveys highlight Cambodia's weak formal institutional quality. It ranks 164th out of 182 jurisdictions in Transparency International's Corruption Perception Index. According to World Governance Indicators, the country is in the 8th percentile in control of corruption, but a good deal higher (36th percentile) on regulatory quality. It performs somewhat better on the Heritage Foundation's Index of Economic Freedom (102 out of 179 jurisdictions) and the World Bank's Ease of Doing Business (102nd out of 179). Property rights, particularly land ownership, are a major problem, with implications for financial development, social trust and cohesion, and income distribution (Naron, 2011). Accepted legal land titles, known as hard titles, exist only in the capital and several secondary urban centers.

This limited institutional capacity has major implications for the process of regional and global economic integration. The government struggles to negotiate and comply with complex international trade agreements, especially the 'trade plus' clauses such as intellectual property rights, government procurement, sanitary and phyto-sanitary measures, and rules of origin. There is substantial, largely unregulated informal cross-border trade. Customs regulations and procedures are opaque, resulting in a flourishing secondary industry of agents and 'brokers' who facilitate transactions (CTIS, 2013). The government-established (though mostly private-owned) special economic zones—with their integrated package of infrastructure, logistics and regulatory compliance—are designed to overcome these problems. This second-best solution has created a 'dual' economic structure that effectively discriminates against small-scale, start-up and rural enterprises that do not have the requisite resources to locate in the zones, or whose location is determined by input supplies. But the zones are arguably the most effective transitional response pending broader economy-wide reform.

5. Conclusions

Cambodia's first TPR demonstrates that the economy is comparatively open, formal trade barriers are relatively low, and they mainly take the form of tariffs. There is no attempt to estimate effective rates of protection in the report, but these also are likely to be generally low, apart from a few cases of tariff escalation. The Cambodian government has deliberately chosen this open-economic strategy, made easier by the absence of major commercial vested interests such as state enterprises or large industrial conglomerates lobbying for protection. From an extremely low and narrow base, exports have grown rapidly, accompanied by some product and market diversification. The early heavy reliance on trade taxes in the budget is also declining, though it remains high. The country has been able to effectively build on preferential export market access—particularly for garments to the US—and it has now established a modest reputation as an attractive location for footloose, labor-intensive activities. For example, it was able to capitalize on the opportunities created by multinationals adopting a "Thailand plus one" strategy, especially in the wake of the massive supply side disruptions from the late-2011 floods and ongoing political disturbances. These impressive achievements are further consolidated by Cambodia's membership in the dynamic Southeast Asian regional trade and investment arrangements, including the ambitious 'seamless market' to commence in late 2015 as part of the ASEAN Economic Community. The growing integration that flows from the expanding cross-border road networks—as part of the six-nation Greater Mekong Subregion infrastructure program—is also a contributing factor.

Cambodia has grown rapidly because of good economic policies, combined with the return of peace, a conducive neighborhood effect and large inflows of capital, both concessional finance in the 1990s and increasingly private flows over the past decade. Development outcomes have been significantly better than could have been imagined 20 years ago. It is arguably the fastest-growing postconflict economy in recent history.

However, its experience also illustrates that a strategy of economic openness is a necessary but not sufficient prerequisite for rapid, broad-based, sustainable and inclusive development. The major barriers to economic integration are now principally behind the border, including high logistics and infrastructure costs, opaque regulations, a weak legal system and high levels of corruption. Moreover, social outcomes have lagged economic growth and economic development is narrowly based. The glaring inequalities associated with the inflows of foreign capital and skills, and the concentrated domestic political patronage networks that benefit from these inflows, threaten to undermine social cohesion and may provoke a nationalist backlash. To ensure that openness remains broadly beneficial and durable, the impressive progress to date will need to be accompanied by a higher priority for social expenditures, extending the tax base to the very wealthy, a more inclusive political system, and institutional, legal and civil service reform.

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Trade Policy Challenges in a Small, Open, Fragile, Postconflict Economy: Cambodia

This paper analyzes the World Trade Organization's first Trade Policy Review of Cambodia, Cambodia's rapid economic growth is underpinned by open trade and investment policies in the context of dynamic neighborhood growth effects. With tariffs very low, most of the country's trade policy challenges are "behind the border" issues, including weak bureaucratic capacity, high levels of corruption, poor infrastructure, and limited human capital.

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