

Chapter 1

Economic Growth

High economic growth performance in Cambodia in the last decade is no longer pleasant news for either the government or stakeholders. The shift is now on poverty reduction that is playing a pivotal role in shaping the policy process for development. The simple reason is that there is no automatic mechanism to ensure simultaneous growth and poverty reduction.

The baseline is also not anymore the “year zero” from 1975 – 1979 during which the country was plunged into the darkest pages of its history, the disaster and genocide, such that survival was the only ultimate hope of every Cambodian. Expectations towards prosperity and national pride on the international stage are now unsurprisingly high, which the majority of stakeholders believe that Cambodia deserves, given its rich, natural and cultural resources.

Figures on high growth rates of the economy in recent years have failed to gain applause from many government officials and stakeholders because the growth is not concomitant with social improvement such as in poverty, health, and education.

According to EIC documentation and studies, strong economic performance in the past decade has produced minimal impact on the improvement of the Cambodian people’s livelihoods. The recent revision of national account estimates by the National Institute of Statistics (NIS) places the Gross Domestic Product (GDP) growth rate at 7 percent in 2003 and 7.7 percent in 2004, driven mainly by unexpected growth in garment exports in spite of the MFA phase-out, a boom in construction, and a record number of 1 million foreign tourists, plus large inflows of foreign assistance.

Available data for the first nine months of 2005 and various surveys are used in EIC’s revised forecast for economic performance for the year 2005 and the following year. The forecasted scenarios are based on prospects for each sector, evaluation of reform progress and global economic environments. While economic growth projected by the World Bank for Thailand is 5.2 percent, for Laos 7 percent, and for Vietnam 7.5 percent growth in 2005, EIC projects that Cambodia’s economy will grow at around 5.0 percent in 2005 down from 7.7 percent in 2004 and lower than the government’s forecast.

**Table 1.1: Economic Growth of Cambodia, and its neighbors
(%, 2000 prices)**

	2002	2003	2004	2005e	2006p
Cambodia	5.2%	7.0%	7.7%	5.0%	4.9%
Laos PDR	5.8%	5.3%	6.0%	7.0%	6.5%
Thailand	5.3%	6.9%	6.1%	5.2%	5.6%
Vietnam	7.1%	7.3%	7.7%	7.5%	7.5%

Sources: NIS and EIC for Cambodia, The World Bank for Laos, Thailand, and Vietnam.

The growth forecast for 2006 is about the same rate as that of 2005 even though growth in the agricultural sector is expected to rebound. These growth rates continue to be boosted by high tourist arrivals, expansion in residential construction and real estate, and the good performance of the garment industry due to temporary measures taken by the US and EU to restrict their garment imports from China.

There are five main factors leading to the lower growth rates. Lower growth of exports of the garment industry, drought, and the continuous hike of the international price of oil are three current factors causing a lower rate of growth in 2005. Petroleum products account for about 1/3 of the total imports of goods, the second largest after imports of raw materials for the garment and textile industry. Preliminary analysis by EIC on the relation between prices of petroleum and intermediate inputs reveals that a 10 percent increase in retail prices of petroleum will reduce GDP growth between 0.5 percent to 1 percent. The reduction in growth is a result of an increase in petroleum-induced costs of intermediate inputs and deliveries, where selling prices either rise less than costs or are constant.

The fourth factor is the speed of reforms in critical areas, also affecting indirectly the economy's growth prospect in the following year. For example, growth in the agricultural sector, excluding weather conditions, is subject to irrigation renovation, natural resources management reforms, whereas growth in industrial and service sectors is dependent on multi-faced reforms in trade and investment, in public finance, and in the legal and judicial systems. Some of these reforms are unlikely to be achieved in the short term, but are feasible should political will exist.

Last but not least, external factors such as the continuous increase in the price of petroleum, the security situation, and changes in international trade regimes, especially the implications of Vietnamese membership in the WTO are important. These external factors continue to affect inflows of foreign direct investment (FDI), growth in competing

export industries and service sectors in the short run. The country's garment industry is facing stiffer competition so that actions are required in order to maintain the sector's competitiveness in the quota-free world. In fact, the garment industry has shown its weary strength of growth as its exports start to slow down from their high and fast growing period over the past five years.

Table 1.2: Cambodia's Economic Growth (% , 2000 prices)

	2002	2003	2004	2005e	2006p
Agriculture	-2.8%	12.0%	-2.1%	1.3%	3.8%
Paddy	-7.8%	22.3%	-12.3%	-0.4%	5.6%
Industry & Construction	17.7%	12.3%	16.5%	6.9%	5.4%
Garments	21.2%	16.9%	24.9%	8.5%	7.1%
Services	4.4%	0.1%	9.2%	6.5%	5.7%
Tourism	18.8%	-10.3%	23.6%	17.9%	14.0%
Total GDP	5.2%	7.0%	7.7%	5.0%	4.9%

Sources: NIS for 2002-2004, and EIC model projection for 2005-2006.

Repeatedly, surveys and studies by EIC suggest that anti-corruption and reforms in the legal and judicial systems, the backbone of the rule of law, are the most urgent areas needed to provide an environment for economic growth, equitable income distribution, and poverty reduction in the country. Most stakeholders consulted encourage the government to take decisive action to deal with these two fundamental problems for Cambodia's departure from the status-quo.

1.1. Agriculture

Agriculture is natural-resource-based and is mainly comprised of paddy, crops, livestock, forestry, and rubber. The sector is very important to the economy for its immediate affect on living conditions of the poor. However, development of the sector depends on geographical and natural conditions. Without irrigation systems, most arable lands are suitable for only one-off paddy rice production a year such that drought continues to threaten the livelihoods of farmers.

In 2004, the country suffered from a severe drought and a sudden reduction of fish stock which caused agricultural production to decline by 2.1 percent. Paddy production fell by more than 12 percent and fishery was 3 percent lower than its production in 2003. Growths in the forestry and rubber sectors keep declining possibly the result from the government's

moratorium on commercial loggings and processing since 1999, in combination with illegal deforestations. However, continuous growth in other crops and livestock from 2003 showed a new driving force for agricultural diversification.

Most recent field surveys by EIC³ confirm the growing tendency of farmers to complement their unpredictable paddy cultivation with animal (cattle, pigs, and poultry) and other crops. Livestock happens to be a new source of growth and income for the poor. However, lack of capital and inaccessibility to credits are the main obstacle for poor farmers to invest in animal husbandry. Therefore, an initial solution should be direct support in grants (prohibition on sale) of farm animals to the poor.

Table 1.3: Production of Agriculture Sectors (% increase, 2000 prices)

	2002	2003	2004	2005e	2006p
Paddy	-7.8%	22.3%	-12.3%	-0.4%	5.6%
Other Crops	-0.9%	29.0%	6.1%	2.1%	6.4%
Livestock	-1.2%	5.1%	4.3%	3.7%	4.1%
Fishery	0.6%	1.7%	-3.3%	0.9%	0.9%
Rubber & Forestry	-7.6%	-5.3%	-1.5%	-0.2%	0.0%
Total Agriculture	-2.8%	12.0%	-2.1%	1.3%	3.8%

Source: NIS for 2002-2004, and EIC model projection for 2005-2006.

For 2005, the agricultural production will be either flat or slightly increase due to another year of severe drought in many paddy producing areas such as Battambang, Prey Veng, Svay Rieng, Kampong Speu, Takeo and Kandal provinces. Therefore, growth in agriculture is expected to be at roughly 1.3 percent compared with 2.4 percent forecasted by the government. The annual growth rate of the sector for 2006 is expected to recover and increase by 3.8 percent. The forecasted growth is caused by expansion in livestock, more arable (cleared) lands for other crops, and paddy, given their favorable increase in prices and the government's commitment to rehabilitate countryside irrigation systems in the following years.

Nevertheless, seasonality of agricultural production, unexpected fluctuations of prices, and uneven distribution of land are the main challenges for the farmers to prosper. For some parts of the country, cultivation of paddy rice is the only option. Diversification of agricultural

³ One of which was the EIC's Cambodia Poverty Assessment: Regional Case Studies, sponsored by the World Bank (forthcoming). Most focus groups consulted by EIC agreed that raising cattle and pigs are their main supplement sources of incomes and saving.

production is possible for others depending on natural endowments and economic conditions (comparative advantages, marketability, price stability, and institutional arrangements to support the process).

The lack of appropriate investment in irrigation systems, high input costs such as petroleum and fertilisers and price manipulations by middlemen are among the main obstacles to agricultural expansion and high income earnings for farmers. The mode of agricultural production is no longer purely free inputs from nature. Marketing and technological supports are still limited. An adequate energy policy, especially intended lower prices of petroleum, is fundamental to lower costs of production boosting the sector's competitiveness.

Institutional arrangements such as “contract farming” should be widely introduced. Moreover, a liaison office⁴ to bring farmers directly to buyers should be established. The office will be a workable mechanism to reduce price manipulations from middlemen and to ensure the predictability of supply and demand forces of the market through execution of future contracts with fixed prices and quantities, the very favorable form of contracts that could prevent risks resulting from fluctuations (suppression) of prices⁵.

However, the starting point for the poor landless is simply to give them land for cultivation for their survival and grants in animal stock for them to prosper, provided that re-sale of these lands and grants is not allowed for a certain period of time. Land reforms, natural resources management are the decisive factors in achieving the government's goal of poverty reduction through strong and stable growth in agriculture.

1.2. Industry & Construction

Industry in Cambodia is driven mainly by the clothing, apparel, and footwear sector. This high concentration has posed a serious concern on overall economic sustainability. Attempts have been made by the government to safeguard this sector through the labour compliance project monitored by the International Labor Organization (ILO) in order to secure orders from US buyers. The government is also lobbying the US Congress to enact the Trade Act through which countries heavily affected by the Tsunami and some poor countries including Cambodia are granted duty-free exports to the US markets.

⁴ For more sophisticated arrangement, “future market for agricultural commodities” should be established. This has been long and common practice of many countries in the region and the world.

⁵ It should be noted that lower prices of staple foods may be beneficial for net food consumers and encourage activities (such as livestock) rather than single paddy rice culture as argued by International Monetary Fund. (2004). *Cambodia: 2004 Article IV Consultation – Staff Report*. p. 31 – 38.

In 2004, total industry and construction grew by more than 16 percent supported by growth in all sectors except the food, beverage and tobacco industries, which declined due to a fall in agricultural products, according to a revised estimate of the NIS. However, the garment industry got an unexpected boost in spite of the quota-phase-out at the end of 2004. The garment and textile industries rose exceptionally by 25 percent due to their strong export performances which account for more than 84 percent of the total exports.

Table 1.4: Production of Industry Sectors (% increase, 2000 prices)

	2002	2003	2004	2005e	2006p
Garments and Textiles	21.2%	16.9%	24.9%	8.5%	7.1%
Food, Beverage & Tobacco	-1.2%	5.6%	-2.1%	1.6%	2.0%
Other Manufacturing	7.8%	0.7%	3.1%	3.3%	3.2%
Electricity, Gas and Water	17.1%	15.7%	4.7%	9.5%	8.6%
Construction & Mining	27.0%	11.0%	13.0%	6.4%	3.0%
Total Industry & Construction	17.7%	12.3%	16.5%	6.9%	5.4%

Source: NIS for 2002-2004, and EIC model projection for 2005-2006.

Their total quantity exports increased by 26 percent boosted by a 21 percent increase in exports to the US, 34 percent to the EU, and 71 percent to the rest of the world. However, fiercer competition caused a decrease in prices of garment exports to the US by more than 5 percent compared with prices in 2003. Construction and mining also increased by 13 percent fuelled by soaring residential construction, followed by a 5 percent growth in electricity, gas, and water, and 3 percent growth in other manufacturing.

Based on data for the first seven months of 2005, EIC estimates that the growth rate of industry and construction for 2005 is down to about 7 percent due to a lower increase in garment and textile exports to the US and a decrease in exports to the EU markets. Total exports of garments in the first seven months of 2005 increased by only 10 percent compared with 23 percent growth in the same period last year. Cambodian exports of garment and textile were retained, thanks largely to “safeguard” measures taken by the US and EU under WTO rules to restrain an influx of Chinese imports to their markets.

The price of exports in the US market will continue to go down before adjustments of the world market for garments and textiles are

completed and when prices become more stable. However, prices in the EU are less volatile in 2005 and the following years for the market is more open.

Table 1.5: Cambodia's Garment Exports (% increase, year average)

	2002	2003	2004	2005e	2006p
Quantity					
USA	15.8%	10.2%	20.6%	22.6%	8.5%
EU	11.0%	19.3%	34.2%	-17.0%	0.0%
Others	65.1%	146.8%	71.1%	14.0%	15.0%
Total	15.3%	14.7%	25.7%	12.4%	7.3%
Prices					
USA	-0.6%	6.7%	-5.5%	-2.2%	-0.1%
EU	3.9%	-4.2%	6.3%	0.0%	2.0%
Others	-4.9%	13.5%	-4.2%	15.0%	3.5%
Total	0.4%	4.7%	-1.6%	-2.3%	0.4%

Source: Ministry of Commerce for 2002-2004, EIC estimates for 2005-2006, based on the expert opinions.

The construction sector, however, is expected to slow down to 6 percent growth in 2005, down from 13 percent in 2004. The lower rate of growth is a result of a slow down in public constructions since many big roads have almost been completed. Lower disbursement of capital expenditure of the government in the first half of 2005 and few constructions of hotels are also the reason, despite continuous strong growths in garment factories and private constructions, especially flats and apartments.

According to a forecast for 2006, growth in industry and construction is down to about 3 percent due to continuous weaker growth in garment exports and completion of construction booms in flats and apartments. The forecast is based on the assessment of export performances of garments and textile to the US and the likelihood of Vietnamese membership in the WTO in 2006 or 2007. The Vietnamese accession to WTO may divert FDI away from Cambodia and lead to some factory moves, given cheaper costs of displacements and incentives from the US removal of quota restrictions on the garment and textile imports from Vietnam⁶.

⁶ Based on expert opinions.

The situation will be reversed if the Trade Act is adopted, through which Cambodia could enjoy tariff-free access to the US markets, especially for garment and textile exports. The actual implementation of registered investment projects would also affect the growth prospects of the industry and the economy as a whole.

The prospects for diversification of industry are largely dependent on the government commitments towards reforms and the ability to improve the business environment of the country. Studies by the World Bank, EIC, and other institutions⁷ identify many constraints in doing business in Cambodia. Among these are higher costs of doing business which are mainly caused by corruption, costs of transportations, and higher costs for utilities due to the higher price of petroleum. The question is whether comparative advantages gained from the country's accession to regional and world markets are enough to attract foreign investments in spite of these myriad transaction costs.

1.3. Services

Services have become the biggest sector in the economy since 1999 according to both NIS and EIC estimates. The most significant shares of the service sector are the wholesale and retail trades followed by transports and communications, and the hotel and restaurant sectors. Of particular notice, the large proportions in trade service and transport and communications reflect high intermediate transaction costs in economic activities.

For 2004, the service sector, excluding public administration, increased by more than 10 percent. Of all the gains, hotels and restaurants grew by 24 percent thanks to a record one million tourist arrivals into the country⁸. Other private services such as rentals and real estate also increased more than 11 percent following booms in residential and apartment constructions. Finance and banking also expanded both in areas of coverage and amounts of financial services operations.

The number of foreign tourists was up by 41 percent in 2004 after a 12 percent fall in 2003. The gains were the result of the country's security improvement compared with the threats of terrorism and violence in other countries. More frequent flights from the countries in the region to Cambodia are also factors leading to these higher tourist turn-outs.

Higher imports and exports, improvement in national and rural roads, and growing mobile phone and internet businesses boosted the

⁷ EIC, Cambodia Competitiveness Report 2005-2006

⁸ Excluding spot visitors to Preah Vihea Temple.

transport and communication sectors. In effect, they also helped facilitate trade in 2004. These sectors attained about 6 percent growth each.

Table 1.6: Production of Service Sectors
(% increase, year average, 2000 prices)

	2002	2003	2004	2005e	2006p
Transport & Communication	7.6%	2.3%	6.2%	4.1%	4.4%
Trade	0.6%	2.2%	6.3%	5.6%	4.6%
Hotel & Restaurants	18.8%	-10.3%	23.6%	17.9%	14.0%
Other Private Services	1.8%	2.2%	11.2%	4.8%	3.9%
Total Private Services	4.7%	0.4%	10.3%	6.8%	5.8%
Public Administration	-0.3%	-4.3%	-6.8%	1.3%	3.1%
Total Services	4.4%	0.1%	9.2%	6.5%	5.7%

Source: NIS for 2002

For 2005, the projected growth rate of services is 6.5 percent, about 3 percent lower than the growth in 2004. The forecast assumes moderate growth in the agricultural and industrial outputs, imports, exports, and the projected foreign tourist arrivals all of which utilise services.

Table 1.7: Foreign Tourist Arrivals in Cambodia
(% increase, year average)

	2002	2003	2004	2005e	2006p
Through Phnom Penh	5.3%	-22.6%	17.4%	25.0%	15.0%
Through Siem Reap	42.4%	-1.4%	66.1%	50.0%	35.0%
By Land & Boat	34.0%	-7.2%	47.3%	30.0%	20.0%
Total	21.3%	-12.5%	40.8%	34.7%	23.7%
Number (000's)	801	701	987	1,329	1,645

Source: Ministry of Tourism for 2002-2004, EIC Estimates for 2005-2006, based on the professional opinions

Based on trends and seasonality, EIC estimates that the number of international tourist arrivals will increase by 35 percent in 2005 compared with 2004⁹. However, based on the trends, the average growth rate of the services during 2006 is expected to stabilise at 5.7 percent growth with

⁹ According to the Pacific Asia Travel Association, Cambodia topped the list of tourist arrivals in the Asia Pacific region in the first 6 months in 2005. Number of foreign tourists increased more than 50 percent, higher than data from Ministry of Tourism which estimates the rise at 38 percent for the first 6 months of 2005 compared with that of 2004.

moderate gains from all subsectors of the services. Prospects for the sector may be overturned by increases in the price of petroleum and depreciation of the Riel and inflation pressures that make financial services more expensive due to a possible raise in the lending rates.