

Chapter 1

Economic Growth

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The Economic Institute of Cambodia estimated that the country's economic growth rebounded to 6.5 percent in 2004,³ after continuously slowing during 2001-2003. As expected,⁴ data released by the Ministry of Commerce showed that Cambodia's garment exports were very strong, reaching almost US\$ 2 billion in 2004, and the number of foreign tourists visiting Cambodia reached about 1 million people. These two sectors alone have contributed more than 80 percent of total GDP growth. However, unfavorable climatic conditions and weak management of natural resources have significantly impacted the agriculture sector in 2004.⁵

Table 1.1: Cambodia's Economic Growth (% , 2000 prices)

	2002	2003	2004e	2005p	2006-2008
Agriculture	-0.9%	8.5%	-4.0%	3.9%	2.9%
Paddy	-8.7%	26.9%	-15.6%	7.7%	2.3%
Industry & Construction	10.4%	9.6%	14.3%	-0.5%	-0.1%
Garments	14.3%	13.4%	24.2%	-1.7%	-0.5%
Services	7.5%	2.8%	8.4%	5.0%	4.9%
Tourism	11.0%	-5.5%	22.7%	10.7%	9.8%
Total GDP	5.5%	5.3%	6.5%	3.2%	3.0%

Sources: NIS for 2001-2003, EIC estimate for 2004, and model projection for 2005-2008

For 2005 and beyond, the elimination of the quota system for garment products will very likely induce a decline of Cambodia's garment exports, especially to the US market. This contraction will, naturally, slow down the overall GDP growth rate. The slowdown could probably be avoided by eliminating unnecessary transaction costs to increase the relative competitiveness of the garment sector in the quota-less world.

³ This economic growth estimation for 2004 is ½ percentage point lower than that of the EIC previous estimation, because the drought was more severe than expected. However, EIC economic growth estimation remains higher than that of the most recent IMF assessment made early 2005 (6 percent growth for 2004, and 2.3 percent in 2005).

⁴ EIC Cambodia Economic Watch, October 2004, pages 10 and 13.

⁵ Based on EIC calculation, garment and tourism industries contributed respectively 3.5 and 1.8 percentage points in the total GDP growth for 2004, while other industry and service sectors contributed about 2.5 percentage points. A severe drought occurred last year and the decline of paddy production contributed negatively (-1.3 percentage point) to the total GDP growth.

However, we continue to expect that the tourism sector will continue to grow steadily, while agriculture production will remain strongly dependent on weather. As a result, Cambodia's economic growth will drop to just 3.2 percent in 2005, and around 3 percent per annum in the coming years.⁶

1.1. Agriculture

The Cambodian agriculture sector is characterized by a sharp decline of natural resources, including forestry and fish stocks, and low and erratic growth of paddy production, because of a lack of an effective irrigation system. Employing more than 70 percent of Cambodia's workers, and accounting for about 30 percent of the economy, the agricultural sector grew only about 2.5 percent per annum during the last five years. Due to the very low productivity, incomes generated by the agriculture sector could not support enough rural livelihoods. A Poverty Profile of Cambodia in 1999 revealed that about 80 percent of the poor derived their main source of income from agriculture.

The 2004 drought has caused significant damage to rice production. A recent report by the Ministry of Agriculture⁷ showed that about 12 percent of the crop of cultivated areas has been totally destroyed, and large parts of the rest of the land have been partly affected by lack of water. As a result, production of paddy during last year's wet season reached only 3.13 million tons, against 3.84 million tons of same season of 2003, which represents a decline of 18 percent. Despite this sharp decline, the government estimated that Cambodia will still enjoy a large rice surplus for local consumption and exports this year. To some extent, other crops also suffered from the last year drought. Its production growth is estimated to slow down from 8.8 percent in 2003 to 2.3 percent in 2004.

Livestock production was basically flat in 2004 because of bird flu disease and sharp competition from neighboring imports. In 2004, Cambodia's nascent poultry industry has been strongly affected by the disease. Although most of the country's poultry production comes from traditional breeding, which has not been impacted by the disease, some Cambodian consumers still avoid eating poultry meat.

⁶ The contribution of the garment industry to the total GDP growth will be negative (-0.3 percentage point) in 2005, against +3.5 percentage points in 2004. The contribution of the agriculture sector will be positive (about 1 percent) as we assume that there will be no more droughts in 2005.

⁷ Ministry of Agriculture, Forestry and Fisheries, Activity Review on 2004-2005 and Objectives for 2005-2006, April 2005

Table 1.2: Production of Agriculture Sectors
(% increase, 2000 prices)

	2002	2003	2004e	2005p	2006-2008
Paddy	-8.7%	26.9%	-15.6%	7.7%	2.3%
Other Crops	8.5%	8.8%	2.3%	5.3%	6.2%
Livestock	1.8%	5.2%	0.4%	2.0%	2.4%
Fishery	3.1%	-3.6%	0.3%	1.1%	1.1%
Rubber & Forestry	-30.2%	-2.1%	-2.7%	-0.4%	-0.5%
Total Agriculture	-0.9%	8.5%	-4.0%	3.9%	2.9%

Source: EIC, compiled from the primary data of the Ministry of Agriculture for 2001-2004, and model projection for 2005-2008

However, fish production slightly recovered from the previous year's decline. According to a recent EIC and Cambodian Parliament joint field study,⁸ production of small fish that are used to produce popular salt fish pâté *Prabok* significantly increased, but normal commercial fish production remained low. In 2004, small fish production increased by 25 percent, leading to a price decline of almost the same proportion.

For 2005 and beyond, Cambodian crop production will still depend on unpredictable weather conditions, because an effective irrigation system will not be in place.⁹ Given the very low government budget revenue expected for the next coming years, prospects for a rapid improvement of agriculture infrastructure will be dim. As a result, rice production will expand moderately by about 2 percent per annum, almost the same rate as the population growth.

Thanks to the expansion of new cultivated land however, non-rice crop production will continue to grow significantly (5 to 6 percent per annum). The non-rice crops are expected to contribute more substantially to rural livelihoods and to the Cambodian balance of payments. Official statistics do not show any information on external trade of these types of products, as they were informally traded with neighboring countries.

⁸ The Senate, National Assembly, and EIC, Fishery Assessment in Kampong Chhnang and Pursat, January 2005

⁹ Although an irrigation system in Cambodia basically does not exist, rice cultivated areas during the dry season represents about 12 percent (275,000 ha) of the total rice cultivated area. These lands are generally situated near natural lakes.

Statistics of the Ministry of Agriculture showed that production of corn, cassava, and beans was doubled during the last few years. In addition, prices also steadily increased. As a result, the income of Cambodian farmers who grow these types of crops significantly improved. Some of them who hold at least 5 ha of land become even relatively rich.¹⁰ Nevertheless, production of vegetables remained flat or declined, because of sharp competition with the neighboring countries. The government should encourage Cambodian farmers to switch from their rice growing to non-rice crops, especially corn and beans, which can be exported easily to Thailand, Vietnam and China. Moreover, these crops do not need so much water as rice for growing.

The decline in forestry and fish stocks pose serious problems. Government efforts to halt illegal logging and strengthen forest concession practices have thus far been insufficient to halt unabated exploitation. Small scale, community based forests with strict adherence to technical standards may be enough to cover demand for domestic wood consumption, but any continuance of large scale commercial logging will need to have transparent and credible management and to show compliance with environmental and social impact regulations.

A jump in the international price of rubber in 2004 helped rubber production to increase in nominal terms but to post negative growth in real terms because of the previous felling of older rubber trees. Newly planted trees have not yet reached maturity. With fertile land suitable for rubber expansion and some prospects for privatization of state-owned rubber companies, production and quality could improve. Moreover, capital investments in rubber processing are expected. Better prices and higher production would benefit both companies and the workers and farmers living nearby. A re-emergence of rubber plantations and production would be a meaningful growth aid in the agricultural sector.

1.2. Industry & Construction

The industrial sector achieved a remarkable growth of 14.3 percent growth in 2004, thanks to an impressive increase in garment exports. This is up from 10.4 percent in 2002, and 9.6 percent in 2003. The garment industry, a dominant factor in Cambodia, posted 24.2 percent growth in 2004, compared to 13.4 percent in 2003. The electricity and water sectors increased their growth by 13.6 percent, whereas wood, paper, and

¹⁰ Cambodian Senate and EIC Research Team: Could Cambodian farmers be rich?, EIC Economic Review no 3, January-March 2004

publishing shrank as compared to 2003. The decline in wood processing paralleled the decline in forestry production. Poor forest management is largely the reason for this.

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

	2002	2003	2004e	2005p	2006-2008
Garments and Textiles	14.3%	13.4%	24.2%	-1.7%	-0.5%
Food, Beverage & Tobacco	2.8%	2.5%	2.1%	1.9%	2.4%
Other Manufacturing	2.1%	2.2%	1.7%	0.6%	0.4%
Electricity, Gas and Water	13.8%	13.7%	13.6%	11.7%	6.9%
Construction & Mining	9.7%	7.5%	1.4%	-0.8%	-1.9%
Total Industry & Construction	10.4%	9.6%	14.3%	-0.5%	-0.1%

Source: EIC, compiled from the government primary data for 2001-2004, and model projection for 2005-2008

However, expectations of continued growth in the garment industry will need to be tempered in the face of the quota phase-out by the end of 2004 that will increasingly hurt the industry due to inadequate competitiveness and prevailing high transaction costs. Preliminary results of a study on labor competitiveness in the Cambodian garment industry show that, out of 80 factories surveyed, about half remain optimistic for the future, as they expect to increase their production capacity in the coming years. Only about 20 percent feel that they would reduce their production, while the remaining 30 percent take the position of “wait and see”.¹¹

Nevertheless, based on another survey conducted in the same period with the 100 top CEOs in Cambodia, which included about 34 from garment factories, most garment factory managers expressed some concern after the elimination of the quota system in early 2005. Most of them feel that 2005 will be more difficult than the previous years, although the situation remains under control. Most of factories that are facing order problems now produce garment products that were protected by the quota system.¹²

Accordingly, EIC expects that Cambodian garment exports to the US market will decline about 4 percent per annum in the coming years, while during the same period, exports to other markets will continue to increase at a moderate rate. As a result, overall garment exports will just

¹¹ Funded by USAID, this study is conducted by Nathan Associates, AIRD, Werner International and EIC in March-April 2005. Its final results will be released in June 2005.

¹² Sponsored by the World Economic Forum, this survey is conducted by EIC in March-April 2005. Its final results will be publicly released in October 2005.

slightly decline (about 1 to 2 percent per year). This is a fairly rosy, best-case scenario. The negative impact will be more dramatic if the assumed access to the EU market fails to materialize.¹³

On the price side, we expect that Cambodian exporters will be forced to reduce prices, especially on the products that were under US quota system because of tight competition after the quota system elimination.¹⁴ As a result, prices of garment exports to the US market will continue to decline by 3 to 4 percent per year between 2005 and 2008. However, price pressure will not be so high in other markets, because Cambodian producers are accustomed to competition in these markets.

Table 1.4: Cambodia's Garment Exports
(% increase, year average)

	2002	2003	2004	2005p	2006-2008
Quantity					
USA	15.8%	10.2%	20.6%	-4.4%	-4.1%
EU	11.0%	19.3%	34.2%	2.0%	5.0%
Others	65.1%	146.8%	71.1%	5.0%	6.0%
Total	15.3%	14.7%	25.7%	-2.3%	-1.0%
Prices					
USA	-0.6%	6.7%	-5.5%	-3.8%	-3.2%
EU	3.9%	-4.2%	6.3%	1.0%	2.0%
Others	-4.9%	13.5%	-4.2%	0.2%	1.8%
Total	0.4%	4.7%	-1.6%	-1.7%	-0.1%

Source: Ministry of Commerce for 2001-2004, EIC Estimates for 2005-2008, based on the expert opinions

For these reasons, EIC projects a bottoming out of growth in the garment industry in 2005. Even though Cambodia is a full member of the World Trade Organization (WTO) and could theoretically reap some growth benefits through the market access that membership offers, the reality is that quota elimination also means stiffer competition for a garment sector that came to life in an environment protected by world-wide quotas.

¹³ Hach Sok, Cambodia's Garment Industry in 2005 and Beyond, EIC Economic Review, Volume 1 no 5, October-December 2004

¹⁴ The US imposed the quota on Cambodia in 1999. The sale of garment products under the US quota system represented about 31 percent of total garment exports in 2004, down from 66 percent in 1999.

Unfortunately, in the last several years, the industry and the rest of the economy have benefited from only sporadic attempts at real reform, and it seems unlikely that there will be sudden comprehensive measures reducing the costs of doing business that would offer Cambodia a more competitive edge.

As a result, EIC projects that the garment industry will decrease slightly in 2005, pulling down overall growth figures. Prospects for the following years will be entirely dependent on how aggressive the reform process is. External factors will no longer be a panacea for the garment industry. Whether it lives or dies will depend on the nature of domestic factors and reforms. Broad based industrial development, particularly in agro-industry, must accompany the diversification of the agricultural sector. This will require huge initial investments by the government in infrastructure, rationalization of agricultural land concessions, and clear and enforceable laws and regulations, before the private sector can be enticed to bring in capital and technology. In plain terms, this dual track policy can only be achieved as long as the environment is conducive to investments and markets for both domestic consumption and export.

However, the decline in production of forestry and fisheries may hinder the prospects of high value-added diversification. Wood processing may not be viable if the current downturn in forestry continues. Effective implementation of both social and commercial concession policies in these natural resource sectors will provide the ability to move forward. Therefore, there is an urgent need for immediate action to tackle these multifaceted constraints. No one will invest in the agricultural sector if the overall environmental background of the country is allowed to deteriorate.

Construction, the second biggest industrial sub-sector, constituting more than 19 percent of the sector's value, significantly slowed in 2004 (only 1.5 percent increase), after experiencing a strong growth of 7.5 percent in 2003, and 12 percent in 2002. Non-residential private construction increased but development of public infrastructure was hindered by lower capital expenditures by the government and donors. Residential construction growth figures are likely underestimated, as many new construction projects went unregistered due to loose management during the political stagnation of mid-2003 to mid-2004. It is worth noting that the boom in residential construction, although contributing to growth, is not seen as a substantial aid to broad-based development and poverty reduction.

Growth is anticipated to be somewhat negative in the next coming years, because of sharp decline in new investment in both garment and

tourism sectors. The stock of hotel rooms in Siem Reap greatly exceeds what is needed. Development of public infrastructure will not be as strong as the past, anticipating low government budget revenue and foreign aid.

1.3. Services

The service industry represents the biggest share of the economy and increased by 8.4 percent in 2004, up from only 2.8 percent in 2003. That recovery can in part be attributed to the rebound in international tourist arrivals during 2004. The recovery of transportation, trade, and other private service sectors also played a role in expanding the whole service sector. Except for public services (basically flat in 2004 because of political deadlock after the general elections), Cambodian service sectors expanded more than 9 percent last year.

Table 1.5: Production of Service Sectors
(% increase, year average, 2000 prices)

	2002	2003	2004e	2005p	2006-2008
Transport & Communication	5.9%	6.4%	6.0%	3.7%	3.4%
Trade	4.6%	5.3%	4.4%	3.3%	3.5%
Hotel & Restaurants	11.0%	-5.5%	22.7%	10.7%	9.8%
Other Private Services	6.4%	4.9%	6.1%	3.4%	2.7%
Total Private Services	6.8%	2.8%	9.2%	5.2%	4.9%
Public Administration	15.1%	2.7%	0.0%	2.8%	3.9%
Total Services	7.5%	2.8%	8.4%	5.0%	4.9%

Source: EIC, compiled from the government primary data for 2001-2004, and model projection for 2005-2008

The growth in the service sector in 2004 was on an accelerating trend, as the tourism sub-sector rebounded from the lows of 2003 and continued to expand. The total number of foreign visitors during the first eight months of 2004 increased by 41 percent compared with the same period of 2003, reaching the level of almost 1 million. The number of tourists arriving through Siem Reap airport so far in 2004 has been up by 66 percent and arrivals by land and boat have been up 47 percent. In 2005, the number of foreign tourists arriving through Siem Reap will very likely exceed that through Phnom Penh.

Table 1.6: Foreign Tourist Arrivals in Cambodia
(% increase, year average)

	2002	2003	2004	2005p	2006-2008
Through Phnom Penh	5.3%	-22.6%	17.4%	7.0%	5.7%
Through Siem Reap	42.4%	-1.4%	66.1%	20.0%	18.0%
By Land & Boat	34.0%	-7.2%	47.3%	16.0%	15.0%
Total	21.3%	-12.5%	40.8%	14.4%	13.4%
Number (000's, end of period)	801	701	987	1,129	1,647

Source: Ministry of Tourism for 2001-2004, EIC Estimates for 2005-2008, based on the professional opinions

Cambodia will need to sustain this growth by finding ways to diversify its tourism offerings. Certain areas of Cambodia which thus far remain “unspoiled” could potentially be turned into ecotourism sites. The presence of foreign tourists exploring Cambodia’s nature resources could serve to help prevent illegal exploitation and destruction of these areas. Tourists may want, for example, to visit hill tribes living near forested areas to see how they utilize the area around them in a sustainable way. Making new areas of Cambodia beyond Angkor Temples into true tourist destinations will rest in large part on whether the government will be able to provide sufficient security and infrastructure.

Domestic trade, transportation, and financial services are potential contributors to growth. But increased production would be pointless without correlated attention to infrastructure development, in particular roads and railways. Further rehabilitation and reconstruction of roads will link products to markets. This will open trading opportunities to remote areas of the country that are currently unable to access outside markets. Increased mobility of people, goods and services will in turn create a positive circle of market dynamics.

Financial services also are still rudimentary, which handicaps an important channel of capital transfers from unused funds to productive investments. Major financial services are concentrated in Cambodia’s main cities. Credit in rural areas is available through a few commercial banks and specialized microfinance institutions, but the dominant source of credit appears to be informal lending (usurers). Ironically, there are excess funds lying idle in the vaults of commercial banks, which could be otherwise used for more productive purposes.

significantly recovered from the very low level of 2002. Actual FDI is estimated to remain relatively strong in 2004, with investment mostly focused on hotel construction in Siem Reap.

The most recent data from CDC on registered investment shows however that private investment in 2004 dropped to US\$217 million, representing a 31 percent decline compared with 2003. New investment in the garment industry remained relatively strong, reaching US\$68 million in 2004 compared with US\$75 million in 2003. These figures are surprisingly in opposition to what many have perceived as the expected sharp slowdown of the garment industry, given the threat of the elimination of garment quotas by the end of 2004. A recent EIC survey with factory owners and trade union leaders confirmed the fact that while small garment factories are tending to close down, some big factories have continued to expand their capacity.

Table 2.2: Private Investment Projects Approved, 1999-2004

	1999	2000	2001	2002	2003	2004
Number of Investment Projects Approved						
Total	96	96	188	37	66	54
Garment	44	52	76	16	31	28
Hotel	3	10	4	4	11	3
Others	49	34	108	17	24	23
Fixed Assets Approved (millions of dollars)						
Total	474	266	217	240	314	217
Garment	80	77	100	18	75	68
Hotel	25	71	71	47	114	24
Others	369	119	46	174	126	125

Source: CDC, *Cambodian Investment Board*

Due to continued capital increase in the garment industry, garment factories are operating at full capacity to meet the increase in demand and to compensate for the closure of some smaller factories. The future of the garment sector will depend upon the capacity of the industry to compete in a world without quotas. Enhancing management skill and structure to improve productivity of workers, and increased investment geared toward a technological upgrading of the factories in Cambodia will need to be a part of this.

In addition, the number of hotel rooms in Siem Reap has already reached the saturation level in 2004. The CDC data clearly confirms this observation, as the number of approved projects in hotel construction in the whole country dropped to 3 projects in 2004 from 11 projects in 2003. In

terms of fixed assets, approved investment in hotels fell to US\$24 million in 2004, from US\$114 million in 2003. As a result, EIC expects that actual FDI will likely drop by about half from 2005 to 2008, compared with that of 2004.

2.3. Productivity

Productivity is the key to increased competitiveness and building better businesses that are attractive to investors. According to an EIC estimate, total productivity of workers (value-added per worker) in Cambodia increased about 3 percent per annum during the last five years, while real GDP growth rose by 6 percent per annum. This growth has allowed Cambodia to keep its competitiveness relatively strong. However, Cambodia will face great challenges in the future with the expected sharp economic slowdown.

Productivity in agriculture was very low (about US\$300 per worker per year), and fluctuated as a function of the weather. Because of severe drought, productivity in the agricultural sector declined by 6.5 percent in 2004. During the last five years, this productivity was basically flat because of lack of investment in that sector. Prospects for improvement in the near future will be thin as no irrigation system is yet in place.

Productivity in the industrial sector was much higher (about US\$2,200 per worker in 2004),¹⁷ and enjoyed about a 6 percent increase per annum during the last five years, thanks to the good performance of the garment industry. In 2004, productivity of the industrial sector increased by 7.5 percent, while that of the garment sector rose by more than 10 percent. Nevertheless, prospects for a sharp increase of productivity of this sector in the near future will not as good as in the past because of poor prospects for garment exports. It is clear that the Cambodian garment industry has to improve its productivity for survival after the elimination of the quota system. According to preliminary results drawn from a study on labor productivity in Cambodia's garment industry,¹⁸ Cambodia still has much room to enhance labor productivity through improvement of management skills in the garment factories.

¹⁷ Productivity in term of value-added per worker of the garment industry reported in the World Bank is about US\$ 1,100 per worker. EIC estimate is twice as much. This difference might be explained by different methodologies.

¹⁸ Funded by USAID, this study is conducted by Nathan Associates, AIRD, Werner International and EIC in March-April 2005. Its final results will be released in June 2005

Table 2.2: Productivity of Workers (% Increase, US\$2000 price)

	2002	2003	2004	2005	2006-2008
Agriculture	-0.4%	5.7%	-6.5%	1.2%	0.4%
Paddy	-8.0%	23.6%	-17.8%	4.8%	-0.2%
Industry	4.8%	5.3%	7.5%	2.4%	2.2%
Textile & Garment	7.7%	7.6%	10.8%	4.7%	4.7%
Private Services (*)	4.3%	0.2%	6.2%	3.9%	3.7%
Tourism	3.1%	-2.7%	8.0%	4.0%	3.7%
Total (*)	3.0%	3.1%	2.7%	2.7%	2.3%

Source: EIC Estimates,

(*) Excluding Public Administration

Like the industrial sector, productivity in the private service sector (excluding public administration) is relatively high (about US\$2,400 per worker in 2004). It increased about 4 percent per annum during the last five years. In 2004, this productivity significantly recovered (6.2 percent increase) from a depressed situation in 2003 owing to a rebound in tourism. For 2005 and beyond, we expect that productivity in the service sector will continue to be relatively strong with a growth rate of about 4 percent per annum.

In general terms of competitiveness, Cambodia does possess comparative advantages in certain areas. Unfortunately, these competitive edges are dulled by many factors identified in the World Bank report. The top four constraints are: corruption; crime, theft and disorder; anti-competitiveness or informal practices (smuggling); and regulatory policy uncertainty. These factors unfavorably add to the risks and costs of doing business in Cambodia. As a result, Cambodia has continued to suffer from low FDI inflows over the last several years. If the trend continues, the country will not be able to develop adequately and certainly will not reach the level of economic development of the other countries in the region. The goal of poverty reduction will remain elusive.