

Chapter 2

Trade, Investment and Productivity

Sok, Hach

External trade and FDI continued to play very important roles in boosting the Cambodian economy during the last seven years. Exports of garment products and tourism have been the primary sources of job creation (at least 300,000 jobs or 5 percent of the country's workforce), and have contributed substantially to the country's balance of payments during that period. After experiencing a sharp decline during 2000-2002, Cambodia's FDI seems to have recovered slightly in 2003 and 2004, thanks to investments in the garment and tourism sectors. Continued reliance on these sectors to draw foreign capital cannot be taken for granted, however, as the garment sector is facing huge upcoming challenges in global competitiveness, and the number of hotel rooms in Siem Reap has already reached the saturation level.

2.1. External Trade and Capital Movements

EIC estimates that total exports (including re-exports) in 2004 increased by 16 percent, to about US\$2.5 billion, reflecting the strong growth in the exports of garments (26 percent increase). Despite higher rubber export prices, export of agriculture products dropped however by half, because of last year's drought. Meanwhile, imports also increased significantly by 17 percent to more than US\$3 billion. Contributing to that figure was a 26 percent rise in fuel imports. EIC estimates that Cambodia's total imports of fuel reached about US\$600 million in 2004. As a result, the total trade deficit increased in 2004, reaching US\$643 million in nominal terms, or about 14 percent of nominal GDP, up from 12.4 percent in 2003.

Due to the rebound of the tourism sector, the surplus in the service sector significantly improved in 2004, reaching 5 percent of GDP, up from 3.7 percent in 2003. The net income generated from tourist spending is estimated to reach about US\$500 million in 2004. Most unfortunately, that figure did not include revenue from tourist transportation because Cambodia does not have a stake in the airlines or other transportation industries serving the international markets funneling tourist arrivals to Cambodia. In sum, the balance of trade and services remained basically stable during 2002-2004, between 8.5 and 9 percent of nominal GDP.

According to IMF balance of payments statistics, the outflows of incomes owed by expatriates, including salary and profits generated by FDI, were broadly balanced by the inflows of money repatriated by Cambodians overseas, which includes workers' remittances (about US\$120 million) and other private transfers (US\$80 million).¹⁵

Table 2.1: Cambodia's Balance of Payments (% GDP)

	2002	2003e	2004e	2005p	2006-2008 (year average)
<i>Exports of Goods</i>	43.9%	50.8%	53.7%	49.0%	42.6%
<i>Imports of Goods</i>	58.1%	63.1%	67.7%	64.2%	56.9%
Trade Balance	-14.2%	-12.4%	-14.0%	-15.2%	-14.3%
Agriculture	1.2%	3.4%	1.6%	2.0%	2.0%
Textiles & Garments	10.6%	12.3%	14.2%	12.7%	10.8%
Oil & Gas	-10.1%	-11.3%	-13.1%	-12.7%	-10.4%
Other Goods	-15.9%	-16.7%	-16.8%	-17.1%	-16.7%
Balance of Services	5.5%	3.7%	5.1%	5.7%	7.0%
Transportation	-3.1%	-2.8%	-3.6%	-4.1%	-5.2%
Travel (Tourism)	10.4%	7.9%	10.5%	11.8%	14.6%
Others	-1.8%	-1.5%	-1.8%	-2.0%	-2.4%
Balance of Incomes	-4.2%	-3.9%	-4.4%	-4.7%	-5.1%
Current Transfers (net)	11.2%	10.7%	9.7%	9.2%	8.2%
Private Transfers ¹	4.9%	4.9%	4.5%	4.2%	3.8%
Government Transfers ²	6.3%	5.8%	5.2%	5.0%	4.4%
Current Accounts	-1.6%	-1.9%	-3.7%	-5.0%	-4.2%
Capital & Financial Accounts	6.4%	7.0%	7.1%	6.2%	5.5%
Official Loans ³	3.9%	3.6%	3.3%	3.0%	2.6%
Foreign Direct Investment	1.3%	2.4%	2.7%	2.1%	1.9%
Others (net)	1.2%	1.1%	1.0%	1.0%	0.9%
Change in Foreign Reserves⁴	4.8%	5.1%	3.4%	1.2%	1.2%
<i>At the National Bank</i>	2.9%	1.8%	0.9%	0.4%	0.3%
<i>Outside the National Bank</i>	1.9%	3.3%	2.5%	0.8%	0.9%

Source: IMF Balance of Payments Statistics for 2002, EIC model projection for 2003-2008

¹ Money transferred by Cambodian overseas

² Grants provided by donors to the government

³ Net of debt amortization

⁴ Overall balance reflects change in country's foreign reserves. As Cambodia is a dollarized economy, and private individuals and institutions can hold foreign currencies, the overall change of the balance of payments not only affects the foreign reserves of the National Bank, but also other economic agencies, such as private financial institutions, businesses and households.

¹⁵ IMF (2004), Balance of Payments Statistics, April

However, the amount of foreign aid granted by donors has been estimated to decline to 5.2 percent of GDP in 2004, from to 5.8 percent in 2003, and 6.3 percent in 2002, because of the long political deadlock which occurred after the July 2003 elections.¹⁶ Overall, Cambodia's current account deficit would thus enlarge, reaching 3.7 percent of nominal GDP in 2004, from 1.9 percent in 2003, from 1.6 percent in 2002.

Nevertheless, the capital accounts seem to be a bit more positive. Thanks to an upturn in investment in the tourism sector, and relatively stable foreign loans, the surplus of capital accounts is estimated to be slightly increasing, potentially reaching 7.1 percent of GDP in 2004, up from 7 percent in 2003, and 6.4 percent in 2002. The overall balance of payments causing the change in foreign reserves of Cambodia has thus declined to 3.4 percent of GDP in 2004, from 5.1 percent in 2003.

In 2005 and beyond, Cambodia's external trade is expected to significantly slow down, because of garment export decline. In nominal terms, the value of external trade will be basically flat. However, related to the nominal GDP, external trade will likely drop by about 10 percentage points from 2004 to 2008. As a result, external trade will be no longer a source of growth for Cambodia. The expected decline in garment exports will effect a dramatic deterioration of the balance of trade in goods. Nevertheless, surplus in trade of services will substantially increase, thanks to expected strong growth in tourism. In sum, the balance of trade of goods and services would remain broadly stable, as a percentage of GDP.

Despite the potential decline in FDI and stagnation of grants provided by donors in the coming years, EIC does not expect any decline in flows of incomes sent abroad as long as the amount of interest linked to foreign loans continues to increase. The overall balance of payments of Cambodia will thus very likely turn negative in the next three years, compared with a strong surplus in the past.

2.2. Private Investment and Stocks of Capital

According to Council for the Development of Cambodia (CDC), total fixed assets registered in 2003 were US\$314 million compared with US\$240 million in 2002. This increase was driven mainly by domestic private investment in the service sector which accounts for 44 percent of the total registered investment. Based on its own surveys with professionals, EIC estimates that FDI actually implemented in 2003

¹⁶ In fact, foreign aid granted by donors remained broadly stable in nominal terms during 2002-2004.

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.