

Chapter 1

Economic Growth

Cambodia's real GDP growth reached only 5.3 percent in 2003, down from 5.5 percent in 2002, and 5.7 percent 2001. The growth was moderate for a country which in 2003 weathered domestic political uncertainties, including a lengthy political deadlock following national elections, and exogenous factors like SARS that adversely affected investment, consumption, tourism and delayed aid disbursements. The main contributors to growth in 2003 were a recovery in agriculture following a decline due to drought in 2002 and continued growth in the garment sector. However, services sector activity was weakened by a decline in the hotel and restaurant turnovers as a result of fewer tourist arrivals.

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

	2001	2002	2003e	2004p	2005p
Agriculture	2.6%	-0.9%	8.2%	-4.2%	4.1%
Paddy	4.5%	-8.7%	26.9%	-11.9%	7.5%
Industry & Construction	11.1%	10.4%	9.6%	15.6%	0.6%
Garments	29.6%	14.3%	13.4%	25.6%	-1.3%
Services	5.4%	7.4%	2.9%	9.1%	5.6%
Tourism	12.3%	10.5%	-5.3%	21.8%	9.7%
Total GDP	5.7%	5.5%	5.3%	7.0%	3.5%

Source: NIS for 2001-2003, EIC Projection for 2004-2005

Economic growth is likely to be stronger for 2004. Data available for the first eight months of the year show that Cambodia's garment exports remain very strong and the tourism industry has significantly recovered from last year's downturn. However, unfavorable climatic conditions and weak management of natural resources may result in a negative growth in the agriculture sector in 2004. This will be offset by gains in both the garment and tourism sectors, which could well lead overall economic growth to a surprisingly robust rate, possibly as high as 7 percent for 2004.

For 2005, the elimination of the quota system for garment products will very likely induce stagnation or even a slight decline in the

growth of Cambodia's garment exports, especially to the US market.⁵ This stagnation or contraction will, naturally, slow down the overall GDP growth rate. However, as most garment factories are performing at near full capacity presently, a sudden plunge in the garment industry is unlikely as many have anticipated. The slowdown could probably be avoided altogether through eliminating unnecessary transaction costs (bureaucracy, corruption, energy, and transport costs) to increase the relative competitiveness of the garment sector in the quota-less world.

1.1. Agriculture

Agriculture is one of the most poverty-stricken sectors, and thus deserves special attention. It is the primary source of income for rural households, which comprise about 85 percent of the population. Agriculture employs more than 70 percent of Cambodia's workers, and it accounts for more than 30 percent of the economy. A Poverty Profile of Cambodia in 1999 revealed that about 79 percent of the poor derived their main source of income from agriculture.⁶

The sector recovered to reach an estimated 8.2 percent growth in 2003 - the highest rate in the past seven years thanks to extremely favorable climatic conditions. Paddy production alone increased by 26.9 percent, thanks to plentiful rains. Livestock was up by 7.4 percent. However, fishery, rubber, and forestry turnovers stalled and posted negative rates in real terms due to poor management and the further degradation of natural resources. A jump in the international price of rubber in 2003 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 simply not reached maturity yet.

The growth declines in both forestry and fisheries pose serious concerns. Government efforts to halt illegal logging and strengthen forest concession practices have thus far been insufficient to halt unabated exploitation⁷. Small scale, community-based forests with strict adherence to technical standards may be good enough to cover demand for domestic wood consumption, but any continuance of large scale commercial logging will need to transparent and credible management and to show compliance with environmental and social impact assessments.

⁵ Ministry of Commerce (2004), *Cambodia's Garment Industry: Meeting the Challenges of the Post-Quota Environment*, October.

⁶ Ministry of Planning, A Poverty Profile of Cambodia -1999.

⁷ Budget revenues from these sectors declined from US\$ 11 millions in 2000 to only US\$ 2 millions in 2003, see MEF's State Budget Implementation.

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

	2001	2002	2003e	2004p	2005p
Paddy	4.5%	-8.7%	26.9%	-11.9%	7.5%
Other Crops	8.0%	8.5%	7.4%	5.4%	5.3%
Livestock	-1.8%	1.8%	5.2%	1.2%	2.2%
Fishery	4.6%	3.1%	-3.6%	-7.4%	1.1%
Rubber & Forestry	-19.8%	-30.2%	-2.1%	-2.7%	-0.4%
Total Agriculture	2.6%	-0.9%	8.2%	-4.2%	4.1%

Source: EIC, compiled from the primary data of the Ministry of Agriculture for 2001-2003, and model projection for 2004-2005

Likewise, the sudden reduction in inland fisheries production in 2003, 14 percent below that of 2002, is a serious blow.⁸ The question of the sector's sustainability now has become a public debate. As the available fish supply has become scarcer, the price has skyrocketed. Fisheries management practices are inadequate at both the central and community governing levels. Incomplete regulations and a lack of enforcement have invited inefficiencies. Although, ideally, individual fishermen and farmers could be educated about resource management, on a practical level they would likely find that their own poverty leaves them no alternative but to fish illegally during the banned season or to clear inundated forests for cultivation to survive.

The expansion of rice exports⁹ continues to be lag behind Cambodia's potential. In part the official numbers are low because activity is so heavily under-reported. The official exports in the last several years have been far lower than estimated real exports. For example, the reported export of rice through the Customs and Excise Department in 2003 was merely US\$0.6 million, whereas unofficial exports estimated by EIC reached US\$111 million.¹⁰ The informality of trade, and thus the likely massive underreporting, in paddy rice leaves it vulnerable to price suppressions due to a lack of bargaining power, quality control, market information, and access to new customers.¹¹

⁸ Ministry of Agriculture, Forestry, and Fisheries, *Fisheries Statistics Year 2003*: Fisheries Products in 2003 was 308,750 tons compared with 360,300 tons in 2002.

⁹ The government encouragement the exports of surplus rice by eliminating export barriers, but only require a export license to ensure food security, see further Sok, Chea, and Sik, "Marketing Constraints to Rice Production Development," in CDRI: Cambodia's Annual Economic Review – 2001, (p. 25 – 45).

¹⁰ The estimation of EIC is based on the quantity of rice surplus and farm gate price of rice, compiled by the Ministry of Agriculture.

¹¹ World Bank (2003): Towards A Private Sector – Led Growth Strategy for Cambodia, Volume 1: Value Chain Analysis (p. 42 – 50).

Table 1.3: Production and Yield of Paddy

	Unit	2001	2002	2003	2004p	2005p
Cultivated Area-Total	000 ha	2,241	2,137	2,242	2,222	2,250
Dry Season	000 ha	267	292	275	275	280
Wet Season	000 ha	1,974	1,845	1,967	1,947	1,970
Production-Total	000 ton	4,099	3,823	4,711	4,179	4,518
Dry Season	000 Ton	823	907	873	873	897
Wet Season	000 Ton	3,276	2,916	3,838	3,306	3,621
Yield-Total	Ton/ha	1.8	1.8	2.1	1.9	2.0
Dry Season	Ton/ha	3.1	3.1	3.2	3.2	3.2
Wet Season	Ton/ha	1.7	1.6	2.0	1.7	1.8

Source: Ministry of Agriculture for 2001-2003, and EIC model projection for 2004-2005

In the short run, the prospects of the agriculture sector remain unpredictable but weak given factors like a high dependency on weather conditions and a lack of crop diversification. Moreover, sub-sectors such as fisheries and forestry are in danger mainly due to poor management. They should be under rehabilitation and prudent care to avoid overexploitation. These two sub-sectors have the clear potential to contribute to economic development and poverty reduction, *but only if* workable mechanisms were to exist that could ensure appropriate exploitability and sustainability.

The current rise in the international price of rubber may encourage an increase in Cambodian rubber production. With fertile land suitable for rubber expansion and some prospects for privatization of state-owned rubber companies, production management and quality could be improved. Moreover, capital investments in rubber processing are expected. Better prices and production enhancement would benefit both companies and the workers and farmers living nearby. A re-emergence of rubber plantation and production would be a meaningful growth aid in the agricultural sector.

Because agriculture yields were remarkably high for 2003, the projection for growth in 2004 is expected to revert to a somewhat lower and more normal level, due to a current drought and to the continued drop in fisheries and forestry production. However, there is the prospect for optimism should a commitment to sustainable reforms in natural resources management help the sector recover again in 2005.

1.2. Industry & Construction

The industrial sector achieved 9.6 percent growth in 2003. This is down from 10.4 percent in 2002, even though the garment, electricity and water sub-sectors remained strong. The garment industry, a dominant factor in Cambodia, posted 13.4 percent growth in 2003, slightly lower than its 2002 growth rate of 14.3 percent. The electricity and water sectors increased their growth by 13.7 percent, whereas wood, paper, and publishing shrank as compared to 2002. The decline in wood processing paralleled the decline in forestry production. Poor forest management is largely the reason for the setback. The agro-industry sector, which could offer high potential for new sources of growth in Cambodia, expanded very slowly, just about at the level of population growth (2.5 percent per annum). This weakness is likely due to the non competitiveness of this sector in the external market.

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

	2001	2002	2003e	2004p	2005p
Garments	29.6%	14.3%	13.4%	25.6%	-1.3%
Food, Beverage & Tobacco	3.6%	2.8%	2.5%	2.1%	1.8%
Other Manufacturing	-3.5%	2.1%	2.2%	1.9%	1.0%
Electricity, Gas and Water	14.3%	13.8%	13.7%	13.4%	12.6%
Construction & Mining	-8.1%	10.0%	7.5%	4.4%	3.2%
Total Industry	11.1%	10.4%	9.6%	15.6%	0.6%

Source: EIC, compiled from the government primary data for 2001-2003, and model projection for 2004-2005

The industrial sector remains very strong in 2004, underpinned by the impressive performance of the garment industry and the possibility of construction growth. The growth in exports of garments and footwear in the first eight months of 2004 reached 30 percent in quantity, and 27 percent in value, compared to the same period of 2003. During that period, garment exports to EU markets soared by 46 percent, whereas to the US they increased by 24 percent.

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 expose the industry to damage due to inadequate competitiveness and prevailing high transaction costs. According to an EIC simulation that assumes that a) Cambodia does not

address good governance issues, yet b) somehow manages to increase its access to the EU market in line with an expected world trend, the garment industry's exports would nevertheless shrink by at least 7 percent by the end of 2007. At least 10,000 jobs would be lost in such scenario. 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.¹²

Table 1.5: Cambodia's Garment Exports

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

Source: Ministry of Commerce for 2001-2003, EIC Estimates for 2004-2005, based on the first 8 months trend in 2004 and 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. Unfortunately, in the last several years the industry, and the rest of the economy, has 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 reforms process is. External factors will no longer be

¹² Ministry of Commerce (2004), *Cambodia's Garment Industry: Meeting the Challenges of the Post-Quota Environment*.

a panacea for the survival of the garment industry. Whether it lives or dies will depend on the nature of domestic factors and reforms.

The possibility of 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 regulations¹³, 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 at the same time.

Construction, the second biggest industrial sub-sector, constituting more than 19 percent of the sector's value-added, remained strong, although its growth slowed 7.5 percent in 2003, compared to 12 percent in 2002. Non-residential private construction increased, but development of public infrastructure was hindered by lower capital expenditures by the government. 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 it contributes to growth, is not seen as a substantial aid to broad-based development and poverty reduction.

Construction figures appear to be on the rebound in 2004 after the slow growth of last year. Private construction appears to have recovered and accelerated with about a 30 percent increase in total construction permitted in Phnom Penh in the first seven months in 2004. There also is a current boom in the building of new hotels in Siem Reap, in response to the prospect of significant increases in the number of foreign tourists this

¹³ Removing all impediments identified the World Bank (2004), *Cambodia: Seizing the Global Opportunity: Investment Climate Assessment & Reform Strategy*

year. Public construction also is expected to rise given that capital expenditures of the government in the first half of 2004 have been higher than the same period of 2003. Growth is anticipated to continue in the future, as it is likely that Cambodia will continue to receive foreign aid for infrastructure construction.

1.3. Services

The services industry, which is the biggest share of the economy, grew only by 2.9 percent in 2003, down from 7.4 percent in 2002. That slower growth can in part be attributed to the slowdown in international tourist arrivals during 2003 due to the various factors mentioned earlier. The slowdown in public services and banking sectors during the election period also played a role in limiting activity expansion in the service sector.

According to the Ministry of Tourism, the number of international tourist arrivals was 0.7 million in 2003, a decrease of 10.9 percent from 2002. Tourist numbers from the USA, Italy, Germany, France, Canada, Japan, and Australia declined very significantly in 2003 compared with the previous year. The overall hotel occupancy rate dropped to 45 percent, 5 percent lower than 2002, and the average length of stay declined to 5.5 days from 5.8 days. Further breakdown of the hotel occupancy rate shows that the length of stay in Siem Reap remained relatively short (about 3.5 days), compared to that of Phnom Penh (6.5 days). This situation might be explained by the lack of rural tourism infrastructure around Siem Reap Angkor.

However, other service sectors, such as transport, trade and other services gained in 2003, thanks mainly to agriculture production increases and the increase in imported trading goods.

The growth in the service sector in 2004 is on an accelerating trend, as the tourism sub-sector rebounds from the lows of 2003 and continues to expand. The total number of foreign visitors during the first eight months of 2004 increased by 46 percent compared with the same period of 2003. The number of visitors from South Korea rose dramatically (up 145 percent), and there was a 68 percent rebound in tourists from Taiwan and Thailand. The number of tourists arriving through Siem Reap airport, so far in 2004, has been up by 72 percent, and arrivals by land and boat have been up 54 percent. If this trend continues for the remainder of 2004, the number of foreign visitors to Cambodia could reach 1 million.

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

	2001	2002	2003e	2004p	2005p
Transport & Communication	5.8%	5.9%	6.4%	6.1%	4.5%
Trade	4.3%	4.6%	5.3%	5.1%	4.1%
Hotel & Restaurants	12.3%	10.5%	-5.3%	21.8%	9.7%
Other Private Services	5.2%	6.4%	4.9%	7.9%	4.9%
Public Administration	-5.3%	15.1%	2.7%	2.9%	4.5%
Total Services	5.4%	7.4%	2.9%	9.1%	5.6%

Source: EIC, compiled from the government primary data for 2001-2003, and model projection for 2004-2005

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 natural resources could serve to help prevent illegal exploitation and destruction of these areas. Tourists may want to, for example, visit hill tribes living near forested areas to see how they utilize the world around them in self-sustaining ways. Making new areas of Cambodia, beyond Angkor Wat, true tourist destinations will rest in large part on whether and/or when the government would be able to provide sufficient security and infrastructure.

Table 1.7: Foreign Tourist Arrivals in Cambodia (000’s)

	2001	2002	2003	2004p	2005p
Through Phnom Penh	331	348	270	312	343
Through Siem Reap	133	189	186	323	371
By Land & Boat	197	264	245	363	417
Total	660	801	701	998	1,131
%increase	27.0%	21.3%	-12.5%	42.3%	13.4%

Source: Ministry of Tourism for 2001-2003, EIC Estimates for 2004-2005, based on the first 8 months trend in 2004 and professional opinions

Domestic trade, transportation, and financial services are potential contributors to growth. But increased production will 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 available in rural areas is partly financed 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.