

Chapter 2

Trade, Investment and Competitiveness

External trade, FDI, and foreign aid have played very important roles in boosting the Cambodian economy. Exports of goods (especially garment products) and services (especially tourism) have been the primary sources of job creation (at least 300,000 jobs), and have contributed substantially to the country's balance of payments during the last seven years. After experiencing a sharp decline during 2000-2002, Cambodia's FDI seems to have recovered slightly in 2003 and early 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. Moreover, although many donors have expressed a willingness to continue to help Cambodia rebuild its economic and social infrastructure, foreign aid will not last forever if critical governmental reforms in such areas as administration and judiciary remain uncompleted.

2.1. External Trade, Incomes, and Capital Movements

EIC estimates that total exports (including re-exports) in 2003 increased by 22 percent, to about US\$2.1 billion. This figure reflects the strong growth in the exports of paddy and garments (see table 2.1). Total garment and footwear exports grew by 20 percent, and accounted for over 80 percent of total exports. Paddy exports increased an estimated six fold compared to 2002, reaching about US\$111 million. Meanwhile, imports also increased significantly by 15 percent to more than US\$2.7 billion. Contributing to that figure was a 19 percent rise in fuel imports.

In terms of trade balance, higher rubber export prices and the sharp increase in rice exports were the reasons for the dramatic increase of the trade surplus in agricultural products in 2003. The trade surplus in the garment sector also continued to improve. However, the trade deficits in energy and non-garment manufacturing goods significantly rose due to the expansion of economic activity, and higher international oil prices. As a result, the total trade deficit declined in 2003, reaching US\$521 million in nominal terms, or representing about 12.4 percent of nominal GDP, down from 14.1 percent in 2002. The surplus in the service sector significantly declined in 2003 due to the unusually weak performance of the tourism sector.

In 2004, external trade is expected to grow even faster, thanks to the robust growth of garment exports. Official import and export data released by the Customs department shows that, in the first half of 2004, total exports have increased by 21 percent, fueled by exports of garments and footwear. Exports of rubber have risen by 12 percent compared with the same period in 2003. Meanwhile, total imports also have expanded dramatically, 18 percent higher than during the first half of 2003. However, the import of fuel remained flat according to official figures, with true figures elusive due to rampant smuggling. A reliable indicator that the amount of fuel imported is most likely increasing is the fact that automobile imports are up by 86 percent. The surge in automobile imports has been due to a recent lowering of tariffs imposed by the government.

Despite the significant increase in garment exports, the trade deficit is expected to grow in 2004, reaching 14.7 percent of GDP, primarily due to the dramatic increase in international oil prices. Nevertheless, the size of the deficit will be partially offset by the sharp surplus in the service sector with the strong recovery in tourism. The net income generated from tourist spending could reach about US\$500 million in 2004. Most unfortunately, that figure will 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 will remain 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).¹⁴

However, the amount of foreign aid granted by donors has been estimated to decline to 5.6 percent of GDP in 2004, from 5.8 percent in 2003, and 6.3 percent in 2002, because of the long political deadlock which occurred after the July 2003 elections.¹⁵ Overall, Cambodia's current account deficit would thus enlarge, reaching 2.9 percent of nominal GDP in 2004, from 2.4 percent in 2003, from 1.6 percent in 2002.

¹⁴ IMF (2004), Balance of Payments Statistics.

¹⁵ In fact, foreign aid granted by donors remained broadly stable in nominal terms.

Table 2.1: Cambodia's Balance of Payments

	Million US\$			Percentage of GDP		
	2002	2003e	2004p	2002	2003e	2004p
<i>Exports of Goods</i>	1,750	2,132	2,490	43.8%	50.7%	53.5%
<i>Imports of Goods</i>	2,314	2,653	3,175	57.9%	63.0%	68.2%
Trade Balance	-564	-521	-684	-14.1%	-12.4%	-14.7%
Agriculture	42	134	77	1.1%	3.2%	1.6%
Textiles & Garments	421	516	658	10.5%	12.3%	14.1%
Oil & Gas	-400	-475	-602	-10.0%	-11.3%	-12.9%
Other Goods	-627	-696	-817	-15.7%	-16.6%	-17.5%
Balance of Services	220	158	271	5.5%	3.8%	5.8%
Transportation	-125	-134	-141	-3.1%	-3.2%	-3.0%
Travel (Tourism)	415	353	496	10.4%	8.4%	10.6%
Others	-70	-60	-83	-1.8%	-1.4%	-1.8%
Balance of Incomes	-168	-188	-200	-4.2%	-4.5%	-4.3%
Current Transfers (net)	448	448	477	11.2%	10.6%	10.3%
Private Transfers ¹	196	205	220	4.9%	4.9%	4.7%
Government Transfers ²	252	243	259	6.3%	5.8%	5.6%
Current Accounts	-64	-103	-134	-1.6%	-2.4%	-2.9%
Capital & Financial Accounts	255	295	339	6.4%	7.0%	7.3%
Official Loans ³	156	149	168	3.9%	3.5%	3.6%
Foreign Direct Investment	54	99	123	1.3%	2.3%	2.6%
Others (net)	46	47	48	1.2%	1.1%	1.0%
Change in Foreign Reserves⁴	191	192	206	4.8%	4.6%	4.4%
<i>At the National Bank</i>	115	75	45	2.9%	1.8%	1.0%
<i>Outside the National Bank</i>	76	117	161	1.9%	2.8%	3.4%

Source: IMF Balance of Payments Statistics for 2002, EIC model projection for 2003-2004

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 does not only affect the foreign reserves of the National Bank, but also other economic agencies, such as private financial institutions, business and household.

Nevertheless, the capital accounts seem to be 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 increasing, potentially reaching 7.3 of GDP in 2004, from 7 percent in 2003, and 6.4 percent in 2002. The overall balance of payments that translates the change in foreign reserves of Cambodia has remained broadly stable at around US\$200 million in 2003 and 2004.

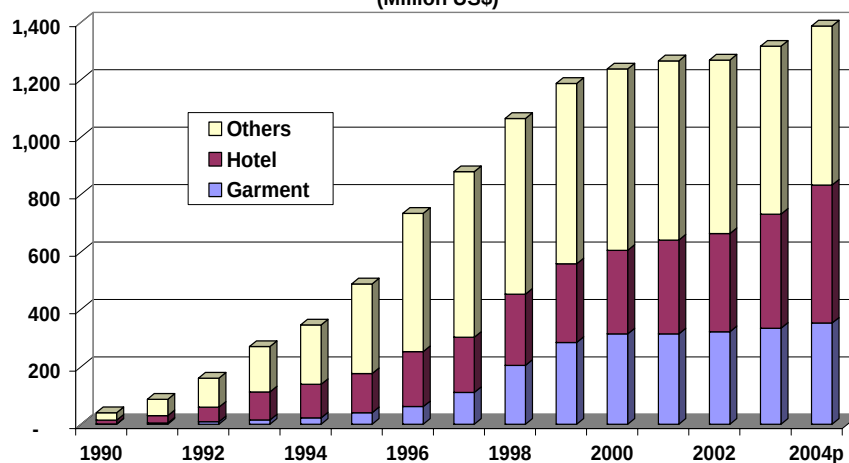
2.2. Private Investment and Stocks of Capital

According to a monthly report released by Council for the Development of Cambodia (CDC), total fixed assets registered in 2003 were US\$312 million compared with US\$242 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 basically doubled compared to the very low level of 2002. This increasing trend continued during the first half of 2004, with investment mostly focused on hotel construction in Siem Reap.

The most recent data from CDC on registered investment shows that private investment in the 8 months of 2004 was US\$222 million almost the same amount compared with the same period in the previous year. However, new investment in garment was triple reaching US\$47 million compared with US\$15 million and the expansion investment in garment industry recorded 48 percent higher than that of 8 months in 2003. But the registered capital declined, which attained only US\$29 million during the same period, representing a drop of 27 percent from the same period in 2003. This figure is surprisingly contradicted to what many have perceived the expected slowdown of the garment industry given the threat of the elimination of garment quotas by the end of 2004. A recent EIC survey of factory owners and trade union leaders confirmed the fact that while small garment factories are tending to close down, big factories have continued to expand their capacity. In addition, investment in hotels in Siem Reap has already reached the saturation level in 2004.

Cambodia's accumulated FDI increased significantly between 1995 to 1999, reaching about US\$1.2 billion by the end of 1999. Garment factories and hotels represent about half of that total investment. However, that momentum seemed to halt in 2000. Thanks to a boom in hotel construction in Siem Reap and Kampong Som (Sihanoukville) since 2002, the number of hotels in these two cities significantly increased in 2003 and 2004, and thus, the overall stock of capital in the tourism sector has continued to grow strongly. Investment in casinos also significantly increased. However, the level of FDI in other sectors, including non-garment manufacturing sectors such as the food industry, plastic industry and motorcycle assembly, were unchanged.

**Figure 2.1: Cambodia's Stocks of FDI
(Million US\$)**



Source: EIC Estimates

The absence of increased capital in the garment industry has yet to be reflected in any weakness in production. 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. Increased investment geared toward a technological upgrading of the factories in Cambodia will need to be a part of this.

2.3. Productivity and Competitiveness

Productivity is key to building better businesses that are attractive to investors. Higher productivity means higher efficiencies, higher profits and higher wages. All layers of the economy benefit. In many countries, productivity measures describe the relationship between real output and the labor time involved in its production. It reveals how fast and best a product can be produced, or how many products can be made in a unit of time.

Government figures in Cambodia relating to productivity are in the form of value-added per worker statistics. According to an EIC estimate, productivity in agriculture was US\$345 in 2003, an increase of 5.5 percent compared with 2002. Productivity in the industrial sector¹⁶ was US\$2,021 per worker in 2003, or 5 percent higher than that of 2002. Productivity in

¹⁶ 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 shows twice higher. This gap might be explained by different methodology.

the services sector (excluding public administration) increased by 0.5 percent, reaching about US\$2,241 per worker.

It may be less meaningful, however, to compare productivity between countries in general or in certain sectors, since the many factors that affect productivity vary by country¹⁷. Differences exist in, for example, returns on investments, profit margins, costs of doing business (both in monetary and non monetary terms), resource endowments, existing infrastructure and market dynamics.

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

	2000	2001	2002	2003e
Agriculture	332	328	327	345
Paddy	154	151	139	172
Industry	1,726	1,834	1,925	2,021
Textile & Garment	1,818	2,048	2,205	2,373
Private Services (*)	2,062	2,119	2,229	2,241
Tourism	4,548	4,735	4,933	4,853

Source: EIC Estimates, (*) Excluding Public Administration

A recent World Bank report on the investment climate in Cambodia has generated a great deal of interest on the subject of competitiveness. The argument goes that competitiveness matters more than productivity does. Providing at least a functioning business environment has been the key to economic survival and expansion in Cambodia. In general terms of competitiveness, Cambodia does possess comparative advantages in certain areas.

In the agricultural sector, for example, Cambodia has a high comparative advantage in resources, i.e. land areas, forestry, water sources, and inland and marine fisheries. The average land area per capita is about 1.3 hectare, one of the highest gross distributions in the region. Arable land is about 0.27 ha per capita¹⁸. These areas have the potential for agricultural expansion, especially for high value-added crops. In general, the natural endowments of the country are among the most favorable in the region, even though they are gradually deteriorating.

¹⁷ Productivity is jointly affected by changes in technology; capital investment; level of output; utilization of capacity, energy, and materials; the organization of production; managerial skill; and the characteristics and effort of the work force.

¹⁸ Total land area is 18.1 million ha and arable land is 3.7 million ha. Population in 2003 was estimated to be 13.7 million.

Unfortunately, indicators of land concentration show that 10 percent of the population owns 40 percent of the land.¹⁹ Additionally, land disputes are widespread and there are many problems in state land management. These factors may be discouraging investors interested in even those areas with good infrastructure, since most such areas are privately owned and are expensive investment prospects. In fact, the current land concession policy has not produced any significant impact on agricultural development. Some concessions even remain completely inactive. In short, appropriate land management is crucial not only to agriculture but also to industrial development.

The industrial sector is narrowly-based. As noted above, cheap labor (due to the high supply of unskilled workers) is the country's main cost advantage. This advantage will only grow over the next decade as Cambodia's demographics will push hundreds of thousands of new job seekers onto the market each year. The dominance of the sewing industry bears witness to this. Moreover, incentives granted under the Law on Investment are highly favorable, including tax exemptions and flexible requirement in investment modes. Easy access to the region and world markets would tend to make Cambodia a favorite investment destination.

The service sector also benefits from some inherent advantages. The country's cultural heritage is significant. The temple complex around Angkor Wat is world famous and has only become safe and easy to access during the last five years. Additionally, Cambodia enjoys a unique natural beauty. It is centrally located in a highly dynamic regional tourist destination. The potential for future development of the sector is simply enormous.

Alas, 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, (the World Bank, 2004, page iv). These factors generally and obviously 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.

¹⁹ Sophal Chan, and Sarthi Acharya (2002). *Facing the Challenge of Rural Livelihoods*, CDRI, Working paper No. 25.

Table 2.3: General Impediments to Competitiveness

1.	Lack of enforcement of existing regulations
2.	Poor infrastructure, supporting services and labor skills
3.	High official and unofficial public sector administrative costs
4.	Limited availability and high cost of inputs including energy and finance
5.	Weak legal framework, particularly to safeguard rural businesses
6.	Poor or non-existent public services
7.	Quasi-monopolies and high public sector administrative costs discourage natural evolution of forward and backward market linkages
8.	Closed agreements between public and private entities discourage investments in support services

Source: World Bank: Towards A Private Sector – Led Growth Strategy for Cambodia, Volume 1: Value Chain Analysis, 2003.