

Part 1. Lessons from a Decade of Rapid Growth

KEY MESSAGES:

Cambodia's income per capita has been increasing at 7.6 percent for the past decade, more than doubling. This is a significant performance by comparison to the past 50 years of development across countries. How did this happen and what are the lessons for Cambodia on how to sustain rapid growth?

Chapter 1 reviews **Cambodia's growth experience** and highlights:

- The role of four key sectors (garments, tourism, construction, and agriculture) and lack of diversification;
- The openness of the economy, the stable macroeconomic environment (from 1998 to 2006), and the recent rapid growth of the financial sector (since 2005); and
- The low level of domestic savings and investment.

Chapter 2 **analyzes these achievements along three dimensions** - all three suggesting limits to their sustainability:

- A first dimension ("history and geography") is that Cambodia has seized the opportunity of its history (restoring stability) and geography (openness to a dynamic region) to harness growth.
- Another dimension is that Cambodia has fueled its growth by using its assets, such as its forests, lands, and heritage, but somewhat depleting them. The focus on using assets has also distorted incentives in favor of less sustainable sources of growth.
- A third dimension is that, in a challenging governance environment, sector-specific arrangements of governance have emerged to enable specific sectors to flourish (e.g. garments). Good governance in some sectors has translated into growth.

Chapter 3 reviews Cambodia's experience in **translating growth into jobs and poverty reduction**. It highlights:

- Growth has had a profound impact toward a major structural transition (significant poverty reduction; improvement in most social indicators; nascent urbanization).
- A major channel has been the creation of jobs, especially outside agriculture, and changing demographics (with a significant decrease in the dependency ratio - the ratio of non-working age to working age population).

This first part tells a story of remarkable achievements in a challenging environment. However, it questions the sustainability of these achievements, especially at a time of considerable uncertainties in the global economy.

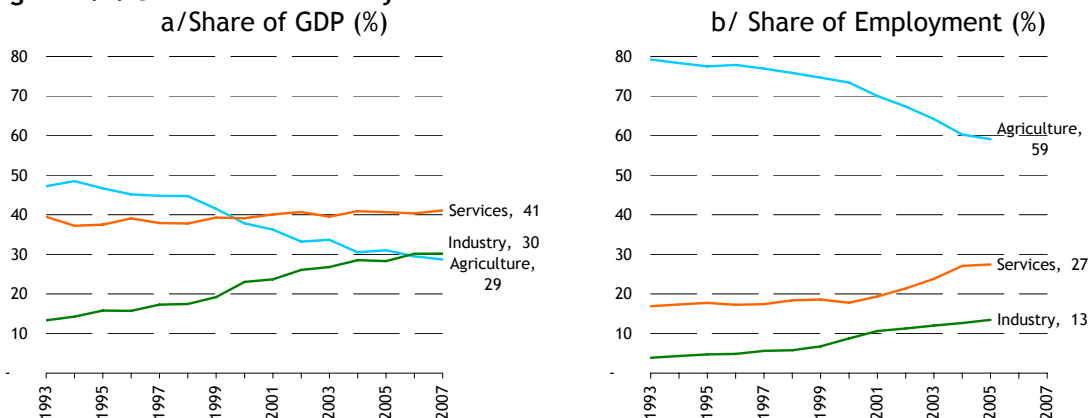
1. Features of Cambodia's Growth Performance

1.1. **Cambodia has established a remarkable track record of growth over the past decade.** Growth has averaged 9.8 percent per annum over the past decade, and was above 10 percent in the four consecutive years from 2004 to 2007. This chapter reviews the features of this performance. Section A reviews the four key sectoral drivers of growth over this decade. Section B focuses on the macroeconomic performance, reviewing national accounts, balance of payments, and fiscal and monetary developments. Section C sums up lessons learned from this review.

A. Four Key Drivers of Growth - and Poor Diversification

1.2. **Most of the growth over the past decade has been driven by four sectors: garments, tourism, construction and agriculture.** The industry and services sectors accounted for 4.5 and 4.8 points of growth per annum respectively (against 2.0 for agriculture, although the contribution of agriculture was above 2 percent over 2003-07).³ As a result, the economy has undergone a profound transformation, with agriculture by 2007 ranking behind both industry and services in terms of value-added (although still first in terms of employment, Figure 1.1). The pace of this transformation appears consistent with that of countries that experienced Sustained Rapid Growth (SRG) over the past half-century (Box 2.1).

Figure 1.1: Cambodia's economy has started its transformation



Source: NIS, national accounts.

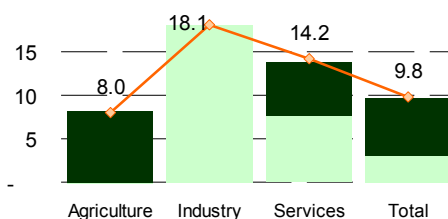
1.3. **Agriculture remains a very crucial part of Cambodia's economy.** Although it accounts for 29 percent of the GDP in 2007, 59 percent of the population relies on this sector for their livelihood. Agriculture has been growing at 4.4 percent over the past decade, against 4.0 percent in Vietnam and 3.9 percent in Lao PDR. Growth in the sector is driven by crops (mainly rice) and, to a lesser extent, livestock and fisheries:

³ The contribution of services includes the growth of tax on products net of subsidies. Cf. national accounts.

- Crops*, accounting for 14 percent of 2007 GDP and 1.1 point of GDP growth over 1998-2007, are dominated by rice. Eighty percent of farmers grow rice, 60 percent of them for subsistence. Rice covered 2.6 million ha in 2007 (two thirds of arable land and 90 percent of cultivated land) and production grew from 3.4 to 6.7 million tons between 1997 and 2007. Although data are patchy, this would mean that Cambodia has been an exporter of rice since 2004, with around 2 million tons now exported (around US\$300 million) each year. Yields remain however low (at 2.6 tons/ha, against 3.5-4.0 on average in the region). Cassava is a promising crop, with yields recently reaching 23 tons/ha (a level similar to Thailand and Vietnam) – but only 3 percent of cultivated land is used for it. Other crops include cashew nuts, maize, and jathropha. Cambodia has historically produced rubber as well: growth (and exports of around US\$175 million in 2006) of rubber have accelerated in recent years and recent significant investment in rubber will generate further growth in the future. Tobacco production has been driven by the presence of a large international investor. Fruits and vegetables are grown only on a small scale, despite a significant potential: as a result, Cambodia cannot meet its demand (fueled by hotels) and imports vegetables.
- Silk*, now accounting for US\$10 million of exports, has also a potential to develop. The domestic market is expanding with tourism, while export could also grow fast.
- Livestock* (pigs and poultry mainly, to sell meat and eggs), accounting for 5 percent of 2007 GDP and 0.3 point of GDP growth over 1998-2007, remains a crucial part of most farming activities and an important savings device. On the positive side, the stock of livestock has increased at an average of 2 percent per annum over the past decade. On the negative side, many issues of standards and trade prevent the sector from realizing its potential (Box 2.2).
- Fisheries*, accounting for 7 percent of 2007 GDP and 0.2 point of GDP growth over 1998-2007, are an important, though declining source of growth. Inland fisheries (in particular around the Tonle Sap, an exceptionally rich freshwater environment) dominate the sector (with fish complementing rice in Cambodian traditional diet), while marine fisheries are largely for export. Reforms since 2000 have attempted to promote better management of the fish stock and the development of community fisheries, but the declining size of the fish

Figure 1.2: Growth was driven by job creation and productivity gains

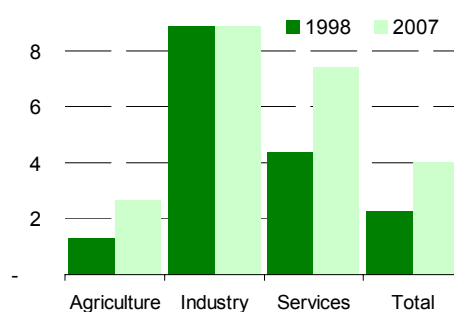
a/ Contributions of Employment and Labor Productivity to Growth (98-07)



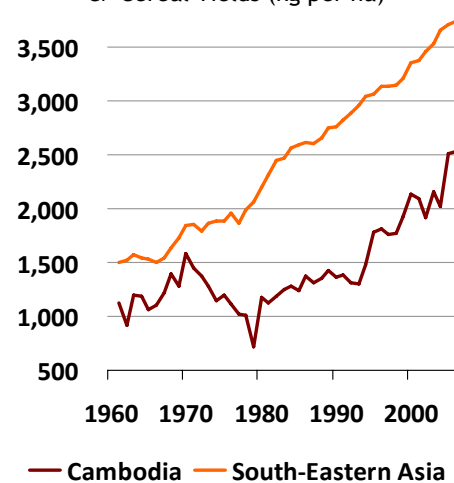
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Legend:
 ■ Labor Productivity Growth
 ■ Employment Growth
 ◇ Growth of Value-Added

b/ Labor Productivity (million 2000 riels)



c/ Cereal Yields (kg per ha)



Sources: WDI, NIS, National Accounts.

stock remains a concern. Cambodia exports around US\$100 million of fish each year, but exports are constrained by the absence of Sanitary and Phyto-Sanitary (SPS) standards.

- *Forestry*, accounting for 2 percent of 2007 GDP and -0.1 point of GDP growth over 1998-2007, played an important role in the 1990s, with significant illegal logging. Since strong regulations were put in place around 2000, massive logging has been curbed and activity in the sector relates more to community-level logging – as forestry continues for many communities to play a supporting role for rural livelihoods. Cambodia’s forests are estimated to cover about 11 million ha (or 60 percent of the country), although there is considerable debate about this statistic.

1.4. Growth in agriculture has been driven by land and productivity gains – even though yields remain low (Figure 1.2). Employment in the sector has been stable between 1998 and 2007.⁴ It has achieved productivity gains of around 2 percent per annum, with yields also starting to increase since the mid-1990s. Regression analysis shows that the yields gains between 2004 and 2007 can be largely explained by changes in the input mix and additional irrigation.

1.5. Industry is the fastest growing sector. Its relative size nearly doubled, from 17 to 30 percent between 1998 and 2007. Growing at an average of 16 percent per annum, it contributed 3.4 points of growth per annum over the decade. Growth in the sector is driven by manufacturing (mainly garments and footwear) and construction:

- *Garments (and footwear)*, accounting for 16 percent of 2007 GDP and 2.4 point of GDP growth over 1998-2007, is the country’s leading export sector and has been growing at an average of 28 percent per annum: exports went from almost zero in 1994 to US\$2.8 billion in 2007 (70 percent to the US market – where Cambodia was the 8th largest supplier in 2007 – and 22 percent to the European Union (EU). Cambodia’s exports are mainly low-end garments and some footwear, with no diversification to textile or more complex garments. The majority of firms focuses on “CMT”, i.e. the simplest part of the value chain. The story of the garment sector’s initial development, survival at the end of the Multi-Fiber Arrangement (MFA) in 2005, and recent challenges is reviewed in Box 2.2.
- *Food manufacturing*, accounting for only 2 percent of 2007 GDP and 0.1 point of GDP growth over 1998-2007, is an area of unmet potential.
- *Other manufacturing* are also underdeveloped, with only a few recent examples of assembly factories (bicycles, cars, motorcycles).
- *Construction*, accounting for 7 percent of 2007 GDP and 0.7 point of GDP growth over 1998-2007, has been booming since 2002. But it has significantly decelerated in 2007 and into 2008, with signs of overheating (rising prices of labor and construction materials) and concerns about a bubble in the real estate sector.
- *Electricity, gas and water*, accounting for 1 percent of GDP and 0.1 point of GDP growth over 1998-2007, has developed very rapidly, but without catching up with demand (Chapter 6).
- *Mining*, accounting for 0.4 percent of 2007 GDP, has been growing fast in recent years but from a very low base. It remains mainly artisanal: its growth potential is explored in Chapter 5.

1.6. Industrial growth has mainly translated into employment growth, with little productivity growth. Almost 100,000 new jobs were created each year between 1998 and 2007. Over the same period, labor productivity was stable (with a decline first and a rebound then). In

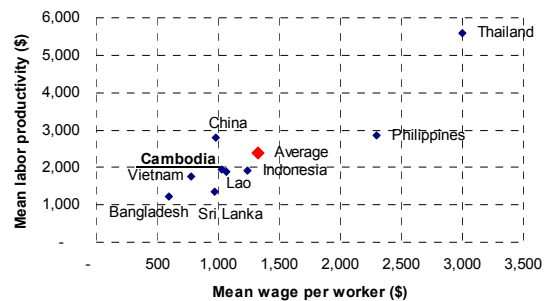
⁴ Employment data is weak because of the large informal sector. The data used here is based on census and household surveys. Based on the national accounts, some 80,000 jobs would have been created on average per annum in agriculture.

garments, this translates into a level of labor productivity close to that of Vietnam and Lao PDR, but below China (Figure 1.3).

1.7. **Services have maintained a steady share of Cambodia's economy**, at around 40 percent of GDP. This sector spans a wide range of activities from finance and telecoms, to trade and tourism, real estate and informal services:

- ♦ *Trade*, accounting for 8 percent of 2007 GDP and 0.5 point of GDP growth over 1998-2007, was driven by both domestic and international trade. International trade has been well served by Cambodia's various international commitments (to the ASEAN, to World Trade Organization (WTO)). Domestic trade has benefited from the decade of rapid growth in incomes for most Cambodians. Large parts of the sector remain however informal, in part a response to disincentives (such as red tape and corruption at border posts) to formalizing.
- ♦ *Real estate*, accounting for 8 percent of 2007 GDP and 0.8 point of GDP growth over 1998-2007, has been developing with the construction sector (see above).
- ♦ *Transport and communication*, accounting for 6 percent of GDP and 0.6 point of GDP growth over 1998-2007, has been driven mainly by tourism and trade. Telecommunication – which accounts for around 10 percent of this sub-sector – has been growing very rapidly with the development of cell phones and internet providers (see Section 4.A). Although Cambodia may not seem to be well-positioned to enter the international IT market, there are organizations such as Digital Data Divide (DDD), located in Phnom Penh and Battambang, which is providing data processing and digitalization services to client such as Harvard Crimson newspaper of Harvard University, Bain Capital, and MobiTel.
- ♦ *Hotels and restaurants*,⁵ accounting for 4 percent of 2007 GDP and 0.5 point of GDP growth over 1998-2007, is largely driven by tourism. Cambodia was one of the fastest growing tourist destinations in South-East Asia in the 1960s. Although it did not recover until the mid 1990s, tourist arrivals has now risen to more than 2 million in 2007, with two-thirds of visitors coming from East Asia (South Korea in particular). The rapid growth of tourism owes to Cambodia's exceptional cultural heritage and its natural endowment (and its location in a dynamic region), recent stability, and key policies (such as the Open Sky Policy introduced in late 1997).
- ♦ *The financial sector*, accounting for 1 percent of 2007 GDP and 0.1 point of GDP growth over 1998-2007, has developed from a very low base and expanded very rapidly (see above and Chapter 6). It remains dominated by the banking sector, with a very small insurance sector starting up and a few investment funds created in 2007-08.
- ♦ *Public administration*, accounting for 1 percent of 2007 GDP, is small, poorly paid, and not very effective (Chapter 8).

Figure 1.3: In the garment industry, wages and productivity are not in the low-range any more



Note: based on investment climate surveys; labor productivity and wages are measured in 2004 US\$. *Source:* World Bank (2008d).

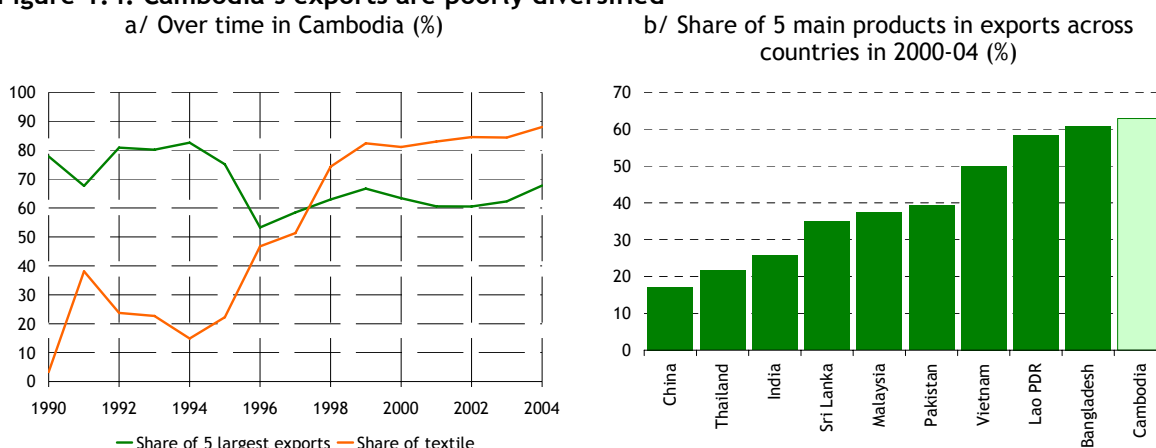
⁵ The classification in the national accounts has no single sector for tourism. The contribution of tourism is mainly reflected in hotel and restaurants, and to a lesser degree in transport services.

- ♦ “Other services”, accounting for 9 percent of 2007 GDP and 1.2 point of GDP growth over 1998-2007, include a variety of formal (e.g. education and health) and informal (e.g. “household services”) services that have been growing rapidly with the development of the economy.

1.8. **Growth in services has also led to employment creation**, with services absorbing around 100,000 jobs per annum over 1998-2007. As a result, labor productivity has increased by around 6 percent per annum over that period.

1.9. **Consistent with this pattern, Cambodia’s exports are very poorly diversified** (Figure 1.4). Cambodia’s five main products account for more than 60 percent of its total exports, a concentration significantly higher than other countries.

Figure 1.4: Cambodia’s exports are poorly diversified

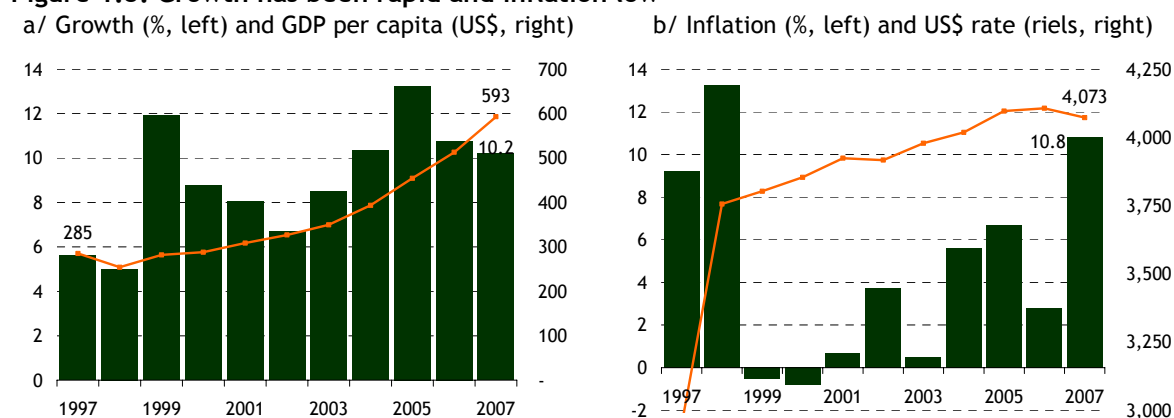


Source: World Bank, based on UN Comtrade database.

B. Macroeconomic Stability, Rising Export, Weak Investment

1.10. **Cambodia has established a strong track record of growth and stable macroeconomic conditions** (Figure 1.5). Growth accelerated in 1999 as the domestic political situation became clearer and the external economic situation improved following the 1997 Asian crisis. Growth averaged 9.8 per annum, with inflation largely remaining below 5 percent throughout the period.

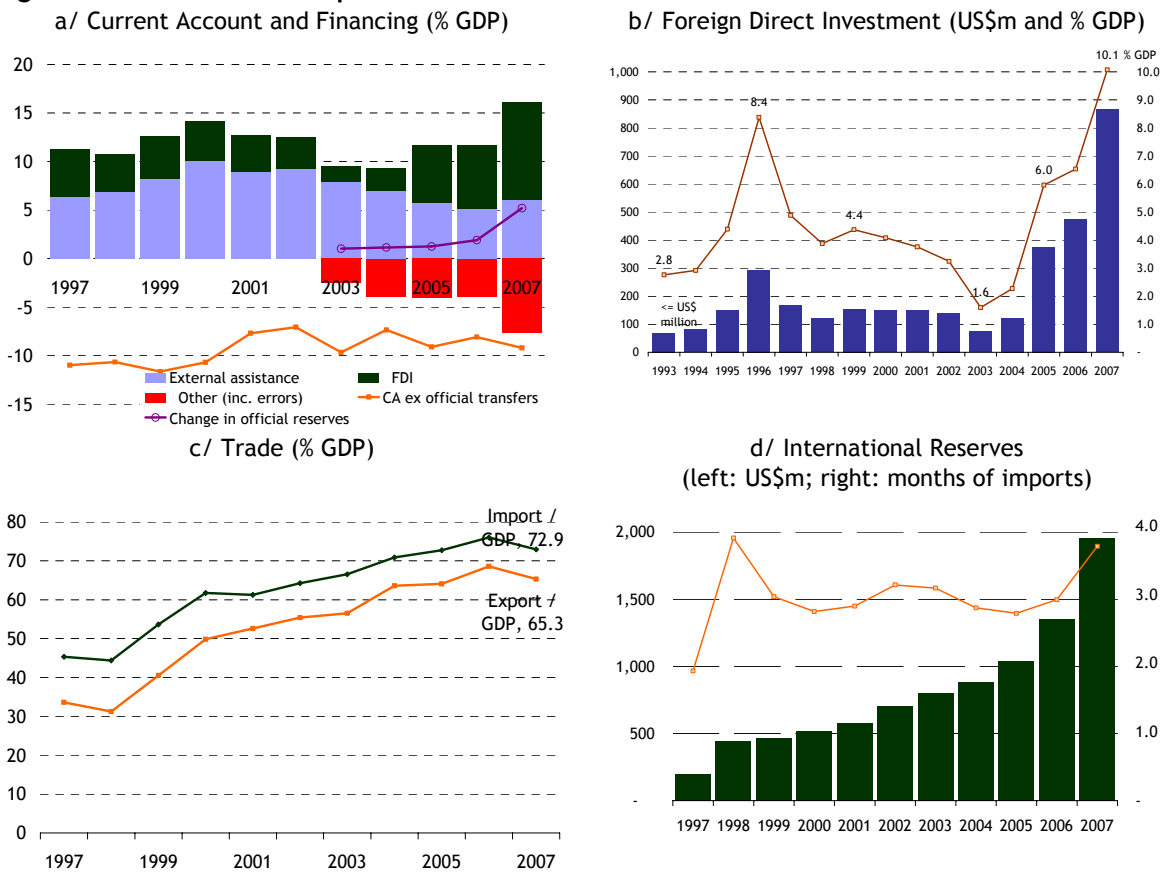
Figure 1.5: Growth has been rapid and inflation low



Source: NBC and NIS. [needs updating with new population numbers]

1.11. **This performance has largely benefited from a very favorable external environment** (Figure 1.6). The external environment generated a strong demand for exports and large capital flows (official and private) to finance the large current account deficit. Until 2007, there were few major terms-of-trade shocks⁶: fluctuations in global prices of petroleum products had been smoothed by a decision to use fixed administered prices for the taxation of these imports and the end of the MFA and its quota system, although much feared (see World Bank, 2004) did not generate any significant shock to the garment sector.

Figure 1.6: External developments were favorable until mid-2008



Source: NBC and NIS.

1.12. **However, performance has deteriorated significantly in 2008.** Although the limited development of the financial sector is shielding Cambodia from direct impact of the financial turmoil in the global economy, this highly uncertain environment will exacerbate four pre-existing vulnerabilities:

- First, the *four drivers of growth* (Section A) are subject to the uncertain environment. Garments and tourism will directly suffer from the global slowdown, especially in the US for garments and in South Korea for tourism. Construction was also weakening and will further slow down as foreign investment in real estate slows down. On the other hand, agriculture could respond positively to higher prices of rice, although the supply response remains uncertain, a question further reviewed in Part 2.

⁶ Annual variations of terms of trade (measured by the implicit deflators of imports and exports in the national accounts) were less than 3 percent since 1999.

- Second, the *large current account deficit* was more than financed by inflows of private and official capital flows. International reserves have increased sharply in 2006-07, to more than three months of imports. Although private flows are not short term (mainly FDI) and Cambodia has limited debt obligations, the financing of the current account is a significant vulnerability.
- Third, the *rapid development of the financial sector* has created risks that could materialize if the slow down in the economy, in real estate in particular, is marked (see below).
- Finally, concerns about *rising inflation* have made the policy response complex. Although this risk might be already addressed in late 2008 – as the original drivers (higher prices of food and oil; depreciation of the dollar; and rapid growth of credit to the private sector) are all being reversed – it requires constant monitoring, especially given its impact on the real effective exchange rate and competitiveness (Chapter 6).

1.13. Although it has limited policy instruments available to it, the RGC appropriately managed the policy mix and structural reforms. In a largely dollarized economy, the policy mix relies mainly on fiscal policy, which has been relatively conservative in recent years, preventing inflationary pressures from emerging until recently. The budget has generated an increasing current surplus in recent years, leading to negative domestic financing – mainly through a reduction in arrears (Figure 1.7). Monetary policy has allowed a deepening of the financial sector, although – until mid-2007 – at a pace consistent with macroeconomic stability. Current and capital accounts are open and there is no restriction on the exchange rate. Most sectors of the economy are liberalized (see also Box 1.1).

Box 1.1: The State of the Economy in 1992

A report from development partners in 1992 concluded that “with insufficient resources to generate productive income, and isolated from the mainstream of world trade, Cambodia has run its physical capital down and has severely stretched its meager human resources”. Transport infrastructure was dramatically lacking; only 20 percent of the Phnom Penh population had access to piped water; the delivery of social services, although supplemented by NGOs, was poor. The economy was subject to weather uncertainties and unreliable access to raw materials and spare parts. Only resilience in agriculture was maintaining some income and food supply.

The report noted positive reforms, but stressed that these reforms had been undertaken as a partial and ad hoc response to difficulties, hence with uneven results. Starting 1989, agricultural land had been returned to the tiller. Some autonomy had been given to state-owned enterprises in 1989, but with weak results.

Growth had responded positively, but with significant variations (16, 2, 0 and 14 percent respectively for GDP growth in 1988-1991). The budget, even after almost stopping all public investment and maintenance expenditures, and reducing public employment, had a financing gap equivalent to 40 percent of expenditures. This was due to a decline in revenues, down to 4 percent of GDP in 1992, in part because of the liberalization of the economy. This translated into a major deficit, while Cambodia had lost its access to a credit facility from the Soviet Union and not yet gained access to development aid. In turns, this had fed into inflation (70, 157 and 121 percent in 1989-91).

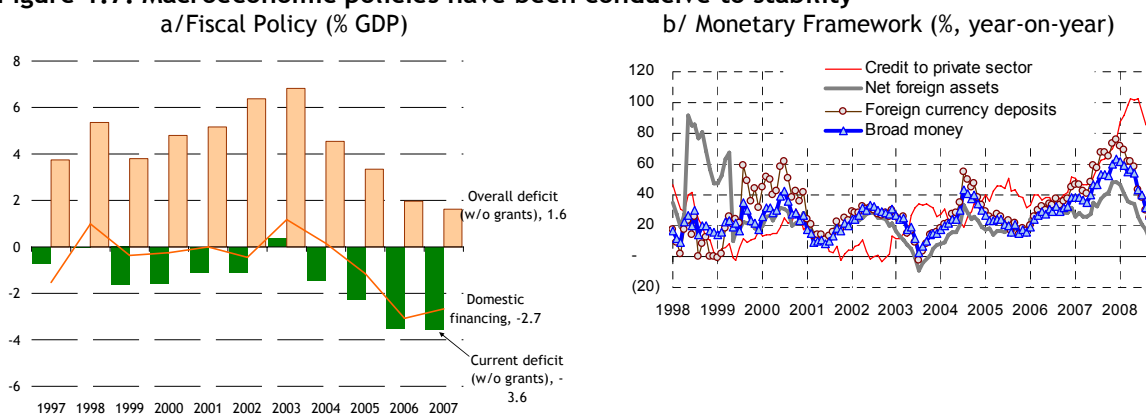
The focus of the strategy at that time was twofold: (i) absorb the returning refugees and settle the internally displaced persons and demobilized troops; and (ii) stabilize the economy, strengthen institutions, and prevent a further degradation of basic public services.

Source: World Bank and others, 1993.

1.14. Cambodia is still largely a dollarized, cash-based economy (see Im, Dabadie, and Sokha, 2007). The local currency – Cambodian Riels (CR) – in circulation represents only about 6 percent of GDP and is mainly used in the interior of the country and for small transactions. In the banking system, cash (almost all US dollars) represents an unusually large share of assets (about 5 percent). Total currency holdings, including dollars, can be assumed at about 60 percent

of bank deposits.⁷ Over 90 percent of deposits (and loans) are denominated in dollars. The main exception is the public sector: riels must be used to pay taxes and other public sector bills and the public sector pays in riels. The dollar is also used as a store of value throughout the country. This feature implies that (i) the fluctuations of the real exchange rate measured in riels have a diffused impact on the economy (see also Chapter 6 and 7) and (ii) monetary and exchange rate policies have limited effectiveness.

Figure 1.7: Macroeconomic policies have been conducive to stability



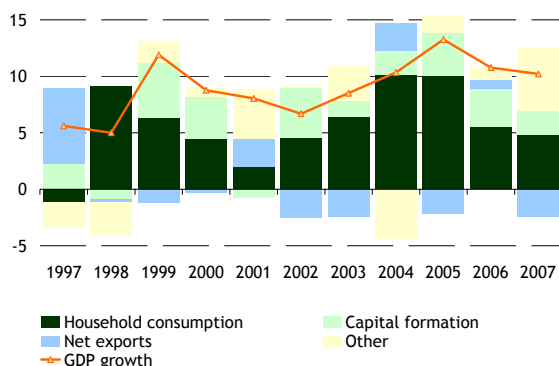
Sources: MEF, NBC, NIS, Staff

1.15. Other important features of growth in Cambodia are the strong growth in consumption, the weak level of investment, and the small size of the public sector. Consumption has been one of the main drivers of growth, contributing 5.7 points of growth per annum (Figure 1.8). Exports have increased fast, but the contribution of net exports to growth has been very small (0.1 percentage point on average). On the investment side, it is a major achievement that the investment-to-GDP ratio has increased from 15 percent in 1997 to 21 percent in 2007, contributing 2.4 points of growth per annum on average. However, this level is below what other countries with rapid growth have typically achieved (Table 2.1) and, in a growth accounting framework, the contribution of physical capital accumulation to growth has been limited. The composition of investment is also problematic: public investment is low and the rapid increase in FDI (see next paragraph) suggests that domestic investment has been particularly limited, possibly averaging only around 5 percent of GDP per annum (Figure 1.8). Finally the public sector is unusually small (Chapter 8).

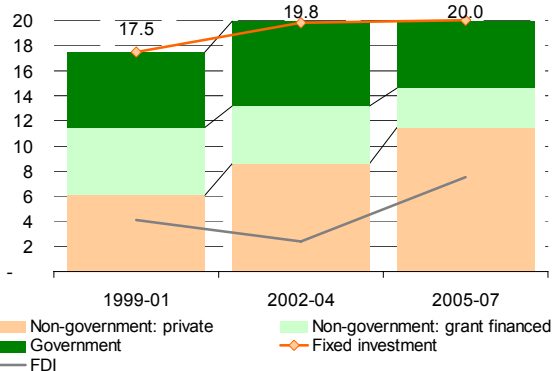
1.16. FDI has increased significantly since 2004. FDI was very low throughout the 1990s and into the 2000s. Since 2004, it has increased significantly, growing 10 times between its low level of 2003 and its highest in 2007. Asian investors – from ASEAN, China, Hong Kong, Taiwan, South Korea – continue to dominate inflows. Some recent interest from Middle Eastern investors, especially in agribusiness, was noted in 2007. The level of FDI in 2007 was significant by the size of the economy (10 percent of GDP); low in absolute terms (US\$867 million, against, for instance, US\$6.7 billion in Vietnam); and very significant relative to investment (equivalent to 52 percent of gross fixed capital formation). FDI continues to be focused mainly on garments, tourism, and real estate.

⁷ Assuming conservatively that dollars in the hands of the public are merely twice as large as riel holdings (not the 9:1 ratio for deposits).

Figure 1.8: Growth has been driven largely by consumption and investment by FDI
a/Contributions to growth (%)



b/Investment (% GDP)

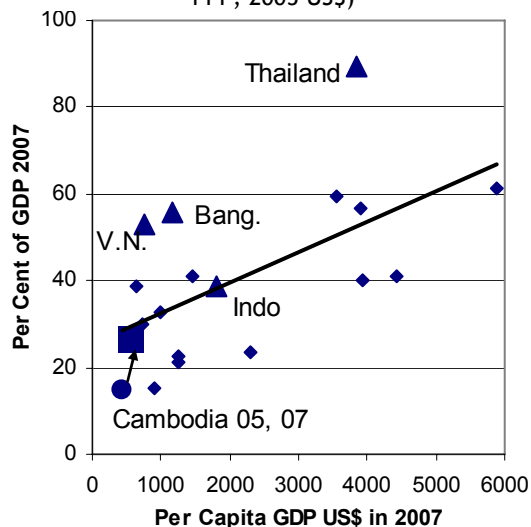


Source: World Bank, WDI.

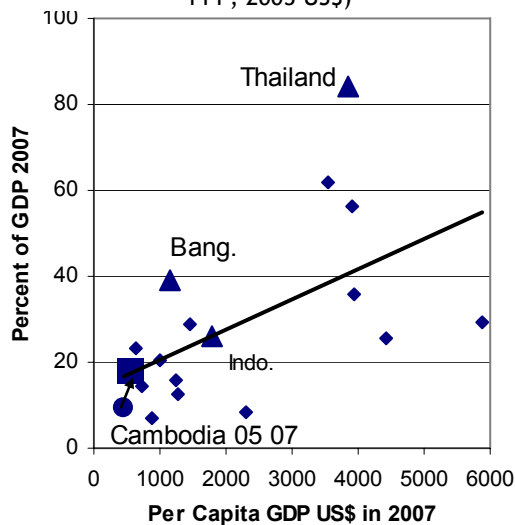
1.17. Finally, a critical development has been the rapid growth of the financial sector since 2005. As recently as 2005, Cambodia's financial system was less developed in terms of loans and deposits than those of countries with similar per capita incomes. The commercial banking system is now about what can be expected given Cambodia's per capita income, though it remains small in absolute terms (Figure 1.9). There appears to be a growing confidence in the banking system as evidenced by an extraordinary increase in deposits. Lending of bank and Micro-Finance Institutions (MFIs) has risen even faster. Access to credit has increased and a few banks have increased branches, Automatic Teller Machine (ATMs), and consumer credits substantially. A somewhat larger number of banks have increased real estate development and construction lending very rapidly.

Figure 1.9: The financial system is catching up with countries at similar levels of development

a/Deposits (% GDP) and per capita income (GDP, PPP, 2005 US\$)



b/Loans (% GDP) and per capita income (GDP, PPP, 2005 US\$)



Source: World Bank, WDI, IMF, International Financial Statistics.

1.18. However, the banking sector remains small and most of the growth to date was achieved without bank finance. The loans-to-GDP ratio reached 18 percent in 2007, while new credit issued in 2007 (around US\$700 million) was less than the amount of net FDI. Also

growth in credit has been largely directed at consumption, working capital, and real estate, but less at fixed investment.

1.19. The commercial banking system dominates Cambodia’s financial system and is concentrated. This structure is similar to that in most low income developing countries. At the end of 2007, there were 17 commercial banks, of which 11 were either branches of foreign banks or majority foreign-owned. In addition, there were 7 specialized banks, which were much smaller, with total assets equal to less than 2 percent of commercial bank assets. They cannot take deposits and have much lower capital requirements than commercial banks. Finally, in 2007, there were 17 MFI with a total of 6 percent of the assets of banks and 10 percent of the loans. However, MFIs have the vast majority of total loan customers – 76 percent of the 821,426 borrowers by end-2007. MFIs are very limited in their ability to take deposits. The commercial bank industry is concentrated and growing more so. At the end of 2007, the “big five” banks had 72 percent of total assets in the market with about 80 percent of the loans and 72 percent of deposits. The growth in concentration reflects three of the largest banks’ use of modern techniques and the problems and slower growth of the other two, which share some ownership. MFIs are important in the market for small loans outside Phnom Penh; for example, their total lending for agriculture is more than that of commercial banks. Two MFIs have more loans than many smaller banks. The non-bank financial sector is basically non-existent in Cambodia, although a stock market is under consideration. A few private equity funds emerged in 2007, but the recent global financial turmoil has delayed their plans.

1.20. The overall performance of the banking system appears to be in line with or better than most banking systems – but this might be misleading. Against standard metrics, the sector appears to be very profitable, efficient, and stable when compared to East Asia and developed countries (Table 1.1). However, this is difficult to square with the poor performance of the banking system in the past, the state of the domestic

Table 1.1: Performance Indicators of the Banking System

Financial Performance Ratios	Cambodia	East Asia and Pacific Region	Developed Countries
	2007	2006	2006
Profitability			
Net Interest Income / Average Assets	4.2%	3.2%	1.6%
Return on Assets (Net Income / Average Assets)	2.8%	1.2%	0.9%
Return on Equity (Net Income / Average Equity)	16.3%	16.6%	15.9%
Efficiency			
Operating Expenses / Average Assets	2.5%	2.7%	1.9%
Operating Expenses / Operating Income	43.6%	47.0%	53.4%
Capital Adequacy			
Capital Adequacy Ratio	24.0%	11.2%	8.7%
Equity / Total Assets	17.0%	7.8%	8.7%
Asset Quality			
Total Loans / Total Assets	47.1%	54.3%	47.4%
Non-Performing Loans / Total Loans	3.4%	5.7%	1.8%
Loan to Deposit Ratio			
Total Loans / Total Deposits	63.8%	65.3%	78.3%

Sources: The East Asia and Pacific and Developed Country ratios were calculated by the IFC, Global Financial Markets Department based on data from Bankscope on several top banks in major countries. The data on Cambodia is from staff based on the average of 17 banks from the National Bank of Cambodia, “Annual Report 2007,” Banking Supervision Department, http://www.nbc.org.kh/sup_reports/en/Supervision_Report_%202007_EN.pdf. The data for Cambodia is not on average assets or equity as it was not available in all cases, but instead total assets and total equity for 2007. It should be noted that by using the average assets or equity, the ratios would rise significantly as the assets and equity were at much lower levels in 2006 than 2007.

economy and business environment, the limited transparency and quality of auditing and accounting, and the realities on the ground within the banks and the supervisory authority. In fact, the underlying reasons for these performance indicators often lie in structural inefficiencies. For instance, there are concerns about the quality of reporting on Non Performing Loans

(NPLs) and on classification. The concentration of NPLs in two banks is also a major concern. A downturn in the economy, especially in real estate, could quickly erode returns, increase NPL ratios, and weaken capital adequacy ratios.

1.21. **The increase in financial sector risks must be monitored and managed.** With deposits growing over 2005-07 by about 33 percent per annum relative to GDP, and loans by 50 percent (mainly driven by an increase in the size of loans), a number of risks have emerged:

- Rapid growth of lending has contributed to *inflation*. Although inflation does not reflect the typical case of monetary growth to finance government spending, monetary expansion is driven by rising capital inflows, the run-down of “under the mattress” dollar holdings, and the rapid growth in credit. The National Bank of Cambodia (NBC) tried to limit the overall growth of credit by raising reserve requirements in July 2008.
- A potential risk is the rapid growth of *consumer credit*, a new area for the banks. But the risk is mitigated by the fact that much of this growth has come in banks with reasonable systems for handling it. The same holds true for the rapid growth of bank lending to *agriculture* although the credit for the sector still remains small. The risks in both types of lending are the lack of good information on borrowers and possible increases in consumer lending by banks in the face of weak information and without good systems to manage these credits, as well as the risk of a macroeconomic slowdown that could affect these credits.
- The rapid growth of credit for *real estate development and construction* represents even more risks. Lending in this area has contributed to the property boom and inflation; a fall in property prices could create problems for the involved banks, some of which already have high NPLs. These problems could spill over into a loss of confidence and problems in the banking system generally and ultimately into the economy.

C. Summing Up

1.22. This review of 10 years of rapid growth outlines an economy that has:

- Been growing fast, fueled by exports and domestic consumption;
- Initiated its structural transformation (at a pace consistent with experience of other SRG countries at that stage of development);
- Not diversified significantly beyond exports already produced at the beginning of the past decade;
- Maintained macro-economic stability, largely thanks to a favorable environment (also thanks to appropriate policies, although the authorities’ instruments to manage the policy mix are limited).

1.23. The next two chapters ask (i) how this happened and (ii) what the impact has been on the Cambodian people.

2. Explaining Cambodia's Growth Performance

2.1. **There are important lessons from Cambodia's achievements over the past decade.** Chapter 2 outlines a number of key drivers and dimensions of growth to date. They set the background for understanding potential ingredients for growth looking forward. These lessons are put in the context of other countries' experience with development, in particular those summarized by the Growth Commission (Box 2.1).

Box 2.1: The Growth Commission Report: Habits of Successful Economies

The Growth Commission's report (<http://www.growthcommission.org>) argues that "growth is not an end in itself. But it makes it possible to achieve other important objectives of individuals and societies. It can spare people en masse from poverty and drudgery. Nothing else ever has. It also creates the resources to support health care, education, and the other Millennium Development Goals to which the world has committed itself. [In short, the report takes the view] that growth is a necessary, if not sufficient, condition for broader development, enlarging the scope for individuals to be productive and creative."

The report identifies some of the distinctive ingredients involved in successful growth in 13 countries that have sustained 7 percent growth for 25 years and other countries that have been less successful:

- Involvement with the **world economy**. The world economy offers developing countries a deep, elastic market for their exports and allows countries to specialize in new export lines and improve their productivity in manifold ways. It also provides opportunities for inward technology transfer and foreign direct investment.
- High rates of **investment**, perhaps 25 percent of GDP or more, predominantly financed domestically and including infrastructure investment of perhaps 5 percent of GDP or more.
- Investment in **education, training, and health**, with private and public spending in these areas as high as 7-8 percent of GDP.
- Increasingly **capable, credible, and committed governments** that are supported by the public and wedded to the goal of high inclusive growth, but pragmatic in their pursuit of it and which ensure equality of opportunity and reasonable social safety nets.
- A **policy** environment favoring high levels of investment, job creation, competition, mobility of resources, and efficient urbanization. This environment should include a reasonable degree of macroeconomic stability.
- **Equality of opportunity** and reasonable amounts of equity and social protection, particularly in economic transitions, in terms of income and access to basic services and training.

In addition, the Commission advises that the cost of pollution should be considered from the outset, even if the toughest environmental standards of the rich countries are not adopted. The report also calls on developing countries to wean themselves off fuel subsidies, which impose a mounting fiscal burden as energy prices rise, diverting money that would be better spent on neglected public infrastructure.

While these elements are important for sustained high growth, the Report recognizes that it "does not provide a formula for policy makers to apply—no generic formula exists. Each country has specific characteristics and historical experiences that must be reflected in its growth strategy. But the report does offer a framework that should help policy makers create a growth strategy of their own. It will not give them a full set of answers, but it should at least help them ask the right questions."

The Commission's report was the product of two years of inquiry and debate by 19 experienced policy makers, academics, and business people, mostly from developing countries, and two Nobel Laureates, including Michael Spence, who chaired the commission.

Source: Growth Commission Report (2008).

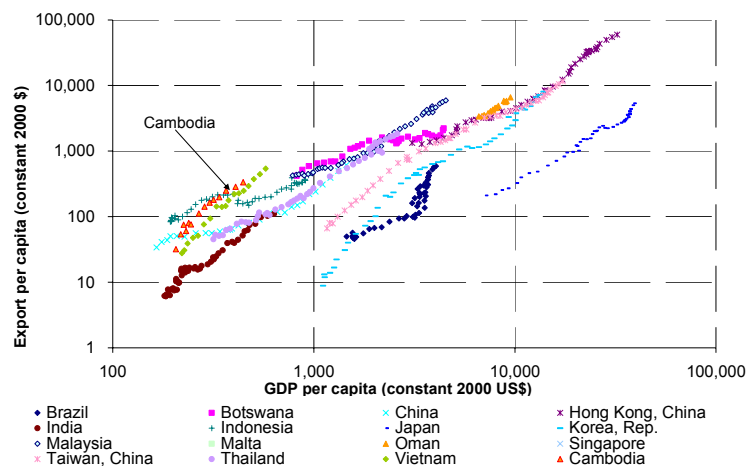
A. History and Geography

2.2. **The first dimension of Cambodia’s growth to date has been its favorable geography and its recovery from conflict and instability.** Cambodia sits in a dynamic region, with access to international markets and dynamic neighbors such as Vietnam and Thailand. Cambodia managed its historical transitions to end the three-decade long conflict and shift from a command-and-control economy to a market-oriented economy (Hughes, 2003). At the same time, Cambodia seized the opportunity presented by a rapid growth in global demand and by its location as a coastal country in a dynamic region.

2.3. **First, Cambodia has generated a growth peace dividend by establishing a track record of political and macroeconomic stability.** This stability was achieved in the late 1990s and maintained in the early 2000s, at a historical period of rapid world growth, in particular in East Asia. Political stability has been a foundation of sustained growth. Another implication of history was the return of part of Cambodia’s Diaspora, bringing funds, knowhow, and ideas. Cambodia also achieved significant inflows of external assistance following the 1991 Paris Agreement.

2.4. **Second, Cambodia seized this historical moment through opportunistic trade and investment policies.** First, with its nascent *garment* sector growing very rapidly and concerns about such growth in the US, it agreed with the US extended quotas in exchange for strict enforcement of labor standards (Box 2.2). Second, this approach was complemented by a favorable *investment regime* (equal treatment for

Figure 2.1: Cambodia has higher exports per capita than other SRG countries at its level of development



Source: World Bank, WDI.

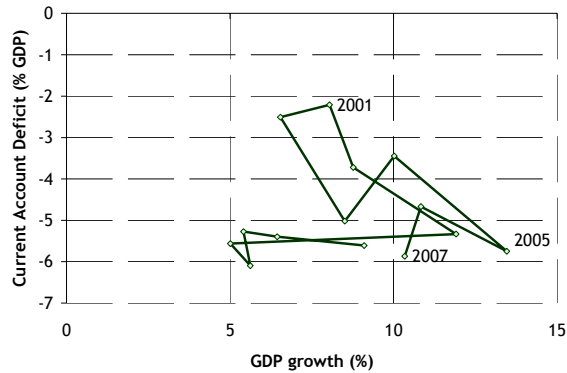
domestic and foreign investors; tax holidays for a large range of “qualified investment projects”). Third, the *trade regime* is also very open, with the applied tariff rate at 14.2 percent and import duties at only 2.7 percent of imports. Cambodia joined ASEAN in 1999 and the WTO in 2004. Although trade with regional partners is below potential (Section 4.C), these international commitments were useful to create confidence among investors. Fourth, Cambodia managed well the policy reforms around 1990 to liberalize its economy (Box 1.1) and began to establish a track record of legal reforms. All of this enabled it to harness the historically high global demand and take advantage of its low cost structure. Cambodia’s level of exports per capita is higher than other SRG countries at Cambodia’s level of development (Figure 2.1), although this is owed partly to exports of tourism services. Cambodia also achieved a high level of foreign investment, dominated by investors from Asia.

2.5. **Third, growth also benefited from Cambodia’s demographic transition** (Chapter 3). With fertility rates decreasing, demographic growth slowed down and the dependency ratio (ratio of the young and elderly to those working) started to decline. This contributed around 2 points of GDP per capita growth. This is unusual in the sense that most other SRG countries saw this transition happen only after they had reached US\$1,000 in GDP per capita.

2.6. **This first dimension highlights the key role of openness and macroeconomic stability** (also two of the key ingredients highlighted by the Growth Commission, Box 2.1). For today's growth agenda, it underscores the importance of managing recent inflation pressures and financial sector risks (Chapter 7). It also emphasizes the role of logistics and trade facilitation in allowing a small open economy to seize regional and global opportunities.

2.7. **On the other hand, this dimension stresses the vulnerability of Cambodia's achievements.** In a global environment characterized by considerable uncertainties, this narrative reveals that growth is very fragile and dependent on the global environment. Growth outcomes have been largely dependent on the availability of foreign savings (see the negative correlation between growth and the current account deficit, Figure 2.2). This highlights the importance of diversification for sustaining growth and reducing these vulnerabilities. Even rapid achievements in the area of regulations and institutions are not always anchored in a long tradition of business in Cambodia, but rather often imported from other countries: this explains why several of these achievements are only *de jure*, not *de facto*. Finally, this dimension highlights that Cambodia went through a unique window of opportunity with the establishment of peace coinciding with a favorable external environment.

Figure 2.2: Growth tends to accelerate when more foreign savings are available



Source: World Bank, WDI. Data for 1994-2007.

B. Use of Natural Assets and Domestic Savings

2.8. **The second dimension is that Cambodia's rapid growth has been driven by the exploitation of its natural assets.**⁸ The forestry sector, which generated significant income in the 1990s (and, by many accounts, fed into subsequent waves of investment in real estate), is a clear example. Concerns have also been raised about the depletion of the fish stock. Together the forestry and fishery sectors accounted for 19 percent of GDP growth in 1993-98, but only 2 percent in 2003-08. Forest products accounted for 43 percent of exports in 1994 and less than 1 percent in 2006. In fact, the Government, out of concerns for these issues, banned logging in 2000, reformed large commercial fishing lots in 2002, and has been promoting community approaches to forestry and fishery management since then. The historical site of Angkor has also driven a very rapid growth in tourism (with the number of tourists increasing from 200,000 in the early 1990s to 2 million now), amid concerns about its sustainability.

2.9. **Despite this rapid use of natural assets, savings have been low** (Figure 2.3). There could possibly be some dis-savings, with a rapid depreciation of existing assets.⁹ The low level of savings was also evident in the public sector, where public savings have been historically low (Chapter 8), but this is offset by domestic assistance (from private donors) and external assistance. The situation has changed somewhat since 2003 in the public sector. This low level of savings would be consistent with the short time horizon frequently noted in Cambodia (in part

⁸ See for instance Sloth, Sreng, and Bottra (2005).

⁹ It might be useful to undertake some analysis of a broader definition of savings, including natural assets, to guide policy-making, especially if mineral resources are present in Cambodia. Data on forestry (cover and quality) are scant and controversial. Data on fish stocks are largely inexistent. Data on underground resources are undisclosed or inexistent.

the result of its level of development, limited financial sector, and post-conflict situation), although this might change as the proportion of working-age Cambodian increases (this age group has a higher propensity to save).

2.10. The unsustainable use of assets is compounded by a questionable allocation of investment.

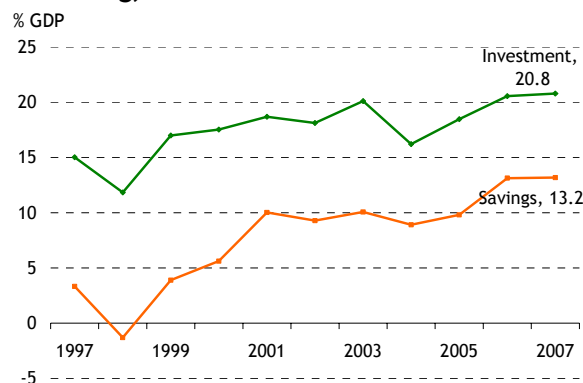
There are high returns on some classes of assets, with capital inflows in 2007-08 driving some of the increases in asset prices. Forestry generated significant returns in the 1990s. Land speculation and a real estate boom have created significant returns: prices in Cambodia are at levels suggesting that investors plan to recoup their investment not only from using or renting their asset, but also through capital gains.¹⁰ As a result of these high returns, banks are looking at rates of returns well above 40 percent, which the manufacturing sector is unlikely to generate. The weak quality of investment is also shown by poor utilization rate (including in garments and tourism) and, in some sectors, low mark-ups (low profits over wages), possibly signaling a low cost of financing.

2.11. This dimension is consistent with the recent increase in inequality. As discussed in Chapter 3, inequality rose sharply in 2004-07 at a time of rapid growth. Inequality in assets (land in particular) is large (World Bank, 2007). This contrasts with the experience of SRG countries, many of which have avoided sharp increases in inequality.

2.12. This second dimension is also highly unsustainable. There is first the obvious risk of exhausting assets. The distortions introduced by a focus on natural resources are also a constraint on diversification (e.g. the financial sector and entrepreneurship are directed to further use of natural resources, as opposed to investment in manufacturing or innovation).

The experience in SRG countries also highlights the importance of increasing savings and investment to 25 percent of GDP or more (Table 2.1). Most of these countries also show a marked increase in these two rates between the first and second decades of sustained rapid growth. It should finally be noted that this dimension has important implications for the management of extractive industries in a way that supports sustainable growth (Chapter 5).

Figure 2.3: Investment and savings have been increasing, but remain low



Source: NIS, national accounts

Table 2.1: Savings and Investment in Sustained Rapid Growth Countries

	Timing		Gross Capital Formation (% GDP)		Gross Savings (% GDP)	
	First ten years	Next ten years	First ten years	Next ten years	First ten years	Next ten years
Botswana	1960-70	1970-80	19.9	42.6	(2.7)	21.6
Brazil	1950-60	1960-70	n/a	19.7	n/a	19.9
Cambodia	1998-2007	n/a	18.5	n/a	8.6	n/a
China	1961-71	1971-81	21.1	31.4	29.1	31.3
Hong Kong	1960-70	1970-80	25.6	26.1	24.6	31.1
India	1988-98	1998-2007	23.4	27.7	22.4	26.0
Indonesia	1966-76	1976-86	16.6	26.4	16.1	30.3
Japan	1950-60	1960-70	n/a	35.6	n/a	36.2
Korea	1960-70	1970-80	19.5	28.6	9.2	22.3
Malaysia	1967-77	1977-87	21.0	27.2	24.9	29.9
Malta	1963-73	1973-83	27.7	26.2	6.4	13.0
Oman	1960-70	1970-80	16.7	28.0	62.6	50.2
Singapore	1967-77	1977-87	36.2	43.2	24.2	39.8
Taiwan	1965-75	1975-85	26.5	27.3	26.1	31.8
Thailand	1960-70	1970-80	21.0	26.1	18.9	22.3
Vietnam	1988-98	1998-2007	21.1	32.5	12.5	27.8
<i>Average fast growing</i>			22.8	30.3	21.1	29.0

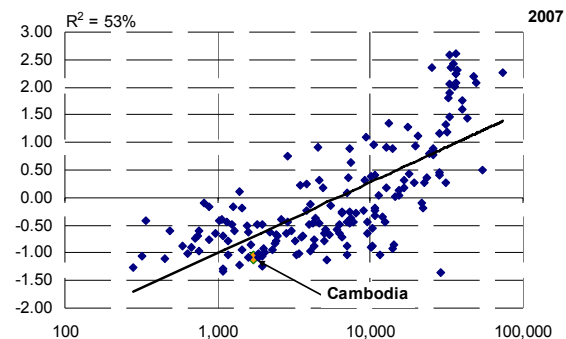
Source: World Bank, WDI, Staff estimates.

¹⁰ The ratio of house prices (per square meter) to income (GDP per capita) is above 4 in Cambodia, against 2.6 in Vietnam and less than 1 in almost all other Asian countries (even though the yield on the rental of properties is not particularly high).

C. Sector-Specific Governance

2.13. Cambodia has achieved rapid growth even while firms complain about poor governance. In surveys such as the Investment Climate Assessment (ICA), firms report high levels of corruption, and register complaints about the quality of the public services that usually underpin growth. Cambodia rates low on most international governance scores, even compared to countries at the same level of development (Figure 2.4).^{11 12} A more specific question for understanding this growth paradox is this: “*Why have successful sectors been able to thrive even with such apparently poor governance conditions?*” Beyond the role of governance arrangements that ensured political and macroeconomic stability (Section A), there must be arrangements that are specific to the sectors that are growing.

Figure 2.4: The perception of corruption is high, even compared to countries at the same level of development



Source: WDI for GDP per capita (2005 PPP US\$ per capita); World Bank Institute for Control of Corruption (index on a -2.5+2.5 range, higher means less corruption).

2.14. The garment industry, the leading growth sector, offers useful lessons (Box 2.2). It is an example of hand-in-hand governance, where the Government (in particular the MOC) and the firms (coordinated by the GMAC) worked together to create an environment that generated growth. The strategic vision developed by the RGC, with the US Government, helped align expectations for investors. The link to export quotas and the supervision by the International Labor Organization (ILO) helped establish the credibility of these higher expectations. The rents for Government from managing quotas (which ended in 2005 as the MFA was dismantled) increased incentives. Subsequently, the existence of a strong and capable business association, GMAC, helped sustain support to the industry and create a sense of security given GMAC’s capacity to get things done with the RGC. This, for instance, is evidenced by the reduction in trade costs in this sector, at a time when these costs were still increasing for other industries (Figure 2.5).

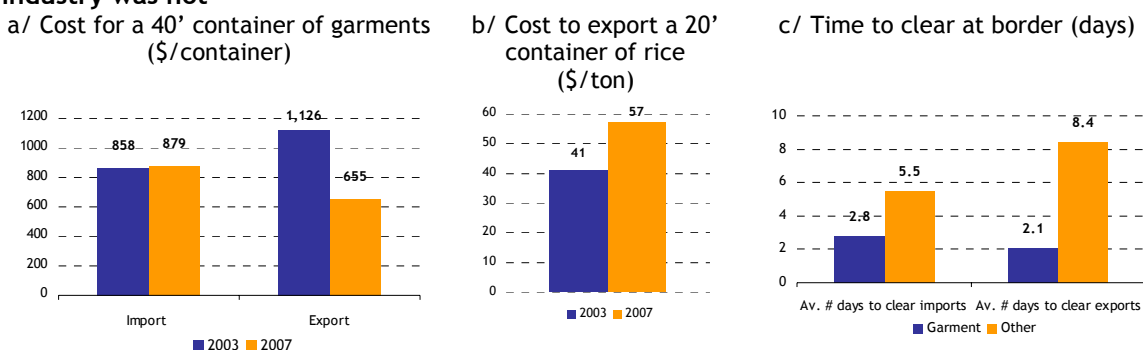
2.15. The roles of international drivers, foreign investors, domestic collective action mechanisms, and high stakes seem to have been critical in these achievements. External pressure was instrumental in creating the opportunity for growth in the sector. The Government’s response was probably driven by the high stakes, with a very labor-intensive sector (now employing 300,000 workers) and significant rents from the quotas. Coordination within Government (which is often challenging given its fragmented nature) was ensured through the dialog being monopolized by the MOC. Foreign investors helped sustain the Government’s focus on the sector. The business association created the vehicle to solve collective action problems and maintain the necessary close relationship with the Government.

¹¹ In the most recent versions, Cambodia ranks in the 20-30th lowest percentiles for four dimensions of the World Bank Institute governance indicators, and 14th lowest for rule of law and 8th for control of corruption; it ranks 166th out of 181 countries in the Transparency International Corruption Perception Index; it ranks 135th out of 181 in the World Bank’s Doing Business indicators and 110th out of 131 in the World Competitiveness Indicators.

¹² There is ample evidence that governance and development are tightly linked (although the link between growth – as opposed to the *level* of development – and governance continues to be debated).

Its role was facilitated by the clustering of many factories, the homogeneity of the sector (most factories facing similar issues), and the strong pressure from global buyers (Box 2.1).

Figure 2.5: The garments industry was able to make trade cheaper and faster, but the rice industry was not

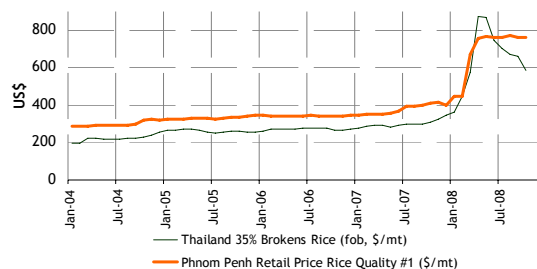


Source: JDI, 2007b and World Bank (2008d).

2.16. **Another example of collective action arrangement is the G-PSF.** This Forum, established in 1999, has been instrumental in giving the private sector a sense of security regarding Government responsiveness. The Forum, which meets twice a year under the chairmanship of the Prime Minister and has eight working groups meeting regularly, provides a vehicle for the private sector to raise its concerns and for the RGC to be held accountable for its decisions by the private sector (it has also been used for consultation on legislation). This – and more broadly the capacity for investors to approach the Government – is viewed by investors as an important device for creating a sense of security for their investments.

2.17. **By contrast, many other sectors lack these arrangements.** In livestock, returns are potentially high and there was significant interest among otherwise successful Cambodian investors and foreign investors. Even so, the sector remains stunted, incapable in particular of dealing with intractable issues of sanitary standards. Rice, as well, has been limited to small amounts of milled exports, despite the significant quantities of paddy exports, as evidenced by huge surplus production in recent years. The recent dramatic increase in rice prices might provide the incentive to develop a hand-in-hand relationship between a champion in Government and a domestic industry, possibly – based on lessons from the garment sector – with a role for third-party monitoring and foreign investors. But the rice sector seems to lack the external discipline of the garment sector, as shown by recent developments in price (Figure 2.6). In part, this reflects coordination issues among small rice producers and traders, giving more market power to traders downstream in the value chain.

Figure 2.6: The price of rice in Phnom Penh is driven by international prices, but only when they rise



Data in riels per kg. Note: The import parity price is calculated by adding to the cost of rice in Thailand the cost of transport and the duties to import rice to Cambodia. Source: NIS, Staff estimates.

2.18. **This approach helps show that poor governance has a differentiated impact across sectors.** Poor governance acts a barrier to entry: it takes an active hand-in-hand relationship to break through this barrier and provide comfort to investors. Hence returns must be high to motivate this relationship. Alternatively, the nature of a sector may make it less vulnerable to poor governance: for instance, in tourism, small-scale operations have worked well (even though

possibly not as well as if governance had been better) because they are often too small to be exposed to bad governance and the direct contact with tourists implies significant competitive pressures. Yet, in the same sector, very few more complex operations have worked (large operations, such as the management of large hotels or the site of Angkor Wat, exist but do not require complex value chains). More generally, most productive activities in Cambodia are focused on value chains with very few steps, a constraint on diversification further reviewed in Chapter 6.

Box 2.2: A Tale of Three Sectors

Garments, rice, and livestock are three sectors that have considerable promise in Cambodia. Yet, one is vibrant (garments); one might be emerging (rice); and one is stunted (livestock). Comparing these three sectors highlights the importance of governance for growth and illustrates how governance can improve and support growth in some sectors but not others. This helps explain the paradox of double-digit growth with relatively poor governance.

Evidence suggests that two factors may help explain garment's success: (a) the presence of a private sector organization - the GMAC - which produced collective action to lobby authorities for negotiated industry-wide rent-seeking rates and (b) international drivers/incentives such as an overwhelmingly foreign presence in garments (more than 95 percent of garment factories are foreign owned) along with quota exports to the United States linked with minimum labor standards that produced enough rents for all parties involved. The GMAC - MOC relationship is exceptional. Establishing a garment sector in Cambodia proved a win-win proposition both for foreign investors and local stakeholders.

By contrast, the rice and livestock sectors compare unfavorably to garments. No credible private sector organization for collective action exists in either sector, although rice has competing rice milling associations whose membership is diffuse both geographically and politically. Livestock does not enjoy even that modicum of organization, in part because of a lack of social capital, which was destroyed during the Khmer Rouge period. Indeed, even the word cooperative/collective is frowned upon for its socialist roots. Moreover, in both rice and livestock, foreign involvement is minimal compared to garments. Livestock had foreign involvement in the export of cattle through a joint venture with a Malaysian partner, but that partnership ended in 2005, allegedly because of onerous unofficial payments. Rice may have an opening in exports to the EU through its zero tariff for Least Developed Countries initiative "Everything But Arms". However, this will require stringent Sanitary and Phytosanitary Standards to be met, and the overall demand for Cambodian rice is unlikely to be significant given Thailand and Vietnam's dominance in the sector.

In summary, what is clearly different among garments, rice, and livestock is the involvement of international players, the creation of new opportunities (as opposed to the division or displacement of pre-existing rents), and the generation of social capital to fight long ingrained patron-client networks.

"Good enough governance" itself is not a permanent condition; it can go either way, and the key to policy is tipping it in the right direction. Potential factors for promoting growth include tackling the constraints observed in each of the sectors that reach far beyond those sectors alone. Of course, there are too many constraints for each to be binding per se. Garments, rice, and livestock all require transportation and electricity and face similar unofficial payments. However, garments clearly has achieved good enough governance through collective action and negotiation, while livestock has hardly developed beyond smuggling activities. Rice could enjoy good enough governance in the future, but it is unclear whether the two entities (Green Trade and the National Cambodian Rice Millers Association) now allowed to export in excess of 100 tons without permits will reinvest rents into capital that will create the needed market makers in the industry or merely engage in rent-seeking.

Source: based on research by Ear (forthcoming).

2.19. This approach is not without risk. There is first the risk of the Government or the private sector seeking to extract too much out of this hand-in-hand relationship, squeezing the golden goose. In the case of garments, this could mean the Government imposing too high informal taxes on the exports, or the private sector receiving unreasonably high tax exemptions. There is also the risk of this relationship disserving public interests – as opposed to generating growth (in the vein of what is known as crony capitalism). Non-competitive allocation of public contracts, abuse of land rights, or restriction of competition would fall in that category.

2.20. This analysis of the rapid growth – poor governance paradox points towards two directions for the future. One option is to continue this approach, with sectors being picked

depending on the incentives for elements of government and entrepreneurs to develop this kind of hand-in-hand relationship. It is likely that quite a few sectors could develop that way and external pressure would help break some of the barriers (such as on standards). There is certainly still potential for growth through that mechanism. There would be various ways to support these arrangements (e.g. supporting business associations in their coordination / advocacy / knowledge-sharing role), while recognizing the inherent decentralized nature of these relationships. Yet, such an approach is inherently limited and raises questions at least about diversification, if not about growth sustainability. Hence, over time, a second option, based on broader improvements in governance, will have to be developed. This will require a forum to identify key governance constraints, develop solutions, and hold the government accountable for enforcing them. One option is to use a G-PSF strengthened with capacity for research or with improved linkages with the SNEC in order to “cause private interests to take an interest in the accomplishment of socially desirable objectives”.¹³

D. Summing Up

2.21. Although they have mainly to do with how to *ignite* – as opposed to sustain – growth, there are important lessons from these three dimensions:

- ♦ Each dimension suggests, for distinct reasons, a sense of the un-sustainability of growth. This could be because past growth was a one-off event, based on historical opportunities, or based on running down pre-existing assets. Alternatively, it could be because the nature of the growth, through sector-specific arrangements, makes it difficult to scale up.
- ♦ In particular, especially given the experience of other SRG countries, it seems that Cambodia will not be able to sustain growth without higher rates of investment (domestic in particular).
- ♦ On the other hand, each dimension highlights some elements of a sustained growth strategy that are in place. For instance, a few connections to global markets have been made and the importance of macroeconomic stability is now adequately factored in by policymakers. Stakeholders have established a track record of problem-solving, which enabled the growth of sectors like garments and tourism.
- ♦ No single dimension can by itself explain Cambodia’s growth experience. The view that growth has been entirely the result of *laissez-faire* and the liberalization of the 1990s is not credible: otherwise, growth would have been much more broad-based. The view that governance constraints across the board prevented growth is at odds with the growth performance. Yet, the overall weak governance – beyond its impact on service delivery and citizens’ daily life – can in part explain the lack of diversification, hence the fragility of growth.

¹³ Cf. the notion of “focal monopoly of governance” (Meisel and Ould Aoudia, 2008). Such focal monopoly helps the state to produce the confidence necessary for investment, coordinate actions of various stakeholders, and align individuals’ private returns with social returns: this reduces transaction costs and provides security for stakeholders’ expectations. Meisel and Ould Aoudia illustrates the concept with the case of France in the 30 post-war boom years and the French Planning Office; Taiwan from 1949 on with the Industrial Development Commission and numerous associations set up under the Kuomintang; Singapore under Lee Kuan Yew from 1959 on with the Economic Development Board and the National Wage Council; and South Korea under Park Chong Hee from 1961 on with the Economic Planning Board. These offices fostered “dialogue and coordination among public and private elites in which confidence is inextricably created on a basis that is simultaneously interpersonal, process-based, and institutionalized”.

3. Translating Growth into Jobs and Poverty Reduction

3.1. **Growth is a means to an end:** it enables a society to achieve key national development outcomes in terms of poverty reduction, improved livelihoods, higher education levels, and better health. Sustained growth profoundly transforms countries. This chapter examines the connections between economic growth and poverty reduction through the lenses of demographic change and employment. Understanding the dynamic of the labor market, the types of jobs that Cambodians choose, and the extent to which growth has been shared is critical for assessing the economy's potential and the constraints it faces (Part 2). While this chapter focuses on the experience so far, Chapter 10 will review the challenges of managing the transformation of growth into positive social outcomes. Section A summarizes trends and patterns in living standards, the incidence of poverty, and inequality. Section B describes Cambodia's ongoing demographic transition and the implications of this for the dependency ratio. After a broad outline of trends in employment over the same period (Section C), Section D decomposes growth in per capita GDP into demographic change, productivity gains and structural transformation. Section E summarizes the chapter.

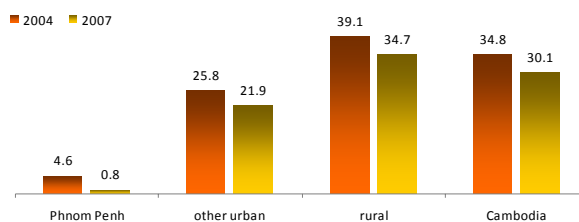
A. Poverty Reduction in the Market Economy

3.2. **Poverty has been steadily reduced.** Until 2004, it was widely believed that economic growth in Cambodia had occurred with minimal effect upon poverty levels. Analysis of the 2004 Cambodia Socio-Economic Survey (CSES) disproved this, finding that living standards (as measured by real per capita consumption) had risen in both urban and rural areas. Comparisons between the 1993-94 and 2004 surveys found that the poverty headcount had declined by 10-15 percentage points over the first decade following the Paris Peace Settlement, falling from 45-50 percent to 35 percent (World Bank 2006). This amounts to a rate of poverty reduction of between 1 and 1.5 percentage points per annum.

3.3. **With double-digit growth in the past few years, poverty reduction has accelerated.** The most recent available statistics, from the 2007 CSES, suggest that over the three years from 2004 to 2007 poverty fell further to 30.1 percent (at a rate of 1.6 percentage points per annum, Figure 3.1). The vast majority (over 90 percent) of the poor are found in rural areas.

3.4. **The conclusion that poverty has declined is supported by other, non-consumption, indicators of wellbeing.** The food share of total household expenditure has fallen significantly

Figure 3.1: Poverty incidence has been decreasing



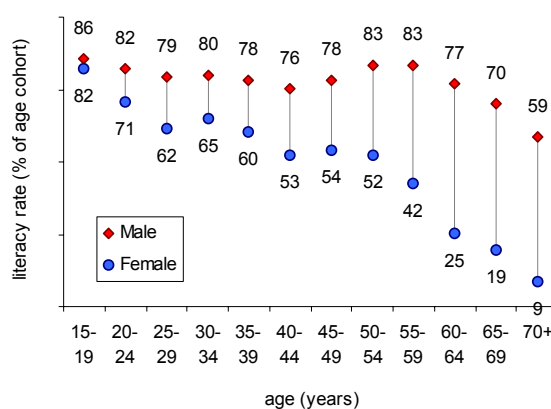
Note: poverty incidence as a % of population measured using the national poverty line. Source: CSES 2004 and 2007, analyzed by Knowles 2008.

across all consumption quintiles, while the quality of housing and ownership of key assets have risen. The poverty gap – the average distance by which the consumption of poor households falls below the consumption poverty line – has also declined throughout the country, indicating that those who remained below the line experienced less severe poverty in 2007 than in 1993-94 or 2004. Broadly speaking, women as well as men have benefited from economic expansion and rising average consumption, as significant numbers of young rural women have found employment in the new garment industry.

3.5. In terms of human development, most health indicators have shown marked improvement. Comparison of the Cambodia Demographic and Health Surveys (CDHS) of 2000 and 2005 suggests that child survival rates improved dramatically (infant and under-five mortality rates both fell by about a third), reflecting gains in antenatal care, immunization coverage and child nutrition. Access to and use of public health services increased markedly, and the average cost of treatment fell by a quarter, while the frequency of treatments rose.¹⁴ One outcome which has not shown improvement is the maternal mortality ratio, which remained (at 472 per 100,000 live births) in statistical terms unchanged since 2000.

3.6. Education, too, has shown remarkable progress. As with health, status is still extremely low, but showing rapid improvement. Between 1997 and 2007, net enrollment increased by 27 percentage points for primary level, 16 points for lower secondary level, and 11 for upper secondary level (Figure 4.3). Years of schooling and literacy rates have risen fastest amongst groups who were previously disadvantaged in education, resulting in closing gaps in outcomes between men and women, urban and rural populations, and rich and poor. Key issues in the education sector now are to retain children in school and improve the quality of education (Section 4.C). Over-age enrollment is a significant structural problem and school dropout accelerates rapidly after primary level: only half of enrolled children finish grade 5, while only a third finish grade 9.

Figure 3.2: Literacy rates are improving and the gender gap is closing



Source: CSES 2004.

3.7. These trends suggest that the relationship between growth and poverty reduction has been positive and in line with international averages, but not exceptional, reflecting increasing inequalities. The benefits of the very high rates of growth have accrued primarily to the upper ends of the income distribution, with more modest gains in the living standards of the poor (Table 3.1). While per capita consumption has risen and poverty has fallen for all groups and throughout the country, they have improved faster for the richest quintile and for people in urban centers than for the poorest quintile and those in rural areas. Combined with indicators that suggest growing inequalities in access to opportunities (e.g. higher inequality in land ownership), these trends suggest the need for continued monitoring of inequality, and for active policies to improve access for the poor to productive resources, capital and affordable services,

¹⁴ The CDHS 2005 also found HIV incidence to be considerably lower than routine sentinel survey estimates had suggested: a reconciled estimate places HIV incidence at just under 1 percent. This reflects a remarkably effective response (by Government, NGOs and donors) to the emergence of HIV in Cambodia in the early 1990s.

to ensure that they can benefit from – and contribute to – national economic growth (World Bank 2007).

Table 3.1: Growth, Inequality, and Poverty (2004-07)

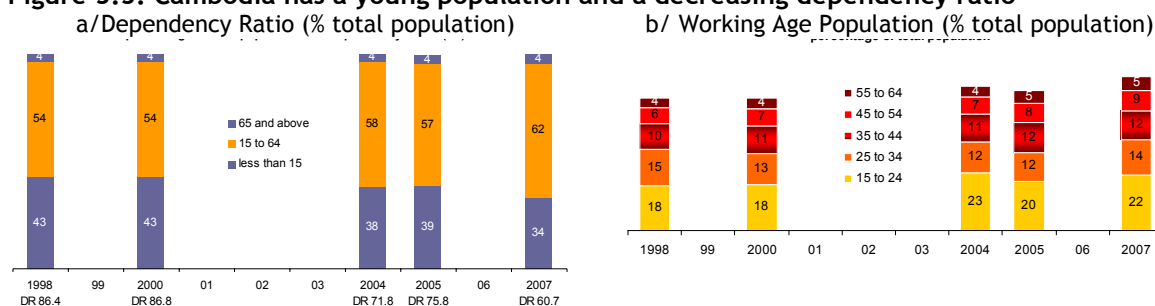
	mean p.c. consumption (riels per day, constant 2004 Phnom Penh prices)			poverty headcount (% below national poverty line)			Gini coefficient (0 = perfect equality, 1 = perfect inequality)		
	2004	2007	change	2004	2007	change	2004	2007	change
	rural	3,081	3,649	18%	39.1	34.7	-4.4	0.33	0.36
other urban	4,929	6,275	27%	25.8	21.9	-3.9	0.43	0.47	0.04
Phnom Penh	8,067	10,952	36%	4.6	0.8	-3.8	0.37	0.34	-0.03
Cambodia	3,692	4,616	25%	34.8	30.1	-4.6	0.39	0.43	0.04

Source: CSES 2004 and 2007, analyzed by Jim Knowles 2008.

B. Cambodia's Demographic Transition

3.8. **Cambodia's demography is driven by its history.** During the 1970s, civil war followed by revolutionary violence and economic mismanagement under the Khmer Rouge resulted in profound and traumatic demographic transformation. The best estimates suggest that about 250,000 people died during the civil war (1970-75) and a further 2 million during the Democratic Kampuchea period (April 1975-January 1979).¹⁵ With the fall of the Khmer Rouge and the return to a semblance of normality, Cambodia experienced the first of its two post-war baby booms, with a spike in the number of births over the years 1980-81. The second such baby boom occurred at the start of the 1990s, as the country moved towards a peace settlement, free market economics and multiparty politics. These periods of very high fertility have had a number of consequences.

Figure 3.3: Cambodia has a young population and a decreasing dependency ratio



Source: 1998 Census, 2000 and 2005 CDHS, 2004 and 2007 CSES.

3.9. **These baby booms have given rise to a generation now working its way through Cambodia's population structure in the form of a "youth bulge".** Combined with a quite rapid drop in fertility rates observed since 2000, the population structure of Cambodia has been characterized since the late 1990s by a steady decline in the dependency ratio, as a very large number of Cambodians have entered the economically active age range (15 to 64 years), relative to those in the dependent age groups (taken here to be those under 15, of whom there are still many, and those over 65, of whom there are few). Of these economically active adults, a third are between 15 and 24 years. This bulge is sufficiently large that it is resulting in quite large

¹⁵ For a review of the wildly varying estimates, see Sharp 2008. Of the c. 2 million estimated excess fatalities during the DK period, it is thought that approximately a third were due to execution or torture and the remainder due to a fatal combination of overwork, starvation and lack of medical care under DK collectivization policies.

changes in dependency ratios, even over a period as short as the three years between the 2004 and 2007 surveys (Figure 3.3).

C. Employment Trends

3.10. Labor force participation in Cambodia, as in most low income countries, is high (87 percent in 2007). In developing countries, almost all of the working age population are employed, in the sense of having at least one job (rather than being left without any earnings, as unemployment benefit schemes do not exist). This results in extremely low numbers of people who report in surveys that they do not have a job. In Cambodia, “the unemployed” are officially defined as those in the labor force who did not work but were available for work and were seeking work during the past reference week. Using this definition, the percentage of the total labor force unemployed (i.e. the unemployment rate) was estimated at 3.5 percent in 2007.

3.11. There is a pattern of employment shift from agriculture to industrial and services sectors over the past decade (Figure 1.1). Labor migrated from rural areas where job opportunities are insufficient to cities where labor-intensive manufacturing and tourism-related services have been growing rapidly. The share of employment in agriculture gradually declined from 75 percent in 1993-94 to 70 percent in 2001 and 58 percent in 2007. The share of industry employment, on the other hand, went up from 5 percent in 1993-94 to 15 percent in 2007, while the share of service employment gradually rose during the same period.

3.12. Employment in Cambodia is characterized by a large proportion of the labor force that works in informal economic activities (either self-employed or work for non-registered enterprises). Formal sector employment – despite strong growth – remains small: only 25 percents of the workforce are paid employees, while the remainders are split roughly equally between self-employment and unpaid family labor. There has not yet been an official consensus on how many workers are engaged in informal economic activities, but the Cambodian Development Resource Institute (CDRI) estimated 95 percent were employed by the informal sector in 2000-2001, while the Economic Institute of Cambodia (EIC) estimated 85 percent (ILO, 2006).

3.13. However, the unemployment rate does not adequately reflect level of labor absorption by economic growth in developing countries. Workers who usually do not earn much from one job desire to have additional jobs. The majority of those in the working age population have two jobs throughout the year. Typically, the rural labor force primarily engage in crop farming activities and secondarily – during the off-farm season – in collecting forest and fish resources, working as wage laborers or running small businesses and trade activities. The urban labor force, on the other hand, is primarily employed as paid employees in public or private sectors, with secondary jobs as self-employed workers.¹⁶

3.14. The quality of jobs created in Cambodia is still relatively low. This is not surprising, given the level of educational attainment and the structure of employment in the country at present. Agriculture requires the least formal education, and pays the lowest hourly wages; amongst waged employees, levels of education are higher in the public sector, but wages are higher in the private sector (Table 3.2). The impact of education on earnings can be disaggregated by sex and level of education: annualized returns to primary education (i.e. the effect that an extra year of primary schooling makes to average earnings) appear greatest for

¹⁶ “Underemployed” is officially defined as employed persons who expressed the desire to have additional hours in their present job or in an additional job or to have a new job longer working hours. The latest available figure for underemployment rate is for 2001 when the rate was estimated at 38 percent. The rate is likely to still be high given that there are substantial number of new jobs seekers and many workers have primary and secondary jobs.

those over 30; for university education, annualized returns appear highest for young males (22 to 30 years) and older females (those over 30), suggesting a relative shortage in the labor market of young better-educated male graduates.

3.15. While wages have increased across the board over the last three years, the increase has been uneven.

The rise in earnings has been greatest (90 percent) for households in the top 10 percent of the wealth distribution, but only 40 percent for those in the bottom 10 percent. This helps explain the rapid rise in inequality in living standards observed between 2004 and 2007 (see also Chapter 10). Within any given wealth band, the returns to education appear relatively limited for the population as a whole, though they do appear significant – and increasingly important – for the wealthiest group (Figure 3.4).

Table 3.2: Educational Attainment and Earnings (Ages 15-65, by Sector, 2007)

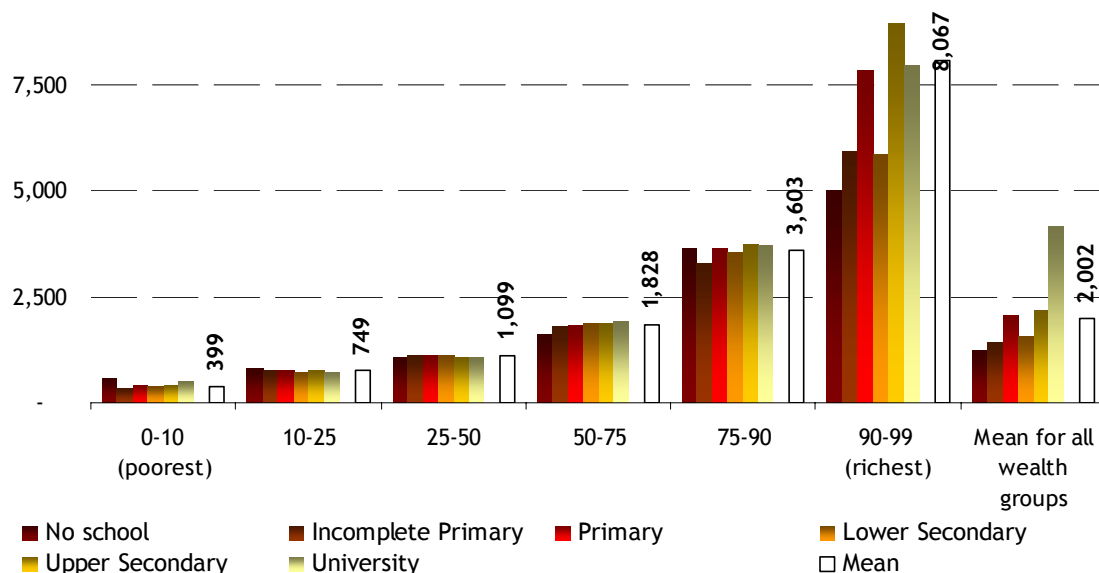
	education (years)	wages (riels / hour)
For wages - Public	9.5	1,298
For wages - Private	6.8	2,035
Agriculture	3.3	1,051
Non-agriculture	6.7	1,696
Manufacturing	5.6	1,380
Public administration and defense	9.0	1,077

Source: CSES 2007, see background paper on returns to education.

3.16. The segmentation of the labor market does not seem to be driven by labor market institutions.

This segmentation is apparent from the large informal sector, the uneven quality of jobs, and the disparate rates of return. However, labor market policies do not appear to drive this (Box 3.1). Firms' surveys (Figure 6.4) and the Doing Business indicators confirm that labor market policies are not the primary driver of this segmentation, which has more to do with other regulatory and governance constraints (Chapter 6).

Figure 3.4: Education makes little difference to earnings, except for the richest group



Source: CSES, analyzed by Lall 2008.

Box 3.1: Labor Market Policies and Institutions

A framework for labor market policies was established in the 1993 Constitution and later elaborated by the 1997 Cambodian Labor Law, which provides a legal framework for the protection of employees and employers. However, the Labor Law has yet to be fully and effectively enforced for all businesses. Garment factories and larger registered companies - despite some implementation shortfalls - abide by provisions in the code, with the garment industry setting the monthly minimum wage at US\$50. There is a high level of freedom to form unions, the most numerous and active of which are trade unions in the garment industry (such that employers often complain that there are too many unions) and to a lesser extent in the hotel industry and other registered businesses.

The Cambodian government has ratified all eight ILO core International Labor Conventions through which labor protection programs, in particular against child labor, have been mainstreamed and advocated. These include the Conventions on Forced Labor and Abolition of Forced Labor; Freedom of Association and Protection of the Right to Organize; the Right to Organize and Collective Bargaining; Equal Remuneration; Discrimination (Employment and Occupation); Minimum Age; and the Abolition of the Worst Forms of Child Labor.

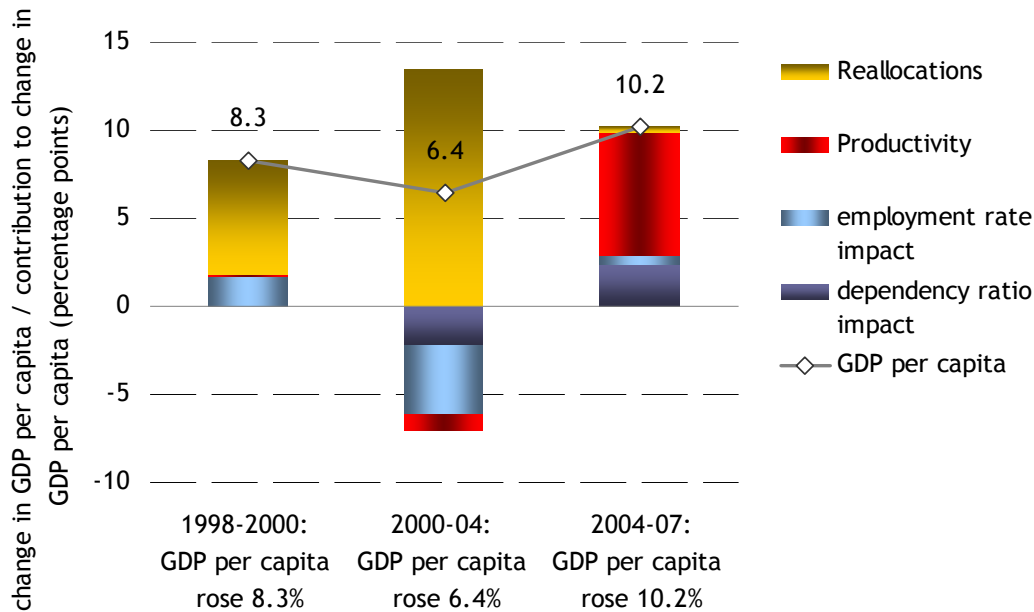
D. Productivity, Employment, and Poverty Reduction

3.17. **This section decomposes growth in per capita GDP** into demographic change (falling dependency ratio), productivity gains (increasing productivity per worker within each sector), and structural shift (the importance of proportional change of employment in different sectors, focusing on the shift out of low-productivity sectors into ones with higher per-worker productivity). With the data available, it is possible to perform this decomposition for three sub-periods within the last decade (1998 to 2000, 2000 to 2004, and 2004 to 2007). With important caveats regarding the coverage and reliability of data, this helps estimate the relative importance of demographic evolution, structural change and productivity in explaining, first, growth and, second, the distribution of that growth and the consequences of that distribution for poverty reduction trends. One key finding is that this balance between these factors has changed over that past 14 years, and is continuing to change (Figure 3.5).

3.18. **Improvement in living standards over the first part of the decade (1998 to 2004) was driven primarily by structural transformation.** Between 1998 and 2000, this reallocation of employment share from low-productivity agriculture to higher productivity industry contributed 6.5 percentage points of the 8.3 percent annual growth rate in GDP per capita; between 2000 and 2004, this continued inter-sectoral shift in employment (with industry and, now, services both gaining share from agriculture) contributed 13.5 percentage points (offset by the negative effects of other factors which brought net growth in per capita GDP down to 6.4 percentage points per annum). Over this period, productivity declined in industry and first rose and then fell in services (Figure 1.2). At the same time, demographics – through a decrease in the dependency ratio, somewhat offset by a slightly higher unemployment rate – contributed 0.8 percentage points per year.

3.19. **In recent years, a significant acceleration in productivity gains has driven the improvements in GDP per capita.** Between 2004 and 2007, productivity gains in the three sectors contributed 6.9 percentage points to the overall 10.2 percent of annual growth. At the same time, reallocations played a minor role. Demographics continued to play a positive role, contributing 2.9 points per annum through the combination of the lower dependency ratio and the higher employment rate.

Figure 3.5: Demographics, structural transformation, and productivity have contributed to growth in different periods



Source: CSES, Census, National Accounts, Staff estimates.

3.20. **This highlights the role of the considerable improvements in productivity observed between 2004 and 2007.** The improvements have been most pronounced in agriculture, where after bad harvests in 2000, values for labor productivity have risen rapidly since 2004. More recently, between 2004 and 2007 per-worker output in services and (more modestly) industry have contributed significantly to growth in per capita GDP. In the case of industry, however, these recent improvements appear only to have restored productivity to around its 1998 level.

3.21. If structural shift was the main source of gains up until 2004, and productivity gains have become important since then, **changing demographic structure has also emerged as a significant factor since 2000**, and has continued to play a very important role. Between 2000 and 2007 the dependency ratio dropped by over a quarter: whereas in 1998 every 100 working age adults had to support 86 dependents, by 2007 the ratio was down to 61:100.

E. Summing Up

3.22. **The foregoing analysis suggests the critical role of demographics and structural transformation in Cambodia's growth performance and, more recently, the role of productivity improvements.** The evolution of the population structure has been a major driver of rising output and living standards (see also, for example, Lundström and Ronnäs 2006). This could imply a less sustainable growth model than if growth and poverty reduction had been driven primarily by productivity gains. The reallocation of labor from agriculture to services and, even more, industry, has also driven growth, confirming the key role of this structural transformation.

3.23. **Looking forward, the beneficial role of the demographic transition in terms of a stable, low dependency ratio will continue to be felt for several decades to come.** Demographic projections will not be possible until the detailed analysis of the 2008 census data

has been completed in late 2009.¹⁷ At this stage, however, it seems that dependency ratios will continue to be broadly favorable, as the large bulge in the 15-30 age range will continue to work its way up through the working-age population. If fertility rates continue to fall, this should keep the proportion of children in check, even as the baby boom generation, now in the young adult age range, themselves start having children (creating a minor “echo” of the original baby boom).

3.24. However, demographics will not now deliver a new *gain* in productivity of the kind that contributed to rising per capita GDP over the last ten years. The future is likely to be one of a broad stabilization in the population structure, at least in the crude terms of the ratio between working age and dependent age groups. Since the dramatic expansion of the labor force that occurred as the baby boomers came of age has now finished, there do not seem to be strong prospects of a further stepwise improvement in the dependency ratio of the kind that has helped drive improvements in per capita GDP between 2000 and 2007.

3.25. This implies that, in the future, growth (rising real per capita GDP) will have to be driven by a combination of structural transformation (a movement of workers out of low-productivity agriculture into higher-productivity industry and services) and sustained productivity improvements (improving value-added per worker within each sector). Sustaining productivity improvements in industry and services – which has not been the case for most of the last decade in Cambodia – is important also for keeping productivity in these sectors higher, so that they attract labor from agriculture and lead Cambodia to continue its structural transformation.

¹⁷ Earlier population projections, while technically strong, did not anticipate the speed with which fertility rates have fallen (see NIS 2005). For this reason, they significantly over-estimated what the population would be in 2008, forecasting a population of 14.56 million, compared to the value of 13.39 million recorded in the 2008 census. This makes it hard to use these existing forecasts to make detailed predications about the evolution of the working age population and the dependency ratio.