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Paper 14: Cambodia Phase 2

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Global Financial Crisis Discussion Series Paper 14: Cambodia Phase 2[1]

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Acronyms

3mma	Three-Month Moving Average
ACP	African, Caribbean and Pacific
ADB	Asian Development Bank
AFD	Agence Française de Développement
ASEAN	Association of Southeast Asian Nations
ATC	Agreement on Textiles and Clothing
BFC	Better Factories Cambodia (ILO)
BoP	Balance of Payments
CARD	Council for Agriculture and Rural Development
CCTU	Cambodian Confederation of Trade Unions
CDC	Council for the Development of Cambodia
CDRI	Cambodia Development Resource Institute
CLC	Cambodian Labour Confederation
CMDG	Cambodian Millennium Development Goal
CMT	Cut-Make-Trim
DTIS	Diagnostic Trade Integration Study
EBA	Everything But Arms
EC	European Commission
EIC	Economic Institute of Cambodia
EIU	Economist Intelligence Unit
EU	European Union
FAO	Food and Agriculture Organization
FCD	Foreign Currency Deposit
FDI	Foreign Direct Investment
FGD	Focus Group Discussion
FIAS	Foreign Investment Advisory Service
FIDH	International Federation for Human Rights
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GDCC	Government–Donor Coordination Committee
GMAC	Garment Manufacturers Association in Cambodia
GMS	Greater Mekong Sub-region
GSP	Generalized System of Preferences
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IOM	International Organization for Migration
ITUC	International Trade Union Confederation
LDC	Least Developed Country
MoC	Ministry of Commerce
MFA	Multi-Fiber Arrangement
MFI	Microfinance Institution
MoLMUPC	Ministry of Land Management, Urban Planning and Construction
MEF	Ministry of Economy and Finance
MoT	Ministry of Tourism
NBC	National Bank of Cambodia
NIE	Newly Industrialising Economy
NIS	National Institute of Statistics
NGO	Non-Governmental Organisation
NPL	Non-Performing Loan
NSDP	National Strategic Development Plan
NZAID	New Zealand's International Aid and Development Agency

QIP	Qualified Investment Project
RCA	Revealed Comparative Advantage
RGC	Royal Government of Cambodia
RoO	Rules of Origin
SAARC	South Asian Association for Regional Cooperation
SEDP	Socioeconomic Development Plan
SEZ	Special Economic Zone
SSI	Semi-Structured Interview
TATA	Trade Agreement on Textiles and Apparel
UN	United Nations
UNCTAD	UN Conference on Trade and Development
UNDP	UN Development Program
UNESCAP	UN Economic and Social Commission for East Asia and the Pacific
UNESCO	UN Educational, Scientific and Cultural Organization
UNWTO	UN World Tourism Organization
US	United States
USAID	US Agency for International Development
VAT	Value-Added Tax
WEF	World Economic Forum
WFP	World Food Programme
WTO	World Trade Organization
y-o-y	Year-on-Year

Abstract

The global financial and economic crisis is the latest in a series of external shocks to hit Cambodia in the space of about two decades, following on from the food crisis that struck in 2006 and the Asian financial crisis of 1997. Wrestling with the effects of these three crises has represented a major feat for Cambodia's post-conflict economy. The global financial crisis hit Cambodia through its second-round effects on trade, private capital flows and, ultimately, the country's growth sectors. Its overall impact has been all too clear. From being one of the fastest-growing economies in the world, Cambodia is now poised to suffer one of the steepest contractions in output in developing East Asia. In the decade before the crisis, the country experienced significant reductions in poverty, whereas the number of poor Cambodians is now expected to increase.

There have been indications that the Cambodian economy has already bottomed out and is now on the rebound, but there are significant downside risks involved in this upturn. The fate of the garment sector, the economy's sole major export driver, remains uncertain, having lost competitiveness in the global post-quota environment. The government has not had the fiscal capacity to deliver a bigger and sustained stimulus, and the effectiveness of some of its responses has been of concern. In the end, recovery will require not only a rosier external environment but also internal improvements. Cambodia will need to go beyond traditional dependencies, latch onto neglected aspects of competitiveness, decisively implement its governance reform agenda and deal effectively with the problems facing the economy and particularly the agriculture sector.

1. Introduction

The wheels have turned once again. Then not even a decade old, the post-conflict economy of Cambodia had to wrestle with the effects of the Asian financial crisis back in 1997-1998. After this, the country experienced the tentative beginnings of economic takeoff, eventually growing at a breathtaking annual pace of more than 9% on average, managing a partial shift towards more productive industrial and services sectors. The food crisis struck in 2006 and the global financial crisis hit the country by the middle of 2008. Without question, wrestling with the effects of three major external shocks in the space of two decades, following a period of destruction and isolation, has comprised a major feat for the Cambodian economy.

The seismic shift in performance triggered by the global economic meltdown has been all too clear in Cambodia. Prior to the financial mayhem, Cambodia was among the 10 fastest-growing economies in the world and its poverty rate was decreasing at a modest rate. Now the country appears poised to suffer one of the steepest contractions in growth in developing East Asia, as well as an estimated absolute increase in the number of poor by 0.2 million, based on a poverty line of $1.25 a day (ADB, 2009b; CDRI, 2009d; IMF, 2009f; 2009g; World Bank, 2009c; 2009d).

As in other developing economies whose financial sectors may not be that globally integrated but whose real economies are, Cambodia has been hit more by the second round of the global shock. This recalls a vital lesson from the country's experience during the Asian financial crisis: the first bout of an economic storm is never the last. Given its lack of exposure to toxic subprime products and its stronger defence against the contagion effects of externally driven crises, Cambodia, along with other East Asian countries, was initially considered capable of bypassing the storm. As matters worsened, however, the country eventually succumbed to the second-round impacts of the shock, transmitted through trade, capital flows and, ultimately, the country's growth drivers. As activities in the real sector skidded to a standstill, the strain on the financial sector mounted. Most unfortunate of all, the poor have been put at even more risk.[3]

Signs of world recovery, albeit sluggish, have been detected. This report follows up on Cambodia's shift in growth performance and the tough but necessary track towards economic resurgence.[4] In the end, the country's sustainable recovery will rely as much, if not more, on internal improvements (pull factors) as on a rosier external environment (push factors). Cambodia must alter and progress beyond traditional dependencies, latch onto vital but neglected aspects of competitiveness and, as is underscored numerous times, implement its economic and governance reform agenda decisively.

3 See CDRI (2009a) and Jalilian et al. (2009) for similar assessments.

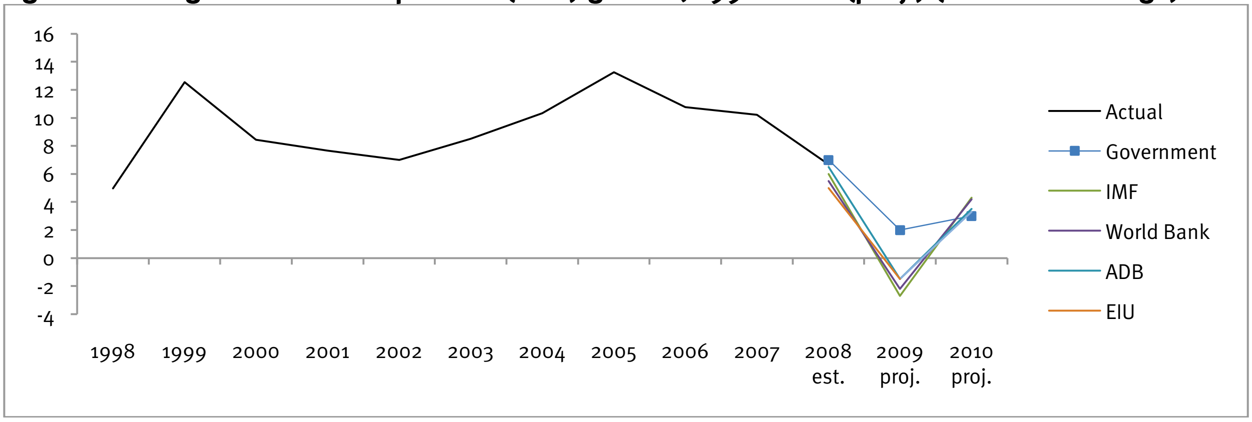
4 The first Global Financial Crisis Discussion Paper on Cambodia was published in May 2009 (Jalilian et al., 2009).

2. The effects of the global crisis

2.1 Brakes on growth

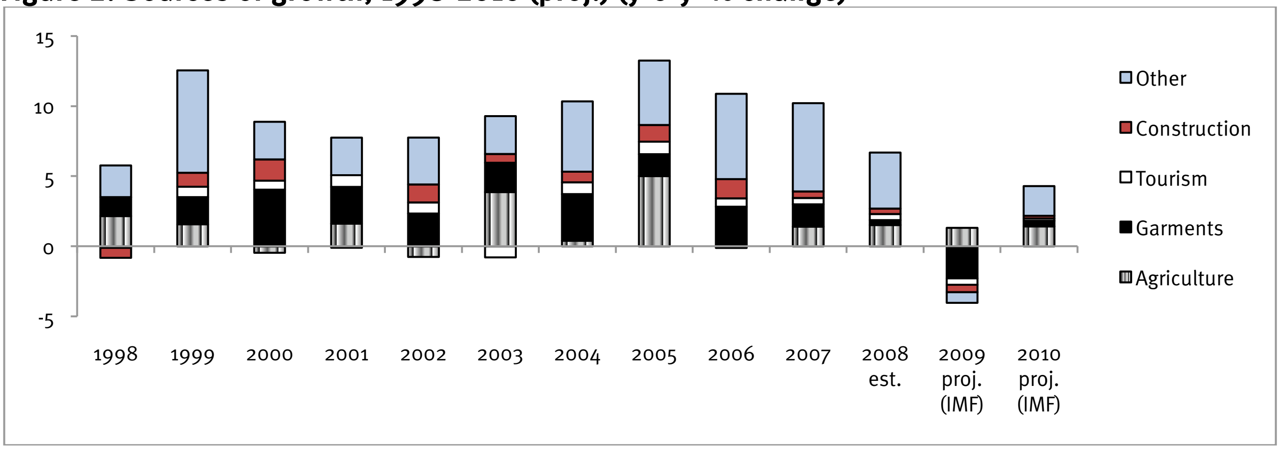
After exceptional growth between 1998 and 2007, at an annual average of 9.4%, Cambodia's output growth slipped to an estimated 6.7% in 2008, a far cry from 2007's growth of 10.2%. Nevertheless, this overshot the bleaker growth forecasts for 2008 issued by key development institutions, and is closer to the earlier projection made by the Royal Government of Cambodia (RGC) of around 7% (Figure 1).[5] It was chiefly a surge in the growth sectors – garments, tourism, construction and agriculture – that propelled Cambodia's growth prior to the financial turmoil; a downturn in three of them (agriculture being the exception) has caused such growth to peter out over the crisis period (Figure 2). It is important to recognise, however, that it is not only the global shock, transmitted through trade and investment channels, that has generated these effects: non-crisis-related factors have also been involved in the slowdown in the growth sectors. Performance was generally still strong in the first three quarters of 2008 but it was downhill from then on.

Figure 1: Real gross domestic product (GDP) growth, 1998-2010 (proj.) (annual % change)



Sources: Actual 1998-2008 and government estimates/projections: data from NIS and MEF. For 2008-2010 estimates/projections: ADB (2009b); EIC (2009a; 2009b); IMF (2009f; 2009g; 2009h); Green and Ith (2009); World Bank (2009d).

Figure 2: Sources of growth, 1998-2010 (proj.) (y-o-y % change)



Sources: IMF (2009h); data from NIS.

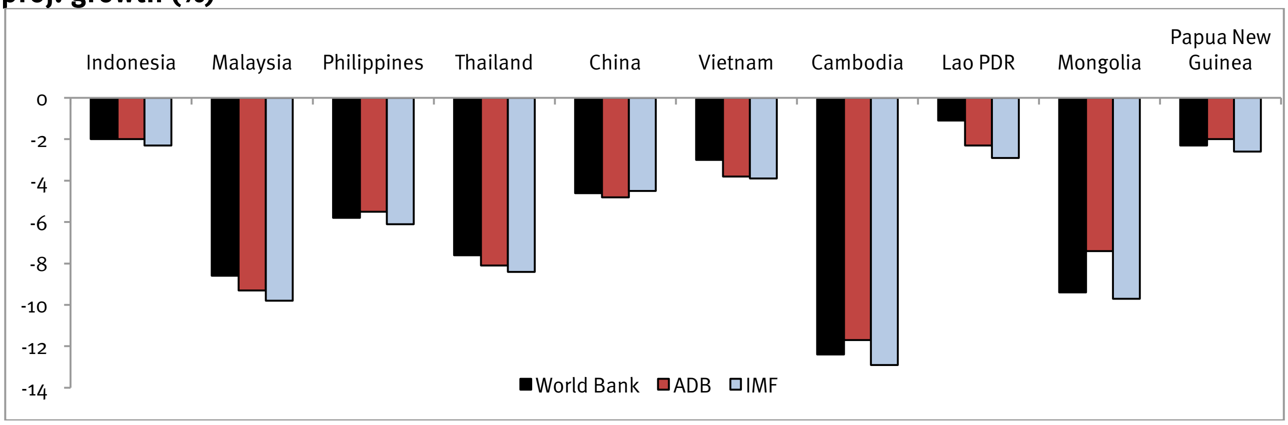
5 There are many widely known reasons for the variations in economic output forecasts. One relates to data possession and availability, whereby projections are based on the data available to the forecaster and are revised as newer data come in. Another basic source of the discrepancy refers to differences in definitions, methodologies and assumptions. In Cambodia, as in other developing countries, accuracy and quality of data are further undermined by inadequacies in the statistical infrastructure and human resources strength and competence.

Dramatically revising its growth outlook for 2009, the RGC now predicts that Cambodia's real output will expand by a mere 2% this year. The old official estimate of 6% was markedly different from other forecasts, and rested on the then more upbeat assessment of the economy, later to be tainted by worse-than-expected decelerations in the growth sectors. Other forecasts are more pessimistic still. Wider output contractions have been predicted by the International Monetary Fund (IMF), the World Bank and the Asian Development Bank (ADB), which have downgraded their 2009 growth estimates to -2.7%, -2.2% and -1.5%, respectively. However, the Economist Intelligence Unit (EIU) has improved its forecast to -1.5%, attributing the upgrade to the impact of global recovery (Green and Ith, 2009).

Prior to this, the EIU sparked serious controversy when it lowered its 2009 growth outlook to -3% and, on the basis of this perceived greater economic distress, ranked Cambodia as the fourth most susceptible country to social and political unrest (tied with Sudan and a notch higher than Iraq) (EIU, 2009). The government has candidly challenged these gloomier appraisals of the Cambodian economy, stating that the contribution of the rural sector, firm donor support, the expansionary 2009 budget and continued investor confidence will be able to prop up economic growth (CDRI, 2009d; McLeod, 2009; Nguon, 2009d; D. Ros, 2009a; Sciaroni, 2009a). Tentative indications of rebound were indeed detected by the second half of 2009, suggesting from an optimistic standpoint that the Cambodian economy could have already bottomed out. This is in aggregate terms, with rebound in some areas, such as tourism, balancing out persistent upsets in the garment sector in particular, the latter suggesting that this sector may not yet have seen the worst. Furthermore, given downside risks, including that of a global double dip and limited fiscal capacity to sustain remedial measures, any recent gains could easily be reversed, with the threat again differing depending on the sector.

In any case, Cambodia seems poised to experience the most pronounced drop in growth between 2007 and 2009 in all of developing East Asia, even if it is able to manage 2% positive growth this year (Figure 3). Other garment manufacturers and US market-dependent exporters in the said region (such as Vietnam) have similarly suffered sharp contractions because of the global recession, but the slowdown has been more acute in the case of Cambodia because of the characteristics of its industrial sector.

Figure 3: Real GDP growth in developing East Asia, estimated difference between 2007 and 2009 proj. growth (%)



Sources: Based on data from ADB (2009b); IMF (2009g); World Bank (2009d).

2.2 Favourable winds drop

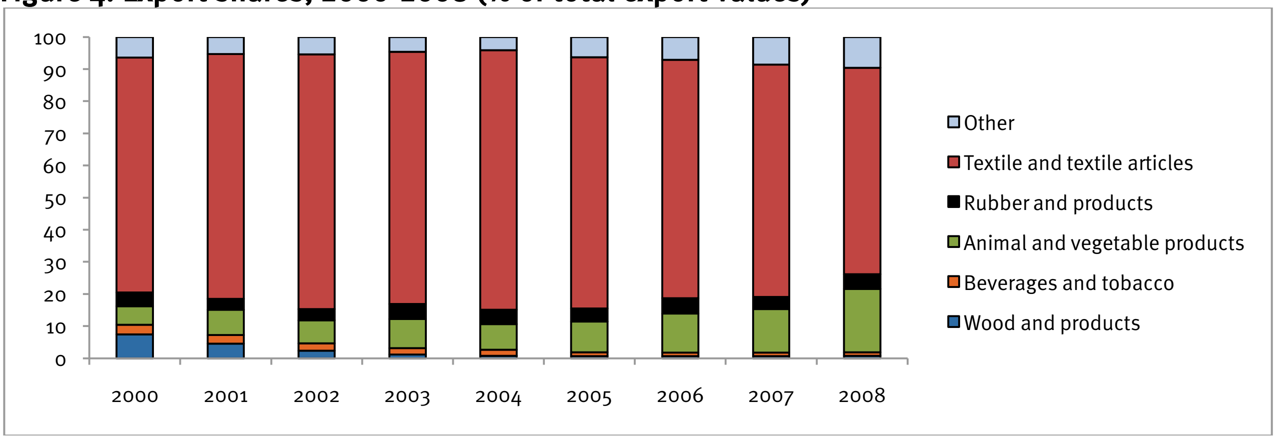
More robust trade and capital inflows were the two key favourable winds behind the rapid expansion of Cambodia's growth sectors, carrying the country to its position as one of the fastest-growing economies prior to the global recession. The growth sectors were all indebted to the liberal trade and investment regime pursued since the 1990s, immediately after the end of Cambodia's isolation period: such a regime yielded the necessary support for the reconstruction of the economy and the eventual beginnings of a structural transformation that allowed for the reallocation of farm labour to more productive industrial and services sectors. With the crisis, however, came a contraction of global trade and a stifling of especially private capital transfers: that is, the winds dropped. As the growth sectors have slowed down, inherent vulnerabilities in long-trusted growth patterns have been exposed.

2.2.1 Trade: In garments we trust

The global crisis has made history in certain respects, including by halting global trade so hard that world trade volumes have dropped for the first time in a quarter of a century (World Bank, 2008a). It has pushed the US, the euro zone and Japan into synchronised recession, with global structural imbalances pinpointed as the root problem of the longest-running downturn in the post-World War II period (e.g. Obstfeld and Rogoff, 2009; Panouvic, 2009; Perelstein, 2009). The Keynesian demand shock (e.g. Vines, 2009) reverberated in all corners of the world, severely hitting trade with countries that sourced a major part of their growth from their partial structural transformation to industrial export-driven economies (e.g. Rodrik, 2009), including Cambodia. The force of the crisis transmitted through the trade channel has been a function of the country's trade openness and dependence as well as its position in global and regional value chains (e.g. Keane, 2009).

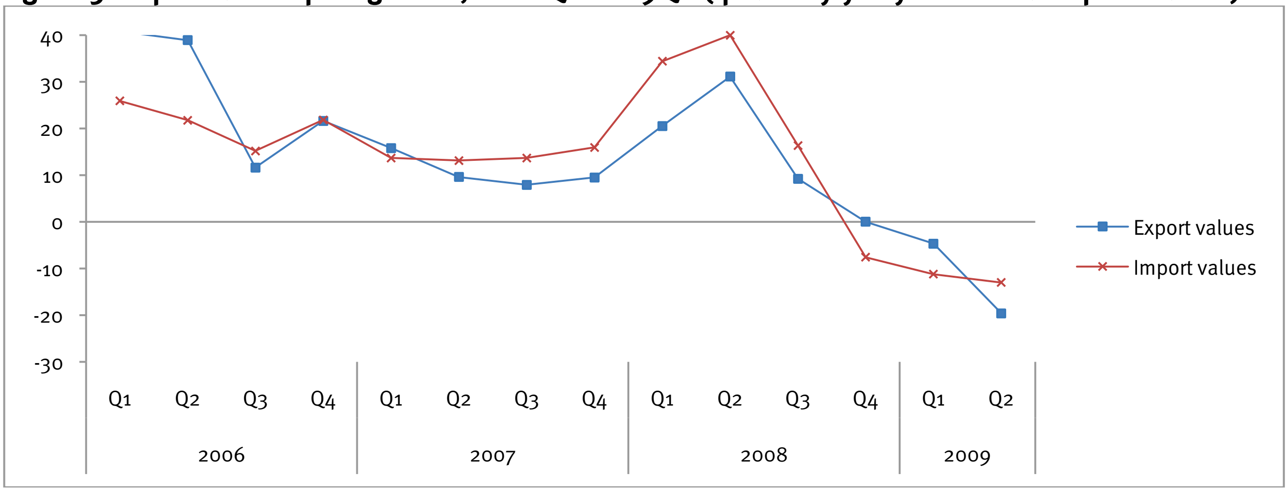
A consequential lesson, one that need not have waited for a global crisis to gain the spotlight, is that Cambodia's high trade openness but limited diversification and sophistication carried a great deal of risks, and is not entirely compatible with the aim of sustainable growth. As dealt with more in the discussion on the garment sector and in Annex 1, Cambodia's export base is dominated by garments. Exports from agriculture, where another of the country's comparative advantage supposedly lies, given vast natural resource endowment and a substantial labour supply, account for an increasing but very modest share of total exports. Other manufactured goods account for even less (Figure 4). In the first three quarters of 2008, growth of exports, but more so of imports, remained robust, resulting in a wider trade deficit. From the final quarter of 2008 to at least the first half of 2009, the situation changed abruptly: both export *and* import growth contracted, anticipated to lead to a narrowing of the trade deficit in 2009. Export and import values for the first semester (the first six months) of 2009 fell by about 12% each compared with the same period in 2008 (Figure 5).

Figure 4: Export shares, 2000-2008 (% of total export values)



Source: NIS and NBC data.

Figure 5: Export and import growth, 2006Q1-2009Q2 (quarterly y-o-y % of total export values)



Source: NIS and NBC data.

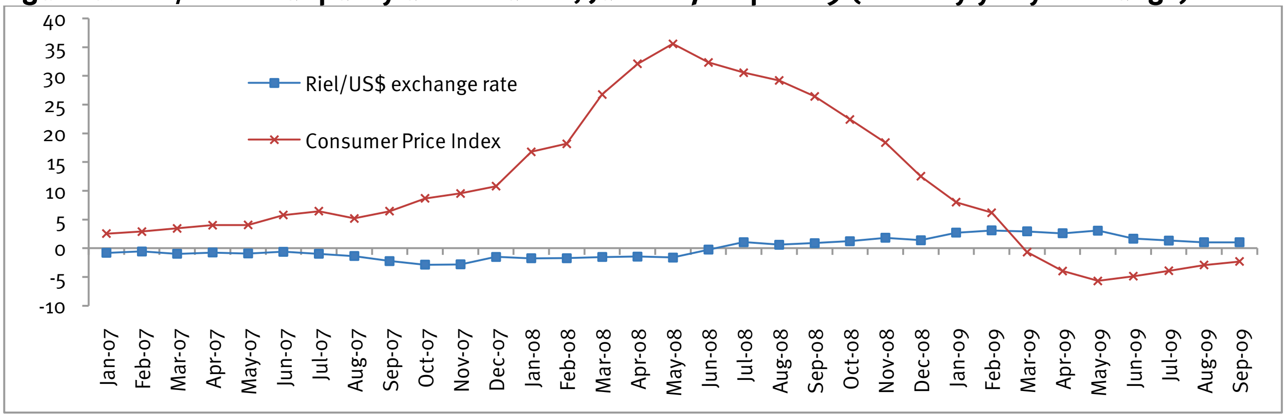
The contraction in export values and volumes stemmed primarily from the thinning of Cambodia's garment trade, its leading export activity, with the US and European Union (EU), its leading export markets, alongside a reduction in garment export prices (cut in unit values) (further explored in the discussion on the garment sector). Cambodia's agricultural export crops, rubber and cassava, have also had their share of cutbacks in external demand and export prices, following the plunge in related industrial production and world commodity prices across the board (FAO, 2009a). The price of Cambodian rubber exports at least has seen a recent rebound, after dipping to a historic low of about $1400 per tonne early this year.[6] Generally pro-cyclical in nature, demand for rubber, including that produced in Cambodia, has recently picked up, presumably on the back of renewed global industrial production and sales, stock build-ups and expectations of earlier and stable world recovery. Unlike other exportable crops, meanwhile, rice exports have by and large been able to avoid the impact of the price shocks. International rice prices in general have remained higher than their previous levels, although these too have weakened, together with other commodity prices (FAO, 2009b). Lowering of prices and reserve build-ups have bolstered rice imports, while competitive prices, bumper crops, favourable rainfall patterns and government support have galvanised supply. However, Cambodian rice may not be able to reach its export potential this year, or in the immediate years to come, for a host of reasons, including lack of capital investments. Thai rice has seen a slip in price competitiveness, but other rice exporters, particularly Vietnam, have proven to be fierce competition, as evidenced for instance by their penetration of the Philippine rice import market, the world's biggest, which is something that Cambodia still has not been able to secure (Chun, 2009e).

The weakening in imports, on the other hand, has been underpinned primarily by the decline in petroleum prices and by a respite in the previously strong domestic appetite for durable imports. Car and motorcycle imports began sharp declines by about the third quarter of 2008, and this continued well into 2009 (MEF data). While inflationary pressures have abated (Figure 6) since the recession cooled down escalating prices consequent to the food and energy crises, uncertain household incomes as a result of the recession, still higher-than-before petroleum prices and overall lower levels of economic activity have worked together to bring about lower import growth. Short periods of strengthening and weakening of the domestic currency against the dollar over the period of the crisis have also affected costs of imports and competitiveness of Cambodian exports. The real effective exchange rate of the country has significant appreciation which, in turn, affects its export competitiveness and prospects (IMF, 2009h; World Bank, 2009d). Any serious nominal exchange rate fluctuations have been averted, however, owing to interventions by the National Bank of Cambodia (NBC). Unfortunately, these have been costly in terms of reserves and deposits used, and will be more

6 As reported in Chun (2009d), rubber prices increased by 37% in October 2009 relative to the start of the year. Based on data from the Malaysia Rubber Board and Osiriz/InfoArroz/InterRice, recent price levels remain lower than the prices before the global crisis, however.

so if they continue, in view of the loosening of the government's fiscal stance. While watching out for any setback in the economy's rebound, the exchange rate must be allowed to assume a greater role in facilitating adjustments in the current account position and limiting interventions to prevent serious volatility (IMF, 2009h).

Figure 6: Riel/US dollar parity and inflation, Jan 2007-Sep 2009 (monthly y-o-y % change)



Source: NIS and NBC data.

2.2.2 Capital flows: Risks to openness

Foreign direct investment

Cambodia is among the developing Asian economies that have been most open to foreign capital.[7] Locational determinants of FDI include both enterprise-level and host country advantages, which Cambodia and companies based therein have increasingly exhibited since reintegrating into the international community in the 1990s. Government intervention in terms of policy liberalisation, macroeconomic management and political stabilisation has played a critical role in providing assurances with regard to the profitability of investing in the country. One certain enabling factor has been the liberal investment regime intently pursued by the RGC through the country's overarching national plans,[8] given momentum by Cambodia's membership in regional and multilateral organisations, specifically the Association of Southeast Asian Nations (ASEAN) and the World Trade Organization (WTO). The Law on Investment, as amended, is one of the most liberal in the region, gratifying as it does investor needs with its provisions enshrining equal treatment of nationals and foreigners, permitting 100% foreign ownership in most sectors,[9] offering a generous package of tax incentives to qualified investment projects (QIPs),[10] overtly denouncing nationalisation and allowing repatriation of invested capital.[11] The RGC has additionally adopted long-needed critical laws as part of its regional commitments,[12] improved investment facilities[13] and deepened dialogue with the private sector.[14]

7 The ADB (2009b) has identified Cambodia as among 12 highly integrated developing Asian economies in terms of capital flows. This group has accounted for around 95% of total FDI inflows in the past two decades.

8 Improving the investment climate is an integral part of the RGC's private sector development strategy.

9 See Cambodia's Law on Investment, the 1994 version or as amended, for these (in CDRI, 2009d). Local equity participation, prior authorisation or other conditions are required to be met by such sectors as cigarette manufacturing, rice milling and movie production (US Department of State, 2009a). Foreign ownership of hospitals and clinics is restricted and foreign ownership of land is prohibited. However, conditional foreign ownership of real estate is now being considered in view of the real estate slump. Also, even with the prohibition of foreign ownership of land, legal permission is in place for long-term leases and 99-year concessions (e.g. CDRI, 2009d; Sciaroni, 2009b).

10 These incentives include profit tax holidays, duty-free import of inputs and 100% exemption from export taxes. There are, of course, carve-outs to these privileges. See Cambodia's Law on Investment, the 1994 version or as amended (CDC, 2006; CDRI, 2009d; Sciaroni, 2009b). Provision of these incentives, however, particularly tax holidays, has been criticised as inappropriate and at times not necessary for attracting investors.

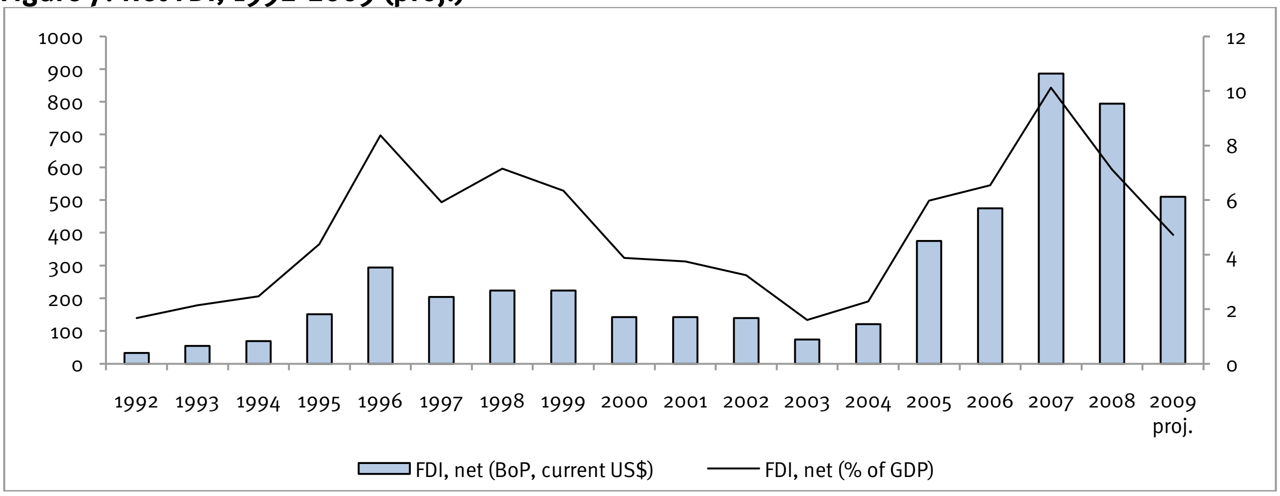
11 See Cambodia's Law on Investment (CDC, 2006; CDRI, 2009d; Sciaroni, 2009b; US Department of State).

12 These critical laws include the Intellectual Property Laws, the Laws on Commercial Enterprises and Arbitration, the Law on Customs and the Stock Market Law (CDC, 2006; EIC, 2009b; Sciaroni, 2009b; US Department of State, 2009a).

FDI inflows to Cambodia have demonstrated a bias towards the garment and tourism industries and can be categorised as export oriented and efficiency seeking.[15] The competitive advantage of the garment sector, based in particular on its preferential access and labour cost advantage, has served as a significant pull factor. In the case of the tourism industry, this competitive advantage rests on its natural asset, Angkor Wat. The proximity of the country to major input sources and regional production networks has likewise significantly influenced FDI entry.

Corollary to capital account openness, however, is vulnerability to deterioration in or loss of relative competitiveness of the internal locational determinants (the pull factors), swings and shocks in the external environment (push factors) or simply the whims of investors. This has been manifested in the ebbs and flows of FDI in Cambodia during normal periods and the sharp pullbacks in such investment during crises. FDI volatility has been found to be conditioned by relative considerations of market, political, financial and legal risks (Aizenmann, 2002; Büthe and Milner, 2008; Lensink and Morrissey, 2001; Rahman, 2008; World Bank, 2004). The integration of corporate production networks has facilitated this volatility, as it enabled multinational enterprises to easily fragment, shift and change the mode of production across different geographical locations. In times of crisis, losses and risks are magnified, and so is FDI response. Worse than what transpired when the contagion effects of the Asian financial crisis struck Cambodia, net FDI in the country experienced a precipitous drop when the current crisis deepened in the middle of 2008. A painful 36% reduction in net FDI is expected for 2009 (Figure 7). The credit crunch, gloomy market conditions and heightened risk perceptions have affected both capacity and propensity to invest (UNCTAD, 2009) and served as universal explanations for the decline of global and country-specific FDI. In the specific case of export-oriented industries, such as Cambodia's garment sector, market concentration on the US, which was the epicentre of the crisis, along with erosion of competitiveness in the post-quota environment, has put off investments. Given Cambodia's lack of equity and bond markets, distress to the economy transmitted through the investment channel has actually been modest by comparison: FDI has been found to be more resilient in times of crises relative to other private capital flows (ADB, 2009b). Other developing Asian economies suffered terrible blows from the plunge in stock market prices and the steep increase in risk premiums on debt securities before the situation achieved some measure of rebound around the first or second quarter of 2009 (ADB, 2009a; 2009b).

Figure 7: Net FDI, 1992-2009 (proj.)



Sources: NBC data; World Development Indicators 2008; World Bank (2008a).

13 Such as special economic zones (SEZs) (see also CDRI, 2009d).

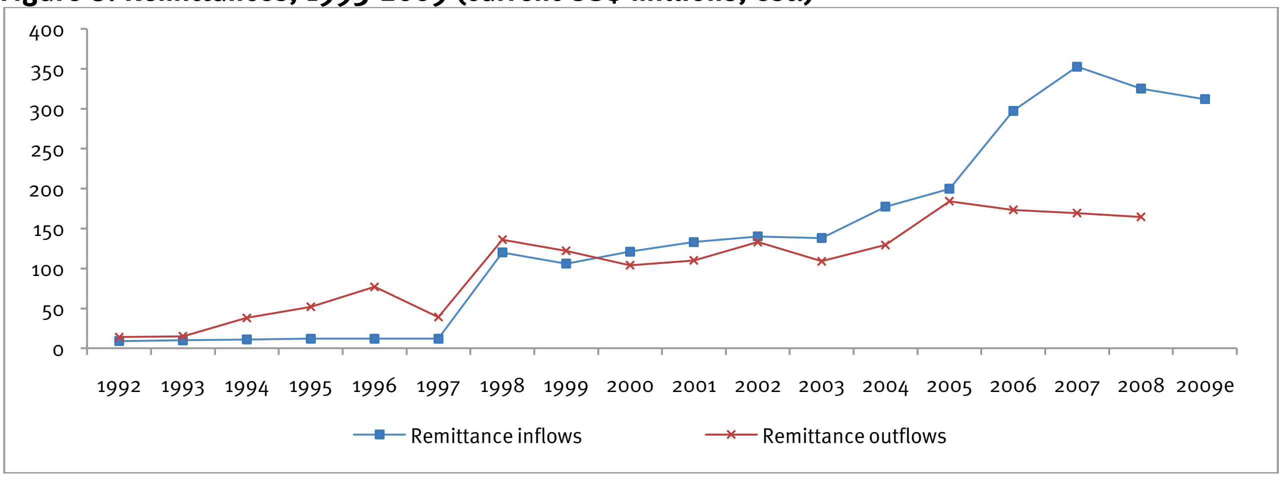
14 A prominent example of the public–private sector consultative mechanism in this regard is the Government–Private Sector Forum (www.cambodia-gpsf.org).

15 Dunning and Lundan (2008) identify four types of activity of multinational enterprises: natural resource seekers, market seekers, efficiency seekers and strategic asset or capability seekers. Blonigen et al. (2009) described tariff-jumping FDI as allowing a foreign firm to avoid trade barriers by locating production in the destination market.

International remittance flows[16]

By and large, international remittances have been found to exhibit more resilience than other capital flows, FDI included (Ratha and Mohapatra, 2009; Ratha et al. 2009a), and this has seemed also to be true in the experience of Cambodia thus far. An estimated decline of 8% was seen in formal international remittance transfers to Cambodia in 2008.[17] In the expected reduction in international remittance inflows to East Asia and the Pacific of 1.5% in 2009,[18] transfers to Cambodia this year are expected to decline by 4% (Figure 8). The trend is likely to be gloomier if informal remittances are taken into account, given the tightening of regulations and the crackdown on irregular migration that ensued following increasing unemployment and underemployment in receiving states. Overall volumes have remained, however, and are expected to remain stable; any decline will be modest compared with that facing FDI inflows.[19] Key explanatory factors for any decline could be as follows: the smaller size of new migration flows; increased pressure for return migration with employment loss and fewer good prospects in destination countries; greater strategic desire of migrants to save in the host country given economic uncertainties increasing job insecurity; and smaller value of remittances in terms of the source country's currency. Already, Thailand and Malaysia, the top two destination countries for Cambodian migrant workers, have officially closed their doors to new inflows (S. Ros, 2009).[20] Although no data on numbers of returnees are readily available, employment pressures and increased xenophobia in Thailand, for instance, have likely induced the return of a number of migrants. This is supported by scattered accounts of unwanted return from Thailand to Cambodia (e.g. Tong and Pon, 2009). Meanwhile, consideration of migration investments and greater difficulty in re-entering destination countries is likely to deter any mass return migration.

Figure 8: Remittances, 1993-2009 (current US$ millions, est.)



Sources: Ratha et al. (2009a; 2009b).

Foreign aid: China's recent prominence[21]

Highly aid dependent, Cambodia has banked on development assistance to finance most of its national priority requirements, particularly in relation to social interventions and capital expenditures,[22]

16 Limited data are available on remittances in the Cambodian context. No government estimates are available on the expected decline or increase in international remittances for 2009.

17 Data from Ratha et al. (2009a; 2009b). Note that government figures for migrant remittances are lower.

18 In its latest estimation, the World Bank puts the possible drop in international remittances to developing countries in 2009 at 6.1%, or $21 billion (Ratha et al., 2009b). Other earlier estimates have suggested bigger declines, of $25-67 billion (Calì and Dell'Erba, 2009) and $40 billion (Calì et al., 2008).

19 Based on various calculations by the authors.

20 Earlier, Korea, Cambodia's third market for migrant workers, announced a reduction in the number of Cambodian workers to be accepted in 2009 to only 1000 (S. Ros, 2009). However, after a visit by the President of Korea in the third week of October 2009, it was agreed that the country would receive an additional 3500 workers from Cambodia (Cheang, 2009c). It is not clear whether this applies for this year or is to be spaced out for several years.

21 Few data are available on individual donor strategies.

both critical in serving as automatic stabiliser/employment generator during crisis periods. Nearly $1 billion in aid for 2009 was pledged back at end-2008. With the crisis inciting concerns about aid budgetary pressures in donor countries and a loss in the dollar value of aid, the country's official development partners have sought to reaffirm this indicative commitment (e.g. Fan, 2009). The scope of donor responses to the crisis is said to have included choices about aid volumes, aid instruments and aid programming (te Velde and Massa 2009). There has been no known cutback in the total aid commitment to Cambodia for 2009. Rather, total committed aid just received a huge boost, with a reported increase in financing from China, now Cambodia's top donor, replacing Japan. China reportedly topped up its aid pledge back in 2008 of about $260 million with an additional $593 million funding for various government infrastructure projects (Cheang, 2009b; Jalilian et al. 2009; Reuters 2009a; 2009b). Based on discussion with key development partners, Chinese aid has been criticised for its lack of such traditional conditionalities as that affecting governance, which in turn impinges on aid effectiveness. In terms of actual disbursements, implementation of foreign finance targets under the current budget law was at 55% for the first seven months of this year, compared with 70% for the same period in 2008 (MEF, 2009c). Most official financing is off budget, however, and it is difficult to obtain data on this. With reference to the 2009 Government–Donor Coordination Committee (GDCC) priority projects, on which data on expenditure have been presented, actual spending this year is expected to miss the target by about $87 million, or 23% of the programmed amount. As of September 2009, disbursements on only one-third of priority projects had reportedly been made on or above target. Expenditures on priority economic projects and safety nets have, as of the same date, reportedly missed their targets by about 30%. These under-achievements have been attributed to common problems affecting the aid administration in Cambodia, such as delays in programme approvals, procurement and recruitment (Yanara, 2009), rather than the crisis.

In terms of donor responses affecting aid instruments or modalities, decisions rest ultimately on aid effectiveness objectives rather than on crisis impacts, although the latter appear to have enhanced impetus for fulfilling the former. Effectiveness of budgetary support has been acknowledged, for instance, but enhancement of the use of this over other modalities in the end rests on strengthening the foundations of trust between the government and its development partners. Meanwhile, more definable changes in aid programming of selected donors seem to be imminent, and these are likely to affect planned individual aid commitments and directions (leading, for instance, to abandonment of intended aid increases for coming years, reallocation of regional aid and/or greater area prioritisation). However, the extent to which the crisis has influenced the decisions leading to these changes varies.[23]

2.2.3 Back to a balance of payments deficit

Propped up by the still upbeat situation during the earlier quarters of 2008, but dragged down by the deceleration in economic activity in the last quarter of that year, the balance of payments (BoP) registered a positive but lower than before surplus of about 3% of GDP in 2008. A widening of the current account deficit to about 11% of GDP, stemming from the slowdown in exports, occurred along with an 8% decline in net FDI, but also with expansion in the net foreign assets of commercial banks in 2008 relative to the previous year. As the crisis deepened, Cambodia's overall external position was bound to worsen in 2009. For the first time in more than a decade, its overall BoP is poised to turn negative, despite a narrower current account deficit. As mentioned elsewhere, net FDI is expected to decrease by about 36%, whereas tourism receipts are expected to register much lower growth in 2009 relative to 2008. Net FDI and tourism receipts had already declined by more than 50% and 0.2%, respectively, in the first half of 2009 compared with the same period in 2008. Banks' foreign liabilities have reportedly grown, whereas private transfers have declined significantly over the same period. The negative overall balance for this year's first semester is estimated at around $4 million. Supported by strong capital inflows earlier last year, gross official reserves increased from 3.1 to 3.4 months of imports between 2007 and 2008. However, these are expected to fall back to about 3.1 months of

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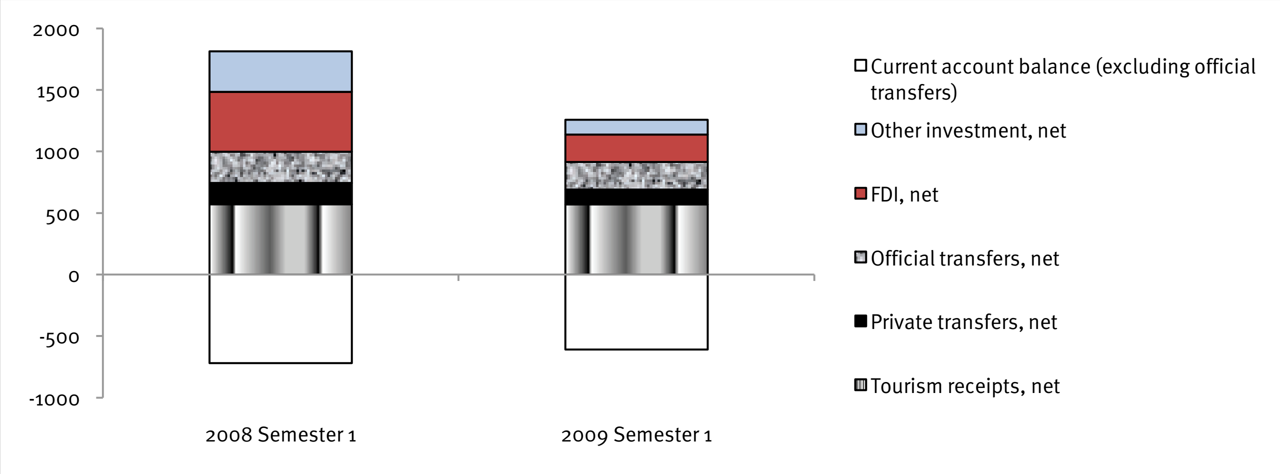
22 As per the 2008 Cambodia Aid Effectiveness Report (CDC, 2009), development assistance financed 85% of total National Strategic Development Plan (NSDP) requirements in 2006 and 95% in 2007. Direct external financing, which is off budget, accounts for about 70% of total capital spending (NGO Forum, 2007).

23 Based on results of stakeholder consultations.

imports by the end of this year, especially with the central bank's exchange rate market interventions, meant to stabilise the riel against the dollar (World Bank, 2009c; 2009d).

Figure 9: BoP, Semester 1 of 2008 vs. Semester 1 of 2009 (US$ millions)



Source: NBC data.

2.3 Growth sectors lose steam

With fewer favourable factors supporting their growth, three of Cambodia's growth drivers – garments, tourism and construction – have lost much of their steam over the crisis period. In 2008, all grew at below-average growth rates for the decade 1998-2007. Further deterioration occurred in 2009. Agriculture, the fourth growth pillar, has been able so far to overcome its erratic growth pattern of earlier years, which marred its reliability as a growth engine. Its growth of about 5.7% in 2008 helped cushion Cambodia from the brunt of the crisis, as well as the 5 million or so people[24] employed in the sector. The potential of agriculture as driver of longer-term growth is another issue, however.

2.3.1 Garments: Lagging competitiveness

After growing at a remarkable average rate of 28% per annum in the decade 1998-2007, Cambodia's garment sector has endured a sudden sharp contraction over the crisis period.[25] The crisis, which has coincided with the removal of safeguards imposed against Chinese garments after the Agreement on Textiles and Clothing (ATC) ended in 2004, has unsurprisingly triggered a contraction in Cambodia's garment industry, which is mostly US market concentrated, mostly cut-make-trim (CMT), about 90% foreign owned and governance challenged. Overall, growth in clothing export values and volumes was still strong until the third quarter of 2008. It was downhill from then on. Year-on-year growth of total clothing export values (in terms of three-month moving averages, or 3mma) had turned consistently negative by November 2008, and reached a low of -24% in April 2009 before edging up to about 18% in September 2009. The decline in garment export prices clearly influenced a reduction in value, as total export volumes dropped at lower though still significant rates of around 19% in April 2009, and 15% in September of the same year. Total values for the first nine months of 2009 were about 19% lower relative to the same period in 2008, whereas volumes over the same period declined by about 16% (Figure 10). Adverse developments are expected to shrink total garment export values by about 30% in 2009 relative to the 2008 total,[26] a contraction never before seen in the modern history of Cambodia's garment industry.

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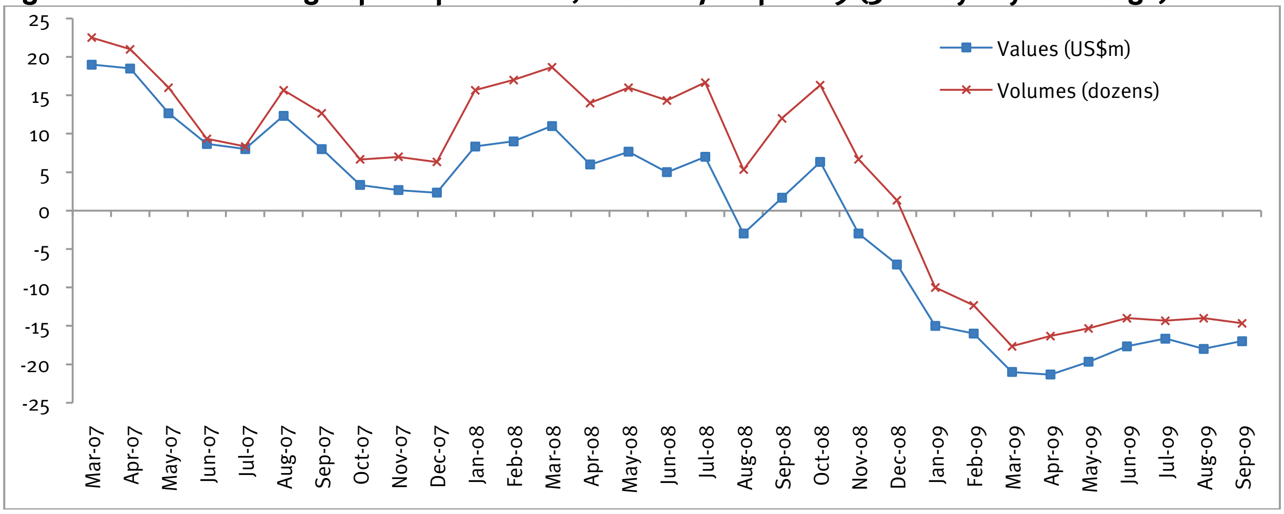
24 According to the National Institute of Statistics (NIS, 2008), about 73% of all employed persons in Cambodia are based in the primary (agriculture, forestry and fishing) sector.

25 A detailed discussion on the origins and characteristics of the industry is provided in Annex 1.

26 According to stakeholder consultations, there are hopes that sales will pick during the Christmas holidays.

Figure 10: Total clothing exports per month, Mar 2007-Sep 2009 (3mma y-o-y % change)



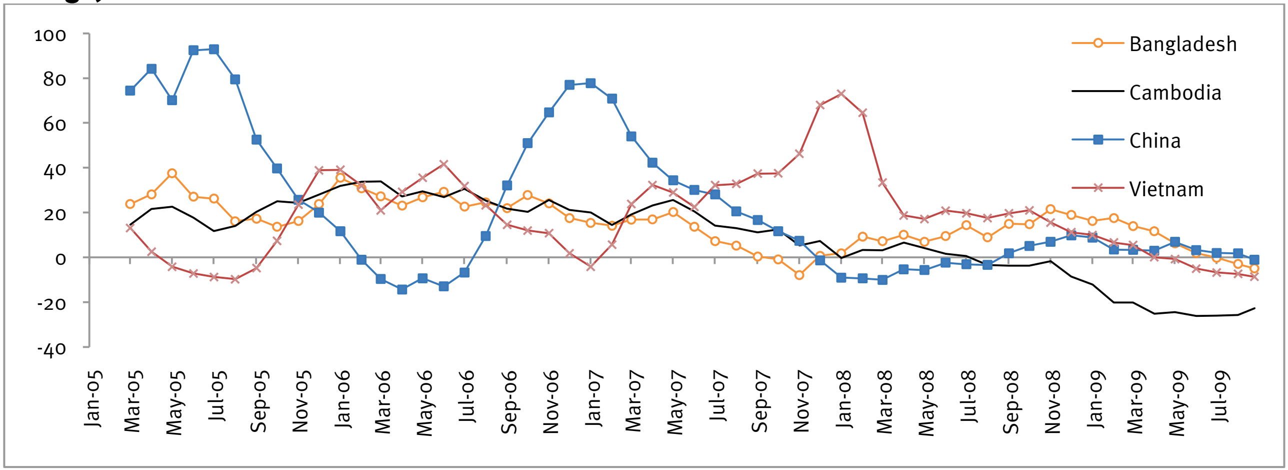
Source: MEF data.

The struggle that the domestic garment industry has been facing has one of its roots in the sector's lack of diversification, although this does not fully account for the souring of the industry's export performance. As further explored in Annex 1, the US market accounts for about three-fourths of garment shipping from Cambodia. Unfortunately, an inevitable impact of the recession in the US has been a slump in retail sales and a shift among American consumers towards cheaper goods. For a host of reasons, briefly explored below and touched on in Annex 1, Cambodia has suddenly found itself losing ground to competitors, particularly China and Bangladesh, another least-developed country (LDC) equally dependent on the US market. In 3mma terms, the value of Cambodia's garment exports to the US shrank by about 22% in the first nine months of 2009 relative to the same period in 2008, whereas the corresponding values for China and Bangladesh increased by about 6% and 2.5%, respectively. Vietnam's exports also decreased, but by a far lower rate of around 7% (Figure 11). It is important to note, however, that US garment imports from Bangladesh and China have started to decline in recent months, possibly suggesting time lag effects.

As explored in Annex 1, the majority of the garment factories in Cambodia have been engaged in CMT, the simplest activity on the value chain, with the lowest value addition. Figures 12 and 13 show that non-knitted and crocheted garment exports from Cambodia have experienced steep declines in value terms, but so have knitted and crocheted garment shipping, although at lower rates. Bangladesh, by contrast, has been able to retain its market position longer, especially in relation to knitwear and crocheted garments. Cambodia's clothing exports to the EU, its second largest market, similarly dropped by about 7% in value terms in the first eight months of 2009 relative to the same period in 2008 (Chun and Green, 2009), whereas at least imports from Bangladesh appear to have remained stronger.[27]

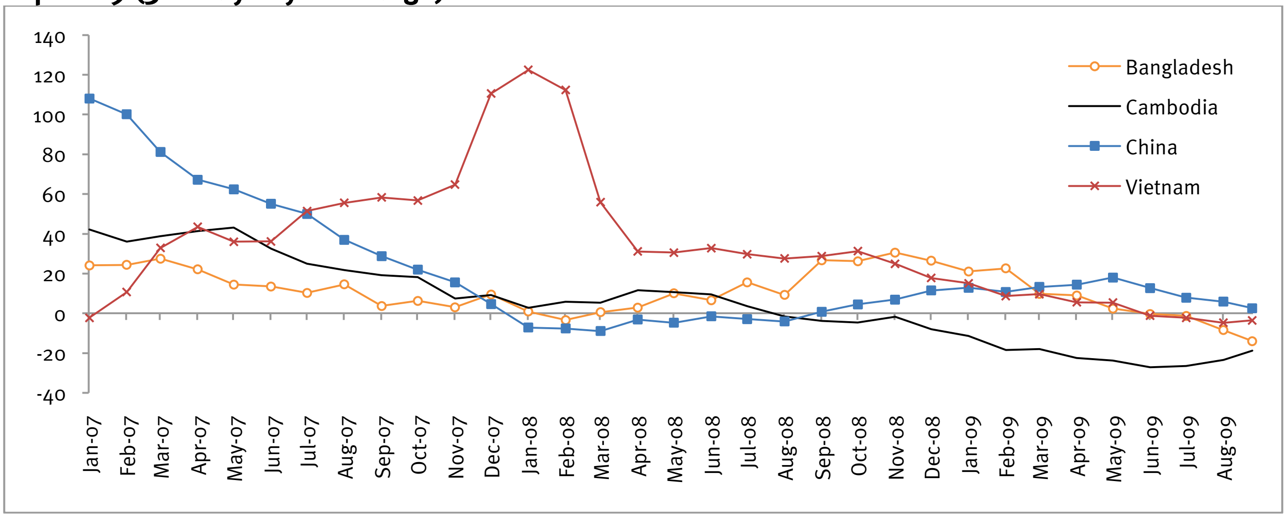
27 Based on www.emergingtextiles.com/?q=art&s=090915-bangladesh-country-report&r=bangladesh&n=1.

Figure 11: Comparative values of garment exports to the US, Mar 2005-Sep 2009 (3mma y-o-y % change)



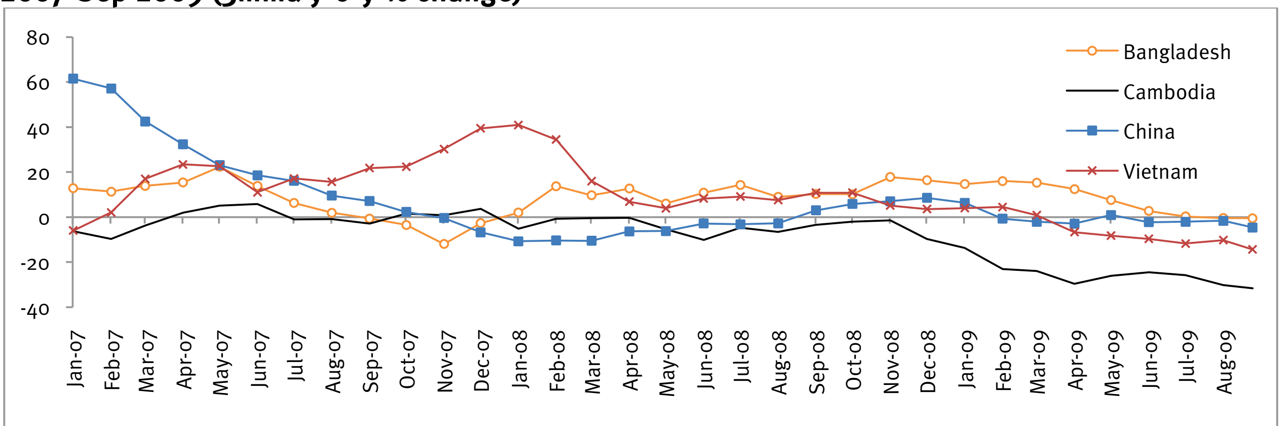
Note: Garment export values refer to the sum of figures under categories H61 and H62.
Source: USITC database.

Figure 12: Comparative values of garment exports to the US, knitted and crocheted, Jan 2007-Sep 2009 (3mma y-o-y % change)



Note: Knitted and crocheted garment export values refer to the sum of figures under category H61.
Source: USITC database.

Figure 13: Comparative values of garment exports to the US, non-knitted and crocheted, Jan 2007-Sep 2009 (3mma y-o-y % change)



Note: Non-knitted and crocheted garment export values refer to the sum of figures under category H62.
Source: USITC database.

That competitors in the industry were able to retain or even enhance their market share over the period of the crisis indicates that there is more to the story than just the lower demand induced by the global recession dimming exports. A combination of preference erosion, exchange rate effects and other structural characteristics of and constraints facing Cambodia's garment industry, with implications for its cost competitiveness and therefore vulnerability to the external shock – i.e. lack of vertical integration, low position in the value chain, considerable dependence on FDI, labour standard compliance, higher firm-level costs owing to higher power rates and alleged costs of corruption – stand out as chief explanatory factors in the current predicament of the domestic garment sector.[28]

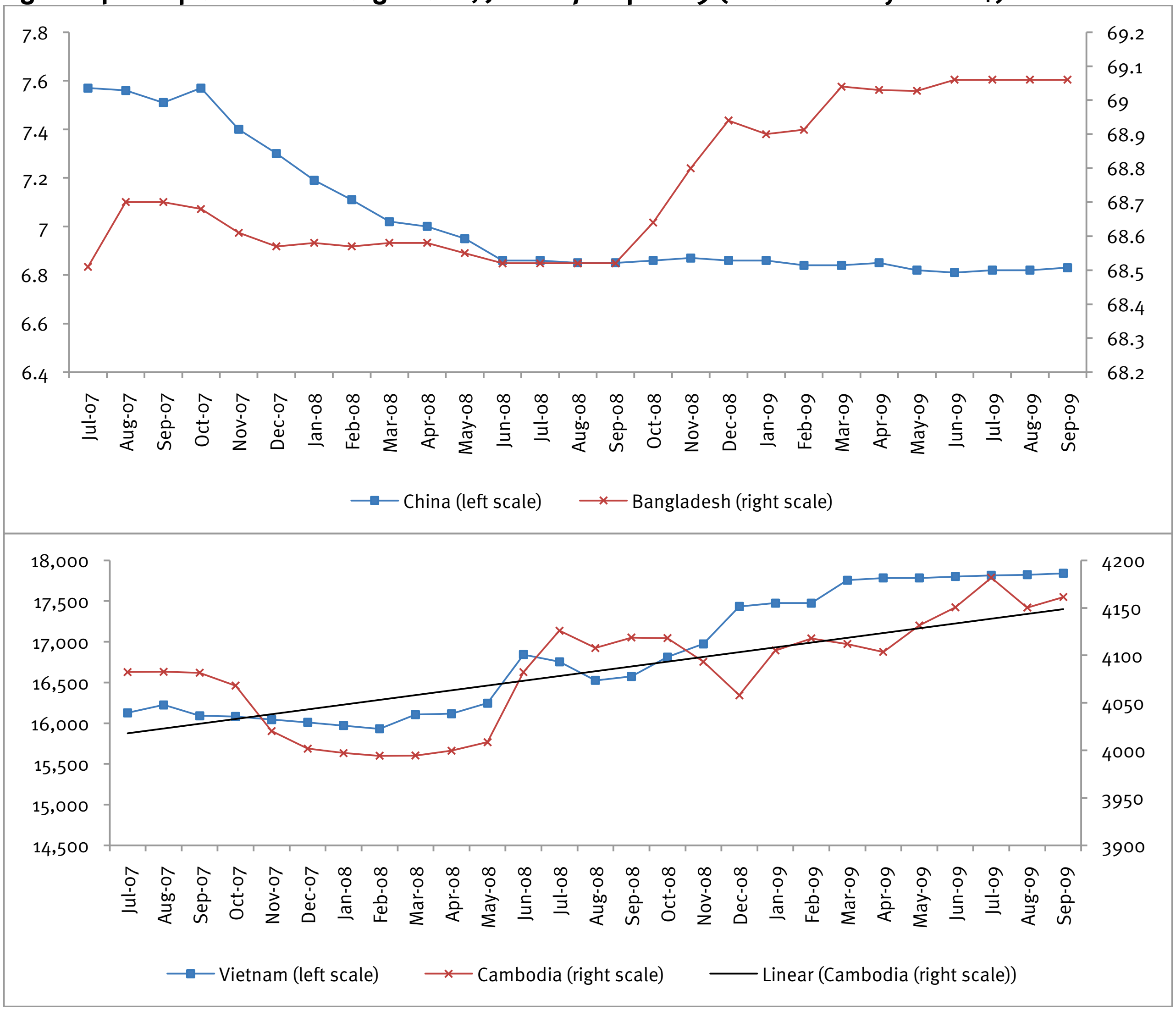
China has long been predicted to increase its share in the global clothing market in the post-Multi-Fiber Arrangement (MFA) environment (Adhiraki and Yamamoto, 2008; Martin, 2009), having in its arsenal economies of scale, a huge supply of garment labour, with lower wages and higher productivity, and a developed upstream textile and accessory industry. The appreciation of the yuan from the fourth quarter of 2008 to the earlier quarters of 2009 (Figure 14), along with liquidity shortages, however, has helped caused some diversion of imports from China to other competitors, such as Bangladesh. This has to some extent underpinned the slowdown of China's garment export growth. Seeking to prop up the finances of struggling textile and garment firms, government interventions, such as increasing export tax rebates, have been implemented in the country (Wang et al., 2008). On the other hand, the taka's significant depreciation against the dollar (Figure 14) has been in Bangladesh's great favour, as its garment industry faces intense competition from and a price war with Cambodia and fellow South Asian states India, Sri Lanka and Pakistan. This exchange rate trend has made garments from the country less expensive and has undoubtedly helped Bangladesh hold on to its market share in the US. By contrast, the Cambodian riel had episodes of strengthening against the dollar by the middle of 2008 (Figure 14), which must have compounded the adverse impact of the retail sales slump in the US (the Cambodian economy is dollarised, therefore appreciation of the dollar against other currencies such as those from Bangladesh and Vietnam would work against Cambodian producers). As for the Vietnamese national currency, the dong turns out actually to have depreciated against the dollar (Figure 14), so the slight decline in its garment exports to the US must be explained by other factors.

Preference erosion and, related to this, the deceleration in FDI flows, has constituted another serious blow to Cambodia's predominantly foreign-financed garment industry. As explored in Annex 1, of paramount attraction to investors has been the preferential access of the country in major markets. Together with the credit crunch and heightened actual and prospective financial risks, the erosion of this key element of the industry's competitive advantage with the removal of safeguards against Chinese imports must have put off investments. Reportedly, at least 93 garment and shoe factories permanently closed their gates in the first 11 months of 2009, and 53 others temporarily suspended operations. Over the same period, about 55 new factories registered (May, 2009c).[29]

28 With the exception of the role of the exchange rate, all of these are discussed in more detail in Annex 1.

29 One response to this accusation has been that some investors bailing out failing garment factories require such factories to open up under a new name to avail themselves of the tax break. However, the crisis effects, together with fallouts with workers, have been real reasons for the closure of many companies (S. An, 2009a; 2009b).

Figure 14: Comparative exchange rates, Jul 2007-Sep 2009 (local currency vs. US$)



*Source*s: Bangladesh Bank data; World Bank (2009d).

Labour standard compliance, as emphasised in Annex 1, has been a key source of the country's differentiation from other competitors. With export licensing conditioned on factory participation in labour standard monitoring, however, this comes at a cost. The financial rewards from this type of differentiation have also been made uncertain by the crisis and post-quota scenario. There have been indications that labour standard compliance is a significant but not sufficient determinant of buyers' purchasing decisions against the backdrop of a price war in the global market (Chun and Finch, 2009).[30] Over the period of the crisis, there have also been observations of reported deterioration in the quality of labour relations. The number of strikes in 2008 was reportedly 30% higher than in 2007 (Kang et al., 2009).[31] Industry-wide strikes reportedly also doubled in the first half of 2009 compared with the same period in 2008, with the majority having occurred in the garment sector (O'Toole and Green, 2009). Lawsuits received by the Arbitration Council, an independent body established in Cambodia to decide on collective disputes not resolved by conciliation,[32] also reportedly increased significantly (May, 2009c). Stakeholders, including the Garment Manufacturers Association in Cambodia (GMAC), are inclined to blame unions partially for the worsening of the garment industry's

30 Also stressed during a stakeholder consultation. That labour standard compliance is only a basic and not a sufficient consideration in buyers' purchasing decisions was said to be true even before the crisis.

31 Observations on strike incidence raised during stakeholder consultations differ. On the one hand, incidence is known to have increased; on the other, frequency of strikes has reportedly actually decreased but the duration and number of participating workers was enough to result in the same amount of production loss.

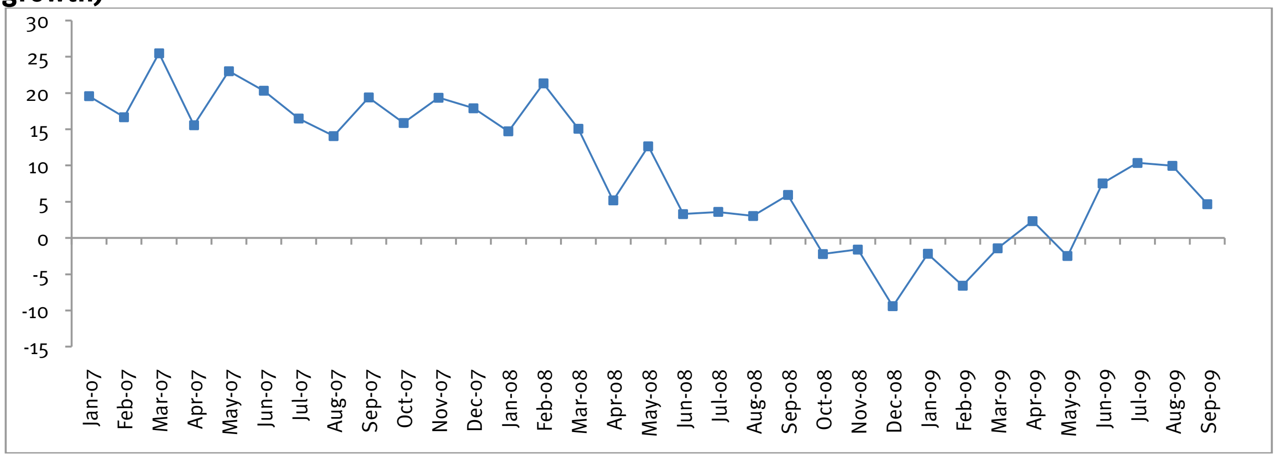
32 See the official website of the Arbitration Council (www.arbitrationcouncil.org/eng_index.htm).

plight in the face of the crisis. They consider the presence of numerous unions, discussed more in Annex 1, as a key hurdle to lifting up the industry's cost competitiveness. Union representatives readily discredit this, citing for one the low level of unrest caused by unions in the country, relatively speaking (Chun, 2009a). In contrast, unions do not figure significantly in the garment industry of Bangladesh: unions are permitted to exist as federations but are reportedly *de facto* not recognised at the factory level (FIDH, 2008).[33] For almost the entire of 2008, trade unions in Bangladesh also suffered a ban, imposed as the country was put under a state of emergency.[34]

2.3.2 Tourism: The inevitable downturn?

Tourism[35] in Cambodia has also visibly decelerated, suspending its double-digit average growth of the past decade. In 2008, it grew[36] at significantly less than the 2007 growth of 10.3% and the decade average of about 13% (NIS data). The final quarter of 2008 marked the start of the slowdown, as year-on-year growth of international arrivals turned consistently negative for the final quarter of 2008 (Figure 15). This continued well into the beginning of 2009, in line with the sharper drop in world tourism and tourism in Asia and the Pacific in the starting months of the year. By the end of 2009's first semester, however, tentative signals of the sector's comeback were seen, with year-on-year growth of international visitor arrivals turning positive by June. Still, the prognosis for tourism's expansion in 2009 remained conservative, with international arrivals expected to grow at the slower rate of 3.5% (from 5.5% in 2008). Given this, and depressed spending by tourists who have come, tourism receipts are also expected to grow at a much smaller rate compared with past years, at 1.4% specifically (from 13.7% in 2008).[37]

Figure 15: International visitor arrivals in Cambodia, Feb 2007-Sep 2009 (monthly y-o-y % growth)



Source: Based on data from MoT.

A number of factors, mostly, but not all, connected to the crisis, can be blamed for the fizzling out of tourism growth.[38] The blow from the crisis in the country's traditional key markets, South Korea and Japan,[39] is foremost among these. Data show that numbers of South Korean and Japanese tourists

33 So-called participation or social welfare committees are said to exist at the factory level but, at least in the factories inspected by the International Federation for Human Rights (FIDH), all have been appointed by management. Such committees reportedly also cannot bargain. See FIDH (2008).

34 A state of emergency declared in Bangladesh at the start of 2007 led to the imposition of a ban on trade unions. This was relaxed partially in September 2008 and lifted up in December 2008 (US Department of State, 2009; ITUC, 2009).

35 Tourism is reflected mainly in the hotels and restaurants category of Cambodia's national accounts.

36 Preliminary data from the NIS puts 2008 growth at about 6.8%. The Economic Institute of Cambodia (EIC) estimates it at 5.7% (2009b).

37 Forecasts and related data are sourced from the Ministry of Tourism (MoT). Per such data, growth of tourism receipts between 2004 and 2007 was 43% on average, then narrowed down to 13.7% in 2008.

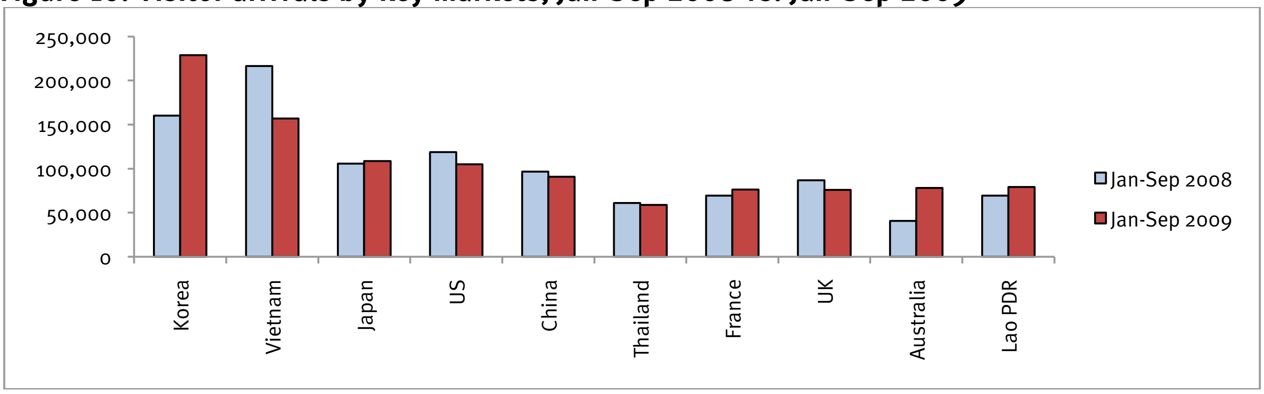
38 The same assessment was made in the first report (Jalilian et al., 2009).

39 South Korea's economy was predicted to contract by 1% in 2009 and Japan's by 5.4% (IMF, 2009g).

experienced sharp drops, of around 27% and 12%, respectively, in the first nine months of 2009 relative to the same period in 2008 (Figure 16). Although isolating effects from those of the crisis is tricky, developments such as the internal political crisis in Thailand,[40] the resulting closure of the Thai airport back in November 2008 and the persisting Thai–Cambodian border standoff[41] must have directly and indirectly aggravated the downslide in tourism traffic and the perceived risks of visiting Cambodia. Interestingly enough, with the Thai-Cambodian military face-off surfacing in July 2008, the number of tourists from Thailand fell during the second half of the year by 26% compared with the same period back in 2007. This decline continued well into the first nine months of 2009 (Figure 16). Traveller traffic bound for Preah Vihear Temple, which is in the conflict area, also reportedly slimmed down, as numbers of visiting tourists fell by more than 30% in the third quarter of 2009 relative to the same quarter back in 2008 (Xinhua, 2009e). Additionally, concerns over the spread of the H1N1 virus[42] must have compounded the effect on tourism of distressed consumer confidence, lower incomes and exchange rate uncertainties consequent to the crisis.

What has propped up the lower but still positive growth of tourism in Cambodia has been the increase in the number of sub-regional and domestic tourists or, in terms of mode of arrival, land- and waterway-based tourism. With a recent visa fee waiver acting as an incentive, the number of Vietnamese and Lao tourists visiting Cambodia in the first nine months of 2009 increased, by 43% and 92%, respectively, relative to same period in 2008 (Figure 16).[43] Bolstered by this cross-border tourism, arrivals by land and waterways rose by about 22% (whereas those by air declined by 13%) over the same period (MoT data). Meanwhile, in the first five months of 2009, the number of Cambodian tourists was reportedly four to five times higher than that of foreign tourists, and about 5% higher than the figure for the same period in 2008 (Kay, 2009). The official target of a 3.5% increase in international tourist arrivals for 2009 was predicated significantly on the hopes of a continued surge in 'regionalization' of tourism in the country, with greater domestic tourism hoped to support tourism growth overall. While such an upsurge is welcome news, the downside is that spending by sub-regional and local tourists can probably not counterweigh the dip in tourist receipts from travellers from more developed countries.

Figure 16: Visitor arrivals by key markets, Jan-Sep 2008 vs. Jan-Sep 2009



Source: Based on data from MoT.

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40 Thailand is a major gateway for tourism in Cambodia. Many tourists come to Cambodia via Thailand.

41 The political and military tension between Thailand and Cambodia, rooted in the conflict over the listing of Preah Vihear Temple as a World Heritage site by the UN Educational, Scientific and Cultural Organization, and sovereignty claims on surrounding areas, has intensified since the time of writing of the initial report. The conflict has reportedly claimed at least seven lives so far, and has rendered hundreds homeless with the destruction of a market at the foot of the temple during the height of the fighting. It has been suggested that an arbitration body or dispute settlement mechanism within ASEAN be set up to deal with the deadlock, but Thailand has reportedly rebuffed attempts to internationalise the issue and has expressed its preference for bilateral negotiations (Associated Press, 2009b; Cheang, 2009a; Sam, 2009; Vong, 2009).

42 As of 17 December 2009, six Cambodians had died of the virus, with about 531 confirmed as infected (Xinhua, 2009f).

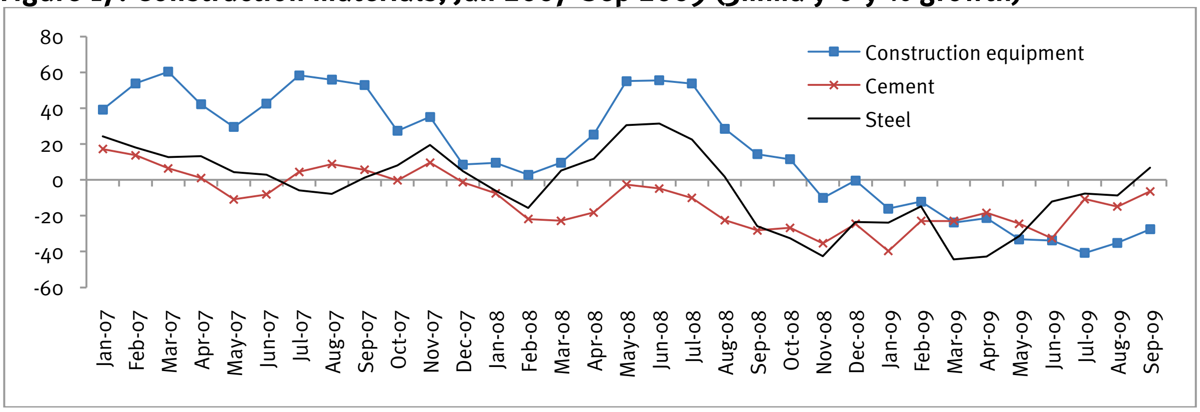
43 Based on data from the MoT, visa fee waivers appear to have positively impacted only sub-regional tourism, for which travel costs are cheaper. Cambodia has also extended the waiver to travellers from the Philippines, Malaysia and Singapore: arrivals from these three countries fell by 30%, 9% and 4%, respectively, in the first eight months of 2009 compared with the same period in 2008.

Crisis or no crisis, the tourism sector of Cambodia arguably could have been headed for an inevitable slowdown or stagnation. Its rapid growth has been unsustainable, banking mainly as it is has on its natural comparative advantage, Angkor Wat, at the expense of other tourist sites (running some environmental risks in the process),[44] and on attracting mass tourism from traditional markets without necessarily increasing the value added of its tourist services and products and at the same time carving out new tourist markets (CDRI, 2009a; 2009b; 2009d; Gardère, 2009). In this regard, the opportunity cost of relying on traditional dependencies has been apparent. Improved competitiveness cannot be attained successfully through quick fixes which at best address short-term problems. Tourism has been a commanding propeller of the world's increasing service orientation, and Cambodia is but one of many countries striving to become significant visitor economies.[45] In the most recent travel and tourism competitiveness listing, the country ranked 118th out of 133 countries, whereas its neighbours in the Greater Mekong Sub-region (GMS), Thailand and Vietnam, took the 39th and 89th spots, respectively. What separated Vietnam and Cambodia, in particular, was not quality of human resources or natural assets (in fact, Cambodia ranked higher than Vietnam in the index covering these criteria), but the better state of the regulatory and business environment as well as infrastructure in the former (WEF, 2009). Such results illuminate further the unsustainable dimension of tourism's expansion in Cambodia, together with the missing diversification beyond its natural comparative advantage and traditional markets and offerings.

2.3.3 Construction: And then the bubble burst

The construction sector has also suffered. Overheating until about the middle of 2008, the sector was hit hard by the impacts of the crisis via the investment channel *and* by the effects of the bursting of the domestic real estate bubble after a period of speculative frenzy. Closely aligned with real estate development (as well as the tourism sector in general) and predominantly foreign financed (often Korean), the downturn in the construction sector has thus not been much of a surprise. Available data suggest that the sector's growth receded to 5.8% in 2008, from 6.7% in 2007, although another estimate places 2008 growth at only 3%.[46] An oft-cited visible symptom of this recession has been the slowing down or deferment of construction of mega projects in the capital, Phnom Penh.[47] Import volumes of construction materials in particular, specifically of steel and cement, have declined significantly from their peaks back in the middle of 2008 (Figure 17). For 2009, an 8% contraction in the construction sector was expected (IMF, 2009h).

Figure 17: Construction materials, Jan 2007-Sep 2009 (3mma y-o-y % growth)



Source: Based on data from MEF.

44 For instance, it has been noted that the uncontrolled pumping of underground water to support the hotel and restaurant industry in Siem Reap may be destabilising the earth on which the Angkor Wat temples stand (Associated Press, 2009a).

45 According to Deloitte (2008), the visitor economy rests on two components: tourism's direct contribution (from sectors directly providing tourism goods and services) and indirect impacts (from supporting businesses in the supply chain).

46 The 5.8% growth estimate is per NIS data; the 3% is an EIC estimate (2009b).

47 According to Leng (2009), only one mega-project (with a value of $100 million or more) has been completed recently (the Koh Dek Koul Island project) and only two projects (De Castle and CamKo City) have been fighting the effects of the crisis, although relevant construction has also slowed down. Mega projects such as the IFC Tower (expected to be the highest building in Cambodia) have officially been stalled, with developers reportedly waiting for the financial storm to pass.

What inflated – and ruptured – the domestic real estate bubble is not any different from the developments that have underpinned asset bubbles throughout history in both developed and emerging economies.[48] The bubble was pro-cyclical, inflated because financial liberalisation was fast taking place, credit was booming and growth sectors were expanding. It affected both commercial real estate and residential markets, and was fuelled by over-optimism about economic fundamentals, incomes and business prospects. Rising real estate prices may for some time have been a response to real demand, as benefits of Cambodian growth increased household wealth and demographic changes made real estate more valuable in areas like Phnom Penh. Speculation eventually came on the scene, however, with purchase and sale of property used to secure short-term profit. Property prices reportedly increased between 50% and 80% in 2007 and between 50% and 100% by the middle of 2008 compared with prices in preceding years (IMF, 2009a; Jalilian et al., 2009). The traditional moral hazard problem may have materialised as a result of asymmetric information, relaxation of loan underwriting standards and implicit safety nets.[49]

Inflation of real estate bubbles is also known to be accelerated by banks, given that high real estate prices increase the value of their capital and related collateral, and thus the attractiveness of holding more real estate loans.[50] This accelerator effect may be more muted in the case of Cambodia, however, as most real estate transactions are known to be cash based and, in aggregate terms at least, real estate loan holdings of the banking system are comparatively modest.[51] Like any genuine bubble, the domestic real estate bubble would have burst sooner or later, with or without the global crisis. What the crisis did was accelerate the occurrence of and deepen the bust. In general, it accomplished this by eliciting a severe deterioration in the real economic environment, actual and prospective. One specific way it hastened and worsened the bust, and hurt the construction sector in the process, was by dissipating one of the favourable factors sustaining the industry – that is, FDI.

Real estate prices had reportedly slumped by up to 40% by August 2009 (C. An, 2009a). Despite scrapping the cap on real estate lending, data show that bank credit to the sector fell continuously, from about 7.6% in August 2008 to around 6.4% a year after, although the real size of bank lending to real estate may be more than reflected under this category. The drop in real estate lending is in line with the overall squeeze in private sector credit, as shown below. Given past experience with asset bubble bursts, recovery in the real estate sector is expected to come later and slowly, although there are varying opinions as to the exact pace.[52]

As noted, the gloomier environment for construction this year has been related to the slowdown in FDI inflows. The number of construction projects reportedly declined during the first half of 2009 vis-à-vis the same period in 2008, although total project value increased by 33% (Xinhua, 2009c). However, the rate of implementation of committed FDI in Cambodia is observably modest. Against the background of lacklustre economic prospects, many investors are believed merely to be testing the waters (ibid). Some approved projects are thus not expected to materialise (no data are available to support this).

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48 For more, see Allen and Gale (1998), Catte et al. (2004), IMF (2003) and Lai et al. (2009), among others.

49 As indicated in Pak et al. (2008), there is no formal deposit insurance in Cambodia, although laws, regulations and supervision functions have been put in place by the central bank for the protection of depositors as well as the banking sector overall. Also, there may be implicit safety nets, given the reported political clout of some players.

50 This has been called the 'accelerator effect'. See, for instance, Herring and Wachter (2002).

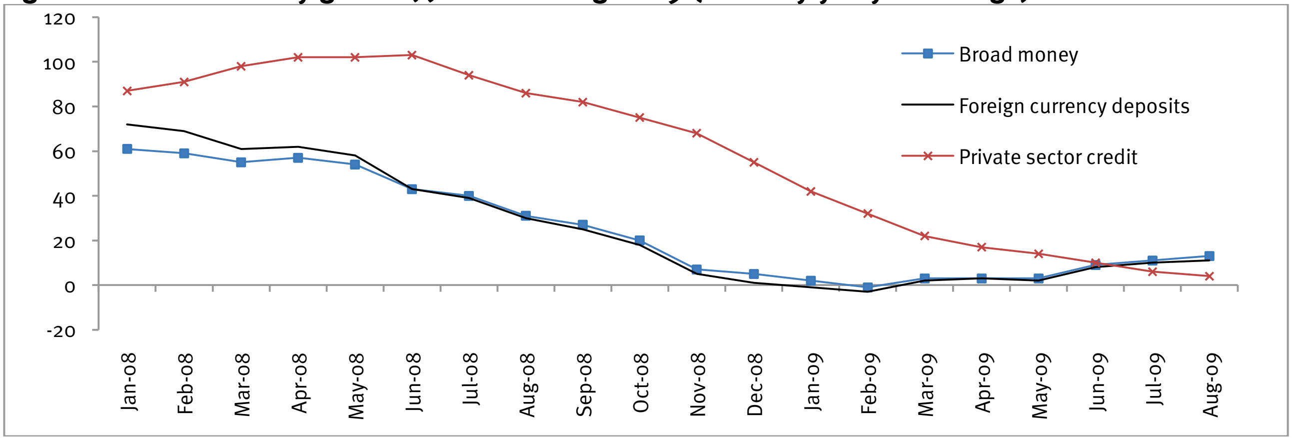
51 The so-called over-expansion of the property market, for instance, which contributed to the severity of the Asian financial crisis, saw real estate shares in total loans at a minimum of 15% to 25% in such countries as the Philippines and Korea, and at a maximum of 40% to 55% in Hong Kong (Quigley, 2001). As explained in the main text, however, note that credit extended by the banking sector in Cambodia to real estate may be bigger than the figures shown. As shared in stakeholder consultations, other types of bank lending, such as lending to the construction sector and personal lending, may be linked to real estate activities.

52 Based on stakeholder consultations and reported accounts, some believe that recovery will come much sooner than expected.

2.4 Strained money conditions: Liquidity and credit squeeze

The clear tightening of monetary conditions by the middle of 2008 continued well into 2009, although improvements have been tracked in recent months in tune with the observed recent pickup in economic activity. Year-on-year broad money growth dropped from nearly 60% in February 2008 to -1% a year after, then rebounded slightly to about 13% in August 2009 (Figure 18).

Figure 18: Broad money growth, Jan 2008-Aug 2009 (monthly y-o-y % change)



Source: NBC data.

Earlier on, financial soundness indicators showed that the domestic banking system was able to maintain its robust position alongside its expansion, given adequate capital cushions and liquidity on top of little problematic loans (IMF, 2009; Jalilian et al., 2009). The size of the banking sector in Cambodia has grown rapidly to its current composition of 27 commercial banks, one state-owned bank and five other specialised banks. Although concentrated in few banking institutions, total bank assets as a percentage of GDP grew from 26% in December 2006 to 47% in December 2008, with loans as a percentage of GDP growing by about 11 percentage points over the same period (NBC data). Since then, however, signs of greater strain have become more evident, as banks have needed to confront increased liquidity and credit risks.

About 70% back in February 2008 of year-on-year growth of foreign currency deposits (FCDs), which comprises about 97% of total bank deposits, dropped to -4% a year after (Figure 18). Some major foreign currency withdrawals have reportedly been made, as well as infusions of emergency funds from overseas parent companies, the banking system being significantly reliant on foreign capital.[53] To help stave off the drying up of liquidity, the NBC earlier on had to slash the reserve requirement from 16% to 12% as soon as signs of easing in inflation became clear. Higher interest rates on dollar deposits (Figure 19) have also been offered to attract more of such deposits and to capture more of the cash remaining 'under the mattress'.

At the start of 2009's second half, a small but definite upturn in the liquidity situation took place, prompting assessments that the liquidity threat had passed. The growth of FCDs year on year rose to 11% by August 2009 (Figure 18). Liquidity ratios were well up (and above the prudential limit), from 81% at end-2008 to 93% by August 2009 (Figure 20). The IMF has acknowledged that there is now ample liquidity in the system (IMF, 2009f), and domestic banking sector representatives concur, although caution has been expressed regarding how liquidity is concentrated on big banks and how downside risks can easily overturn the situation.[54] In contrast, concern over credit risks, as reflected in continued guardedness over private lending, has not yet dissipated, although sentiments vary as to the gravity of such credit risks.

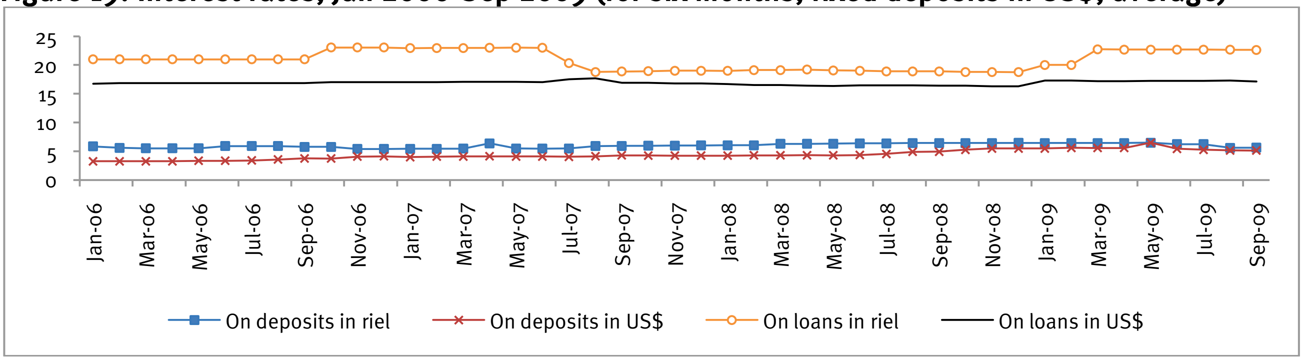
53 According to NBC data, foreign capital constituted about 67% of the commercial banking system's total paid-up capital as of end-December 2008.

54 Based on stakeholder consultations. See Annex 2 for more.

On a year-on-year basis, private sector credit grew by more than 100% during the second quarter of 2008, and remained strong (with 50% growth) by the end of the year. However, this boom arguably occurred on the back of some problems, which the NBC sought to resolve as part of its efforts to help shield the domestic banking system from any further strain. At about 3.7% at end-December 2008, the share of non-performing loans (NPLs) in total loans had risen to 5.9% by August 2009 (Figure 20), still a low level considering the past rapid expansion of credit. The increase is attributable partly to the loan reclassification implemented by the NBC, as per its earlier and tougher regulation on asset classification and provisioning.[55]

The portfolio share of bank lending to real estate (Figure 21), whose risks more than intensified owing to the bubble bursting and the pinch of the crisis, has also turned out to be modest according to available data, although this may not be completely accurate as part of personal lending, for instance, may have been funnelled to real estate activities. Given the close linkage between construction and real estate development in the country, bank credit to the construction sector carries some of the risks associated with the latter. In addition, loan rescheduling may continue to mask NPL problems. The NPL ratio was expected to reach 10% at the maximum by the end of 2009 (Nguon, 2009c). Proving continued cautiousness in lending, year-on-year growth of private sector credit fizzled out to a mere 4% by August 2009. As already pointed out, bank lending to the real estate sector dropped to 6.4% in August 2009, from 7.6% a year earlier (Figure 21). Performance against other prudential indicators, such as the liquidity ratio (see above) and the capital adequacy ratio, however, suggest that the banking system has adequate cushioning to protect itself against potential risks, credit or otherwise. Minimum capital requirements were also raised late in 2008 for compliance by existing banks before end-2010 and fulfilment by aspiring entrants as part of the keener monitoring of the banking sector's expansion.[56] The NBC's on-site and off-site surveillance has been aimed at tracking down potentially problematic loan restructurings, but the central bank's thin supervisory capacity may be undermining the full reach of its supervision.

Figure 19: Interest rates, Jan 2006-Sep 2009 (for six months, fixed deposits in US$, average)

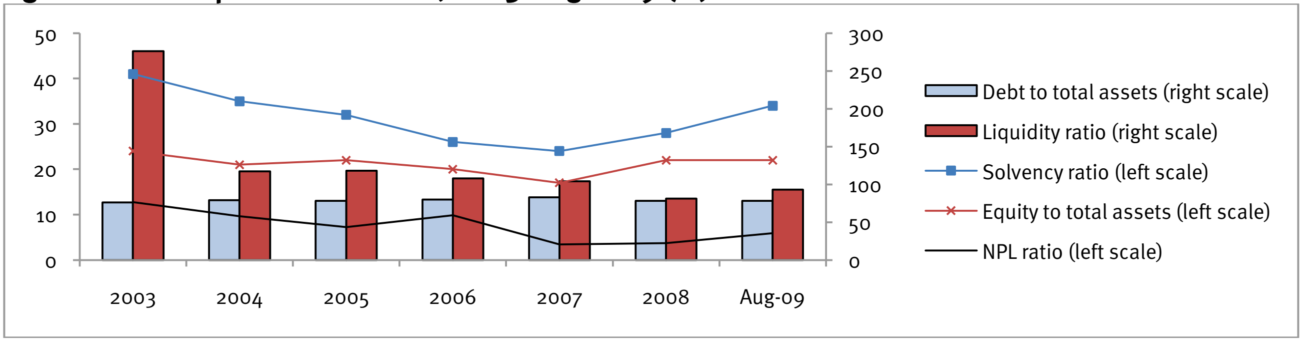


Source: NBC data.

55 See the government Prakas (Declaration) on Asset Classification and Provisioning in Banking and Financial Institutions issued in early 2009 (www.nbc.org). Owing significantly to the expansion of the banking sector in 2008 and the above Prakas, which also increased provisioning requirements, return on earnings per NBC data fell from 13.11% at end-2008 to 3.69% in August 2009. That of return on assets dropped from 2.88% to 0.82% over the same period.

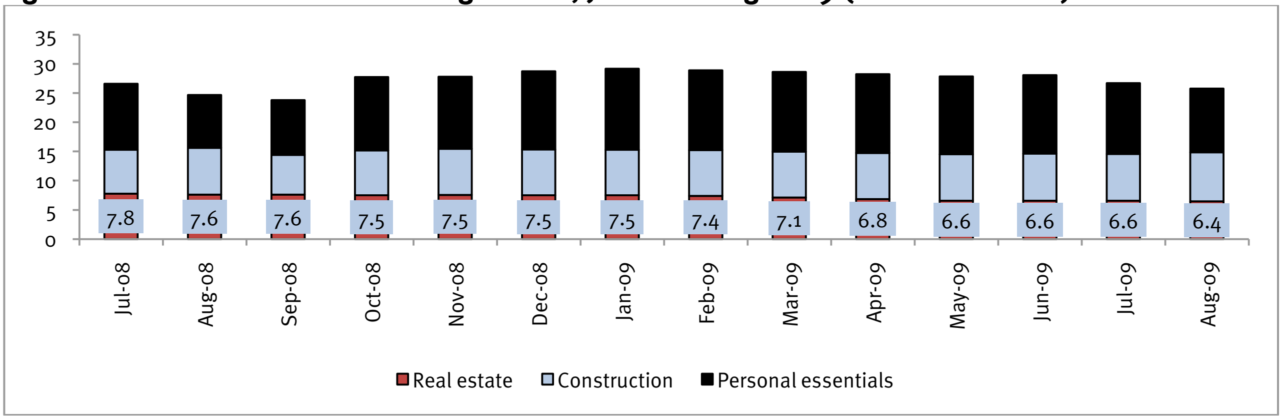
56 The NBC raised minimum capital requirements as follows: minimum of 50 billion riel for local commercial banks incorporated as companies; of 150 billion riel for commercial banks with shareholders; of 10 billion riel for local special banks incorporated as companies; and of 30 billion riel for special banks with shareholders (EIC, 2009b).

Figure 20: Bank prudential ratios, 2003-Aug 2009 (%)



Source: NBC data.

Figure 21: Commercial bank lending shares, Jul 2008-Aug 2009 (% of total loans)



Source: NBC data.

Not only commercial and specialised banks but also microfinance institutions (MFIs) have been feeling the knock-on effects of the crisis, after seemingly being unperturbed earlier on. Owing to their proximity to rural clients and offers of cheaper loans to small and medium-sized enterprises and the agriculture sector, MFIs have become increasingly popular over the years, although the sector remains small compared with the commercial banking system (Jalilian et al., 2009). As of August 2009, there were 20 licensed MFIs and 25 registered and over 60 unregistered non-governmental organisations (NGOs) extending microfinance (NBC data). Despite minimal exposure to sectors rendered riskier by the crisis, such as real estate and construction, MFIs nonetheless experienced greater strain as the crisis deepened and restrained the flow of foreign capital, on which the sector is heavily reliant.[57] Foreign lenders to domestic MFIs have reportedly tightened loans, causing cancellation of contracts in some cases, upping the cost of available financing and augmenting the burden on their clients as some or all of the interest hike is passed on (Chhun, 2009). The NBC-issued regulation permitting MFIs to secure a license to take deposits directly from the public serves the purpose of helping MFIs buffer the risks associated with heavy dependence on foreign funds.[58] More so than for commercial banks, prudential indicators seem to suggest that MFIs have been able to bypass most of the impacts of the crisis transmitted through the relevant channels. Their NPL ratio climbed to 2.7% in August 2009, from 0.4% at end-2008, but this remains a low level, especially considering how fast microcredit has expanded. Part of the increase is also attributable to the loan reclassification mandated by the NBC. Capital adequacy ratios also climbed from 20.4% in 2008 to 23.5% in August 2009.[59]

Even with the upturn for the banking sector as a whole by 2009 second half, and with the preventive actions of the NBC, concerns remain about the robustness of selected banks, a potential worsening of the NPL problem and downside risks in the external environment, such as a double recession.

57 According to NBC data, foreign capital constituted about 73% of the MFI sector's total paid-up capital.
58 According to the results of the stakeholder consultations, two such licenses have so far been granted.
59 According to NBC data and stakeholder consultations.

2.5 Poverty effects: The human face of the crisis

About 9 million and 14 million more people in East Asia and the Pacific are projected to remain in extreme and moderate poverty in 2009 and 2010, respectively. Cambodia is among the countries in the region expected to suffer from an absolute increase in poverty. Specifically, an additional one to four percentage points in the poverty headcount between 2007 and 2010 is expected (World Bank, 2009d). Of all the crisis impacts in Cambodia, the setback in poverty reduction efforts, which saw the poverty rate decline from about 45% in 1994 to about 30% in 2007 (Jalilian et al., 2009), has been the most unfortunate. Cambodia will now be more hard pressed to attain its Millennium Development Goals (CMDGs) by 2015 (An, C. 2009b).[60]

Job losses and greater underemployment in the country's crisis-hit growth sectors have certainly hurt the incomes of poor households. As mentioned earlier, the continued slowdown in the garment sector reportedly led to the permanent shutdown of at least 93 garment and shoe factories in the first 11 months of 2009 (Chun, 2009b). This in turn has led to job losses of at least 38,190. The suspension of operations of 60 factories has affected 35,337 jobs (May, 2009c).[61] The slump in the garment industry has a 'female and rural face', given how women coming from rural areas dominate the garment workforce.

Job losses and increased underemployment in the construction and tourism sectors have been of consequence as well. It is estimated that about 25,000 construction workers had lost their jobs as of April 2009 (Xinhua, 2009a), with working days in the sector reportedly dropping to 10-20 days a month for several months (World Bank, 2009d). Meanwhile, the tourist workforce is estimated to have contracted by 2.3% in 2009 (EIC, 2009b). Reported results of a survey of 72 hotels indicate that 30% to 50% of jobs had been shed at 12 hotels, with working hours decreasing also by 30% to 50% at the remaining surveyed hotels (Chun and Ith, 2009). These employment effects will have a bearing on other industries with linkages to the growth sectors.

Daily earnings surveys by the Cambodia Development Resource Institute (CDRI) substantiate claims about consequential declines of income across sectors over the period of the crisis. The survey results reveal that eight out of the 10 surveyed worker categories have experienced a significant fall in real daily earnings, although declines have occurred during different periods (Figure 22).[62]

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60 Cambodia reportedly is on track to meet three of the CMDG targets but is unlikely to meet three other goals. See C. An (2009b) as well as Cambodia's MDG profile at www.mdgmonitor.org/factsheets_00.cfm?c=KHM.

61 As mentioned elsewhere, 55 new factories reportedly opened within the same period, creating about 15,173 jobs (May, 2009c). Based on the same source, cited in Jalilian et al. (2009), job losses from September to December 2008 reached about 29,000. Added to the reported 38,190 and 35,337 jobs affected in the first 11 months of 2009, this gives a total of 102,527 jobs affected (both permanent and temporary), or more or less one-third of the total garment workforce. However, this may be inaccurate, as sources for the two figures are different. It is also believed that about 30,000 to 50,000 more jobs in the garment industry are at risk (Phen, 2009).

62 Since 2003, CDRI has been conducting four survey rounds a year (February, May, August and November, except in 2008, when the survey was conducted only in November) on daily earnings of workers from 10 'vulnerable' occupations. For the May 2009 survey, two occupations were added: tourist sector workers and migrant workers. See Tong and Pon (2009a; 2009b).

Figure 22: Average real daily earnings, Nov 2007-Nov 2009 (% change)

Source: Tong and Pon (2009).

Results of focus group discussions and semi-structured interviews conducted by CDRI[63] not only supported the above findings on employment and income reduction across vulnerable worker groups, but also revealed deterioration in other aspects of welfare, together with the portfolio of coping mechanisms utilised over the period of the crisis. Revelations regarding the implications of the crisis for children and women are particularly disconcerting, and warrant special consideration in the design and dispensation of social safety nets. Another finding of concern relates to the perceived lack of intensification of safety net provision and dwindling of informal safety nets over the period of the crisis. Importantly, discussion results cautioned against attributing the welfare deterioration exclusively to the effects of the global economic recession.[64] This noted, key preliminary findings of discussions are summarised in Box 1.

Box 1: Surviving the crisis – effects and coping mechanisms. Summary of results of CDRI's May and August 2009 FGDs and SSIs

Job availability and security: There has been a general reduction in job availability in both urban and rural areas (of approximately 30 to 40% over the past six months as per the May 2009 survey). This trend has been more pronounced in the garment, construction and rural rice farming sectors. Cuts in overtime work and working days for the employed have also been reported. As per the August 2009 survey results, some improvement has been detected in select groups; still, widespread dissatisfaction with job availability and security remains.

Wage rates and earnings: No dominant trend relating to wages has been found – some rates have increased, some have remained stagnant. In the case of the garment sector, different wage rates have been applied since the crisis struck. While some factories have retained monthly base salaries, some have shifted from base salaries to quota-based salaries, a move which likely has translated to significant reductions in earnings as work availability has become scarcer with the reduction in garment orders. Indeed, regardless of the trends in wage rates, discussion results uncovered a general reduction in earnings of vulnerable workers owing to the general decline in job availabilities and overtime work. The drop in earnings of garment workers has been found to be particularly sharp, disenabling said workers from remitting money to their families. By and large, these findings on earnings are consistent with those of the survey discussed earlier.

Labour market decisions: Leading the set of coping mechanisms utilised over the period of the crisis were the changes in labour market decisions of affected households and individuals. These changes include increased labour force participation of household members and employment shifts between formal sectors and/or from the formal to the informal sector. There were reported incidents of children being withdrawn from school and requested to work and contribute in household income generation. Terminated and underemployed garment workers have also hunted for and found jobs in the entertainment industry and low-skilled construction work. These repercussions of the crisis on children and women are particularly troubling and merit thoughtful consideration in the design and implementation of social safety net programmes.

63 CDRI conducts FGDs and SSIs with selected vulnerable worker groups and rural households. The two most recent FGDs and SSIs were conducted in May and August 2009 (So, 2009; Theng and Kem, 2009a; 2009b).

64 According to Theng and Kem (2009a; 2009b), other shocks (adverse weather conditions, higher input prices, pest outbreaks) have contributed to the overall welfare deterioration. So (2009) also identifies factors such as health-related risks, deaths in the family, fluctuating agricultural prices, natural disasters and divorce as key sources of vulnerability.

Consumption effect: With incomes and job prospects hurt, there has been a reduction in the quantity but more so the quality of both food and non-food (e.g. clothes, alcohol, cigarettes) consumption. For instance, although single garment workers have not reduced their food intake, they otherwise have had to reduce their consumption of non-food items on top of their remittances, the latter affecting consumption of dependent family members.

Migration and remittances: Contrary to popular assumptions, rural-to-urban migration has not abated. The discussion results revealed persistence in inflows of new rural migrants, who choose to try their luck in the cities despite being aware of the increased uncertainty involved in landing a job. There have also been accounts of return migration, however, whereby terminated garment workers, for instance, go back to their families in the provinces and help tend the fields. Such return migration has added more to the surplus of agricultural labour, has decreased wages and has cut down job prospects for farmers selling their labour in exchange for cash or non-cash payments/favours. Further, not only has the crisis caused sharp declines in remittance transfers to rural households, it has also set off 'reverse remittances', or remittances sent from rural households to members working in the cities, particularly in garment factories.

Debt burden: Between the May and August 2009 discussions, the debt burden resulting from deterioration in incomes, exhaustion of savings and other factors seemed to have been exacerbated. Debt is owed to MFIs, private lenders and people in social networks, and access to new loans has become much more difficult and expensive. Debt proceeds have been used to repay outstanding loans, finance migration of family members and even purchase basic consumption items such as food, among others. Heavy indebtedness seems to have forced some borrowers to 'disappear', that is, to leave their villages in order to escape debt collectors.

Utilisation of common property resources: Discussion results revealed greater pressure on common property resources and, by implication, increased threat of their depletion or misuse. This increased pressure has been attributed to such factors as rapid population growth, implementation of the privatisation policy and mismanagement of natural resources. Especially for those lacking assets, survival over the period of the crisis has banked more than ever on resourcefulness in securing food and other needs in scarcer common resources.

Social safety nets: Per the May 2009 survey results, no intensification of formal social safety net provision in view of the crisis has been reported. Common safety nets that the government (as well as NGOs) provide and that interviewed workers are aware of involve rural health services, free food programmes and construction jobs. However, discussion results showed no observation of increased provision of such formal safety nets in the past six and 12 months.

Some assistance from NGOs, such as the Cambodian Red Cross, has reportedly been received, but this is mostly one-time emergency support (say, after a natural disaster or fire), with limited geographical scope, and hence is unlikely to be able to sustain the recovery of the poor from the crisis or other adverse circumstances. Cash and in-kind assistance from political parties was received around the time of the elections (felt to be for the purpose of attracting votes) but not since then. No increased support from pagoda committees has been observed, although these remain active in taking care of the elderly in their local areas.

Other informal coping mechanisms have been tapped and proved crucial over the period of the crisis, as a result of fewer resources, heightened competition for scarcer job opportunities and some reported backlash in security. One of the distinct informal coping strategies conveyed was group travel and offer of services: higher incidence of robbery has prompted workers to travel and stay in packs for enhanced protection, and offering labour as a group has helped in wage bargaining. The perception survives that shocks are in a way community shocks, underpinned by trust and solidarity; family, patronage and other informal social networks have significantly helped in risk mitigation and provided insurance against the worsening of household poverty. Preservation of networks is deemed vital in obtaining additional debt, securing information on job availabilities and landing jobs during tough times. Construction workers, for instance, give value to maintaining good connections with foremen, as this enhances their chances of getting work. Sad to say, however, deterioration in the strength of informal bonds has been observed over the period of the crisis. A sense of individualism has heightened, as people and their households prioritise their needs first, having found themselves in a worse situation than before.

*Source*s: So (2009); Theng and Kem (2009a; 2009b).

3. Way to recovery

Bouncing back from the devastating effects of the crisis has taken tremendous and synchronised curative efforts at the global level. Response has generally been swift, with the Keynesian remedy to shocks, which caused a huge policy debate at the time of the Asian financial crisis, widely sanctioned and adopted in order to contain contagion effects and to insulate vulnerable sectors and groups. The nature and extent of the response has varied among countries, however, with those with more means able to discharge more costly and comprehensive recovery strategies than those with less capacity, such as Cambodia. Recovery in the short term for the country has rested largely on rebound in the external environment (push factors) and reactive responses, given limited room for manoeuvre. Cambodia will have consciously to drive more sustainable recovery by redressing weaknesses in pull factors and by proactively mapping its growth trajectory on the basis of a wider and more country-relevant economic base and more inclusive participation, as per the country's supposed governance agenda.

3.1 Recovery outlook and risks

The mix of external rebound and, to a lesser extent, a swift but limited set of internal policy responses has elicited signs of rebound in the Cambodian economy. In 2010, modest output growth of 3% to 5% is expected. At the aggregate level, recovery will be based on a less tentative footing, as some sectors pick up the slack in others. On a sector basis, however, recovery in some industries will be more timid and tentative, as this is contingent on developments other than the passing of the crisis aftershocks.

In the short term, hope of recovery in garments is pinned on a US and EU recovery riding on the back of renewed consumer spending. There is consensus, however, that such a recovery will be sluggish, with uncertain sustainability.[65] The possibility of a global double dip following withdrawal of stimulus programmes cannot be eliminated. This has led to calls for caution in planning official exit strategies. Consumer spending, which makes up two-thirds of the US economy, is expected to remain lukewarm, given rising unemployment, reduced wealth and higher propensity to save. Even assuming that US apparel retail sales have bottomed out, they are still expected to remain weak throughout 2010 (Research Recap, 2009). Tight job markets and implementation of exit strategies weigh heavily against consumption in Europe also. However, the rising clothing market share of Bangladesh and China during the crisis, at least in the US, demonstrates that cost competitiveness in the post-quota environment can counterweigh losses from preference erosion and the impact of the crisis, as consumers opt for cheaper goods. Hence, just as the downturn in the garment sector was incited by both the slump in demand and preference erosion, so is its recovery and the downside risks related to the two. With external demand beyond the influence of Cambodia's small economy, the longer-term growth of its garment industry rests largely on latching its competitive edge onto factors other than trade preferential treatments. This can be achieved through both cost and non-cost elements, and on a bigger portfolio of markets and products which can insure against shocks in one market or product group.

Recovery in the construction sector is linked to recovery from the domestic real estate bubble burst and the pumping in of public infrastructure investments. Optimistic views suggest that real estate activity will spring back to life soon enough, although prices will not be reverting to their pre-crisis levels and most transactions will remain cash based, as before. A pessimistic take on the situation suggests that the return to normality will take several years. The withdrawal of the liquidity that contributed to the bursting of the bubble has continued to restrain investors who, together with prospective buyers, seem to be taking a 'wait and see' approach with regard to how fast and certain the macroeconomic turnaround is. Excess housing, which became much more obvious as demand fizzled out over the

65 According to IMF (2009f), the US and the euro area are expected to grow by 1.5% and 0.3%, respectively, in 2010 after experiencing 2.7% and 4.2% contractions this year.

period of the crisis, is expected to level out. More focus is likely to be channelled into selling and maintaining existing dwellings than into building new ones.

Not least because it has proved more resilient than the other two growth pillars, recovery in the tourism sector is expected to come easier. Sluggish growth is expected for world tourism as a whole, with factors such as low inflation supporting a boost but uncertainties surrounding recovery, especially of advanced economies, dragging down growth (UNWTO, 2009). In the case of Cambodia, the expected increase in regionalisation, that is, tourism from within the ASEAN region, is hoped to cover the risks associated with tourism from more developed areas although, as mentioned, spending from the former is not expected to fill gaps in receipts that have followed a double dip in arrivals from higher-income countries.

Two specific risks to the recovery of tourism are the likely resurgence in oil prices and the threat of an H1N1 pandemic. The recession yanked down oil prices from historical peaks in mid-2008, but prices remain higher than the historical average, and the decline is expected to be confined to the period of the crisis. With the fundamental factors driving up oil prices unchanged (such as China and India's burgeoning energy consumption from the demand side and production constraints on the supply side), crude oil prices reaching the $100 per barrel mark are again highly likely. This impinges not only on the short term but also on the longer-term cost structure of airlines. Airfares as a percentage of travel costs are expected to increase significantly, and this will change travel behaviour (see Ringbeck et al., 2009). Meanwhile, although other Southeast Asian countries have already seen a decline in overall transmission of swine flu, Cambodia has continued to see an increase in its number of cases.[66]

The immediate outlook for agriculture is positive, extending its role from crisis buffer to pillar supporting stable short-term recovery. On average, agriculture grew by about 4.5% per annum in 1998-2007, but this growth has been unstable on a yearly basis. However, for the past four years, the sector has been growing at a stable rate of about 5%, and it is anticipated to manage the same rate of growth in the immediate term, give or take. Expansion of cultivation areas, higher yields owing to factors such as increased use of fertiliser and greater labour productivity have jointly driven growth, although the last two developments in particular have taken off from a low base. Several measures implemented by the government to harness the performance of agriculture over the period of the crisis include the establishment of the Agriculture Support and Development Fund[67] and the granting of a three-year tax holiday for agricultural investment projects,[68] as well as zero tariffs on importing agricultural materials.

Both traditional and newer risks challenge the reliability of agriculture's contribution to the economy. Significantly rain fed, crop production in Cambodia has always been susceptible to adverse weather conditions: abnormal weather patterns – too much rain during the wet season, a longer dry season, greater incidence of lightning strikes – have been experienced by vulnerable farming households and disrupted the planting cycle, reduced demand for labour at a time when it should be sufficient, led to crop failures and lower production and, ultimately, diminished household incomes (So, 2009; Theng and Kem 2009a; 2009b). Meanwhile, volatility of prices will remain a major risk. Uncertainty of global recovery promises price fluctuations, especially of pro-cyclical exportable crops, although higher than average price levels will benefit farmers and hopefully encourage investments in the sector. Although agriculture will remain key to poverty reduction – cross-country evidence has more than affirmed its favourable impact on the latter, transmitted via its direct output and employment benefits as well as positive feedback effects – whether the sector can still be a key driver of longer-term growth is of concern. The World Bank (2009a) estimates that, based on other countries' experience, agriculture in Cambodia is unlikely to grow more than 5% or so annually, contribute more than 2% to yearly output

66 Xinhua (2009f); www.who.int/csr/don/2009_11_06/en/index.html.

67 With initial funding of about $18 million, the use of this fund is to provide: 1) short-term credit for purchasing rice from farmers; 2) medium-term loans to rice processing firms; and 3) medium- and long-term loans for non-rice activities (Hun, 2009).

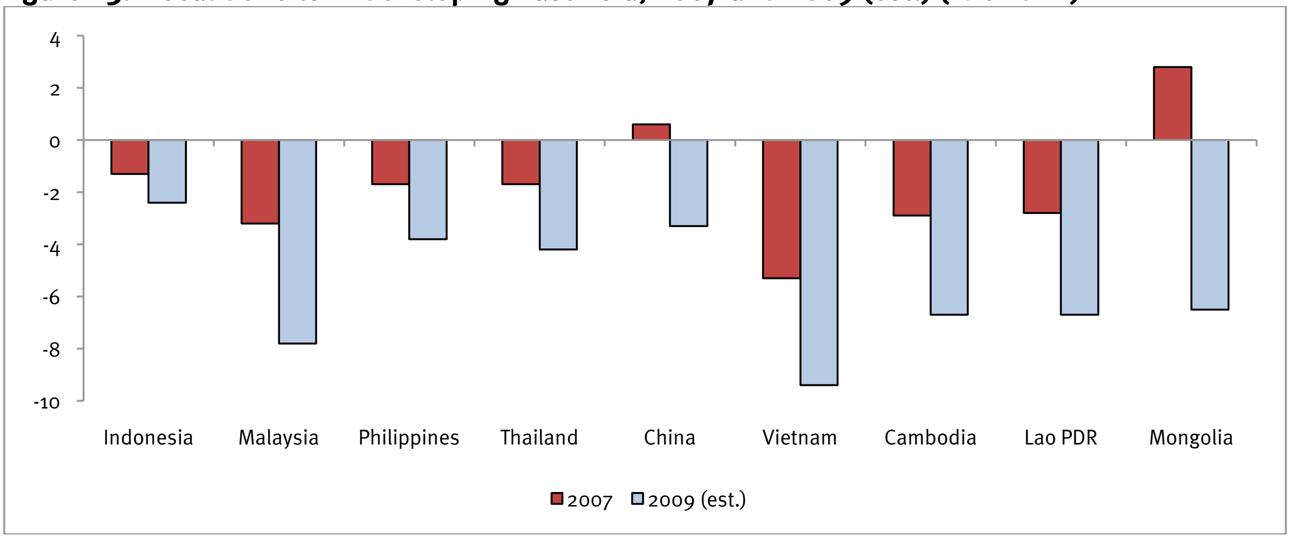
68 Income tax exemption for three years has been granted to QIPs in agriculture and agro-industry, with an initial capital of 4 billion riel or more (S. An, 2009b).

growth or account for more than 20% of GDP by the time the country reaches $1000 in GDP per capita. In any case, there is still ample room for boosting agricultural growth in terms of yield improvements, higher volume of exportable products and a more diversified set of crops, among others.[69]

3.2 Pro-recovery policies and strategies

Unlike during the Asian financial crisis, when use of government pro-cyclical policies faced resistance, most notably by the IMF, and stirred the famous debate between the institution and Joseph Stiglitz (Rogoff, 2002; Stiglitz, 2002), Keynesian interventions, unopposed, have virtually dominated global and country responses to the current crisis, prompting Stiglitz himself to cite the 'triumphant return of John Maynard Keynes' (Stiglitz, 2008). In all of developing East Asia, fiscal deficits rose between 2007 and 2009 as stimulus programmes were enacted (Figure 23). China, Singapore, South Korea, Malaysia and Thailand dispensed massive fiscal stimuli relative to their GDP, including public infrastructure investments, tax breaks and incentives, subsidies and rebates, expansionary budgets and increased social safety net expenditures (World Bank, 2009d). Unlike its neighbours, however, Cambodia has not had the capacity to enact a stimulus scheme over and above an expansionary budget and a few other measures, or even to run up a budget deficit equivalent to what has been necessary, owing to limits on external financing. Acknowledging the financing constraints tying the hands of the Cambodian government, concerns have nevertheless been raised with regard to the appropriateness and effectiveness of some of the strategies enacted within the government's capacity. Even more fundamental, the fiscal room for stimulus would arguably have been wider if longstanding problems such as alleged state capture and corruption (within and outside the bureaucracy), affecting tax and non-tax revenues and aid proceeds, had been stamped on. There is also arguably room for further borrowing. These critiques are of great merit but, as with all criticisms, must be put in perspective.

Figure 23: Fiscal deficits in developing East Asia, 2007 and 2009 (est.) (% of GDP)



Source: World Bank (2009d).

The global crisis has brought forth a mix of policies that correspond with specific aims: quick fixes to prevent further decline in aggregate demand and output, sustained stimuli to realise rebound and longer-term strategies and structural reforms to ensure sustainable recovery and prevent history from repeating itself. Strategies at various levels are not always compatible with one another, and this poses a real and serious dilemma for policymakers, especially at a time of crisis, when the public is unyielding in asking for immediate relief. For instance, Keynesian interventions admittedly come with a high price tag, as deficit financing can threaten debt sustainability and price stability as well as trigger agency problems. It is ultimately the public who will pay this price in the future and, this can prompt

69 With the right type of investment and support, agriculture in Cambodia has the potential to grow much faster and in a more stable fashion, contributing significantly and in a sustainable way to overall growth (Jalilian et al., 2009).

people to save, rather than spend today, which counterweighs the objective of government intervention under the Keynesian principle of boosting aggregate demand.

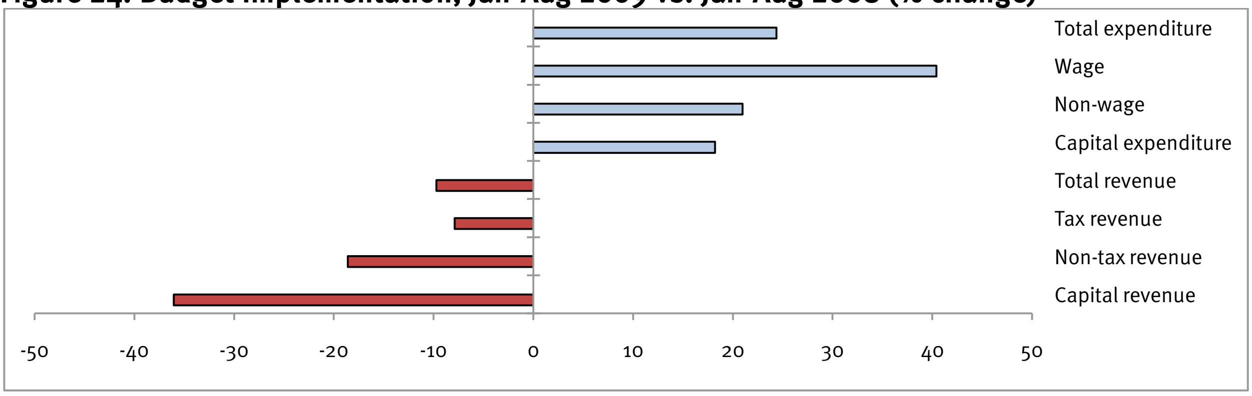
Policies such as selective tax holidays and subsidies have been criticised strongly for being distortionary without guaranteeing that the intended beneficiaries will indeed benefit, or that their intended objectives will be the purposes served in the end. While this critique has a strong basis, the cost of failing to implement such measures when actually needed is higher in crisis periods. The objective of preventing further job losses and shielding the poor and vulnerable from further hardship may weigh more than *laissez faire* in policy considerations. Further, from a political economy perspective, the cost of enacting policies that are sure to be destabilising when a country is already in a fragile state is extremely high. It is true that a crisis presents the ideal window of opportunity for change. However, by no means does this relegate the need and importance of pacing the change, nor does it connote that policy dilemmas evaporate even as the whole country unites in the aim of recovering from the crisis.

3.2.1 Expansionary budget

To accommodate greater spending, the budget deficit was allowed to expand to the target 4.3% or so of GDP in 2009. It was projected that the RGC would overshoot this target by about 2.4% by the end of the year (IMF, 2009f; World Bank, 2009d). There was optimism that the RGC would be able to attain its revenue targets for 2009, owing to continuing improvements in tax administration, arrear recovery and information exchange (IMF, 2009f; Naron, 2009; World Bank, 2009d). However, directly reflecting the slowdown in the real economy, plus losses resulting from the tax holidays enacted by the government in response to the crisis, tax revenues for the first eight months of 2009 were about 8% lower than 2008's collection for the same period. Meanwhile, total expenditures swelled by around 24%.

Most of the programmed increase in spending represents a higher defence and civil service budget for wages: this has elicited concerns. The completion of the 2009 draft budget law[70] came on the heels of the food crisis and at the peak of the Thai–Cambodian border military clash, when the severe impact of the crisis in Cambodia was yet to be fully realised. Initial appraisals actually considered East Asian countries such as Cambodia to be in a position to weather the crisis. There was not so much of an opposition to the military budget hike then as there is now, when there is already widespread awareness of the harsh effects of the crisis and the opportunity costs of channelling funds away from priority sectors. Further, the higher wage bill was arguably intended to enable extremely low-paid government employees to cope with the cost of living, then upped by the food and energy shocks (Naron, 2008). In any case, especially as 2009 went on and the deficit was permitted to widen against the target on full revelation of the crisis effects, the increase in spending also incorporated higher capital and non-wage expenditures. For the first eight months of 2009, the two were higher than 2008's figures for the same period by about 31% and 20%, respectively (Figure 24). Spending on priority sectors also increased, by approximately 16% over the same period (MEF data).

Figure 24: Budget implementation, Jan-Aug 2009 vs. Jan-Aug 2008 (% change)



Source: MEF data.

70 The 2009 Budget Law was passed in December 2008 but preparation of the draft started months before, of course.

Still, that military and civil service wage bills have been at the receiving end of a huge share of spending at the expense of priority sectors has been raised as a critical issue. As implied earlier, the proposed hike in the defence budget in 2010 has already been a focal point of policy critique, with total military spending reportedly accounting for about 14% of the proposed total budget, while the priority sectors of agriculture, rural development and water resources will account for a mere 5% (Cheang and Strangio, 2009). Analysed from the need to boost aggregate output, cushion the fall in household incomes and set off and sustain recovery from the crisis, this spending approach may not be as effective in funnelling more funds to automatic stabilisers and the priority sectors, which are expected to prop up growth and where most of the poor and the vulnerable are based. It is worth pointing out, however, that government employees, including military personnel, also receive low net salaries comparable with workers in other sectors, and giving them their long-awaited wage increase can similarly help in giving aggregate consumption a lift. Analysed also from the perspective of national defence, and assuming that this indeed is the intention, augmenting the defence budget gains justification, as the government insists (ibid).

Just as it has been stressed that the negative developments occurring over the period of the crisis are not entirely attributable to the external shock, so it must be recognised that the crisis has not eliminated the numerous other challenges all competing for the government's attention and resources. It is easy to criticise the appropriateness of enlarging the military and civil service wage bill at a time when the country must recover from the crisis – and this criticism indeed has solid basis – but it is not warranted not to acknowledge that the situation poses a real policy dilemma and that increasing public sector pay likewise will have positive effects on domestic demand, and in fact has been a longstanding suggestion to address the country's governance problems, which in turn affect its fiscal capacity. At the same time, it warrants highlighting that lack of alignment of the budget with national priorities is a problem that has been raised even well before and outside the discussion on the effects of the current crisis. Analyses of previous and existing budgets have found a lack of translation of the government's policy commitments to agricultural and rural development, among others, in budget planning and execution (NGO Forum, 2008a; 2008b).

While there has not been much of a crisis policy response from which to exit, timing the country's exit strategy is nonetheless of importance and, in addition, some measures may need to be maintained, as their purposes actually go beyond the requirements of the crisis. For 2010, running another expansionary budget, albeit with a lower deficit (5.5% of GDP, as per IMF recommendation – IMF, 2009f) is essential to moderate the impact of stimulus withdrawal on the one hand and to ease financing pressures on the other. Apart from allocation of the increased spending, another concern has been the domestic financing of the deficit, which puts price and exchange rate stability at risk (IMF, 2009f; World Bank, 2009d). Although current external debt levels are considered sustainable (IMF, 2009a), incurring more official borrowing against the backdrop of lower output growth and private capital flows can easily increase future debt distress.[71] While aid flows are expected to be stable, especially with Chinese aid in the picture, aid budgetary pressures and reforms may also change the face of aid in Cambodia. The lack of equity and bond markets also precludes the RGC from tapping other sources of financing.

3.2.2 Stimulating private capital flows

Revival of FDI and other investment flows to Cambodia must not be made to rest solely on recovery in the external environment, although it appears that the crisis has motivated the government to address some of its longstanding issues in this regard. As mentioned earlier, FDI flows gravitate towards the competitive edge of a country, as determined by some locational criteria, covering both firm-level and host country advantages. Short-term remedial measures implemented by the government to sustain its attractiveness to FDI to the extent feasible has come in the form of tax breaks in the garment and agriculture sectors and easing travel facilitation for the benefit of the tourism industry, for example.

71 According to IMF analysis (2009a), the net present value of external debt as a percentage of GDP under the scenario of lower output growth and smaller FDI flows or smaller FDI flows and higher borrowing costs breaks indicative thresholds.

Reaffirmation of the government's commitment to keeping the business climate amenable to investor interests may also have contributed to maintaining existing FDI and enticing replacement flows to some extent. However, sustainable recovery from the FDI slump, which means not only increasing the share of regional FDI flows but also diversifying the receiving sectors, entails the resolution of the longstanding bottlenecks that increase the costs of doing business in the country.

Cambodia's overall competitiveness ranking lags behind those of its GMS neighbours, Thailand and Vietnam.[72] The latest investment climate survey identifies the topmost business constraints in Cambodia as corruption, macroeconomic and regulatory uncertainties, corruption-related anti-competitive policies and high cost of power (World Bank/IFC, 2009). The government has undertaken major efforts in response to these constraints, ranging from building up the national grid system (World Bank 2009a), to implementing public financial management reform, to drafting an anti-corruption law, but the success rate among the initiatives has varied and, in certain areas, progress has been noticeably slow, arguably because of a lack of political will. Capturing the optimum gains and positive externalities from FDI flows while reducing their volatility also necessitates deepening financial markets (ADB, 2009b) and investing more in human capital development. As mentioned, the banking sector currently dominates the domestic financial system. The institution of other financial intermediaries, such as stock markets, is important, but the timing poses issues. There are other sector-specific barriers to greater FDI flows; some of these are touched on in passing in the discussion on policy responses in the garment and tourism sectors.

Stimulating international remittance flows is likewise not straightforward. One proven way of increasing remittance transfers is reducing remittance costs, which can be achieved by introducing more competition in the money transfer industry. The ease of doing this varies, however (greater for high volume corridors such as Thailand to Cambodia and less for lower volume corridors). In any case, other means of containing remittance costs can be enforced, such as compelling transparency in pricing, and this is achievable as a short-term strategy. Another complication regards how cracking down on informal remittance mechanisms as part of the short- or longer-term policy mix can do more harm than good. For obvious reasons, irregular migrants (a group sizeable in number in Thailand, for example (Chan, 2009; IOM, 2006)) are hesitant to tap formal channels; restraining informal mechanisms may therefore only increase the cost and risks associated with utilising these.

3.2.3 Monetary easing and financial deepening

The underdevelopment of Cambodia's financial sector can be credited for the country's immunity to the first-round assault of the crisis – in this sense, its handicap worked as a blessing in disguise. However, such underdevelopment has also acted as a constraint to the ability of the government and financial institutions to respond more effectively to the second-round effects. While the NBC's responses to the strain experienced by the financial sector have been timely and well deserving of praise, the capacity of the central bank to do more has been restrained by the heavy unofficial dollarisation of the economy.

In prominent cases such as those of Latin American countries, dollarisation emerged out of a desire to avoid a repeat of past currency crises, which had led to painful exchange rate devaluations, banking collapse and output declines. Dollarisation has also followed repeated episodes of high and chronic inflation that resulted in massive loss of confidence in the local currency and of the credibility of the central bank.[73] In both cases, the foreign currency has become more attractive as a store of value and means of payment, resulting in asset and currency substitution. The origins of Cambodia's dollarisation differ somewhat from these experiences. The influx of aid and other external transfers following the country's re-emergence from isolation in the early 1990s commenced the process. Not long after, the country experienced nearly complete *de facto* dollarisation, sustained by the same supply-side

72 According to the World Economic Forum (WEF) 2008-2009 Global Competitiveness Index rankings, Vietnam and Thailand ranked 70th and 34th, respectively, out of 130 countries (one country included in the 2007-2008 ranking was excluded). Cambodia ranked 109th. According to the World Bank's Ease of Doing Business rankings, Vietnam and Thailand ranked 93rd and 12th, respectively, out of 183 countries. Cambodia ranked a far-off 145th (WEF, 2008; World Bank/IFC, 2009b).
73 See, for instance, Alvarez-Plata and Garcia-Herrero (2008); Antinolfi and Keister (2001); Meyer (2000).

dynamics together with a lack of confidence in the use of the riel, the national currency (de Zamaróczy and Sa, 2002).

With the rapid growth in the past decade, and given the actual and perceived costs of dollarisation, Cambodia's characteristic as a bi-currency economy has been put into question, with even the sovereignty issue raised as a critique. The global crisis is also inevitably asking for a reassessment of the issue, given that the costs of dollarisation would have been very pronounced if the crisis had impacted the financial system more than it has. While a full exploration of this topic is beyond the scope of this paper, three important points must be made. First, the nature of Cambodia's current dollarisation is not straightforward: it is composed of both 'good news' and 'bad news' dollarisation, that is, it reflects both the country's economic takeoff in the past decade and the underdevelopment of the domestic financial sector, institutions and legal framework, as well as hysteresis (CDRI, 2009d). In addition, it must be noted that the case for or against dollarisation is likewise not clear cut. The claimed chief costs of dollarisation include loss of seignorage, loss of the central bank's ability to act as lender of last resort and loss of independent monetary policy, all of which constrain ability to respond to external shocks. Without needing to mention the benefits of dollarisation, these losses must not be assessed by themselves, that is, without taking stock of other considerations, not least of the factors that can and do moderate them. For instance, the fiscal benefits of macroeconomic stability emerging from the beneficial effects of dollarisation (lower inflation, interest rates and currency risk) can well counter the seignorage loss. Further, there are other sources of liquidity than the central bank, and this cushions the feared greater liquidity and solvency risks associated with dollarisation in times of crisis. When monetary institutions are also facing credibility problems, the scenario minus dollarisation can be more problematic and misses out on the benefits of dollarisation's role as a commitment device.[74]

With the above in consideration and other constraints, such as thin supervisory capacity, there has been an inevitable limit to what the NBC can execute in response to the crisis. However, what it has been able to do has proven timely, pre-emptive and worthy of recognition. Especially with the global crisis coming just at the heels of exceptionally high price levels, the central bank has had to time monetary easing carefully with inflation easing. With prices having come down from their high levels, the NBC slashed the reserve requirement from 16% to 12% to help inject more liquidity into the system. It removed the cap on real estate lending to stem the effects of the bubble burst. It created an overdraft facility (although backed by limited amount) to help solvent banks struggling with temporary liquidity shortages. It issued a tougher regulation on asset classification and provisioning to diagnose more accurately the NPL situation and to ensure that banks were in a better position to cover potential losses. It toughened regulations on reporting of major exposures to better assess credit risk concentration. It strengthened regular and targeted off-site and on-site surveillance. It has started granting licenses allowing MFIs to directly access public deposits.

Potential loopholes on, say, NPL monitoring must be sealed, however, as misled diagnoses lead to a false sense of security, which in turn results in neglect, or off-track responses. More than quick fixes directly responding to the short-term requirements of the crisis, bigger steps aimed at deepening the financial system are also necessary to fortify the capacity of the sector to withstand an external shock or the risk of itself being the source of a crisis.[75] The financial structure remains immature, with a limited number of financial instruments, an underdeveloped interbank market, absence of official deposit insurance and rating agencies and limited credit information sharing, among others (Pak et al., 2008). The NBC has been weighing its choices in terms of addressing these deficiencies, carefully considering the pros and cons of the possible remedies and the system's absorptive capability. Internally, it is also trying to build the capacity of its manpower, given the resources available to it.[76]

74 See, for instance, Alvarez-Plata and Garcia-Herrero (2008); Antinolfi and Keister (2001); Baliño et al. (1999); Chang and Velasco (2002); Edwards and Magendzo (2003); Schmitt-Grohé and Uribe (2000).

75 See Chhun (2009); EIC (2009b); Jalilian et al. (2009); Keat (2009); Nguon (2009b). See also the NBC website (www.nbc.org.kh/index.asp). The above statements are also based on results of stakeholder consultations.

76 Based on stakeholder consultations.

The financial infrastructure also noticeably lacks a capital market. While this has shielded the country from some major direct and contagion crisis effects, it also has constrained the generation of additional stimuli for pump-priming the stale economy. Stock exchange plans, circulated from 2008, have caused quite a stir, not least because of the mixed messages generated by the government committing to launching a bourse while crisis grips the country (Jalilian et al., 2009). The exchange, governed by a joint venture agreement between the RGC and the Korean exchange, is reportedly now set to open in the first quarter of 2010, although without company listings (Nguon, 2009e). The timing issue must go beyond the repercussions of the crisis, or when the exchange building will be completed, however. The RGC's Financial Sector Blueprint 2001-2010 and Financial Sector Development Strategy 2006-2015 set out some preparatory steps, including enactment of necessary laws and regulations and establishment of the Securities and Exchange Commission, but many of the prerequisites remain missing. A basic aim of capital market development is to capture savings, but the domestic savings rate remains low, partly because of the still low level of public financial literacy and confidence in the system. Other problems include a narrow investor base, problematic compliance with transparency and corporate governance standards, which affect the size of eligible issuers, and absence of security intermediaries. Operating the exchange without dealing with these is arguably a premature move.

3.2.4 Growth sector-specific strategies

Garments

Rebound of exports and overall trade relies largely on a rebound in the garment sector. Supported by the findings of the Diagnostic Trade Integration Study (DTIS) 2007 (MoC/UNDP, 2007) and a Revealed Comparative Advantage (RCA) analysis made by the World Bank (2009a)[77] (although these analyses were done prior to realisation of the severe impact of the crisis and preference erosion), garments keep their high export potential and are necessary but not sufficient export drivers of sustainable recovery from the global shock. Given fiscal constraints, government responses catering specifically to the short-term needs of the industry over the period of the crisis have been limited, and have included suspension of the advance profit tax (Cham, 2009b; May, 2009a) and a reduction of employer contributions to social security.[78]

Despite the known revenue losses and distortionary effects of tax incentives (Klemm, 2009), most, if not all, Keynesian responses implemented across the globe in reaction to the meltdown have involved such incentives.[79] In this globalised world, placing well in the tax competition has been a dominant motivation for the extension of such privileges. This applies not only during normal circumstances but more so during crisis periods, when keeping investors in and business operations going assume even greater urgency. Choice and design of tax incentive, however, have a bearing on the effectiveness of such incentives. Suspending payment by garment firms of the advance profit tax was meant to help factories manage their cash flows and contain losses, and firms reportedly found relief in this policy action. However, notwithstanding the distortions that this untargeted, non-discriminatory policy may have led to, other strategies would arguably have been more effective, such as an investment tax credit or tax credit on training expenditures. However, these alternatives unfortunately create distortions too: it is difficult and premature to gauge the effect of tax responses when they are implemented versus when they are not, more so in crisis periods when immediate relief is a political demand. A different issue touching on tax incentives refers to accusations that garment factories have been using the economic downturn as a pretext to close down only to reopen under new names (S. An 2009a). The legal and institutional grounds that make this opportunistic behaviour possible must be investigated.

Alongside quick fixes, the government, in tandem with GMAC, has been working on more sustainable solutions to restore and preserve the strength of garment exports. A key lesson from the differentiated impact of preference erosion (with competitors Bangladesh and China gaining more market share in the

77 Based on the model of Hausmann et al. (2006).

78 The government has reduced factory management contribution to safety net pensions from 0.8% to 0.5% of wages per month for the period 2009-2010 (Cham, 2009b; May, 2009a).

79 See Deloitte (2009) for a brief survey of tax responses to the crisis across the globe.

US while Cambodia slips) is that the country must focus on improving factors underlying cost competitiveness other than preferential access. However, it appears that most efforts are still devoted to securing replacement preferential arrangements or improving conditions under existing preferential schemes. The RGC and GMAC have been bent on lobbying for duty-free access to the US market and greater flexibility of the Rules of Origin (RoO) requirement under the Everything But Arms (EBA) initiative. It is not only that the relevant trade bill in the US Congress has a slim chance of passing or that, if passed, Cambodia will not necessarily be among those favoured, given strong supporters of, say, African garment producers.[80] These requested concessions, if granted, will also extend to fellow competing LDCs (Green, 2009a; 2009b) and, by the end of the day, if the supply-side constraints facing Cambodia's garment sector are not remedied, it will still lose out or fail to maximise the benefits under the non-reciprocal arrangement.

Bottlenecks both inside and outside the firm will have to be addressed. Direct labour costs have been found to be the highest of all costs incurred by garment factories in Cambodia, although wages remain comparably low. Still, higher productivity of workers in competitor countries more than compensates for the disparity in pay. Another important difference is that, in Cambodia, entitlements make up a significant part of workers' income, while incentive pays are low. In Vietnam, incentive pays are reportedly common (Nathan Associates Inc. and Werner International, 2007). This is one specific area that can be examined. To their credit, the RGC and private stakeholders have acknowledged other vital steps towards improving the competitiveness of the country's garment exports, including scaling up its garment outputs and working on building the necessary backward linkages, including an upstream textile and accessory industry. However, previous discussions imply that the heavy foreign ownership of the industry may pose an inherent obstacle to the achievement of these plans. Simply put, they may not be part of the global strategy of the local firms' parent companies overseas, as other countries have made significant headway in the relevant upstream industries or more value added products, and can therefore deliver these products more efficiently and at lower cost. At this juncture, the real challenge facing the RGC seems to lie in increasing local investment in the industry on a level playing field, that is, while sustaining its policy of non-discrimination. For example, the Bangladeshi garment industry was set up with foreign investment but was in time taken over by local capital.

Needless to say, the crisis has also emphasised the importance of market diversification, and locations such as Japan,[81] Russia, the Middle East and non-traditional European markets present opportunities. Regional agreements are expected to facilitate this process. Addressing top business constraints, corruption and high power costs are other key items on the agenda. Corruption, in addition to increasing transaction costs, skews the playing field in favour of those who tolerate it. Crises present rare windows of opportunity for change but, realistically, it is important to pace this change and moderate expectations temporarily when severe crises put countries in a fragile state. Even though corporate responsibility seems to have taken a backseat in buyers' purchasing decision criteria recently, with suppliers coming face to face with less demand, this source of differentiation of the domestic garment industry will remain a unique anchor of its competitive edge and must not be abandoned.

Tourism

The policy mix administered to rekindle tourism in the country has constituted a relatively bigger, more diversified and more visible set of responses. In a nutshell, the immediate strategy seems to have been to focus on reviving the number of tourists coming in through regionalisation and vamped-up marketing; the longer-term strategy refocuses on enhancing the quality of the tourists (e.g. targeting better spenders) and products and gearing up to tap other tourist sites and markets. Travel facilitation, intensified marketing and cost reductions were at the forefront of the quick fixes. The government kept the visa exemptions for fellow GMS countries Vietnam and Lao PDR and ASEAN countries Singapore, Malaysia and the Philippines. It has opened and is set to open new border checkpoints and waterways.

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80 Expert opinions believe that the proposed Trade Act of 2009 will meet the same fate as the proposed Trade Act of 2005 and Trade Act of 2007, both of which failed to get passed (Gillison, 2009; Green, 2009a; 2009b).

81 There have reportedly been concrete indications of interest by the Japanese in taking more orders from Cambodia and other Southeast Asian countries. The ASEAN-Japan Partnership Agreement is expected to facilitate this process.

It re-launched the national carrier, Angkor Air, and enabled direct flights between Cambodia and the Philippines. It aired international advertising campaigns and had plans to air the same in targeted national markets. It organised showcasing activities and established provincial tourism offices. Meanwhile, a 10% to 20% reduction in the price of tourism services, including accommodation, food and transportation, has reportedly been undertaken by the private sector, with 30% to 40% of travel agencies operating in the country having slashed prices of package tours (MoT, 2009).

Longer-term measures aimed at upping the quality of tourism, improving tourism infrastructure and diversifying markets have already been set in motion. As mentioned, the competitiveness of Cambodia's visitor economy lags behind that of other countries, owing to infrastructure hurdles and weaknesses in the regulatory and business environment. The enforcement of quality-enhancing regulations is therefore timely. These regulations have imposed quality standards on hotels, resorts and manufacturers and sellers of souvenirs. Simultaneously, the RGC has initiated maintenance and repair works that have a direct bearing on travel facilitation. For instance, national roads leading to key border checkpoints have reportedly been restored. Tapping other tourist sites and non-traditional tourist markets has also been high on the agenda, although such diversification seems to have been the hardest to concretise. Angkor Wat specifically, but the Siem Reap–Sihanoukville–Phnom Penh triangle generally, remains the key pillar of tourism. Given the underdevelopment of other areas and the traditional fixation on Angkor Wat, both of which discourage investors from undertaking risks and venturing into other areas, it will take time and a great deal of persuasion by tourism reformers to realise this objective. Creating niches in non-traditional markets also entails more marketing. To its disadvantage, Cambodia's reputation as a country spoiled by civil war, political infighting and massive corruption resounds loudly in the international community. This is not just a problem of public education. The government has to prove that it has genuinely made progress in instilling stability and improving governance. The Thai–Cambodian border tensions, one of the non-crisis related factors contributing to the tourism downturn, have tainted this assertion.

Construction

Given its links to residential and commercial real estate development, recovery in the construction sector is connected to a pickup in real estate activity. Reacting to the joint impact of the burst bubble and the crisis, the NBC early on approved the quick fix of scrapping the 15% cap on bank lending to the real estate sector once inflationary pressures subsided. However, this appears to have had a restrained influence on actual bank lending, as real estate credit as a percentage of total loans has continued its decline, as shown earlier.

What is hoped to be more sustainable support to the competitiveness of the sector relative to Cambodia's neighbours lies in paving the way for foreign ownership of real estate in the country. In the middle of this year, a sub-decree permitting co-ownership of individual apartments or condominium units was passed. This allows for the formulation of a law granting foreigners the right to own private units from the first floor up of co-owned buildings. A draft of this law has reportedly been the subject of consultation with the public and the private sector (CDRI, 2009d; Trading Markets, 2009). Mirroring concerns in Vietnam, where rules on foreign ownership of property are currently being clarified in a bid to rouse the listless real estate market (Deshayes, 2009; Property Wire, 2009a), a central concern regarding this move is how foreign ownership may step up speculation in the property sector and further affect the affordability of housing and other properties for less fortunate Cambodians. It is therefore of importance that appraisal of the proposed legislation naturally incorporates assessment of the accompanying regulation.

Investment withdrawal and overall deceleration in real estate activity also set the tone for the enforcement of another set of new regulations in 2008, with the end of protecting buyers from errant real estate developers and agents. Specifically, the new regulations reportedly set the following requirements: 1) deposit of 2% of total project values at the NBC; 2) opening of an account with a commercial bank in Cambodia where payments from buyers will be placed; and 3) obtaining government approval before developers can gain access to their funds in the bank. This departs from the practice of needing to get only written permission from the Ministry of Land Management, Urban

Planning and Construction (MoLMUPC) and an investment license from the Council for the Development of Cambodia (CDC). The new regulations reportedly also now require real estate agents and developers to secure licenses for renting and selling from the MEF, for a price dependent on the project value. However, these new regulations met such strong opposition that the newly formed Association of Cambodian Real Estate Developers had as its first task to relay its concerns on the matter, that activity in the sector, already downtrodden, could become more constrained. The government has been asked at least to defer the policies, to implement them in a graduated manner and to qualify further the provisions to reflect the distinction between developers who collect payments before construction and those who do not (C. An, 2009a; 2009b; CDRI, 2009d; Property Wire, 2009b; The Mirror, 2009). Meanwhile, without needing to wait for things to ramp up in real estate or for foreign investors to get over their 'wait and see' approach, the construction sector can get a boost from public infrastructure investments. Capital expenditures financed by donor assistance, specifically Chinese aid, have seemingly been providing this needed lift.

Social safety nets

An estimated less than 1% of Cambodia's GDP on average goes towards social safety nets, a figure lower than the average spending by developing nations of 1% to 2% of GDP (Broderick, 2008). There is currently no comprehensive social safety net system in Cambodia, even though social protection has been made an integral and core part of the government's overarching development plans. Social interventions have so far been fragmented, uncoordinated, limited, episode driven, donor specific and unsustainable (CARD et al., 2009). Joining the host of already existing social safety nets,[82] the government over the period of the crisis has created the Government Fund for Short-Term Vocational Training[83] and the Fund for Self-Employment,[84] with funding support from donors. To ensure a greater degree of sustainability, these safety nets must at least be operated under the umbrella of a comprehensive and cohesive social safety net system. In a recent move, the government has reportedly been examining how to place social protection programmes under the purview of the Inter-Ministerial Technical Working Group on Food Security and Nutrition. A national social safety net strategy was also reportedly set to be put in place by the end 2009 (CARD et al., 2009).

The significance of dealing with the weaknesses of current social safety net provision cannot be overemphasised, as a sizeable number of Cambodians are exposed to poverty-related and other risks such as landlessness, food insecurity and health-related problems. The global crisis has certainly been an eye opener as to how imported shocks can heavily impact the plight of vulnerable people and households in open economies. The findings of CDRI's FGDs and SSIs lend concrete proof to this statement. As stressed earlier, the discovered impact of the crisis on women and children of poorer groups is particularly troubling, and illustrates the demand for targeted social safety nets that prevent the deterioration of their welfare resulting from, say, forced labour force participation in unlawful, degrading and risky activities. Also, although provisions under existing safety net programmes have reportedly been dispensed over the period of the crisis (World Bank, 2009d), findings of CDRI's FGDs and SSIs revealed a perceived lack of intensification of such provision, badly needed to help poorer groups cope with their worse income situation and greater overall vulnerability. Apart from suggesting the obvious funding liabilities, this also suggests gaps in the design of safety net programmes. Finally, it is important to note that, although informal social safety nets play a useful role in risk mitigation, they cannot be and are not substitutes for official safety nets. As demonstrated by the finding that individualism has heightened over the period of the crisis, thereby affecting the reliability of informal networks, informal social safety nets can easily become anti-cyclical.

82 Other social safety nets are being provided under the following: the Health Equity Fund; the Food Emergency Programme; Food for Work (World Food Programme (WFP)); the Mother and Child Health Programme (WFP); school feeding programmes; the National Social Security Fund; the Emergency Food Assistance Project; and Tonle Sap Poverty Reduction and Smallholder Development (S. An, 2009b; CDRI, 2009d; Jalilian et al. (2009).

83 This fund, with an initial budget of $6.5 million, is being used to finance short-term vocational training of about 40,000 laid-off and jobless workers from the agriculture, industrial and services sectors (CDRI, 2009d; Phen, 2009).

84 This fund, initially worth $1 million, is being used to provide credit to accomplished trainees who wish to and can do business or any initiative by themselves (CDRI, 2009d).

4. Conclusion

Recessions are painful eye openers. This does not necessarily mean that action will follow, but crises do always uncover a handful of lessons that it is essential to consider. In the case of Cambodia's experience with the global crisis, at the top of the list appears to be the fact that the crisis has been only part of the problem. In its haste to have a taste of development and to experience what other countries have experienced, perhaps, Cambodia has initiated the takeoff of its economy without setting out the specific destination or undertaking all or even most of the necessary preparations. Any takeoff that is so fast and so badly equipped may be exhilarating initially but is bound to end up in a hard and backbreaking fall.

This follow-up report has detailed Cambodia's seismic shift in growth performance over the crisis period. Although the crisis may have had permanent effects, these may well have come about sooner or later anyway, given the unsustainable fashion that the economy was growing in. Nevertheless, the aftermath of the shock is presenting the opportunity to assess past mistakes, to fill in the gaps and to steer the country's growth back in a more sustainable direction. 'Headwinds' were largely responsible for the previous takeoff. This time, letting the winds take the lead in determining the country's destination will not do. As emphasised earlier, sustainable recovery does depends in part on a rosier external environment, but more so on improvements in pull factors. Longer-term growth entails going beyond traditional dependencies and breaking cocoons of protection that have so far generated a false sense of security. Focus must be directed towards vital but neglected aspects of competitiveness and, throughout the process, partnership between the government and the people is critical. Political will and public vigilance are both needed to set in motion long-awaited reforms. Meanwhile, to avoid another hard fall, it is crucial to steer away from shortcuts. Yes, change is necessary, but success will be more attainable if the course is taken slowly and with perseverance.

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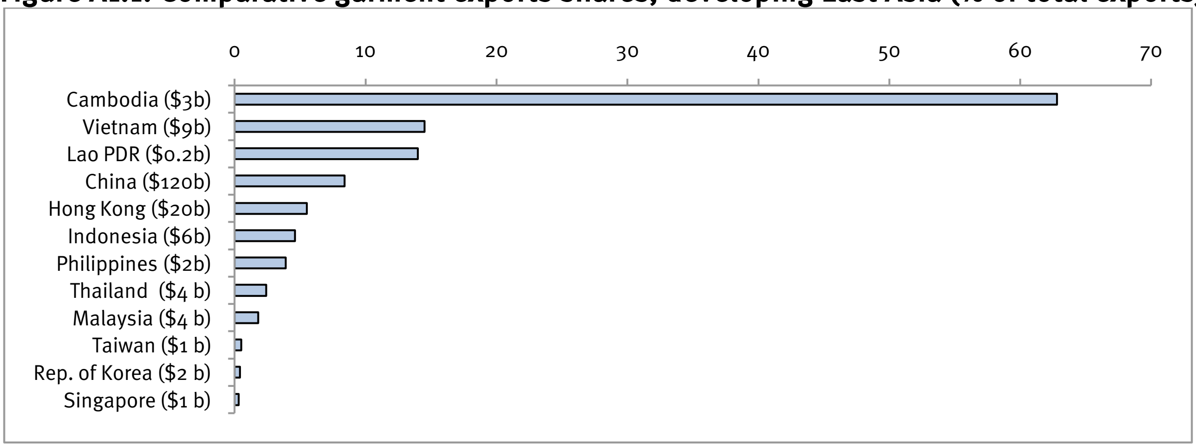
Annex 1: Cambodia's garment industry – uniqueness turned vulnerability

Cambodia's garment sector is unique in the world. No other country is as dependent as Cambodia on a garment industry. The sub-sector is more than 90% foreign owned, concentrated on one export market, with low value addition and lack of domestic linkages, accounting for the majority of manufacturing sector employment, struggling with corruption as the investors' number one concern and yet heralded at the same time as a global model of labour standard compliance. Interestingly enough, this very uniqueness has shaped the impact of the global economic crisis on the industry and has been impinging on the sector's shaky path to recovery (CDRI, 2009d).

Dominating the limited export mix

Within East Asia, Cambodia's export sector is most dependent on garments. In value terms, the country's garment exports of $3 billion (1.8% of total exports from East Asia) are meagre compared with China's, which amounted to a huge $120 billion in 2008 (70% of the same total). Cambodia's garment exports are also lagging behind those of its GMS neighbours, Vietnam and Thailand, which shipped approximately $9.1 billion and $4.3 billion worth of garments respectively in 2008 (Figure A1.1). Relative to global totals, Cambodia's garment export sales constituted a mere 0.8% of global trade in 2007.[85] In terms of export share, however, Cambodia far outranks its East Asian counterparts. Clearly the leading export sector, garments' share in total exports was at the 70% to 80% level before dropping to somewhere between 60% and 65% in 2008. The gravity of this export dependence becomes apparent when set against the export shares of garments in its East Asian neighbours, the highest being at only 15%. The garment industry of Bangladesh shares some aspects of the uniqueness of Cambodia's garment sector; for this reason, the two have often been compared and considered as each other's closest competitor. As in the case of Cambodia, garment exports of Bangladesh experienced undisrupted growth following the industry's takeoff and have come to account for about three-quarters of the country's total exports, with the US and EU responsible for about 90% of the total. Notwithstanding the fact that there are critical differences between the garment industries of the two,[86] with such differences having important implications for the post-crisis revival of each, both are clearly confronted with the challenge of expanding and upgrading their export base on top of dealing with a cost structure dependent on a shrunk competitive advantage based on preferential access.

Figure A1.1: Comparative garment exports shares, developing East Asia (% of total exports)



Sources: UN ComTrade; World Bank (2009c).

85 Figure calculated using data from WTO International Trade Statistics.

86 For instance, Bangladesh's garment industry is mostly locally owned and dominated by small firms, whereas that of Cambodia is mostly foreign owned and dominated by larger firms (e.g. Yamagata, 2007). There are also quality differences between the exports from the two countries that should be considered.

Export diversification and sophistication are two strategies proven not only to stimulate and accelerate growth but also to sustain it (Berg et al. 2008; Hausmann et al., 2005; Hausmann et al., 2006; Johnson et al., 2006). Especially as the global crisis has unravelled the high risks embedded in the growth pattern that Cambodia has sustained in the past two decades, expanding the country's export portfolio is clearly a pressing mission that needs decisive implementation. Fortunately, there have been technical studies that on the whole suggest how specifically this task may be embarked on.[87] Lacking the necessary policy nudge, the persistence of the current structure has led to and will continue to encourage inefficiencies and risk avoidance behaviour, which are not good for the country's growth ambitions.

Market concentration

There is a clear lack of diversification in Cambodia's garment industry, in terms of both market and, for later discussion, output. Trade route is dominated by exports to the US, which accounted for about three-quarters of total garment export values pre crisis on average. The EU accounted for most of the remaining share (Figure A1.3). This trade pattern has resulted more from the leading influence of push factors, with earlier export strategies more reactive than proactive, adjusting to external requirements rather than to a broader national trade development strategy.[88]

Indeed, the takeoff of Cambodia's garment industry can be traced back to the signing of the MFA back in the 1970s, which allowed mainly the US and the EU and other European countries to extend quota restrictions on garment shippings from then established garment exporters such as Asia's newly industrialising economies (NIEs). This created a positive spillover and thereafter the fourth production shift[89] (Figure A1.4) in favour of the latecomers in the garment industry.[90] Established manufacturers in the quota-controlled countries tapped countries like Cambodia as intermediaries in order to escape the quotas, while Western buyers used their factories as well to escape the import restrictions. The conclusion of the Uruguay Round and the establishment of the WTO in 1995 saw the formal replacement of the MFA with the ATC (although this was also simply called the MFA). The ATC mandated the phase-out of all import restrictions in 10 years' time and, as such, in essence went against the

87 See, for instance, the DTIS (MoC/UNDP, 2007) and the World Bank RCA (World Bank, 2009a).

88 The emergence of Cambodia from isolation at the end of the Cold War came with the daunting task of reinstituting the basic foundations of a free market economy. The first national plans post-Cold War (i.e. the National Programme to Rehabilitate and Develop Cambodia and, on the basis of this policy document, the First Five-Year Socioeconomic Development Plan 1996-2000 (SEDP I)) committed to economic liberalisation, creation of environment suitable for foreign capital and reintegration of the country into regional and international economies. The implementation of such plans in a post-conflict environment was, however, understandably racked with a multitude of problems. First of all, it was well recognised that the Cambodian government could not be credited with ownership of the earlier plans as they were formulated mostly by foreign consultants answering to the country's donors, especially the ADB. While normalisation of relations with the West in particular revived trade flows before cut by embargoes, and massive aid flow practically kept the country alive, market reforms concentrated first on internal changes, which were in turn influenced by the power struggle among competing groups, interrupted by episodes of civil war and political infighting and undermined by institutional weaknesses. These reforms included privatisation of land, sell-off of state-owned enterprises and removal of price controls that in the end worked not really to achieve SEDP I's central aim of rural development (more budget was channelled to urban areas, contrary to the intent of the plan) but instead to increase the wealth and solidify the power of old and new elites and establish patronage networks. SEDP I mentioned the importance of the labour-intensive apparel industry, but in relation more to its contribution to employment creation. The membership of Cambodia in ASEAN in 1999 and the succeeding SEDPs gave more focus to trade development policy, but it was not until the first DTIS (2001) in preparation for the desired accession of Cambodia to the WTO that constraints to trade deepening were given real official analysis, and not until the second DTIS in 2007 that export diversification and sophistication possibilities were subject to close technical scrutiny (MoC/UNDP, 2007; Teramoto, 2002).

89 Production shifts have been driven by several factors, including: ensuring market access; industrial upgrading; move to technology-intensive goods and textile and garment outputs with more value added and wage increases in established garment manufacturers; and cost competitiveness of latecomers given their huge labour surpluses and liberalisation of their economies (Adhikari and Yamamoto, 2007; Rahman, 2004).

90 Other latecomers included South Asian manufacturers Bangladesh, Sri Lanka and India.

WTO's requirement of non-discrimination and prohibition of import quotas. Between the enactment of the ATC and 1998, the value of Cambodia's garment exports experienced a substantial increase (Figure A1.2), with its US market share leaping from a negligible 2% in 1995 to more than 80% three years after (Figure A1.3).

This goaded US apparel companies into calling for protection against garment imports from Cambodia, hurling specific criticism at how the indecent work conditions in the country underpinned the cost competitiveness of its garment industry. Hence, Cambodia was put under the quota system with the signing of the Trade Agreement on Textiles and Apparel (TATA) in 1999. This made quota bonuses to Cambodia contingent on its garment sector's compliance with the Cambodian Labour Law and international labour standards. Monitored by the International Labour Organization (ILO) under the Better Factories Cambodia (BFC) programme,[91] such compliance earned Cambodia the maximum allowable quota bonus of 18% by 2004 (Polaski, 2005). However, the TATA expired with the conclusion of the ATC at end-2004.

Between 1999 and 2004, Cambodia's garment export values increased by about 300%, from $660 million to nearly $2 billion (Figure A1.2), again with the US market accounting for about three-quarters of the annual totals on average and with the share of exports under quota averaging about 69%.[92]/[93] As mentioned earlier, the majority of Cambodia's non-US garment exports are shipped to the EU. Given preferential access, the EU's market share has in fact been nipping into the share of the US market, albeit slowly. Back in 1999, Cambodia signed the European Commission (EC)–Cambodia Trade in Textiles Agreement, providing Cambodia's garment exports unlimited access to the EU market. With its entry into ASEAN in the same year, the EU granted Cambodia regional cumulation and derogation benefits, following liberalisation of the conditions of the EU's Generalized System of Preferences (GSP) scheme. The bilateral agreement was also eventually extended beyond its original expiry year of 2002.[94] In addition, Cambodia benefits from the duty- and quota-free access permitted under the EU's EBA initiative launched back in 2001. Given restrictive RoO requirements on top of supply-side weaknesses, Cambodia has unfortunately been unable to optimise its gains from EBA so far. It is estimated that only 36% of the country's garment exports qualify under this initiative (Oxfam, 2004). A developed textile industry is amiss in Cambodia, and the country imports most of its textile and accessory needs from its non-ASEAN neighbours, particularly China. Given this, even the flexibility afforded by the regional accumulation benefit cannot be fully exploited because Cambodia's main textile and accessory suppliers do not qualify under the EBA's RoO.[95]

To a significant extent, the competitive advantage of Cambodia's garment industry was then tied up with its preferential access to major markets. While the optimum benefit from preferential access is eroded by the attendant direct costs (such as those of export licenses auctioned by the government),

91 BFC started in 2001 under the name ILO Garment Sector Project. Implemented by the ILO and now financed by a number of donors (i.e. government, GMAC, the US Agency for International Development (USAID), international garment buyers, Agence Française de Développement (AFD), the World Bank, the Cambodian Confederation of Trade Unions (CCTU), the Cambodian Labour Confederation (CLC) and New Zealand's International Aid and Development Agency (NZAID)), its key tasks are compliance monitoring and remediation. Key issues that are monitored include working conditions (including contracts, wages and social benefits), occupational safety and health and labour rights (including freedom of association, freedom from discrimination and non-use of child labour). Monitoring is done by means of unannounced visits. See www.betterfactories.org.

92 MoC (2004). The EIC (2007), however, reports lower quota shares, the average for the period 1999-2004 being only about 52%. The implication of these differing figures is important, as said figures relay whether preferential access has been a major driver of garment export expansion. A mere 52% average quota share does not convincingly affirm this trend.

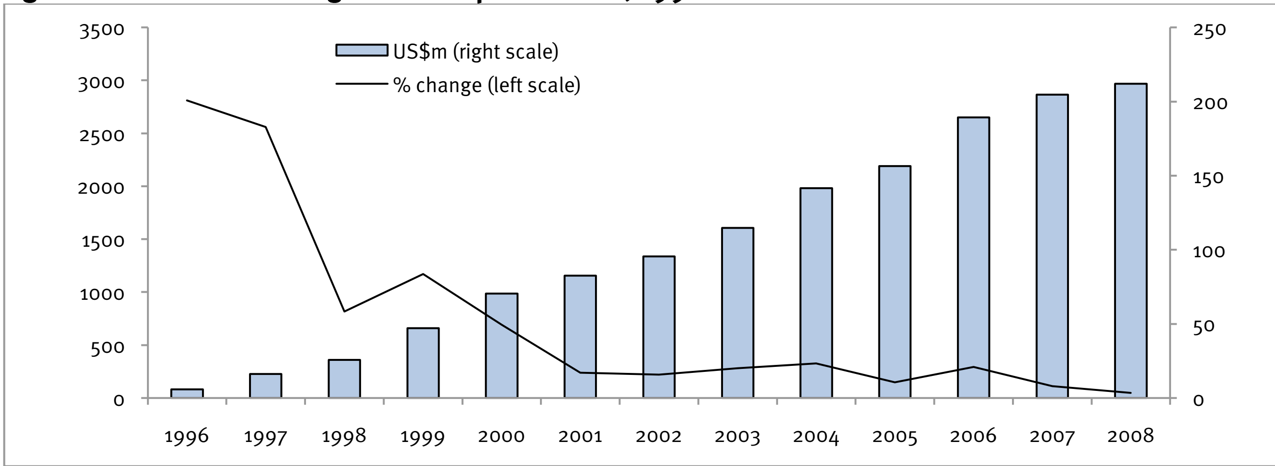
93 Aside from the sources already mentioned, this brief account of the history of US–Cambodia garment trade is based also on the following sources: Bargawi (2005), Marston (2007) and MoC (2004).

94 EC (2007); www.delkhm.ec.europa.eu/en/trade/index.htm; UN Economic and Social Commission for East Asia and the Pacific (UNESCAP, 2004).

95 See Bargawi (2005); EC (2008); http://ec.europa.eu/trade/issues/global/gsp/eba/ug.htm; EIC (2007); Heintz (2007); World Bank (2008b). According to EC (2008), for Cambodia to meet the regional cumulation criterion, imported materials need to come from ASEAN (except Myanmar), the South Asian Association for Regional Cooperation (SAARC) and African, Caribbean and Pacific (ACP) countries.

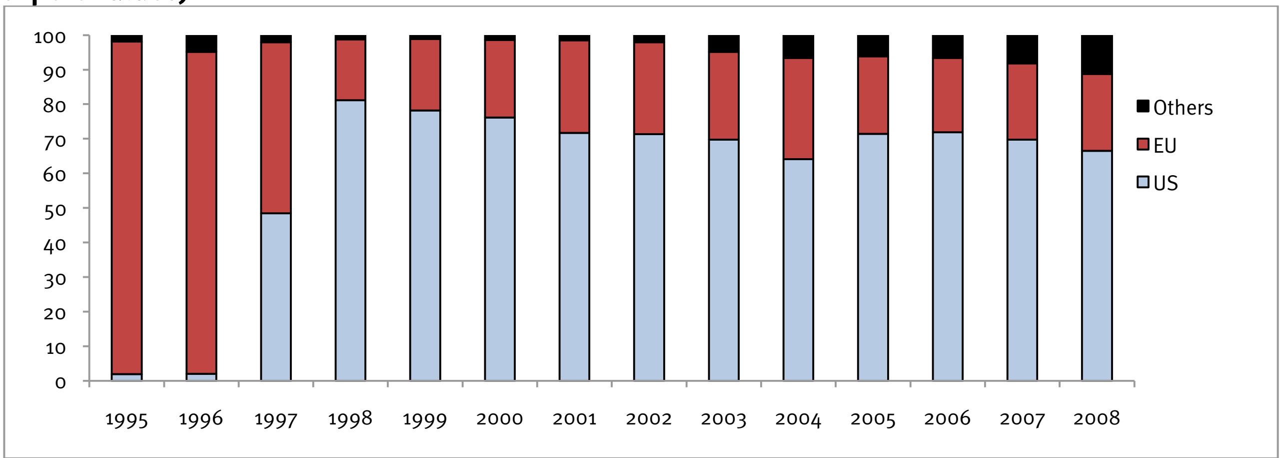
exclusions and restrictions embedded in the policy (such as RoO and product exclusions), and transaction costs (such as the costs attendant on compliance with labour standards and administrative requirements),[96] such access has enabled the accumulation of rents resulting from the higher value of goods in tariff and quota protected markets. One argument that has been posited is that the US preferential arrangement actually restricted the growth of Cambodia's garment industry.[97] While this is true based on textbook economics, an understanding of the context that bred such a scheme (i.e. pressure from a powerful interest group and constituency, the US garment industry) suggests that only suboptimal results could have been attainable. While high utilisation of quotas can be taken to suggest that more would have been exported if not for the restrictions, this rests on the debatable assumption that Cambodia would have competed ably with those with and without non-reciprocal access.

Figure A1.2: Cambodia's garment export values, 1996-2008



Sources: MoC (2004) for 1996-2003 data; Cham (2009a; 2009b) for 2004-2008 data.

Figure A1.3: Market shares in garment exports, 1995-2008 (% of Cambodia's total garment export values)



Sources: MoC (2004) for 1995-2003 data; Cham (2009a; 2009b) for 2004-2008 data.

With its preferential access serving as a competitive edge, the end of the ATC and, incidentally, the accession of Vietnam to the WTO, inadvertently sparked earnest concerns about how the domestic garment industry would endure the competition and the concomitant dwindling of prices. No contraction happened, however; on the country, the sector's performance following the expiry of the

96 While an easy conclusion is that the US preferential arrangement with Cambodia was beneficial and enabled the domestic garment industry to flourish, another credible insinuation is that such an arrangement instead restricted the growth of Cambodia garment exports.
97 This argument was briefly discussed in the 2001 DTIS.

ATC sidled closer to optimistic predictions,[98] with the total value of its garment exports still managing consecutive increases between 2005 and 2008. However, the structural changes in the US clothing trade post-ATC also included greater upsurges in imports from China, India and Bangladesh (Yamagata, 2007). Further, the average rate of Cambodia's garment export growth declined noticeably to 11% in the period 2005-2008, from about 20% in the preceding four-year period. More importantly, the expansion was not accompanied by the necessary market diversification or output sophistication. Between 2005 and 2008, the US continued to account for Cambodia's bulk of garment exports. True, its share has been dwindling but exports to countries other than the US and the EU still accounted for only about 11% of the total by end-2008 (Figure A1.3). The labour cost advantage and reputational premium proceeding from its labour standard compliance of course worked to support the industry's positive growth (although the latter slightly diminishes the former as it pushes up the cost of labour). With overall enhancement in the educational attainment and skills of the garment workforce, labour productivity also improved and, as of 2004, was found to be higher than in Bangladesh and Vietnam but still lagging behind China and Thailand (World Bank/IFC, 2009a). The spate of FDI pre-crisis was also an indicator of confidence in the profitability of Cambodia's garment trade. For the most part, improvements have been coming from a low base and other longstanding bottlenecks remained little resolved. Another exogenous development post-ATC also stands as a critical explanation for why Cambodia was able to preserve its niche in US and EU markets, that is, the imposition by the US and EU of safeguards against Chinese imports. These expired at end-December 2008. With this expiry, China's value share in the US clothing market was expected to reach 40% in 2009 from 35% in 2008.[99]/[100]

Lack of output sophistication and value chain upgrading

CMT factories dominate Cambodia's garment sector. The rest of the industry's structure features a number of full package companies involved in pre-production and logistics and subcontractors that simply take on excess CMT work from the CMT or full package companies and are not responsible for any other phase of the manufacturing process. CMT factories work under the instruction of offshore holding companies, which reimburse the factories for their costs and take responsibility for the other stages in the value chain, including planning and pre-production activities such as buyer contact, product specification and sourcing (Nathan Associates Inc. and Werner International, 2007). Unlike full package companies therefore, CMT factories have limited recourse when responding to price competitions, have little or no leeway at all when it comes to decisions about factory scaling-up and are vulnerable to changes in global business plans of their parent companies. CMT manufacture is also the

98 MoC (2004) and EIC (2007), for instance, predicted a 5% continued growth of the garment industry under the growth scenario (assumptions included implementation of economic and legal reforms, maintenance of competitive elements and resolution of bottlenecks relating to input costs and backward linkages, for example, and constant market shares). Bargawi (2005) also advanced an optimistic post-quota situation for Cambodia's garment sector given that the estimated drop in unit value sales of 10% to 15% was foreseen to be readily absorbable by Cambodian exporters through savings made on the export license 'tax' and, if insufficient, savings on input costs, efficiency improvements and reduction in profit margins. The results of the 2004 Foreign Investment Advisory Service (FIAS) Buyers' Survey also suggested no abrupt adverse change in the performance of the country's garment industry. In contrast with these optimistic outlooks, the IMF (2004) posed that Cambodia's garment industry was among the most vulnerable to the quota phase-out, given its lack of market diversification. Specifically, it predicted about $220 million decline in its exports to the US and EU combined and 2% deterioration in GDP growth as a result of the quota removal in 2005.

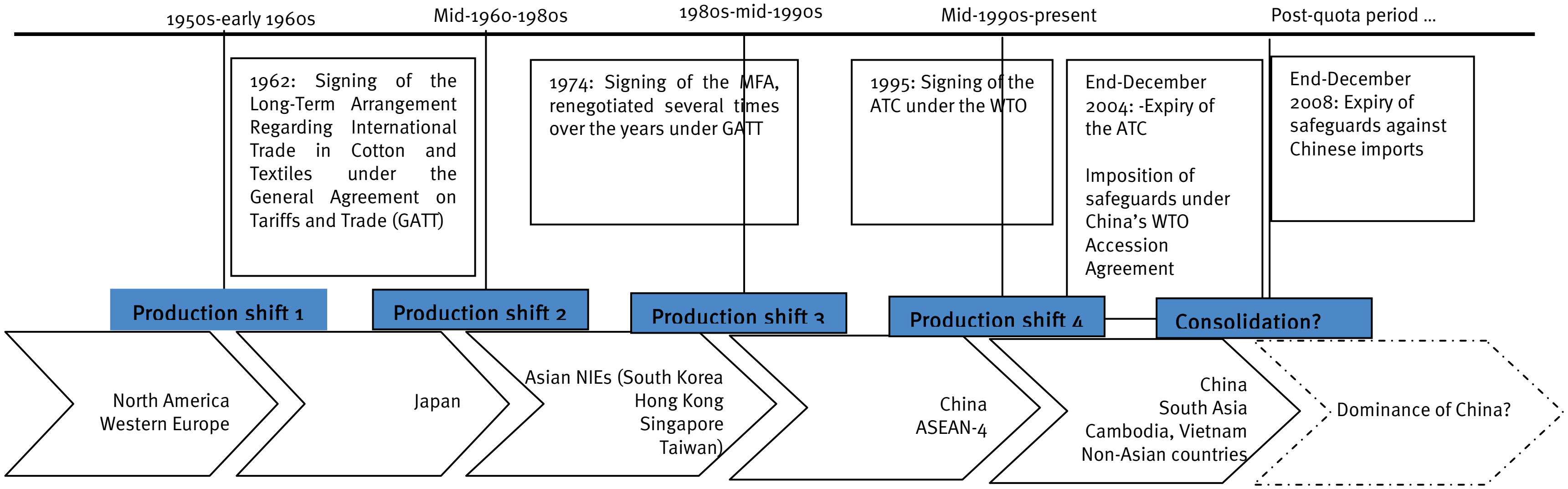
99 See Martin (2009). Following the expiration of the safeguards at end-December 2008, Chinese clothing exports to the US surged too fast, even prompting a warning from the Chinese Chamber of Commerce for Import and Export of Textiles. Based on the latest data from the Office of Textiles and Apparel of the US Department of Commerce, US apparel imports from China grew by 4% in the second half of 2009 compared with the same period in 2008 (non-apparel imports declined by 17%). Amid concerns about the onslaught of Chinese textile and garment exports, officials from the Obama Administration have been considering invoking the safeguard clause under Section 241 of the US trade law. See Wang (2009).

100 The results of the simulation by Hoekman et al. (2009), which aimed to assess the impact of most-favoured nation liberalisation on benefiting countries show that, among sectors, clothing will suffer the most from preference erosion and, among benefiting countries, Bangladesh and Cambodia will be most heavily affected. The calculations are based on the so-called competition-adjusted preference margin.

part of the value chain that is the simplest and the easiest to coordinate (World Bank, 2009a), and thus has the lowest value addition and greatest competition at the international level. Figure A1.5 indicates that the majority of Cambodia's total garment exports to the US and EU have been the single-transformation product type – woven garments – which, by implication, has the lowest value added. Multi-transformation products – knitwear garments – have only comprised about 15% of total export values and gone mostly to the EU.[101]

101 Leading buyers of garments made from Cambodia have been The Gap, H&M, Levi Strauss, Adidas and Target e.g. Natsuda et al., 2009). Garment exports have been dominated by non-knitted apparel such as cotton and synthetic men/boys and women/girls trousers and shorts.

Figure A1.4: Cambodia – a latecomer in the global garment industry



Sources: Bargawi (2005); Gereffi and Memedovic (2003); MoC (2004); Rahman (2004); Yamagata (2007).

Figure A1.5: Cambodia's garment industry – at the low level of the value chain

Woven cut and sew garments	**Knit cut and sew garments**	**Knitwear garments**
(Around 60% of total exports)	(Around 25% of total exports)	(Around 15% of total exports)
Cotton growing	Cotton growing	Cotton growing/wool crop/man-made fibre production
Ginning	Ginning	Ginning/fibre dying
Yarn spinning	Yarn spinning	Yarn spinning
Weaving	Yarn dying	Yarn dying/winding
Fabric processing	Circular knitting	Flat-bed knitting
Garmenting	Fabric processing	Linking
Garment washing	Garmenting	Inspection, pressing, packing
Packing	Garment washing	Shipping
Shipping	Packing	Wholesale
Wholesale	Shipping	Retail
Retail	Wholesale	

Source: Consolidated from MoC (2004). Activities in grey are where concentration is.

The ability of the domestic garment sector to enhance its position in the value chain is restrained by the absence of industrial backward linkages and technological sophistication on top of some longstanding bottlenecks that negate savings from improvements in other aspects of factory productivity. As mentioned elsewhere, Cambodia's garment industry imports most of its yarn and fabric requirements from outside, specifically non-ASEAN states. Even accessories, trimmings and some packaging materials, production of which requires limited investment and thus can be undertaken by local investors with the right incentives, are mostly imported. Except perhaps for the top performers, there has been little investment in technological upgrading and acquirement of knitting, dying and finishing facilities that will allow manufacture of higher value added products. The cheapness of labour on which the competitiveness of Cambodia's garment industry partially lies naturally reduces the incentive to indulge in such investment. The uncertainty of returns from business expansion also likely discourages parent companies from pouring money into technological upgrading. Presence of extensive outside competition additionally serves as a constant reminder of how parent companies can limit expansion or relocate their production in Cambodia if proven necessary by erosion of competitiveness or by the impact of external or domestic shocks.

To the disadvantage of Cambodia, international competitiveness has increasingly hinged on the vertical development of the sector, which includes a working upstream textile and other input industries. This satisfies the ever-increasing demand of buyers to get their orders when they want them. With their established and large-scale textile industry, China, India and Vietnam outdo Cambodia and Bangladesh in this regard. In the case of woven garments, Cambodia's delivery lead times are slower by up to two months compared with that of China. As for knitted garments, its lead times are slower by up to one month or so compared with that of Bangladesh, given that considerable investment in the latter has been intently channelled to knitting technologies, leading to a profitable degree of self-sufficiency in the area (MoC, 2004). Technological upgrading within the garment sector is important not only for value chain upgrading but also to enhance the quality of existing outputs and avoid wastage. A practical point to consider, however, is that, while the aforementioned weaknesses of Cambodia's garment industry served as the root causes of the industry's vulnerability to the crisis and the post-quota environment, addressing them cannot be possibly be done overnight. Under pressure, the RGC, the domestic garment industry and its representative interest group, GMAC, are confronted with the pressing task of quick fixing the loss of short-run competitiveness while mulling over the prospects of enhancing long-term competitive advantage.

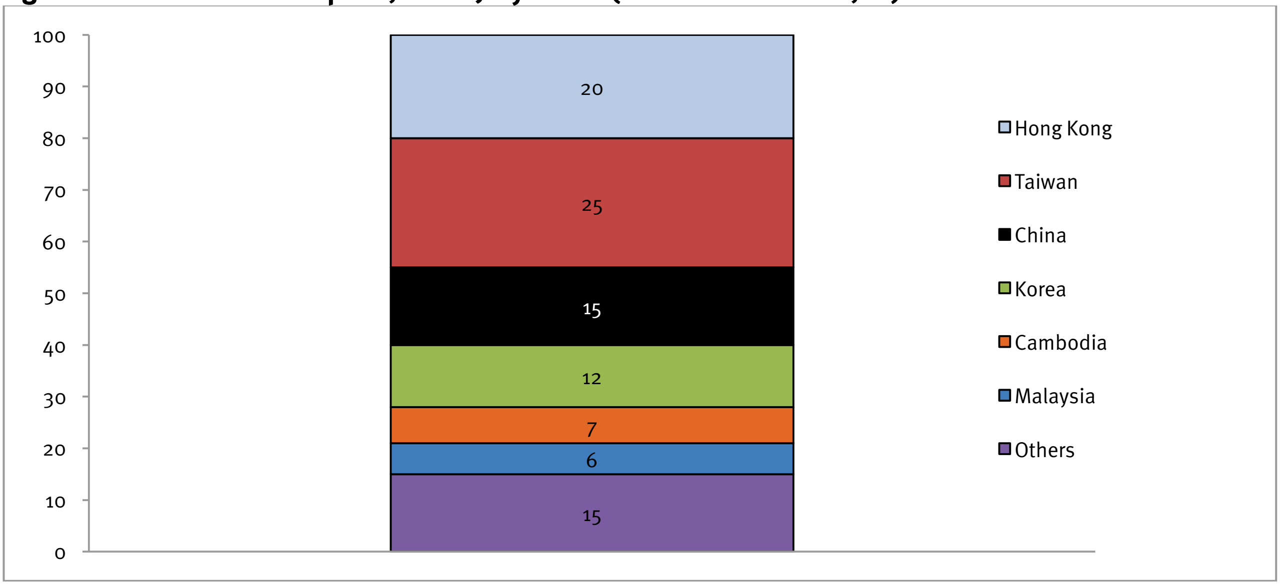
Foreign control

Cambodia's garment industry is more than 90% foreign owned. This is a major point of distinction between it and the garment sector of Bangladesh, and has bearing on the impact of the crisis on each. FDI from Chinese investors accounts for about 60% of the industry's capital (Taiwan's share at 25%, Hong Kong 20% and mainland China 15%) while local investment merely has a single-digit share (Figure A1.6).

As earlier mentioned, FDI has been drawn to Cambodia by its host country and firm-specific advantages which, in the case of the garment industry, have been significantly represented by its preferential status and low-cost labour. Another source of its differentiation from others and attraction to FDI (at least pre crisis) has been its level of compliance with labour standards, which has been hoped to appeal to buyers valuing corporate social responsibility. Lacking local capital following decades of war and isolation, the entry of FDI provided the necessary financial support to set up the garment industry in the country. The benefits of FDI, however, go beyond the direct gains in capital formation, employment creation and foreign exchange generation. There are positive externalities such as knowledge spills, productivity increases and technological transfer. However, these are not automatic gains; some conditions seem imperative to be able to capture these spillovers. There is actually no consensus as to whether a beneficial relationship exists between FDI and growth. Welfare losses may in fact overshadow the benefits if the potential spillovers are not captured (Alfaro, 2003; Borensztein et al., 1995; Contessi and Weinberger, 2009; Fillat Castejon and Woerz, 2006; Moran et al., 2005; te

Velde, 2002). Cambodia lacks the prerequisites to be able to seize such knock-on benefits. Limited numbers of skilled and trained manpower, for instance, prohibit the placement of Cambodians in higher positions within the industry, thus the transfer of managerial or technical expertise (Nathan Associates Inc. and Werner International, 2007). As in other LDC garment manufacturers, expansion of garments has not been accompanied by development in the technological capacity of domestic firms (UNCTAD, 2007).

Figure A1.6: Source of capital, as of July 2008 (investment share, %)



Source: Kang et al. (2009).

Another point worth mentioning is that FDI may be more resilient than equity flows but, as mentioned earlier, can still be very volatile, particularly in a sector such as garments, and, either in the form of mergers and acquisitions or greenfield projects, can be subject to sharp decline in times of crisis. The task of retaining FDI as opposed to attracting new FDI assumes equal if not greater importance during crisis periods as economic downturns urge multinational corporations to restructure their costs and compel divestments, be they in the form of repatriated earnings, reverse intra-firm loans or debt repayments to parent companies. These ultimately result in downsizings, temporary closures or complete relocation of production (UNCTAD, 2009). For FDI-dependent garment manufacturers, another issue is whether FDI can serve as an engine for long-term growth. The experience of Bangladesh shows how the initial development of the garment sector can be led by foreign ownership and its deepening and acceleration by local firms with the government playing a catalytic role (te Velde, 2002; Yamagata, 2007).

Other challenges

The cost competitiveness of garment firms in Cambodia is also challenged by costs directly incurred at the factory level but with implications for sector-wide viability and reputation. Three of these costs are briefly discussed here.

Labour standard compliance: Costs and loopholes

Direct financial returns have accrued to Cambodia's garment industry owing to its labour standard compliance and, in this regard, its reputation as an international model of sectoral good governance (Jalilian et al., 2009). As earlier noted, previous quota allotments by the US were linked to adherence to national and international labour standards. The ILO-managed BFC programme was tasked with monitoring compliance and, while supposed to be voluntary, participation in the initiative was essentially compelled by the conditioning of export licensing by the RGC on said participation.[102] Also, many buyers apparently attach value to this practice. A previous survey showed that more than 40% of buyers believed that consumers find labour compliance of major or critical importance (World Bank/IFC, 2004).

BFC reports have shown high compliance among inspected firms with particular aspects of working conditions such as minimum wages and regular overtime payments.[103] In relation to worker rights, they have also revealed minimal interference in freedom of association, minimal discrimination and nearly no use of child and forced labour in participating factories. The quality of labour relations management in Cambodia is, however, not perfectly captured by such reports, and even BFC admits to the limitations of its monitoring activities and acknowledged on-the-ground realities that prove elusive to verification. Of all operating factories, BFC inspections have covered only about 70% on average in the past three years. In addition, the programme does not cover subcontractors, which comprised roughly 15% of the total number of firms in the garment manufacturing business sometime in 2007 (Nathan Associates Inc. and Werner International, 2007). BFC also recognises the difficulty of detecting breaches of standards relating to child labour and sexual harassment, for instance. Corruption has also reportedly led to misreporting of working conditions and underreporting of transgressions. Suspected collusion between management and union representatives, moreover, taints the finding of high freedom of association and low anti-union discrimination in the garment industry. Worker intimidation is also not the only factor explaining reluctance of workers to speak candidly of violations. Fear of job loss leads to self-censorship.

In the corporate world, the idea that corporate social responsibility is an integral part of competitiveness has only grazed the surface. In general, making commitments to the former only becomes profitable if the increased demand from the ethical market results in returns higher than the costs imposed by adhering to decent working conditions and labour rights and not any lower than the returns from alternative strategies. Downward pressure on prices caused by crisis periods and fierce competition, however, makes it hard to obtain this profitability, as firms are driven to keep costs at the very minimum. Decent working conditions and the quality of labour relations management are therefore expected to be countercyclical, but not all of their aspects. Strike incidence, for instance, has been found to be more pro-cyclical, although sectoral and country variations have been observed (Cramton and Tracy, 2002; Deveraux and Hart, 2008; Kennan, 2006). Strikes in Cambodia are among the key reasons explaining the exceptionally low utilisation rate in the garment sector. Not only do they directly result in a huge loss of working time but also they induce a degree of uncertainty, which deters factories from taking orders for fear of not being able to deliver. There is considered to be a huge number of unions in Cambodia (about 1000 in the 300 or so operating garment factories pre crisis, with some factories having multiple unions) and many strikes occur illegally.[104] On average, eight days of production per factory per year are said to be lost to strikes, labour disputes and other forms of unrest in the garment sector. The ILO-created Arbitration Council has been able to resolve about 67% of these disputes; however, whether awards are binding or not rests with the disputing parties. The majority of the awards are not implemented (Austermiller, 2009; World Bank/IFC, 2009a; Zack, 2009).

The cancer that is corruption

The culture of corruption is an oft-cited problem affecting Cambodia's competitiveness. Results of the 2007/2008 Cambodia Investment Climate Survey point to corruption as the top business constraint in the country (World Bank/IFC, 2009a).[105] Despite noted improvements in bureaucratic procedures and regulations that affect the garment sector and create openings for corruption, the survey reveals the continuity and institutionalisation of the practice, resulting not only in high informal payoffs but also in firm behaviour that compromises efficiency, innovation and diversification. Per the survey findings,

102 By 2010, BFC is hoped to evolve into an independent local organisation.

103 Information in the rest of this section is based on various BFC reports and documents (see www.betterfactories.org/).

104 100% of the strikes reported in the April 2009 Synthesis Report of the BFC were considered illegal, for instance.

105 For additional information, Transparency International's Corruption Perception Index score for Cambodia was 1.8 in 2008, from 2.3 in 2005 (scoring ranges between 10 (highly clean) and 0 (highly corrupt)) (www.transparency.org).

about 84% of firms doing business in Cambodia make informal payments, amounting to 5% of annual sales on average. Putting up a business in the country allegedly has a median cost of $240 at the MoC, $300 each for tax and VAT registration and $630 for labour registration (ibid). The expectation to pay is noted to be higher for the garment industry. Tax inspections in particular appear to result in frequent and significant corruption. The survey findings suggest that incidence of informal payments has increased from 42% to 60% of cases, and so has the average value of such payments, from $100 to $300. Again, garment firms have been noted to be more susceptible to inspections and expectation to make informal payments. Notwithstanding improvements in certain respects, government procurement remains loaded with opportunity for illegal rent seeking. The survey results reveal that the median payment value has increased to 8% of the contract. The costs of corruption in procurement are noted to be higher for exporters, which include garment enterprises. Needless to say, reducing or eradicating corruption completely has tremendous benefits from a business perspective. Firms that make 50% less of informal payments have been found to have productivity higher by 3.75%. Reducing delays in customs clearance can also increase productivity by 1.15% (ibid).

The high cost of power

High cost of electricity is another oft-cited problem for industries in Cambodia, as it has direct reductive effect on productivity and sales and undermines plans for upgrading. As noted, this high cost emerges from the country's small and fragmented generating capacity (absence of national grid and presence of many independent power providers), the high cost of imported oil, the lack of a high voltage transmission system and extensive power leakages during transmission and distribution (World Bank, 2009a). Even with the price reductions that have been attained in the past decade, the cost of power in Cambodia (noted to be ranging from $0.18 per kwh in urban areas to $0.30-90 kwh in rural areas) remains significantly high, especially if compared with costs in neighbouring countries such as Vietnam and Lao PDR ($0.05 and $0.06 kwh, respectively) or other Asian countries such as China ($0.07 kwh), which happen to be Cambodia's competitors in the world garment market. Even while the garment industry is not electricity intensive, the burden that high power costs impose on domestic garment factories is reflected in the fact that more than 80% of such factories (against only 36% to 39% economy wide) have been using generators to meet about 54% of their electricity needs (against 26% economy wide). Electricity costs have been noted to account for about 5% to 7% of unit costs, a share considered high given the limited power requirement of garment factories. Average losses from power outages in 2007 have been estimated at around 4% of sales for an average firm. Absent of power outages, productivity can also increase by about 3.7% for mean users of electricity (World Bank, 2009a; World Bank/IFC, 2009a). With all this in view, efforts of the government directed at upgrading the power grid and diversifying sources of power (e.g. more hydropower plants) have been more than welcome.

Annex 2: The crisis according to stakeholders[106]

Garment sector

The garment industry has not bottomed out, with current trends still comparable with the situation in the past six months. The plunge in Cambodia's market share in the US is evident, while export drops in the EU market have been more modest. Even though a few factories have managed to clinch some orders, many have suspended expansion plans and are simply maintaining the same production capacity. Fixed-term contracts for employees have not been renewed. Given that Bangladeshi and Vietnamese garment exports have remained relatively strong, even against the backdrop of falling garment prices and lacklustre demand, the downturn facing Cambodia's garment industry can ultimately be credited to a loss in competitiveness. The sector's lagging competitiveness stems from different sources. On labour issues, while wages in Cambodia are comparatively lower than those in, say, Vietnam, higher productivity in the latter compensates for the discrepancy. Labour unrest is another concern; while strike incidence has not increased between 2007 and 2008, the total strike duration and amount of participating workers have led to more or less the same amount of production loss. They have certainly hurt industrial relations. Unionism and labour unrest are of lesser concern in, say, Vietnam and Bangladesh.

It is true that labour standard compliance has set Cambodia's garment industry apart from other manufacturers. Mainly for such purposes, the government has continued its policy of conditioning the granting of export licenses on factory participation in labour standard monitoring. However, the cost of ensuring compliance adds onto the cost of garment exports. At the end of the day, labour standard compliance is a basic but not the key consideration in buyers' purchasing decisions. What clinches the deal is the relative price of the garment – this was true even before the crisis. Caution must also be exercised in assessing the results of labour monitoring exercises, given potential pressures against full disclosure of breaches.

Lower competitiveness also stems from the higher cost of doing business in the country, which in turn owes to higher trade facilitation costs and infrastructural weaknesses. More expensive electricity is a serious bottleneck also underpinning the lack of progress in one other element of competitiveness in the garment sector – that is, the presence of a developed upstream textile, accessory and packaging industry. The lack of backward linkages precludes Cambodia's garment industry from diversifying to more value-added products. With 90% of the industry foreign owned, upgrading decisions depend on the global business plans of parent companies overseas. Cost advantages in producing fabric, accessories and packaging materials in the country will have to be demonstrated to influence these decisions. Interest in building the upstream industry is there but underdeveloped infrastructure, for instance, is preventing investors from going any further. Informal payments also add on to the cost of garment exports from Cambodia, and must be dealt with.

Government policy responses have included suspension of the advance profit tax, reduction of the employer contribution to social security and setting up of a fund for training. Longer-term solutions have included negotiating for preferential market access in the US and finding a means to increase market share in minor markets such as Japan, South Korea and Middle Eastern countries. Regional agreements such as the ASEAN–Japan partnership agreement are expected to facilitate expansion in other markets. Notwithstanding factors that could undermine their effectiveness (e.g. training would not necessarily bring about increased productivity), these responses have certainly been helpful. Certain points of importance must be noted, however, most prominent of which is that preferential treatment alone cannot shore up Cambodia's competitiveness. Market access can indeed be a boost, as investors flocked to Cambodia in the first place because of the preferential quotas extended to it.

106 Gathered during consultations with sectoral representatives in October and November 2009.

The African experience, however, informs us that, where supply-side constraints are serious, the utilisation of the preference will be low. In the end, it is the investment potential based on greater efficiency that counts.

Donor community

2009 will see a worse contraction in output. While signs of bottoming out have been detected in tourism and construction, there remains greater uncertainty in the fate of the garment sector. Agricultural growth is expected to be stable, providing support to the sluggish economy. The global recession's impact in Cambodia has structural roots. Limited diversification has cost the economy, with the crisis hitting the narrow economic base supporting growth in past years hard. Garments, the country's leading exports, have lost competitiveness. A central concern relates to the high rate of unionism and labour unrest. The sector's reputation as a model of labour standard compliance is not expected to help much and clinch buyers' purchasing decisions, particularly in crisis periods. While abrupt withdrawal from relationships with domestic producers will be discouraged because of their cost to buyers' reputations, at the margin, or in terms of excess orders, buyers are expected to prefer less costly garments from competitors.

Government responses meant to stimulate the industry are perceived as limited and less effective than alternative strategies. For instance, targeted incentives that reward investments in machinery or productivity would have been more effective than the tax holidays granted. Overall, the government response has been viewed as limited. The expansionary budget has not really seen greater allocation towards priority sectors; instead, most of the budgeted increase has been set to go towards the military and civil service pay. On the revenue side, progress in tax administration efforts, which underpinned the increases in tax revenues collected, is commendable; on the spending side, however, more of the expenditures must be channelled to priority sectors. Going back to the issue of civil service pay, the fate of the Merit-Based Pay Initiative is of concern: it is hoped that government support to this initiative will continue. With regard to financing, there is indeed more room for borrowing, but this will be accompanied by risks to debt sustainability. While current debt distress is low, this could easily get overturned.

Aid flows are expected to remain stable – there is and will be no cut but no increase is coming either, at least insofar as traditional aid is concerned (that is, mainly excluding Chinese aid). Aid budgetary pressures not only affect aid volumes and values – they are also set to affect the prioritisation of aid programmes. Aid reform at home is also set to trigger changes in regional allocation of aid. Where it is meant to keep its priority status, Cambodia will not be affected, although reprioritisation of programmes will have to be done. In at least one case, though, Cambodia will be affected. Chinese aid has provided the government with the needed boost in funding specifically for infrastructure, but it cannot replace traditional aid. In relation to aid modality, the continued low level of trust will hinder progress in the use of budget support. Common problems affecting aid disbursements, such as delays in procurement, are expected to continue.

The banking sector is not out of danger – the NPL problem may be worse than it looks, especially for small inexperienced banks. Detecting the real situation is difficult for the already overstretched central bank. Household debt meant for financing consumption has also been increasing, and this poses another risk. Private sector credit growth, although it has experienced a rebound recently, still remains low. With the roots of the crisis structural in nature, the way to sustainable recovery entails structural reforms. Diversification is a must, and the way to do this, acknowledging as well the fiscal constraints facing the country, is to identify the areas where constraints are the most binding (e.g. education, trade facilitation, productivity) and work on such areas. Based on the experience of other countries, it is doubtful whether agriculture and agri-business can serve as a driver of longer-term growth.

Banking sector

The Cambodian economy had already bottomed out by about the second half of 2009. There was and is no financial, specifically banking, crisis in the country. No bank has collapsed. The danger has already passed and any persistent concerns pertain only to selected banks, not to the banking sector as a whole.

The banking sector has expanded rapidly in past years. As a percent of GDP, total bank assets reached 47% in 2008, from 26% in 2006, whereas total deposits and loans reached about 29% and 27%, from 19% and 12%, respectively, over the same period. MFIs likewise experienced rapid expansion, with deposits almost doubling between 2006 and 2008. It is true, however, that banks have been affected by the global crisis and have experienced both liquidity and credit risks as a result of its effects. Liquidity was the most important because it acts as a buffer to losses. Foreign currency deposit growth dropped on a year-on-year basis and major foreign currency withdrawals, specifically by South Korean investors, have reportedly been made. Currently, however, there is already sufficient liquidity in the system, although it is concentrated in big banks. Despite the challenging environment, bank liquidity ratios have also remained well above the prudential limit and, increased from 81% in 2008 to about 93% in August 2009. Capital adequacy ratios remained stable. MFIs have also been affected, although to a lesser extent than banks. Some tightening in lending has been reported, making foreign financing more expensive.

Credit risks have also become evident, with the quality of loan portfolios having faced the threat of deterioration. Maturity mismatch has not been so much a problem; the credit risks were mostly connected to loans made to the real estate sector, which has seen a slump in activity. This in a way fed an increase in NPL ratios. It is, however, important to point out that real estate loans as a percentage of total loans have turned out to be modest. Also, the recorded increase in the NPL ratio is partly attributable to the reclassification of loans implemented by the NBC after issuing the relevant regulation. Compared with NPL ratios in past years, the August 2009 NPL ratio for banks, of about 5.88%, is low. Also, an increase in the NPL ratio of, say, up to 10% poses problems but is nonetheless not expected to be terminal. Such a rise in credit risk can be managed because of the capital buffers that absorb losses. Again, it is additionally important to stress that the NPL problem, if it worsens, may be serious only for selected banks, not the banking industry as a whole. It is important to isolate the cases of these selected banks. To ensure that the banks will have sufficient cover for potential losses, the NBC has also toughened requirements in provisioning. The decline in bank profitably so far in this year has owed significantly to this. As in the liquidity risk, MFIs have been less exposed to the higher credit risks, given that the composition of their portfolios is normally dominated by loans to the agriculture sector and small and medium-sized enterprises. Still, the crisis has prompted more caution in valuing collateral quality.

The NBC's responses to the crisis and their timing have been commendable. The central bank rightfully toughened its stance on overdraft lending and property lending. The dollarisation of Cambodia, however, has limited the extent to which it can act. De-dollarisation in the country will not come naturally; it has to be directed by policy and changes in legal provisions. The NBC also has to be consistently rigorous in its surveillance to uncover potential problematic loan reschedulings. Undetected, these reschedulings may only be postponing the NPL problem. Furthermore, the real extent of lending to the real estate sector may be more than the figure reflected strictly under the said category. As of August 2009, 6.4% of total loans went to real estate, with 8.4% and 7.2% going to construction and personal lending, respectively. The latter two loan categories must carry some of the risks associated with real estate. There is a sense of optimism that the real estate sector will rebound sooner than expected, although prices cannot return to their pre-crisis levels as yet. The NBC has undertaken other steps to curb the effects of the crisis on the financial sector. It has slashed reserve requirements, increased capital requirements, put up an overdraft facility, toughened on-site and off-site surveillance and reporting requirements and granted licenses allowing qualified MFIs to take deposits directly from the public. As longer-term solutions, it is also weighing its options on how the financial structure may be improved and the system deepened through, say, the issue of other liquid financial instruments and establishment of a credit bureau. The setting up of a well-functioning capital market may also be feasible in the long run, but not in the short run, owing to missing prerequisites such as improved accounting standards and a broader investor base.

The global crisis was like a tsunami that could not be stopped. The focus now must be on how to emerge from it. Government expenditure so far has been relatively small, understandably so because of its limited fiscal capacity. To boost available resources, it can consider further borrowing, although without losing sight of debt sustainability risks. The growth outlook is positive, with prospects buoyed by the expected strong performance of the agriculture sector and the informal economy. In the longer term, the crisis will have made the Cambodian economy stronger by prompting corrections in the allocation of resources and forcing inefficiencies out of the system. In the specific case of the banking sector, it can weed out inefficient institutions, which will be good for the banking industry overall. The expansion of the financial sector may also go on more carefully. Again, what is important to note is that, if the situation ever worsens, it will only be for selected banks, not the banking sector as a whole.

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