Cambodia

Rebuilding for a Challenging Future

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Alejandro López-Mejía, Srobona Mitra, Sònia Muñoz,
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International Monetary Fund

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The following symbols have been used throughout this publication:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (e.g., 2003–04 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (e.g., 2003/04) to indicate a fiscal (financial) year.

"n.a." means not applicable.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this publication, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

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Preface

The material presented in this Special Issues was originally prepared as background for discussion at the IMF Executive Board in September 2004. Assessments contained in some of the chapters have in some cases been overtaken by recent events, but the medium-term challenges remain the same. The authors are grateful to the Cambodian authorities for extensive discussions and for their assistance in providing data and other source material.

The background papers were prepared in 2003–04 under the general guidance of David T. Coe and Il Houng Lee of the Asia and Pacific Department and benefited from comments of department staff. Wafa Fahmi Abdelati coordinated production of the manuscript. The authors would like to thank Rupin Thomas for excellent research assistance, Nadine Dubost and Elizabeth Handal-Kocis for secretarial support, and Gail Berre, Esha Ray, Teresa Del Rosario, and Alicia Etchebarne-Bourdin of the External Relations Department for production of the publication.

The opinions expressed are solely those of the authors and do not necessarily reflect the views of the IMF, its Executive Directors, or the Cambodian authorities.

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Abbreviations

ASEAN	Association of Southeast Asian Nations
ATC	Agreement on Textiles and Clothing
CPI	Consumer price index
CDC	Center for the Development of Cambodia
CR	Cambodian riel
CSES	Cambodia Socio-Economic Survey
EU	European Union
FCD	Foreign currency deposits
FCU	Foreign Currency Unit
FDI	Foreign direct investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GIC	Gross incidence curve
GLS	Generalized least squares
GSP	Generalized System of Preferences
ICSID	International Center for Settlement of Investment Disputes
LDC	Least developed country
LIA	Low-income Asian country
LIC	Low-income country
LOI	Law on Investment
LOT	Law on Taxation
MBPI	Merit-based pay initiative
MEF	Ministry of Economy and Finance
MFA	Multifiber Agreement
MFN	Most favored nation
NBC	National Bank of Cambodia
NIEA	Newly industrialized and emerging economy
NIS	National Institute of Statistics
NPRS	National Poverty Reduction Strategy
NT	National Treasury
OLS	Ordinary least squares
PAP	Priority Action Program
PCB	Permanent Coordination Body
PFM	Public financial management
PFMRP	Public Financial Management Reform Program
PMU	Project Management Unit
PPP	Purchasing power parity
PRGF	Poverty Reduction and Growth Facility
RGC	Royal Government of Cambodia

RoO	Rules of origin
SCAC	Supreme Council Against Corruption
SCM	Supreme Council of Magistracy
SIC	Schwarz information criterion
SPS	Sanitary and Phytosanitary
TA	Tax administration
T&C	Textile and clothing
TBT	Technical Barriers to Trade
TCAP	Technical Cooperation Action Program
TRIM	Trade-Related Investment Measures
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UN	United Nations
UNTAC	United Nations Transitional Authority in Cambodia
VAR	Vector auto regression
VAT	Value-added tax
WEO	World Economic Outlook
WTO	World Trade Organization

CHAPTER

1 Overview

Il Houng Lee and David T. Coe

Cambodia's reconstruction and reform efforts have spanned almost 25 years. Beginning after the 1975–79 Khmer Rouge period, early efforts were beset by ongoing internal tension and civil unrest that persisted until 1998. Two coalition governments in 1993 and 1998 made some headway in rehabilitating the economy, but were stymied by the continuing civil unrest. The current coalition government, formed in mid-2004, has announced a strategy aimed at revitalizing economic reforms.

Despite these efforts, the medium-term outlook is highly uncertain. Cambodia remains one of the poorest countries in the region, with about 40 percent of the population still in poverty. The scheduled phaseout of the garment quota system at the end of 2004, combined with a deterioration in external competitiveness and weak governance, could limit medium-term growth to 2–4 percent, implying stagnant living standards.

A. Post-Conflict Restructuring and Economic Recovery

Cambodia's economic reconstruction efforts began within the framework of a centrally planned economy. Rebuilding institutional and physical infrastructure was particularly difficult since most of the educated population had either been killed or fled the country during the Khmer Rouge period. Civil conflict and the withdrawal of external assistance stalled progress on market-oriented reforms introduced in the mid-1980s. Even the coalition government formed following United Nations (UN)-sponsored elections in 1993 could not fully quench internal tensions, which erupted into a violent conflict in 1997. Only after the 1998 national elections was the resulting coalition government able to start pursuing more coordinated reforms, albeit with mixed results.

In the late 1990s, basic institutions were set up and various laws ranging from commercial contracts to accounting were adopted. The Financial Institutions Law (1999) provided the legal basis for successful bank relicensing. New accounting standards were introduced, and the regulatory framework for banks

was strengthened in tandem with bank supervision. A buildup in the administrative capacity of the customs and tax services, achieved with substantial foreign assistance, improved fiscal revenue. However, progress in other public administrative reforms, notably the civil service, has been slow, limiting government capacity. Perhaps most important, progress in judicial reform has been stagnant since the mid-1990s, seriously undermining the rule of law.

Reform stalled in the wake of the July 2003 elections when tensions between the former coalition partners delayed the formation of a new government. A power-sharing agreement between the main parties eventually paved the way for the formation of a new coalition government in June 2004. The new government announced a "Rectangular Strategy" reform agenda that focused on nurturing the agricultural sector, developing the private sector, building human capacity, and rehabilitating physical infrastructure. Good governance is the overarching objective of the return strategy, cutting across all issues. The momentum for reform was further boosted in October 2004, when Cambodia joined the World Trade Organization (WTO) as the 148th member.

Macroeconomic performance was generally positive in the decade to 2004. Real GDP growth averaged 6–7 percent, and inflation was kept to single digits, except briefly in 1998 in the wake of the Asian financial crisis. Prudent fiscal policy provided an anchor for price stability, especially since the late 1990s when recourse to domestic bank financing was largely avoided. The external current account deficit (excluding transfers) peaked in 1999 at 13¼ percent of GDP, reflecting increasing reliance on foreign savings during the 1990s, but then stabilized at around 9–10 percent of GDP. The exchange rate was relatively stable against the U.S. dollar. International official reserves rose marginally from 2½ months of imports in 1997 to about 3 months of imports at the end of 2003.

Favorable external developments contributed to the relatively strong macroeconomic performance. In 1996, the effective average U.S. tariff rate for garments produced in Cambodia was reduced from 50–70 percent to 10–20 percent under the bilateral Agreement on Textiles and Clothing. Exports to the United States soared from nearly zero in 1995 to more than $1 billion in 2003—about 70 percent of total garment exports. In addition, large aid inflows, averaging 12 percent of GDP, helped finance domestic investment and fueled construction activities. Finally, the regained political stability in the late 1990s eliminated an important impediment to tourism in Cambodia, a country richly endowed with natural and historic attractions, leading to a sharp increase in the number of tourists.

These favorable developments, however, concealed underlying weaknesses that, if left unaddressed, could limit growth in the medium term to 2–4 percent a year. In particular,

- A deterioration of competitiveness was masked by quotas imposed on garment exports from China to the United States, which boosted Cambodian garment exports.
- Poor public administration and weak governance—partly due to slow progress in legal and judicial reform—have exacerbated uncertainty in the business environment, while inadequate infrastructure and high wages in the formal sector have kept operating costs high.
- Agricultural development has stagnated due to limited access to arable land and markets. Agriculture has traditionally been the main income source for most of the population and accounts for more than 40 percent of real GDP.
- Government capacity remains severely constrained by lack of human capital and entrenched governance problems. The quality of the civil service remains poor, and fiscal revenue, currently at 10½ percent of GDP, is hardly enough to meet basic priority spending needs.

B. Sustainable Growth to Achieve Poverty Reduction

As Cambodia emerges from post-conflict rehabilitation, the main challenge is achieving poverty reduction through sustainable growth. Against this background, Chapter 2 assesses the extent to which recent growth has or has not benefited the poor. According to household surveys, the rural areas, where most of the poor live as subsistence farmers with highly volatile incomes, have failed to benefit directly from favorable external developments and were largely left behind. For example, since 1993/94, average household expenditure in rural areas declined from 33 percent of household expenditure in Phnom Penh to 28 percent in 1999, and is estimated to have declined further to about 25 percent in 2002.

The impact of Cambodia's growth on poverty is reviewed using growth incidence curves developed by Ravallion and Chen (2003). Growth incidence curves plot the cumulative share of the population by daily expenditure per person against the growth rate in that expenditure of each population percentile between two periods. The growth incidence curves reveal that between 1994 and 1999, economic growth in urban areas has been pro-poor, that is, the poor have benefited. By contrast, growth in the rural areas was significantly anti-poor. Most troubling, households in the poorest 20 percentiles of the rural population experienced the largest widening income gap.

The anti-poor growth is not surprising because the sources of recent growth were based on garment exports, tourism, and aid inflows that benefited only a limited segment of the population. As a small open economy with ample unused arable land and a large unskilled labor force, Cambodia's comparative advantage

is widely recognized to be agriculture. However, slow growth in this sector—partly due to poor supporting infrastructure, but also because of limited access to land due to hoarding—has pushed Cambodia further away from its stated objective of meeting the Millennium Development Goals. Moreover, slow growth in agriculture reduces the capacity to absorb growing entrants to the labor market. Recent experience clearly argues for greater policy focus on agricultural development, a reorientation of policy that will succeed only if also supported by donors.

Chapter 3 explores the determinants of long-term sustainable growth more generally, based on an analysis of cross-country panel data. A few stylized facts from the data show that Cambodia's initial conditions—with respect to life expectancy and GDP per capita—in the 1970s were among the weakest and have been very slow to improve. Physical and human capital formation has been anemic, negatively affecting growth.

Results from a standard growth model estimated using five-year averages from 1970 for 144 low- and middle-income countries indicate that higher real per capita growth is associated with lower initial income levels, better macroeconomic performance, faster human and physical capital accumulation, smaller government, and stronger institutions and governance. These results imply that higher long-term growth in Cambodia could be achieved by better education, more rapid physical capital formation, and improved governance. This is a formidable policy challenge in an economy suffering from weak public administration and lacking financial resources.

C. Policy Challenges

Uncertainties in the short- and medium-term outlook are intensified by the scheduled elimination of the garment quota system under the Agreement on Textiles and Clothing in January 2005. As discussed in Chapter 4, there are a number of factors suggesting that the effects of the quota elimination on Cambodia and other low-income Asian countries are likely to be severe. Garment manufacturers have rapidly moved production to countries with preferential access to U.S. markets. With the removal of these preferences, production is likely to move to countries where labor costs are relatively low. The impact of a reduction in garment production will be significant because the share of garments in total exports is large: more than 75 percent in Cambodia and Bangladesh, and about 55 percent in Nepal and Sri Lanka, in 2002. Moreover, when approximately 15 percent of restrictive quotas were eliminated in 2002 at the time of "third-phase quota integration," most countries lost substantial market share to China.

Assuming that the impact of the 2005 quota elimination is proportionally similar to what occurred in 2002, the value of Cambodia's garment exports could decline

by as much as 12 percent in 2005, potentially reducing GDP growth to 2 percent. Not all of the impact may be realized in 2005 as U.S. buyers may not want to pay the search cost to find new suppliers when there is still the possibility of the U.S. government using the WTO Agreement on Safeguards to impose new quotas on China. Equally, many of the garment factories in Cambodia are owned by Chinese who may continue exporting from their Cambodia-based factories in order to hedge against possible safeguard action by the United States on their China-based factories, as appeared to be the case in early 2005.

Cambodia urgently needs to diversify the sources of growth, for which it will have to rely substantially on foreign financial assistance. As elaborated in Chapter 5, foreign aid flows have averaged 12 percent of GDP a year, reaching $500 million in 2003, and this amount is expected to remain broadly unchanged in the medium term. About 70 percent of aid flows were in the form of official grants, making Cambodia one of the largest recipients of foreign aid (as a percent of GDP) among Asian countries. Reflecting the country's recent history, aid flows were provided initially as food aid and emergency relief, then as investment projects, and increasingly as technical assistance. By 2003, technical assistance accounted for about 40–50 percent of total foreign aid. However, compensation payments to foreign advisors accounted for the bulk of technical assistance, raising questions about the appropriateness of aid allocation in a country with vast investment needs in basic infrastructure.

The policy challenge is to create an environment that will attract foreign direct investment. Foreign investment inflows peaked at 9 percent of GDP during the mid-1990s, but have fallen below 5 percent of GDP since 2000. The decline in foreign direct investment reflects limited economic opportunities after the initial boom in investment to meet pent-up demand for tourism and to export—often illegally—Cambodia's rich forestry resources. However, the needed diversification of the economy, especially following the quota elimination, will require stronger interest by foreign investors than seen in the past few years. Accordingly, serious and worsening governance problems will need to be addressed forcefully if Cambodia is to make headway toward strengthening longer-term growth.

To expand the role of the government and improve its effectiveness, the revenue envelope will have to be expanded. Despite recent achievements, fiscal revenue is hardly enough to meet basic priority spending needs and pay adequate civil service salaries. Although strengthened tax and customs administration helped raise revenue from 8 percent of GDP in 1998 to 11¼ percent in 2002, total revenue remains low compared with an average of 16 percent of GDP in neighboring low-income countries, as discussed in Chapter 6. Consequently, government spending is compressed, civil service wages remain well below private sector wages, and roads and other public facilities are poorly maintained. Moreover, the budgetary process is opaque and inefficient, calling for urgent reforms in public financial management.

Cambodia's public finances have evolved substantially during the past 10 years. In 1992, major reforms were initiated with the help of foreign experts in the areas of tax policy and tax and customs administration. A second wave of reforms were introduced during 1995–96 that included income taxation, a 20 percent excise on gasoline, and raising the turnover tax rate. Despite these efforts, tax revenue stagnated at about 6 percent of GDP, since the impact of new tax policy measures was broadly offset by a deterioration in revenue administration. It was only with the introduction of the 10 percent value-added tax (VAT) in 1999 that revenue clearly improved from 8 percent of GDP to 10 percent of GDP.

During 2001–02, improvements in tax and customs administration, notably assisted by the Technical Cooperation Action Program, contributed for the first time in a decade to an increase in revenue to above 11 percent of GDP. Efforts focused on ensuring a more effective use of preshipment inspection services and increased transparency to reduce hidden costs in customs procedures. Moreover, anti-smuggling operations were strengthened through interagency cooperation and the establishment of anti-smuggling units. Greater information sharing among government agencies, better tax auditing, and strengthened administrative capacity resulted in better tax collection and a decline in tax arrears. Unfortunately, during the 2003 political impasse, government revenue slipped back to 10½ percent of GDP. Continued revenue collection at this low level will severely limit the government's capacity to invest in education and infrastructure. Hence, improving fiscal revenue performance remains one of the key challenges.

Another challenge is to improve competitiveness. A depreciation of the exchange rate, however, is likely to have only a limited impact on competitiveness because most costs, including wages, are denominated in U.S. dollars. Given that most of the poor live in rural areas where incomes, especially of those who do not own land, are denominated in local currency, a depreciation could further reduce their purchasing power through higher inflation of prices denominated in local currency. Chapter 7 reviews exchange rate policy options that could minimize adverse impacts on the poor from an exogenous shock such as the elimination of the quota system.

The exchange rate reflects changes in demand for riel by a small fraction of the urban population who hold riel cash balances for transactions purposes and to pay taxes, and by the government. Although most of the poor in rural areas hold riel cash balances, they appear not to be able to participate in the foreign exchange market due to limited information and lack of access to the foreign exchange market. In such a shallow market, a small imbalance of supply and demand can have a large impact on the exchange rate. An increase in currency risk stemming from an increase in exchange rate volatility will prompt those holding riel to convert them into U.S. dollars, as foreign exchange market participants are mainly concerned with retaining the value of their wealth in U.S. dollar terms.

A vector auto regression model was used to estimate the extent of pass-through from exchange rate depreciation to domestic inflation, using monthly data from January 1996 through December 2003. Tests show that both exchange rate depreciation and partner inflation Granger-cause domestic inflation. The pass-through from exchange rate depreciation to domestic prices is 18 percent on impact, and around 41 percent by the end of the first year. On the basis of these findings, possible responses to a variety of shocks are considered. While exchange rate flexibility should be maintained in order to absorb fundamental changes in the real equilibrium exchange rate, careful consideration needs to be given to the redistributive effects of exchange rate changes.

Over the long run, Cambodia would benefit from de-dollarization since, in addition to loss of seigniorage, the lack of monetary policy independence and the central bank's inability to act as a lender of last resort could eventually threaten financial stability. However, de-dollarization is expected to be a gradual process, and any forceful administrative measures should be avoided. Chapter 8 discusses international experiences of de-dollarization, including options for Cambodia.

A recent IMF study covering 117 countries found that financial dollarization as measured by foreign currency deposits in broad money doubled in the last decade. However, some of the low-income countries in Asia that were able to avoid or contain dollarization shared common characteristics such as low inflation and macroeconomic stability. Moreover, the few countries—Poland and Israel—that managed to de-dollarize their economy had embarked successfully on a disinflation program initially building around a strong exchange rate anchor. It is not certain, however, whether the conditions in these two countries can be replicated by other countries, especially since the initial level of dollarization was not high in the first place.

Many countries, however, failed in attempts to de-dollarize their economies. Often, these attempts involved administrative controls without fully restoring confidence in the local currency. These experiences indicate that restoring confidence in the local currency in Cambodia, a process that will require political and macroeconomic stability for a sustained period, is a prerequisite to de-dollarization. They also suggest that recourse to administrative controls might undermine efforts to reestablish confidence in the local currency.

The new government's Rectangular Strategy reform agenda rightly identifies good governance as the key cross-cutting objective. Good governance, however, cannot take root under a weak judiciary. Chapter 9 examines the status of legal and judicial reform, and what measures can be implemented in the short run to strengthen the judiciary. Although legal and judicial reform has been on the government's agenda for the past 10 years, work has accelerated only recently. Key legislation to strengthen the judicial system, including laws on the status of judges and prosecutors, the organization and functioning of courts, the civil and criminal codes, and the status of clerks, has not yet been adopted. The legal

framework will substantially improve once laws related to WTO accession, described in Chapter 10, are adopted. The government is committed to adopting 46 pieces of legislation, of which 14 pieces had been adopted by end-2004. The remaining laws, originally envisaged to be adopted during 2004–06 will now most likely be adopted during 2005–07. These laws are aimed at providing a fair and predictable business environment. However, only the successful implementation of these laws can provide the necessary improvement in the rule of law, which in turn will require an independent judiciary backed by strong political commitment.

Unfortunately, progress was slower in judicial reform. In 2003, the government approved a comprehensive Strategy for Legal and Judicial Reform and circulated an action plan for its implementation. In 2004, these draft action plans were refined into a list of short- and medium-term priorities. Among the short-term priorities are restructuring of the Supreme Council of Magistracy, adoption of the law on the organization and functioning of courts, and enactment of the anti-corruption law. Apart from these, there has been little progress in judicial reform. Unless progress is made on this front, Cambodia's future remains uncertain as investors will continue to stay away.

D. Conclusion

Reconstruction efforts of the past two decades were hampered by the deep scar left behind by the Khmer Rouge and the civil unrest that followed. Ground was slowly gained with the help of sizable foreign aid, in rebuilding human capital, physical infrastructure, and institutions. Yet, considerable efforts are still needed on all these fronts before Cambodia can fully compete with neighboring countries in global markets. Foremost, Cambodia has yet to establish a predictable private sector environment governed by the rule of law, which in turn has to rest on an independent and capable judicial system. Unfortunately, this has been an area where progress has been slowest. Hence, it is not a surprise to find that foreign investment in the nongarment sector has been negligible.

With the elimination of the quota system, development of other sources of growth has become more urgent. Tourism is the only identified source of growth in the foreseeable future. However, tourism by itself cannot provide jobs for the growing population or reduce widespread poverty. To do this will require agricultural development of the large areas of uncultivated land in the rural areas where most of the poor live. Cambodia needs a clear strategy on land use that will spur agricultural development, determined efforts to establish the rule of law and improve economic governance, and a stronger revenue base to finance investment in human capital and infrastructure. These will be key to encouraging foreign investment and economic diversification. In the absence of a strong political commitment to push the reform agenda forward, Cambodia's economic prospects are at best uncertain.

Growth and Poverty

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CHAPTER

2 Achieving Pro-Poor Growth in Cambodia

Sònia Muñoz

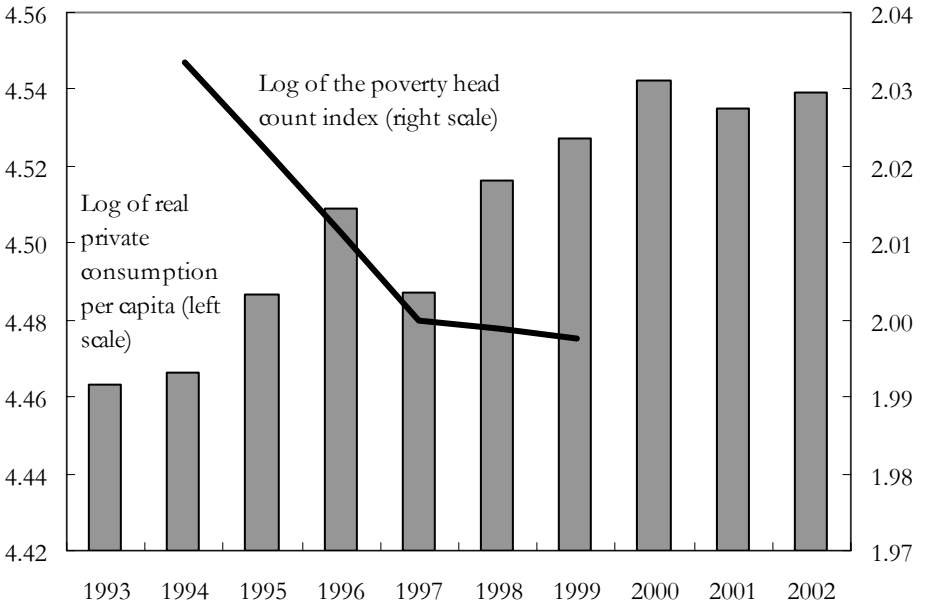
Growth has not been pro-poor in rural areas where the overwhelming majority of the poor live, and the poorest 50 percent of the population would be the main beneficiaries of an increase in rural incomes. Using household data for 1993/94 and 1999, this chapter aims at (1) analyzing whether the strong growth in Cambodia has been pro-poor, and (2) identifying the factors that can improve the "anti-poverty effectiveness" of growth in Cambodia. Section A presents the evolution of poverty in Cambodia. Section B analyzes the impact of growth on poverty. Section C discusses the two main factors that have reduced the benefit of growth to the poor, and, in Section D, poverty reduction measures are suggested.

A. Stylized Facts

Cambodia's troubled history exacerbated poverty and perpetuated economic inequities. Decades of destructive conflict, civil war, and economic, political, and social instability have contributed to the widespread poverty that currently exists in the country, especially among rural dwellers. The conflict resulted in the destruction of infrastructure, human capital, and institutions, as well as a large proportion of Cambodians being displaced, maimed, orphaned, or widowed. Not surprisingly, these conditions created deep poverty, and the aftermath has been accompanied by widespread economic and social inequities.

The proportion of the population classified as poor declined by only 3 percent between 1994 and 1999 despite strong growth, and is suspected to have increased since then. Cambodia's economy grew at an average of 6 percent during 1994–2002, while the population with income below half a dollar a day, measured by the head count ratio, fell from 39 to 36 percent. The modest decline in poverty is corroborated by the slow increase in real per capita private consumption. Since 2000, real private consumption per capita has actually declined, implying a likely rise in poverty (Figure 2.1).

Figure 2.1. Real Private Consumption and Poverty



Source: World Bank, *World Development Indicators* (2004).

Neighboring countries' starting positions were worse, but their poverty has declined much faster than Cambodia's. For example, the poverty ratio in Lao P.D.R. declined from 45 percent to 39 percent between 1993 and 1998. Vietnam has been much more successful, reducing the very high initial ratio of 58 percent in 1993 to 38 percent in 1998, and to 29 percent in 2002 (Figure 2.2).

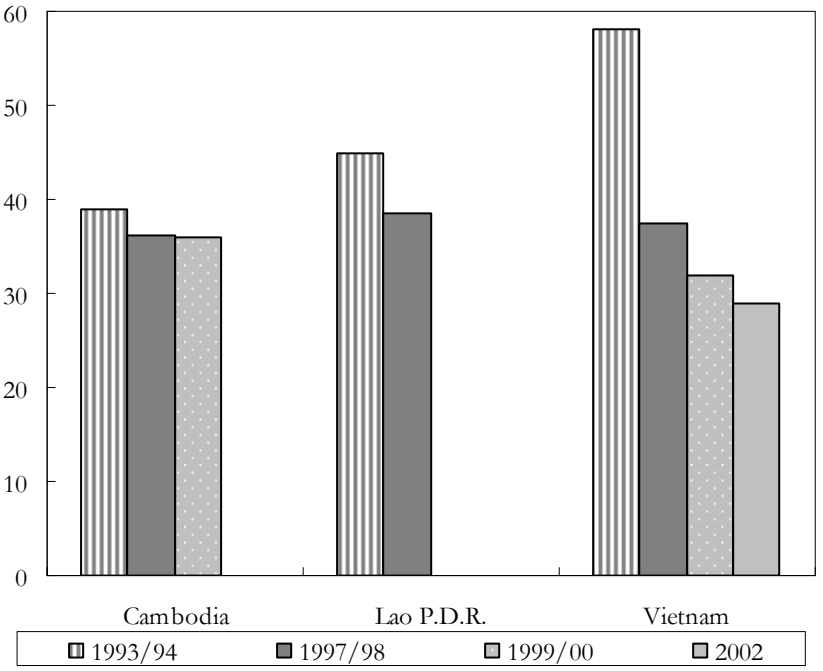
B. Analysis of the Poverty Impact of Growth

To assess the impact of growth on poverty, we use household level data from the Cambodia Socio-Economic Survey (CSES). The CSES collects expenditure data from roughly 6,000 households. This analysis uses data for 1993/94 and 1999, the first and last surveys available, and the poverty line for rural areas, Phnom Penh, and other urban areas.[1] Poverty measures based in 1993/94 were derived by deflating expenditures in each year. We use a head count ratio of 43 percent

[1]A poverty line is the line below which a given population is believed to live in poverty. It is a line taken to imply an income that is adequate for a person to consume a food basket that provides at least 2,100 calories of energy per day with a small allowance for nonfood items such as shelter and clothing.

Figure 2.2. Percentage of Population Living Below the Poverty Line

(In percent)



Source: World Bank, *World Development Indicators* (2004).

for rural households and 25 percent for urban households. The calculations for rural and urban households are done separately, since there are striking differences between the rural and urban sectors in Cambodia.

We use a measure of the growth rate consistent with the Watts index for the level of poverty developed by Ravallion and Chen (2003). The Watts index (W_t) as a measure of poverty is defined as the mean growth rate of the poor:

$$W_t = \int_0^{H_t} \log\left[z / y_t(p) \right] dp \qquad (1)$$

where $y_t(p)$ is the quantile function (obtained by inverting the cumulative distribution function of expenditure $p=F_t(y)$ at the pth quantile) and z is the poverty line.

Equation (1) can be written as follows:

$$W_t = \log\left(z / y_t^*\right) \tag{2}$$

where

$$\log y_t^* \equiv \int_0^{H_t} \log y_t(p)\, dp + (1 - H_t) \log z \tag{3}$$

is the mean of log censored expenditures, where the censored expenditure is $\min[y_t(p), z]$, that is, actual expenditure when located below the poverty line, and the poverty line itself otherwise; and y_t^* is a stable monotonic decreasing function of the actual value of the Watts index, that is, y_t^* is the exact money metric of the Watts index. The growth rate in y_t^* is the aggregate growth rate in the expenditures of the poor, and $H_t = F_t(z)$ is the head count index.

Differentiating equation (3) with respect to time, we get

$$\frac{d \log\left(y_t^*\right)}{dt} = -\frac{dW_t}{dt} = \int_0^{H_t} \frac{d \log y_t(p)}{dt}. \tag{4}$$

This is the measure of the growth rate consistent with the Watts index for the level of poverty.

Growth incidence curves (GIC) are used to assess whether recent growth in Cambodia has been pro-poor. Following Ravallion and Chen's (2003) methodology, the GIC is defined as follows:

$$g_t(p) \equiv \frac{d \log y_t(p)}{dt} \quad for\ 0 \le p \le 1. \tag{5}$$

The equation shows how the growth rate varies by percentile of the distribution ranked by y. By normalizing equation (4) by the head count index, one obtains the mean growth rate of the poor as follows:

$$g_t^p \equiv \frac{1}{H_t} \int_0^{H_t} g_t(p). \tag{6}$$

Assuming that all expenditure levels grow at the same rate (leaving distribution unchanged), equation (6) collapses to the growth rate of the mean expenditure or the ordinary rate of growth, γ_t, and the change in the Watt index

($-dW^*_t/dt$) equals $\gamma_t H_t$ (from equation (4)). The GIC plots the cumulative share of the population (depicted on the x-axis) against the growth rate of expenditure in the pth percentile (depicted on the y-axis) between two periods.

The rate of pro-poor growth, given by equation (5), can be rewritten as

$$g_t^p \equiv \frac{dW_t}{dW_t^*}\gamma_t \tag{7}$$

and is defined as the growth rate of the mean (of daily expenditure per person) times the ratio of the actual change in poverty to the change that would have been observed under distribution neutrality (i.e., growth that would have impacted each percentile equally). If the distributional shifts in expenditure favor the poor, then the rate of pro-poor growth exceeds the rate of growth in the mean and the growth benefits the poor more than the average population, and vice versa.

Between 1994 and 1999, economic growth in urban areas appears to have been pro-poor. The rates of pro-poor growth exceeded the growth rate of the mean expenditure, suggesting that economic growth was accompanied by falling inequality. The highest growth rates were observed at around the 30th percentile (Figure 2.3).

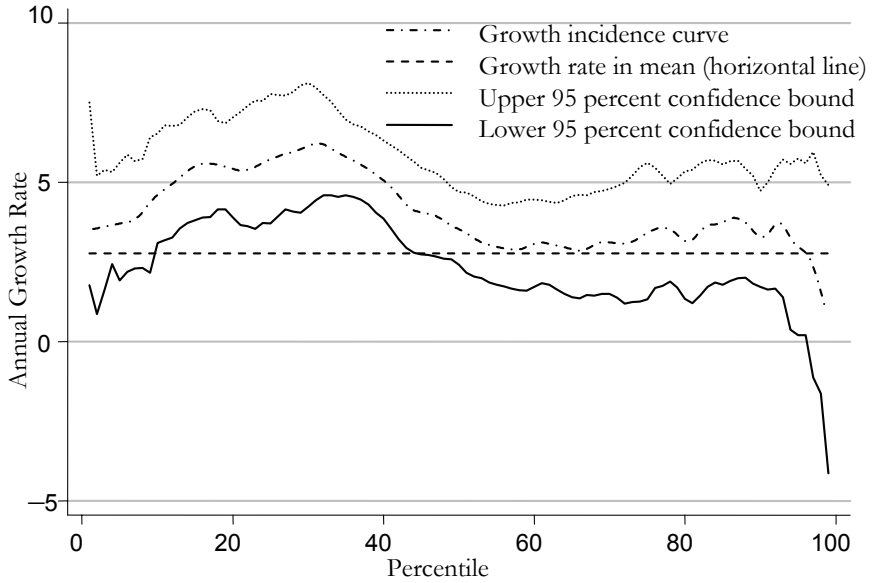
By contrast, growth in rural areas was strongly anti-poor. Between 1994 and 1999, there was a distributional shift unfavorable to the poor, since the rate of pro-poor growth was appreciably lower than the rate of growth in the mean. The 20 percent poorest households experienced a growth rate that was not relatively favorable to them, resulting in increased poverty in this group. The growth rate tends to rise along the distribution, slowing around the seventh decile and peaking at the high end (Figure 2.4).

The distributional impact in the rural areas is magnified when viewed in the context of the overall economy. The growth rate in the mean in the urban areas was higher than in that of the rural areas by 1 percent annually. At the same time, as noted earlier, growth in the urban areas was pro-poor while it was anti-poor in the rural areas. Thus, income disparity between the poor in the rural areas and the rich in the urban areas has widened substantially.

C. Factors Affecting Pro-Poor Growth

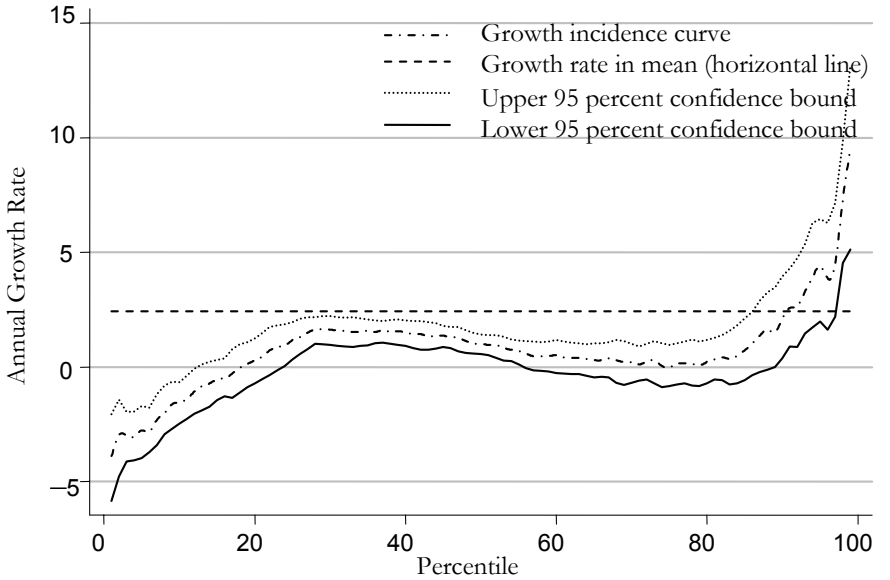
While economic growth is the basic vehicle for reducing poverty, the extent to which the poor benefit from overall growth varies among countries depending on each country's income and asset distribution. Ravallion (2004) emphasizes

Figure 2.3. Growth Incidence Curve: Urban



Sources: Cambodia, National Institute of Statistics; and IMF staff estimates.

Figure 2.4. Growth Incidence Curve: Rural



Sources: Cambodia, National Institute of Statistics; and IMF staff estimates.

that the initial degree of inequality as well as its evolution are the two factors that make growth more or less pro-poor. Unequal access by the poor to physical assets, infrastructure, and social services makes it harder for them to partake in the opportunities afforded by the overall economic growth. Moreover, recent studies show that the sectoral structure of growth influences the effect that growth has on poverty, and emphasize that rural and agricultural growth have direct effects on poverty alleviation.[2]

Initial Conditions

The reduced economic opportunities in the rural areas with respect to limited access to land, infrastructure, and financial resource assets mitigated poverty alleviation. Cambodia has a highly unequal distribution of income, caused to a substantial extent by highly unequal land ownership (Figure 2.5). Most land in the country is not yet registered, and only 10 percent of farmers have formal title to their farming land. The majority of the land is suspected to be in the hands of a few powerful groups. At the more aggregate level, demarcations between land for different uses—forests, agriculture, urban areas, and so forth—have yet to be made, complicating and delaying any land redistribution initiatives. Furthermore, inadequate infrastructure has limited farmers' access to markets.[3]

Sectoral Growth Pattern

Recent economic growth has benefited from favorable external factors, notably the bilateral trade agreement with the United States. In particular, the agreement contributed to a strong growth of garment exports and the creation of over 200,000 jobs. In addition, construction activities related partly to large aid inflows, and to a lesser extent tourism, also contributed to buoyant overall GDP growth. However, with the exception of the strong rebound in 2003, agriculture barely kept up with population growth.

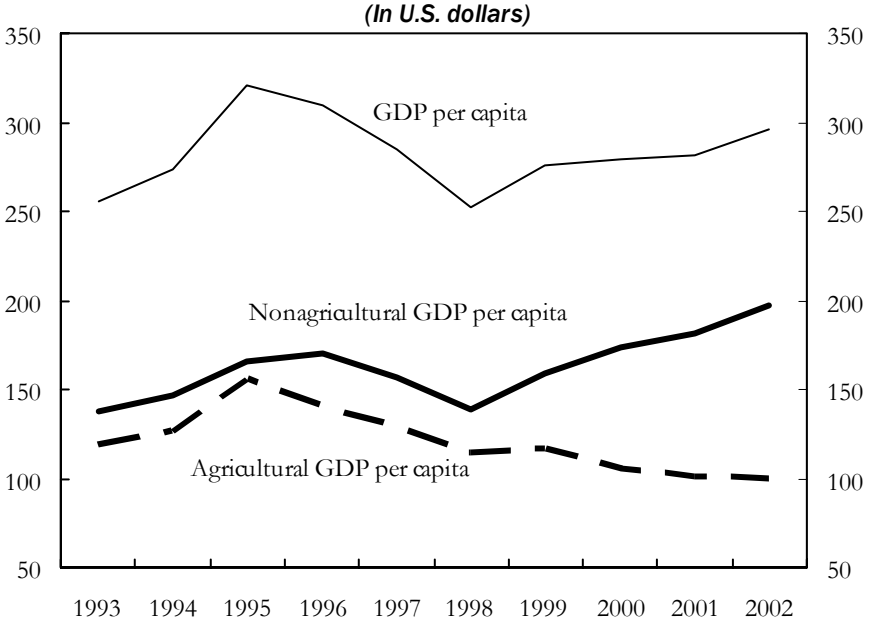
Low growth of the agricultural sector has had an adverse impact on the poor. On the one hand, agricultural GDP divided by total population (used as a proxy for per capita) has been falling since 1995, while 80 percent of the poor depend on agriculture for their livelihood. In turn, income per capita in the rural areas started to fall from 1995 onward.

[2]Empirical evidence linking measures of poverty to agricultural output can be found in Ravallion and Datt (1996 and 1998) and Timmer (2002).

[3]Rural roads, with only 16 percent of the total road network paved, and the rail system are in poor condition.

Figure 2.5. Agricultural and Nonagricultural GDP Per Capita[1]

(In U.S. dollars)



Sources: Cambodia, Ministry of Planning and National Institute of Statistics (NIS); and IMF staff estimates.

[1]In the absence of population data in these two sectors, for illustrative purposes, agricultural GDP and nonagricultural GDP were divided by total population.

Lack of available land and investment led to substantial underutilization of human resources in the rural areas. Timmer (2003) points out that short work days at wage-paying jobs, disguised unemployment, and long hours spent on low-productivity tasks suggest that marginal productivity of rural labor is very low. In such circumstances, he notes that new resources such as capital to build local irrigation systems or rural roads to allow farmers access to markets, new agricultural technology that raises yields, or higher rural household income enable rural inhabitants to spend and invest in education, further raising their marginal productivity.

Worsening income distribution in rural areas offset the positive effect of overall growth. Table 2.1 shows the change in poverty between the two household surveys undertaken in 1993/94 and 1999 decomposed into three components: the growth component (the difference between the two poverty indices keeping the distribution constant), the redistribution component (the change in poverty if

Table 2.1. Growth and Inequality Poverty Decomposition
(In percent)

	Rural	Urban
Poverty rate in 1993/94	0.427	0.246
Poverty rate in 1999	0.389	0.184
Change in poverty:	–0.038	–0.062
Due to:		
Growth component	–0.339	–0.025
Redistributional component	0.301	–0.037
Residual component	0	0

Source: Author's calculations based on Ravallion and Datt (1992).

the mean of the two distributions is kept constant), and the residual component (the change in poverty due to interaction of growth and inequality). Supporting the previous results from the GICs, worsening redistribution almost offset the positive effect of economic growth in rural areas. However, redistribution alleviated poverty in urban areas and it was quantitatively more important than growth.

D. Suggested Measures for Poverty Reduction

Countries that foster higher farm incomes and encourage rural investment benefit from higher total factor productivity in addition to the higher rural output itself. Timmer (2002) and Mellor (1999) argue that increased farm production leads to higher employment and lower basic food prices, both of which reduce poverty.[4] Furthermore, increased farm incomes stimulate demand

[4]Lower staple food prices can stimulate livestock production and provide local markets with high-quality animal protein. In addition, the low cost of these staple foods could promote agricultural diversification into other crops such as fruits and vegetables with better demand prospects. Finally, small and medium-sized enterprises in rural areas could benefit from low nominal wages, made possible by low basic food prices, and speed the absorption of surplus labor.

for goods and services in the rural areas, provide food, and can generate savings that contribute to industrialization.

Land reform is a key measure that will allow the poor to benefit from higher returns in agriculture. Agricultural growth will not reduce poverty significantly if increased farm income accrues to wealthy people who tend to spend on imports or capital-intensive goods and services. Besley and Burgess (2000) analyze the impact of land reform on rural poverty and growth by coding land reform legislation amendments of India's states between the 1950s and 1992. They find that poverty, as measured by the poverty gap and the head count ratio, was reduced as a result of land reform achieved during the previous four years. However, they also find that this poverty reduction may have come at the cost of lower agricultural growth.

Adequate rural infrastructure is critical to profitable farming, and, hence, to poverty alleviation. Public provision of rural infrastructure such as roads to markets, market centers themselves, communication networks, and air and sea port facilities help farmers with marketing surpluses. Timmer (2003) notes that the effects of higher agricultural productivity also spread to subsistence-oriented farmers, especially if rural infrastructure is constructed by the poor themselves through labor-intensive public works programs.

Based on different assumptions about growth of agriculture and the garment sector, it can be shown how different sectoral growth could benefit the poorest 50 percent of the population. For the purpose of this analysis, households sampled in the 1999 survey are divided into deciles of equal size, from the group with the lowest consumption expenditure (labeled D1) to the group with the highest (D10). As the second column in Table 2.2 shows, the lowest decile D1 accounted for less than 3 percent of total expenditure recorded in the survey; the highest group D10 accounted for 35 percent. Growth rates of 3 and 6 percent are assumed depending on whether agricultural productivity improves along with different scenarios for urban growth. Specifically, the subsequent columns show the result of the simulations in terms of percentage change in expenditure for each decile—given the particular spending pattern of each of the households in each group.

The simulations show the importance of rural income growth for reducing poverty. More rapid growth of rural incomes allows a faster growth in expenditure of the lower deciles. Moreover, higher rural incomes allow farmers to invest in farm and human capital leading to further poverty alleviation.

Table 2.2. Simulation Results

Decile	Percentage of Expenditure	Rural Incomes Increase by 6 Percent and Urban Incomes by 3 Percent	Rural Incomes Increase by 3 percent and Urban Incomes by 6 percent	Rural Incomes Increase by 6 Percent and Urban Incomes Do Not Increase	Rural Incomes Increase by 3 Percent and Urban Incomes Do Not Increase	Rural Incomes Do Not Increase and Urban Incomes Increase by 3 Percent
		Expenditure (percent change)				
D1	2.6	5.2	3.7	4.4	2.2	0.7
D2	3.9	5.2	3.8	4.4	2.2	0.8
D3	4.9	5.3	3.6	4.6	2.3	0.6
D4	5.7	5.5	3.5	5.0	2.5	0.5
D5	6.3	5.4	3.5	4.9	2.4	0.5
D6	7.4	5.1	3.9	4.1	2.1	0.9
D7	8.7	4.5	4.5	3.0	1.5	1.5
D8	10.7	4.1	4.9	2.2	1.1	1.9
D9	15.2	4.1	4.9	2.2	1.1	1.9
D10	34.5	3.7	5.3	1.5	0.7	2.3

Source: Author's calculations based on Cambodia Socio-Economic Survey.

E. Conclusion

The poor in rural areas have not benefited from economic growth, while growth in urban areas has been clearly pro-poor. Highly unequal distribution of income, and asset inequality, including limited access to land, infrastructure, and financial resource assets, have prevented growth in rural areas. By contrast, the redistributional effect of growth in urban areas has helped to improve the welfare of the poor in the cities.

Investment that mobilizes underutilized resources, or that provides funds to increase human and physical capital among the rural population, will have high returns for the poor. A new growth strategy that alters investment priorities in favor of rural growth, like those pursued in Indonesia after 1966, China after 1978, and Vietnam after 1989, will improve factor productivity because of improved resource allocation. China's strategy was to use world markets to access basic food staples and keep food costs low to provide a competitive advantage to its labor-intensive industries and producers of high-value agricultural commodities. Low grain prices can encourage livestock production and small and medium-sized enterprise activities in rural areas, and allow farmers to specialize in higher-value products (Timmer, 2003). Consequently, a strategy that raises the productivity of staples and uses these low-cost products to diversify into high value-added agricultural products will generate pro-poor growth.

A simple simulation has illustrated the importance of rural growth to the poor. A successful structural transformation of the agricultural sector could raise rural wages. The emphasis should turn to land reform, diversification into crops and livestock, and access to supply chains.

CHAPTER

3 Determinants of Growth in Cambodia and Other Low-Income Countries in Asia: Evidence from Country Panel Data

Wafa Fahmi Abdelati

This chapter explores the determinants of long-term sustainable growth in Cambodia from a cross-country analysis of the sources of growth. Section A describes Cambodia's recent economic growth performance and compares it with other low-income countries (LICs) for the period from 1970 to 2003. Section B gives an overview of the differences between Cambodia and some country groupings with respect to a number of growth determinants identified in the literature. Section C presents estimation results based on seven five-year-period averages for the 144 countries. Using these results, we consider the implications for steady-state growth in Cambodia by comparing its performance relative to that of countries in the Association of Southeast Asian Nations (ASEAN).

A. Cambodia's Growth Experience and Prospects

In the last five years, Cambodia's growth performance has been among the best of LICs. Cambodia's GDP growth rate has averaged 6–7 percent during 1999–2003, reflecting both external factors and good macroeconomic policies. Per capita GDP growth was much lower, however, at an average 3.8 percent (Table 3.1). This growth performance is significantly higher than the average for all developing countries and for LICs.[5]

[5]LICs are defined as the group of Poverty Reduction and Growth Facility (PRGF)-eligible countries. ASEAN excludes Brunei Darussalam due to data limitations.

Table 3.1. Real GDP Per Capita Growth[1]

(Annual average, in percent)

	1970–2003	1999–2003
All (144)	1.5	1.6
PRGF (70)	1.0	1.5
LIC-nonfuel (68)	1.0	1.0
Asia (23)	2.8	2.1
Asia excluding China (22)	2.6	1.8
Asia excluding islands (18)	3.1	2.8
Asia-LIC (15)	2.4	2.0
Transition (29)	2.1	4.7
Transition LIC (13)	1.5	4.3
ASEAN (9)	3.4	3.2
ASEAN LIC (4)	3.1	4.4
Cambodia	**3.5**	**3.8**
Lao P.D.R.	2.9	3.4
Vietnam	3.7	3.9

Source: IMF, *World Economic Outlook* database.

Notes: ASEAN=Association of Southeast Asian Nations; LIC=low-income countries; PRGF=Poverty Reduction and Growth Facility.

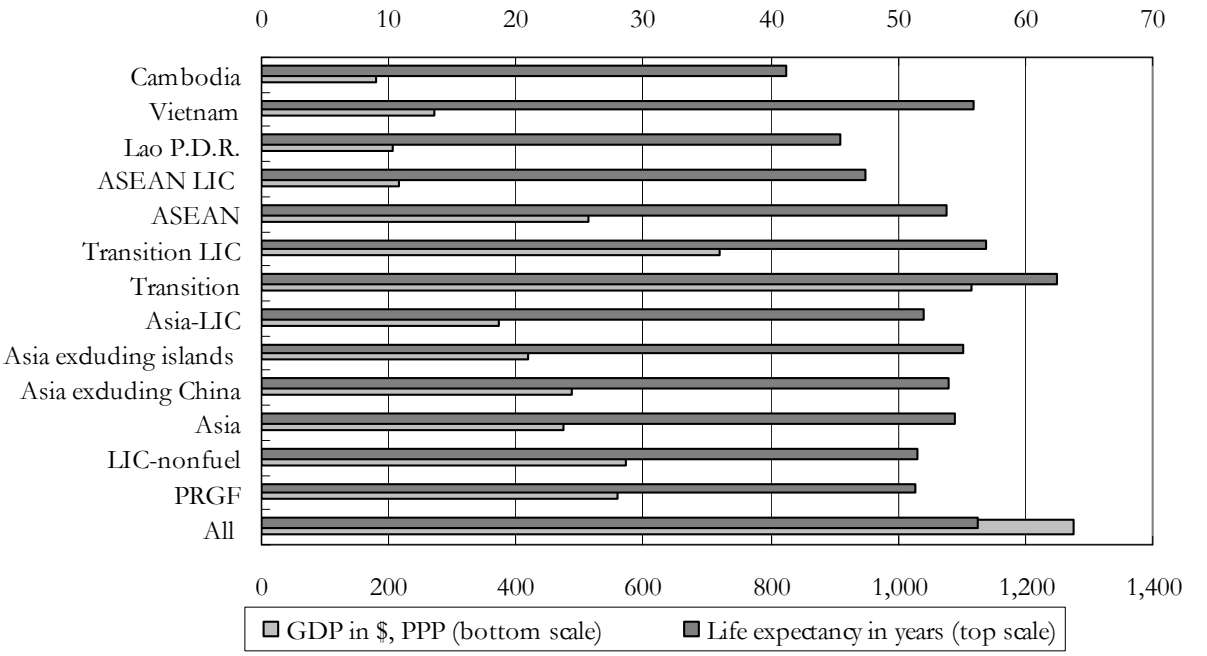
[1]Excludes advanced economies. Asia and ASEAN exclude Brunei Darussalam.

Cambodia's pace of growth is similar to that of other ASEAN low-income countries (Myanmar, Vietnam, and Lao P.D.R.) and transition countries.[6]

However, prospects for weaker growth in the period ahead call for a deeper exploration of the factors that can contribute to sustained growth. As will be disclosed in Chapters 4 and 5, Cambodia has benefited from preferential access to the United States since 1996 under the Multifiber Agreement. With the elimination of the quota system in January 2005, growth is expected to slow down as its garment industry will be exposed to direct competition with neighboring countries. Cambodia's low labor productivity, inadequate and expensive infrastructure, and a cumbersome regulatory environment—as confirmed by recent World Bank value chain studies and investment climate assessment—do not bode well for future sustainable growth (World Bank, 2004). Identification of key impediments to growth has become an urgent agenda.

[6]It should be noted, however, that Cambodia's GDP per capita growth over the longer period is misleading because it reflects the sharp reduction in population in the 1970s.

Figure 3.1. Initial Conditions, 1970



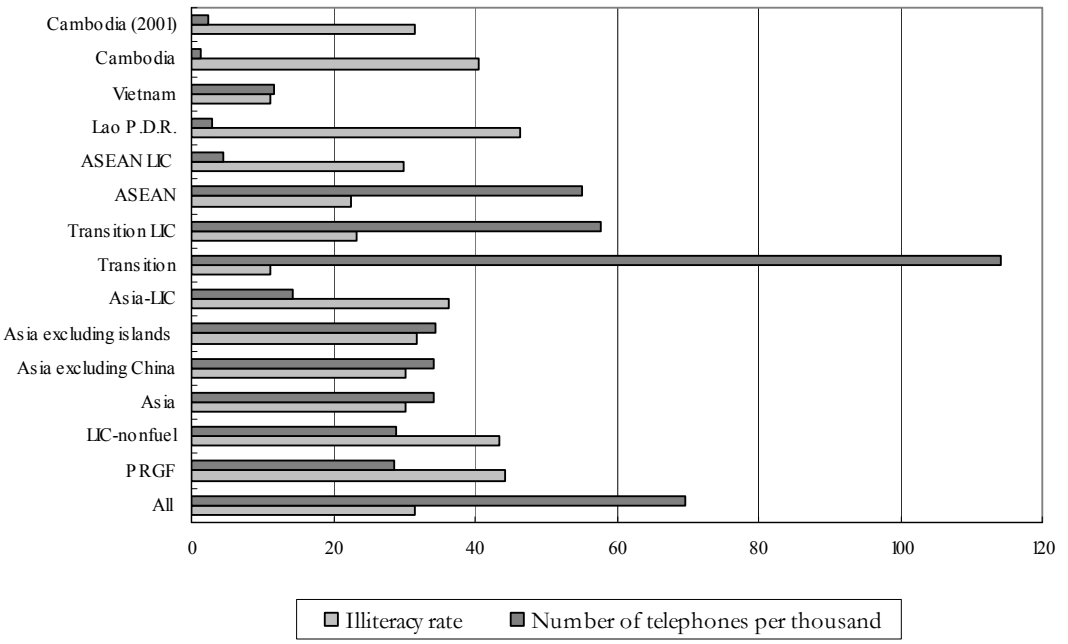
Source: IMF, *World Economic Outlook* database.
Notes: ASEAN=Association of Southeast Asian Nations; LIC=low-income countries; PRGF=Poverty Reduction and Growth Facility; PPP=purchasing power parity.

B. Overview of Growth Determinants

We begin the analysis by assessing Cambodia's performance for the period 1970–2001 against a number of factors that have been positively associated with growth. These include initial conditions, macroeconomic polices, improvements in human and physical capital, institutional factors, and other exogenous factors.

- Cambodia's initial conditions in 1970 are among the weakest of LICs. In 1970, it had one of the lowest per capita GDP in purchasing power parity (PPP) terms, about one-third that of other LICs (Figure 3.1). Life expectancy, which is one indicator of human capital conditions, was about 41 years compared to the Asian average of 54 years.

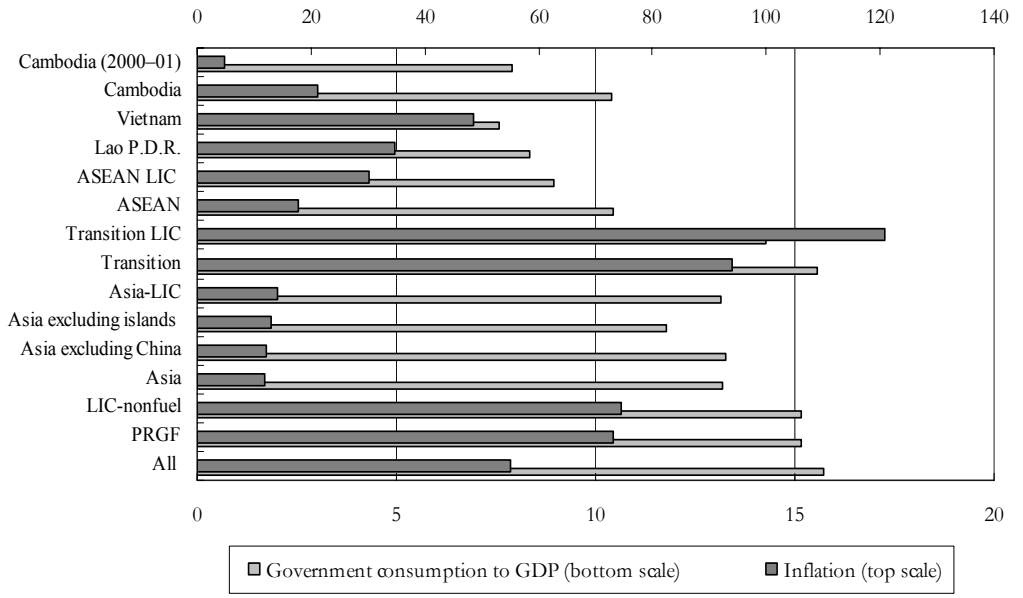
Figure 3.2. Human and Physical Capital
(Average 1970–2001)



Sources: IMF, *World Economic Outlook*; and World Bank, *World Development Indicators*.
Notes: ASEAN=Association of Southeast Asian Nations; LIC=low-income countries; PRGF=Poverty Reduction and Growth Facility; PPP=purchasing power parity.

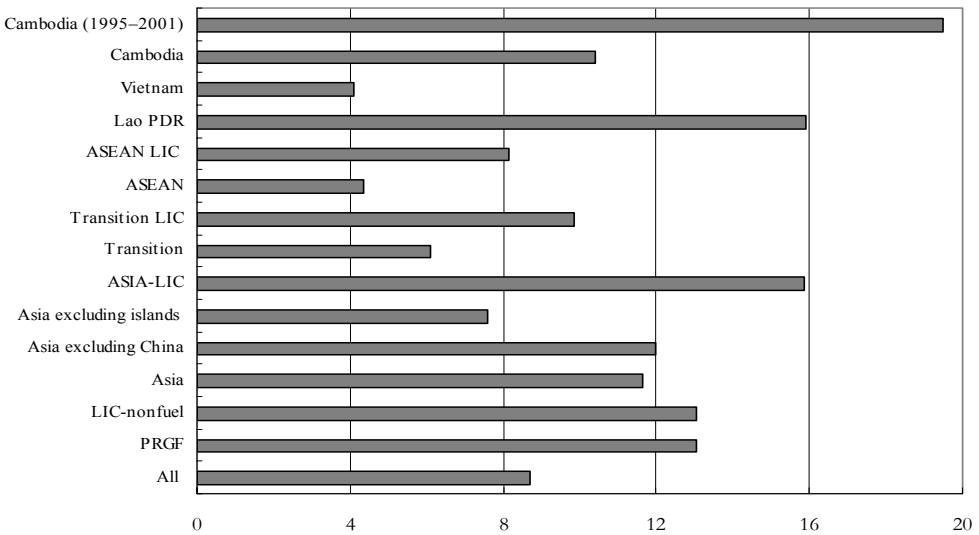
- Physical and human capital development has been anemic. Physical infrastructure, as proxied by the number of telephones per thousand inhabitants, has remained very low and only began to increase in the last decade (Figure 3.2). Illiteracy rates have remained high, particularly compared to the fast-growing economies of ASEAN and transition countries.
- Macroeconomic policy indicators, on the other hand, have been better than the average for ASEAN and for transition economies. Accordingly, inflation has remained relatively subdued, and budget balances within the range for LICs (Figure 3.3).
- Favorable external conditions, including foreign aid flows and trade agreements, have helped propel recent growth. Cambodia's per capita aid has amounted to 10 percent of per capita GDP in the period 1970–2001 and has increased to 20 percent in the period 1995–2001 (Figure 3.4). Moreover, its terms of trade have remained relatively favorable and stable (Figure 3.5).

Figure 3.3. Macroeconomic Policies
(In percent, average 1970–2001)



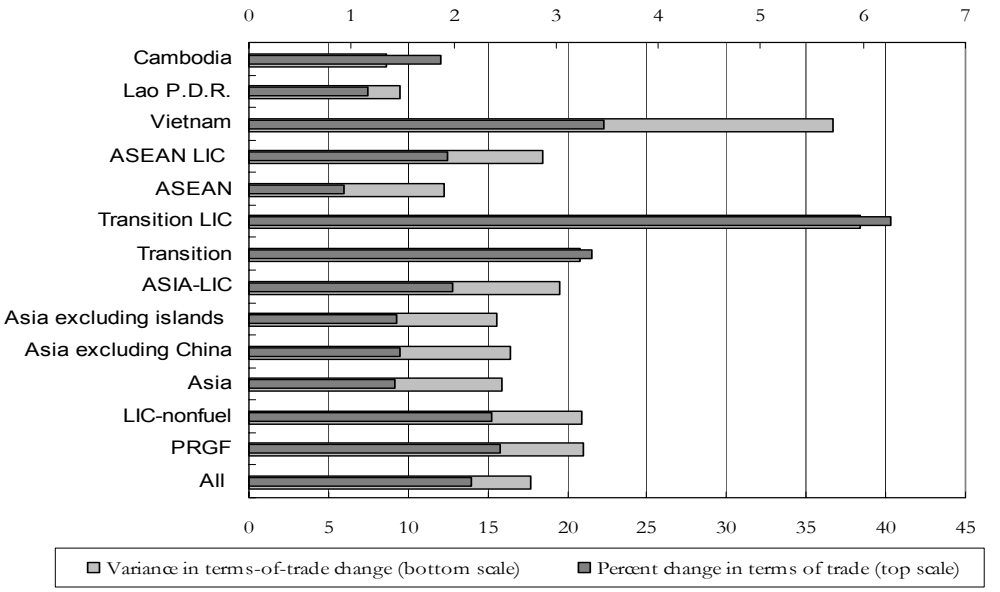
Sources: IMF, *World Economic Outlook*; and World Bank, *World Development Indicators*.
Notes: ASEAN=Association of Southeast Asian Nations; LIC=low-income countries; PRGF=Poverty Reduction and Growth Facility; PPP=purchasing power parity.

Figure 3.4. Aid Per Capita
(Aid flows as percent of GDP, average 1970–2001)



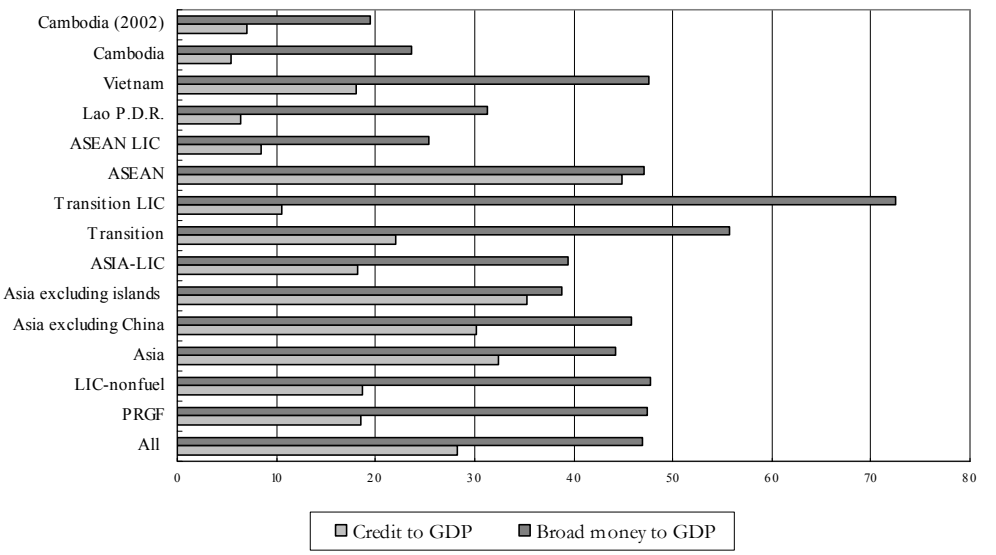
Sources: IMF, *World Economic Outlook*; and World Bank, *World Development Indicators*.
Notes: ASEAN=Association of Southeast Asian Nations; LIC=low-income countries; PRGF=Poverty Reduction and Growth Facility; PPP=purchasing power parity.

Figure 3.5. Terms-of-Trade Volatility
(Average 1970–2003)



Sources: IMF, *World Economic Outlook*; and World Bank, *World Development Indicators*.
Notes: ASEAN=Association of Southeast Asian Nations; LIC=low-income countries; PRGF=Poverty Reduction and Growth Facility; PPP=purchasing power parity.

Figure 3.6. Financial Development Indicators
(In percent, average 1970–2001)



Sources: IMF, *World Economic Outlook*; and World Bank, *World Development Indicators*.
Notes: ASEAN=Association of Southeast Asian Nations; LIC=low-income countries; PRGF=Poverty Reduction and Growth Facility; PPP=purchasing power parity.

Table 3.2. Governance Indicators

	All	PRGF	Asia	Asia-LIC	Transition	Transition LIC	ASEAN	Lao P.D.R.	Vietnam	Cambodia
Combined index[1]	–0.2	–0.4	–0.2	–0.4	–0.2	–0.5	–0.1	–0.6	–0.4	–0.7
Voice and accountability	–0.2	–0.4	–0.3	–0.4	–0.2	–0.6	–0.6	–1.0	–1.2	–0.7
Political stability	–0.1	–0.4	–0.1	–0.3	0.1	–0.2	0.2	1.0	0.4	–1.1
Government effectiveness	–0.3	–0.6	–0.1	–0.3	–0.3	–0.5	0.2	–0.1	–0.2	–0.7
Lack of regulatory burden	–0.2	–0.4	–0.1	–0.4	–0.2	–0.6	0.1	–1.1	–0.5	–0.3
Rule of law	–0.3	–0.6	–0.2	–0.6	–0.3	–0.6	–0.1	–1.3	–0.5	–0.9
Control of corruption	–0.3	–0.6	–0.3	–0.6	–0.3	–0.6	–0.2	–0.9	–0.6	–0.9

Source: Kaufman, Kraay, and Zoido-Lobatón (1999).
Notes: ASEAN=Association of Southeast Asian Nations; LIC=low-income countries; PRGF=Poverty Reduction and Growth Facility.
[1]Each of the six governance indicators is measured in units ranging from –2.5 to 2.5, with higher values corresponding to better governance outcomes.

- As with other transition economies, Cambodia lags in institutional capacity and its markets are underdeveloped. Financial markets remain shallow, with bank credit to the private sector at around 7 percent of GDP, and the ratio of broad money to GDP under 20 percent (Figure 3.6).

Weak governance has become the Achilles' heel for growth as transition economies, including Cambodia, increasingly depend on private sector development. An earlier World Bank cross-country study shows Cambodia as weaker than most developing countries on a number of different governance indicators (Table 3.2). The average index shows that, overall, Cambodia scores lower than the average for Asian LICs and transition LICs, and well below the ASEAN average in each of the six different indicators.

C. Results from Econometric Analysis and Implications for Cambodia

A growing literature has focused on the theoretical and empirical investigation of the impact of policies and conditioning factors on the steady-state rate of growth. Empirical investigation has generally taken the form of either comparative regression analysis, growth accounting, or, more recently, a combination of the two.[7] The growth accounting approach estimates the

[7]Early papers that spurred research include Barro (1991) and Fischer (1993).

contribution of capital accumulation and improvements in total factor productivity, but does not capture the influence of economic policies and external factors (such as changes in the terms of trade). The more eclectic cross-country approach, inspired by the theory of endogenous growth, attempts to explain differences in growth rates by a wide range of macroeconomic, structural, and external factors. Attempts have been made to combine both approaches by adding factor contributions and conditioning factors to estimate their contributions to growth in the same equation, or to estimate the influence of policies and conditioning factors on the rate of human and physical capital accumulation and, thus, on growth.[8]

For developing countries, two cross-country studies by IMF staff have focused on drawing lessons from the impact of macroeconomic and structural policies on differences in growth rates across countries. A 1999 study investigated the impact of macroeconomic and structural policies on growth in 84 low- and middle-income nontransition countries, subdividing them into PRGF-countries and non-PRGF countries (IMF, 1999). The study found that the gap between the growth rates of PRGF and non-PRGF countries has narrowed, and confirmed the positive role that good policies—single-digit inflation, low budget deficits, outward-oriented policies, and streamlined governments—can play in improving growth. A 2003 study covering 94 countries, including 69 low-income countries, found that institutional quality has a more significant impact on growth and performs better than macroeconomic policy variables (with the exception of trade openness) in explaining the differences in the level of income, in growth rates, and in the volatility of growth.[9] Another 2003 regional study that combined the growth accounting approach and institutional quality for a cross-country sample of 74 countries, including 53 low- and middle-income countries, found the lower growth rates of Middle Eastern countries can be explained by the larger size of government, poor quality of institutions, misalignment of the real exchange rate, terms of trade volatility, and barriers to trade.[10]

Cambodia and other transition economies have been typically excluded from cross-country studies of long-term growth. One reason might have been that structural rigidities and weak influence of market forces were thought to make it difficult to distinguish the role of macroeconomic policies in promoting capital accumulation and productivity growth. More practically, however, data shortcomings have precluded the inclusion of these countries, either because many have become independent states only since the early 1990s, or because

[8]Bosworth and Collins (2003) review the recent literature and apply the combined approach to 84 high- and low-income countries, utilizing Barro and Lee's (2000) data set of educational attainment and by extending the data set on initial capital stock contained in a 1993 World Bank study.

[9]Chapter on "Growth and Institutions," IMF (2003d).

[10]Section on "How Can Economic Growth in the Middle East and North Africa Region Be Accelerated?" IMF (2003c).

earlier data collection methods were deemed unreliable. Accordingly, while some improvements have been made in data quality, the results of the following analysis still reflect such weaknesses. Nevertheless, inclusion of these countries would produce more relevant results for assessing Cambodia's medium-term growth prospects.

Estimation Approach

A standard growth model was estimated for 144 low- and middle-income countries. Transition economies are included where data permit. The countries (denoted by *i*) include 71 LICs, of which 15 are Asian LICs. Variables are averaged for seven five-year periods (denoted by *t*), with the seventh period ranging from two to four years, depending on data availability. Real per capita GDP growth is the key dependent variable, and growth in labor productivity is used as an alternative dependent variable.[11] The explanatory variables and their means are described in Appendix Table A3.1 and the countries are listed in Appendix Table A3.2 in the appendix to this chapter. The basic regression takes the following form:

$$\text{Per capita growth}_{it} = \text{constant} + \beta\,[\text{initial conditions}]_{i} + \delta\,[\text{macroeconomic policy}]_{it} + \varphi\,[\text{labor and capital inputs}]_{it} + \lambda\,[\text{external factors}]_{it} + \theta\,[\text{institutional factors}]_{it} + \mu_{it} + \upsilon_{it}. \quad (1)$$

$$\text{Labor productivity growth}_{it} = \text{constant} + \beta\,[\text{initial conditions}]_{i} + \delta\,[\text{macroeconomic policy}]_{it} + \varphi\,[\text{labor and capital inputs}]_{it} + \lambda\,[\text{external factors}]_{it} + \theta\,[\text{institutional factors}]_{it} + \mu_{it} + \upsilon_{it}. \quad (2)$$

A number of estimation methodologies are used to test the robustness of the coefficients. Ordinary least squares (OLS) has been typically used with either annual pooled data or period averages. Using the panel data organized in seven five-year period averages, we use a random effects application while assuming that the independent variables are independent of the unobserved individual

[11]Further work is needed to develop estimates of initial physical capital stock and human capital for many of the countries included in this study, thereby allowing application of the growth accounting approach to decompose the sources of growth.

country effects (μ_{it}) and the true disturbance term (υ_{it}) for all *i* and *t*.[12]
A key concern is the endogeneity of macroeconomic and institutional factors and their possible correlation with the unobserved omitted factors. This could be addressed by using two-stage least squares with appropriate instrumental variables for the endogenous explanatory variables, but it is typically difficult to obtain good instruments for these variables.[13] In the absence of readily available instruments, we used three approaches in addition to OLS. The first is a generalized least squares (GLS) estimation that allows for heteroscedastic effects between the country panels. The second is the Hausman-Taylor estimation method whereby some variables are designated as exogenous and used to instrument for variables suspected to be endogenous. The third alternative uses the lagged dependent variable along with first differences of the independent variables and applies the Arellano-Bond estimator.

Results

The results shown in Table 3.3 are consistent with other studies in the literature. The empirical analysis confirms that higher real per capita growth is associated with lower initial income levels, better macroeconomic performance, faster human and physical capital accumulation, smaller government, and stronger institutions and governance. Variations in trade openness and trade restrictiveness did not yield significant coefficients for explaining growth performance. Labor force growth had the wrong sign, possibly due to widespread unemployment and underemployment.[14] Similar results are obtained when labor productivity growth (change in output per worker) is used as the dependent variable. While there is room to further improve variable measurement and estimation methods, overall, the results are useful for illustrating the implications of the determinants of sustained growth for Cambodia.

[12]This is a restrictive assumption that is arguably difficult to support. However, a fixed effects model, which does not require this assumption, is excluded because it ignores the time-invariant variables, such as the institutional factors that are of particular interest here. In principle, however, alternative time-varying measures of institutional indicators could be used, if readily available.

[13]In the study on the impact of institutions in the September 2003 *World Economic Outlook* (*WEO*; IMF, 2003c), geographic latitude and ethno-linguistic diversity were used as instruments for institutions, but no instruments were used for macroeconomic variables. Data sets of instruments used in cross-country analysis, such as the percent of population speaking a foreign language or the origin of the legal system, have typically excluded transition economies.

[14]This may be due to mismeasurement of labor inputs: very few countries report hours worked or overall employment figures, and employment was therefore measured by labor force growth or population growth. The 2003 *WEO* study used "economically active population growth differential," measured as the rate of growth in the labor force minus the population growth rate, but using this measure yielded a wrong sign in our analysis as well, and the different result may stem from excluding advanced economies. The growth in the labor force is apparently not a good measure of labor input, possibly due to the prevalence of underemployment in many developing countries, particularly in the rural areas and in state-owned enterprises.

Table 3.3. Summary Regression Results for Panel Data

	(1)	(2)	(3)	(4)		(5)	(6)		(7)	(8)
	OLS (robust SE)		GLS (Hetero panel)			RE (Hausman-Taylor)			Arellano-Bond Estimator	
Dependent Variable	rGr_PC	Gr_Y/L	rGr_PC	Gr_Y/L		rGr_PC	Gr_Y/L		rGr_PC	Gr_Y/L
Initial period GDP (log)	–0.755	–0.807	–0.555	–0.424		–1.957	–1.989	D1	–6.174	–5.016
	0.252 ***	*0.248* ***	*0.190* ***	*0.179* **		*0.595* ***	*0.589* ***		*1.000* ***	*1.005* ***
Labor force growth	–0.340	–0.669	–0.243	–0.622		–0.250	–0.634	D1	–0.076	–0.334
	0.119 ***	*0.141* ***	*0.098* **	*0.094* ***		*0.133* *	*0.131* ***		*0.186*	*0.182* *
Log of inflation	–0.974	–1.048	–0.743	–0.824		–0.849	–1.011	D1	–0.990	–1.052
	0.143 ***	*0.137* ***	*0.071* ***	*0.087* ***		*0.148* ***	*0.145* ***		*0.198* ***	*0.196* ***
Government consumption to GDP	–0.112	–0.094	–0.128	–0.118		–0.110	–0.110	D1	–0.151	–0.141
	0.023 ***	*0.025* ***	*0.010* ***	*0.015* ***		*0.033* ***	*0.032* ***		*0.055* ***	*0.054* *
Terms of trade change, lagged	0.032	0.033	0.021	0.017		0.027	0.027	D1	0.051	0.040
	0.018 *	*0.019* *	*0.011* **	*0.010* *		*0.015* *	*0.015*		*0.018* ***	*0.018* **
Terms of trade volatility	0.000	0.000	0.000	0.000		0.000	0.000	D1	0.000	0.000
	0.000	*0.000*	*0.000*	*0.000*		*0.000*	*0.000*		*0.001*	*0.001*
Weather: crop decline	–3.318	–3.871	–1.924	–2.682		–3.578	–3.880	D1	–4.362	–4.826
	0.799 ***	*0.734* ***	*0.411* ***	*0.420* ***		*0.711* ***	*0.700* ***		*0.983* ***	*0.976* ***
Broad money to GDP	0.000	–0.013	–0.001	0.003		0.003	–0.006	D1	–0.018	–0.042
	0.029	*0.028*	*0.017*	*0.017*		*0.029*	*0.028*		*0.046*	*0.046*
Aid per capita, as percent of GDP per capita	0.030	0.031	0.041	0.051		0.085	0.064	D1	0.069	0.018
	0.020	*0.021*	*0.012* ***	*0.015* ***		*0.027* ***	*0.026* **		*0.041* *	*0.041*
Telephones per thousand	0.002	0.002	0.002	0.001		0.001	0.002	D1	0.009	0.004
	0.003	*0.003*	*0.002*	*0.002*		*0.003*	*0.003*		*0.005* *	*0.005*
Trade restrictiveness index	–0.011	0.031	–0.055	–0.016		–0.020	0.025	D1	–1.273	–1.574
	0.058	*0.062*	*0.037*	*0.037*		*0.174*	*0.176*		*0.960*	*0.950*
Gross capital formation to GDP	0.128	0.175	0.141	0.149	(EN)	0.138	0.197	D1	0.194	0.289
	0.023 ***	*0.040* ***	*0.014* ***	*0.015* ***		*0.025* ***	*0.025* ***		*0.038* ***	*0.038* ***
Trade to GDP	–0.009	–0.004	–0.008	–0.010	(EN)	–0.003	–0.004	D1	0.008	0.011
	0.016	*0.016*	*0.009*	*0.009*		*0.014*	*0.014*		*0.025*	*0.025*
Secondary school enrollment	0.019	0.000	0.010	–0.003		0.045	0.023	D1	(dropped)	(dropped)
	0.010 **	*0.010*	*0.006* *	*0.006*		*0.019* **	*0.019*			
Dummy for fuel exporters	–0.449	–0.408	–0.925	–0.296		0.941	0.818	D1	(dropped)	(dropped)
	0.586	*0.595*	*0.377* **	*0.441*		*1.426*	*1.434*			
Government efficiency	1.450	1.535	1.544	1.436	(EN)	2.274	2.101	D1	(dropped)	(dropped)
	0.338 ***	*0.309* ***	*0.202* ***	*0.208* ***		*1.358* *	*1.358*			
Lagged dependent variable								LD	–0.001	0.022
									0.050	*0.049*
Constant	9.348	9.935	6.141	6.215		14.718	15.890		1.206	1.035
	1.907	*1.948*	*1.333*	*1.271*		*4.534*	*4.492*		*0.226* ***	*0.229* ***
Number of observations	640	640	640	640		640	640		463	462
R-squared	0.299	0.367								
rho						0.616	0.629			
ST									40.65 (14)	39.54 (14)

Sources: Author's estimates based on IMF, *World Economic Outlook*; and World Bank, *World Development Indicators.*
Notes: Standard errors in italics. Significance of the coefficients at the 1, 5, and 10 percent level are designated by *, **, and ***, respectively.
rho is the fraction of the variance due to u_i.
(EN) = variables designated as endogenous variables in Hausman-Taylor estimation method.
D1 = first differenced variables in the Arellano-Bond method, no lags were used for the independent variable.
ST refers to chi -squared value of the Sargan test for overidentifying restrictions.
Time dummy variables were used in equations (3) to (6).

Table 3.4. Difference Between ASEAN Average and Cambodia on Growth Determinants[1]

	Regression Coefficients	ASEAN Mean Value (1970–2001)	Cambodia Mean Value (1970–2001)	Impact on Per Capita GDP Growth
Secondary school enrollment	0.045	41.0	17.5	-6.0
Gross capital formation to GDP	0.138	24.6	14.0	–10.5
Government consumption to GDP	–0.110	10.5	10.4	0.1
Trade to GDP	–0.003	92.6	58.0	0.2
Lagged improvement in terms of trade	0.027	1.2	2.3	1.3
Terms of trade volatility	–0.001	12.2	8.7	0.0
Weather (years of low crop yield)	–3.578	0.1	0.1	0.0
Broad money to GDP	0.003	47.1	23.6	–0.3
Government effectiveness[2]	2.274	2.7	1.8	–113.7
Telephones per thousand	0.001	55.1	1.2	–4.4
Aid per capita as percent of per capita GDP	0.085	4.3	10.4	5.0

Sources: IMF, *World Economic Outlook*; World Bank, *World Development Indicators*; and Kaufman, Kraay and Zoido-Labatón (1999).

[1]Regression results from equation (5) in Table 3.3.

[2]Scale adjusted from between –2.5 and +0.25 to between 0 and 5. Similar coefficients obtained for the other governance indicators.

Although most of the methods yielded similar coefficients, equation (5) in Table 3.3 was used to draw implications for Cambodia. When pooling the data, the OLS estimator in equations (1) and (2) does not take advantage of the benefits of panel data analysis that can capture the impact of country-specific effects stemming from unobserved, and hence, omitted variables. The Arellano-Bond estimator is deemed less suitable as it did not yield a significant coefficient for the lagged dependent variable, negating the usefulness of this estimator.[15] The Hausman-Taylor estimator was preferred as it allows relaxation of the assumption of exogeneity of all regressors, and some of the exogenous variables could be used as instruments for governance indicators, trade openness, and capital formation to GDP, yielding similar coefficient estimates.

Lessons for Cambodia

Lessons for achieving more robust sustainable growth can be drawn by comparing Cambodia to strong performers. For illustration purposes, the results from equation (5) in Table 3.3 are used to estimate the contribution to per capita growth in Cambodia of the main growth determinants. The estimated contribution in the last column of Table 3.4 suggests that Cambodia has benefited from high per capita aid flows and stability in the terms of trade.[16]

[15]However, tests confirmed the absence of first-order correlation in the residuals and the existence of second-order correlation, and rejected the null hypothesis in the Sargan test for overidentifying restrictions.

[16]Similarly, although the coefficient for weather, proxied by the number of years with a large drop in crop yield, was large and significant, Cambodia's share of bad weather is similar to that of other ASEAN countries and better than the average for all nonfuel-exporting LICs (Appendix Table A3.1).

In contrast, Cambodia's growth performance has been constrained by a number of factors. These include lower levels of education and capital formation (infrastructure development as proxied by the number of telephones). Accordingly, improvements in those areas could potentially yield significant improvements in long-term growth. Above all, improved government effectiveness could be an important contributor to boosting growth. The same result was obtained by substituting government effectiveness with each of the other governance indicators shown in Table 3.2.

D. Conclusions

Cambodia has experienced more rapid growth than other LICs since the Asian crisis. The higher growth rates are partly consistent with the experience of other LICs and transition countries, which are starting from a lower base. Cambodia has also benefited from large aid inflows that have boosted economic activity. Relative macroeconomic stability, compared to other LICs, has also helped support higher growth rates.

The crucial question for Cambodia is how to sustain high growth rates in the presence of a number of adverse developments that are likely to lead to slower growth. Compared to the fast-growing Asian economies, Cambodia and other LICs have weaker human and physical capital base and institutional infrastructure. Sustaining such high growth rates in the future would require Cambodia to catch up with other countries in labor skills, market institutions, infrastructure, and strengthened governance. At the same time, continuing with the macroeconomic stability and a relatively open trade system will remain crucial to supporting private sector activity.

Appendix

Table A3.1. Description of Data and Group Means for 1970–2003[1]

	All (144)	PRGF (70)	LIC-Nonfuel (68)	Asia	Asia Excluding China	Asia Excluding Islands (18)	ASIA-LIC (16)	Transition (29)	Transition LIC (13)	ASEAN (9)	ASEAN LIC (4)	Lao P.D.R.	Viet-nam	Cam-bodia	Number of Observations[2]
Dependent variables															
Real GDP per capita	1.4	0.9	0.8	2.5	2.3	3.0	2.1	2.0	1.4	3.4	3.1	2.6	3.5	3.4	1,008
Growth of ouput per labor	1.1	0.7	0.7	2.6	2.4	3.0	2.4	1.7	0.8	3.2	3.3	3.2	3.2	3.5	921
Initial conditions															
Log of GDP (1970)	7.7	7.1	7.1	7.2	7.2	7.1	6.9	7.9	7.3	7.3	6.5	6.5	6.6	6.5	1,007
1970 GDP in U.S. dollars, PPP	1276	560	571	474	488	419	374	1115	719	512	217	207	272	179	1,008
Labor growth															
Labor force growth	2.4	2.3	2.3	2.4	2.5	2.4	2.3	1.1	2.0	2.5	2.0	2.0	2.2	1.9	921
Population growth	2.1	2.2	2.2	2.1	2.2	2.2	2.1	0.9	1.6	2.2	2.2	2.5	2.0	2.2	1,008
Human capital															
Life expectancy (in years)	60.2	54.5	54.7	60.0	59.6	59.9	57.6	66.0	61.4	59.5	52.0	47.8	62.1	45.7	1,000
Log of life expectancy	4.1	4.0	4.0	4.1	4.1	4.1	4.0	4.2	4.1	4.1	3.9	3.9	4.1	3.8	1,000
Illiteracy rate	31.6	44.1	43.4	30.1	30.3	31.8	36.4	11.2	23.4	22.6	29.9	46.4	11.0	40.6	847
Primary school enrollment	91.0	83.4	83.5	96.4	95.5	96.2	93.1	99.4	98.8	99.6	98.2	96.0	107.5	93.9	855
Secondary school enrollment	45.1	30.5	30.6	38.7	38.1	38.5	33.0	75.2	61.8	40.9	27.3	20.9	46.8	17.5	847
Tertiary school enrollment	11.5	6.0	6.1	7.2	7.4	7.6	3.6	22.7	15.3	10.3	2.9	1.4	4.2	1.3	807
Physical capital															
Number of telephones per thousand	69.5	28.5	29.0	34.3	34.3	34.6	14.3	114.1	57.8	55.1	4.4	3.0	11.7	1.2	941
Capital formation to GDP	22.8	21.5	21.5	24.4	23.8	24.6	21.8	25.6	23.4	24.6	16.8	18.9	23.1	14.0	823
Macroeconomic policies															
Inflation	55.2	73.1	74.6	11.8	12.2	13.0	14.2	94.1	120.9	17.8	30.2	34.7	48.5	21.0	1,006
Log of inflation	2.2	2.3	2.3	1.9	2.0	1.9	2.1	2.1	2.2	2.0	2.5	3.0	2.8	1.7	974
Government balance	–4.2	–5.7	–5.6	–4.0	–4.2	–3.8	–5.2	–3.4	–6.4	–2.7	–5.2	–8.7	–5.2	–4.3	945
Government consumption to GDP	15.7	15.1	15.2	13.2	13.3	11.8	13.2	15.6	14.3	10.5	9.0	8.3	7.6	10.4	813
Openness															
Trade to GDP	85.7	82.2	82.5	79.6	82.5	73.0	65.4	108.4	135.7	92.6	43.7	51.3	76.7	58.0	906
Trade Restrictiveness Index	4.6	4.6	4.6	4.2	4.2	4.2	3.8	4.8	4.8	4.8	4.3	2.5	6.0	4.5	1,008
External factors															
Terms of trade (ToT) change	2.2	2.5	2.3	0.7	0.7	0.7	0.9	3.9	7.7	0.9	2.1	2.0	2.6	1.7	998
Terms of trade change, lagged	2.2	2.5	2.3	0.8	0.8	0.8	0.9	4.0	8.0	1.2	2.5	0.9	3.6	2.3	997
Variance of ToT change	17.7	21.0	20.9	15.8	16.4	15.6	19.5	20.8	38.4	12.2	18.5	9.5	36.7	8.7	1,001
Fraction of years of low crop yield	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.0	0.1	0.1	924
Aid per capita in U.S. dollars	45.4	54.1	55.3	48.3	50.2	28.2	62.6	25.8	31.0	11.2	16.0	31.5	9.2	18.4	900
Aid per capita to GDP per capita	8.7	13.0	13.0	11.7	12.0	7.6	15.9	6.1	9.9	4.3	8.1	15.9	4.1	10.4	899
Financial sector development															
Credit to GDP	28.2	18.5	18.7	32.5	30.2	35.3	18.2	22.0	10.6	44.8	8.4	6.4	18.0	5.4	826
Broad money to GDP	47.0	47.5	47.8	44.2	45.8	38.8	39.4	55.8	72.5	47.1	25.4	31.3	47.6	23.6	914
Institutional factors															
Composite index	–0.2	–0.4	–0.4	–0.2	–0.2	–0.2	–0.4	–0.2	–0.5	–0.1	–0.7	–0.6	–0.4	–0.7	1,001
Voice and accountability	–0.2	–0.4	–0.3	–0.3	–0.3	–0.5	–0.4	–0.2	–0.6	–0.6	–1.1	–1.0	–1.2	–0.7	1,001
Political stability	–0.1	–0.4	–0.4	–0.1	–0.1	–0.1	–0.3	0.1	–0.2	0.2	–0.2	1.0	0.4	–1.1	875
Government effectiveness	–0.3	–0.6	–0.5	–0.1	–0.1	0.0	–0.3	–0.3	–0.5	0.2	–0.5	–0.1	–0.2	–0.7	987
Lack of regulatory burden	–0.2	–0.4	–0.4	–0.1	–0.1	0.0	–0.4	–0.2	–0.6	0.1	–0.7	–1.1	–0.5	–0.3	994
Rule of law	–0.3	–0.6	–0.6	–0.2	–0.2	–0.2	–0.6	–0.3	–0.6	–0.1	–1.0	–1.3	–0.5	–0.9	889
Control of corruption	–0.3	–0.6	–0.6	–0.3	–0.3	–0.3	–0.6	–0.3	–0.6	–0.9	–0.1	–0.9	–0.6	–0.9	798

Sources: IMF, *World Economic Outlook*; World Bank, *World Development Indicators;* and Kaufman, Kraay and Zoido-Labatón (1999).

[1]For many variables, data cover 1970–2001.

[2]Number of observations refers to number of five-year period averages per variable.

Table A3.2. List of Economies Included in the Analysis

Africa
- Angola
- Benin
- Botswana
- Burkina Faso
- Burundi
- Cameroon
- Cape Verde
- Central African Republic
- Chad
- Comoros
- Congo, Dem. Rep. of
- Congo, Rep. of
- Côte d'Ivoire
- Djibouti
- Equatorial Guinea
- Ethiopia
- Gabon
- Gambia, The
- Ghana
- Guinea
- Guinea-Bissau
- Kenya
- Lesotho
- Madagascar
- Malawi
- Mali
- Mauritania
- Mauritius
- Morocco
- Mozambique
- Namibia
- Niger
- Nigeria
- Rwanda
- São Tomé and Príncipe
- Senegal
- Seychelles
- Sierra Leone
- South Africa
- Sudan
- Swaziland
- Tanzania
- Togo
- Tunisia
- Uganda
- Zambia
- Zimbabwe

Asia
- Bangladesh
- Bhutan
- Cambodia
- China
- Fiji
- India
- Indonesia
- Lao P.D.R.
- Malaysia
- Maldives
- Myanmar
- Nepal
- Pakistan
- Papua New Guinea
- Philippines
- Samoa
- Singapore
- Solomon Islands
- Sri Lanka
- Thailand
- Tonga
- Vanuatu
- Vietnam

Europe
- Albania
- Bulgaria
- Croatia
- Cyprus
- Czech Republic
- Estonia
- Hungary
- Latvia
- Lithuania
- Macedonia, FYR
- Poland
- Romania
- Slovak Republic
- Slovenia

Former Soviet Union
- Armenia
- Azerbaijan
- Belarus
- Georgia
- Kazakhstan
- Kyrgyz Republic
- Moldova
- Mongolia
- Russia
- Tajikistan
- Ukraine

Middle East
- Algeria
- Bahrain
- Egypt
- Iran, I.R. of
- Jordan
- Kuwait
- Lebanon
- Libya
- Malta
- Oman
- Qatar
- Saudi Arabia
- Syrian Arab Republic
- Turkey
- United Arab Emirates
- Yemen, Republic of

Western Hemisphere
- Antigua and Barbuda
- Argentina
- Bahamas, The
- Barbados
- Belize
- Bolivia
- Brazil
- Chile
- Colombia
- Costa Rica
- Dominica
- Dominican Republic
- Ecuador
- El Salvador
- Grenada
- Guatemala
- Guyana
- Haiti
- Honduras
- Jamaica
- Mexico
- Netherlands Antilles
- Nicaragua
- Panama
- Paraguay
- Peru
- St. Kitts and Nevis
- St. Lucia
- St. Vincent and the Grenadines
- Suriname
- Trinidad and Tobago
- Uruguay
- Venezuela, R.B. de

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Exports, Foreign Aid, and Investments

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CHAPTER

4 Implications of the Removal of Quota on Textiles and Clothing Exports

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This chapter examines the implications of the removal in 2005 of quotas under the Agreement on Textiles and Clothing (ATC) on the economies of low-income Asian countries (LIAs).[17] The garment sector, which took off after receiving preferential market access to the United States in 1996, has been a major contributor to growth in Cambodia since then. The analysis concludes that Cambodia is one of the most vulnerable LIAs to the removal of textile and clothing (T&C) quotas, since T&C exports make up almost 80 percent of its total exports, and because Cambodia is exporting almost exclusively to quota-protected markets such as the United States and the European Union (EU). Estimates presented in this chapter suggest that Cambodia's GDP growth could be reduced by about 2 percentage points after the removal of the quota system. The ATC and other agreements that can have an impact on T&C trade in Asia are summarized in Section A. Section B provides reasons why Cambodia and other LIAs are vulnerable to the removal of the quota system, and Section C presents the estimates of the impact of the elimination of the quota system on LIAs.

A. The ATC and Other Agreements That Have an Impact on T&C Trade in Asia[18]

The ATC was introduced with the aim of phasing out the quota system under the 1974 Multifiber Agreement (MFA). The ATC, which became effective on January 1, 1995, is a 10-year nonextendable agreement that requires WTO members to gradually phase out T&C quotas in four stages. However, only about 20 percent of U.S. and EU quotas were removed up to 2004, with the remaining quotas removed at the beginning of 2005.

[17]Bangladesh, Cambodia, Lao P.D.R., Mongolia, Nepal, Sri Lanka, and Vietnam.

[18]This section draws from Mekong Capital (2003).

The ATC does not cover tariff issues related to T&C. Under the most-favored-nation (MFN) principle, a General Agreement on Tariffs and Trade (GATT) signatory is required to provide all members the same conditions of trade. Accordingly, MFN tariff rates are expected to be applied for trade among WTO members unless a country is entitled to preferential rates, such as under the Generalized System of Preferences (GSP) and the EU's Everything But Arms program. These are programs under which a number of industrialized countries have recently granted comprehensive tariff- and quota-free access to least developed countries (LDCs).

GSP schemes constitute a departure from the traditional nondiscrimination principle of the GATT. In contrast with the MFN principle, under a GSP scheme each country has its own list of preferential tariffs for qualified products. A key problem associated with the GSP schemes is that they include rules of origin (RoO) requirements that many LDCs are unable to meet, making these countries ineligible for preferential tariffs.[19] Furthermore, certain sectors and countries may be excluded from GSP programs if they are likely to have a negative impact on domestic industries. In the United States, T&C are considered a "sensitive" product such that no preferences are given to LDCs.

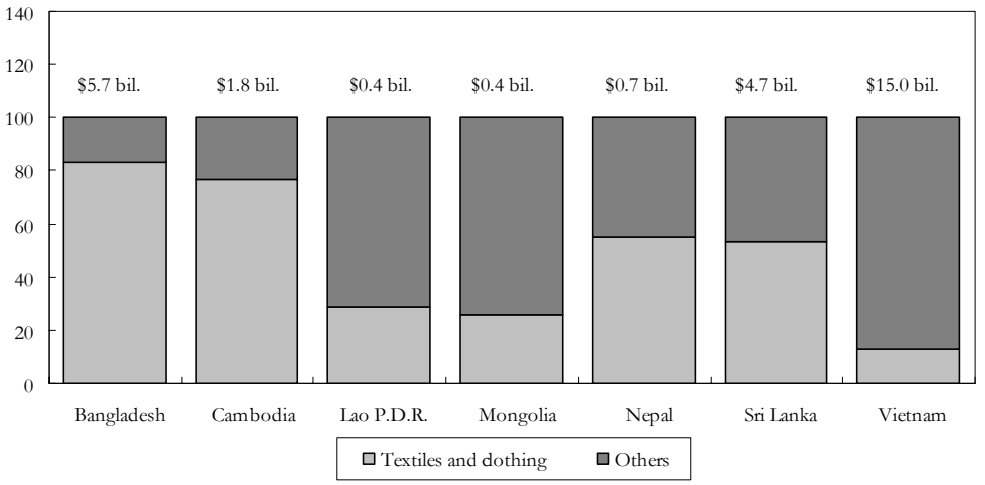
Although unlikely, the United States could use the WTO Agreement on Safeguards to impose new quotas on China, to Cambodia's advantage. Under this agreement, the United States can impose quotas on China potentially up to 2013. However, imposing quotas on China using safeguard clauses is costly. As a consequence, the U.S. government has used this agreement sparingly. Since the removal of 20 percent of quotas in 2002, the United States introduced new quotas covering less than 3 percent of T&C imports from China, with a duration of one to three years. Expanding quotas beyond that time frame would require other compensating measures by the United States, for example, offering concessions to China in other sectors.

B. What Makes Cambodia Vulnerable to the Removal of Quotas?

Most LIAs, Cambodia in particular, are vulnerable to changes in T&C policies since the share of T&C in total exports is large. In 2002, this share was more than 75 percent in Cambodia and Bangladesh, about 55 percent in Nepal and Sri Lanka, and close to 30 percent in Lao P.D.R. and Mongolia. In Vietnam,

[19]As a result of RoO requirements, 58 percent of Lao garment exports to the EU were tariff-free compared to 27 percent for Cambodia in 2001.

Figure 4.1. Exports of Asian Countries, 2002
(In percent of total exports)



Source: World Bank, *World Integrated Trade Solution*.

however, T&C exports represented only 13 percent of total exports, although T&C exports increased rapidly following the bilateral trade agreement with the United States in early 2002 (Figure 4.1). During the period 1996–2002, Cambodia was the only country that experienced a dramatic increase in the share of T&C in total exports (Table 4.1).

Most LIAs are unable to compete with China in quota-free markets. In 2002, LIA exports to quota-free markets (such as Japan) were negligible, whereas those to quota markets (e.g., the European Union and the United States) represented more than 85 percent of total T&C exports in most cases (Figure 4.2 and Table 4.2). In contrast, China's exports of T&C to Japan were higher than to the European Union and the United States combined, and those to the rest of the world represented almost 60 percent of total T&C exports. This trade pattern provides an indication of the degree to which the quota system restricts China from attaining greater market share.

Intraregional T&C trade is insignificant for LIAs, but not for the newly industrialized and emerging economies in Asia (NIEAs). NIEAs (such as Hong Kong SAR) are large producers of textiles, which require capital and technology. By contrast, LIAs export mostly garments, and very limited amounts of raw materials such as fiber and wool. The significant size of some of the NIEAs' exports to China suggests that the latter is dependent on imported inputs for its garment exports.

Table 4.1. Exports of Asian Economies, 1996 and 2002

(In millions of U.S. dollars, unless otherwise indicated)

	1996[1]			2002[2]		
	Total	Textiles and clothing	Others	Total	Textiles and clothing	Others
Low-income countries						
Bangladesh	3,539	2,663	875	5,682	4,730	952
Cambodia	801	102	699	1,750	1,342	408
Lao P.D.R.	317	91	226	350	100	250
Mongolia	424	27	397	404	104	300
Nepal	364	263	101	709	392	317
Sri Lanka	3,192	1,614	1,578	4,683	2,503	2,181
Vietnam	7,256	1,150	6,106	15,029	1,975	13,054
Other Asian economies						
China	151,047	37,155	113,892	325,595	61,661	263,935
Hong Kong SAR	27,431	10,740	16,691	16,786	9,316	7,470
India	33,404	9,167	24,237	44,306	10,871	33,435
Indonesia	49,727	6,504	43,223	55,886	7,804	48,083
Korea, Rep.	124,404	16,941	107,463	159,915	14,612	145,303
Malaysia	78,280	3,681	74,599	87,916	3,112	84,803
Singapore	124,651	2,741	121,910	124,679	2,386	122,293
Taiwan Province of China	115,646	15,088	100,558	122,765	12,288	110,477
Thailand	55,628	5,632	49,996	65,071	5,492	59,579
	(In percent of total exports)					
Low-income countries						
Bangladesh	100.0	75.3	24.7	100.0	83.3	16.7
Cambodia	100.0	12.8	87.2	100.0	76.7	23.3
Lao P.D.R.	100.0	28.6	71.4	100.0	28.6	71.4
Mongolia	100.0	6.4	93.6	100.0	25.8	74.2
Nepal	100.0	72.4	27.6	100.0	55.3	44.7
Sri Lanka	100.0	50.6	49.4	100.0	53.4	46.6
Vietnam	100.0	15.8	84.2	100.0	13.1	86.9
Other Asian economies						
China	100.0	24.6	75.4	100.0	18.9	81.1
Hong Kong SAR	100.0	39.2	60.8	100.0	55.5	44.5
India	100.0	27.4	72.6	100.0	24.5	75.5
Indonesia	100.0	13.1	86.9	100.0	14.0	86.0
Korea, Rep.	100.0	13.6	86.4	100.0	9.1	90.9
Malaysia	100.0	4.7	95.3	100.0	3.5	96.5
Singapore	100.0	2.2	97.8	100.0	1.9	98.1
Taiwan Province of China	100.0	13.0	87.0	100.0	10.0	90.0
Thailand	100.0	10.1	89.9	100.0	8.4	91.6

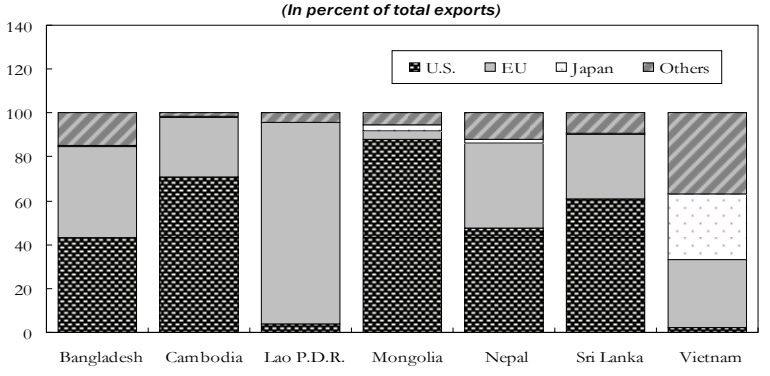
Sources: World Bank, *World Integrated Trade Solution*; and IMF staff reports.

[1]Data for Lao P.D.R. and Sri Lanka are for 1997 and 1994, respectively.

[2]Data for Nepal are for 2000. Data for Bangladesh, Indonesia, Malaysia, Taiwan Province of China, Thailand, and Vietnam are for 2001.

Figure 4.2. Exports of Asian Countries, 2002

(In percent of total exports)



Source: World Bank, *World Integrated Trade Solution*.

Table 4.2. Textile, Clothing, and Textile Fiber Exports of Asian Economies, 1996 and 2002

	Textiles and Clothing Exports		Destination of Textile and Clothing Exports (2002)[2]					
	1996 [1]	2002 [2]	China	Japan	EU	U.S.	Other Asian [3]	Others
	(In percent of total exports)		(In percent of total exports of textile and clothing)					
Low-income countries								
Bangladesh	75.3	83.3	0.0	0.5	41.4	43.2	1.3	13.5
Cambodia	12.8	76.7	. . .	0.4	27.0	71.1	. . .	1.5
Lao P.D.R.	28.6	28.6	0.0	. . .	91.8	. . .	. . .	. . .
Mongolia	6.4	25.8	3.6	2.6	3.8	88.0	0.5	1.6
Nepal	72.4	55.3	0.0	2.1	38.3	47.8	6.7	5.1
Sri Lanka	50.6	53.4	0.0	0.8	29.2	60.7	1.4	7.9
Vietnam	15.8	13.1	1.1	29.9	30.8	2.4	25.1	. . .
Other Asian economies								
China	24.6	18.9	. . .	21.5	9.6	11.2	30.4	27.3
Hong Kong SAR	39.2	55.5	25.9	0.5	20.5	42.4	3.5	7.3
India	27.4	24.5	0.8	2.2	30.3	23.0	6.1	37.7
Indonesia	13.1	14.0	1.6	6.1	24.5	28.5	11.3	28.1
Korea, Rep.	13.6	9.1	15.0	6.0	9.0	21.3	15.3	33.4
Malaysia	4.7	3.5	1.3	6.1	20.4	37.4	18.4	16.3
Singapore	2.2	1.9	2.1	0.9	20.6	41.6	19.6	15.1
Taiwan Province of China	13.0	10.0	1.8	2.9	5.7	18.3	42.4	28.8
Thailand	10.1	8.4	1.2	6.6	19.1	41.5	8.7	23.1

	Destination of Textile Fiber Exports (2002)[2]					
	China	Japan	EU	U.S.	Other Asian[3]	Others
	(In percent of total exports of textile fibers)					
Low-income countries						
Bangladesh	3.0	0.0	7.0	16.0	15.0	59.0
Cambodia	. . .	. . .	. . .	. . .	. . .	. . .
Lao P.D.R.	. . .	. . .	. . .	. . .	. . .	. . .
Mongolia	45.0	7.0	34.0	2.0	8.0	4.0
Nepal	0.0	33.0	25.0	6.0	0.0	36.0
Sri Lanka	5.0	17.0	37.0	8.0	16.0	17.0
Vietnam	. . .	. . .	. . .	. . .	. . .	. . .
Other Asian economies						
China	. . .	11.8	34.2	2.2	42.8	8.9
Hong Kong SAR	68.5	0.1	0.7	0.3	7.6	22.8
India	1.9	6.0	16.3	9.5	14.5	51.7
Indonesia	3.1	2.5	8.4	2.6	34.4	49.1
Korea, Rep.	30.7	1.4	13.6	13.3	16.3	24.7
Malaysia	29.6	7.9	0.5	3.6	39.6	18.8
Singapore	1.0	0.0	0.1	0.4	69.7	28.8
Taiwan Province of China	13.5	7.9	6.8	9.3	36.8	25.7
Thailand	13.4	5.0	1.1	6.7	40.8	32.9

Sources: World Bank, *World Integrated Trade Solution*; and IMF staff reports.

[1]Data for Lao P.D.R. and Sri Lanka are for 1997 and 1994, respectively.

[2]Data for Nepal are for 2000. Data for Bangladesh, Indonesia, Malaysia, Taiwan Province of China, Thailand, and Vietnam are for 2001.

[3]Includes Hong Kong SAR, India, Indonesia, Korea, Malaysia, Singapore, Taiwan Province of China, and Thailand.

Table 4.3. U.S. Textile and Apparel Imports from China, India, and Low-Income Asian Countries, 2003[1]

(In millions of U.S. dollars)

Category	Total 2003 Est. A	Subtotal 2003 Est. B= SUM(C:W)	A/B	C	D	E	F	G	H	I	J	K	L
U.S. total imports	78,761	53,679	68	1,456	945	2,914	362	15,448	488	1,227	3,616	1,247	11,181
China	11,279	3,847	34	731	210	579	246	545	152	173	177	182	180
India	3,344	2,205	66		71			190		35		11	346
Subtotal	7,817	6,504		3	87	425	3	1,753	4	259	259	418	1,342
Bangladesh	1,961	1,669	85		11	218	0	336	2	53	68	84	111
Cambodia	1,205	903	75	1	9	45	2	261	2	2	31	23	197
Lao P.D.R.	5	4	99			2							
Mongolia	182	159	87			1		58		0	1	1	54
Nepal	161	130	81					59				2	46
Sri Lanka	1,542	1,166	76	1	40	67		254		61	61	98	150
Vietnam	2,417	2,152	89	1	24	79	1	748		129	76	144	639

Category	M	N	O	P	Q	R	S	T	U	V	W
U.S. total imports	2,064	2,450	2,808	728	760	544	1,299	2,457	817	261	609
China	0	185	129	71	35		140	44	44	6	18
India	389	492	258	133	76	13	67	64	34		23
Subtotal	36	402	549	45	196	44	200	171	210	7	90
Bangladesh	21	157	271	29	35	32	56	110	35		39
Cambodia	2	30	53		63		15	17	143	3	3
Lao P.D.R.			2								
Mongolia		1	9		2		6	2	3	1	20
Nepal	2	11	2	2	2		1		2		
Sri Lanka	1	151	104	6	58	12	49	26	11	2	11
Vietnam	6	52	107	8	34		61	11	14	1	16

Sources: U.S. Office of Textiles and Apparel; and IMF staff estimates.

[1]Columns C to W include: C category 666 (other finished apparel); D category 636 (dresses); E categories 359/659 (other cotton and man-made fiber apparel); F category 845 (sweaters); G categories 347/348 and 647/648 (cotton trousers and slacks); H category 362 (quilts and bedspreads); I category 635 (coats women/girls); J categories 638/639 (knit blouses and shirts); K category 634 (other coats); L categories 338/339 (knit shirts and baby silk); M category 369 (other cotton, manufactured); N categories 341/641 (women/girls N category knit blouses and S and V woven shirts); O categories 340/640 S to V categories trousers and N-K shirts; P category 363 (S and V skirts); Q category 342 (flat goods); R category 669 (other man-made fiber manufactured); S categories 334/335 (women/girls cotton coats and other coats); T category 352 (cotton underwear); U category 351 (cotton pajamas); V category 438 (K- shirts/blouses); W category 345 (cotton sweaters).

The removal of MFA quotas in 2005 will affect a significant part of total T&C exports from Asian countries. Indeed, at least 40 percent of total Chinese and Indian T&C exports to the United States (about $6 billion) are currently constrained by the MFA quotas. Accordingly, the potential loss of U.S. market share by LIAs is large since about 83 percent of their T&C exports ($6.5 billion) are products on which quotas restrict Chinese and Indian exports to the United States (Table 4.3).

The negative impact of the removal of MFA quotas on Cambodia may be counterbalanced somewhat by other changes in trade policy in developed countries. Currently, the European Union and Canada are considering relaxing their RoO requirements. For example, Cambodia may be able to export more items at zero tariff to Canada in the future. Second, the United States may grant Cambodia more favorable terms for T&C exports.

Cambodia does not export significant raw materials and, therefore, will not benefit from the expected increase in demand for raw materials in China. Countries such as Mongolia, whose raw material exports are equivalent to almost half of their T&C exports, will most likely benefit from increased demand from China.

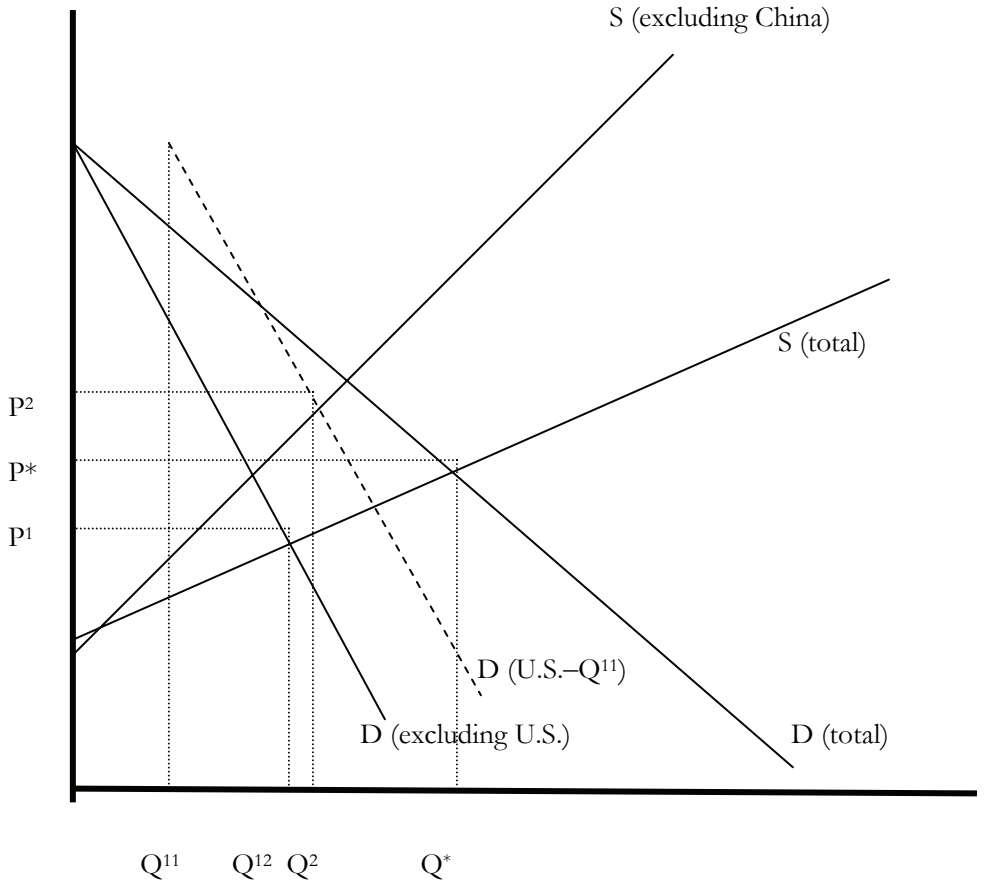
C. The Estimated Impact of the Removal of MFA Quotas on Cambodia

The removal of the quota system in 2005 might reduce T&C prices in quota zones and lead to a reallocation of the exporting countries' market share.[20] Countries with the strongest competitive positions, whose output is currently constrained by quotas, will increase their market share while those countries currently reaping rents from the quota system will lose. The 2002 experience, when approximately 15 percent of restrictive quotas were eliminated (the so-called "third-phase quota integration") gives some indication of the relative underlying competitive positions of these countries. In particular, China and India's exports to the United States increased by about 81 percent and 10 percent, respectively, on the affected products while most LIAs suffered a decline in their exports (Table 4.4).

The assessment presented in this chapter of the potential impact of the quota phaseout in 2005 on LIAs relies on the 2002 experience. The exercise analyzes separately the effects of the quota removal in the U.S. and EU markets. In both markets, it is assumed that the same relative shifts take place among countries' exports that followed the "third quota integration." To the extent that labor supply is fairly inelastic in the short run, it is not likely that China, for example,

[20]However, prices in quota-free zones (such as Japan) would likely rise as the welfare loss from the quotas is eliminated and a new world equilibrium arises (see Box 4.1).

Box 4.1. Quota-Constrained World Equilibrium in the Textile and Clothing Market



In the absence of any quota, the unconstrained equilibrium occurs at price P*, and quantity Q*.

Without losing generality, assume that the United States has imposed a quota (zero ceiling) on all Chinese exports. Then China will export to the world excluding the U.S. at P^1. Firms in other countries will also compete for the non-U.S. market. The world market share will be $Q^{12}–Q^{11}$ for China, and Q^{11} for the rest of the world. The rest of the world can still export to the (quantity-constrained) U.S. market. They will export $Q^2–Q^{11}$ to the United States at P^2.

Once the quota in the U.S. market is eliminated, the market will return to its original unconstrained equilibrium. In this process, markets with quotas (U.S.) will see a decline in their prices while the previously unconstrained markets (rest of the world) will see an increase because firms will shift their exports to the United States.

Table 4.4. Estimated Impact of the Removal of Quotas in 2005

	Actual Impact on Textiles and Clothing Exports to the U.S. from Eliminating 15 Percent of Quotas in 2002[1]	Actual Impact on Textiles and Clothing Exports to the EU from Eliminating 15 Percent of Quotas in 2002	Estimated Impact on Textiles and Clothing Exports to the U.S. from Removing Remaining Quotas in 2005[2] (1)	Estimated Impact on Textiles and Clothing Exports to the EU from Removing Remaining Quotas in 2005[3] (2)	Total Impact (1)+(2)	Impact on External Current Account[4]	Impact on GDP Growth[4]
	(In value terms, percent change)		(In millions of U.S. dollars)			(In percent of GDP)	(In percent)
Low-income countries							
Bangladesh	–29	–21	–475	–415	–890	–1.2	–0.6
Cambodia	–26.8	. . .	–196	–25	–221	–3.9	–2.1
Lao P.D.R.	0	. . .	–1	–6	–7	–0.2	–0.1
Mongolia	–100	. . .	–42	0	–42	–2.5	–1.3
Nepal	–17	. . .	–16	–10	–26	–0.3	–0.2
Sri Lanka	–34	–7	–367	–50	–417	–1.6	–0.9
Vietnam	3,700	–17	130	–104	26	0.0	0.0
Other Asian countries							
China	81	39	2,999	2,283	5,282	0.3	0.1
India	10	–9	272	–105	167	0.0	0.0

Sources: World Bank, *World Integrated Trade Solution*; United States International Trade Commission; European Commission; and IMF staff estimates.

[1]Change in textile and clothing imports in product lines to the U.S. for which quotas were eliminated on January 1, 2002. The large increase in Vietnam reflects a very small base and the benefit from the 2001 bilateral trade agreement with the U.S.

[2]The quota removal in 2005 in the U.S. market is assumed to have the same impact among countries' exports as the quota removal in 2002, except for Lao P.D.R., Mongolia, and Vietnam. For Lao P.D.R. and Mongolia, the 2005 impact is calculated as the average of the 2002 impact in Bangladesh, Cambodia, Nepal, and Sri Lanka. In Vietnam, as it is not a WTO member and hence still subject to quota, it assumes a quota increase of 15 percent.

[3]The quota removal in 2005 in the EU market is assumed to have the same impact among countries' exports as the quota removal in 2002. For Cambodia, Lao P.D.R., Mongolia, and Nepal, where the impact of the 2002 quota removal is not available, the 2005 impact is assumed to be the same as in Sri Lanka.

[4]Assumes that the import content of exports is 65 percent for all countries.

will be able to increase its exports of the affected items by the same magnitude as it did on the items when only 15 percent of its quota was phased out. Therefore, the relative shifts presented in Table 4.4 are upper bounds, rather than point estimates, at least in the short term.[21]

One can argue that the reliance on the 2002 experience could result in overestimating the decline in LIA exports of quota-restricted items. This is because some producers may have already switched in 2002 from producing quota-restricted items to non-quota-restricted items to reduce the impact of the 2005 shock. To counterbalance this overestimation, non-quota-restricted items are assumed to grow by a generous 8 percent; part of this growth may come from a shift to production of non-quota items. Moreover, the two factors that limit this overestimation are: (1) producers may have started switching to other products well before 2002, and (2) in 2005 a significantly larger percentage of quotas will be removed, which makes production substitution more difficult.

[21]The assessment on the EU market is complicated because of lack of detailed data and the GSP granted to some LIAs.

The results of this exercise suggest that exports from China to the United States and the European Union could increase by up to $5.3 billion in 2005. In contrast, exports of LIAs (excluding Vietnam) to the United States and the European Union could decline by $2 billion. Vietnam is the only LIA country reviewed in this exercise that is expected to gain market share.

The external current account balance and GDP growth could be significantly affected in some LIAs. Cambodia and Mongolia could be more heavily affected by the removal of quotas, while the effects on Lao P.D.R. and Nepal may be negligible. Ignoring the secondary impact from lower income, the deterioration of the current account balance would range from 3 percent of GDP (Cambodia) to almost zero (Lao P.D.R. and Nepal). In addition, assuming the value added in T&C production is 35 percent on average for these countries, the decline in GDP growth would range from 2 percent (Cambodia) to almost zero (Lao P.D.R. and Nepal). The impact on Vietnam would be much more favorable should it succeed in joining the WTO.

D. Conclusion

Cambodia is among the most vulnerable countries in Asia to the removal of the quota system since almost 80 percent of its exports are in T&C. Moreover, Cambodia is currently exporting almost 100 percent of its T&C exports to the quota-protected markets of the United States and the European Union. Preliminary estimates suggest that Cambodia's GDP growth could drop by about 2 percent after the removal of quotas.

China is expected to gain most from the quota removal. China's T&C share in the combined U.S. and EU markets could increase from 8.5 percent in 2002 to 11.5 percent following the quota removal. In contrast, LIAs could see their share of T&C exports decline in these markets from 5 percent to 4 percent over the same period.

The negative impact on GDP could be significant for some LIAs. Cambodia and Mongolia appear to be the countries that could be more heavily affected by the removal of quotas, whereas the effects on Lao P.D.R. may be negligible.

Cambodia cannot rely on safeguards for relief from the negative impact of the quota removal. The negative impact on LIAs may be lessened somewhat if the United States uses the WTO Agreement on Safeguards to impose new quotas on China. It is difficult to predict whether future measures by the U.S. government to curb Chinese exports will protect exactly those categories that Cambodia produces, and the extent and impact of such measures.

CHAPTER

5 Foreign Aid Flows and Foreign Direct Investment in Cambodia

Koji Nakamura

When Cambodia embarked on its economic reconstruction in 1993, its physical infrastructure as well as human capital were nearly decimated by the decades-long civil war. With few domestic resources at its disposal, Cambodia relied heavily on external financing and technical assistance. Foreign direct investment (FDI) played a more limited role. Section A reviews the amount and sectoral distribution of foreign aid, and Section B examines its contribution as well as any side effects on the economy. Section C reviews factors that contributed to foreign direct investment inflows, and in Section D, future FDI prospects are assessed in the context of the current investment climate.

A. Recent Developments in Foreign Aid Flows

Foreign aid flows in Cambodia have averaged 12 percent of GDP a year in the past decade, reaching $500 million in 2003 (Table 5.1). About 70 percent of aid flows were in the form of official grants, largely provided by bilateral donors, while the rest were concessional loans mainly from the World Bank and the Asian Development Bank.

Cambodia is one of the largest recipients of foreign aid among the Asian countries in percent of respective GDP, along with Lao P.D.R., Bhutan, and Mongolia (Figure 5.1). Moreover, it has the lowest average interest rates on its borrowing (Table 5.2) and a very large share of official grants, in part reflecting the extensive technical cooperation provided by donors.

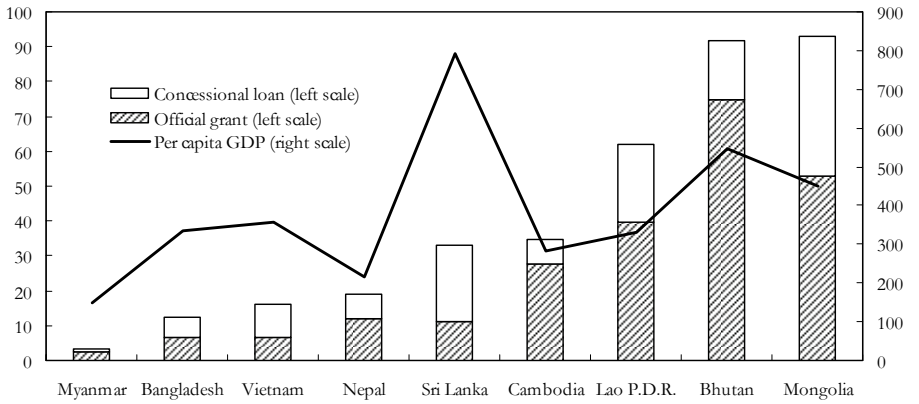
From a functional perspective, most of the aid flows were provided for specific purposes, initially as food aid and emergency relief assistance, and then investment projects and technical assistance (Table 5.3). By 2003, technical assistance accounted for about 40–50 percent of the total, most of which was spent on compensation of technical assistance advisors. Investment projects accounted for about 35–45 percent of the total aid flows.

Table 5.1. Aid Flows
(In percent of GDP, unless otherwise indicated)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Loans	0.6	3.2	3.4	1.2	2.8	1.7	1.9	2.8	3.2	4.7	4.1
Official grant	10.0	9.9	11.5	11.8	8.9	9.8	8.1	8.9	8.2	7.6	7.9
Total	10.6	13.1	14.9	13.0	11.8	11.5	9.9	11.7	11.4	12.3	12.0
(in millions of U.S. dollars)	257	355	502	443	391	354	342	418	423	491	504

Sources: Council for the Development of Cambodia, *Development Cooperation Report*; and Ministry of Economy and Finance.

Figure 5.1. Comparison of Aid Flows[1]
(In U.S. dollars per capita)



Source: World Bank, *Global Development Finance.*
[1]Average of 1995–2001.

Table 5.2. Aid Flows in Low-Income Countries
(In percent of GDP; average 1995 – 2001)

	Grant	Loan	Total	Average Interest Rate (In percent)
Bangladesh	1.9	1.7	3.7	1.6
Bhutan	14.2	3.1	17.3	2.4
Cambodia	9.6	2.4	12.0	1.0
Lao P.D.R.	12.1	6.6	18.7	1.8
Mongolia	11.9	9.1	21.0	2.1
Myanmar	1.9	0.7	2.7	1.1
Nepal	5.6	3.3	8.8	2.1
Sri Lanka	1.4	2.8	4.2	3.0
Vietnam	1.8	2.7	4.5	1.8

Source: World Bank, *Global Development Finance*.

Table 5.3. Share of Aid Flows by Type
(In percent of total)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Technical assistance	24.2	29.7	33.7	36.1	48.0	54.8	49.8	44.9	37.3	42.9	46.1
Investment project	23.2	38.7	40.7	40.5	40.8	44.0	33.4	35.4	45.8	45.0	43.4
Budget support	22.8	19.3	15.2	12.8	0.7	0.0	9.0	8.2	9.7	7.4	5.6
Food aid	29.7	12.3	10.5	10.6	10.6	1.3	7.7	11.6	7.1	4.7	4.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Council for the Development of Cambodia, *Development Cooperation Report*.

Table 5.4. Share of Aid Flows by Sectors
(In percent of total)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Education and health	17.8	13.9	13.1	15.1	21.0	28.0	27.9	23.2	23.5	25.7	28.1
Infrastructure	28.0	24.7	29.7	31.0	31.8	28.0	24.4	24.7	26.0	24.4	20.4
Agriculture and forestry	8.9	7.2	7.3	13.1	6.2	3.7	7.1	9.9	7.7	9.8	10.1
Institutional building	21.3	28.3	28.7	31.1	25.4	22.0	15.2	15.5	17.9	19.0	10.8
Others	24.0	25.9	21.1	9.6	15.6	18.3	25.5	26.7	24.8	21.0	30.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Council for the Development of Cambodia, *Development Cooperation Report.*

Sectoral distribution of aid was highly skewed toward education and health, and infrastructure, which together accounted for about 50 percent of total aid flows. The share of education and health has increased with greater involvement by the World Bank and the Asian Development Bank, while the share of institutional building has gradually declined as the country emerged from a post-conflict situation. By contrast, less than 10 percent of the aid was spent for agricultural development (Table 5.4), which is the main source of income for the poor.

B. Contribution of Aid Flows

Aid flows have not only played a critical role in helping Cambodia rebuild the basic economic system, but have also helped the government run the country. While Cambodians returning from abroad have partially filled the hole in human capital left by the Khmer Rouge rule, a large number of foreign experts were needed to fill in the remaining gap. Moreover, the near absence of institutions,

Table 5.5. Education Indicators, 2002

	Cambodia	Average[1]
Literacy ratio	69	74
Secondary school enrollment ratio (gross)	22	57

Source: World Bank, *World Development Indicators*.

[1]Average of low-income Asian countries excluding Cambodia, Lao P.D.R., Nepal, Sri Lanka, and Vietnam.

including a legal structure, required a large amount of foreign technical assistance to draft laws, especially for WTO accession, and establish basic operating procedures. Such needs were reflected in the large share of technical cooperation in total aid flows.

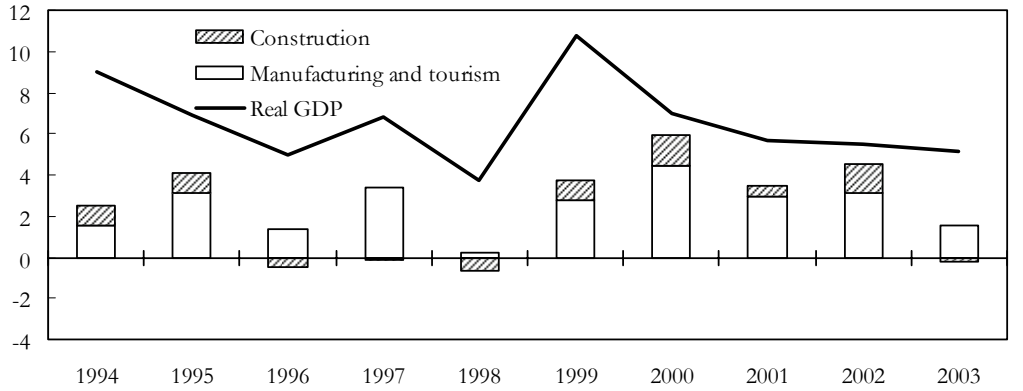
The remaining aid flows were used largely to enhance the country's long-term growth prospects. Aid flows were critical in supplementing investment in education and health, and basic infrastructure, which lagged substantially behind, even relative to other low-income countries (Table 5.5). With much of the attention paid to these urgent issues, the amount of resources allocated to a more direct means of alleviating poverty has been small. This is partly reflected in the lesser aid flows to agriculture and rural development, which averaged 19 percent a year in the recent past.

Aid flows appear not to have led to a "Dutch disease" situation in Cambodia. Much of the country's labor force (largely unskilled) is still underutilized and aid flows were spent on payments of imports of goods and services. Little was spent on locally produced goods and services, reflecting the limited scale of domestic manufacturing output and the capacity of the services sector. Even the construction sector largely uses imported materials.

Providing a quantitative assessment of the contribution of aid inflows is marred by weak data and other parallel developments. The bilateral trade agreement with the United States, which led to a sharp increase in garment exports, and the pickup in tourism reflecting pent-up demand for visits to historic sites following political stability in the late 1990s led to rapid growth in these sectors. The contribution to growth from these two sectors was large, such that it is difficult

Figure 5.2. Sector Contribution to GDP

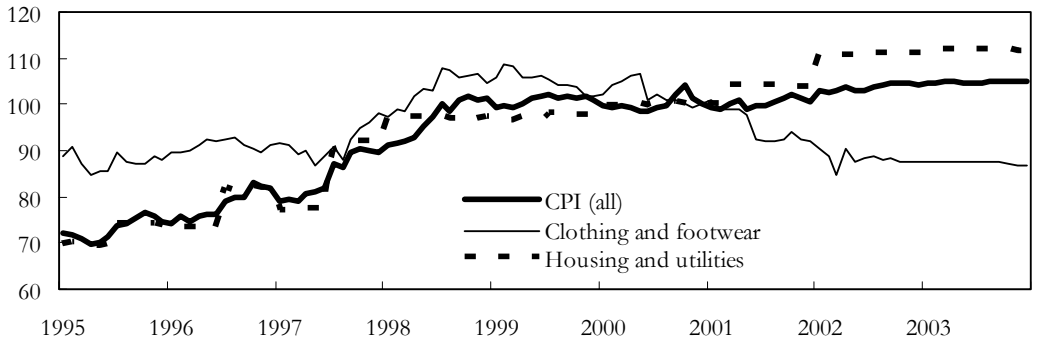
(In percent)



Source: Cambodia, National Institute of Statistics.

Figure 5.3. Consumer Price Index (CPI)

(December 2000 = 100)



Source: Cambodia, National Institute of Statistics.

to separate the net impact of aid flows on the relative growth of the tradables and nontradables sectors, which is one measure of assessing the Dutch disease[22] (Figure 5.2).

[22]Nkusu (2004) suggests that Dutch disease in the context of aid flows is suspected if (1) the real exchange rate appreciates, and (2) the tradables sector shrinks relative to the nontraded sector.

The real exchange rate has appreciated, even though data weakness bars drawing a definite conclusion[23] (Figure 5.3). Prices of tradable goods as measured by prices of clothing and footwear have risen by less than the prices of nontradable goods such as housing and utility prices. However, utility prices are affected by world oil prices, and housing prices might have been driven up not only by aid inflows but also by the recent increase in wealth of the urban areas that led to a sharp increase in demand for housing, faster than housing supply.

There is an ongoing debate as to whether or not aid flows induce corruption in the recipient countries. There is little evidence to suggest that aid flows in Cambodia have, or have not, induced corruption. About half of the total aid flows are executed outside the government budget and are thus subject to close scrutiny and control of donors, and even those that are channeled through the budget are closely monitored by the respective donors. A case could be made, however, that donors' budgetary financing weakens the authorities' resolve to raise fiscal revenue.[24]

C. Foreign Direct Investment

FDI approvals increased dramatically following the peace accord and the reconstruction efforts led by the United Nations Transitional Authority in Cambodia (UNTAC) that began in 1993, but declined thereafter (Table 5.6). Actual FDI disbursement, while more phased, broadly exhibits a similar trend.

1994–95 period: The initial FDI approvals concentrated on tourism and construction sectors (Figure 5.4). Cambodia's cultural heritage, notably the country's ancient monuments, were perceived by investors as having a strong potential to attract a large number of foreign tourists, especially with the advent of political stability. The ensuing construction of hotels and basic infrastructure attracted large investment into the construction sector.

1996–98 period: The second wave of investment concentrated on logging. The high-quality hardwood in Cambodia, which required little formalities to log, attracted investment into the logging industry. However, due to strong complaints from the donor community regarding the rapid and chaotic depletion of the forests, the government finally embarked on a major reform of its forest policy in January 1999.

[23]The consumer price index (CPI) is calculated only in the main urban areas.

[24]Aid flows are said to induce corruption when resources are transferred without the accompanying accountability of the decision maker. An alternative view is that aid flows are associated with improved rules and conditions that limit the discretion of the recipient country's officials, thus decreasing corruption. The results of recent empirical studies are mixed. While Alesina and Weder (2002) suggest that aid flows are positively correlated with corruption, results by Tavares (2003) suggest the opposite.

Table 5.6. Foreign Direct Investment in Cambodia
(In millions of U.S. dollars)

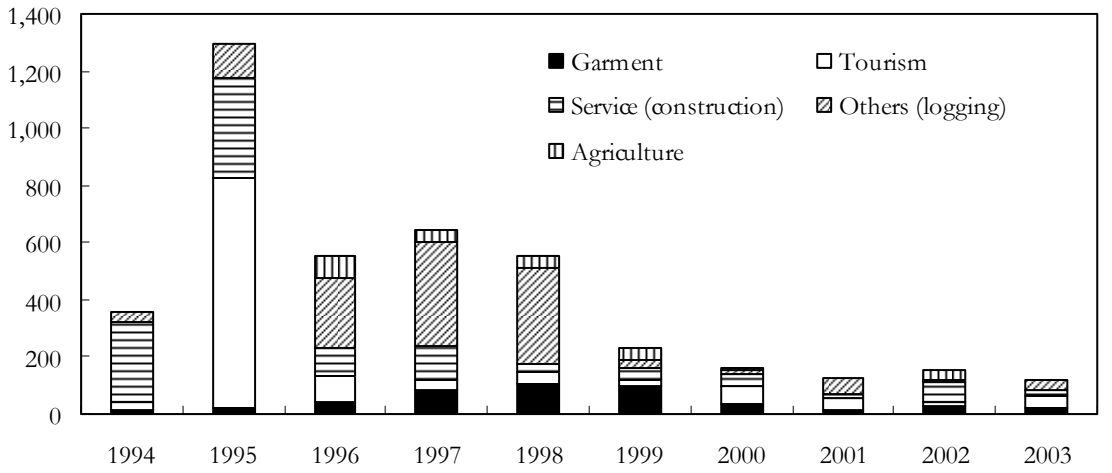
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
FDI approval[1]	282	1,910	617	578	556	196	160	140	145	65
In percent of GDP	10	57	18	17	18	6	4	4	4	2
FDI disbursement[2]	80	151	294	168	243	230	149	149	145	87
In percent of GDP	3	4	9	5	8	7	4	4	4	2

Sources: Council for the Development of Cambodia; National Bank of Cambodia; and National Institute of Statistics.

[1]Approvals issued by the CDC.

[2]National Bank of Cambodia's estimates.

Figure 5.4. FDI Approval by Sector[1]
(In millions of U.S. dollars)



Source: Council for the Development of Cambodia.

[1]Estimated by IMF staff based on CDC investment approval data.

The next wave of foreign investment was in the garment industry, in response to the 1996 signing of the bilateral trade agreement with the United States that substantially reduced the effective tariff rate imposed on Cambodian garment exports. However, since the relatively labor-intensive garment manufacturing industry did not require a large amount of investment to set up factories, the associated amount of FDI inflows was modest.

1999–Present: FDI inflows to Cambodia have been weak since 1999. Annual FDI approvals fell below $200 million, a decline that occurred against a backdrop of restored macroeconomic and political stability. The decline was partly related to changes in the outlook for garment exports with the expected phaseout of the quota system that would put Cambodia on an equal footing with all WTO members. Only moderate investment in tourism-related activities continued to attract foreign interest.

D. Future Prospects of FDI

Except for the three sectors identified above that provided surges at different periods in the past, FDI inflows to other sectors have been weak. With the elimination of quotas on garments, and the pent-up demand on tourism gradually reaching a satiation point, there are no obvious factors left that would attract foreign investment in the future. Accordingly, Cambodia will be subject to competition on par with its neighboring countries for general FDI inflows to the region for which competitiveness and investment climate will become more important. The following factors, however, argue for poor prospects.

- **Widespread governance problems.** As confirmed by a recent study by the World Bank (2004), the informal costs in Cambodia are high: the so-called bribe tax is roughly 5 percent of total sales in the manufacturing sector, the highest among five countries for which similar data are available.
- **Weak rule of law.** Although the legal framework could be strengthened with the expected enactment of numerous laws related to WTO accession, the reform of the judiciary, critical for implementation of these laws, remains uncertain.
- **High cost of production.** Energy costs in Cambodia are high, reflecting the dilapidated state of the country's diesel generators and the lack of domestic sources of fossil fuels.
- Small local market. The economy is too small to attract foreign investments targeted for the local market.

Private sector–led growth in Cambodia clearly depends on mobilizing FDI given the scarcity of domestic savings. Although it is difficult to address all the problems mentioned above in the short term, the government needs to take bold steps to provide the basis for a more competitive economy. In the short run, at least providing a more predictable business environment through streamlining red tape could reduce the cost associated with uncertainties. The agenda for the medium to long term remains large: given governance is a cross-cutting issue, strengthening the judiciary will need to receive priority while at the same time the government should foster human capital formation through expanding education to everyone (Borensztein, De Gregorio, and Lee, 1998).

Fiscal Management

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CHAPTER

6 Fiscal Developments and Challenges

Alejandro López-Mejía and Robert Hagemann

Fiscal reform has been the cornerstone of Cambodia's macroeconomic program since the restoration of political and economic stability in the late 1990s. Fiscal revenue improved, social spending was increased considerably, and domestic financing of the budget was largely avoided. Despite this progress, fiscal revenue and social spending still lag behind the average of countries at a similar development stage. More generally, substantial reforms are still needed to improve both the efficiency and fairness of Cambodia's public finances, so that they can play a more helpful role in poverty reduction.

Section A provides a fresh look at fiscal developments in Cambodia in the 1990s and Section B reviews fiscal reforms since 1999. Section C discusses the challenges ahead for reforming Cambodia's public finances, which are to be addressed through the Royal Government of Cambodia's (RGC) recently adopted "Public Financial Management Reform Program" formally launched on December 5, 2004 (see Royal Government of Cambodia, 2004).

A. Developments Since the Early 1990s[25]

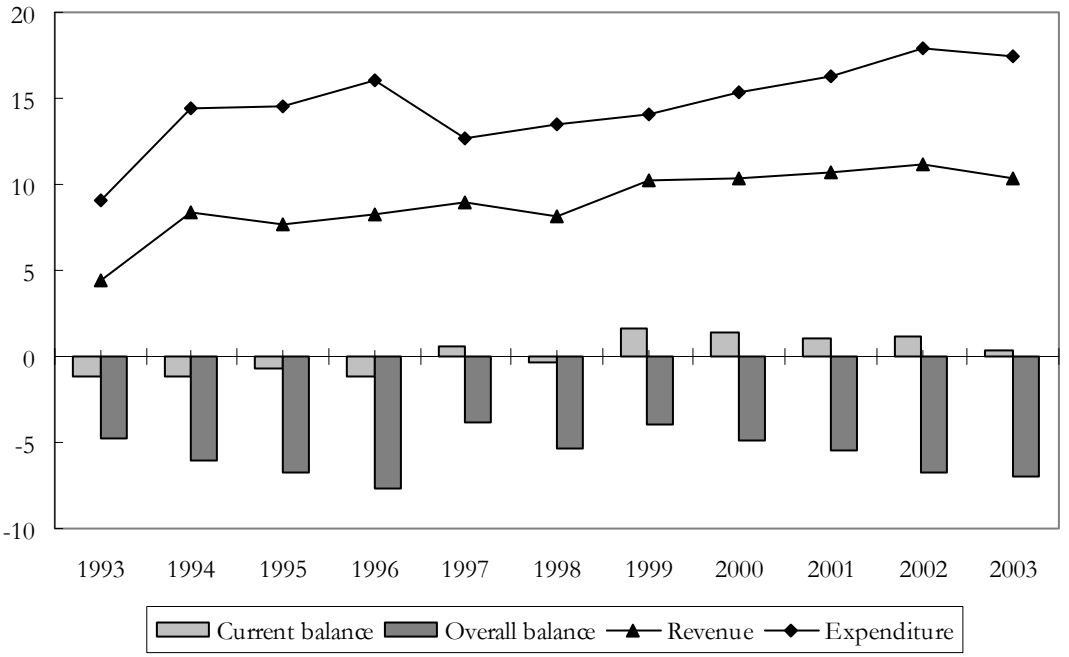
The Early Challenges: 1990–94

Cambodia's public finances have evolved substantially during the past 10 years. As the country emerged from international isolation, public revenues were less than 5 percent of GDP, comprised overwhelmingly of duties and taxes on traded goods (Figure 6.1). Public spending was more than double the state's receipts, and both the current and overall budget balances were in deficit. During the early years, and despite substantial foreign financing of the deficit, resorting to central bank financing led to high rates of inflation (see IMF, 2004b). Priority was thus

[25]For a broader discussion of reforms in the 1990s, see IMF (2000).

Figure 6.1. Public Finances, 1993–2003

(In percent of GDP)



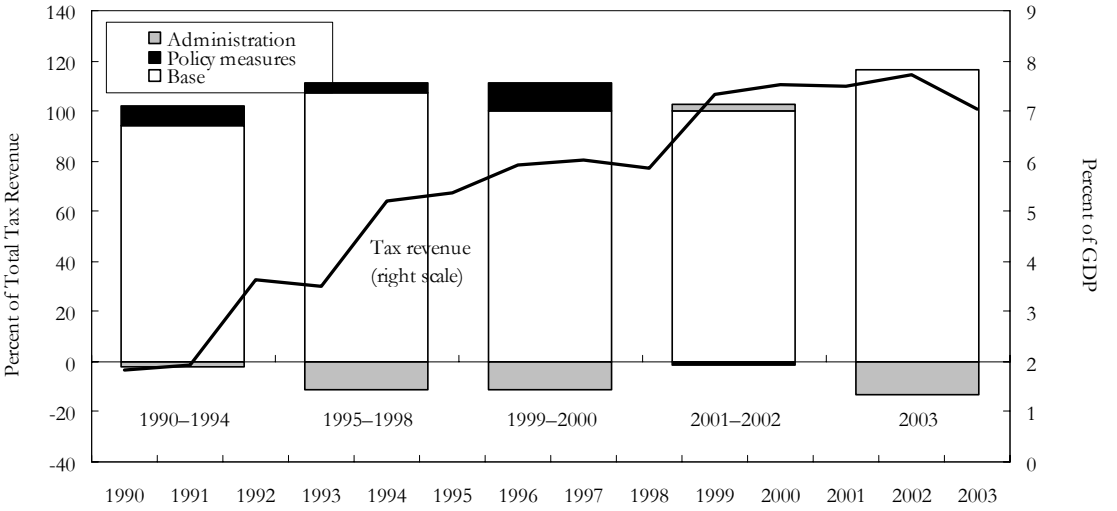
Sources: Cambodian authorities; and IMF staff estimates.

given to mobilizing public revenues to meet the growing expenditure requirements for reconstruction and basic public services.

The revenue efforts undertaken in the early 1990s were initiated from extremely low levels of revenue collection. After all, a modern taxation regime did not exist under the socialist regime in the 1980s. Under these circumstances, during 1990–93, total revenues represented only 4–6 percent of GDP, and were 4–5 percent of GDP lower than expenditures. Moreover, with limited external financing, central bank financing averaged 3–4 percent of GDP annually, contributing to hyperinflation of over 100 percent.

In 1992, a major fiscal reform was initiated with the assistance of foreign experts, followed by a significant revenue effort by the new government formed after the UN-sponsored free election in 1993. Revenues increased to about 9.5 percent of GDP in 1994 and, together with substantial concessional lending, eliminated reliance on central bank financing. The reform program covered all aspects of Cambodia's revenue system in tax policy and tax and customs administration. The increase in revenue was attributed to growth in the tax base and policy measures (Figure 6.2). Despite efforts, the contribution of administrative

Figure 6.2. Total Tax Revenue
(Central government)



Sources: Cambodian authorities; and IMF staff estimates.

improvements to revenue growth was negative.[26] The most effective policy measures related to revenue from international taxes, which increased from almost zero in 1991 to about 5 percent in 1995. The main measures were (1) introduction of a consumption tax on imports in 1993, generating about 1 percent of GDP in 1994; and (2) a higher ad valorem duty rate on petroleum products, which was increased gradually from 3–5 percent in 1992 to about 50 percent in 1994, and generated duty collections of about 1 percent of GDP in 1994—compared to virtually nothing in 1991.

Attempts to Modernize Amid Political Instability: 1995–98

During 1995–98 further attempts were made to deepen fiscal reform. New taxes were introduced in 1995–96, such as a tax on income from wages, a 20 percent excise tax on gasoline, a higher duty on petroleum products, and an increase in the turnover tax. To improve tax policy and tax administration, a new Law on

[26]See the Appendix for a brief description of the methodology used to quantify the impact of administrative improvements.

Taxation (LOT) was adopted in 1997.[27] Government efforts also focused on broadening the tax base, especially in the area of domestic taxes, through significant improvements in tax administration.[28] Efforts included the establishment of a Large Enterprise Bureau in the Tax Department and a computerized database of large tax payers.

Despite these efforts, during 1995–98 total tax revenue stagnated at about 6 percent of GDP, mainly due to a deterioration in customs administration, while nontax revenue decreased to 2 percent of GDP. Against a backdrop of political and military instability, the authority of the Ministry of Economy and Finance (MEF) to collect revenue was undermined. Revenue performance in turn weakened due to the granting of widespread ad hoc exemptions of customs duties, smuggling, an accumulation of tax and nontax arrears, and significant losses in forestry revenue. Indeed, reflecting the overall deterioration of governance, forestry revenue during 1995–98 amounted to only 0.4 percent of GDP per year, compared to potential revenues of about 3–4 percent of GDP per year.[29] Under these circumstances, coupled with difficulties in restraining military and security spending, in 1998 the government used central bank financing of the budget for the first time since 1994.

B. Fiscal Reforms Since 1999

Revenue Developments Since 1999

Fiscal performance improved dramatically in 1999. Total revenue rose from 8.1 percent of GDP in 1998 to 10.2 percent in 1999. The reform of the tax system since January 1999 aimed at moving away from direct taxation of trade and incomes to indirect taxation, relying mostly on a 10 percent VAT that replaced the turnover tax and consumption tax on imports. The VAT boosted revenue and improved the efficiency of the tax system by simplifying the tax structure, widening tax coverage, and reducing cascading. The fiscal reform momentum that started in early 1999 was strengthened during 2000–02 under

[27]The main measures in the LOT, including the VAT, only began to be implemented in 1999, however. The LOT divided the Cambodian tax system into real and estimated regimes. The real regime, which defines the base of VAT taxpayers, covers incorporated businesses regardless of size of turnover, but excludes unincorporated businesses, many of which may in fact be large enterprises.

[28]However, improvements in tax administration over this period should be viewed relative to the very low level of state revenues in the base year. Even with these notable improvements, by 1999 there remained serious noncompliance and tax arrears problems under the "real regime" and a high degree of discretion allowed in tax assessments under the "estimated regime" (see IMF, 2000), which facilitated corruption.

[29]Proper resource management would have yielded lower revenue since logging took place at highly unsustainable rates.

the PRGF arrangement aimed at strengthening the revenue structure and overall administration. Accordingly, revenue had not been increased through changes in tax rates since 1999, except for increases in petroleum taxes and excises on cigarettes and beer in 2002 to offset a reduction in customs duties relating to tariff restructuring as part of a comprehensive trade liberalization program. Nevertheless, revenue rose only marginally in 2002, to 11.2 percent of GDP. Revenue collection was undermined in 2003 by political constraints, and fell to 10.4 percent of GDP, due largely to weaker-than-budgeted customs revenue collections.

Although most of the growth in revenue since 1999 is attributed to the expansion of the tax base, recent efforts to enhance tax and customs administration should not be underestimated (see IMF, 2003a, Annex 2). Technical assistance, notably that provided through the Technical Cooperation Action Program (TCAP),[30] was instrumental in improving administration, including the expansion of VAT coverage by increasing the number of taxpayers.[31] Indeed, during 2001–02, improvements in customs administration contributed for the first time in a decade to an increase of revenues (Figure 6.3). Efforts focused on ensuring a more effective use of preshipment inspection services, and increased transparency to reduce hidden costs in customs procedures. Moreover, anti-smuggling operations were strengthened through enhanced interagency cooperation and the establishment of anti-smuggling units in key border provinces. Unfortunately, these efforts recoiled in 2003 due to the political impasse.[32]

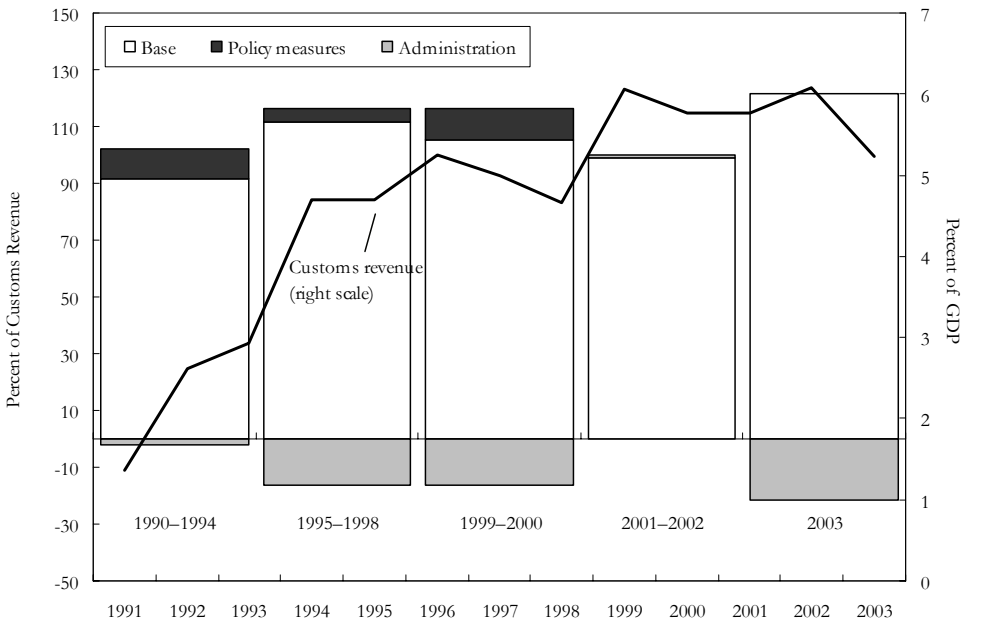
Improvements in tax administration during 2001–02 included an initial exchange of information between government departments and strengthening tax auditing strategies and capabilities (Figure 6.4). As a result of these initial steps, tax arrears have started to be collected. Efforts to collect tax arrears were intensified using a variety of enforcement measures, including the freezing of bank accounts, the temporary confiscation of imports, and delicensing. The collection of arrears (taxes plus penalties and interest) has increased continuously during the past several years: $1.5 million in 2001, $5.8 million in 2002, and $18.7 million in 2003 (0.4 percent of GDP).

[30]The TCAP, launched in May 2001, was a multidonor program of technical assistance designed to build capacity in the key institutions responsible for the formulation and implementation of macroeconomic policies. The TCAP also comprised technical assistance in the statistics and legal areas as well. See www.imf.org/Cambodia.

[31]The coverage of the VAT in Cambodia is much wider than the former turnover and consumption taxes, exempting only (1) public postal services, (2) hospital and medical services, (3) public transportation, (4) insurance and financial services, (5) imports for personal use exempted from customs duties, (6) nonprofit activities in the public interest, and (7) imports of goods related to diplomatic and international organizations.

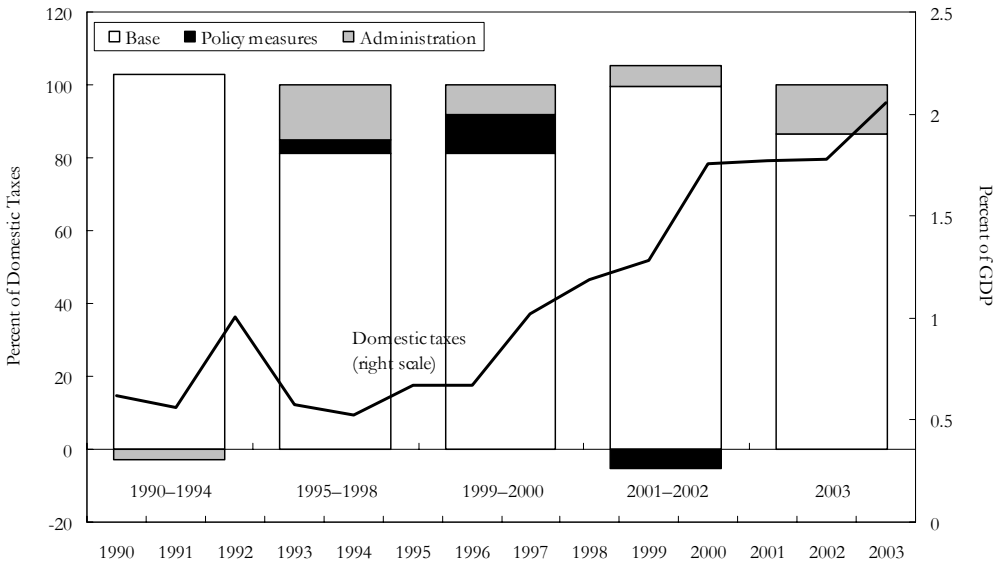
[32]In particular, smuggling of gasoline and diesel is estimated to have been quite substantial in recent years. A recent analysis of the smuggling of petroleum products estimates lost revenue of about 260 billion riel ($65 million), about 1.6 percent of GDP. See IMF (2004d, Chapter 10).

Figure 6.3. Customs Revenue



Sources: Cambodian authorities; and IMF staff estimates.

Figure 6.4. Domestic Taxes
(Central government)



Sources: Cambodian authorities; and IMF staff estimates.

Box 6.1. The Law on Investment

The 1994 Law on Investment (LOI), recently amended (see below), has seriously eroded the revenue base. Revenue collected by the Customs and Excise Department—currently accounting for about 75 percent of total tax revenue—would have been even greater were it not for the substantial erosion of the dutiable base. Indeed, forgone import duties are approximately equal to collected duties. The law provides very generous tax incentives to investors compared to other countries. In particular (1) tax holidays are permitted up to eight years, (2) profits are taxed at a reduced rate of 9 percent (instead of the normal rate of 20 percent) after the end of the holiday period, (3) reinvestment of profits is tax free, and (4) repatriation of earnings and other incomes is tax free.

Exempted Import Duties by Exemption Regime
(In percent of GDP)

	1998	1999	2000	2001
Total exempted import duties[1]	4.7	5.2	6.3	7.3
Diplomatic missions and international organizations	0.1	0.1	0.1	0.1
Investment law provisions	3.6	3.9	4.9	5.8
International aid	0.6	0.3	0.3	0.3
Nongovernmental organizations	0.1	0.2	0.1	0.1
Other	0.4	0.8	0.8	0.9
Memorandum item				
Total import duties[1]	4.1	6.2	6.0	6.2

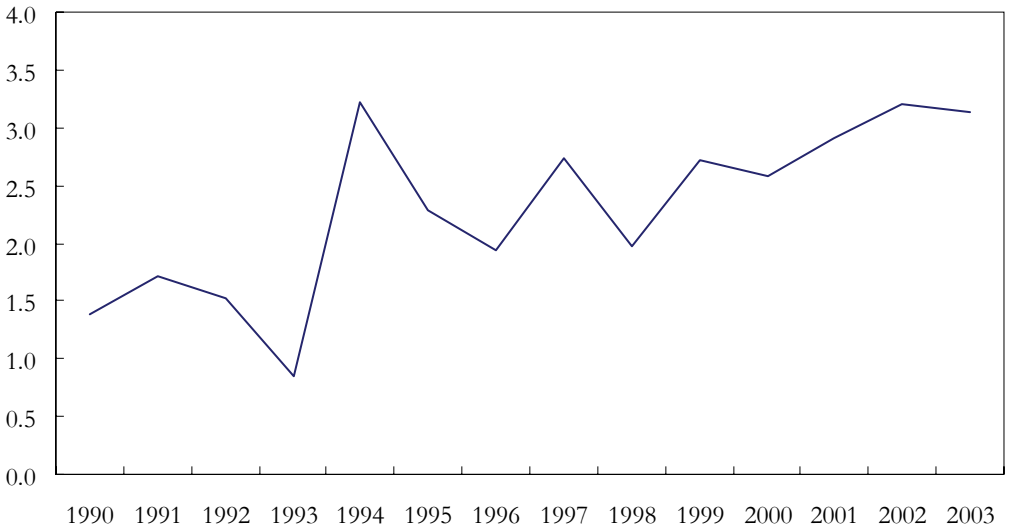
Sources: Cambodian authorities; and IMF staff estimates.
[1]Includes all tax exemptions on imports (i.e., customs duties, excises, and value-added tax).

Amendments to the LOI, enacted (along with requisite amendments to the Law on Taxation) by the National Assembly in early 2003, will potentially broaden further the scope of exemptions, depending on the implementing regulations currently being drafted. Under the amended LOI, investors can now choose to be subject to a special depreciation schedule rather than require tax holidays. The amendments to the LOI eliminate the cumbersome matrix determining the length of the tax holiday, the reduced tax rate on profits of investment companies (grandfathered for those already entitled the rate of 9 percent), and the dividends tax exemption, and they increase transparency by defining clear procedures for granting exemptions. However, the new LOI continues to grant generous exemptions—extensive tax and customs duty exemptions, including projects located in Export Promotion Zones—and differential tax holidays by economic sector that could complicate tax administration and go beyond the maximum three-year tax holiday advised by IMF staff. The extension of duty exemptions on a wide range of imported inputs to almost all qualified investors is a significant relaxation compared with the previous requirement that qualified investors satisfy certain export performance criteria.

Much remains to be done to broaden the revenue base, however. In particular, revenue from international taxes would have been much higher in the absence of large tax and customs duties exemptions. Indeed, during 2002–2003, about 60 percent of all imports were exempted from customs duty, mostly under the 1994 Law on Investment (LOI). In addition, although a clearing of the

Figure 6.5. Nontax Revenue

(In percent of GDP)



Sources: Cambodian authorities; and IMF staff estimates.

backlog of applications for tax exemptions during late 2002 reflected improved transparency, it seriously undermined the domestic tax base, more than halving the projected profit tax collections for 2003. As noted in Box 6.1 (see above), recent amendments to the LOI appear to have broadened further the generosity of investment incentives.

Regarding nontax revenue, several measures were implemented over the last four years, but actual collections have been consistently below expectations. Indeed, nontax revenue only increased from 2.7 percent of GDP in 1999 to about 3.2 percent in 2002, and declined slightly in 2003 (Figure 6.5). The main policy measures introduced in 1999 include (1) transparent collection of garment quotas through regular auctions, (2) introduction of a quota management fee and a garment export license fee, and (3) increasing the timber royalty to an average of $54 per cubic meter, helping to maintain forestry revenue at the 1998 level despite a large reduction in the volume of logging. In 2002, however, forestry revenue declined sharply as all logging activity was suspended pending the establishment of a forestry concession system based on sustainable practices. The main nontax revenue policy measures since 1999 comprised the revision of the contract terms of the entrance tickets at the Angkor temple complex in 2000 and 2002, and the introduction of visa stickers in December 2001. In addition, in 2002, royalty fees from casinos were increased and the share of garment quotas to be auctioned was raised. Despite these measures, there remain significant estimated arrears from telecommunications, civil aviation, and state-owned enterprises and immobile assets leased to the private sector.

Expenditure Developments Since 1999

During the past several years, public expenditure policy has been supportive of macroeconomic stability and was restructured to focus spending toward priority areas. The level of current expenditure remained consistent with a current budget surplus of 1–1.5 percent of GDP during 1999–2002, ensuring sufficient funding for local development projects and helping to avoid any domestic financing of the budget. A military demobilization program initiated in late 2001 was helpful in reorienting expenditure to priority areas (agriculture, rural development, health, and education). Spending on military and security was reduced from 4 percent of GDP in 1998 to 2.5 percent in 2003, while spending on priority sectors rose from 1.5 percent of GDP to 3.6 percent. Still, despite these improvements, education and health expenditures still lag behind the average of countries at a similar stage of development.

The overall public sector wage bill has averaged below 40 percent of current expenditure. But given a fairly sizable public sector workforce (civil administration and military and security combined), funding of basic operating expenses, and low revenue mobilization, remuneration remains far too low to recruit and retain qualified persons. Monthly remuneration in 2002 ranged from $21 to $40 depending on the educational attainment of a civil servant. Even with the government's decision to raise salaries by 15 percent beginning in 2005, the typical civil servant earns far less than even an unskilled garment worker.

Despite the few spending improvements noted earlier, public expenditure management remains weak, and reforms have been difficult to achieve to date. The use of the banking system for government transactions is still very limited, several offsetting arrangements exist with suppliers whereby overdue taxes are offset against government obligations, and the practice of separating U.S. dollar and national currency revenues and expenditures persists. As a consequence, the cash management system remains fragmented, leading to poor budget execution, marked differences between the budget plan and actual spending, and a significant bunching of commitments toward the end of the year.

Because the bunching of expenditures is partly due to extensive pre-auditing by the MEF, an attempt to resolve this problem was made through the introduction of the Priority Action Program (PAP) in 2000. The PAP was intended to ensure that the priority sectors of health, education, rural development, and agriculture could gain access to their full budget allocation by obtaining 25 percent of the budget allocation automatically on a quarterly basis, replacing pre-audits by post-audits. However, despite some initial success in increasing the disbursement ratios, the old pre-audit arrangements have not been successfully replaced, the PAP budget plan has typically not been fully committed until late in the fiscal year, with full disbursement requiring close to two years.

Mindful of the inconsistency between the objectives of PAP and its poor implementation, the government took steps during 2003 to accelerate disbursement of PAP. In September 2003, the RGC established a task force to accelerate PAP disbursements to the health and education sectors. The task force has been somewhat effective in ensuring that a portion of available cash was earmarked for disbursement to these sectors, and by October 2003, 100 percent and 80 percent of committed 2002 PAP expenditures had been disbursed to the ministries of health and education, respectively. An acceleration of PAP disbursements to the ministry of education was achieved in 2003, reducing the lag between commitment and full disbursement at both the ministries of education and health to 23–24 months. Notwithstanding the efforts of the task force, disbursing the backlog of previous years' commitments caused unavoidable delays in liquidating PAP spending budgeted for 2004; as of November 2004, only 24 percent and 60 percent of committed 2004 PAP resources for education and health, respectively, had been disbursed.

Other efforts to improve budget planning and execution were initiated during the past two years. Beginning in 2002, efforts focused on improving cash management, regarded as the root of the shortcomings in the budget execution. As a result, revenue accounts held by line ministries began to be integrated with the National Treasury's single account, and the operations of the Cash Management Committee were improved by implementing a specific format for cash management procedures and enhancing the coordination between the National Treasury (NT) and the Foreign Currency Unit (FCU) of the MEF.[33] More recently, the FCU was transferred to the NT, helping to ensure better information on and improved management of the unit's financial resources. In the treasury area, working groups at the NT had been making efforts to implement standardized accounting procedures and methodologies for the public sector. In addition, with assistance from the Asian Development Bank, a medium-term expenditure framework began to be developed, aimed at integrating more tightly medium-term spending plans with the priorities spelled out in the government's National Poverty Reduction Strategy (NPRS).[34]

C. Remaining Agenda

Despite significant progress to date, Cambodia faces a daunting challenge to transform its public financial management system into one that is capable of adequate service delivery. The reforms implemented under the 1999–2003 PRGF, with technical assistance provided under the TCAP, were aimed at bolstering relatively rapidly the operational capacity of key institutions of macroeconomic management to help boost revenue mobilization, and to

[33]The FCU carries out treasury functions for those parts of the budget denominated in foreign currency.

[34]See *IMF–World Bank Joint Staff Assessments,* March 6, 2003, and October 22, 2004.

improve expenditure execution and cash management. Durably transforming the public financial management system into one that delivers cost-effective higher quality public services was always known to be a long-term project.

Recognizing this challenge, the RGC has recently launched its Public Financial Management Reform Program (PFMRP). The PFMRP, conceived and being implemented using a sector-wide approach, aims to complete the full modernization of Cambodia's public financial management (PFM) system by 2015 in four successive stages, or platforms: (1) ensuring that the budget is a credible instrument for implementing the RGC's development strategy, (2) introducing effective financial accountability, (3) improving the linkages of priorities and service targets to budget planning and implementation, and (4) holding budget managers accountable. The long-term objective is to transform the public financial management so that it is consistent with best international standards (Royal Government of Cambodia, 2004). This long-term program, while focusing on the institutional and policy reforms needed to modernize the public financial management system, will also address the medium-term revenue challenge posed by the NPRS.

It is within the context of this recently launched initiative that the Cambodian authorities and their development partners will have to tackle, in a systematic and coordinated manner, a number of challenges in order to modernize the public financial management system and make it an effective instrument of macroeconomic and social policy. The remainder of this section focuses on these key challenges.

The Revenue Challenge

Despite improvements in revenue performance during the past few years, Cambodia is a long way from a self-sufficient and sustainable fiscal position. Cambodia's fiscal revenue ratios—especially tax revenue—remain very low compared with other countries at similar stages of development (Table 6.1). Increasing fiscal revenue to above 14 percent of GDP by 2009 will be necessary to meet the expenditure needs underlying the government's development strategy while also allowing for increased debt service payments arising from the expected completion of external debt rescheduling agreements with the United States and the Russian Federation.[35] In this context, fiscal policy will have to continue aiming at a sustained current budget surplus of about 1 to 2 percent of

[35]Figures in this chapter assume that concessional rescheduling had been reached in mid-2004 on comparable terms to the 1995 Paris Club agreement (i.e., flow rescheduling on Naples terms), although such rescheduling has not yet been agreed. They assume a 40-year maturity with a 16-year grace period, and interest rate of 3 percent for the U.S. debt. Similar terms are assumed on the debt owed to the Russian Federation, after an initial up-front discount of 70 percent. For a discussion of other possible rescheduling scenarios, see IMF (2004a, Annex II).

Table 6.1. Comparison of Tax Revenue Structure with Other Selected Countries
(In percent of GDP; unless otherwise noted)

	Fiscal Revenue[1]						
		Tax revenue					
			of which:				
	Total revenue	Total	Direct taxes	Indirect taxes	Trade taxes	Other revenue[2]	Per Capita GDP (US$)
PRGF Asian countries	16.2	12.8	3.1	7.3	2.3	3.8	427
Bangladesh	8.6	7.1	1.2	5.8	2.0	1.5	370
Lao P.D.R.	11.4	9.2	2.0	3.8	1.0	4.6	310
Nepal	11.2	9.2	2.1	4.1	3.0	2.0	240
Sri Lanka	17.0	14.7	2.4	10.2	2.1	2.3	830
Vietnam	20.6	15.6	5.5	6.3	3.4	5.0	410
Mongolia[3]	28.5	20.8	5.3	13.4	2.1	7.7	400
PRGF sub-Saharan African countries	17.6	13.7	3.9	5.5	4.6	2.0	323
Of which: selected agriculture countries	14.4	11.4	1.8	3.8	3.3	2.1	277
Cameroon	17.8	12.2	3.3	6.5	2.5	0.7	570
Guinea-Bissau	19.5	10.8	0.0	0.0	0.0	8.7	160
Mali	14.7	14.0	2.6	5.0	5.4	0.7	210
Niger	8.9	8.3	1.5	1.9	4.4	0.6	170
Tanzania	11.8	10.6	2.7	6.7	1.2	1.2	280
Togo	13.8	12.3	0.4	2.8	6.1	0.8	270
Cambodia (in 2001)	11.7	8.4	1.0	4.6	2.8	3.3	259

Source: IMF staff country reports.
[1]Data refer to average of 1999–2001.
[2]Includes nontax and capital revenue.
[3]Other revenue includes only nontax.

GDP, with a declining overall deficit (excluding grants) that is fully financed by external concessional resources.

The medium-term revenue objectives can be achieved by containing further erosion of the revenue base and strengthening customs and tax administration. Broadening of the revenue base needs to be focused on reducing the scope of existing tax and duty exemptions. A simple and transparent investment regime with lower tax rates would be more attractive to potential investors than a system that provides for large exemptions, especially when lack of capacity makes enforcement problematic. On customs administration, the automation of customs procedures, as part of a broader trade facilitation initiative (World Bank, 2004), would improve the capacity of the Customs and Excise Department and reduce hidden costs. Against a backdrop of evidently rising smuggling, however, substantial efforts are needed to strengthen anti-smuggling capacity. Ongoing reforms at the tax department include strengthening audit capacity, establishing taxpayer services, and computerization. To eventually achieve maximum benefit

Table 6.2. Indicators of Debt Sustainability
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Public debt–stabilizing primary deficit[1]	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Primary deficit									
Including grants (projected)	2.7	3.6	4.3	3.9	3.8	3.4	3.0	2.6	2.2
Excluding grants	5.4	6.5	6.8	6.1	5.8	5.4	4.8	4.4	3.8
Public external debt outstanding	67.2	68.4	70.8	68.5	47.5	48.9	48.9	48.4	47.3
Public external debt service (cash basis)									
In percent of revenues	1.7	2.0	4.0	3.8	7.5	8.5	8.3	8.7	9.0
In percent of exports of goods and services	1.0	0.9	1.2	0.9	1.9	2.0	2.2	2.4	2.5
Memorandum item									
Public external debt service (accrual basis)									
In percent of exports of goods and services	3.1	2.8	2.9	2.3	1.9	2.0	2.2	2.4	2.5

Sources: Cambodian authorities; and IMF staff estimates.

[1]Assumes 2.5 percent interest rate and 6.2 percent annual GDP growth.

from these initiatives, however, the tax department will have to introduce significant organizational reforms, to restructure the department along functional lines. All of these should lead to a steady reduction in tax avoidance, additional expansion of VAT coverage through increases in the number of taxpayers, and enhanced compliance through the acceleration of VAT refund procedures.

Cambodia continues to rely significantly on nontax revenues. However, greater transparency over the terms governing the use of state assets will also be key to transfer the appropriate amount of revenue to the budget. In particular, efforts should be made to (1) ensure that procurement procedures are based on competitive bidding, and applied to all public acquisitions and contracts, (2) respect the government's commitment to have all contracts reviewed by MEF and approved by the Minister of Economy and Finance, and (3) publicly disclose the terms of all (past and future) contracts, subject them to audit by the National Audit Authority, and carry out periodic external audits of some contracts, disclosing the results.

An evident challenge facing the authorities is maintaining fiscal sustainability, which in turn depends importantly on improved revenue mobilization. Even if the revenue target is achieved, Cambodia's fiscal position appears to be only marginally sustainable over the medium term due to the implications of an eventual rescheduling of external debt agreements. Indeed, to retain public debt sustainability, the primary deficit would need to be reduced from about 4 percent of GDP in 2003 to below 2.25 of GDP over the medium term (Table 6.2). Since debt service would increase by about 1.5 percent of GDP by 2009, about 70 percent of the increase in revenue will be needed just to meet additional debt service obligations and to facilitate the reduction of the primary deficit. Accordingly, given that the ratio of debt service to government revenue would average 7.75 percent of GDP over 2003–07, a fundamental adjustment in expenditure priorities would be required.

Improving Expenditure Management and Service Delivery

Enhancing public expenditure management is at the heart of the government's reform program in this area. Several institutional reforms are particularly important for success: (1) improving the realism of the annual budget; (2) streamlining the approval and control processes of expenditure execution to enable line ministries to better fulfill their mandates while remaining accountable; and (3) shortening the delays in disbursing budget appropriations to line ministries through better cash management, including through full centralization of government accounts in the treasury single account, as well as by taking the necessary steps to reduce the use of cash in government transactions.[36]

The first priority is to ensure that the national budget is realistic so that it becomes a strategic instrument for public policy. In this respect, an early priority of the PFMRP agenda is to develop capacity within the MEF to forecast revenues and expenditures. Thus, a key early action in the public financial management reform agenda is to develop an overarching resource mobilization policy and framework (including tax, nontax, and debt).[37] In order to construct this critical building block, agency-specific responsibilities and cross-agency interactions have been identified, and a timeline has been laid out. An integral part of this challenge is, of course, to improve the macrofiscal framework and budget forecasting capabilities (both within-year and medium-term) of the fiscal authorities. Avoiding the accumulation of additional spending arrears has to begin with realistic fiscal projections.

The second priority is devolution of spending decisions to the line ministries while simultaneously holding them accountable for results. Key to granting more spending autonomy to line ministries without increasing the fiduciary risk to public funds is to improve the budget execution and cash management systems, as well as the effectiveness of public financial control mechanisms. These in turn hinge on substantially improved budgetary information. To this effect, an early ongoing priority is the redesign of the public accounting system—one that meets international standards, notably those set out in the IMF's *Government Finance Statistics* manual—and introduction of an improved budget tracking system (a financial management information system).

Key Features of the Public Financial Management Reform Strategy

The public financial management reform strategy in Cambodia embodies a number of aspects critical for success.

[36]The PFMRP is of course much more comprehensive.

[37]See Activity 3 of the "Consolidated Action Plan" of the PFMRP (Royal Government of Cambodia, 2004).

- Government ownership: The PFMRP in Cambodia combines the detailed reform strategies of each of the key agencies. Moreover, management of the reform process itself rests with the PFM Reform Committee within the MEF. The committee, chaired by a senior official of the ministry, comprises all the relevant agency heads, who in turn have full ownership of reforms at their agencies.
- **Donor coordination:** Coordination is critical to enhancing capacity building and avoiding duplication and/or conflicting advice to country officials; either of these slippages results in wasted resources and delays in achieving the needed reforms. To ensure better coordination, Cambodia's development partners involved in providing technical assistance in the public financial management area have formed a Development Partners Committee to ensure that providers of technical assistance work in a coordinated and harmonized manner.
- **Incentives to civil servants:** Against a backdrop of totally inadequate formal wages paid to public employees in Cambodia, most donor-financed projects are accompanied by salary supplements paid to select staff. In an environment of low public wages, insufficient motivation, and moonlighting, this is often the only way to get the job done. However, a number of features of the salary supplementation systems used in Cambodia by development partners are widely seen as counterproductive and need to be addressed: they are not merit- or performance-based, they are subject to abuse and misuse, their levels and modes of disbursement vary widely across government agencies, and they retard progress toward a proper civil service pay reform.

Against this background, the PFMRP envisages a merit-based pay initiative (MBPI) for civil servants that is expected to play a key role in the reform. The MBPI approach strikes an appropriate balance between the need to attract and motivate able counterparts on the one hand and the risk of undermining civil service capacity on the other. Several features of this initiative are novel. First, under the proposed initiative, the government contribution to the wage supplement will increase over time so that by the end of the program the merit-based payments are fully financed by the government. This ensures that the salary supplements are sustainable and eventually integrated into the government's salary structure. Second, the eligibility criteria for supplementary pay are transparent and strictly based on merit. This ensures that people with equal qualification and performance receive equal pay, which should reduce frictions within the civil service. Other features of the MBPI include a decompression of the pay scale across those civil servants participating in the public financial management reform program, taking into account cash and noncash benefits, and incorporates the overall medium-term impact on the wage bill.

D. Conclusion

Since Cambodia's emergence from international isolation and war, fiscal policy has been at the center of the reconstruction process. Most importantly, it has been and must remain the cornerstone of the policy framework for macroeconomic stability. After more than a decade of struggle to reform the public finances, notable progress has been achieved. But serious shortcomings remain. These shortcomings are addressed head-on and comprehensively, and in a coordinated manner, under the PFMRP. If successfully implemented, the PFMRP holds the promise of enhancing considerably the contribution that the public sector needs to make to reduce poverty in Cambodia.

Appendix. Quantifying the Revenue Impact of Administrative Improvements

A number of different approaches can be used to estimate the impact of changes in tax and customs administration. The impact of some administrative reforms can be directly measured, such as reinforced efforts to collect tax arrears. This method can be characterized as a "bottom-up" approach. In most instances, however, estimation requires a more indirect approach. In this paper, the revenue yield from tax administration (TA) measures is derived by subtracting from revenue collected two other components that contribute to the revenue yield in any period.

The change in the total yield from a revenue item (e.g., tax or import duty) between two period comprises three components: (1) the change in the size of the imposed base in the absence of policy measures, (2) rate changes or policy-determined changes in the base, and (3) administrative improvements. Given observed revenue, disentangling the relative size of each component requires estimation of at least two. For present purposes, the contribution attributable to the change of the tax base is estimated by assuming a degree of automatic responsiveness of a revenue item to changes in the applicable or a proxy base (i.e., the elasticity of the revenue item). In this paper, a unitary elasticity is assumed, implying that on unchanged policy, the revenue yield should hypothetically increase (or decrease) at the same rate as the change in the proxy tax base. The contribution from policy measures is the impact of policy measures. Finally, the revenue impact of administrative changes is derived by subtracting the latter two estimates from actual revenue. Symbolically,

$$TA_t = TR_t - e^{*}TR_{t-1}\,\Delta B_t - PM_t,$$

where TR is total revenue collected (actual); e is the elasticity of taxes and is assumed to be equal to 1; ΔB is the change in the tax base proxy (i.e., nominal GDP for domestic taxes and retained imports, excluding those related to the garment sector, for customs); and PM represents policy measures taken in time t.

Given the counterfactual nature of the estimation methodology, the results presented in this appendix should be taken as illustrative. For example, the impact of improvements in tax administration could have been larger if buoyancy was assumed to be less than 1, which could be the case in growing economic sectors with widespread exemptions (e.g., the garment sector).

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Exchange Rate Policy and De-Dollarization

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CHAPTER

7 Pro-Poor Exchange Rate Policy

Il Houng Lee and Srobona Mitra

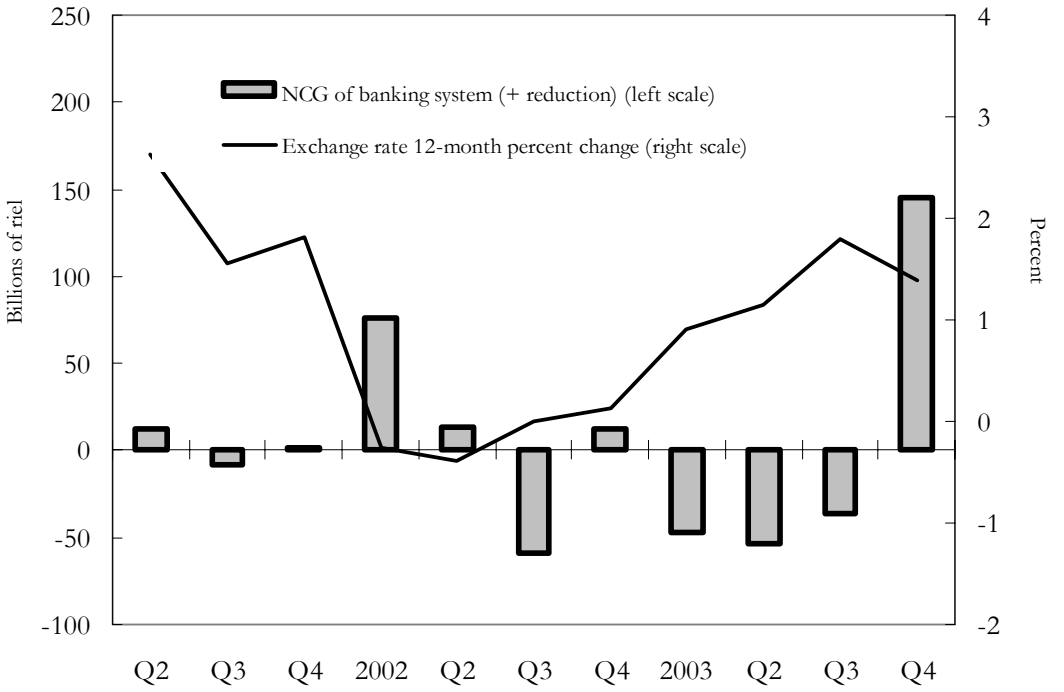
This chapter reviews exchange rate policy options that could minimize any adverse impact on the poor from an exogenous shock such as the elimination of the quota system in early 2005. As long as the buildup of pressures on the balance of payments is modest relative to the level of official reserves, maintaining a stable exchange rate could reduce potential adverse effects on incomes of the poor. In Section A, we present stylized facts, unique to Cambodia. Section B presents results of estimation of exchange rate pass-through to better assess policy implications. In Section C, we provide pro-poor exchange rate policy options.

A. Stylized Facts

Cambodia is a de facto dollar economy. Most prices, except for some prices of nontradable goods and services in rural areas, are denominated in U.S. dollars, and up to 95 percent of total liquidity (including estimated cash in circulation) is in U.S. dollars. The domestic currency, the Cambodian riel (CR), is used mainly by the rural population as a medium of exchange, by the urban population as "coins" complementing U.S. dollars in circulation, and by the government, which spends more in riel than it collects.

As such, it is difficult to interpret the exchange rate as the relative value of currencies of two countries that would normally change in response to differentials in inflation and productivity growth, or changes in the terms of trade. But rather, the exchange rate reflects changes in demand for riel by a small fraction of the urban population who hold riel cash balances for transaction purposes. Although most of the poor in the rural areas hold riel cash balances, they appear not to contribute much to exchange rate changes due to limited information and access to the foreign exchange market. The demand for riel is normally met by government spending through its extensive network of treasury branches across the country. In 2002, for example, the government injected about CR 0.3 trillion (i.e., spending in riel net of collection in riel), of which about two-thirds was retained as cash in circulation, matching the trend increase

Figure 7.1 Changes in Net Claims on Government (NCG) and Exchange Rate



Sources: Cambodian authorities; and IMF staff estimates.

in riel demand in tandem with economic growth. The remaining amount was converted back to U.S. dollars by the private sector (Figure 7.1). Given the relative stability of growth of riel demand, barring any adverse sentiment, excessive cash injection of the government financed by bank borrowing is usually translated into a depreciation of the exchange rate, as the above chart shows, unless the National Bank of Cambodia (NBC) sells its foreign exchange, which it does not often do.

The demand for riel is also sensitive to noneconomic news such as political developments. Any negative news that raises country risk will immediately lead to further dollarization and, on a much larger scale, to capital outflows. This was evidenced when the total stock of foreign currency deposits dropped by 20 percent in the course of one to two weeks during the July 2003 elections. Moreover, bank owners effectively withdrew their capital—which could not actually be withdrawn unless they liquidated the bank—in the form of bank loans to themselves. An increase in the currency risk, such as an increase in the exchange rate volatility, will prompt those holding riel to convert into U.S. dollars, as those who have access to the foreign exchange market are more

concerned with retaining the value of their wealth in U.S. dollar terms. Only a small amount of excess supply or demand could affect a change in the exchange rate because the market is very shallow. With this in mind, a National Bureau Economic Research working paper reviewed about 85 countries that tried to de-dollarize (Reinhardt, Rogoff, and Savastano, 2003), and found that only two of them managed to reduce the foreign currency deposit ratio significantly and keep it low for some time through reduced exchange rate volatility.

Inflation in trading partners in U.S. dollar terms has moved broadly in tandem with domestic prices (in riel), except for the Asian crisis period.[38] During 1997–98, although the weighted average of trading partners' inflation in their respective currencies rose to 7–8 percent, in U.S. dollar terms, inflation declined to below minus 30 percent due to the large devaluations of the exchange rates against the U.S. dollar (see Figure 7.2a). Once trading partner inflation is converted into riel, the large difference during the Asian crisis is sharply reduced (Figure 7.2b), although the initial sharp depreciation in late 1997 (especially of the Thai baht) and the sharp appreciation in 1998 are clearly evident in the remaining gaps during this period.

The overall pass-through from exchange rate changes to domestic inflation in a dollarized economy needs to consider the "accounting" effect of exchange rate movements into domestic price (expressed in riel) in addition to policy and other responses of different components of CPI to exchange rate changes.[39] To illustrate this point, denote $P_T = P^*$ where P_T is the price of tradable goods and P^* is the world price, both in U.S. dollars.[40] The price level in turn is defined in U.S. dollars as $P = P_T^{\varepsilon} P_N^{(1-\varepsilon)}$ where $0 \le \varepsilon \le 1$ and $P_N = P_N^{US\beta}\left(\frac{P_N^{CR}}{e}\right)^{(1-\beta)}$. P_N^{CR} is the price of nontradables denominated in riel; β is the share of the nontradable goods denominated in U.S. dollars where $0 \le \beta \le 1$ and e is the exchange rate where $de/dt > 0$ implies a depreciation. However, since the official CPI is collected in riel, the observed price level is $P^{CR} = eP_T^{\varepsilon} P_N^{(1-\varepsilon)}$, which encapsulates the "accounting" effect.

Changes in the domestic price level can thus be accounted for by (1) nominal exchange rate changes, (2) changes in P_T approximated by partner-country

[38]The main trading partners, which together account for more than 60 percent of Cambodia's total imports, are Thailand, Singapore, Hong Kong SAR, Korea, and Vietnam. The monthly trading partners' inflation data were compiled from monthly CPI and exchange rate data, but using annual trade weights.

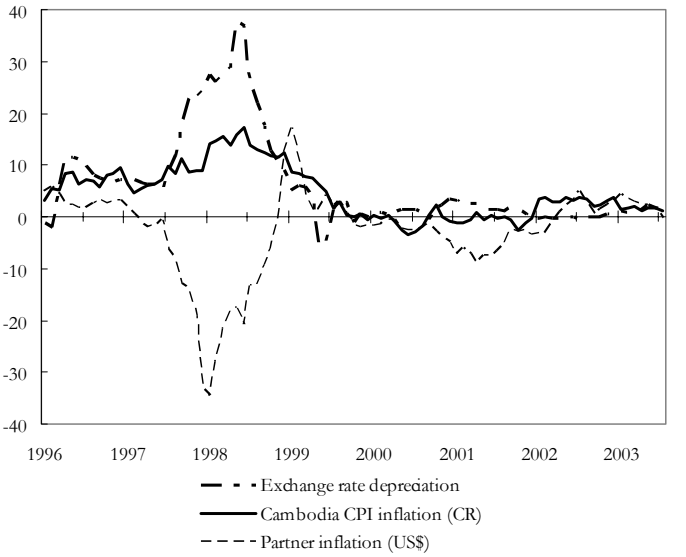
[39]These effects would normally depend upon the source of the exchange rate shock.

[40]The real exchange rate r is defined as $r = P_N/P^*$ where P_N is the price of nontraded goods.

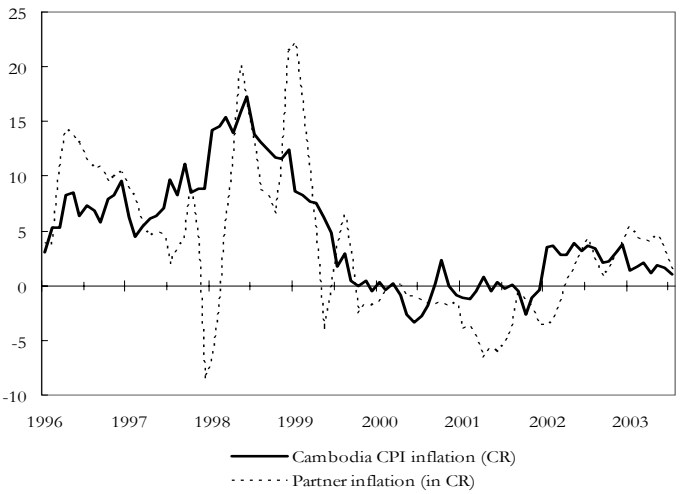
Figure 7.2. CPI Inflation and Exchange Rate Depreciation

(In percent)

a. Domestic CPI Inflation, Trading Partner Inflation, and Exchange Rate Depreciation



b. Domestic CPI Inflation, Trading Partner Inflation, and Exchange Rate Depreciation



Sources: Cambodian authorities; and IMF staff estimates.

inflation[41], (3) changes in prices of nontraded goods indexed and priced in U.S. dollars, and (4) change in the riel-denominated price of nontraded goods:

$$\dot{P}^{CR} \equiv (\beta + \varepsilon - \beta\varepsilon)\dot{e} + \varepsilon\dot{P}_T + \beta(1-\varepsilon)\dot{P}_N^{US} + (1-\beta)(1-\varepsilon)\dot{P}_N^{CR}$$

where $\dot{X} = dX / X$.

The immediate pass-through from exchange rate changes to domestic inflation in the accounting sense is $\beta + \varepsilon - \beta\varepsilon$. The size of this can vary depending on the extent of currency substitution, indexation of domestic prices to the dollar, the size of the tradable goods sector, etc. As examples:

- If all prices are indexed and denominated in U.S. dollars, $\beta = 1$ pass-through is full (=1).
- If all nontraded goods are denominated and priced in riel, $\beta = 0$ immediate pass-through is ε.
- If the tradables sector is very large or, as a simplification, if there were no nontraded goods, $\varepsilon = 1$ (and $\beta = 0$) : pass-through is full.
- If the tradables sector is very small or, as a special case, nonexistent, $\varepsilon = 0$: pass-through is β. If, in addition to a small tradables sector, most prices of nontradables are denominated in riel, then pass-through is 0.

The observed pass-through could be different from this "accounting" effect owing to movements of prices arising from policy responses of the central bank to exchange rate movements, unrelated but concomitant domestic demand and supply shocks, and decisions by producers on whether to increase prices of goods (depending on elasticity of demand) in response to higher cost of imported inputs.[42]

B. Estimating Pass-Through of the Exchange Rate

A vector auto regression (VAR) model is used to estimate the extent of pass-through from exchange rate depreciation to domestic inflation, using monthly

[41]This assumes that imported-traded goods are priced in the producers' currency (here, U.S. dollars).

[42]In general, price and exchange rate movements are likely to be positively correlated when they are caused by common factors, like monetary shocks. If the shock is purely external, like a shock to partner country inflation caused (for example) by partner country monetary policy, the correlation between price and exchange rate responses should be near zero. On the other hand, when the authorities target inflation, and use contractionary monetary policy to reduce upward pressures in prices, the exchange rate would tend to appreciate (resulting in a negative correlation with prices).

data from January 1996 through December 2003. Owing to data constraints, only a trivariate VAR is considered, recognizing that there could be external factors other than exchange rate that could affect the domestic price level. The U.S. dollar inflation rate of trading partner countries is considered as a suitable candidate that might affect domestic inflation. A real variable, like the output gap, is left out because of the lack of data.[43]

Granger causality tests show that both exchange rate depreciation $\hat{e}$ and partner inflation π^* Granger-cause domestic inflation rate π; however, inflation does not Granger-cause $\hat{e}$ and π^*. The variables $\hat{e}$ and π^* do not Granger-cause each other.

To retrieve the structural shocks to each variable, short-run restrictions are imposed—shocks to $\hat{e}$ and π have no contemporaneous effect on π^*, and shocks to π have no contemporaneous effect on $\hat{e}$. These restrictions have the same effect as that of ordering the variables as π^*, $\hat{e}$, and π.[44] The lag-length of 2 was chosen using the Schwarz information criterion (SIC), although the results are robust to inclusion of higher lags.

Following a 1-standard deviation shock (increase) to the exchange rate (a depreciation), domestic inflation goes up—with a maximum effect at four months. The associated pass-through[45] from exchange rate depreciation to domestic inflation is 18 percent on impact, around 41 percent by the end of the first year, and 51 percent at the end of two years following the shock (Figure 7.3). The negative effect of partner country inflation shocks on domestic inflation appears to follow the strong negative relationship—arising from common shocks to regional exchange rates against the U.S. dollar—observed in some periods during the aftermath of the Asian crisis.

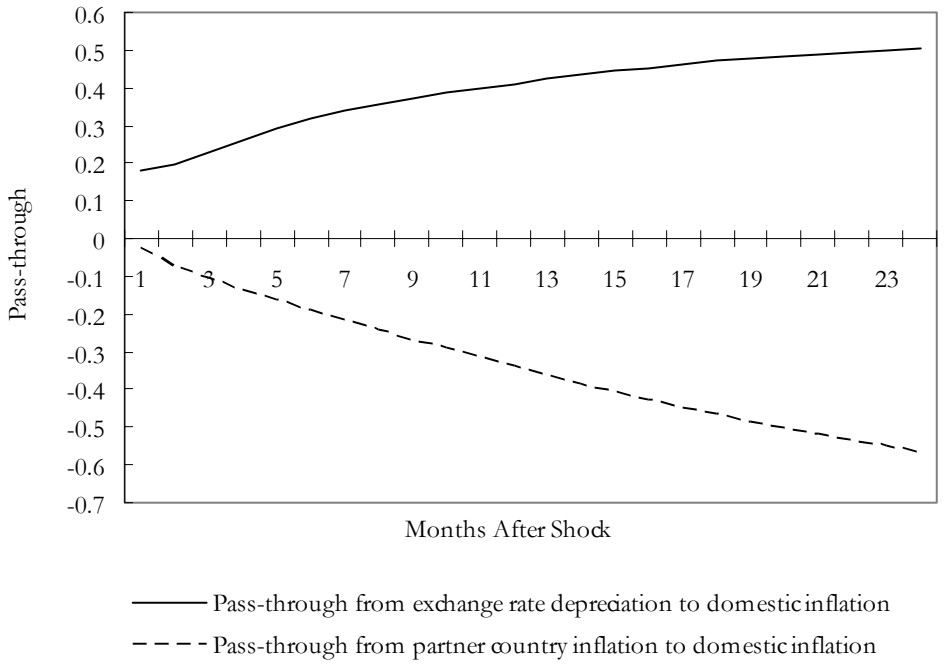
[43]Various unit root tests confirmed the presence of unit roots in the riel-U.S. dollar exchange rate and domestic CPI series; therefore, 12-month changes in the logarithm of these variables have been used for the quantitative analysis. The partner country inflation rate series was found to be stationary.

[44]This alternative to the recursive Cholesky orthogonalization requires imposing enough restrictions to identify the orthogonal (structural) components of the error terms. An ordering with $\hat{e}$ first and π^* second does not change the results in this case.

[45]Pass-through at time t is calculated from the accumulated impulse responses as $\frac{\sum_{i=1}^{t} IR_i(\pi \text{ to } \hat{e} \text{ shocks})}{\sum_{i=1}^{t} IR_i(\hat{e} \text{ to own shocks})}$; IR is impulse response.

Figure 7.3. Pass-Through of Exchange Rate and Partner Inflation

(In percent)



Sources: Cambodian authorities; and IMF staff estimates.

To assess whether the large shocks in the Asian crisis are producing this result, the VAR was rerun using a sub-period of January 1999 to December 2003. The results now show that the impulse response of inflation owing to partner inflation shocks is positive, mostly at five to nine months. However, the impulse response because of exchange rate shocks is now negative, but not significantly different from zero. The result could reflect one or more of the following: (1) greater domestic policy focus on bringing down inflation in Cambodia in the post–Asian crisis period; (2) an increased weight of nontraded goods denominated in local currency (unobserved) in the CPI in recent years; or (3) other large shocks arising out of the nontraded goods sector.

The source of the exchange rate shock is mainly external. This will result in a pure accounting effect in the first round—given nontradable prices are sticky in riel, and tradable goods prices are set by partner countries in U.S. dollars. In U.S. dollar terms, real income of the poor will decline by the exchange rate depreciation effect. But in the subsequent rounds there could be some

adjustment according to whether the exchange rate depreciation is perceived to be permanent or temporary. If this depreciation is seen as very short lived, then there should be no adjustment in wages, and hence prices, of the nontradables sector.

C. Pro-Poor Exchange Rate Policy

An exogenous shock such as the elimination of the quota system in 2005 could worsen the trade deficit by about $120 million (equal to about 20 percent of net international reserves). While the impact on banks is likely to be limited, for example, to a slower growth in U.S. dollar deposits,[46] confidence could be shaken, leading to further dollarization and capital outflows. The NBC could respond either by allowing the exchange rate to depreciate or by defending the rate, which would not be difficult given the limited amount of foreign exchange reserves such a defense might require. However, the implications of these policy options are more widespread.

Case 1. No foreign exchange market intervention: Suppose the NBC does not intervene and the exchange rate depreciates, say by 10 percent. The net impact on the fiscal position is estimated to be about 0.2 percent of GDP of additional revenue in domestic currency terms (see Table 7.1). The net fiscal gain generated from the depreciation will not change much in the short run even if the government were to simply spend more in riel as, except for civil service wages and social transfers, government spending is largely tied to U.S. dollar prices.

Case 1a: Since the fiscal position should not be procyclical, especially at a time when real GDP growth is expected to slow, the government would need to raise civil service wages and social transfers at least to a level that would maintain a balanced recurrent budget. In the first instance, the result of this policy will be as follows: (1) the nongarment formal sector wealth (financial assets) and income will be unchanged, (2) the financial wealth (which consists only of riel cash holding) of the rural poor will be reduced by 10 percent in U.S. dollar terms, and (3) their income in U.S. dollar terms will be adversely affected to the extent that there is less-than-perfect pass-through and some of the nontradable goods and services they provide are denominated in riel terms. To illustrate the point, define real income of the rural poor as $\frac{q_N P_N + q_T P_T}{P}$ where $q_N P_N$ is the nominal income from producing nontradable goods and services. Since, as noted earlier, P_N is partly denominated in riel terms (assume for the sake of simplicity that all

[46]During 2001–02, balance of payments surpluses were partly absorbed by large increases in foreign currency deposits.

Table 7.1. Budgetary Outlays, 2002
(In percent of GDP)

	Domestic Currency	Foreign Currency	Total	Impact of 10% depreciation	Total
Revenue	9.0	2.3	11.2	0.2	11.5
Expenditure	–10.7	–7.3	–17.9	–0.7	–18.6
Foreign financing	0.0	7.0	7.0	0.7	7.7
Domestic bank financing	–1.1	0.0	–1.1	0.0	–1.1
Domestic nonbank	0.7	0.0	0.7	0.0	0.7
Total	–2.0	2.0	0.0	0.2	0.2

Sources: Cambodian authorities; and IMF staff estimates.

nontradable goods are denominated in riel), real income in U.S. dollar terms is defined as $\frac{q_N P_N^{CR}(\frac{1}{e}) + q_T P_T}{P}$. To the extent there is less than full pass-through of e to P_N^{CR}, the nontradables component of their real income $\frac{q_N P_N^{CR}(\frac{1}{e})}{P}$ will decline as e increases. The reduced consumption of the poor will marginally contribute to further adjustment of the balance of payment.

Case 1b: Alternatively, the government could allow the fiscal position to be procyclical. In this case, civil service wages and social spending will decline, leading to an adjustment through contraction of aggregate demand. In this case, (4) civil servants will be relatively poorer, and (5) the recipients of social spending will be adversely affected.

Case 2: Foreign exchange market intervention: If the NBC intervenes to maintain a stable exchange rate, international reserves will decline. At least in the first instance, however, it will not lead to any of the results noted in (2) through (5).

Under both cases, the secondary impact will be lower GDP growth, hence reduced income, mainly in urban areas. Rural areas will be affected to the extent that there is less transfer from urban workers' income to their families.

D. Conclusion

While exchange rate flexibility should be maintained in order to absorb exogenous shocks, careful consideration will need to be given to the

redistributive effects of the exchange rate policy. This is particularly so in cases where the potential impact of a shock on the exchange rate and on international reserves is not expected to be large, and where an adjustment of the exchange rate will not have significant impact in helping to absorb a change in the structure of the economy, given the high degree of dollarization and its asymmetry across income groups.

CHAPTER

8 International Experience of De-Dollarization

Wafa Fahmi Abdelati

This chapter summarizes recent research by IMF staff on country experiences of de-dollarization. Section A describes recent global trends of increasing dollarization and the experience with price stability and exchange rate pass-through in dollarized economies. Section B outlines various de-dollarization approaches countries have pursued. Section C reports that there are only a few cases of successful dollarization. The final section discusses options for Cambodia.

A. Dollarization Trends and Implications

Dollarization has been on the rise in the past two decades. A recent IMF study covering some 117 countries found that financial dollarization, as measured by the share of foreign currency deposits (FCD) in broad money, doubled in the last decade (Table 8.1).[47] This trend partly reflects the return of deposits previously held abroad following the easing of FCD restrictions in most countries. *Financial dollarization* (the use of foreign currency as a store of value) is easy to measure because data are readily available in financial statistics. However, the true extent of dollarization, which should encompass *payment dollarization* (the use of foreign currency for transactions purposes) and *real dollarization* (the use of foreign currency for denominating prices and wages), is more difficult to assess because information is not readily available.

Some countries, however, were able to avoid or contain dollarization. The IMF study found that those countries in Asia that did not experience periods of high inflation or severe macroeconomic instability, including India, Sri Lanka, and Bangladesh (as well as more advanced economies such as Singapore, Malaysia, and Taiwan Province of China), retained domestic currency–denominated private savings. Some countries, including Chile and Colombia, that did experience large

[47]This section draws on Reinhardt, Rogoff, and Savastano (2003).

Table 8.1. Increasing Trend of Dollarization

(In percent of foreign currency deposits to broad money)

Country Group *(Number of countries)*	1980–85	1988–93	1996–01
Africa *(48)*	0	2	7
Emerging Asia *(26)*	3	8	11
Middle East *(14)*	11	20	21
Transition economies *(26)*	—	17	29
Western Hemisphere *(29)*	5	13	23
of which: South America *(11)*	10	23	35

Source: Reinhardt, Rogoff, and Savastano (2003).

macroeconomic imbalances barely escaped dollarization by introducing financial indexation that helped contain the erosion of financial savings. Yet another group of countries, such as the República Bolivariana de Venezuela, Nigeria, and many countries in sub-Saharan Africa, relied on financial repression and capital controls. However, these measures led to waves of capital flight, financial disintermediation, and high levels of dollarization.

B. Approaches to De-Dollarization

The approaches taken by countries to reverse dollarization can be broken down into three types.

- **Macroeconomic policies:** Pursuit of policies aimed at maintaining exchange rate and price stability (to avoid erosion of local currency value), including through inflation targeting to arrest inflation expectations. Financial liberalization that resulted in higher domestic interest rates also contributed to limiting dollarization.

  Example:

  - Following price stabilization, the FCD ratio declined substantially in Poland and Israel. In Armenia, Estonia, and Lithuania, financial liberalization led to an increase in domestic interest rates, thereby helping to contain dollarization.

- **Regulatory/legal reforms:** Changing the regulatory incentive structure through the setting of differential reserve requirements or remuneration rates, or adjusting provisioning and liquidity requirements, introducing alternative financial instruments, and requiring all or certain payments or contracts to be conducted in local currency.

Examples:

- In Nicaragua, a premium was paid on dollar-indexed deposits over dollar deposits. Price and interest-rate indexation were broadly used in Brazil to contain dollarization.
- Peru, in the late 1980s, imposed a 2 percent transaction tax on check payments in foreign currency. Lao P.D.R. introduced a decree requiring all domestic transactions to be carried out in local currency, supplemented by improvements in the payments, clearing, and settlement systems and the issuance of large-denomination banknotes.
- Bolivia, Honduras, Nicaragua, and Peru had higher reserve requirements for FCD than for local currency deposits, although Uruguay refrained from imposing the higher reserve requirement to avoid driving dollar deposits offshore. Israel used differential remuneration rates and imposed a one-year holding period for all FCD to encourage the use of dollar-indexed deposits over dollar deposits.

- **Administrative enforcements:** Direct administrative measures such as prohibition of FCD for residents, restrictions on residents holding accounts abroad, and forced conversions of dollar to local currency deposits.

  Examples:

  - Israel limited payments in foreign currency by imposing a ban on direct transfers of FCD among residents (Table 8.2).
  - Lebanon limited foreign currency lending to 60 percent of FCD, forcing banks to keep the remainder offshore. Vietnam, Malaysia, and the Philippines restricted foreign currency loans to particular uses or borrowers.
  - Peru, Bolivia, and Mexico had forced conversions of FCD in the 1980s. In many African countries, FCD are still not allowed or are severely restricted. But in most cases there are indications of extensive (unmeasured) use of dollars as cash in circulation.

C. Successful De-Dollarization Experiences

However, only four out of 85 countries surveyed during 1980–2001 succeeded in de-dollarization.[48] Of those, only two countries, Poland and Israel, appear to

[48]The criteria used to identify successful de-dollarization include reducing the foreign currency deposit to broad money ratio by 20 percent and remaining below that level until the end of the sample period.

Table 8.2. Use of Foreign Currency in Selected Countries

(In percent of foreign currency bank deposits to broad money)

	1980	1985	1990	1995	2000
Argentina			34	44	55
Azerbaijan				50	40
Bhutan					25
Bolivia			71	79	85
Bosnia and Herzegovina					60
Cambodia				56	68
Croatia				57	70
Haiti					30
Israel	29	48	27	20	18
Lao P.D.R.				43	75
Mexico	17	3	15	10	6
Mongolia				20	26
Nicaragua			29	55	70
Pakistan			3	15	8
Peru	38	67	80	63	69
Philippines				22	29
Poland		25	80	29	15
Romania			4	23	41
Russia				20	27
Turkey			23	47	44
Uruguay			80	65	72
Vietnam		2	33	21	32
Yemen, Rep. of				23	31

Sources: Reinhardt, Rogoff, and Savastano (2003), p. 46; Baliño and others (1990), pp. 4–6; and Leung and Kompas (2005); pp. 7–8.

have had lasting reversals with minimal side effects. For Mexico and Pakistan, it is too early to tell if de-dollarization will be sustained. Moreover, Mexico experienced doubling of capital flight and a drastic reduction of bank credit to the private sector.

In the cases of Poland and Israel, both countries embarked on a successful disinflation program initially built around a strong exchange rate anchor. In Israel, the domestic financial system offered alternative forms of indexed assets, including dollar-indexed deposits (Patzams) with higher reserve remuneration rates. The Patzams proved an effective substitute for dollar deposits. In Poland, interest rates on domestic currency assets were raised to maintain a differential in favor of local currency deposits. But it is not at all clear that the conditions in

Israel and Poland can be replicated by other countries, especially since the initial level of dollarization was not high in the first place.

In contrast to the few successes, there have been many more countries with unsuccessful attempts at de-dollarization. Often, these attempts involved administrative enforcements without fully restoring confidence in the local currency or eliminating the underlying instability that led to dollarization in the first place. In both Peru and Bolivia, foreign currency deposits accounted for about 30 percent of total deposits in the early 1980s. Both countries attempted forced conversion that led to an increase in cross-border deposits, capital flight, and reduced financial intermediation. Eventually, by the end of the 1980s, foreign currency deposit in both countries increased further, to 70–80 percent.

There are also several countries that have intentionally opted to maintain a high level of foreign currency as part of their broad money. In Asia, Bhutan allows free use of the Indian rupee and Brunei Darussalam the Singapore dollar to facilitate trade and economic cooperation with their larger neighbors, and to benefit from stable macroeconomic conditions. For similar reasons, Lesotho and Namibia allow the use of the South African rand, Bosnia and Herzegovina the euro, and Haiti and The Bahamas maintain use of the U.S. dollar alongside their own currency. A few other countries, including Panama, El Salvador, and Timor-Leste, opted for full dollarization.

D. Steps Toward De-Dollarization in Cambodia

De-dollarization is a long-term objective for Cambodia. Country experience has shown that de-dollarization is a long-term process that, foremost, requires restoring confidence in the local currency. Confidence is restored when the private sector is sure that it will not be financially penalized for holding the local currency. Accordingly, only when continued macroeconomic stability and relative exchange rate stability are maintained will financial deepening be brought about by an increase in the use of domestic currency.[49]

Exchange rate stability is important in maintaining price stability in highly dollarized countries. The 2003 IMF Executive Board paper found systematic differences in the pass-through from exchange rate to prices.[50] The impact of exchange rate changes on inflation was found to be largest for countries with a high degree of dollarization and where there was little private liability dollarization (low share of private sector debt in total external debt). However,

[49]In a recent paper, Ize and Levy-Yeyati (1998) argued that greater real exchange rate flexibility would reduce incentives for dollarization. They advocated a floating exchange rate combined with an inflation targeting approach to foster the use of the local currency, based on a theoretical model that derives depositors' optimal portfolios.

[50]The Board paper was later published as Reinhardt, Rogoff, and Savastano (2003).

the impact was the lowest in countries where overall dollarization is low and domestic dollarization was negligible.[51] These results were consistent with the reluctance of central banks to tolerate large exchange rate changes, and also support Cambodia's pursuit of a stable exchange rate.

Policies could be pursued that encourage the use of local cash without recourse to administrative controls that might result in capital flight. Such policies would comprise measures to conduct all public sector transactions in local currency, including an increase in the use of riel in the collection of tax and nontax revenue and in payments for capital expenditure. In 2001, 74 percent of nontax revenues and 67 percent of capital expenditure were collected in foreign currency. Creating a wedge in reserve requirements between FCD and local currency deposits could be another potential instrument. Introducing riel-denominated treasury bills could he useful in the future but is not an immediate measure to facilitate de-dollarization since banks have little need to manage riel liquidity given the low demand for riel. Finally, introducing a larger denomination of riel currency would enable payment of larger transactions in riel.

[51] Domestic dollarization in this case refers to the ratio of foreign currency deposits in broad money and the share of government debt that is foreign currency–denominated.

Legal Environment and WTO Accession

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CHAPTER

9 Legal and Judicial Reform: Recent Developments and Prospects

Nadia Rendak and Damien Eastman

While legal and judicial reform has been on the government's agenda for the past 10 years, only in recent years has this work accelerated. So far, some progress has been made in drafting new legislation necessary to support a market economy, while results are considerably more modest in judicial reform. Section A provides a general background, Section B describes the current legal and judicial system, and Section C summarizes ongoing reform efforts. After discussing recent anti-corruption initiatives in Section D, the last section outlines challenges faced by Cambodia in implementing legal and judicial reform and considers actions that can be taken in the short term to accelerate reforms.

A. Background

Several decades of conflict undermined Cambodia's economy and dealt a serious blow to its legal and judicial system. In 1993, Cambodia reemerged as the Kingdom of Cambodia in the form of a constitutional monarchy and started on the path of democratic reform. A new constitution was adopted in September 1993 based on the principles of liberal democracy and separation of powers. The RGC formed pursuant to the constitution, started reforms to transform Cambodia into a market economy.

However, after more than 10 years of effort, Cambodia is still confronted with serious legal and judicial reform challenges. Cambodia faces an urgent task of improving governance and creating a predictable business environment, both of which are crucial for achieving sustainable economic growth. Implementing broad-ranging legal and judicial reforms would be key for improving governance. Legal and regulatory frameworks should be established to assure effective public sector management and help promote private sector development. An effective and independent judiciary should be created to resolve disputes between individuals and businesses and to safeguard the rule of law.

To date, progress in legal and judicial reform in Cambodia has been slow and uneven, and governance remains weak. In a recent World Bank report on the investment climate in Cambodia (World Bank, 2004), corruption was identified as the most important obstacle to private sector development. Weak and unpredictable enforcement of the existing laws, contracts, and court decisions; inconsistent interpretation of laws and regulations; deficiencies in the public procurement regime; and the lack of accountability of the government all contribute to a poor image of Cambodia in the eyes of the international business and official communities.

B. The Current Legal and Judicial System

Cambodia's legal and judicial system has undergone a substantial transformation since it achieved independence in 1956. Initially modeled after the French legal system based on a civil code and a French-style judiciary, then almost completely destroyed under the Khmer Rouge regime from 1975 to 1979, Cambodia's legal and judicial system now represents a complex web of old and new laws, policies, and judicial institutions.

As in other countries with a continental legal system, legislation is the primary source of law in Cambodia. Other sources of law include the constitution, international treaties ratified by Cambodia, government decrees and regulations, and regulations adopted under the United Nations Transitional Authority, as well as customary laws. According to the 1993 constitution, previously passed legislation remains in effect to the extent that it does not contradict the new constitution. Therefore, Cambodia's legal system currently comprises French-style laws adopted prior to 1956 as well as legislation subsequently adopted under various governments.[52] Since 1993, many new laws have been adopted to support the emerging market-based system, and more legislation is being developed in connection with Cambodia's accession to the WTO. Since there is no uniform interpretation of the above-mentioned constitutional provision, there is often confusion as to the extent to which different old laws apply. As new legislation is adopted, ensuring consistency between the old and new laws will represent a major challenge for Cambodia.

Despite many changes over the years, Cambodia's court system remains modeled after the French-style judiciary. The 1993 constitution established a judiciary separate and independent from the legislative and executive branches. Under the constitution and the 1993 Law on the Organization of Courts, Cambodia's judicial system now comprises provincial and municipal courts, a Military Court, a Court of Appeals, and a Supreme Court. Provincial and municipal courts are located throughout the country and are composed of a judge and a prosecutor.

[52]For a more detailed discussion of Cambodia's legal and judicial system see Sok and Denora (1998, pp. 4–15).

These are lower-level courts that adjudicate the majority of disputes. A municipal court decision can be appealed to the Court of Appeals on issues of both law and fact. The Supreme Court, located in Phnom Penh, is the highest court, with jurisdiction over the whole territory of Cambodia. With a few exceptions, the Supreme Court hears only questions of law.

Two other institutions, while not a part of the judiciary, play an important role in Cambodia's legal system. First, the Constitutional Council was established in 1993 to decide the constitutionality of laws and regulations. Second, the Supreme Council of Magistracy (SCM) was established pursuant to the constitution to assist the king in guaranteeing the independence of the judiciary. The SCM is in charge of disciplining judges and prosecutors and ensuring the proper functioning of the courts. The SCM is chaired by the king, to whom it submits recommendations on the appointment, suspension, and removal of judges.

At present, there are no specialized courts or law to facilitate independent arbitration in Cambodia. However, the establishment of a commercial court and commercial arbitration is envisaged under WTO accession, and a nonbinding arbitration process was recently established under the Ministry of Labor to resolve labor disputes. In rural areas, many disputes go through an informal conciliation process before they reach the court. In the absence of specialized commercial courts, there is usually no distinction in the lower trial courts among civil, criminal, and commercial matters, or between different aspects of a single dispute.

Cambodia's judicial system is plagued with problems and is regularly identified as one of the country's most corrupt institutions.[53] There is a perception shared by both individuals and businesses that fair and impartial resolution of their grievances through the formal court system cannot consistently be attained. The SCM is politicized and has thus far proven ineffective. There is no legal framework ensuring that only qualified individuals are appointed as judges. There are currently around 195 judges and prosecutors in Cambodia, most of whom were appointed under the previous regime, and many lack the necessary training and experience, especially to resolve commercial disputes. Political interests intervene heavily in the discharge of justice—judges who act against powerful political interests risk dismissal. Cambodia's courts are generally understaffed and lack resources to effectively adjudicate cases. Enforcement of court judgments is very expensive and unpredictable. All this creates a general distrust of the judiciary and makes it, in its present form, an obstacle to the establishment of the rule of law.

[53]In World Bank (2004), the judiciary was rated lowest in Cambodia among a number of public institutions and agencies rated for their integrity.

C. Recent Developments

While some progress in legal and judicial reform has been achieved, reforms have proved slow and difficult. During 1994–2000, several attempts were made by the government to formulate a strategy for reforming the legal and judicial system. In February 1994, the "National Programme to Rehabilitate and Develop Cambodia" set out an overall vision for legal and judicial reform, and an action plan to implement the program was published by the government in February 1995. Several laws identified as requiring attention—including a law on the status of judges and prosecutors, a law on the organization and functioning of courts, the civil and criminal codes, and the law on status of clerks and bailiffs—were to be adopted within three years of the publication of the action plan. However, as of January 2005, none have been adopted. Strengthening of the judiciary and law enforcement was also identified as a cross-cutting issue under the government's 2001 Governance Action Plan and in the National Poverty Reduction Strategy adopted in 2002. Again, no concrete action followed.

Various institutional arrangements were made over the years to facilitate reforms but they have been mostly ineffective. In March 1994, a Council of Jurists was created under the Council of Ministers to assist the government in formulating reforms. Later, in April 2000, a separate Judicial Reform Council was established to formulate and implement reforms under the Supreme Council of State Reform, which in turn was created in 1999 and chaired by the prime minister. Despite these institutional changes, reform measures envisaged in 1994–1995 failed to produce any concrete results. In June 2002, a new body, the Council for Legal and Judicial Reform, was established, and a Permanent Coordination Body (PCB) for the Council was formed in August 2002.

In June 2003, the government approved a comprehensive Strategy for Legal and Judicial Reform ("Strategy") and circulated an action plan for its implementation. The action plan, however, did not prioritize reform measures and lacked details on the responsibilities and financing and implementation arrangements. In December 2003, a national workshop on the implementation of the Strategy was held. At the workshop, five working groups were formed to develop reform recommendations in the following areas: (1) anchoring the legal framework; (2) empowering the market economy; (3) improving the quality of access to legal and judicial services; (4) strengthening legal and justice sector institutions; and (5) introducing and reinforcing alternative dispute resolution mechanisms and legal awareness.

In June 2004, the Project Management Unit (PMU) created under the PCB refined the draft action plan into a list of short- and medium-term priorities[54]

[54]Short-term is defined as 2004–06, while medium-term covers 2004–08.

Box 9.1. Short- and Medium-Term Priorities for Legal and Judicial Reforms Under the June 2004 Action Plan

Since the national workshop on legal and judicial reform in December 2003, the Project Management Unit (PMU) has hosted various group meetings and bilateral meetings with representatives from the justice sector institutions, civil society, and the international community. The proceedings of these meetings have served as input to establishing priorities for the PMU's action plan. The action plan is centered around seven strategic objectives: improving and protecting fundamental rights and freedoms, modernizing the legislative framework, improving access to legal and judicial information, enhancing the quality of the legal process, strengthening judicial services, introducing alternative dispute resolution mechanisms, and strengthening legal and judicial institutions.

Key short-term priorities are focused on a range of new laws and setting the foundation for restructuring the justice sector, and include drafting a Civil Code, Civil Procedures Code, Criminal Code, and Criminal Procedures Code; preparing the Statute of Magistrates; enacting the anti-corruption law; drafting laws to establish a commercial court; adopting a law on commercial arbitration; and measures to institutionalize the publication of statutory laws and court decisions (including a collection of past court decisions).

Key medium-term priorities include completing the legislative framework pertaining to the justice sector, which will involve adopting an Administrative Procedures Code, educating the legal profession with respect to new laws and providing specialist training programs, and completing the restructuring of the courts; providing training and awareness programs on human rights and fundamental rights; introducing a law and policy for legal aid; and developing codes of ethics for judges, prosecutors, and legal practitioners.

(Box 9.1). Listed among short-term priorities are some of the measures that have been pending since the mid- and late 1990s, including the restructuring of the SCM, adoption of the law on the organization and functioning of courts, and enactment of the anti-corruption law. The action plan envisions, however, that implementing these measures may extend beyond 2006, making their quick passage unlikely. The government has circulated the action plan to all interested stakeholders to generate assistance from the international community for various projects.

Apart from the above-mentioned efforts to formulate a reform strategy, there has been little real progress in judicial reform. Among the few positive developments in the last several years are a modest increase of judges' salaries in January 2003 (the salaries were increased on average from $25–30 a month to $200–400 a month), and the establishment of the Royal School of Judges and Prosecutors in 2002. The school was established to train new and existing judges

and prosecutors and to provide continuing legal education.[55] In November 2003, the school enrolled its first 55 students who will graduate in two years to become judges. The school is financed by the government and supported by several donors, including the French government, the United Nations Development Programme, and the German Development Agency. While the establishment of the school is a positive development, it cannot be expected to have an immediate effect on the quality of the judiciary. With the first class to graduate only in late 2005, it will take time for the school to become fully operational, and its contribution to the training of judges and prosecutors will start bearing fruit over a period of several years, at best.

More has been done to modernize Cambodia's legal system when compared with the slow progress of the judiciary. Progress has been made since 1993 in reforming many areas of legislation, including tax legislation and laws governing the banking and financial sectors. The 1996 Central Bank Law and the 1999 Financial Institutions Law, and their implementing regulations, established a sound legal framework for operations of commercial banks and for the central bank's supervision. In 1994–1995, a basic legal framework for public procurement was put in place.[56] A new Land Law, adopted in 2001, established a modern legal framework for land use and transactions in land. A centralized land registry (Cadastre) was created to record title to, and all transactions (such as transfers and mortgages) in, land. Work on land titling is currently under way and is supported by several donors.

Additional laws are needed to strengthen protection of property rights, promote financial intermediation, and strengthen enforcement of creditor rights. Laws on negotiable instruments and payments transactions, insolvency, secured transactions, government and corporate securities, commercial contracts, and commercial arbitration should be adopted or, if already adopted, enacted by the National Assembly. Without these laws, the legal framework for safeguarding financial transactions and resolving commercial disputes—both essential for economic growth—remains incomplete.

Reforms on the legal side further accelerated in 2002 in conjunction with Cambodia's preparation to join the WTO. WTO accession is an important factor in accelerating reforms in general and legal and judicial reform in particular, since WTO membership imposes on Cambodia certain obligations with respect to improving the legal framework for business transactions and enforcement of contracts. To fulfill its WTO commitments, within the next several years

[55]However, the law on the status of judges and prosecutors, which will make completing a training course at the school a mandatory requirement for appointment of all new judges, is yet to be adopted.

[56]This basic legal framework for public procurement is in need of revision, especially with regard to transparency of procedures.

Box 9.2: Establishment of a Commercial Court

A draft law to establish Cambodia's commercial court is currently being revised. The law is aimed at establishing a court by end-2004 (now more likely in 2005) to more efficiently and effectively resolve disputes of a commercial nature. The commercial court would be composed of three judges and two associate judges, each holding office for a renewable five-year term, and appointed by royal decree upon recommendation from the Supreme Council of Magistracy. Only persons who have completed a specialized education program for commercial court judges would be eligible for appointment.

The court would be vested with jurisdiction to hear disputes in a broad range of commercial areas, including business, banking and finance, insolvency, intellectual property, trade, and competition, of both a civil and criminal nature. It would also have exclusive jurisdiction over the recognition and enforcement of foreign court orders and foreign arbitral awards. The operations of the commercial court would be governed by the Commercial Court Rules of Procedure, supplemented by the Civil Procedure and Criminal Procedure codes. The current proposal would seat the commercial court in Phnom Penh, but allow the court to temporarily sit in places throughout Cambodia as necessary.

The current draft law has drawn comments from a number of participants, including donors, who are divided on whether the court should be based on a civil or common law system, and the extent to which the court should be separate from, and consequently outside the potential influence of, the executive branch. Additionally, issues such as the broad nature of the court's jurisdiction (which could lead to the court hearing noncommercial disputes) and whether there should be a threshold or minimum amount in dispute, are areas of the draft law that have drawn comments and proposals for revision.

Cambodia will have to pass 46 new laws ranging from customs to intellectual property. While 14 laws have already been adopted, many others are at a drafting stage.

Accession to the WTO is giving a new momentum to judicial reform. One of the commitments under the WTO is that Cambodia should establish a specialized court to adjudicate commercial disputes. A draft law on a commercial court was prepared under the auspices of the Ministry of Commerce and is now being discussed among government agencies and legal experts. No consensus has yet been reached on many key aspects of the new court (Box 9.2). As a WTO member, Cambodia should also establish procedures for appealing administrative decisions and for enforcing foreign arbitral awards.[57]

[57]In 2001, Cambodia ratified the United Nations Convention on the Enforcement of Foreign Arbitral Awards ("New York Convention") and the Convention on the International Center for Settlement of Investment Disputes between States and Nationals of Other States ("ICSID Convention"), although it has not yet adopted implementing regulations for either of the conventions.

Donors and other representatives of the international community have repeatedly expressed their disappointment with Cambodia's lack of progress in judicial reform, most recently at the 2004 meetings of the Consultative Group of Donors.[58] The authorities have acknowledged that reforms have lagged and have expressed their intention to make progress on legal and judicial reform.

D. Anti-Corruption Initiatives

The Cambodian authorities have long acknowledged governance problems as a cross-cutting issue, but little has been done so far to address them. While the existing criminal laws allow for prosecution for corruption, not a single case has yet been brought to court, and no government official has been charged. Eliminating corruption will require a comprehensive strategy that should include broad-ranging reforms of the civil service, increasing transparency of government operations, and improving the legal and institutional frameworks for government and private business operations (including changes to the public procurement regime).

Some positive recent initiatives aimed at addressing governance issues include Cambodia's endorsement of the Asian Development Bank's and the Organization for Economic Cooperation and Development's Anti-Corruption Initiative for Asia and the Pacific; enactment in 2000 of the Law on Audit and establishment of the National Audit Authority; enactment of a law on accounting; and adoption of a comprehensive anti-corruption law, which was submitted to the National Assembly in early 2004.

The draft anti-corruption law provides for the establishment of an independent anti-corruption agency—the Supreme Council Against Corruption—that would investigate but not prosecute corruption (Box 9.3). The law also requires government officials to declare their assets and liabilities. While the adoption of an anti-corruption law is welcome, its implementation will be key. Successful prosecution of corruption cases will require a strong judiciary and law enforcement.

Curbing corruption in the judiciary will require a comprehensive approach. As a priority, the SCM should be reformed to make it less politicized, more independent, and more effective, and a law on the status of judges and prosecutors should be adopted. The latter is essential to ensure the independence and effective functioning of the judiciary, as it will establish a judicial service tenure system, an appointment process and requirements, service conditions and benefits, codes of conduct, and a defined salary structure. While

[58]Lack of progress in legal and judicial reform was well summarized in the Note on Legal and Judicial Reform prepared by the Cambodian Office of the High Commissioner for Human Rights for January 2003.

Box 9.3. Anti-Corruption Law

A draft of Cambodia's anti-corruption law has been submitted to Parliament. The proposed law is intended to tackle corruption throughout Cambodia and defines corruption to include acts of bribery, the giving or accepting of unlawful gratuities or services, using unlawful authority or power on duty, embezzling or exploiting national assets, tampering with documents, and performing tasks conflicting with designated duties. It mandates that officers of national institutions (officers are defined to include a broad range of publicly elected and appointed officials) declare their assets and debts in writing upon entry or exit from office, and at least once every other year.

The proposed anti-corruption law establishes a Supreme Council Against Corruption (SCAC) with an independent budget and the ability to request additional resources from external donors. The SCAC would comprise six members, each member appointed by a different arm of government and having duties that include the broad authority to present the government with measures to eliminate corruption, examination of reports and instigating investigations where there are allegations of corruption, summoning necessary persons to appear before it, and preparing files and records of its investigations. The law creates a general Secretariat, vested with the power to investigate allegations of corrupt activity. Its organization and functioning is to be clarified in a sub-decree, which has also yet to be enacted. Under the proposed law, neither the SCAC nor the Secretariat is vested with power to prosecute corruptions. The draft law also provides for the rules of evidence, allows the SCAC to order administrative leave for those accused of corruption, and prescribes the penalties for persons involved in corruption, which, depending on the benefit obtained from the corruption, range from imprisonment for one month to 15 years and a fine of twice the amount obtained from the corruption.

Although the proposed law introduces an appointment process allowing the different arms of government to appoint members to the SCAC, and seeks to strengthen that independence by allowing the members of the SCAC to elect the chairman and vice-chairman, the law does not require a potential appointee to meet any minimum professional standards, thus possibly opening the way for appointments that may undermine the true independence of the SCAC.

several drafts of this law and of amendments to the law on the SCM were circulated in the past, none has thus far been adopted. Among other important measures that would help to improve governance in the judiciary is ensuring that all legislation is published on a timely basis and made available to general public. Publicizing court decisions will also increase transparency and effectiveness of the courts.

E. A Way Forward

Despite some progress in legal and judicial reform, reforms have thus far been hampered by limited human and financial resources and the apparent lack of focus and commitment at the top level. It remains to be seen whether the government formed in 2004 will be able to deliver on past promises.

Even with renewed commitments of the new government, Cambodia will continue to face significant challenges in implementing legal and judicial reform. These challenges—limited human and financial resources, weak institutions, and widespread governance problems, including in the judiciary and in law enforcement—are common to many less-developed countries. In Cambodia, they have been exacerbated by several decades of conflict and a very limited pool of capable individuals currently in the public service. While Cambodia has benefited significantly from international assistance in the legal and judicial reform area, that assistance creates additional challenges by the conflicting influence of different schools of thought (civil vs. common law systems) sometimes pursued by different donors. In the absence of a clearly formulated reform strategy, it has been difficult for donors to effectively coordinate their assistance.

The action plan prepared by the PMU in June 2004 sets out an ambitious plan for short- and medium-term reforms. Many of the measures included in the plan are long overdue. The necessary reforms can be implemented only with full commitment at the top level and with the mobilization of Cambodia's internal resources supplemented by international assistance.

While many reform measures may require significant donor assistance, some measures that require little or no such assistance can, and should, be implemented. Those include

- Adopting the law on the status of judges and prosecutors that would establish an appointment process and the terms and conditions of service, including a code of conduct.
- Taking concrete steps to ensure the independence and the transparency of the operation of the Supreme Council of the Magistry, to enable it to fulfill its functions set forth in the constitution.
- Establishing a commercial court that will specialize in commercial dispute resolution.
- Enacting an anti-corruption law that establishes an effective framework for investigation and prosecution of corruption offenses and provides for declaration of income and assets by government officials; and preparing the implementing regulations.
- Publishing all court decisions and creating a repository of all laws in both Khmer and English.

Most of these measures were identified as short-term priorities in the action plan prepared by the Council for Legal and Judicial Reform. Implementing these measures will signal to investors and donors the authorities' commitment to legal and judicial reform and will hopefully help to unlock new investment and additional international assistance.

All this having been said, it has to be recognized that any progress in legal and judicial reform in Cambodia will be gradual. While the adoption of new legislation is important, it will be equally important to ensure that the new laws are effectively implemented. This will require strengthening the existing institutions and creating new institutions necessary to enforce new laws, training new officials, fighting corruption in the government and in the judiciary, and gradually changing the culture in the society toward the rule of law. For the reforms to succeed, it will be necessary for the authorities, the private sector, and the international community to work closely together.

CHAPTER

10 Cambodia's Accession to the WTO

Sumio Ishikawa and Koji Nakamura

This chapter reviews the various reforms that will be introduced in connection with Cambodia's WTO accession. The large number of laws that are expected to be enacted by the National Assembly in the next few years will put in place a sound legal infrastructure conducive to economic activity in Cambodia. However, the benefit of these reforms will, of course, be realized only with full enforcement of the legal framework. Section A provides basic background on the accession process and Section B lists key reform areas.

A. Background

WTO ministers approved Cambodia's Membership Agreement on September 11, 2003. However, in view of the political impasse following the July 2003 elections that prevented parliament from convening, the General Council of the WTO agreed to extend the deadline for ratification of the agreement by the Cambodian parliament from March to September 2004. With the formation of a new government in mid-July 2004, the National Assembly ratified the accession agreement in late August 2004, and Cambodia became a member of the WTO on October 13, 2004.

As part of the WTO accession package, the Cambodian authorities committed to adopt 46 pieces of legislation, of which 14 pieces have already been adopted (Table 10.1). The remaining laws, originally envisaged to be adopted during 2004–06, will now most likely be adopted during 2005–07.[59] These laws are aimed at providing a fair and predictable business environment. They are

[59]All references to future dates, including 2004, shown in this chapter for adoption of laws may now be delayed by up to one year.

Table 10.1. Schedule for Enacting Laws for WTO Conformity[1]

	2001	2002	2003	2004	2005	2006
Judicial Reform						
1 Law establishing the commercial court				Expected		
2 Ratification of the New York Convention on the Enforcement of Foreign Arbitral Awards	Adopted					
3 Commercial Arbitration Law				Expected		
4 Ratification of the ICSID Convention	Adopted					
5 Civil code				Expected		
6 Civil procedure code				Expected		
7 Criminal code					Expected	
8 Criminal procedure code					Expected	
Trade-Related Intellectual Property Rights (TRIPS)						
1 Law on Trademarks and Acts of Unfair Competition	Adopted					
2 Law on Protection of Patent, Utility Models, and Industrial		Adopted				
3 Law on Copyrights and Related Rights			Adopted			
4 Law on Geographical Indications Including Appellation of Origin				Expected		
5 Laws on Layout Designs of Integrated Circuit					Expected	
6 Law on Plant Variety Protection					Expected	
7 Law on Protection of Undisclosed Information					Expected	
Technical barriers to trade (TBT), and Sanitary and Phytosanitary (SPS) Measures						
1 Sub-Decree on Inquiry Points for (1) Services, (2) SPS, and (3)		Adopted				
2 Sub-Decree on Animal Quarantine			Adopted			
3 Sub-Decree on Plant Quarantine			Adopted			
Custom Valuation						
1 Custom Code				Expected		
2 Law on Rule of Origin				Expected		
3 Law on Anti-Dumping Measures and on Countervailing Measures					Expected	
Trade-Related Investment Measures (TRIM)						
1 Amendment of Law on Investment			Adopted			
2 Law on Export Processing Zones				Expected		
Financial Intermediation						
1 Negotiable and Payment Transaction Law				Expected		
2 Accounting Law		Adopted				
3 Insolvency Law				Expected		
4 Secured Transaction Law				Expected		
5 Securities and Exchange Law						Expected
6 Commercial Leasing Law					Expected	
Other areas						
1 Postal Service Law		Adopted				
2 Water Supply Law				Expected		
3 Water Resources Management Law				Expected		
4 Telecommunication Law				Expected		
5 Tourism and Entertainment Law				Expected		
6 Civil Aviation Law				Expected		
7 Merchant Shipping Law					Expected	
8 Land Traffic Law (Highway Code)				Expected		
9 Fisheries Law				Expected		
10 Forestry Law		Adopted		Expected		
11 Land Law	Adopted					
12 Royal Decree on Cooperatives	Adopted					
13 Commercial Contracts Law				Expected		
14 Commercial Agency Law					Expected	
15 Competition Law						Expected
16 Law on Safeguard Measures					Expected	
17 Law on Business Enterprises				Expected		

Sources: World Trade Organization; and Cambodian authorities.

Note: ICSID=International Center for Settlement of Investment Disputes.

1As of February 2004. Due to the delay of formation of the National Assembly after the national election in 2003, the expected dates of enactment are now delayed by about a year.

important for attracting foreign investment, especially in countries like Cambodia where governance is a serious problem, as they will help provide a predictable and transparent investment environment.

The Ministry of Commerce and Negotiation Team for WTO Accession of Cambodia compiled work programs for WTO accession. They identified 101 working programs and assigned them to each relevant ministry with a specific deadline. However, progress has been slow due to a lack of local technical capacity and a lack of coordination among ministries.

B. Key Reform Areas

The reforms are expected to strengthen five aspects of private sector activity. They will (1) provide a transparent legal basis for commercial activities and simplify dispute resolution, (2) ensure that property rights are upheld, (3) protect consumers from unsafe products, (4) facilitate a smooth functioning of external trade, and (5) promote financial intermediation.

- To strengthen the judicial system relating to commercial activities, the authorities have committed to (1) ratify a law in establishing commercial courts, (2) adopt a Civil Code and Civil Procedures Code, (3) introduce a new Criminal Code and a new Criminal Procedures Code, and (4) enact a Law on Commercial Arbitration. Commercial courts are aimed at improving the procedures for settling commercial disputes, which are currently settled on a voluntary basis under the auspices of the Chamber of Commerce. The new Civil Code will establish the ground rules for individuals and businesses that are important for the creation of stable and predictable legal environment. The adoption of the Civil and Criminal Procedures Codes will enable enforcement of contracts, and thereby help strengthen the rule of law. The law on commercial arbitration provides the enforcement mechanism of the United Nations New York Convention that was ratified by Cambodia in 2001. Together with the ratification of the ICSID Convention in 2001, the introduction of the law on commercial arbitration will help businesses reduce costs and the risks of unfair treatment in commercial disputes.

- To protect intellectual property rights, the Cambodian authorities have already adopted, and are drafting a series of laws in line with, the Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement. The areas covered are copyright, trademarks, geographical indications, industrial designs, patents, and layout designs of integrated circuits. The parliament adopted the Law on Trademarks and Acts of Unfair Competition in 2001; the Law on Protection of Patent, Utility Models, and Industrial Designs in 2002; and the Law on Copyright and Related Rights in early 2003. The Law on Geographical Indications and the Law

on Layout Designs of Integrated Circuits are expected to be adopted in 2005. Cambodia agreed to comply with TRIPS no later than the beginning of 2007. Some nongovernmental organizations have raised concern that the ongoing reform in this area may contradict the agreement reached in Doha where the least-developed member countries were excluded from the obligation to implement the section on patents under TRIPS before 2016, particularly in the area of patents for pharmaceutical products.

- To ensure the safety of manufactured and agricultural products, the authorities have committed to fully implement the Technical Barriers to Trade (TBT) Agreement starting on January 1, 2007, and the Sanitary and Phytosanitary (SPS) Agreement starting on January 1, 2008. This requires that the authorities develop technical regulations and conformity assessment procedures as well as train staff for their implementation. "Inquiry Points" need to be established to notify the WTO of new technical regulations and publish them in accordance with the TBT and SPS Agreements. To serve as Cambodia's TBT Inquiry Point, the Department of Industrial Standards of Cambodia was established in the Ministry of Industry, Mines, and Energy by a sub-decree in June 2002. The National Codex Committee at the Ministry of Commerce will serve as Cambodia's SPS Inquiry Point.

- To facilitate external trade and to ensure conformity with WTO requirements, the draft Law on Customs was adopted by the Council of Ministers in December 2002, and is expected to be approved by the parliament in 2005. Cambodia's current customs valuation system is considered not to be in compliance with the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade of 1994 ("Customs Valuation Agreement"). Duplication of work by customs agencies, red tape, delays in processing documents, and overvaluations or inconsistent valuation were all concerns raised by the WTO Working Party. Accordingly, the Law on Customs (1) specifies the customs valuation mechanism, (2) provides a clear statement of importers' obligations and responsibilities, (3) reduces the scope for discretion when granting exemptions, (4) authorizes the minister to establish procedures and requirements through regulation, (5) spells out clearly the powers and obligations of customs officers, (6) provides a transparent and clear set of penalties, (7) facilitates the use of electronic commerce, and (8) clearly specifies customs tariffs.

- Provisions for the Customs Valuation Agreement relating to transparency, confidentiality, right of appeal, sureties for the release of merchandise, and the accompanying interpretation notes were to have been implemented at the time of Cambodia's accession to the WTO. However, the phasing-out of "minimum customs values" and the use of

the valuation mechanism may be somewhat delayed. The present use of minimum customs values will be replaced by "transaction values." The authorities were concerned that the move to transaction values could potentially reduce government revenue, and thus requested a transition period until January 1, 2009, when Cambodia will fully implement the Customs Valuation Agreement.

- The Amended Law on Investment was enacted in February 2003, and a sub-decree to this law is being prepared with the assistance of the World Bank's Foreign Investment Advisory Service. Although the amended law improves transparency by clearly defining procedures for granting tax exemptions, the scope of exemptions was expanded. A sub-decree to establish an industrial zone in Koh Kong was issued in February 2002, and a draft law on an Export Processing Zone is expected to be approved by the National Assembly in 2005. The authorities have committed to ensuring that the measures taken under these laws will be consistent with the Agreement on Trade-Related Investment Measures (TRIM).[60]

- To comply with the principles and provisions of the General Agreement on Trade in Services, Cambodia's authorities have prepared or are preparing several laws to promote financial intermediation. The Accounting Law, aimed at improving financial reporting, including reporting of profits for tax purposes, was enacted in 2002. With technical assistance from the IMF, the authorities have prepared the draft Negotiable Instruments and Payments Transactions Law to reduce payment system risk by eliminating legal uncertainties and to provide a firm foundation for a modern payment system. The law is expected to be enacted in 2005. The absence of a legal basis for secured transactions makes it difficult for banks to provide collateral-based lending. The authorities are also preparing a draft Secured Transaction Law to be enacted by the National Assembly in 2005. It will establish a bare-bones framework authorizing a property owner to use his or her business property as security for a business loan. To ensure orderly and effective insolvency procedures, the authorities are preparing an insolvency law, which is also expected to be approved by the National Assembly in 2005.

[60]The WTO Agreement on TRIM precludes measures that could restrict and distort trade. Reflecting the low-income status of Cambodia, however, the illustrative list contained in its membership agreement includes provisions for requiring enterprises to use a certain amount of locally produced inputs (local content requirements) and to limit the volume or value of imports they can purchase or use relative to their exports (trade balancing requirements).

C. Conclusion

It is expected that WTO accession and the associated legal reforms will contribute to establishing a favorable business environment in Cambodia. However, legal reforms by themselves are not sufficient. Enforcement of these laws and training sufficient legal staff in both the private and government sectors are needed.

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